Board 3.0 -- An Introduction

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ABSTRACT

This paper sketches out the case for a new board model, Board 3.0, as an option for public company boards. The goal is to develop a model of *thickly informed, well-resourced, and highly motivated* directors who could credibly monitor managerial strategy and operational skill in cases where this would be particularly valuable. Unlike the present board model of *thinly informed, under-resourced, and boundedly motivated* directors, Board 3.0 directors could credibly defend management against shareholder activist incursions, where appropriate, with institutional investor owners. Similarly, such directors could find a place in extremely complex enterprise, such as finance, where the costs of business failure are profound. One inspiration for Board 3.0 is found in private equity, in which the high-powered incentives of the Private Equity sponsor have produced a different mode of board and director engagement that seems associated with high value creation. Porting over some of its features to the public company board offers a fresh starting point. The present public board model is an organizational experiment begun approximately 40 years ago, which replaced a prior organizational form that had fallen short. There is no reason to think the present public company board model is the "end of history" for corporate governance. The world of private markets, venture capital and private equity, have made effective use of alternative board models. Our goal is to bring some of that governance experimentalism to public companies. A more credible Board 3.0 model may solve some of the serious information symmetries faced by some public companies: Full disclosure of strategic plans may deprive companies of first mover advantages in competitive markets and, more generally, may put public companies at competitive disadvantage to private companies. Yet markets cannot give value to plans that are not yet revealed, which makes the firm vulnerable to activist shareholder pressure and may push firms to second best strategies. Board 3.0 can solve this problem by generating credibility with the institutional investors called upon to resolve activist challenges. Expanding public company board models with Board 3.0 may avoid the need for corner solutions, such as dual class common structures or take-private transactions. A new public company board option will strengthen the capacity of public markets to facilitate capital formation and will thus aid financial inclusion by sustaining the number of public companies.

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** Richard Paul Richman Professor of Law, Columbia Law School; and ECGI. Given the restrictions associated with the symposium in which our essay appears, we are light on the footnotes that would point to the extensive literature on the corporate governance topics that we touch on here. We appreciate comments received from colleagues at a Columbia Law School Blue Sky Lunch; a presentation to the Advisory Board of the Millstein Center for Global Governance and Corporate Ownership;a Boards Pre-conference at Columbia Law School in 2016, the 2015 Pileggi Lecture, and Jack Coffee, Victor Goldberg, Zohar Goshen, and Leo Strine. We particularly appreciate the time and candor of the private equity parties we interviewed.

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I. INTRODUCTION

This essay sketches out the case for a new model for public company boards: Board 3.0. The now-dominant public board model is an organizational experiment begun approximately 40 years ago, which replaced a prior organizational form that had fallen short. The current model, the "monitoring board," is dominated by part-time independent directors who are dependent on company management for information and are otherwise heavily influenced by stock market prices as the measure of managerial performance. We have seen a recurrent pattern of monitoring boards composed of talented people that fail to effectively monitor. Nevertheless, when companies fall short in business acumen or legal obligation, we have also seen a recurrent response: place even greater demands on the very boards whose structural inadequacies gave rise to the monitoring failures, most systematically, the Millennium accounting scandals that gave rise to Sarbanes-Oxley and the 2008 Financial Crisis that gave rise to Dodd-Frank.

The problem we see is the failure of the monitoring board model to keep up with changes in the business of the corporations that board structure was supposed to monitor. It simply does not scale.

Consider J.P Morgan & Co. in 1976, the publication year of Mel Eisenberg's iconic book that framed the monitoring board model,[1] and then compare it to JPMorgan Chase today. The company's size, the complexity of the markets in which it functions including the explosion of derivative products and markets, the compliance demands on the company to assure its own business success and satisfaction of its legal obligations, and the skills necessary to understand today's international capital and product markets all have grown exponentially since 1976. Figure 1 illustrates that surge, using the rise in its net revenue, number of employees and number of countries in which JPMorgan Chase operated from 1976 to 2017 as a rough proxy for the growth in the magnitude, complexity and extent of regulation of the business that its board was charged to oversee.[2]

[1] Melvin A. Eisenberg, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS (1976).

[2] During the 1976 to 2017 period, the growth was assisted by significant acquisitions: J.P. Morgan & Co. and Chase Manhattan merged in 2000 (prior to the J.P. Morgan-Chase merger, Chemical Bank had merged with Manufacturers Hanover in 1991 and Chase Manhattan with Chemical Bank in 1996), acquired Bank One (and JPMorgan's current CEO, Jamie Dimon) in 2004, and Bear Stearns and Washington Mutual in 2008 as part of the Financial Crisis cleanup of failed financial industry participants.

Figure 1

JPMorgan Chase: 1976 to 2017

	1976	2017	% increase
Net Revenue	$1.8 billion	$99.6 billion	5,533%
Number of Employees	9662	252,539	2,614%
Number of Countries	16	60	375%

Source: Form 14A and Form 10K filings of JPMC and its predecessors

Over the period, JPMC's board transformed itself in response to pressure to adopt the monitoring board model. Board composition shifted from a quite large advisory board (24 directors in 1975) to a monitoring board of 11 or 12 directors by 2002. Received wisdom had become that a small board monitors best.[4] Except for a short-term bulge to handle the "social issues" involved in a large merger,[5] board size then remained roughly steady at JMPC. By the end of the period, all directors except for the CEO were "independent." Although JPMC outperformed many banks during the financial crisis, it was hardly immune from unnerving risk management oversight failures, as compellingly illustrated by the so-called "London Whale" episode, in which the bank suffered massive losses, $6.2 billion, on what was purportedly risk-reducing portfolio hedging.[6] There is no easy way to scale the current board model to meet the new business reality. The number of board members cannot be increased without reducing the board's ability to function. Adding committees may (finitely) leverage directors' time and technical expertise but also creates silos within the board. One path, expectations of deeper engagement that require much more time, will necessarily lead to much higher director compensation, which has been regarded as in tension with independence, given the traditional role management has played in director selection.

The particular business problem that urgently calls out for a new board model is created by the interaction of two developments: the dramatic shift towards majoritarian institutional ownership of most large public companies and the rise of a new form of financial intermediary, the activist hedge fund. The consequence is that, to an unprecedented extent, even the largest public companies (and their management teams) are subject to credible proxy contests by shareholder activists objecting to management's strategic vision or operational competence.[7] On the present board model, well-meaning

[4] See David Yermack, *Higher Market Valuation of Companies with a Small Board of Directors*, 40 J. FIN. ECON. 185 (1996).
[5] The Bank One/JPMC merger referred to in note 2.
[6] See Arwin G. Zeissler, Daisuke Ikeda, and Andrew Metrick, *JPMorgan Chase London Whale: Risky Business* (Yale Prog. On Fin. Stability case 2014-2A-V1 (March 11, 2015), available at https://ssrn.com/abstract=2577827.
[7] We trace these developments in Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Re-valuation of Governance Rights*, 113 COLUM. L. REV. 863 (2013).

directors are nonetheless *thinly informed, under-resourced, and boundedly motivated.* Such directors are poorly situated to defend management against what is at least a credible business counter-vision. The consequence is that institutional investors may themselves resolve through their votes strategic disputes between the activist and company management rather than defer to the board's assessment of the company's existing strategy. Commonly, such disputes are framed in the incumbents' inability to advance the stock price relative to peers and over time. Managements object that stock prices are flawed measures of value creation, especially for strategies that cannot be fully revealed for competitive reasons or are otherwise undervalued, at the least in the short run, by the market's valuation metrics. The consequence of activist pressure, say the friends of management, is value destruction through the sacrifice of long-term value creation that cannot be valued by the market at the time an investment must be made.

The task that confronts public corporations is to effectively respond to the dramatic changes since the emergence of the monitoring board and so better equip the board to function in a radically different business environment, including the greater scrutiny associated with the reconcentration of share ownership. Our goal is to frame a board model composed of a workable number of *thickly informed, well-resourced, and highly motivated* directors who could credibly monitor managerial strategy and operational skill in cases where this would be particularly valuable. Unlike the present board model, Board 3.0 directors could, where appropriate, credibly defend management to institutional owners in the face of shareholder activist challenges, or credibly insist that management take seriously activist proposals that the board thinks warrant due consideration. Similarly, such informed, resourced and motivated directors could find a place in extremely complex enterprises, such as finance, where the costs of business failure are profound both to the shareholders and to the economy more broadly.

To be sure, the Symposium in which this article appears allows us only broadly to sketch the premises that underlie Board 3.0 and how it might be implemented. But our account does allow us to initiate discussion of what problems a new model needs to address, and how a new structure might do so. If nothing else, we can establish that the successor to the current board model will reflect at least as significant a change as did the current model in relation to its predecessor.

One inspiration for Board 3.0 is found in private equity, in which the high-powered incentives of the Private Equity sponsor have produced a different mode of board and director engagement that seems associated with high value creation. Porting over in part, and adapting in part, some of private equity board governance features to the public company, offers a fresh starting point. There are plainly observable reasons to think the present public company board model is hardly the "end of history" for corporate governance; it is hardly a large step to recognize that governance has to evolve to match the radical changes in the markets in which public corporations operate. The world of private markets, venture capital, and private equity, all post-1976 developments, have made effective use of alternative board models. Our goal is to bring some of that governance experimentalism to public companies.

Importantly, a more credible Board 3.0 model may solve some of the serious information asymmetries faced by some public companies: Full disclosure of strategic plans may deprive companies of first-mover advantages in competitive markets and, more generally, may put public companies at competitive disadvantage to private companies. Yet markets cannot give value to plans that are not yet revealed, which makes the firm vulnerable to activist shareholder pressure and may

push firms to second-best strategies. Board 3.0 can address this problem by generating credibility with the institutional investors, so that the board can strike a workable balance between the claims that capital markets may in some circumstances be myopic and that in others managers may be hyperopic, convinced that their own strategy will succeed if only they and it are given ever more time. This tension is baked into the publicly held corporation. Board 3.0 can also avoid the need for corner solutions, such as dual class common structures or take-private transactions, which focus on only one of the two directions in which impaired vision can cause poor strategic choices.

II. THE RISE OF BOARD 2.0

The current board model for public companies has its genesis in academic theorizing in the 1970s that subsequently found acceptance among the elite corporate bar and the Delaware courts. This model, "Board 2.0," conceived of the board as principally "monitoring" the performance of managers in corporations characterized by diffuse shareholder ownership, which separated ownership from control. Such an ownership pattern would induce "rational apathy" on the part of shareholders when it came to monitoring managerial performance and behavior. Thus, monitoring boards, acting for shareholders, were the necessary complement to widely-distributed ownership. In this Board 2.0 model, boards were to be populated by "independent" directors, not economically beholden to the corporation and therefore not under the economic thumb of the CEO.[8] At a minimum such independent directors would constitute a majority of the board; ideally, all directors other than the CEO would be independent.

The monitoring board's predecessor, Board 1.0, was an "advisory" board model, in which the directors were part of the CEO's team: other corporate officers ("insiders"), trusted confidants of the CEO personally, and "affiliated" directors, commonly linked to the Company's outside law firm, its bank, or its investment bank.[9] Board 1.0 was the traditional model of the public company board; it certainly was dominant in the 1950s and 1960s.

The model came under attack for its inability to constrain managerial malfeasance in three particular respects. First, the bankruptcy of Penn Central, a bona fide blue chip until it collapsed, showed that the Board 1.0 model could produce a board that was simply unaware of the business challenges at the firm. Contemporary assessments of directors' attention to a company's affairs were withering.[10] Second, the spread of the conglomerate merger, which produced unwieldly businesses that were beyond the managers' capacity adequately to manage showed that directors were unable to constrain managerial appetites for bigger empires.[11] Directors seemed unaware that in many cases the

[8] Understandably, the Delaware courts' analysis of independence has not taken into account deep social relationships between independent directors and management. While the judicial analysis simply denies the impact of rich social networks, the outcome is not necessarily wrong. Unlike economic relationships, social ties and their strength, while perhaps observable, may be very difficult to verify even to sophisticated courts. A recent case, *Sandys v. Pincus*, 152 A.2d 124 (2016), illustrates the unusual circumstances (co-ownership of an airplane) that would make such social relationships verifiable.

[9] This evolution is traced in Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007).

[10] E.g., Myles L. Mace, DIRECTORS: MYTH AND REALITY (1971).

[11] The current travails of General Electric, widely seen in the past as the best managed conglomerate, illustrates the problem. Thomas Gryta & Ted Mann, *GE Powered the American Century—Then It Burned Out*, WALL ST.

"economic logic" consisted principally in the manufacture of "earnings" through the manipulation of accounting conventions.[12] Third, the so-called "questionable payments" scandal of the 1970s, in which many firms were found (or preemptively confessed) to illegal campaign contributions in the U.S. and bribes paid abroad, showed that Board 1.0 directors could not be counted upon to constrain or even know about management's frank illegal behavior—that was not their job.[13]

The failings of the Board 1.0 model helped shape the Board 2.0 alternative, the monitoring board composed of independent directors. Over the period of the 1970s–2000s, this monitoring model was strengthened in three dimensions: First, expectations shifted from a board with a simple majority of independent directors to one composed almost exclusively of independents except for the CEO. Second, the tests of economic "independence" became increasingly rigorous, focusing particularly on the absence of any other economic relationship with the firm. And third, boards came to (or were required to) employ a robust committee structure that would facilitate focused attention to specific board monitoring tasks. By the end of the period most large public companies had an audit committee, a compensation committee, and some version of a nominating-governance committee that addressed the performance of the board itself.

The driving forces in this evolution were several. First, CEOs came to see the legal advantage of independent directors in helping to fend off unsolicited takeover bids, since the Delaware courts were more likely to validate "just say no" defensive measures if approved by an independent board. Similarly, the courts came to permit "special committees" composed of independent directors to take control of and dismiss shareholder derivative litigation. CEOs thus embraced the presence of independent directors, who could hold off two of management's most feared predators: hostile bidders and plaintiffs' lawyers.

Second, institutional investors—whose ownership stakes steadily grew over the period—strongly lobbied for staunchly independent boards as better protecting their interests. If they would lose the performance pressure of the control market, the institutions wanted directors who would promote shareholder interests in the boardroom.

Third, regulatory and compliance demands grew over the period, which led to the committee structure and strengthened independence standards. In particular, the fallout from the Millennium accounting scandals, exemplified by Enron and WorldCom, led to mandatory independence criteria imposed by the Sarbanes-Oxley Act and subsequent stock exchange listing requirements.

In the wake of these developments, Board 2.0 came to have a strategy for compliance: set up an audit committee that will review the work of outside auditors and to whom the internal audit function would report. If other compliance failures become manifest, set up a special committee that will review an investigation conducted by outside lawyers. This strategy of reliance on outside experts has been

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J. (Dec. 14, 2018), https://www.wsj.com/articles/ge-powered-the-american-centurythen-it-burned-out-11544796010 (tracking the company's history from its previous highs to its current difficulties).

[12] *See, e.g.*, Peter Steiner, MERGERS: MOTIVES, EFFECTS, POLICIES 103–19 (1975) (showing how mergers that show earnings created through "pooling" accounting could enhance a company's apparent growth rate and thus purportedly increase the stock price); Patrick Hopkins, Richard Houston & Michael Peters, *Purchase, Polling and Equity Analysts' Valuation Judgments*, 75 ACCT. REV. 257 (2000) (application of purchase-pooling conventions can distort analysts' assessments).

[13] This understanding of the limited directors' role underpinned *Graham v. Allis-Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963), which held that directors had no duty to undertake compliance monitoring.

carried over, with less success, to executive compensation: set up a compensation committee that will "review" the work of outside compensation consultants.

When it came to oversight of the company's strategy and operational performance, however, Board 2.0 was left somewhat at sea. Typically, the board meets bi-monthly; management plays a dominant role in shaping the board's agenda and selecting/assembling the information for board review. The board has no easy way to generate "deep dive" board meeting presentations into the firm's business and strategy that might inform a critical perspective on the management account; the board is "under-resourced" for this purpose. In light of the time-constraints of the decidedly part-time directorship model and the lack of an alternative information channel, Board 2.0 directors are "thinly informed." Indeed, the main source of their non-management information flow about the company is the stock price, which is informed by the diligent information gathering and digesting by securities analysts and other market participants. Thus the firm's stock price performance, year-to-year and in comparison to peers, has become the key metric for Board 2.0 directors, not only because it corresponds to some idea of shareholder welfare but because it provides a thinly-informed director the most reliable measure of management's success. Finally, as monitoring obligations via regulation expanded, less time was left for the board to become deeply knowledgeable about the company's business. Board time is finite and new responsibilities consumed time that previously had been available for non-regulatory efforts.[14]

The tie between Board 2.0 and reliance on the stock price bears emphasis. One limitation of the Board 2.0 model is that the stock price is the only measure of performance that 2.0 directors can have confidence in. That is, such directors *know* that there is much they do not know, and know further that management is in control of the information flow to the board. Directors also know that others, including analysts, may well know more/have thought more, about the firm's economic performance/prospects. In the absence of deep, unfiltered knowledge about the firm, why *shouldn't* such directors evaluate management on the stock price performance? The point of Board 3.0 is to imagine a director model in which directors could credibly *to themselves* and to majoritarian owners assert that the stock price is missing a critical element of expected future realizations.

Another limiting element of the Board 2.0 model is the way that directors are "boundedly motivated." Although "best practice" is to deliver a significant fraction of director compensation in the form of stock-based pay, commonly 50 percent, and to require directors to accumulate an ownership stake during their period of board service, the absolute level of director compensation is not high, nor does it markedly change in response to the director's performance.[15] Yes, a director's ownership stake will increase in value with the stock price, but even stellar performance as a director will not lead to additional compensation for the next period. Moreover, the typical director of a large public company is near the end of a distinguished career at another firm, or retired. This pattern predicts risk aversion; the downside of reputational embarrassment for the director generally exceeds the potential financial

[14] This was illustrated at a board retreat one of us attended. The company's general counsel circulated a year's board meeting agendas with the portion of each day spent addressing regulatory oversight blocked out. The limited time left for strategy discussion was visually apparent.

[15] See John Armour, Jeffrey Gordon, & Geeyoung Min, *Short-Changing Compliance* (ECGI Working Paper, Sept. 2018), https://ssrn.com/abstract=3244167.

gains. This may produce better incentives for compliance oversight but it limits the director's motivation to support business risk-taking, including resisting an activist's challenge when it might be best to do so. Moreover, the part-time nature of the commitment is a feature, not a bug, for such a director: either he/she has another, full-time job, or, if retired, is in primary pursuit of leisure.

The Board 2.0 model has not remained static since its inception. Board autonomy has generally strengthened over the period, in part because of structural features such as a "lead director" for the common case in which the CEO also wishes to remain as board chair; providing a leadership role for one independent director has become the price of the double title for the CEO. Similarly, we have seen the increasing role of the "nom-gov" committee in evaluating director candidates alongside the CEO's input. Directors have become more confident in their monitoring prerogatives and third parties, like outside auditors, have become more attuned to their role in identifying corporate fraud. Perhaps the model is "Board 2.1." Nevertheless, the fundamental dynamic persists: the board typically will be reactive rather than pro-active; directors are information- and time-constrained and have bounded motivation in the intensity of their engagement and the risk-taking they will support.

Changing capital market conditions have altered the governance environment within which boards operate, putting pressure on the standard Board 2.0 model. The re-concentration of share ownership into the hands of institutional investors has potentiated the rise of a new intermediary: the activist hedge fund.[16] Commonly focusing on companies whose stock price has under-performed, the activists come forward with criticisms of the company's strategy and/or management's operational skill. This challenge, framed in governance terms as a proxy contest for board representation, is typically accompanied by an elaborate external critique and proposals for change and may include selling the company at a time management thinks unwise. An activist's credibility will be supported by a substantial investment in the target company and an observable track record of prior shareholder engagements.

The limitations of the Board 2.0 model mean that directors may be less well-informed about the company than the activist and so the directors' belief about current and future strategy will have less influence with the institutions that are the company's majoritarian owners. The concern is that at least in some cases the stock prices will not be indicative of the company's performance and prospects because there are legitimate business reasons for withholding information that would otherwise be impounded in the stock price. Some business strategies or product innovations depend on lengthening the period of first-mover advantage; premature disclosure would reduce shareholder value. Or the market price may reflect uncertainty about management's capacity to execute a complicated strategy. Board 2.0 directors cannot credibly offer assurances—"trust us, we have deeply reflected upon the company's strategy in the context of its competitive environment, capability, and resources"—that would persuade institutions to reject for the time being the activists' contentions.

Activism battles often are cast as the struggle by management to pursue long-term strategies in the face of pressure to maximize in the short-term. This framing misses the governance shortfall in Board 2.0. Just because management says its long-term strategies are first best but just not (yet) appreciated by the market doesn't make it so: the market may be myopic but management may be hyperopic. Directors under the current board model are generally not in position to evaluate and

[16] For elaboration, see Gilson & Gordon, *supra* note 6.

validate strategies that the market does not already understand, and the relevant parties, including the majoritarian institutional owners, understand this.

III. THE PE "PORTCO" BOARD MODEL—ON THE WAY TO BOARD 3.0

What form would an alternative director model take that could deliver credible support to management in the face of a serious challenge by activists? Or, to flip the point, that would drive additional performance whether or not the activists have arrived? Or provide higher quality monitoring in an environment of increasing business complexity? Based on the private equity governance literature and interviews at some significant PE firms, we sketch out a board model that is commonly used in the governance of private companies held in the PE portfolio, "portfolio companies" or "portcos."[17] The exact mix of techniques varies across PE firms and even within a particular firm but includes a common core: a small board (rarely more than six) that includes one or two "deal" people (who identified and shaped the economic logic of the acquisition), one or two "operators" from the PE firm, who focus on the details of the portco management's formulation and execution of strategy, one "outside" director who has industry-specific expertise, perhaps from a stint as a senior executive in a public company, and the portco CEO. The PE firm-designees to the portco board are mid-career; they have a large financial and career stake in the portco's success. The operator will engage with the CEO on a frequent basis, as well with as those who report to the CEO. The board meets frequently, sometimes weekly, depending on the business situation, and the agenda is set by the operator in light of what seems the most important business questions. The operator marshals the portco-specific information that is relevant to the board's discussion. Most important, the portco board has the capacity to fire the CEO and alter the strategy.

One board member will be, in effect, the lead director, who will drive the PE firm's engagement with the portco. This person will have substantial personal financial gain/loss on the line, not only from portco-specific payoffs in an IPO or private exit but also in terms of his/her career within the PE firm. This "empowered lead director" can marshal the full analytic capacity of the PE firm to assess the strategic and operational questions facing the portco. Analysts from the PE firm will be able to access portco-specific information in their work. The annual time commitment that the PE senior staff and analysts will devote to monitoring the portco's performance is in the thousands of hours.

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[17] The relevant literature includes: Viral Acharya, Oliver Gottschlag, Moritz Hahn & Conor Kehoe, *Corporate Governance and Value Creation: Evidence from Private Equity*, 26 REV. FIN. STUD. 368 (2013); Viral Acharya, Conor Kehoe & Michael Reyner, *Private Equity vs. PLC Boards in the U.K.: A Comparison of Practices and Effectiveness*, 21 J. APPLIED CORP. FIN. 45 (2009); Andreas Beroutous, Andrew Freeman & Conor F. Kehoe, *What Public Companies Can Learn from Private Equity*, MCKINSEY ON FIN. (Winter 2007); Ugur Clikyurt, Private Equity Professionals on Public Firm Boards (March 2015) (unpublished manuscript available at https://ssrn.com/abstract=2586466); Francesca Cornelli & Oguzhan Karakas, Corporate Governance of LBOs: The Role of Boards (May 2012) (unpublished manuscript available at https://ssrn.com/abstract=1875649); Paul Gompers, Steven N. Kaplan &Vladimir Mukharlyamov, *What Do Private Equity Firms Say They Do*? 121 J. FIN. ECON. 449 (2016); Ronald W. Masulis & Randall S. Thomas, *Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance*, 76 U. CHI. L. REV. 219 (2009); Ranko Jelic, Dan Zhou, & Mike Wright, *Sustaining the Buyout Governance Model: Inside the Secondary Management Buyout Boards*, 30 BRIT. J. MANAGEMENT 30 (2019).

The core elements of this board model result in directors who are *thickly informed, well-resourced,* and *highly motivated*.

The value of this governance model seems established by the overall success of PE's most experienced and systematic practitioners. Early in the history of PE, a large fraction of the gains came from "financial" strategies. Michael Jensen famously identified the capturing of excess free cash flow through the fixed payments of interest and principal as a major source of leveraged buyout gains.[18] The threat of bankruptcy would limit management's ability to divert such cash to negative net present value projects. Another early "financial" story related to the use of LBOs as a mechanism to break up unwieldy conglomerates that produced negative synergies. Selling off the various subsidiaries to related-industry acquirers would fund the retirement of LBO debt, leaving a surplus for the LBO sponsors. Another part of the "financial" story has been the tax advantage of debt: interest payments are tax deductible (and thus shield the portco's profits from tax) whereas dividend payments are not. Here the source of gains is a transfer from the public fisc, not a reduction in private agency costs.

Over time, the "financial" advantages have dwindled. The LBO movement generated corporate governance externalities: In the effort to avoid becoming the target of a financial buyer, managements avoided accumulating excess free cash, often sold or spun off unrelated parts of the business, and avoided making unrelated acquisitions. Put differently, a potential PE target could duplicate the financial-motivated PE buyer's strategy itself. Yet the role of private equity nevertheless expanded; there has been a steady growth in assets-under-management by PE firms and a steady stream of both take-private transactions and "stay private" (with PE-financing) decisions. Importantly, however, there remains a significant limitation on a potential PE target's ability to imitate the PE's strategy: it cannot adopt the PE's governance structure. There are many explanatory factors in PE's continued success at attracting capital, but one important element is the PE portco governance model, the way in which development and systemization of a corporate governance model can consistently deliver good returns.

The limitations of Board 2.0 for public companies have produced some alternative approaches. A significant number of technology companies have gone public with dual class common stock, on the contention that the current corporate governance framework with single class common is insufficiently protective of the company's ability to innovate and to pursue a founder's "idiosyncratic vision" that may not be appreciated by the market.[19] Alternatively, one reason management of a public company might favor a take-private transaction sponsored by a PE buyer is that private sale due diligence can fully value a strategy and that PE-style corporate governance can be supportive. Each of these alternative corner solutions has downsides. Dual class common makes ambitious assumptions about the persistence of a founder's unique insight and his/her long-term focus on the business; it also raises public policy concerns.[20] Take-private transactions reduce the set of investment opportunities available

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[18] Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.–Oct. 1989, at 61.

[19] See Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560 (2016).

[20] *See* Lucian A. Bebchuk & Kobi Kastiel, *The Uneasy Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 583 (2017); Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641 (2006); Jeffrey Gordon, *Dual Class Common Stock: An Issue of Public and Private Law*, COLUM. BLUE SKY BLOG (Jan. 2, 2018), http://clsbluesky.law.columbia.edu/2019/01/02/dual-class-common-stock-an-issue-of-public-and-private-law/;

to public investors. This unequal access to what might be especially attractive investments raises important public policy concerns as well.[21]

The goal of Board 3.0 is to bring over aspects of the PE portco corporate governance model to public company boards. This will further close the gap between the structural alternatives available to public versus private companies. Apart from firm-specific efficiency gains, expanding the range of public company governance options will strengthen the vibrancy of public capital markets in the competition with private markets and expand the set of investment opportunities for the ordinary investor without access to PE limited partnerships.

IV. How a Public Company Adopts and Implements Board 3.0

Board 3.0, on our conception, is a board that contains a mix of directors on the current Board 2.0 model and "empowered" directors ("3.0 directors") who would specifically be charged with monitoring the strategy and operational performance of the management team. The 2.0 directors would serve, as now, on compliance-focused committees, and otherwise take on the board's responsibilities, especially serving on "special committees" as necessary. The 3.0 directors would serve on an additional committee, the "Strategy Review Committee." Those directors would be supported by an internal "strategic analysis office" that would provide back-up support for a 3.0 director's engagement with the management team. If additional support was necessary, the 3.0 directors could engage outside consultants. The 3.0 directors would be paid principally through long-term stock-based compensation. The compensation expectations of PE operating or lead directors would be a useful comparator. Since a 3.0 director would be a mid-career professional, additional implicit compensation would come through establishing a reputation for fostering and enhancing value creation at the company. A 3.0 director should be term-limited at a particular company, to minimize the risk of capture and to bolster the role of reputation in enhancing director 3.0 credibility.[22]

For expositional purposes we have focused the Board 3.0 model mostly on its capacity to address information asymmetries between the firm and the public market because the myopia claim has figured so prominently in the debate to date. However, the model and, in particular, 3.0 directors may also be particularly valuable in addressing monitoring shortfalls for complex businesses, for example, JPMC, for which the typical 2.0 director is a poor fit.

Board 3.0 will be costly to implement. The costs include the compensation for the 3.0 directors and the staffing of the Strategic Analysis Office. Additional costs will come from the frictions that could well arise if the 3.0 directors came to question the company's current strategy or management's operational skill (though such costs could be more than offset by potential benefits from changes on either dimension). Thus Board 3.0 is meant to be optional for firms whose business plans and operational complexity justify its costs. The attraction of the structure thus plainly increases with the opacity or complexity of a public corporation's business and strategy.

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[21] *See* Jeffrey Gordon, *Is Corporate Governance a First Order Cause of the Current Malaise?*, 6 J. BRITISH ACAD, (Supp.) 405 (2018).

[22] Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L REV. 863 (1991) (addressing structural arrangements to enhance the credibility of this type of director).

How could a company implement Board 3.0? First, the CEO and the management team could propose the opt-in because the 3.0 directors will provide credibility with institutional investors at a time when the company is pursuing a strategy that management believes will be significantly undervalued by public markets – that is, the 3.0 board structure is a response to a belief in market myopia. The CEO's promotion of a Board 3.0 opt-in is a credible signal that the CEO is confident in the strategy and the operational skill of the management team, because the 3.0 director's access to information invites internal questioning and challenges. Second, the impetus for the opt-in could come from the board, specifically the lead director or the nominating-governance committee. The board itself might appreciate that the Board 2.0 model makes it difficult to pursue what the board believes to be the best strategy for the firm, in light of the potential for an activist challenge. Or the board may come to believe it is unable to adequately discharge its monitoring responsibilities given the nature of the firm's business.

Third, the opt-in could come in settlement of an activist challenge. Not all activists maintain the within-firm analytic capacity to engage in an on-going fashion with the strategy and business of an investee company. In general, the shareholder activist targets a firm based on public indicia of apparent under-performance[23] and recruits director candidates (not affiliated with the activist) who are expected to improve the quality of the board. A large fraction of contests settle with the addition of one or more activist candidates to the board.[24] An activist that wants a deeper corporate governance change could press the company to adopt Board 3.0.

One critical question remains: how does the Board 3.0 structure and 3.0 directors gain credibility with institutional investors, the majoritarian voters? Full disclosure, and then observation over time, should make the system self-certifying. The internal resources that support the board's Strategy Review Committee and the 3.0 directors (including appropriate authority as set forth in the charter of the Strategy Review Committee and the company's by-laws); the high-powered compensation for the 3.0 directors; the background and track record of the 3.0 directors—all will be disclosed. The large asset managers have made it clear that the major focus of their corporate governance scrutiny is the quality of the company's directors. They have no interest in reaching out for influence over discrete business questions. But they will be able to evaluate the bona fides of Board 3.0, including the availability of sufficient internal analytic resources, and the background of the 3.0 directors. They will also observe the performance of the firm over time, including the effectiveness of the Board 3.0 structure. One way to think of Board 3.0 from the institutions' perspective is, how long a "leash" does management get when stock market signals are negative? In some cases, Board 3.0 would lengthen the leash, but not indefinitely. And for particular firms, the Board 3.0 model, by offering an intermediate solution, may better navigate the risks of market myopia versus management hyperopia, than can the Board 2.0 model.

[23] See Shane Goodwin, *Management Practices in an Age of Engaged Investors* (U. Colo. Bus. Sch. Working Paper, Sept. 2017), https://ssrn.com/abstract=3045411.
[24] *See* LAZARD'S 2018 REVIEW OF SHAREHOLDER ACTIVISM 8, 10 (Jan. 2019).

V. ADOPTION OF BOARD 3.0 WITH PRIVATE EQUITY AS RELATIONAL INVESTOR

An alternative route that ports over the PE governance model to the public company is through enlisting the PE firm as a "relational investor." The Board 3.0 model presents certain implementation issues, relating in particular to the creation of an internal Strategic Analysis Office and the selection of 3.0 directors. A PE firm already has an analytic back office and a stable of prospective 3.0 directors. "Relational investing" was promoted in the early 1990s as a way to overcome the purported short-termism of hostile bidders while also limiting managerial agency costs, an earlier form of intermediate solution. The thought was that the growing ownership stakes of institutional investors would give rise to a new governance intermediary, the relational investor, in which institutions would come to see themselves as partners in the creation of long-term value; in short, as "owners."[25] The business model of the typical institutional investor did not, however, lend itself to the genuine engagement that was the hope of relational investing. Most institutions have come to pursue extensive diversification and fee minimization, which is inconsistent with the relational investing model.[26] A handful of contemporary firms are known as relational investors; ValueAct Capital is perhaps the most notable example.

PE firms offer a contemporary route for relational investing. They bring business savvy, a governance model, and a long-enough term focus. One could imagine a model in which a PE firm takes a large enough stake in a public company to give it credible skin in the game along with warrants for an upside, and then gets a special class of redeemable stock that give it the right to elect directors for a specified period. The redeemable stock gives both the company and the PE firm exit rights at the end of the period; the parties could continue, modify, or end the relationship. In interviews various PE managers have expressed some sympathy with this idea. A stronger version would specify that the redeemable stock would elect a majority of directors, which would give the PE firm stronger monitoring rights over the firm's strategy and managerial performance. This version of Board 3.0 would make a more complete version of PE corporate governance available to the public company. Motivated by the limits of Board 2.0, other techniques will surely evolve, shaped by the characteristics of particular firms and investors.

VI. BOARD 3.0 AS DISTINGUISHED FROM "BOARD SERVICE PROVIDERS"

Our conception of Board 3.0, and Bainbridge and Henderson's proposal to outsource the board via "Board Service Providers,"[27] share a common premise: the current 1970s conception of the monitoring board and its surrounding regulatory structure, however well-meaning and responsive to an earlier set of governance shortcomings, is no longer sufficient to meet 21st century governance challenges. As we have suggested earlier, addressing these limitations by giving the board more responsibilities in reaction to a failure to meet the ones they already have may be politically understandable, but it does not work.

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[25] *See, e.g.*, Jeffrey N. Gordon, Institutions as Relational Investors: *A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994).
[26] See Gilson & Gordon, *supra* note 6.
[27] Stephen M. Bainbridge & M. Todd Henderson, OUTSOURCING THE BOARD: HOW BOARD SERVICE PROVIDERS CAN IMPROVE CORPORATE GOVERNANCE (2018).

The two analyses differ, however, in important ways. We are sympathetic to the movement toward vertical disintegration in industrial organization and governance. Across a wide range of industries, supply chains have displaced vertical integration.[28] The range of expertise necessary for the development of new products is increasingly beyond the capacity of a single firm to manage. The phenomenon has also extended to managerial functions. This is most obvious in the mutual fund industry, where it has become commonplace for large portions of back and middle office operations to be outsourced to expert firms. The explosion in product complexity matched by an explosion in capital market complexity has made it impossible for all but the very largest asset managers to have the scale and, hence, the expertise necessary to fulfill these functions internally.[29]

But governance is different. We fear that outsourcing the board responds to one agency problem by replacing it with another, more complex one. In supply chain management, both contracting parties are commercially sophisticated and often will have co-developed the ultimate product of which the outsourced element will be a part. As the product matures and uncertainty diminishes, the supply contract becomes more explicit, detailing with precision what is to be made.[30] None of this creates agency problems within an entity on either side of a step in the supply chain.

In contrast, we do observe agency problems when public corporation monitoring is outsourced. The role of the outside auditor is the most obvious example and illustrates the problem. The literature recognizes that management selects the auditor, subject to the routine approval by the independent directors and shareholders. But the auditors present their own conflicts of interests. Recall that the Arthur Anderson debacle resulted in no small part because partners' compensation was affected by client revenues. Determination of proper accounting treatment by the firm's national office when the client and the firm disagreed was, unlike other auditing firms, only advisory; the final determination was made by the regional partner whose compensation, like that of the audit partner, depended on keeping the client. A similar tension is presented by the development of accounting firms' consulting practices, which typically generate higher revenue for the auditor from an audit client than does the audit fees. Again, the monitoring function is subject to agency problems within the entity to which it has been outsourced.

This phenomenon is hardly limited to the audit profession. Think about an economic consulting firm that does litigation support work. When an expert who is represented to the court to be independent also holds equity in the economic consulting firm who supports her, there is an obvious conflict. The best clients are large firms (the large law firms and corporate firms who choose the support firm and the expert) that can be anticipated to have future need for experts. Because the expert's ultimate opinion is crafted only after the expert's firm's retention, and because a client who is disappointed by how far

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[28] Ronald J. Gilson, Charles Sabel & Robert C. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431 (2009).

[29] The outsourcing for mutual funds in some cases extends to portfolio management, the funds' central function. In this setting, portfolio management is undertaken by an unrelated sub-advisor entity under contract with the overall advisor to the fund. *See* Joseph Chen, Harrison Hong, Wexi Jiang & Jeffrey D. Kubick, *Outsourcing Mutual Fund Mgmt*., 67 J. FIN. 523 (2013). In this setting, the mutual fund begins to look more like a platform than a traditional firm. *See* Andrew McAfee & Erik Brynjolfsson, MACHINE, PLATFORM, CROWd (2017).

[30] *See* Ronald J. Gilson, Charles Sabel, & Robert C. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice and Doctrine*, 110 COLUM. L. REV. 1377 (2010).

the expert will stretch may be less likely to retain the expert or his/her firm, an agency problem arises between the expert and the court, to whom the expert asserts her independence.

Our concern with these governance supply chain agency problems is that they appear to be applicable to the outsourcing of the board. If, as would be expected, the choice of the "board service provider," like the choice of the auditing firm, will be driven by management, and if the compensation of those who act as directors necessarily depend on the outsourcing firm's success, then the circumstances begin to resemble that of the auditors, only worse.

To be sure, there are scale and scope economies available from a higher quality board that has the resources to address difficult problems without having to rely on management. But a change in structure to capture these economies is not a new idea; Gilson and Kraakman argued 25 years ago that one could structure a board that was both of high quality and independent of management, by making directors dependent on shareholders to keep jobs designed to be attractive.[31] Board 3.0 captures the idea of improving the skills and experience of independent directors in the same fashion as we observe with the directors of private equity portfolio firms. Board 3.0 directors will have realistic power to develop inside analytic capacity and to retain outside experts where circumstances require it, but without the organizational agency problems embedded in Bainbridge and Henderson's outsourced board proposal. Thus Board 3.0 points the way toward a more talented and engaged board without adding another layer of agency conflicts.

VII. CONCLUSION

Perhaps the most important take-away is that the received board model, Board 2.0 (Board 2.1?)—the monitoring board staffed by part-time independent directors—is an organizational experiment, not a dictate inscribed on stone tablets. The pattern of public corporation ownership has changed radically over the course of 40 years, as has the scale and complexity of the businesses of such firms. Directors who are thinly informed, under-resourced, and boundedly-motivated are not a good complement with today's demands for high-powered governance. Board 3.0 provides a basis for discussion of an optional model for firms that need a governance structure to match the changed circumstances.

[31] Gilson & Kraakman, *supr*a note 22. We should note that over the period since the Gilson and Kraakman article appeared, institutional investors have continued to publicly favor higher quality board members. However, they also remain reluctant to get into the activity of selecting or actively influencing the choice of directors.