U. S. Securities and Exchange Commission
Washington, D.C. 20549 (202) 272-2650

News Release

Remarks to

The 1990 Corporate Governance Review
of the
National Association of Corporate Directors

Philip R. Lochner, Jr.
Commissioner*
U.S. Securities and Exchange Commission
Washington, D.C.

"Corporate Boards and Their Advisers"

Chicago, Illinois

October 22, 1990

*/ The views expressed herein are those of Commissioner Lochner and do not necessarily represent the views of the other Commissioners or the Commission staff.

Good morning, and thank you for that kind introduction.

There is much talk these days about corporate governance. The key to effective corporate governance, of course, is the corporate board --- one that effectively performs its critical role in selecting, rewarding and monitoring management.

As directors, you are personally familiar with the difficulty of performing these tasks, as well as the constant threat of liability that comes with a director's job. Consequently, I commend you for your courage in serving as corporate directors, though I note that a recent article in the Harvard Business Review has apparently questioned your sanity for agreeing to do so.

The critical role of boards in achieving good corporate governance has been widely recognized, and has led to substantial and positive changes in the boards of a significant percentage of large public corporations. For example, greater numbers of independent directors

have been added to boards, boards have made increasing use of their committees to enhance their ability to monitor corporate matters, and boards are typically meeting more frequently now than in the past.

In his study of the corporate boards of Fortune 1000 companies, Jay Lorsch noted the generally high caliber of individuals serving on boards. In particular, he found that boards are made up primarily of responsible and dedicated individuals of high personal and professional achievement who take their board duties seriously. He concluded that the right persons are winding up on corporate boards.

The directors of U.S. public corporations constitute a valuable resource for U.S. business. If some boards have failed, or are perceived to have failed, in performing their responsibilities, that failure, I believe, is more likely to have been caused by individual cases of poor board structure, or procedures, or personal failures than by any inherent flaws in our system of corporate governance.

The importance of effective boards was highlighted in the 1980's by experience with other, more intrusive, means of monitoring and changing corporate performance, such as tender offers. Tender offers, of course, involved substantial costs and disruption for corporations, suppliers, employees and the public. In addition, they have proven to be extremely blunt tools of corporate governance that are apt to be applied without --- as the bankruptcies of recent months have shown --- any guaranty of success. In comparison, of course, effective boards are a far more efficient and a far less costly means of monitoring and improving corporate performance.

Good board performance requires, among other things, that appearances conform to reality. Consequently, an important criterion in evaluating board procedures should be the extent to which they not only enhance the ability of a board to act independently, but also the extent to which they demonstrate that independence to the outside

world.

Today, I would like to focus on a particular aspect of the process of corporate governance that can provide substantial assistance to a board in achieving its goals, but also can cause considerable harm if a board does not act prudently: the board's use of outside advisers. Here, too, it is critical that reality and appearance coincide in order for use of outside advisers to be effective.

The outside advisers most frequently retained by corporations are accountants, attorneys, investment bankers, and --- less commonly --- compensation consultants. These outside advisers can enhance the ability of corporate boards to monitor management performance by providing critical assistance to board members with limited time or limited expertise to devote to a particular matter before the board.

A board's use of outside advisers provides directors with access to personnel who have the necessary time and expertise to provide

additional analysis of management's performance and recommendations. In a world with ever more complex issues and more and more highly specialized areas of knowledge, the increasing use of outside advisers is perhaps inevitable.

In recognition of the useful role that outside advisers can play in assisting boards in the exercise of their responsibilities, state corporation statutes typically permit directors to rely on information and reports provided by outside experts, and limit directors' liability when they so rely. For example, New York and Delaware laws provide that a director is fully protected in relying in good faith upon information, opinions, reports or statements presented to the corporation by an adviser. However, this protection applies only as to matters the director reasonably believes are within such adviser's professional or expert competence, and only if the adviser has been selected with reasonable care.

Some courts have moved beyond these statutes, which merely permit boards to rely on outside advisers, and have indicated that in some circumstances directors must obtain outside advice. Cases such as Trans Union and MacMillan have suggested that the failure to retain outside experts to advise the board concerning major corporate transactions may constitute a breach of the board's duty of due care.

It also should be recognized, however, that a board's use of outside advisers can have significant limitations.

First, as we all know, many outside advisers are incredibly expensive. Boards need to be assured that the cost of using outside advisers is more than offset by the value of the advice received.

Second, care must be taken that outside advisers do not infringe on the proper role of management in running a corporation's business. Management should, after all, be allowed the freedom of action necessary to give the corporation the full benefit of its expertise and

experience. Advisers are hired, in short, to advise.

Third, boards may improperly delegate to advisers the board's responsibility to make the final determination of what course of action is in the best interests of the corporation. Typically, such delegation, when it happens, is de facto, not de jure. Whichever it is, boards cannot abdicate their responsibilities in corporate affairs to their advisers. For example, some courts, such as in the Hanson Trust and Natomas Co. decisions, have held that boards can breach their duty of care by adopting the recommendations of outside experts without making a reasonable inquiry of their own into the matter on which the experts are opining.

These cases, combined with the others referred to earlier, point up the awkward role of a director today: boards have been held liable for failing to obtain outside advice, but they have also been held liable for failing to question or reject that advice.

With respect to when outside advisers should be retained, in the past some have suggested that experts should be retained on a permanent basis to advise boards. Companies have been urged to create a separate staff for the board, in order to assist the board in carrying out its obligation to monitor management. This suggestion generally has been rejected, I think appropriately, as not passing a cost/benefit analysis for most companies. In addition, it seems possible that a board with a permanent staff could end up being the captive of its staff, rather than the staff enhancing the board's ability to exercise its own independent judgment.

The goal, therefore, should be for boards to have outside advisers in those particular circumstances in which they can provide substantial assistance, and yet not unduly intrude on the proper role of management or cause undue expense for the corporation.

Two factors appear to be most important in identifying the

circumstances in which outside advisers can help boards achieve their goals:

(1) the overall importance of the matter at hand to the long-term interests of the corporation and its shareholders and other interested publics, such as employees, customers and suppliers; and

(2) the extent to which management's interests in the matter sufficiently diverge, or appear to diverge, from those of shareholders, so that the board's normal reliance on management's "expert" status may be inappropriate, and management's actions should be subject to more searching board review.

A few examples of situations in which boards commonly use outside advisers may illustrate the application of these factors:

The most common type of outside adviser is a corporation's

auditors. A corporation's financial statements are a fundamental tool by which, at least in part, shareholders, creditors, customers, and the rest of a corporation's public, monitor the performance of the corporation. It therefore is obviously important that a corporation's financial statements be reliable. Indeed, even if the SEC didn't insist on the use of independent auditors for preparation of a corporation's financial statements, it is the type of situation in which a board would expect to insist on use of independent outsiders.

Other situations in which outside advisers are commonly retained are large or important corporate transactions, such as complicated security offerings, mergers and acquisitions. Investment bankers may provide expert advice concerning the financial aspects of these transactions, and attorneys may advise boards of their related legal responsibilities and liabilities.

Because of the importance of these types of transactions and the

possibility that management may not have specialized expertise, it is frequently the case that outside advisers will be retained.

LBOs are another class of transaction where outside advisers are typically retained. Here, not only is the transaction both of sufficient scale and sufficiently radical in its potential to transform the corporation, but also it places management in a classic conflict of interest situation that surely impels the retention of outside advisers to provide unbiased advice to the corporation.

Another example of an outside adviser is the compensation consultant. One of the most important functions of a board, of course, is to set management's compensation, and management obviously may have a conflict of interest in the matter. Indeed, compensation is an important tool that a board can use to align the interests of management with those of the shareholders. To enhance their ability to use this tool, boards have increasingly relied upon outside compensation consultants

to provide expert advice.

The potentially transforming quality of the endeavor may indicate that it also could be helpful for outside advisers to be retained in another context: setting strategic goals for a corporation. Encompassed within this task are a broad variety of matters, such as whether extraordinary distributions should be made to shareholders, the advisability of corporate acquisitions and dispositions, and the extent to which a corporation should be leveraged.

Inevitably, a corporation's strategic decisions require consideration of a multitude of conflicting goals and concerns that will be subjective and difficult to balance. Clear answers will rarely be available. While management obviously must be intimately and substantially involved in these decisions, the board has the ultimate responsibility to make independent judgements concerning what strategic goals are in the best interests of a corporation. Indeed, in his study of Fortune 1000 boards,

Jay Lorsch found that more than 50% of the boards had created strategic planning committees to facilitate board involvement in this area. And outside advisers may be able to provide substantial assistance to boards and their strategic planning committees.

After it has been determined that the services of an outside adviser are needed, a particular adviser or advisers must be selected to provide those services. Beyond finding an adviser that is highly competent, one of the most important issues to address is whether the adviser has any conflicts of interest that may affect its judgment.

To make this evaluation, an analysis needs to be made of an adviser's relationship to the corporation. This analysis should include a review of the services that the adviser currently provides or has provided to the corporation in the past, and all other arrangements made, in connection with each of these services. Too intimate a relationship in the past between client and adviser may raise questions

at least of the appearance that an adviser cannot be sufficiently dispassionate and independent.

Some conflicts of interest may be sufficiently serious to disqualify a potential adviser. Alternatively, if the conflicts are less serious and the adviser is highly qualified, a board theoretically could decide to retain the adviser and evaluate the conflicts by taking them into account in assessing the adviser's work product. There is risk, of course, in this latter approach since it will be more difficult --- at least as a practical matter --- to reach a decision to disqualify an adviser after the adviser has performed all the necessary work prepatory to actually giving the advice.

It also is critical for a board to reflect on the structure of a proposed adviser's compensation, so that it does not necessarily result in a particular kind of advice. A common example would be payment of a very large fee to an investment banker where the fee is contingent

solely on the completion of a transaction. Such a compensation structure can create at least the appearance that the adviser's recommendations will be tainted by personal interest.

Another issue is whether a board should retain advisers separate from, and in addition to, those that may already have been retained by the corporation. In some cases, the fact that an adviser has already worked extensively on a matter for the corporation may mean that the adviser will bring an improved base of information and understanding to the advice-giving function, and that may improve the quality of the adviser's services, as well as lower their cost. On the other hand, advisers that are retained by the corporation may be less likely, or at least perceived as less likely, to offer independent analysis to the board.

After an adviser has been retained, completed its work, and is ready to report to the board, the board must determine how best to make use of the adviser's work product. As the court in the Hanson

Trust case noted, at a minimum the board should ensure that the adviser has been fully informed concerning the matter under the review, and that the adviser has fully informed the board concerning its findings and recommendations. This, of course, is easier said than done. It suggests an obligation on the part of board members to ask hard questions, to follow up on the answers given, and to insist on thorough and thoughtful analysis from advisers.

Finally, and perhaps the most important guideline for good board practice with respect to outside advisers, boards must keep in mind the proper function of the board and the proper function of its advisers. In our system of corporate governance, the board is ultimately responsible for bringing its experience and independent judgment to bear on the most important issues facing a corporation, and reaching a decision that is in the shareholders' best interests. The proper role of the adviser is not to decide, but rather to help the board decide. Boards that

conscientiously fulfill this responsibility, and that are perceived to have done so by the corporation's publics, may help provide a long-term solution to the problem of ensuring good governance of U.S. corporations.

Thank you.