# A Theory of Corporate Governance

## Finding a New Balance for Boards and Their CEOs

**by John Carver**

[This article was originally published as "Leadership du conseil d'adminstration: *The Policy Governance Model*" in the Canadian journal *Gouvernance - revue internationale*, Vol. 2, no. 1, Spring 2000, pp. 100-108. Republication here is by permission of the original publisher.

It was published electronically in English as "A Theory of Corporate Governance: Finding a New Balance for Boards and Their CEOs" by Corporate Board Member, April 2001. A Spanish translation was published as "Una Teoria De Gobierno Corporativo" by the Oficina del la Presidencia para la Innovación Gubernamental, Mexico City, 2001.

A summary in Russian was published as "Corporate Governance Theory: New Balance Between the Board of Directors and the Chief Executive Officer" [translated from the Russian title "Teoriya Corporativnogo Upravleniya: Poisk Novogo Balansa Mezhdu Sovetom Directorov i Generalnym Directorom," in *Russian Enterprises in the Transitive Economy*, Sapir, E. (ed.) Materials of the International Conference, Yaroslavl State University, Vol. 1, October 29-30, 2002, pp. 47-50.

A full Russian translation was published as "Model corporativnogo upravleniya: novyi balance mezhdu sovetom directorov i managementom companii" in the *Economischeski Vestnic*, No. 9, 2003, pp. 101-110. Yaroslavl: Yaroslavl State University.]

**Abstract:** Significant advance in the quality of corporate governance is dependent on the development of governance theory. The Policy Governance model developed by the author is the first universally applicable theory of governance. The model conceives of governance as a function more akin to ownership than to operation. A board exists to add value to shareholders rather than to managers. The board's job can be logically derived from its owner-representative accountability and the necessity for extensive empowerment of management.

Drucker (1974) observed that corporate boards have one thing in common, "they do not function." Others have characterized them as "largely irrelevant through most of the twentieth century" (Gillies, 1992), "pawns (rather than) potentates" (Lorsch, 1989), "ornaments" (Mace, 1971), and, most picturesquely, "like ants on a log in turbulent water who think they are steering the log" (anonymous, quoted by Leighton and Thain, 1997). If boards have been ineffective for much of corporate history, they have been even more unobserved. The topic of corporate governance interested only a few. Graduate business schools paid them little attention; books and the professional articles on boards were pitifully few.

As we enter the 21st Century, the world of corporate leadership is viewed with fascination. Stock exchanges and other authoritative groups issue reports and recommendations. At this writing, there are at least fifteen codes of best practice of recent vintage (Lechem, 1999), including the Toronto Stock Exchange (Canada), the Cadbury Commission (U. K.), the Organization for Economic Cooperation and Development (Europe), and the King Report (South Africa). Governance may have become the most arousing topic in the management spectrum, judging by the rapid increase in books and articles by distinguished experts.

The explosion of commentary deals extensively with committee structure, balancing inside and outside directors, combining the CEO and chair roles, mergers, acquisitions, using directors as customer contacts, and countless other aspects of the board role. What is missing, however, is a theory of the governance job itself. *How* to do the job is important, of course, but the first question is to define just what the job *is*.

Is it even possible to design a part time leadership role with any hope of addressing the massive burden of accountability thrust upon it? How can a board do more than rubber stamp the rapid flow of modern corporate choices when there is no time for relaxed deliberation? How can boards fully exercise their authority without intruding into CEO prerogatives, thereby damaging the executive force crucial to corporate success? How can a board know what it needs to know without being overwhelmed with data? How can boards enhance shareholder value while protecting the interests of society as well? Harold Geneen (1984) claimed they have no capacity for the former and critics carp that boards have scant interest in the latter. How can boards consistently exercise real authority prior to the need to do so cataclysmically—as in firing the CEO?

There is nothing new about the challenge of getting one's arms around the company while keeping one's fingers out, but the pressures of this new age make that task both more necessary and more difficult at an alarming pace. The problem is greater than that traditional *practices* are inadequate—existing *concepts* of governance are not up to the task. We need new paradigms that re-examine and re-design the fundamental task of governing boards.

## Preparing for a New Governance Paradigm

For twenty years I have been concerned with a theory of governance. My work yielded the "Policy Governance model," a new, rational paradigm for directors. The model does not prescribe a certain structure, but a set of principles. These principles are universally applicable and sufficiently integrated to be called a "model" or, indeed, a *theory* of governance.

To my knowledge, there is no other such complete or conceptually coherent model in existence. Mueller (1996) claimed "that there is no accepted theory of governance" (p.11). Indeed, not everyone agrees that such a framework is possible. Leighton and Thain (1997), for example, observe not only that "there is no existing generally-agreed description, theory, or model of the board system" (p.29), but express a belief that it is "impossible to frame a statement of board system rules that would be universally valid" (p.64). I have challenged this position (Carver, 1997a, 1997b, 1997c, 1999a, 1999b; Carver and Carver, 1997) and proposed the Policy Governance model as one candidate for the thus-far missing theory.

Put simply, the Policy Governance model as applied in business answers one question: *How can a group of peers, on behalf of shareholders, see to it that a business achieves what it should (normally in terms of shareholder value) and avoids unacceptable situations and actions?*

The model begins by accepting at face value several assumptions: The board is owner-representative in fact, not merely in rhetoric. As such it has no responsible alternative but to exercise the authority of that role, lest shareholders lose their voice. As such, it cannot abdicate its prerogatives or even allow them to be defined by its employees, including the CEO. Further, the board cannot allow its prerogatives to be assumed or even defined by any subcomponent of the board, including the chair. These assertions are inescapable-there can be no authority exercised within the company that does not flow initially from the board, even if by default. As the supreme authority (after shareholders), the board must be in full control of its own job before presuming to control anything else. This requires that the board *as a group* be responsible for its own actions, its omissions, its agendas, and the delegations it makes.

Beyond devising and controlling its own job, the board must decide what authority and accountability to give others. Chief among those others are the chair and the CEO-separate roles whether or not they are filled by the same person. It is important to reiterate that both the chair and the CEO work for the board, for the integrity of governance is destroyed if in either case the superior-subordinate relationship is reversed. Similarly, the board creates and controls whatever committees it deems helpful to its job; the board can not be beholden to any committee, including the optional executive committee.

A board exists to govern. While no one disputes this, widespread practice suggests that the board exists primarily to advise. CEOs often use their boards for advice, so much so that directors can begin to see their jobs as more advisory than supervisory. Without denying that individual directors have advice to give and without in any way making that advice unavailable to CEOs, it must be recognized that the board—*as a governing body*—does not exist to advise the CEO but to form the accountability link between owners and operators. As that link, the board's job is fulfilled only if it properly defines expectations and demands achievement. Its job is not fulfilled by even sterling advice in the absence of defining and demanding. On the other hand, if defining and demanding is successful, the fact that a board refrained from advising doesn't matter. The board cannot allow its natural desire to advise to obscure the central challenge: How can a board *command* in such a way that management is optimally empowered and challenged at the same time?

I realize that so strong a word as "command" seems anachronistic in these times-and may not be welcomed by either directors or CEOs. But the accountability chain is weakened if the board fails to recognize that it has not only the authority but the obligation to demand. After all, the company belongs to the shareholders, not to the CEO or the board. The board has no right *not* to exercise authoritative ownership prerogatives. Of course, I mean "command" in the same way that the CEO has the right to command within management; it does not imply dictatorial style.

It is important that the board be painstakingly explicit in describing the nature of any delegation; clarity of roles is critical at so powerful a level of organization. What is the chair for? What is the CEO for? What is the audit committee for? What are other officers and committees for? These may seem simplistic questions, but slight variations can be the source of great differences in the governance process and the certainty of delegated performance.

A board needs a CEO so that the *business* proceeds successfully. A board needs a chair so that the *board itself* proceeds successfully. Inasmuch as the chief role of the board, as owner-representative, is to speak for shareholders in defining and demanding operational success, the chair and CEO roles are important ingredients in a board's fidelity to shareholders. In that light, let me summarize each of these roles (whether or not chair and CEO roles are filled by the same person):

1. *The board is accountable to the shareholders* for the company's achieving what it should (such as ROE, long term investment value, etc.) and avoiding what is unacceptable (such as excessive risk, illegality, unethical conduct, etc.). The board must, then, connect with shareholders sufficiently to be able to speak on their behalf, define success and failure for the CEO, and, finally, ascertain and assure CEO performance.
2. *The chair is accountable to the board* for chairing the process so that directors fulfill their commitment to the discipline they have accepted in doing the job. The chair is not, therefore, the "boss" of the board, but its especially empowered servant whose task is tied to board, not CEO, performance. (If the chair is accountable for CEO performance, the chair becomes the de facto CEO.)
3. *The CEO is accountable to the board* for fulfilling the board's definition of business achievement and avoiding the board's prohibitions. The CEO is not accountable for board performance, nor is the CEO accountable to the chair.

These three points are merely logical extensions of the paramount shareholder-board relationship, one of principal-agent nature. While it may seem counterintuitive, this relationship requires that the CEO and chair, in their respective roles, are not accountable to the shareholders (despite how frequently such an accountability is casually assumed in corporate writing), but to the intermediary, the board of directors. Obviously, the owner-representative role requires the board to take on that role in a real rather than rhetorical way, allowing no intervening decision-maker between principal and agent.

These assertions are not enough to constitute a model of governance. They speak merely to integrity in the chain of command. Even with clarity in the chain, it would still be unclear how the board translates shareholder interests and social conscience into decisions that truly govern the institution, yet avoids intruding into management. To introduce this topic, I will focus on the board-CEO relationship.

The fundamental dilemma is this: On the one hand, a responsible board must maintain control over the CEO. On the other hand, a responsible board wants the CEO to utilize all the managerial power and latitude possible—short of the board's giving away the shop. So the format for board expressions to the CEO must somehow achieve optimum board control while granting optimal CEO freedom. While most historical criticisms of corporate boards is that they tend to exercise too little authority, growing social and legal factors currently press boards toward micromanagment and "meddling." Leighton and Thain (1997) lament that pressures of accountability are driving directors into management's job, but find—with, I believe, unnecessary pessimism—that "this trend can probably not be reversed and the confusion and problems involved cannot be avoided." They call for directors to find "a new balance between unavoidable participation in and necessary detachment from management" (p. 101).

**Distinguishing Ends from Means**

So how can a board be powerful in its role, yet grant to the CEO as much authority as possible—short of giving away too much? In short, how can directors find that "new balance"? Using the Policy Governance paradigm, they can do so by controlling corporate "ends" in an affirmative, prescriptive way and by controlling corporate "means" in a limiting, proscriptive way. Let me explain

I define corporate "ends" as the intended results for various shareholder classes, along with their relative priority—that is, the outcomes for which the corporation exists. Ends describe, in the words of Argenti (1993), what the company is for rather than what it does. For example, a company might be in business so that shareholders have a long term return above market. It does not exist to have a particular plant or distribution system-these are means.

I define corporate means as any decisions or realities that are not ends, that is, it is a definition of exclusion. Means include activities, practices, methods, technology, conduct, systems, and a host of operational decision areas. Note that ends issues and means issues are so defined as to be exhaustive of all corporate issues. I am avoiding the words "goals," "objectives," and "strategies," because these words commonly refer to means *and* ends, thereby obscuring the ends-means distinction.

- To control ends in an affirmative and prescriptive way, the board expresses to the CEO its performance expectations with respect to return, share price in relation to market, or whatever in the board's judgment are appropriate benchmarks of corporate success *from the shareholders' perspective*. In other words, an organization is for whatever its owners want it to be for.

- To control means in a limiting and proscriptive way, the board expresses to the CEO boundaries around acceptable managerial decisions. This admittedly unnatural approach preserves great ranges of managerial prerogatives, yet keeps that range within the board's "limits of acceptability." So rather than enter into the management arena to tell the CEO how to run the business, the board constructs a fence around that arena, directing the CEO to stay within it. The board, then, does not tell the CEO how to do the job, but how *not* to do it. In other words, short of imprudent and unethical practices, what an organization *does* (the choice of the CEO) is allowed to be whatever will best serve what it is *for* (the choice of the board).

Let me reiterate that the board *as a body* tells the CEO what to achieve (ends) and what to avoid (unacceptable means). What any given director has to say on these topics is of interest to other directors, but need not be to the CEO. No director, including the chair, has any authority over the CEO. The board jealously guards its wholeness and its authoritative single voice as a group. The CEO is not confronted with a laundry list of directors' individual wishes, but only with the will of the group. Getting to that point, of course, calls for maximum diversity and dialogue within the board and on many issues will require extensive input from others (such as management, auditors, shareholders, investment bankers, etc.). Management is included in this rich dialogue, but should not steer it or be responsible for it.

So the board as a body controls corporate ends *and* means—that is to say, everything. It must do so because it is accountable for everything. But the enlightened method of control is to prescribe the ends while only proscribing the means. Corporate ends are relatively straightforward, brief statements of achievement normally in terms of shareholder value; they are not the company's strategic plan and perhaps not even its long term goals, except for portions of these documents that reproduce the board's decisions. In short, the planning process is left to management, but the board produces the ends toward which plans plan. But while ends are relatively straightforward, proscription of means is ordinarily a little harder to understand, though not difficult to translate into action.

Means control is best thought of this way: What situations, activities, or decisions by management would not be acceptable to the board *even if they worked*? That is, even if ends are being achieved, there are certain risks, ethical violations, and improprieties that would still be off-limits. Proactive expression of these unacceptables fulfills the task.

**Nested Sets of Corporate Decisions**

Decisions about ends and unacceptable means can be stated in language that is broad and comprehensive or narrow and specific. For example, the board might call for "ROE greater than market" or "ROE greater than similarly capitalized construction firms." Similarly, the board might demand that the CEO avoid "fiscal jeopardy" or "a current ratio less than 1.7:1." In each case, the former statement is open to more interpretation than the latter. Since the board is establishing criteria for CEO performance, it must take into account the *interpretive range* of the words it will use.

To be sure that the board covers everything in its overview of the business, it has no choice but to use very broad statements. ("Fiscal jeopardy" covers far more potential danger than "a current ratio less than 1.7:1.") On the other hand, a board must be sure it has not been so broad in its pronouncements that it has, in effect, said little. But addressing narrower issues, the board takes a greater risk of missing something important, that is, leaving gaps in its expectations. (Avoiding a current ratio less than 1.7:1 leaves other fiscal jeopardies unaddressed.) Consequently, broad decisions by the board have the advantage of not omitting issues; narrow or more specific decisions have the advantage of being more pointedly instructive to the CEO. *Completeness is mandatory*; the board's accountability to shareholders for everything requires that the board "blanket" everything with its oversight-otherwise portions of corporate activity are not under board control. *Specificity is discretionary*; how tightly or specifically the board needs to exercise that control is a matter of board judgment-different circumstances and different topics call for different degrees of control.

A simple three-part principle of board decision-making can enable a board to deal with this dilemma and, at the same time, to avoid unnecessary intrusion into managerial prerogatives. First, the board makes decisions at the absolute broadest level in each category (ends and unacceptable means). Second, the board then proceeds step by step into lower levels, making increasingly narrower, more specific decisions. Third, the board stops this progression into detail at the point where it is willing to accept *any reasonable interpretation* of the words thus far used. Since the CEO begins where the board stops, this actually means that *any interpretation the CEO chooses* will pass as acceptable performance if it can be demonstrated to the board's satisfaction to be a reasonable interpretation.

The board simply manages the amount of interpretation to which its words are open. This has the effect of leaving the CEO more or less room to use independent judgment, dependent on how detailed the board chooses to be. It is as if you were to pick up a nested set of boxes by touching only the outside box while the other, smaller ones are allowed to move about within the box controlled by direct touch. A board, of course, can decide to control the next biggest box as well, but under Policy Governance stops cleanly at some point and allows the CEO to control the rest.

This approach yields board documents in categories of ends and means limitations that address the broadest levels of these topics, successfully embracing but not micromanaging the smaller levels. The documents constitute the board's only authoritative instruction to the CEO. So in the place of rubber stamping and predictable approvals, there is extensive delegation disciplined by explicit standards of performance. It is possible in this way for the board to control what it *must* (not all it *can*), fulfilling its accountability to the shareholders, while empowering management extensively. Define-and-demand as a governance approach beats not only the stultifying, intrusive effects of poke-and-probe, but the fecklessness of react-and-rubberstamp as well.

**Rigor and Justice in CEO Evaluation**

CEO evaluation, to be as meaningful as evaluation in other contexts, must be an ongoing, criterion-focused process. Minimal, clear criteria established by the board as just explained enables a "define and demand" approach by the board, as opposed to the more typical "poke and probe" method. The latter appears diligent (directors are constantly advised to "ask good questions"), but is spotty and weak as a control device. It is like a manager who, rather than establish objectives for his or her subordinates, skips that step and simply "asks good questions" as performance goes along. With criteria in place at the front end, the most useful evaluation of the CEO's performance is found in the systematic monitoring of company performance against those criteria.

Of course, as rigorous and uncompromising as is this comparison of reality to expectations, it must be fair as well. Directors must forego any tendency to make judgments of CEO performance on criteria the board has never stated. In other words, if expectations have not been settled by the board as a body and incorporated into its ends or means limitations policies, then they cannot be admitted into the evaluative monitoring. Further, "*any* reasonable interpretation" must mean just that. If allowed to mean the interpretation of the most influential board member or to mean what the board had in mind but didn't say, the CEO learns that the board cannot be taken at its word.

Proper CEO evaluation, then, is a seamless process through time, not a sporadic event. It avoids the phenomenon described by Lorsch (1989) wherein an agreeable club atmosphere is maintained until performance gets so bad the "social fabric" of the board room is rent asunder. Board control is a myth if achieving or retrieving it exacts a calamitous price.

**Board Control of its Meetings and its Relationships**

It may seem unnecessary to say that effective governance requires the board to be in charge of its own job, but boards are typically not in control of governance. They act as if their CEOs are responsible that they be responsible. CEOs rise to the occasion so that, consequently, board meetings are not so much *the board's* meetings as they are management's meetings for the board!

It is important that a board codify its role in terms of values-added, the process to fulfill that role, the discipline necessary to stick to that process, and its relationships to various other entities. If it does not, management will supply the board with whatever management wishes the board to deal with—hardly the mark of a body that really governs. Part of the board's getting in control of its own role is taking the lead in defining its relationships with others. It is important that the board define the relationship with each of its "significant others" so as to preserve the wholeness of the board as the single, authoritative position of owner-representative.

*Shareholders*. Directors using the Policy Governance model put most of their attention on shareholders—avoiding what Monks and Minow (1996) decry as "a failure to link ownership and control" (p. 93). After all, if directors represent shareholders, does it not follow that directors must be in frequent contact with shareholder concerns and wishes? Even if, as argued by Brancato (1997), the very identity of shareholders can and should be determined by board action, it is these owners for whom the board is agent. Contrary to the antiquated, imprecise language of corporate law, directors' *moral* duty is to the shareholders, *not* to the company—particularly since "the company" so easily comes to mean current company management and, in any event, can actually conflict with one's obligation to shareholders.

*Chair*. The model requires that the board as a body accept *group* responsibility for governing the corporation. That is easier said than done, inasmuch as directors are chosen due to their history of *individual* responsibility. The role of chair is a group's device to help it assume its group responsibility well (Carver, 1997b, 1999b). The chair is an instrumentality of the board and great care must be taken to prevent the board from becoming the instrumentality of the chair. The chair exists to aid the board in being true to its accountability, not to supervise the CEO.

*CEO*. The relationship of the board as a body to its CEO is unambiguously as the CEO's superior, not his or her advisor or social partner. The board is the CEO's superior, not the chair; hence, the CEO is not supervised or instructed by the chair. (Directors individually may relate with the CEO and his or her subordinates in whatever ways they find mutually acceptable.)

*Combined CEO-chair*. When CEO and chair roles are combined, governance integrity is much harder to achieve, perhaps impossible. There is no more certain route to management dominance than combination of these distinct roles. Unfortunately, the independent voice of ownership seems to have as little importance as it did over sixty years ago when Berle and Means (1932) noted the breakdown in corporate accountability caused when the board is co-opted by management.

*Committees.*Committees are creations of the board, always under board control. To preserve the board-CEO relationship, they cannot be given authority over the CEO and should not be allowed to fragment directors' sense of whole board responsibility. While board committees might well be given a task of helping the board with some aspect of its job, it is interference with management when a board committee is assigned to help or advise management on some topic. A committee's charge, then, can only be derived from some decision area that the board has retained to itself. For example, shareholder relations, audit, and CEO compensation are such topics; human resources would not be.

*Inside (executive) directors*. There is an inherent conflict in being, at the same time, a director and an executive working for the CEO who works for the directors. It is hard to imagine how such an obvious structural conflict could have become accepted practice if boards of outside (non-executive) directors had been capable and willing to fulfill their owner-representative role. Board access to the wisdom and knowledge of upper management does not require their being directors. The inside-outside composition of boards has led to such jury-rigged solutions as "lead director."

*Lead director*. The unofficial role of "lead director" (described well by Ward, 1997) is a patchwork solution to the board leadership dilemma inherent in the combined CEO-chair role. When a board needs its independence and effective chairing most, the chair position fails to suffice and must be supplemented by an unofficial role. It is hard to devise a suitable board relationship to this role, since it would not exist where governance integrity is paramount.

## Conclusion

Mueller (1996) complains of companies "where the leadership clings to the obsolete concept of a board dominated by the chairman and/or CEO" (p. xiii). He calls for "a board free from domination by inside directors, the CEO or chairman, with informed and qualified independent directors acting in an independent , unaffiliated, disinterested manner" (p. xiii). Corporate practice, however, and even a great deal of corporate governance literature suggest that attaining the degree of governance integrity that shareholders deserve is a long, hard road ahead.

Major, overdue advances in the practice of corporate governance are possible only with a fresh paradigm, one comprehensive enough to be a true theory of governance rather than merely a collection of practices guided largely by historical happenstance. Policy Governance is such a model. Its widespread use requires only that institutional investors and directors be committed to excellence in the board room.

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