The Best and Worst Corporate Boards

From GE at the top to Disney at the bottom, BUSINESS WEEK rates the panels that run Corporate America.

Sometime next summer, 15 men and three women will gather on the 53rd floor of the General Electric Co. building in New York's Rockefeller Center to make one of the most important decisions in the company's 108-year history. GE's board of directors will decide on who will succeed the man widely regarded as the CEO of the century, John F. Welch. Its decision will be made under the watchful eyes of GE's 130 past and current directors, whose black-and-white portraits line the boardroom.

The photographs--a who's who of industry titans that starts in 1892 and includes Thomas Edison, J.P. Morgan, and Walter Wriston--are not just a reminder of GE's rich history and formidable position in Corporate America. They also reflect vast changes in corporate governance, as the stiff, formal pictures of white male industrialists give way to more casual photographs of executives and entrepreneurs whose ranks include women and minorities.

Now, the directors who are emblematic of that transformation can rightly call themselves a model for today's engaged and active boards. At least, that's the accolade bestowed upon them by institutional investors, governance experts, and BUSINESS WEEK's own analysis of board structure and practices. The runner-up for best board in BUSINESS WEEK's two previous reports on corporate governance, this year General Electric (GE) unseats Campbell Soup Co. (CPB) atop the newest honor roll.

For the third time in four years, we surveyed Wall Street's biggest investors and most prominent governance experts for their views of the best and worst boards in America. The results, besides GE's No. 1 standing? Propelled by superior performance for shareholders, the boards of IBM (IBM), Home Depot (HD), Intel (INTC), and Cisco Systems (CSCO) are also near the top. And even though governance pioneers Compaq Computer Corp. (CPQ) and Campbell have seen performance slump, their boards still rank among the best.

There was consistency at the bottom of the barrel as well. For the second consecutive time, the board of Walt Disney Co. (DIS) was named the worst in America. CEO Michael D. Eisner, under pressure from investors ever since the board's $75 million severance package to former President Michael Ovitz two years ago, is coming under increasing fire for Disney's recent lackluster performance. Institutional shareholders want Eisner to put more independent directors on a board that, despite some improvement, remains packed with Eisner chums. Since May, 1998, Disney has lost nearly 18% of its market value, more than $15 billion.

Most of the boards on the "worst" list, in contrast, end up there because of a major downturn or controversy, such as an oversized pay package or frequent repricing of stock options. Not surprisingly, then, newcomers to BUSINESS WEEK's list of rogue boards include the likes of Cendant (CD), Rite Aid (RAD), and Waste Management (WMI). All have made headlines for financial meltdowns and performance woes that caused critics pointedly to ask, "Where was the board?"

Yet for all the continued controversy over weak boards, there's good news here, too: Situations such as those at Disney or Rite Aid are increasingly seen as an anomaly after a decade in which most large corporate boards have gone through a fairly thorough revamping.

The governance revolution that swept through Corporate America's boardrooms in the 1990s has led to far more active oversight. Composed largely of independent directors, they are more accountable than ever. Directors, who rarely if ever bought a single share of their company's stock in the past, are often significantly invested today. And in the face of shareholder dissatisfaction, they are far more likely to demand change. "All the big rhetorical battles are over," comments James E. Heard, chairman of Proxy Monitor and a longtime player in governance circles. "With the exception of a few rogues, most boards are doing the job they're supposed to do."

If the governance battle has largely been won at big companies, however, the war is hardly over. Now, investor attention is shifting toward midsize and smaller companies. Many have boards that are far from independent, and they often flout the most rudimentary governance guidelines. Says Richard H. Koppes, a consulting professor of law at Stanford University: "That's where the activists are aiming their guns."

One recent example: The California Public Employees Retirement System (Calpers) is in the midst of a push to get Tyson Foods Inc. (TSN) to ditch a dual-class stock that allows Senior Chairman Don Tyson to control nearly 90% of the company's voting power. Calpers also is encouraging other investors in Tyson, where it holds 1.8 million shares, to withhold votes from two directors related to Chairman John H. Tyson. And in a new twist that could lead to an explosion in governance activism, Calpers and others are now using the Net to rally shareholder support (page 150).

The focus on smaller companies isn't the only big shift under way as the maturing U.S. governance movement looks for new targets. Many U.S. institutional investors and local gadflies are starting to focus on overseas boards. European pension funds are getting into the act as well. Lens Inc., the Washington-based activist investment fund, has teamed with Hermes Pension Management Ltd. to prod laggard European performers. The world's largest pension fund, the $255 billion Teachers Insurance & Annuity Assn./College Retirement Equities Fund (TIAA-CREF), also is aiming to boost initiatives abroad.

Last year, for example, the fund found itself in the middle of a bitter debate in Italy when Telecom Italia (TI) proposed a spin-off of its wireless and Internet operations. TIAA-CREF and other investors argued that the transaction unfairly benefited Olivetti, which held a big stake in a Telecom Italia holding company. The campaign halted the sale, but Peter C. Clapman, the fund's chief counsel for investments, warns that American investors need to tread carefully in such overseas battles. In France, he notes, media reports hinted that a recent downsizing at Michelin was motivated by U.S. pension funds' demanding higher profits. "To become more efficient, a lot of these companies have to restructure and downsize anyway, but they could blame U.S. shareholders for it," says Clapman. "So we're trying hard to work behind the scenes and not be made a whipping boy."

MEASURING UP. To take the measure of governance in the U.S., BUSINESS WEEK polled 522 of the nation's largest pension funds and money managers, as well as authorities on directors and boards. They were asked to name the most and least effective boards and to grade them on a scale of 0 (poor) to 10 (excellent) in four broad categories: accountability to shareholders, quality of directors, independence, and corporate performance. A total of 99 replied, a response rate of 19% (page 152).

The 126 companies they identified were measured against a set of guidelines that have won broad acceptance among many chief executives, directors, and governance gurus. Boards won points if they met the criteria and lost points if they didn't. In judging independence, for instance, a board earned top points if it had no more than two inside directors; only outsiders on its audit, nominating, and compensation committees; no outside board members who directly or indirectly drew consulting, legal, or other fees from the company; and no interlocking directorships.

Measuring the effectiveness of a board by how it stacks up against such guidelines is not without controversy. "The most important governance standards cannot be externally measured," maintains John C. Wilcox, vice-chairman of Georgeson Shareholders Communications Inc., a proxy advisory firm. "They include qualities of character, values, the willingness to take an independent stand, and other personal factors that are highly visible in the boardroom but invisible from outside."

Of course, the ultimate test of a board's effectiveness is long-term performance. In that arena, few can beat this year's No. 1, General Electric. Under its celebrated chieftain, GE's market value has risen to nearly $500 billion from just $13.9 billion when Welch became CEO in April, 1981. In most other ways, too, GE's board has the basics down pat: The vast majority of the board's 18 members are independent. Its audit, compensation, and nominating committees include no company insiders. And the interests of outside directors, who each own an average $6.6 million of GE stock, are clearly aligned with shareholders.

But just as important are smart practices that help keep directors abreast of the business long before problems get out of control. GE's directors say that open, frank discussions are a hallmark of their meetings. The tone is clearly set by Welch. Presentations by senior management, for example, are not choreographed exercises with little time for questions and challenges. "Jack creates a freewheeling environment where directors are encouraged to speak up," says Director Gertrude G. Michelson, a former senior vice-president of R.H. Macy & Co. who in 1976 became the first woman to serve on GE's board. "He invites and enjoys debate."

CASUAL LUNCH. Moreover, GE's board has made an almost religious practice of ensuring that directors meet often with lower level GE execs without Welch present--a practice all too infrequent elsewhere in Corporate America. Indeed, Welch's biggest innovation may be ensuring the board's deep involvement in what is the most watched CEO succession ever.

It started some four years ago when, at Welch's suggestion, GE's five-person management development committee began a series of two- to three-day trips into the field to meet alone with Welch's potential successors. Directors saw division heads and key players, who not only provided a formal overview of strategy and operations but also talked more informally with board members over lunch or dinner. "That is very unique, not only for a board, but for a CEO to let a board do it," says Director Silas Cathcart, former CEO of Illinois Tool Works Inc.

Yet GE isn't the only board to attract attention--or imitators--to the innovative practices it has put in place. No. 8-ranked Home Depot Inc., for example, requires each of its outside directors to formally visit five company stores every quarter. It's a rule the board takes seriously. Earlier this year, Director Johnnetta Cole resigned her seat largely because she did not have time for the visits.

SLASHED PAY. The store trips equip board members with firsthand information, allowing them to play a more rigorous role. When staffers told directors last year that they were no longer getting customer service training because the outlets were too busy to spare them, board members raised the complaints with top management. The result: Home Depot opened stores an hour later on Sunday so the day could start with an hour of training every week.

Nor have directors at No. 3-ranked Campbell Soup Inc., which has consistently won plaudits for setting strategy and handling CEO succession, sat on their governance laurels. Last year, each of the company's 16 directors evaluated his or her own effectiveness against 35 criteria in an effort to improve their contributions. The board also did the unthinkable: After ordering up a survey of director pay, members decided they earned too much.

The directors then slashed the value of their annual compensation to $113,000, from $160,000.

On the bottom half of the list, Disney's sagging fortunes have turned up the pressure on CEO Eisner, who has tried to soothe critics by making several governance changes. Eisner put two new independent directors on his board in 1998 when two insiders resigned. He agreed to annual elections of all directors by 2001 and allowed an anti-takeover poison-pill plan to expire last year. He also changed the makeup of the audit, compensation, and executive development committees, ensuring they are composed entirely of outsiders.

Even so, Eisner has steadfastly refused to rid Disney's board of his many friends and acquaintances. The board still includes Eisner's attorney, his architect, the principal of an elementary school once attended by his children, and the president of a university that received a $1 million Eisner donation. That's why many view the changes as token gestures, rather than real reform. "Any improvements are a step in the right direction, but Disney has not leaped forward in a brave new direction," says Ann Yerger, director of research for the Council of Institutional Investors. Eisner refused to comment, but a company spokesman rebuffs the continued complaints. "There comes a point when you have to say that we have to make the decisions about the company," he says.

Disney isn't the only hardy perennial to show up on the wrong side of the governance fence. Other repeat performers include Archer Daniels Midland Co. (ADM) and Advanced Micro Devices Inc. (AMD) ADM has only five independent directors out of a dozen and, like Advanced Micro, also has at least one nonindependent board member on its nominating, compensation, and audit committees. Governance experts say the work of these key committees should be done solely by outsiders to quash potential conflicts of interest.

A NIGHTMARE. And two newcomers, Rite Aid Corp. and Cendant Corp., show up just behind Disney in the No. 2 and No. 4 spots. Accounting scandals at both concerns led to management upheavals and probes by the Securities & Exchange Commission. These problems have raised serious questions about their boards. At Rite Aid, which has restated its financial results for the previous three years, the audit committee met only twice in fiscal 1999. Four of the company's nine directors were insiders, and five board members are 70 or older. "It's a corporate governance nightmare," says Stanford's Koppes.

Good governance, however, is no guarantee of superior performance, as clearly demonstrated by the recent results at Campbell Soup and Compaq. In the past 18 months, the performances of both companies have badly trailed their industry peers and the Standard & Poor's 500-stock index. At Compaq, which boasts a highly independent board with a powerful and influential nonexecutive chairman, Benjamin Rosen, directors were unable to successfully recruit a top-qualified CEO from outside after ousting their second chief executive officer in five years. Some blamed the search's failure on Rosen, an irony of sorts because many governance gurus have long advocated having a strong chairman separate from the CEO. "Candidates were afraid of potential backseat driving," says Patrick McGurn of Institutional Shareholder Services Inc., a proxy advisory firm. "If Compaq can screw up such a key function, what happens in companies with crummy governance systems?"

Even so, it's hard to argue against adopting good governance. "You are never going to be guaranteed total success," says Charles Elson, a law professor and board member. "But good governance gives you protection when things go wrong. In the long run, that will play out." Or so GE's shareholders will be hoping when the board finally fills Welch's shoes.

By John A. Byrne