THE BEST AND WORST BOARDS

Our special report on corporate governance

In his 13 years as chief maestro of the entertainment empire that is Walt Disney Co., Michael D. Eisner has suffered few setbacks. His outstanding record as chairman and CEO has made Disney shareholders among the most prosperous in the world. So it came as a bit of a shock to Eisner when he was greeted earlier this year by a chorus of boos from many of the same investors he had helped to enrich. Disenchanted by the Disney board's $75 million payout to former President Michael Ovitz and a lucrative new contract for Eisner, nearly 13% of voting shareholders withheld their support from five directors up for reelection. It was the most sizable 'just say no' vote opposing an incumbent slate of board members since 1995, when almost 1 in 5 shareholders withheld their votes for directors at scandal-ridden Archer Daniels Midland Co.

Now, Eisner and his directors are taking another drubbing. Disney's directors have won the dubious distinction of being named the worst board in America in BUSINESS WEEK's second annual analysis of the state of corporate governance. Institutional investors and boardroom watchers scorn what they see as a meek, handpicked group, many of whom have long ties to Eisner or the company. Yet Eisner shows no signs of backing down. 'We have a fantastic board,' he insists, 'and I hope I'm not intimidated into changing the direction of the board.'

PROGRESSIVE PIONEER. On the other end of the spectrum, Campbell Soup Co. won the honors for having the best board of directors for the second year in a row. Under Chairman David W. Johnson, the company's board continues to build on its reputation as a progressive governance pioneer. Over the past year, what was already one of Corporate America's most highly acclaimed boards got even better. Outside directors took full control of search for a new CEO, rewriting the book on a board's role in management succession. And to ensure that each director makes a strong contribution in the boardroom, Campbell has initiated performance evaluations for all. 'This board is obsessed with self-improvement,' says John M. Coleman, Campbell's general counsel.

Not long ago, many corporate chieftains would have considered initiatives such as Campbell's near-radical precepts. In the clubby, cozy world that typified the corporate boardroom, CEOs packed their boards with trusted friends and colleagues who rarely challenged the chieftain's policies--or prerogatives. Meanwhile, few paid much attention to how well directors performed the job they're paid to do: looking out for shareholders.

Today, however, all that has changed. Fueled by pressures
from such activist investors as TIAA-CREF, the world's largest pension fund, and California Public Employees' Retirement System (CalPERS), stronger governance practices are going mainstream. In boardrooms across Corporate America, directors are struggling to redefine the rules under which they should--and shouldn't--operate. Just as important, many are taking a hard look at how responsibility for a company's performance should be split with the CEO.

SURPRISES APLENTY. Given the often secretive world in which boards operate, however, sorting out the governance laggards from the leaders can be tough. After all, investors never get to see what actually goes on inside the boardroom. So one year after our ground-breaking initial survey of the best and worst boards in Corporate America, BUSINESS WEEK returned to the experts for a fresh look. We asked many of Wall Street's biggest investors for their views and surveyed prominent governance experts. To the seasoned judgment of those groups, we added an objective analysis of the structure and rules under which each board operates.

The result is a list with surprises aplenty on both sides of the ledger. Alongside Campbell, the standouts include the boards at General Electric, Compaq Computer, and IBM--all slates of independent, demanding directors with shareholders who have reaped huge rewards from the companies' successes. Microsoft Corp.'s board zoomed to No.4 from No.16 last year, largely on the strength of kudos from investors.

Happy shareholders also helped push Pfizer Inc., the only company to boast a vice-president for corporate governance, onto the list. It was one of 10 new entrants to the top 25. Other first-timers include Texas Instruments, General Mills, and Dayton Hudson, one of the few companies to impose term limits on its directors (page 92). Eastman Kodak Co., which last year placed 15th on the best list, slipped off this time around, a victim of slumping profits and investor uncertainty.

The list of laggards also features some well-known names. AT&T came close to beating Disney as having the least effective board of directors. Galloping criticism of its handling of the succession of former Chairman and CEO Robert E. Allen fueled its ascent to second place on the worst list, from sixth last year. The boards of H.J. Heinz and Archer Daniels Midland weren't far behind. Dow Jones--under pressure from shareholders because of poor performance--was among 10 newcomers. Others included such badly troubled concerns as Columbia/HCA, Waste Management, and Occidental Petroleum--whose board angered shareholders by handing over $95 million to its CEO to cancel his employment contract. But there was good news for some: Quaker Oats, which last year ranked as the 19th most ineffective board, disappeared from 1997's worst list. Why? Investors applauded a new CEO at the company, which has also rid itself of its money-losing
GAINING CLOUT. In the year since BUSINESS WEEK's first board ranking, much progress has been made. The corporate-governance movement has gained greater prominence and power. TIAA-CREF is actively lobbying chief executives whose boards fail to measure up. Even the Business Roundtable, a collection of big-time CEOs that represents the Establishment, has joined the bandwagon. In September, the group adopted board guidelines that mirror many of the standards that activists have pushed for years.

By those principles, what makes for a good board? Perhaps the most important quality is directors who are active, critical participants in determining a company's strategies. That doesn't mean board members should micromanage or circumvent the CEO. Instead, governance experts say they should provide strong oversight that goes beyond simply rubber-stamping the chief executive's plans. Today, a board's primary responsibility lies in ensuring that strategic plans undergo rigorous scrutiny, evaluating managers against high performance standards and taking control of the succession process.

Another crucial component of top-ranked boards is director independence. Governance experts believe that a majority of directors should be free of all ties to either the CEO or the company. That means a minimum of insiders on the board, with directors and their firms barred from doing consulting, legal, or other work for the company. Interlocking directorships—where CEOs serve on each other's boards—are also out. Along with such out-of-favor perks as director pensions, governance experts believe that such ties lead directors to align themselves too closely with management. But perhaps the best guarantee that directors act in shareholders' best interests is the simplest: Most good boards now insist that directors own significant stock in the company they oversee.

If such guidelines have gained steady ground of late, there are still plenty of holdouts. Some executives dismiss them as academic fluff. Chieftains such as Eisner and H.J. Heinz Co. Chairman Anthony J.F. O'Reilly argue that corporate performance is what really matters. Why should shareholders care what rules or procedures govern board discussions or if directors defer to rather than debate the CEO? If management delivers strong shareholder returns, they maintain, investors shouldn't worry about the rest. "Every board is different," says Donald R. Keough, former Coca-Cola Co. president and a Heinz director. "I've got a simple point of view on governance: Does it work? If it does, why fool around with it?"

PREVENTIVE MAINTENENCE. Yet governance advocates argue that to judge a company only by its stock performance is
shortsighted in the extreme. 'Too many boards fail to pay attention to good-governance practices until times get really tough,' says William D. Crist, president of the board of CalPERS. 'But it's a little like brushing your teeth. If you brush them all along, you'll probably have fewer cavities.'

Indeed, the operative words in governance today may well be preventive maintenance. After a decade in which one seemingly strong company after another stumbled--General Motors, American Express, Sears Roebuck, Archer Daniels Midland, along with the recent troubles of Columbia/HCA, are just the most obvious examples--governance experts are now focused on stopping corporate downfalls before they happen.

Certainly, no one can guarantee that strict guidelines will head off disaster. But one thing is sure: A proactive board of independent directors with their own shares on the line is more likely to spot a problem in advance--and swiftly head it off--than a pack of management loyalists. Moreover, good governance appears to pay off. The best 25 boards in BUSINESS WEEK's 1997 ranking boasted annual total shareholder returns of 27.6% over the past five years, far outpacing the annual gains of 19.8% for the Standard & Poor's 500-stock index, while the 25 worst boards earned average annual returns of only 5.9%.

So which boards are best positioned to weather storms and which likely to get soaked? To answer that, BUSINESS WEEK surveyed 421 of the nation's largest pension funds and money managers, as well as authorities on directors and boards (page 98). They were asked to identify corporations with the most and least effective boards and to grade them on a scale of zero (poor) to 10 (excellent) in four broad categories: accountability to shareholders, quality of directors, independence, and corporate performance. A total of 103 replied, a response rate of 24.5%. The responding money managers and funds manage more than $2 trillion in equity assets.

The 224 companies they selected were then put through another round of scrutiny. Their boards were measured against a set of specific 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 example, a board aced the test 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 draw consulting, legal, or other fees from the company; annual boardroom sessions without the CEO present; and no interlocking directorships.

'TRAIN WRECK.' But are those the right questions to pose? Eisner, for one, doesn't think so. After all, he asks, what's wrong with the board of a company that in the past 10 years
has delivered annual returns to shareholders in excess of 20%?

Plenty, say investors, who increasingly see the Disney board as an anachronism. Among Disney's 16 directors are Eisner's personal attorney--who for several years was chairman of the company's compensation committee--and an architect who designed Eisner's Aspen home and his parents' apartment. Joining them are the principal of an elementary school once attended by his children and the president of a university to which Eisner has donated $1 million. The board also includes the actor Sidney Poitier, seven current and former Disney executives, and an attorney who does business with Disney. Moreover, most of the outside directors own little or no Disney stock. "It is an egregiously bad board--a train wreck waiting to happen," warns Michael L. Useem, a management professor at the University of Pennsylvania's Wharton School.

He and other critics think Eisner should push his friends and colleagues off the board and recruit more directors who are free of any links to Disney. Yet Eisner vigorously defends his board as a vital assembly of tough, savvy, and independent advisers for a unique entertainment corporation. "I wouldn't suggest this board for a U.S. Steel," he says, "but if you are building theme parks, creating Broadway shows, and educating children, wouldn't you want a priest, a teacher, an architect, and an actor on your board?"

As for the directors' independence, Eisner insists that "if we started to fail, and I started to do irresponsible things, the board would get rid of me." Still, the criticism is having some effect. Since February's annual meeting, Eisner has taken his personal attorney, Irwin E. Russell, off the board's compensation committee and installed as its head Thomas S. Murphy, former CEO of Capital Cities/ABC Inc., which Disney bought in 1995.

TOKEN CHANGES. Eisner also plans to move toward annual elections of the full board by 1999 and has asked outside directors to reach into their pockets to invest in Disney stock. As recently as nine months ago, eight of Disney's 16 directors owned few if any shares. Perhaps more significant, though, is what Eisner isn't doing: He has no major plans to change the board's membership or cut back on directors with ties to himself or Disney.

That's why some critics say the changes, while welcome, are largely token. Gary L. Wilson, Disney's former chief financial officer and a company director for 12 years, for example, had no company stock until September, when he purchased only 1,000 shares--for about $78,000. Yet Wilson, who declined comment, has a net worth exceeding half a billion dollars. "I don't think owning more shares of stock would make Gary more or less independent," says Eisner. "He's already as tough and as smart as they come."
Battered by investor criticism, many of the other boards featured on last year's worst list are also trying to shape up. AT&T, Dow Jones, and Waste Management brought on new, more respected directors. Apple Computer overhauled its much-criticized board. ADM, Champion International, and Fleming embraced more liberal governance guidelines. "For any company that hasn't done well, one of the solutions starts with the board," says Robert S. Miller, interim CEO of beleaguered Waste Management. Aside from bringing in new blood, Miller has overhauled the audit panel and replaced ex-executives with outsiders on key board committees.

ADM, last year's worst board, recruited new directors and agreed to have a corporate-governance committee of outsiders rule on whether business ties between directors and the company should disqualify them as board members. But investors are far from satisfied. "They have taken some positive steps," says Ann Yerger, director of research for the Council of Institutional Investors. "But they are baby ones. The board is still heavily weighted with non-independents."

A CONVERT. Elsewhere, Robert E. Stauth, CEO of $16.5 billion food wholesaler Fleming, got a performance evaluation by the outside directors on his compensation committee earlier this year, for the first time ever. Stauth has now become a convert; soon, individual directors will also undergo similar evaluations. "People are fighting something that could be a real positive tool," he says.

Increasingly, such good-governance practices are becoming the preventive medicine a corporate doctor prescribes to forestall disaster. "If a board waits years to correct a major problem, that delay subtracts shareholder value that may never be recovered," says Benjamin M. Rosen, Compaq Computer's nonexecutive chairman. It was Rosen who six years ago spurred a board decision to oust the company's CEO after a single down quarter because of a major strategy dispute. Since then, Compaq's market value has risen twentyfold.

Perhaps nowhere was that view borne out more clearly this year than in the board breakdown that allowed AT&T to stumble so badly. Governance experts argue that AT&T's board should have stepped in more forcefully as ex-Chairman Allen's tenure went awry. Even after the company made bad acquisitions, lost significant market share, and repeatedly turned in disappointing earnings, the board allowed Allen to control the search that resulted in the selection of President John Walter. When the board backed Allen's recommendation in July that Walter not be given the top job, the spurned successor resigned. Only then did the board's outside directors take control, recruiting Hughes Electronics CEO C. Michael Armstrong.
It was a monumental miscue and humiliating public lesson in what not to do if you are a director on a board. 'You cannot leave it up to the chairman to pick the successor,' says Newton N. Minow, a former member of the Federal Communications Commission who sits on the boards of Sara Lee, Manpower, and Aon. 'The two most important events for a board are picking a new chairman or CEO and figuring out what to do when the place is in trouble.' An AT&T spokesperson said the company's directors declined comment.

'CELEBRITY DANCE CARD.' How could AT&T's directors--who have included some of the most prominent executives in business--fail to act more decisively and quickly? Some suspect it had to do with the extended tenure of many AT&T directors. Although the company has gained four new outsiders over the past two years, all five of the remaining independent directors have served on the board for a decade or more. 'Board culture has changed dramatically in the past 10 years, from a celebrity dance card to an active, working institution,' says Charles M. Elson, a director at Sunbeam Corp. and a governance advocate. 'Most of the directors at AT&T came of age when boards didn't mean that much: Your friend puts you on the board, and you protect him.'

Armstrong, on the job only three weeks, refused to comment on the company's past. In a statement to BUSINESS WEEK, however, he noted that half the board's membership has changed in the past two years (page 95). 'Make no mistake about it,' adds Armstrong, 'the AT&T board and its new chairman are focused firmly on the future and creating value for our shareholders.' Also, AT&T will now pay half of directors' compensation in stock, up from only 15% now.

As pressures for boardroom change grow stronger, though, some executives warn that the pendulum is starting to swing too far. They see boards overcorrecting for the years when most merely rubber-stamped the chief executive's wishes. And they fear that the current spotlight on boards will lead to unfair criticism of directors, making them more hesitant to take strategic risks. 'Sometimes, it's not the board's fault' when things go wrong, says Walter V. Shipley, CEO of Chase Manhattan Bank and chairman of the Business Roundtable's panel on corporate governance. 'It can be an honest strategic mistake that has nothing to do with the form or substance of governance.'

Despite the doubters, the best boards continue to raise the bar, convinced that a stronger board can only help improve competitiveness. Last June, Campbell's directors added yet another new wrinkle to their already stringent governance standards. Each director began to evaluate his or her individual performance annually. Every board member completed a formal self-evaluation, assessing how well he or she was doing on attributes ranging from preparation for meetings to participation and input.
The exercise revealed that directors believed they needed more knowhow in consumer marketing and a greater understanding of the bench strength below the senior executive team. The upshot: As many as a dozen managers the directors rarely see will have dinner with board members and on the following day make presentations to them. And next year, Campbell will begin full peer review of each director.

SIZE MATTERS. For many of the best-governed corporations, such self-evaluations are fast becoming a key tool for improving boardroom dialogue. Last year, Compaq’s governance committee also began evaluating the effectiveness of its board and individual directors. As a result, Compaq increased the frequency and length of strategic business presentations to the board and has begun delivering the materials for board meetings to directors earlier, via CD-ROM. The time devoted to discussion at boardroom sessions has also been upped.

To directors at top-ranked boards, such ongoing refinements are crucial to ensuring that every member of the board is an active participant. Size matters, too: At Compaq, enlarging the board beyond its current 11 directors is a nonstarter.

"Once you get much over double digits, the dynamic changes," says Kenneth Roman, who chairs Compaq’s governance committee. "It becomes more of a Japanese tea ceremony; it is programmed and rehearsed. In our board meetings, we are grappling with the issues. It's very informal, and it's very interactive."

A lesson here for Eisner? Perhaps. On Nov. 21, the CEO gathered Disney’s 16-member board for a four-day retreat in Orlando that featured presentations from nearly two dozen of its top execs. Joining the directors were what Eisner calls ex officio board members--investors Warren E. Buffett and Sid Bass, who own large stakes in Disney--to bring the group to 18. "You have a pretty large shareholder representation there, making sure we do it as good as we can," insists Eisner. That hasn’t satisfied critics who think a smaller board with fewer ties to Eisner would do better at reigning in the company’s excesses. Strong stock or no, the board will likely remain one facet of Eisner's performance that continues to draw boos.

By John A. Byrne in New York, with Ronald Grover in Los Angeles and Richard A. Melcher in Chicago

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