Board 3.0: What the Private-Equity Governance Model Can Offer to Public Companies*

by Ronald J. Gilson, Columbia University and Stanford University, and Jeffrey N. Gordon, Columbia University**

This article makes the case for a new model for public company boards, one that we are calling Board 3.0. Today's dominant public board model, here called Board 2.0, is best understood as the outcome of a now mature organizational experiment that, after its start some 40 years ago, succeeded in replacing a prior organizational form that had fallen short. Board 2.0, which we also refer to as the "monitoring board," is dominated by part-time "independent" directors who are nevertheless heavily dependent on company management for information and are reliant on and influenced by stock market prices as the primary measure of managerial performance. In large part because of these informational disadvantages, we have seen a recurrent pattern in which boards composed of talented and successful people fail to monitor effectively the corporate managements they are charged with overseeing. Nevertheless, when companies fall short in business acumen or legal obligation, the policy response has been equally predictable—namely, to place even greater demands on the very boards whose structural inadequacies have been blamed for the most egregious and costly monitoring failures to date: the accounting scandals that gave rise to Sarbanes-Oxley in 2003 and the 2008 Financial Crisis that gave rise us Dodd-Frank.

We see two major problems with the current Board 2.0 model: first, its inability to scale limits its effectiveness in coping with the increased size and complexity of the large public corporation; second, its limited monitoring capacity undercuts its credibility in circumstances in which the firm's stock price may undervalue its prospects because sufficient disclosure would cause competitive harm,

Scale. The monitoring board model has grave limitations in scaling up to match changes in the scope and scale of the corporations that boards are supposed to monitor. Consider J.P Morgan & Co. in 1976, the publication year of Mel Eisenberg's iconic book on the monitoring board model,[1] and then compare it to JP Morgan Chase today. The company's size, the

*This is a revised version of "Board 3.0: An Introduction," 74 *The Business Lawyer* 351 2019.

*We appreciate comments received at a Columbia Law School Blue Sky Lunch; from the Advisory Board of the Millstein Center for Global Governance and Corporate Ownership; and at the 2015 Pileggi Lecture. We particularly appreciate the time and candor of the private equity parties we interviewed.

1 Melvin A. Eisenberg, *The Structure of the Corporation: A Legal Analysis*, Little, Brown and Company, 1976.

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 the satisfaction of its legal obligations, and the skills necessary to understand today's international capital and product markets—all these have grown exponentially since 1976. As shown in Figure 1, the phenomenal rise during the ensuing 40 years in JP Morgan Chase's net revenue, number of employees, and number of countries in which it operates provides a useful proxy for the growth in the sheer size, complexity, and regulatory burden of the business that its board is now charged with overseeing.[2]

JPMorgan Chase: 1976 to 2019

	1976	2019	% increase
Net Revenue	$1.8 billion	$115.6 billion	6,422%
Number of Employees	9662	256,981	2,659%
Number of Countries	16	100	625%

During this period, JPM's board transformed itself in response to pressure—from policymakers, regulators, and investors—to adopt the monitoring board model. Board size fell sharply, from a quite large advisory board (24 directors in 1975) to a monitoring board of 11 or 12 directors by 2002, reflecting in part the by-then received wisdom that small boards monitor best.[3] And except for a short-lived bulge to handle the "social issues" involved in JPM's series of large mergers,[4] board size thereafter remained roughly steady. By the end of the period, all directors except for the CEO were "independent."

Although JPM outperformed many banks, it was hardly immune from unnerving risk management oversight failures. The most eye-opening was the "London Whale" episode (2012) in which the bank's massive losses, on the order of $6.2 billion, were at least initially justified as the outcome of portfolio hedging in the name of risk management—an explanation that continues to inspire skepticism.[5] JP Morgan was not alone in this experience of abrupt reversal from apparently successful board oversight to institutional crisis. For example, Wells Fargo emerged from the financial crisis with a reputation for good management and board oversight only soon to be engulfed by a hurricane-force crisis created by a systematic pattern of fraudulent behavior against its customers.[6] The Federal Reserve insisted on a complete turnover of its senior management and its board, and imposed a limit on its balance sheet size as a hammer to force better corporate governance and risk management.[7]

Given the regularity with which such "aberrations" seem to crop up, there appears to be 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 subject matter-defined committees may serve to leverage directors' time and technical expertise, but can also create silos within the board. One response, 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 the call for independence, given the traditional role management has played in director selection.

Limited monitoring capacity. The particular business problem that now calls out for a new board model is created by the interaction of two developments: the dramatic shift towards majority institutional ownership of most large public companies and the rise of a new form of financial intermediary, the activist hedge fund. The consequence of these two developments is that, to an unprecedented extent, even the largest public companies (and their management teams) are now subject to credible proxy contests by shareholder activists mounting challenges to management's strategic vision or operational competence.[8] And because of some notable limitations of the present board model, the mostly accomplished and well-meaning directors that serve on today's boards are hamstrung in three important ways: they are "thinly informed," "underresourced," and "boundedly motivated." Faced with these disadvantages, such directors are poorly equipped and positioned to defend management against an activist's credible business counter-vision. The consequence is that institutional inves-

2 During the period 1976 to 2017, this 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.

3 See David Yermack, "Higher Market Valuation of Companies with a Small Board of Directors," 40 *Journal of Financial Economics* 185, 1996.

4 The Bank One/JPMC merger referred to in note 2.

5 See Arwin G. Zeissler, Daisuke Ikeda, and Andrew Metrick, "JPMorgan Chase London Whale: Risky Business" (*Yale Program on Financial Stability Case Study* 2014-2A-V1, March 11, 2015), available at https://ssrn.com/abstract=2577827.

6 See, e.g., Hearing before the Senate Banking, Housing, and Urban Affairs Committee (Questioning of Chair and CEO John Stumpf) 2016 WLNR 28620531, September 20, 2016.

7 "In the Matter of Wells Fargo & Co.," Cease and Desist Order, Feb 2, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/files/enf20180202a1.pdf. See also John Armour et al., "Board Compliance," 104 *Minnesota Law Review*, 1191, 1193-94, 2020.

8 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 *Columbia Law Review* 863, 2013.

tors, instead of deferring to the board's assessment of the company's existing strategy, are increasingly likely to find themselves resolving through their votes strategic disputes between the activist and company management. Such disputes are often expressed in terms of the incumbents' failure to increase their stock price, or at least match the price performance of their peers. Managements object—often with justification—that stock prices are a limited measure of value creation, especially for strategies that cannot be fully revealed for competitive reasons. The consequence of activist pressure, say the *friends* of management, is the destruction of value attributable to the inability or unwillingness of management to make the sacrifices of near-term earnings required by significant long-term investment.

Our goal is to frame a new board model—one that is composed of a workable number of thickly informed, well-resourced, and highly motivated directors who could effectively monitor managerial strategy and operational skill in cases where this would be particularly valuable.

The task that confronts today's public corporations is to respond effectively to the dramatic changes that have taken place since the emergence of the monitoring board and so better equip boards to function in a radically different business environment, including the greater scrutiny associated with the reconcentration of share ownership. We need a better way to resolve claims of market myopia vs. management "hyperopia," the tendency of managements to persist in failing strategies in the name of an always receding future. Our goal is to frame a new board model—one that is composed of a workable number of *thickly informed, well-resourced, and highly motivated* directors who could effectively monitor managerial strategy and operational skill in cases where this would be particularly valuable. Unlike the present board model, the Board 3.0 directors we envision 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. The demand for such informed, well-supported, and highly motivated directors is likely to prove especially great 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.

In the pages that follow, we start by discussing in more detail the problems and challenges a new model would need to address, and how a new structure might do so. Much of the inspiration and impetus for Board 3.0 are found in the governance practices of private equity, where the high-powered incentives facing and in turn provided by the private equity sponsors have produced a different mode of board and director engagement—one that has been associated, and credited, with significant increases in productivity and value. Porting over, and in some cases adapting, some PE board governance features to the public company offers a fresh starting point. There are readily observable reasons to think that the present public company board model is by no means 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 developments of the 1970s or later—have made effective use of alternative board models. Our goal is to bring some of that governance experimentalism to public companies.

Perhaps most important, a more credible Board 3.0 model may solve some of the serious challenges stemming from major information asymmetries faced by many if not most public companies. Consider the case of a company intent on preserving its first-mover advantages in competitive markets, but also feeling significantly undervalued by the market because investors fail to "get" its strategy – hardly a new claim but one that is more plausible given the large changes in markets and industries. In such a case, full disclosure of its strategic plans would reduce its competitive advantage and dissipate innovation rents, hardly in the interests of long-term shareholders. Yet because markets cannot give full value to plans that are not yet fully revealed, the company could be vulnerable to activist shareholder pressures that could end up pushing management to a second-best strategy. On the other hand, perhaps the market understands the strategy well enough; the problem is that management doesn't "get" that its strategy is second best.

Board 3.0 has the potential to address this dilemma by convincing institutional investors of the board's willingness and ability to strike a workable balance between two opposing forces: the pressure on management to succumb to perceived capital market demand for near-term profit with the consequence of underinvestment in the company's future; and the perhaps equally, if not even more, common tendency of top executives to persist and overinvest in a failing strategy. This tension between an alleged market-driven corporate "myopia" and what we refer to as managerial "hyperopia" is baked into

the publicly held corporation. Board 3.0 can mitigate this tension in a way that stops short of extreme (or "corner") solutions, such as dual class common structures or going-private transactions, which focus on only one of these two ways in which impaired managerial vision can lead to poor strategic choices.

The Rise of Board 2.0

The current board model for public companies has its genesis in academic theorizing in the 1970s that later found acceptance among the elite corporate bar and the Delaware courts. This model, "Board 2.0," conceived of the board's role as principally "monitoring" the performance of managers in corporations with diffuse shareholder ownership, and hence a separation of ownership from control. Such an ownership pattern was expected to lead to "rationally apathetic" shareholders when it came to monitoring managerial performance and behavior. Thus, boards that effectively monitored a company's managers on behalf of its shareholders were viewed as the necessary complement to widely distributed ownership. In this Board 2.0 model, boards were to be populated by "independent" directors, people not economically beholden to the corporation and therefore not under the economic thumb of the CEO. At a minimum such independent directors would constitute a majority of the board; in the ideal case, 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—a group that included 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, and it was clearly the dominant one in the 1950s and 1960s.

But 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 beyond the managers' capacity to manage effectively, made clear directors' inability to constrain managerial appetites for bigger empires.[11] Directors seemed unaware that in many cases the "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 have made illegal campaign contributions in the U.S. and paid bribes 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 ways: 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.[14] And third, boards chose (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 at least 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"

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 *Stanford Law Review* 1465, 2007.

10 *e.g.,* Myles L. Mace, *Directors: Myth and Reality,* Division of Research, Graduate School of Business Administration, Harvard University, 1971.

11 The current travails of General Electric, widely seen in the past as the best managed conglomerate, illustrate the problem. See this article tracking the company's history from its previous highs to its current difficulties by Thomas Gryta & Ted Mann, "GE Powered the American Century—Then It Burned Out," *Wall Street Journal*, Dec. 14, 2018, https://www.wsj.com/articles/ge-powered-the-american-centurythen-it-burned-out-11544796010.

12 See, e.g., Peter Steiner, *Mergers: Motives, Effects, Policies* 103–19, University of Michigan Press, 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; for an application of how purchase-pooling conventions can distort analysts' assessments, see Patrick Hopkins, Richard Houston & Michael Peters, "Purchase, Polling and Equity Analysts' Valuation Judgments," 75 *Accounting Review* 257, 2000.

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

14 The Delaware courts' analysis of "independence" has not taken into account deep social relationships between independent directors and management, sometimes referred to as "structural bias." While the judicial analysis implausibly 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.

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. As compensation for loss of 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 which 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 carried over, though 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 (or quarterly); management plays a dominant role in shaping the board's agenda, and in selecting and 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 this decidedly part-time directorship model and the lack of an alternative information channel, Board 2.0 directors are "thinly informed." Indeed, a primary source of their non-management information about the company is the stock price, which is informed by information gathering and digesting by securities analysts and other market participants. Thus the firm's stock price performance, both 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 with her or his 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.[15]

The extent of the reliance of the Board 2.0 model on the stock price as a source of information and as a monitoring device bears repeating. It is not much of an exaggeration to suggest that, for many public companies today, the stock price may well be the best measure of performance available to directors, the one in which they have the greatest confidence. In other words, such directors know that there is much they do not know, and they also know that management is in control of the information flow to the board. Directors also know that outsiders, including analysts, may well know more, and indeed 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 in significant measure on stock price performance? The vision held out by Board 3.0 is a director model in which directors could credibly assert—both *to themselves* and to the shareholders they serve—that the stock price is missing a critical element of expected future realizations.

Another central limitation of the Board 2.0 model is the motivation of directors. Although "best practice" is to deliver a significant fraction of director compensation in the form of stock-based pay, commonly 50%, 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.[16] 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 gains. Although this arrangement may produce better incentives for compliance oversight, it clearly limits the director's motivation to support business risk-taking, including offering resistance to 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,

15 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. By far the dominant impression was the little time left for discussion of strategy or anything else.

16 See John Armour, Jeffrey Gordon, & Geeyoung Min, "Taking Compliance Seriously," 37 *Yale Journal of Regulation* 1, 35-37, 2020.

for such a director: either he/she has another, full-time job, or, if retired, has chosen leisure as primary pursuit.

To be sure, 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. In fact, 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, such as outside auditors, have become more committed and attuned to their role in identifying corporate misbehavior.

Perhaps this recent evolution should be thought of as "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.

The New Activist Challenge. 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 both made possible and encouraged the rise of a new intermediary: the activist hedge fund.[17] Commonly focusing on companies whose stock price has underperformed, 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 that 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 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 strategies are long-run value-maximizing but not (yet) appreciated by the market doesn't make it so; though the market may be somewhat myopic, management's expectation may be unrealistic, unduly optimistic about the future—or hyperopic. Directors under the current board model are generally not in a position to evaluate and validate strategies that the market does not already understand, and the relevant parties, including the majoritarian institutional owners, understand this.

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, what model would drive additional performance whether or not the activists arrive and provide higher- quality monitoring in an environment of increasing business complexity? Reflecting our reading of the private equity governance literature and a number of interviews of partners at leading 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."[18]

The exact mix of governance techniques varies among PE firms and even within a particular firm among different

17 For elaboration, see note 8 above.

18 The relevant literature includes: Viral Acharya, Oliver Gottschlag, Moritz Hahn & Conor Kehoe, "Corporate Governance and Value Creation: Evidence from Private Equity," 26 *Review of Financial Studies*, 368, 2013; Viral Acharya, Conor Kehoe & Michael Reyner, "Private Equity vs. PLC Boards in the U.K.: A Comparison of Practices and Effectiveness," 21 *Journal of Applied Corporate Finance* 45, Winter 2009; Andreas Beroutous, Andrew Freeman & Conor F. Kehoe, "What Public Companies Can Learn from Private Equity," *McKinsey on Finance*, 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 Journal of Financial Economics, 449, 2016; Ronald W. Masulis & Randall S. Thomas, "Does Private Equity Create Wealth? The Effects of Private Equity and Derivatives on Corporate Governance," 76 University of Chicago Law Review, 219, 2009.

portfolio companies, but includes the following 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 representatives assigned to the portco board tend to be mid-career; they have a large financial and career stake in the portco's success. The operators 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 operators in light of what seems the most important business questions. The operators marshal 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 serve, in effect, as 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 runs to the thousands of hours.

The core elements of this board model, then, are designed to produce directors who are *thickly informed, well-resourced,* and *highly motivated*. The value of the PE governance model has been demonstrated most forcefully by the remarkable consistency with which PE's most reputable and experienced practitioners have generated productivity gains in the companies they acquire—as reflected in consistently above-"market" returns for their limited partners. Early in the history of PE, a large fraction of the gains came from "financial engineering"—that is, leveraging mature companies with ratios as high as 9 to 1, and motivating operating managers with large equity stakes. Michael Jensen famously identified the payout of excess "free cash flow"—cash that could not be profitably reinvested in the business—accomplished by the contractually fixed payments of interest and principal as a major source of gains from leveraged buyouts.[19] The threat of bankruptcy would limit management's ability to divert such cash to negative net present value projects. Another early "financial" story focused on the role of LBOs in breaking up unwieldy conglomerates dragged down by negative synergies. The proceeds from selling off the various subsidiaries to related-industry acquirers—each willing to pay more than the value of the cash the subs were generating as part of the conglomerate—would fund the retirement of LBO debt, leaving a surplus for the LBO sponsors. And one other 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, however, such "financial" advantages have been largely competed away, in part because the success of the LBO movement generated positive corporate governance externalities that spilled over into the public company sector. For example, in the effort to avoid becoming the target of a financial buyer, the managements of public companies can avoid accumulating excess free cash (by increasing dividends or buying back stock), can sell or spin off unrelated parts of the business, and generally can refrain from using excess cash to make unrelated acquisitions. In other words, a potential PE target can reduce its exposure to the capital market just by duplicating the standard financial-motivated PE buyer's strategy.

Yet the role of private equity nevertheless expanded; there has been a steady growth in the assets under management by PE firms and a steady stream of both take-private transactions and secondary buyouts, or what might be called "staying private" (with PE-financing) decisions. And as this continued growth suggests, there remain significant limits to a potential PE target's ability to imitate the PE's strategy. Perhaps most important, public companies could not easily adopt the PE's governance structure in which operating heads report directly and often to a board representing the firm's largest investors. There are many parts to a full accounting for PE's continued success at attracting capital, but one important element is the PE portco governance model, the consistency with which the development and systematic deployment of a well-designed corporate governance model can deliver high 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, claiming that the current corporate governance framework with single-class common limits the company's ability to innovate and pursue a founder's "idiosyn-

19 Michael C. Jensen, "Eclipse of the Public Corporation," *Harvard Business Review*, Sept.–Oct. 1989, at 61.

cratic vision" that may not be appreciated by the market.[20] 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. But each of these alternative "corner solutions" has downsides. The use of dual-class common, besides raising public policy concerns about managerial entrenchment and shareholder disenfranchisement, makes ambitious assumptions about the persistence and visibility of a founder's unique insight and his/her long-term focus on the business.[21] Take-private transactions reduce the set of investment opportunities available to public investors. This unequal access to what might be especially attractive investments raises important public policy concerns as well.[22]

The goal of Board 3.0 is to make available aspects of the PE portco corporate governance model to public company boards. Along with efficiency gains for individual companies, expanding the range of public company governance options can be expected to strengthen the vibrancy of public capital markets in their competition with private markets while enlarging the set of investment opportunities for ordinary investors without access to PE limited partnerships.

How a Public Company Adopts and Implements Board 3.0

Board 3.0, in 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 be charged specifically with monitoring the strategy and operational performance of the management team. The 2.0 directors would continue to serve, as they do 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." These 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 is necessary, the 3.0 directors could engage outside consultants. The 3.0 directors would be paid principally in the form of long-term stock-based compensation. The compensation expectations of PE operating or lead directors would be a useful guide to the expected level. Since a 3.0 director would be a mid-career professional, additional implicit compensation would come from establishing a reputation for fostering and enhancing value creation at the company. A 3.0 director should assigned term limits at a particular company to minimize the risk of capture and reinforce the role of reputation in enhancing director 3.0 credibility.[23]

For expositional purposes, we have focused the Board 3.0 model mostly on its capacity to address information asymmetries between the company and the public market because the market myopia claim has figured so prominently in the debate to date. Nevertheless, the model and, in particular, 3.0 directors may also be particularly valuable in addressing monitoring shortfalls for complex businesses like JPM, for which, as we saw earlier, the 2.0 director is clearly inadequate.

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 it's not hard to see how such costs could be more than offset by potential benefits from changes on either dimension). Thus, Board 3.0 is being proposed here as a flexible option crafted in response to a company's particular circumstances—not something imposed through a legal or regulatory mandate or frozen by specification of "best practices" —for those companies 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.

How could a company implement Board 3.0? First, the CEO and the management team could propose a voluntary adoption, or "opt-in," on the grounds that the 3.0 directors will provide credibility with institutional investors at a time when management is pursuing a strategy it believes will be significantly undervalued by public markets. The CEO's promotion of a Board 3.0 opt-in, insofar as the new directors' access to information invites internal questioning and challenges, provides a credible signal of the CEO's confidence in the strategy and operational skill of the management team.

Second, the impetus for the opt-in could come from the board, specifically the lead director or the nominating-gover-

20 See Zohar Goshen & Assaf Hamdani, "Corporate Control and Idiosyncratic Vision," 125 *Yale Law Journal* 560, 2016.

21 See Lucian A. Bebchuk & Kobi Kastiel, "The Uneasy Case for Perpetual Dual-Class Stock," 103 *Virginia Law Review*, 583, 2017; Ronald J. Gilson, "Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy," 119 *Harvard Law Review*, 1641, 2006; Jeffrey Gordon, "Dual Class Common Stock: An Issue of Public and Private Law," *Columbia Blue Sky Blog*, January 2, 2018, available at http://clsbluesky.law.columbia.edu/2019/01/02/dual-class-common-stock-an-issue-of-public-and-private-law/.

22 See Jeffrey Gordon, "Is Corporate Governance a First Order Cause of the Current Malaise?" 6 *Journal of the British Academy,* (Supp.) 405, 2018.

23 For an explanation of the structural arrangements needed to enhance the credibility of this type of director, see Ronald J. Gilson & Reinier Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors," 43 *Stanford Law Review,* 863, 1991.

nance 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 company in light of the potential for an activist challenge. Or the board may come to believe it is strained to discharge its monitoring responsibilities given the nature of the business.

Third, the opt-in could come in settlement of an activist challenge. Not all activists maintain the fundamentals-based firm-specific analytic capacity for an ongoing engagement over the strategy and operating performance of an investee company. In general, the shareholder activist targets a firm based on public indicators of underperformance[24] 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.[25] An activist who wants a deeper corporate governance change could press the company to adopt a tailored version of Board 3.0.

One critical question remains: how do the Board 3.0 structure and 3.0 directors gain credibility with institutional investors, the majoritarian voters? Full disclosure, and then careful 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 would 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 extending their reach to the "micro-management" of 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 company over time, including the effectiveness of the Board 3.0 structure.

One way to think of the Board 3.0 from the institutions' perspective is as follows: how long a "leash" does it give management when stock market signals are negative? In some cases Board 3.0 would lengthen the leash, though not indefinitely. And for particular companies, the intermediate solution provided by the Board 3.0 model may do a much better job than Board 2.0 of navigating between the Scylla of market myopia and the Charybdis of managerial hyperopia.

Adoption of Board 3.0 with Private Equity as Relational Investor

An alternative route that ports over a variant of PE governance model to the public company involves 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, relational investors, and that such investors would come to see themselves as partners in the creation of long-term value—in short, as "owners."[26]

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—index funds are the extreme case—that are inconsistent with the relational investing model.[27] A handful of contemporary firms—perhaps most notably, ValueAct Capital—have established reputations as relational investors.

PE firms offer a contemporary route for relational investing. They bring business savvy, a governance model, and a long-enough term focus—which is protected by the PE firm's investors being locked into an investment with a ten-year term (in contrast to the much shorter commitment of hedge fund investors). One could imagine a model in which a PE firm takes a reasonably large stake in a public company to give it skin in the game along with warrants providing an upside, and then gets a special class of redeemable stock that conveys 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, at which point 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

24 See Shane Goodwin, "Management Practices in an Age of Engaged Investors," *Columbia University Business School Working Paper*, December, 2017, https://ssrn.com/abstract=3045411.

25 See "Lazard's 2018 Review of Shareholder Activism," *Lazard's Shareholder Advisory Group*, 8, 10, January 2019.

26 See, *e.g.,* Jeffrey N. Gordon, "Institutions as Relational Investors: A New Look at Cumulative Voting," 94 *Columbia Law Review* 124, 1994.

27 See note 8 above.

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 companies and particular PE firms.

Conclusion

The received board model, Board 2.0—the monitoring board staffed by part-time independent directors—should be viewed as an organizational experiment driven by circumstances, not an edict inscribed on stone tablets. The pattern of public corporation ownership has changed radically over the course of 40 years, as have the scale and complexity of the businesses of such firms. Directors who are thinly informed, under-resourced, and boundedly motivated are not a good match for today's demands for high-powered governance. Board 3.0, with well-informed and intensely interested directors, provides a basis for discussion of an alternative possibility for companies seeking a governance structure that better fits their changed circumstances.

RONALD GILSON is Stern Professor of Law and Business, Columbia Law School, and Meyers Professor of Law and Business Emeritus, Stanford Law School. He is also a fellow of the European Corporate Governance Institute ("ECGI").

JEFFREY GORDON is Richard Paul Richman Professor of Law, Columbia Law School, and a fellow of the ECGI. He is also a co-director of the Millstein Center for Global Markets and Corporate Ownership.