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LEHMAN BROTHERS: PEEKING UNDER THE BOARD FACADE

STRUCTURE OF THE BOARD

The board of directors is often described in terms of its salient structural features. These include the number of independent directors, whether it has an independent chairman, the number and structure of committees, the total number of outside boards that directors serve on, the size of the board, its diversity, and whether directors are compensated in cash or company stock.

The assumption is that these features somehow matter. An independent board is expected to deter self-interested behavior among executives. An independent chairman is expected to bring counterbalance to the leadership of the CEO. A reasonably sized board is expected to balance breadth of knowledge and individual accountability. A diverse board (in terms of gender, ethnicity, and professional background) is expected to foster variety of perspective and healthy debate. A board that is compensated significantly in company stock is expected to have better interest alignment with shareholders.

Academics have studied the causal relations between these structural features and governance quality. Contrary to common perception, the evidence is very mixed as to whether the structure of the board matters at all. While it is clear that board quality is essential to sound governance, it is not clear how board structure translates into board quality. Two boards may look quite similar in terms of their superficial structure, but at the same time prove very different in their effectiveness in representing and protecting shareholder interests.

THE BOARD OF LEHMAN BROTHERS

Lehman Brothers is considered to be an example of a company that failed during the financial crisis of 2008 in large part due to ineffective oversight by the board of directors. Critics have alleged that the board did not sufficiently monitor the decisions of senior management or understand the risks that the company was exposed to as a result of those decisions.

Professor David F. Larcker and Brian Tayan prepared this material as the basis for discussion. Larcker and Tayan are co-authors of the book *Corporate Governance Matters*. The Corporate Governance Research Program is a research center within the Stanford Graduate School of Business. For more information, visit: http://www.gsb.stanford.edu/cldr/cgrp/.

From a structural standpoint, there was nothing unusual about the board of Lehman Brothers. It had 10 directors, eight of whom met the independence standards of the New York Stock Exchange.[1] Their average age was 68 years old (versus 61 years at the average large corporation).[2] Directors had diversity of professional background, including a fairly typical mix of current and former CEOs, and executives from both the for-profit and nonprofit sectors. The directors at Lehman were not overly "busy" in terms of outside board affiliations. They were compensated with a mix of pay that included a healthy portion of equity (restricted stock units and options). In fact, from a structural standpoint, the board of Lehman Brothers was in many ways indistinguishable from the board of Goldman Sachs, which weathered the financial crisis quite well (see **Exhibit 1**).

The failings of the Lehman board only become apparent when we look beyond its structural attributes and consider more subjective factors, such as quality of professional background and engagement in board responsibilities. For example, there is a notable absence of financial services expertise on the board. There is also an absence of current business experience. There were no current CEOs of major public corporations on the board. The former CEOs on the board were well into retirement (12 years on average). This raises the question of whether the professional experiences of Lehman board members were relevant for understanding the increasing complexity of financial markets. In addition, there is some question as to why the directors with nonprofit experience were recruited in the first place. Directors with a nonprofit background tend to have academic or regulatory expertise that is relevant to the industry. At Lehman, this does not appear to be the case. Roger Berlind was a theatrical producer, and Dina Merrill a former actress.[3]

Beyond the qualifications of the board, there is the simple question of how engaged directors were in monitoring the activities of Lehman management. This is a difficult assessment to make, especially given the lack of public information. From news articles, we know that CEO Richard Fuld was "aggressive, confrontation, blunt."[4] We also know that he tended to isolate himself from colleagues, taking a private elevator to his executive suite.[5] These might suggest that Fuld was a difficult executive to monitor. At the same time, there is evidence that the board was not particularly structured to provide either oversight of management or strategic advice. Instead, the responsibilities of independent directorships appeared to be perfunctory. Roger Berlind was appointed to both the audit committee and the finance & risk committee, where financial acumen is most critical. In addition, the finance & risk committee met only two times during the course of the year. The compensation committee met more times (eight) than the audit committee

[1] A director is not considered independent if the director or a family member has been employed as an executive officer at the company within the last three years; has earned a salary in excess of $100,000 from the company in the last three years; has been employed as an internal or external auditor of the company in the last three years; is an executive officer at another company where the listed company's present executives have served on the compensation committee in the last three years; or is an executive officer at a company whose business with the listed company has been the greater of 2 percent of gross revenues or $1 million within the last three years. Source: NYSE Corporate Governance Rules. Available at: http://www.nyse.com/pdfs/finalcorpgovrules.pdf.

[2] Spencer Stuart US Board Index 2008.

[3] Berlind served on the Lehman board since 1985. He and Merrill were both Trustees of the Eugene O'Neill Theater Foundation.

[4] Andy Serwer and Corey Hajim, "The Improbable Power Broker," *Fortune*, Apr 17, 2006.

[5] Dennis K. Berman, "Deal Journal: Where was Lehman Board?" *The Wall Street Journal*, Sep 18, 2008.

(seven). The executive committee (which includes only executive directors) appears to have been more active than either the full board or the independent committees, suggesting that management had significant influence over boardroom matters.

WHY THIS MATTERS

Governance experts place considerable emphasis on structural attributes of the board. Many boards are now indistinguishable in terms of regulatory independence, size, and personal and professional composition. Has this emphasis led to homogenization of the board on superficial levels and a reduction in professional qualifications? Has oversight quality been compromised?

Exhibit 1
Comparison of Board Structure: Lehman Brothers v. Goldman Sachs

Structural Attribute	Lehman Brothers (LEH)	Goldman Sachs (GS)
Board classification	Declassified (as of 2006)	Declassified (as of 2006)
Chairman	Dual Chairman/CEO	Dual Chairman/CEO
Number of board members	10	11
Number of current CEOs/Chairmen/President	3	4
Number of retired CEOs and years since their retirement	3 retired, average 12 years	2 retired, average 3.5 years
Independent board members (according to NYSE)	8	9
Professional background of independent board members	Former CEO Sotheby's Former Chairman IBM Theatrical Producer CEO American Red Cross Chairman GlaxoSmithKline Vice Chairman RKO Pictures / Actress Former CEO Halliburton Principal JDM Financial	Former CEO Sara Lee Former Assistant to President of U.S. Former CEO Medtronic CEO Allstate President Brown University CEO BP Chairman Investor AB Vice Chairman Perseus Vice Chairman Colgate-Palmolive
Average age of board members	68.4	59.4
Number of men vs. women	Men: 8 Women: 2	Men: 9 Women: 2
Number of other boards, trusteeships, committees and other appointments (non-profit boards, presidential appointments, etc.) they currently serve on.	Boards: 19 Trusteeships: 12 Advisory Committees: 5 Other Affiliations: 10	Boards: 17 Trusteeships: 7 Advisory Committees: 4 Other Affiliations: 27
Average annual cash retainer (does not include committee fees)	$55,000	$75,000
Average annual equity compensation	$195,000 (either restricted stock units or options)	$260,000 (either restricted stock units or options)
Number of full board meetings	8	7
Number of executive sessions (independent directors only)	3	5
Committee meetings	Audit: 7 Compensation and Benefits: 8 Nominating and Governance: 5 Finance & Risk: 2 Executive: 11 (written consent)	Audit: 11 Compensation: 5 Nominating and Governance: 5

Source: Lehman Brothers, form DEF-14A, filed with the SEC, April 5, 2005; Goldman Sachs, form DEF-14A, filed April 6, 2005. Calculations by the authors.