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More US lawyers move into the boardroom



By Gillian Tett

Lawyer directors have seemingly changed companies' performance

Are lawyers taking over the world? That is a question many investors and bankers might ponder these days. After all, the 2008 financial crisis and ensuing mess has created a deluge of work for the legal profession. And regulatory reform is likely to keep lawyers busy for many years to come.

But aside from the financial sphere, there is another, less-noticed, area where lawyers are increasingly in evidence: corporate boards. In recent months, a group of American law and finance professors have conducted the first comprehensive analysis* of how American companies performed between 2000 and 2009 – depending on whether they had lawyers on their boards or not. The results make interesting reading.

Most notably, the analysis found that lawyers have become increasingly prevalent on boards; though only 24 per cent of US companies had lawyer directors in 2000, 43 per cent did so in 2009. Moreover, having a lawyer on board apparently goes hand in hand with differences in corporate performance. Companies with lawyer directors seemed to pay their chief executives more, but have less volatility in pay, due to lower levels of corporate risk-taking and default. Litigation risk declines too: stock option backdating litigation, for example, was 94 per cent lower at companies with legal directors. Conversely, when there were no lawyers on the board, there was “a 308 per cent increase in the effect of accounting malpractice litigation on firm value”.

As a result, the authors calculate that corporate value (measured by Tobin's Q, the ratio of market value to replacement value of assets), is typically 9.5 per cent higher when a lawyer is on the board. This could potentially force a rethink of some cherished business school ideas, they argue.

Until now, “the accepted wisdom has been that lawyers should steer clear of public company boards”, in case that creates value-destroying conflicts. And while regulators and investors increasingly demand that boards have external directors, they have not previously seemed to care where those directors hail from. They should pay more

attention to this factor, the report argues, particularly with regard to lawyers. For getting lawyers on board both helps diminish external legal risks and improves internal governance.

“The board’s primary function as an agency-cost-reducer may have been appropriate in the past, but companies have grown too complex for value-maximising boards to simply act as monitor,” the study says. “Greater management by the board ... can increase firm value more efficiently than the standard construct.” Or to put it bluntly, lawyer directors are useful because they actively meddle in a company’s affairs – and demand they become more boring and stable.

Many non-lawyers might dispute this, (particularly since the argument comes from two law professors). And though the study tries to disentangle correlation from causation, it is not entirely clear whether it is really the presence of a lawyer that actually sparks this outperformance. After all, it is possible than a company which chooses to tap lawyers as board members could be better run than their peers in the first place. Conversely, lawyers probably will not join the boards of scandal-plagued companies, given the reputational risks.

The authors should also point out how tough it is to get anybody who is competent, independent and expert to sit on public boards, given the rising legal and reputational risks

But even if these results reflect correlation, not causation, they are interesting, for at least two reasons. First, this pattern suggests investors probably ought to screen for lawyers on boards when they buy US stocks, if nothing else because the presence (or lack) of legal directors might create an arbitrage opportunity. Second, as the authors suggest, investors would do well to take more interest in the background of board directors and the degree to which boards function well (or not).

However, even if companies want to hire more (seemingly value-enhancing) lawyer directors, lawyers are not always eager to serve. They face “greater-than-average risks [of being sued], compared with non-lawyers, [as] a director, as do the insurance companies who provide liability coverage to lawyer-directors and their firms”, says the report.

But the authors should also point out how tough it is to get anybody who is competent, independent and expert to sit on public boards, given the rising legal and reputational risks. At best, this means the most able would-be directors are increasingly choosing to sit on private, not public, company boards. At worst, it is preventing the boards of many public companies from providing effective oversight. That’s a problem of concern to us all – lawyers, non-lawyers and corporate directors alike.

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