Some Thoughts for Boards of Directors in 2012

By Martin Lipton, Steven A. Rosenblum and Karessa L. Cain

December 7, 2011

This memorandum may be accessed online at: http://www.wlrk.com/files/2012/SomeThoughtsforBoardsofDirectorsin2012.pdf

If your address changes or if you do not wish to continue receiving these memos, please send an e-mail to Publications@wlrk.com or call 212-403-1443.
Some Thoughts for Boards of Directors in 2012

I. INTRODUCTION

The current economic and political situation requires corporations and their boards to have bold visions for future growth with long-term investments, to make proactive efforts to modulate the pressures for short-term stock price increases and to take advantage of the valuable insights gained in navigating the worst recession since the 1930s. Many boards have been playing defense rather than offense these last few years, as tough economic conditions have prompted crisis management dilemmas, short-term survival strategies and other challenges. Boards have also been dealing with ever-increasing layers of corporate governance requirements and demands from activist shareholders that shift decision-making power from boards to shareholders. In addition, pressures for short-term increases in stock prices have been constant; Wall Street continues to be intensely preoccupied with quarterly earnings targets, which in turn has fostered an investor mindset that too often measures success on the basis of myopic benchmarks. In this environment, the need for boardroom resolve and commitment to long-term growth is critical not only for companies, but also for the vitality and competitiveness of American businesses in the global economy.

Considerable attention has been devoted to searching for lessons learned from the financial crisis and ways to improve board functioning. This exercise has not been in vain. Some of the “lessons learned” include a renewed focus on risk management, a better understanding of the challenges faced by highly complex, global businesses, and a re-thinking of the experience and skill sets needed for an effective board, leading to a re-examination of whether the trend towards boards with only one non-independent director makes sense. The conflicts of interest of proxy advisory firms and the shortcomings of their governance checklists are being scrutinized by regulators both in the U.S. and abroad. In addition, companies today are increasingly engaged in dialogue with their institutional shareholder base in order to establish long-term relationships. Perhaps one of the most valuable “lessons learned” is that boards need to focus on what works, without the undue distraction of reform for reform’s sake and standardized mandates that pay lip-service to “best practices” but add little if any real value.

At its essence, the core purpose of corporate governance is to build long-term sustainable growth in corporate and shareholder value. It is up to each company’s board to determine the unique boardroom dynamic, culture and personalities that shape its effectiveness, as well as the specific challenges it must navigate in successfully steering the company forward. It is naïve at best, and value-destructive at worst, to assume that the optimal structure for some companies should be prescribed for all companies. The details of a particular governance structure—such as whether the chairman and CEO positions should be separated, and whether a CEO should participate in the search for new directors (as opined on by Institutional Shareholder Services (ISS) earlier this year when it recommended against the re-election of Hewlett-Packard’s nominating committee members)—is best determined by the people who serve on the board and are ultimately responsible for ensuring a successful corporate governance structure.

Now that governance activists have achieved most of the reforms they have sought to effectuate, including majority voting (adopted by approximately 75% of S&P 500 companies), annually elected boards (adopted by approximately 74% of S&P 500 companies),
say on pay (mandatory for annual meetings starting on January 21, 2011) and supermajority board independence (approximately 84% of directors of S&P 500 companies are independent), we should now seek a return to the starting point and basic purpose of corporate governance and, more importantly, less emphasis on stifling boards with off-the-shelf mandates so that they can focus on the more pressing business and strategic issues at hand. Corporate governance is a means to an end, not an end in itself.

Set forth below are some of the more significant issues that boards of directors face in the coming year as well as an overview of some key roles and responsibilities.

II. KEY ISSUES FACING BOARDS IN 2012

1. Underlying Causes of Short-Termism

Although short-termism has been an issue of concern for many years, it has gained new notoriety as one of the root causes of the financial crisis. While the initial political reaction would have exacerbated the problems of short-termism through legislation designed to shift even more power to institutional activists and hedge funds, many observers are now recognizing that a core lesson of the financial crisis is the need to try to combat short-termism. In a speech earlier this year reflecting on her tenure as FDIC Chairman, Sheila Bair suggested that “the overarching lesson of the [financial] crisis is the pervasive short-term thinking that helped to bring it about.” This more measured consideration of the causes of the financial crisis has spurred a flurry of reviews, studies and widespread debate about the ways in which short-termism is impacting corporate performance and functioning of equity markets. In the U.K., for example, the Kay Review was launched earlier this year to examine, among other things, the incentives, motivations and timescales of participants in the equity markets and how these affect the long-term performance of companies.

A notable theme to emerge from these studies is the pervasiveness of short-termist pressures in our markets today. As corporate governance laws and best practices have evolved to enhance the power of activist shareholders, these pressures have become more acute. The trade-off between short- and long-term growth is particularly evident when hedge funds and other activist shareholders press boards for stock buybacks, special dividends, spin-offs and other corporate transactions. On a more day-to-day basis, another source of short-termism is the practice of issuing quarterly earnings guidance. This practice began in the early 1990s in response to demands from institutional investors and research analysts for increased discipline and corporate transparency. As Daniel Vasella, Chairman of Novartis, remarked back in 2002, the “tyranny of quarterly earnings” is “a mindset that can hamper or even destroy long-term performance for shareholders.”

In addition, short-term investment objectives and expectations are not limited to arbitrageurs who specialize in trading strategies designed to take advantage of market volatility. Even the investors who have traditionally represented the more “patient capital” sources have shortened their investment horizons, and the average portfolio turnover at actively managed mutual funds has been estimated at approximately 100% per year in the U.S. Some of the potential causes of this trend include incentive structures of fees and commissions that encourage asset managers to seek short-term benefits, actuarial and mark-to-market valuation rules that effec-
tively place lower bounds on intermediate returns, advances in high-frequency and automated trading, and lack of transparency about the investment strategies and performance of fiduciary duties by managers. As noted in a paper published earlier this year by the Millstein Center for Corporate Governance and Performance and The Committee for Economic Development, “[e]ven though institutional investors own more than seventy percent of the largest 1,000 companies in the United States, there is far less known about many of them than about the public companies in which they invest.”

In today’s environment, boards of directors must guide the company’s strategy to achieve long-term value creation instead of responding to pressures for short-term increases in stock prices. Directors must critically evaluate activist agendas—notwithstanding the threat of proxy contests, withhold-the-vote campaigns and other pressure tactics—to determine for themselves what will further the best interests of the company and its constituents. The company’s long-term strategy should be formulated initially by management and then developed fully in an interactive dialogue with the board, with reassessments as economic conditions develop. We discuss this further under “Long-Term Strategy” below.

2. Regulatory Reforms Aimed at Proxy Advisory Firms

A promising area of regulatory focus is proxy advisory firms. In the U.S., ISS and Glass, Lewis & Co. enjoy a virtual duopoly, with ISS estimated to control approximately 61% of the proxy advisory market and Glass, Lewis & Co. estimated to control approximately 37%. Together and individually they have tremendous influence in directly shaping not only the corporate governance profiles of public companies, but also the composition of boards and board committees, executive compensation policies and even transformative mergers and other transactions that require a shareholder vote. The genesis of their influence stems from a Department of Labor (DOL) determination in 1988 that pension funds, mutual funds and other institutional investors have a fiduciary duty to vote the shares they manage in the best interests of their clients, and the position taken by the SEC in 2003 that investment advisors may discharge this duty by voting their clients’ shares in accordance with a predetermined policy and recommendations of proxy advisors. The net result of these two positions is that many institutional investors, who often do not want to expend the resources to make informed voting decisions, have essentially abdicated their voting responsibilities to the proxy advisory firms. Whether this should be viewed as a legitimate way of fulfilling their duties, as well as whether it is really in the institutional investors’ interest to follow this approach, are both issues that are worthy of continuing examination.

Another concern surrounding proxy advisors is their inherent conflict of interest in advising both investors and companies. For example, ISS advises investors on how to vote their shares while also advising companies on how to obtain a favorable vote recommendation and governance rating that will lead to investor support. The Government Accountability Office has been prompted twice by Congress to examine this issue, and in the “proxy plumbing” concept release issued by the SEC in July of 2010, the SEC noted that failure to adequately disclose and manage such conflicts could be misleading to shareholders and impair their ability to vote on an informed basis.
A third issue is the lack of adequate accountability for informational accuracy in the development and application of proxy advisory voting standards. The credibility and accuracy of proxy advisory firms’ analysis has been strained by, among other things, the sheer volume of voting recommendations they issue each year, the relatively narrow window in each year’s proxy season during which they must review proxy statements, and pressures to cut costs and increase their profitability. In a recent survey of chief HR officers conducted by the HR Policy Association, 53% of respondents said that a proxy advisory firm had made one or more mistakes in a final published report on their companies’ compensation programs. A related issue is the lack of transparency in the analytical models of proxy advisors, which makes it difficult for companies to identify inaccuracies, as well as their “one-size-fits-all” approach to determining governance ratings and voting recommendations.

A variety of potential reforms are being considered and, in particular, the SEC suggested last month that it will soon be following up on its “proxy plumbing” concept to address conflicts of interest and concerns about inaccurate information generated by proxy advisors. In addition, in October of 2010, the DOL proposed amendments to its ERISA rules that would subject proxy advisors to a wide range of fiduciary duties and obligations under ERISA, including a prohibition against engaging in self-dealing transactions. Another proposal that could significantly impact the industry is a re-thinking of the SEC and DOL positions that investment advisors have an affirmative fiduciary duty to vote all portfolio shares on all matters; this could liberate institutional investors to take a more case-by-case approach to voting and substantially reduce the volume of voting matters that are effectively deferred to ISS and other proxy advisors.

3. CEO Succession Planning

As companies begin to rebound from the economic recession, the CEO turnover rate has increased sharply over the last year, with high-profile turnovers at companies such as Hewlett-Packard, PG&E, Yahoo, Apple, Costco and Sara Lee. According to a study by Crist | Kolder, 2011 has featured the highest rate of CEO turnover at Fortune 500 and S&P 500 companies since 2005, whereas the rate for 2010 was the lowest rate in 15 years. Recent surveys have indicated that, although CEO succession planning is ranked by boards as one of their highest priorities, it is also an area that many directors believe merits increased consideration. For example, 32% of the directors surveyed this year for a report by PricewaterhouseCoopers indicated this is a major area of focus, and an additional 59% suggested that additional time should be spent on succession planning in the upcoming year. A recent Corporate Board Member survey of directors reported that 43% of those polled believed CEO succession was the responsibility for which their board was least effective.

There is no job that is more important for the board than selecting the company’s CEO and planning for his or her succession. The board bears the ultimate responsibility for this task, and a protracted delay in finding a suitable replacement can detract significantly from the stability of the company and its ability to react quickly and decisively to evolving challenges. The integrity and dedication of the CEO is vital to enabling the board to meet all of its responsibilities and, in large measure, the fate of each of the board and the CEO is in the hands of the other.
While there are no prescribed procedures for succession planning, it should be a top priority that is addressed on a regular rather than an ad hoc basis. Boards should be involved in identifying talented leaders and developing an expanded pipeline of qualified internal and external candidates, and they should seek first-hand exposure to the company’s most promising executives at board meetings, board dinners and other mentoring opportunities. Although succession planning can be a sensitive topic, boards should address this challenge head-on by developing a profile for future CEOs and other key executives that is tailored to the needs of the company, and by working with the incumbent CEO to establish policies and procedures for the development and evaluation of internal candidates.

4. **A Balanced Board**

One of the realizations to emerge from the financial crisis is the extent to which director independence has been emphasized, sometimes at the expense of expertise, and objectivity and collegiality in boardrooms became viewed as mutually exclusive qualities. The staggering losses of financial institutions resulting from highly engineered credit instruments, and the magnitude and complexity of risk management failures, demonstrated a simple truth: directors who meet today’s stringent standards of independence may be relatively inexperienced in the company’s business and lack real expertise and understanding of relevant industries. As stated in a 2009 study published by Professor Jay W. Lorsch and other members of the Harvard Business School’s Corporate Governance Initiative, “[a]s a practical matter it is difficult, if not impossible, to find directors who possess deep knowledge of a company’s process, products and industries but who can also be considered independent.”

The single most important factor in determining the effectiveness of boards is the talent of the people who serve as directors. Unfortunately, the personal and professional qualities that are often the most valuable are difficult to legislate in categorical terms, and efforts to mandate objectivity has accordingly relied on independence criteria that are imperfect and even arbitrary proxies for objectivity. What is needed is a balanced board that has the right mix of industry and financial expertise, objectivity, diversity of perspectives and business backgrounds, and that also reflects an assiduous emphasis on qualities such as integrity, character, commitment, judgment, energy, competence and professionalism.

The challenges of recruiting and retaining world-class directors are complicated by the significant workload and time commitment required for board service today. The 2011 Public Company Governance Survey of the National Association of Corporate Directors (NACD) suggests that public company directors spent an average of over 227 hours performing board-related activities in 2011. In addition, the reputational risks of withhold-the-vote campaigns, majority voting standards, criticism of executive compensation policies and significant product failure or other risk management crises has increased the reluctance of qualified individuals to serve on public company boards.

Another area in which meeting recruiting goals is difficult relates to gender and other diversity. Despite efforts to improve gender ratios, only about 16% of directors on S&P 500 boards are women. In Europe, several countries have proposed and in some cases adopted reforms ranging from non-binding “best practice” recommendations issued by regulators, “comply or explain” obligations where gender diversity falls below a specified threshold, quotas re-
quiring boards to consist of certain minimum percentages of men and women, and consideration of gender diversity of boards in awarding public subsidies and state administration contracts to companies.

5. **The Problem of Underperforming Directors**

One of the most sensitive tasks that boards face is finding ways to address the problem of underperforming directors. The responsibilities and time commitments required for board service today, as well as the complexity of risk management, financial reporting and the host of other issues that directors must oversee, has raised the bar for effective board service. In addition, in some cases, significant behavioral or personality issues may undermine board functioning, impede candid discussions or lead to balkanization of boardroom dynamics. A study this year by Stanford’s Rock Center and Heidrick & Struggles has reported that more than half of the directors surveyed believed that board turnover was too low.

While there is usually no easy way to induce an underperforming director to resign, the lead director or independent chairman is typically the best person to address the situation. In some cases, it may be productive to suggest additional training and tutorials to help get a director up to speed; in other situations, an over-extended director may be asked to trim other time commitments in order to devote more attention to board matters, or to choose between cutting back other commitments or leaving the board. Many boards have found it helpful to retain an independent consultant to evaluate the performance of directors as well as the board as a whole and suggest ways for restructuring board and board committee composition.

6. **Say on Pay**

In the 2011 proxy season, companies received an average of 92.1% say on pay support from shareholders, with only 38 of the Russell 3000 companies failing to receive shareholder endorsement of their pay programs, according to ISS data. However, ISS’s policy updates for the 2012 proxy season indicate that it will now take a case-by-case approach in recommending whether to approve say on pay proposals, as well as whether to recommend withhold votes on compensation committee members where a company’s say on pay proposal in the previous year received the support of less than 70% of the votes cast. ISS’s evaluation will be based on the company’s response to the concerns expressed by shareholders in the previous year, including disclosed engagement efforts with major institutional investors and specific actions taken to address the issues that led to the lack of support above 70%. Cases where support was less than 50% will “warrant the highest degree of responsiveness.” Given the low threshold of opposition votes triggering the more stringent review, there is a risk that a say on pay vote with majority but less than 70% support will be viewed effectively as a “lost” vote.

In addition, in determining whether to issue a negative vote recommendation based on a perceived pay for performance disconnect, ISS will continue to benchmark a company’s total shareholder return against a peer group, although instead of using the company’s Global Industry Classification Standard (GICS) industry group—which was widely criticized as resulting in misleading peer group performance rankings—ISS will use a narrower peer group of 12 to 24 companies to be selected using market capitalization and revenues (or assets for financial firms) within the applicable GICS group as guidelines. Once ISS has clarified the precise
methodology for determining this peer group, companies should assess whether they are likely to fail the pay-for-performance test and consider potential courses of action.

Uncertainty surrounding the implications of a negative say on pay vote was generated earlier this year when numerous shareholder lawsuits were brought claiming that allegedly inappropriate or improper pay practices evidenced a breach of the duty of loyalty by the board. So far, only the case relating to Cincinnati Bell has been permitted to proceed past the motion to dismiss stage, although a recent order issued by the court in that case raises the possibility that the court’s decision may be withdrawn for lack of jurisdiction.

In October 2011, the Delaware Court of Chancery dismissed a wide-ranging shareholder challenge to compensation practices at Goldman Sachs and strongly reaffirmed the principle that Delaware courts will respect the executive compensation decisions of directors who make such decisions in good faith. In particular, the court noted that “[t]he decision as to how much compensation is appropriate to retain and incentivize employees, both individually and in the aggregate, is a core function of a board of directors exercising its business judgment.” Recognizing that boards set compensation in part as a function of encouraging appropriate risk-taking by employees, the court reasoned that even when risk-taking leads to substantial losses, “there should be no finding of waste… any other rule would deter corporate boards from the optimal rational acceptance of risk.”

Boards and compensation committees should bear in mind the heightened media, populist and shareholder sensitivity to pay packages that could be deemed “excessive,” and prepare in advance for the 2012 say on pay vote. If a company has identified reasons to believe that shareholder support will be low, it should consider whether to proactively commence a dialogue to encourage support; in the case of Pfizer, Johnson & Johnson and other companies, such engagement appears to have had a demonstrable impact on their say on pay vote results last year. It is more important than ever for companies to have a well thought out strategy for winning the say on pay vote by a significant margin. At the same time, however, directors should not lose sight of the underlying goal of executive compensation: to attract, retain and incentivize highly qualified individuals. In the final analysis, the ability to recruit and retain world-class executives is essential to the long-term success of the company.

7. **Defending Against Hostile Acquirors and Other Activists**

Despite the uncertain economic outlook and evidence of a slowdown in the latter half of the year, M&A deal volume for 2011 is projected to finish roughly on par with 2010. Hostile deal activity in particular appears to be on an upswing as companies seek to deploy cash reserves or take advantage of depressed equity values. Hedge funds and other activists have been citing poor stock price performance and stalled growth as evidence of management failures in an effort to bolster their demands for spin-offs and other corporate restructurings. With cash currently accounting for approximately 7.1% of corporate assets—the highest percentage in nearly half a century—activists have been pressing companies to deploy capital in stock buybacks, dividends, acquisitions and other transactions to spur short-term gains for investors. In addition, although the number of proxy fights declined sharply this year, activist pressure continued and many activist demands for board seats were settled before they ripened into a proxy fight.
Healthy companies as well as companies with financial difficulties are increasingly vulnerable to hostile approaches and other activism due to recent corporate governance trends. In particular, many companies have dismantled their staggered board structures, adopted majority voting standards, let their shareholder rights plan lapse and made other changes in response to activist demands and the threat of “withhold” or “against” vote recommendations by ISS. This year, for example, the number of proposals seeking to allow shareholders to act by written consent more than doubled since 2010. Nelson Peltz of Trian Fund Management has predicted that recent corporate governance changes will enable activists to make investments in the heretofore “untouchables”—companies with market capitalizations over $50 billion.

Boards can and should be prepared to reject inadequate offers and other demands that are not in the best interests of their companies. In the Airgas case decided earlier this year, the Delaware Court of Chancery reaffirmed the principle that a steadfast board, confident in management’s long-term business plan, can block opportunistic bids. The board of Airgas had rejected a hostile all cash, fully financed offer made by Air Products, and Air Products had launched a proxy contest to replace the members of Airgas’s staggered board and sought to force the Airgas board to redeem its shareholder rights plan. In upholding the validity of the shareholder rights plan, the court concluded that “the power to defeat an inadequate hostile tender offer ultimately lies with the board of directors.” Shortly thereafter, Air Products terminated its 16-month pursuit of Airgas. Airgas’ shares are now trading well above Air Products’ “best and final” bid.

Advance planning is the cornerstone of good takeover defense. Boards must be prepared to act quickly to resist attacks and/or maximize shareholder value in the event a transaction is ultimately consummated. Boards should periodically review their takeover defenses and areas of potential exposure, taking into account changes in the legal, regulatory and financial environments. As part of this process, boards should identify and maintain dialogue with their critical response team (including financial, legal and other advisors), ensure that their advance notice bylaws are state of the art, continually monitor their shareholder base, and pay attention to investor relations to develop an understanding of shareholder perspectives on the company.

Last month we issued a memo with a more comprehensive outline of takeover preparedness considerations (see Takeover Response Checklist).

8. **Crisis Management**

The upheaval and volatility precipitated by the financial crisis has tested the crisis management skills of many directors, with situations ranging from the unexpected departures of CEOs and other senior executives, rapid deterioration of business conditions, impending liquidity shortfalls, risk management failures or major disasters, public uproar over executive compensation packages and many other challenges. Boards should be carefully attuned to the risk profiles and vulnerabilities of their companies, with a view toward anticipating potential crises.

Once a crisis starts to unfold, boards need to be proactive in taking the reins. The first decision a board must make is whether the CEO should lead the company through the crisis. If the CEO is part of the problem or is otherwise compromised or conflicted, someone else—often one of the other directors—should take a leadership role. If the CEO is not compromised
or conflicted, the CEO should lead the company’s response to the crisis.

In some cases, boards appear either to have overreacted, or to have placed matters in the hands of lawyers, accountants and other outside experts, and thereby lost control of the situation to those outsiders. In particular, the proliferation of independent investigations by special committees (or by audit committees), each with its own counsel and perhaps forensic accountants and other advisors, can be time-consuming and distracting, can sour relationships between independent directors and management, and in extreme cases can result in the lawyers for the special committee hijacking the company and monopolizing the attention of directors and senior management.

Each crisis is different and it is difficult to give general advice that will be relevant to any particular crisis without knowing the facts involved. That said, in most instances when a crisis arises, the directors are best advised to manage through it as a collegial body working in unison. While there may be an impulse to resign from the board upon the discovery of a crisis, directors are best served in most instances if they stay on the board until the crisis has been fully vetted and brought under control. Trusted and experienced advisors can be helpful in assisting the board to gather information and evaluate options, but directors should maintain control and not cede the job of crisis management to outside advisors.

III. KEY ROLES AND RESPONSIBILITIES OF BOARDS

The most effective boards tend to be those that take the time to go beyond the generally prescribed “best practices” and craft bespoke procedures and structures that are calibrated to the needs of the company. In many respects, the process is about finding the right balance in the absence of bright lines, including a balance between the board’s monitoring and advisory functions, and a balance between a “hands on” approach to oversight and more direct engagement in the management of the company.

While the board has always had a dual role as a resource for and advisor of management, on the one hand, and as the monitoring representative of the shareholders on the other, politicians, regulators and activist shareholders have been pushing to tip this balance more and more in favor of the board’s monitoring role. The monitoring role has also gained increasing prominence as a result of the emphasis on effective risk management. A combination of the monitoring and advisory roles is, however, necessary for a board to be truly effective, and each board must find the right balance.

Another key component of a board’s effectiveness is its ability to effectively oversee management—by cultivating dialogue and transparency, asking the right questions, challenging assumptions, and monitoring the flow of information to the board in order to ensure a thorough understanding of the company—while at the same time maintaining its fundamental role of oversight rather than direct management of the company. The challenge is to advise and guide management without preempting their responsibility for running the business.

Board procedures should be fine-tuned to reflect the specific circumstances and challenges facing the company, and each board should look to craft a modus operandi that works for that board. In principle, however, core board functions should include, in addition to func-
tions discussed above, the following:

1. **Setting a Tone at the Top**

   One of the most important factors in ensuring that a board functions effectively and is able to meet all of its responsibilities is having the right “tone at the top” of the corporation. The tone at the top shapes corporate culture and permeates the corporation’s relationships with investors, employees, customers, suppliers, regulators, local communities and other constituents. The board should work with the CEO and senior management to actively cultivate a corporate culture that gives high priority to ethical standards, principles of fair dealing, professionalism, integrity, full compliance with legal requirements and ethically sound strategic goals. In addition, the board should set the standards of social responsibility of the company, including with respect to human rights, and monitor performance and compliance with those standards.

   In setting the tone at the top, transparency and communication is key: the board’s vision for the corporation, including its commitment to ethics and zero tolerance for compliance failures, should be set out in the annual report and communicated effectively throughout the organization. The company’s code of conduct and ethics should be incorporated into the company’s strategy and operations, with appropriate supplementary training programs for employees and regular compliance assessments.

2. **Risk Management**

   The board’s role is one of informed oversight rather than direct management of risk. The board cannot and should not be involved in the company’s day-to-day risk management activities. The directors should determine the company’s reasonable risk appetite (financial, safety, reputation, etc.), and satisfy themselves that the risk management processes designed and implemented by executives and risk managers are adapted to the company’s strategy and are functioning as directed, and that necessary steps have been taken to foster a culture of risk-adjusted decision-making throughout the organization. Through its oversight role, the board can send a message to the company’s management and employees that comprehensive corporate risk management is neither an impediment to the conduct of business nor a mere supplement to the company’s overall compliance program, but is instead an integral component of the company’s corporate strategy, culture and value-generation process. Where board committees are responsible for overseeing different areas of risk management, the work of these committees should be coordinated in a coherent manner so that the entire board can be satisfied as to the adequacy of the risk oversight function and the company’s overall risk exposures are understood.

3. **Director Education and Information**

   The financial crisis highlighted the complexity of many financial, risk management and other issues facing companies today, and there has accordingly been a renewed focus on the information and education programs provided to directors. To enable the board to effectively perform its monitoring functions, the board and management should together determine the information the board should receive and periodically reassess its information needs. The key is to provide useful and timely information without overloading the board with, for example, all information that the CEO and senior management receive. As a starting point, the board
should receive financial information that readily enables it to understand results of operations, variations from budget, trends in the business and the corporation’s performance relative to peers. In addition, the board should receive copies of significant security analysts’ reports, press articles and other media reports on the corporation. By tracking these reports and articles, the board will avoid not only unpleasant surprises but also the possibility of being accused of ignoring problems that were known to others and that could have been known by the directors. The board should also promote lines of communication that will foster open and frank discussions with senior management, and management should be comfortable in informing the board or relevant committees of issues, developments and concerns.

In addition, boards should consider the desirability of an annual two- to three-day board retreat with the senior executives and, where appropriate, outside advisors, at which there is a full review of the corporation’s financial statements and disclosure policies, risk profile, strategy and long-range plans, budget, objectives and mission, succession planning and current developments in corporate governance. To the extent that directors lack the knowledge required for them to have a strong grasp of current industry and company-specific developments and specialized issues, companies should consider the usefulness of tutorials for directors, as a supplement to board and committee meetings. Training and tutorials should be tailored to the issues most relevant and important to the company and its business. Site visits may also be valuable for directors where physical inspection is important for more fully understanding the business and operations of a company. Nearly 90% of the public company directors surveyed for the 2011 NACD survey indicated that they make on-site visits, most commonly once a year.

Companies should also provide comprehensive orientation for new directors. The annual retreat could satisfy a major portion of such an orientation. The content of orientation and training programs should be reviewed to make sure that such programs enable new directors to gain an understanding of the company’s business quickly, and an overview of the company’s risk profile should be incorporated into that training. If necessary, additional time and content should be devoted to educating new directors so that they have a full picture of the company.

4. **Shareholder and Other Constituency Relations**

Shareholder relations have become increasingly complicated as a result of activist trends, and each year they require greater attention by the board. The same is true for relations with creditors, employees, suppliers, customers and communities. Recent reforms such as the advent of say on pay votes are prompting a renewed focus on the proper role of direct dialogue between boards and shareholders, as well as the benefits and disadvantages of more open, regular lines of communication. Some activists, for example, have been seeking direct dialogue not only with companies that have had operational or other performance issues, but also more generally with companies in which they invest. Towards the beginning of 2011, Walden Asset Management suggested that, in addition to quarterly earnings results calls, companies should have an annual conference call with institutional investors to discuss corporate governance and other matters in the proxy statement for the meeting.

While the board should ensure that the company has an effective shareholder relations program, management should generally be the primary caretaker of shareholder and constituent relationships. However, where shareholders request direct communications with the
board, it may be desirable for directors, in appropriate circumstances and following consultation with management, to accommodate such requests. In any event, management and the directors should speak with a unified voice to avoid confusion in the company’s public posture, and they should work together toward the shared goal of avoiding contentious relationships with shareholders and other constituents.

5. **Long-Term Strategy**

   Approval of the company’s long-term strategy is a key board function and an integral part of its role as business and strategic advisor to management. Approximately 72% of directors surveyed by the NACD in 2011 indicated that “strategic planning and oversight” was their top priority for the year. Strategy, business plans and the annual budget should be formulated initially by management and then developed fully in an interactive dialogue with the board, with reassessments as economic conditions develop. As part of the strategic review, the board should also consider the company’s vulnerabilities and other contingencies and determine an appropriate risk appetite for the company. The board should oversee major capital expenditures, acquisitions and divestitures, and other major initiatives undertaken as part of the company’s overall strategic plan.

   Pressures to focus unduly on short-term stock price performance present real challenges to maintaining long-term growth strategies, and the board’s ability to craft a strategic vision and manage these pressures are essential to the overall best interests of the company. In addition, the board should consider all of the company’s constituencies—including shareholders, employees, creditors, customers and local communities—in determining how best to position the company for long-term health, growth and value, which will inure to the benefit of each of these constituencies. An important aspect of this is determining how best to communicate clearly the company’s long-term strategy, as well as appropriate milestones and measurements of progress with respect to that long-term strategy, in order to establish credibility with shareholders and other constituencies.

6. **Monitoring Performance and Compliance**

   While the corporation laws literally provide that the business of the corporation is to be managed by or under the direction of the board of directors, it is clear that the board’s function is not actually to manage, but rather to oversee the management of the company. The role of the board as strategic and business advisor to management as noted above is part of this oversight. The other part is monitoring the performance of the company and management, including monitoring customary economic metrics as well as compliance with laws and regulations. The board does not have a duty to ferret out compliance problems, but it is required to determine that the company has implemented appropriate monitoring systems, and it must take appropriate action when it becomes aware of a problem and believes that management is not properly dealing with it. The board must be sensitive to “red flags” and “yellow flags” and should investigate as warranted. Internal reporting programs have lately been an area of particular focus in light of the potentially significant awards that the SEC will now pay to whistleblowers in specified circumstances. The board should also monitor government relations policies and practices and matters affecting the public persona and reputation of the company, as well as the “tone at the top” of the
company, which, as discussed above, shapes corporate culture and permeates the company’s relationships with its constituents.

7. **The Chairman or Lead Director Position**

The principal rationale cited in support of separating the CEO and chairman positions is that separation will enhance the accountability of the CEO to the board and strengthen the board’s independence from management. However, the extent to which this holds true for any given board will vary depending on the specific circumstances and dynamic of the company’s leadership structure. In some cases, a cohesive board may find it is most effective when acting as a unified whole, rather than designating an independent chairman to serve as the focal point of board leadership. Furthermore, to be effective, a chairman must have legitimacy and credibility both with the other directors and with management, and in this regard, it is often useful to have a level of industry expertise, familiarity with the company’s business and leadership skills that is typically unquestioned in the company’s CEO.

Although activist shareholders and proxy advisors have continued to advocate for an independent chairman as a matter of universal policy, the NACD has noted an uptick this year in directors who reported a combined chairman/CEO role, with 57.5% of directors surveyed reporting a combined position as compared to 54.3% last year. In addition, the Wall Street Journal has reported that the number of executive chairmen of Fortune 500 companies who used to be CEOs of such companies increased to 35 in 2011, as compared to 17 in 2008.

Companies that do not have an independent chairman should have a lead director or a presiding director to supplement the chairman’s role by, for example: (1) presiding at board meetings at which the chairman is not present, including executive sessions of independent directors, (2) serving as a liaison between the chairman and the other independent directors, (3) approving information sent to the board, (4) approving meeting agendas and meeting schedules of the board to assure there is sufficient time for discussion of all agenda items, (5) having the ability to call meetings of the independent directors and (6) if requested by major shareholders, being available for consultation and direct communication with major shareholders where appropriate. The specific contours of a lead director’s role should be determined based on the specific needs of the company.

Each board should determine the chairman and/or lead director structure that works best for it, bearing in mind that effective board leadership is a critical factor in any board’s functioning. Whichever option is selected, SEC proxy rules require companies to disclose whether they have separated the two roles, and their reasoning for the structure they have chosen. Companies that have a combined chairman/CEO position are also required to disclose whether or not they have a lead independent director, and the specific role such director plays in the leadership of the company.