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Some Thoughts for Boards of Directors in 2013

Posted by Martin Lipton, Wachtell, Lipton, Rosen & Katz, on Monday December 31, 2012

Editor's Note: Martin Lipton is a founding partner of Wachtell, Lipton, Rosen & Katz, specializing in mergers and acquisitions and matters affecting corporate policy and strategy. This post is based on a Wachtell Lipton memorandum by Mr. Lipton, Steven A. Rosenblum, Karessa L. Cain, and Kendall Y. Fox.

I. Introduction

The years since the onset of the financial crisis have served to further increase the demands on and scrutiny of public company boards of directors. The assault on the director-centric model of corporate governance continues in the shareholder activist and political arenas, and the challenges of planning for and investing in the long-term health of the corporation have become more daunting. As the power and organization of both governance and hedge fund activists have increased, the pressure to produce short-term results has only grown stronger, regardless of whether the steps necessary to produce those results may be harmful to the corporation in the long run.

In this environment, the challenge for directors is to continue to focus on doing what they believe is right for their corporations while maintaining a sufficient understanding of shareholder sensitivities to avoid a targeted attack that could undermine their ability to act in their company's best interest. The primary focus of a director, of course, should be on promoting and helping to develop the long-term and sustainable success of their company. This encompasses a wide range of activities, including working with management on the company's business and strategies, planning for the succession of the CEO and other key executives, overseeing risk management, monitoring compliance, setting the appropriate tone at the top and being prepared to step in to address any corporate crises that arise. At the same time, the board needs to be aware of and address shareholder demands in a constructive manner, consider how a hedge fund or other activist may view the company and its strategic alternatives and try to ensure that the company maintains a shareholder relations program that clearly articulates the reasons for the company's strategies and engenders support from the company's major shareholders. In some cases, this may include direct communication between board members and institutional shareholders.

A board need not, and should not, simply accede to every list of corporate governance “best practices” promulgated each year by governance activists and proxy advisory firms. That said, a board should proactively consider how best to organize itself and its committees to meet the increasing demands and responsibilities being placed on the board. And the board should pay attention to shareholder hot buttons, whether it be the structure of executive compensation, the separation of Chair and CEO, the adoption or maintenance of a rights plan, the use of majority voting in the election of directors, or any other issue, making conscious decisions as to the best choices for the company on these issues and developing clear explanations for those choices.

The dynamics of the current environment continue to increase the amount of time and energy that board service requires, the volume and complexity of information that directors are expected to digest and the reputational risks that directors face. Although management is responsible for the day-to-day operation of the business, and the board’s role is primarily one of supervision and advice, many directors are finding that to be truly effective in today’s environment, they are required to take a more active role than in the past. Given this reality, directors should consider the commitment that is required in joining a board, and weigh the other demands on their time, before making the decision to accept a new board position.

A few of the more notable issues that boards will face in the new year are highlighted below.

II. Key Issues Facing Boards in 2013

1. Short-Termism

Much attention has been given by governance activists and academics to the “agency” problem of corporate governance. Viewed through this lens, managers and directors are agents of the shareholders and the central goal of corporate governance is to ensure that these agents carry out the wishes of their principals — the shareholders. This view has given rise to the shareholder-centric model of corporate governance, under which anything that gives shareholders more power is good. Far less attention, however, has been given to the fact that, in today’s world, institutional shareholders, hedge funds and the like are also agents, managing and investing other people’s money. Similarly, little attention has been paid to the fact that the incentive structures created for these money-manager agents are wildly skewed to short-term results, not-withstanding that their principals, who are investing for retirement, financial stability and wealth to pass on to their children and their children's children, would be better served by a system that rewarded the long-term health and growth of our companies and our economy.

Historically, the academic and activist communities have used the efficient market hypothesis, the theory that stock prices at all times reflect the intrinsic value of the underlying companies, to support their short-term focus. Under this theory, any action that increases a company's immediate stock price must be good. The corollary to this proposition is that anything that might enable a board of directors to resist a demand for the sale or break-up of a company, or other short-term "value-maximizing" action, should be eliminated. Raiders, hedge fund activists and the like, the argument goes, should not be impeded by poison pills, staggered boards and the business judgment rule. Over the last several decades, the principal-agent model of corporate governance, the efficient market hypothesis and the cry for shareholder democracy have spawned an army of more than 100 activist hedge funds, protected on the flanks by ISS, the Council of Institutional Investors, and union and public pension funds.

Recently, however, some academics, jurists and other observers have begun to call into question these models and theories. Economists have long recognized the flaws of the efficient market hypothesis, pointing to bubbles, trends, herd mentality and crashes as evidence that, at least in the short run, markets are inefficient. Others have begun to spotlight the systematic short-term biases introduced into the market by the compensation structures common to the managers of hedge funds and institutional shareholders. Several well-regarded governmental and academic studies have attributed the 2008 banking crisis to the banks succumbing to the short-term pressures of investors. These studies have recommended or mandated governance and board policy changes to resist such pressures. Requiring directors with banking experience, without regard to diversity and technical independence, has been at the forefront of these recommendations. The voices decrying short-termism are just beginning to swing the governance pendulum back from its shareholder-centric direction. Given the continued campaign being waged by governance and hedge fund activists for ever more shareholder power, these voices need to be supported and nurtured.

2. Shareholder Activism

The growing shift from director-centric to shareholder-centric governance in recent years has facilitated the frequency and effectiveness of attacks on public companies by hedge funds and other activist investors. In the past ten years, there have been more than 300 activist attacks on major companies, and this trend has been accelerating, with the number of campaigns aimed at obtaining board representation or forcing short-term "value-maximizing" actions through September 2012 increasing by 31% over the same period in 2011. The trend is even starker among large public companies — the number of companies with a market capitalization of over $1 billion that have been targeted in 2012 through September has increased by 289% as compared to the same period in 2009. Careful and proactive planning to respond to these attacks has never been more important.

The "value-maximizing" initiatives demanded by activists have been predominantly focused on short-term value drivers — such as requests for special dividends, share repurchases, divestitures and spin-offs of businesses and other fundamental deviations from long-term corporate strategy — and are typically coupled with a threatened or actual proxy contest to install directors who will facilitate such initiatives. In waging these campaigns, activists have been using a variety of tools and have not hesitated to employ creative and aggressive tactics. These include the use of total return swaps and other derivatives to avoid disclosure requirements or to acquire voting power that does not correspond with their economic stake in a company; exploiting the ten business-day loophole in Section 13(d) reporting requirements to amass a significant shareholding position in the period of time before the position must be disclosed; and abusing the passive investment exemption from reporting requirements under the Hart-Scott-Rodino Act. In addition, activists have been the beneficiaries of favorable proxy advisor policies — particularly ISS's frequent support for dissident nominees in short-slate proxy contests — as well as the steady erosion over the past decade of takeover defenses, which has been led by ISS's proxy voting policies.

Notwithstanding these trends, companies can and do successfully defend against activist attacks. There is no one secret to a successful defense, but there are a number of steps that may be helpful. The board and the company should develop and continually refine a long-term strategy that can be clearly articulated and justified. As part of an annual strategy review — or more frequently if warranted by business and other developments — directors should work with management to take a closer look at the company's business portfolios and strategy, bearing in mind the perspectives of major shareholders and potential activist criticisms. Directors can help management in this review by focusing on the business from a shareholder point of view. In some cases, such perspectives can bring useful insights, whereas, in others, they may unduly emphasize short-term gains at the expense of long-term value creation. But, in either event, the exercise allows the board and the company to make conscious decisions as to the best direction for the company. And if an activist or other shareholder makes a proposal or advocates a strategy that the board has already considered and rejected, the company will be able to explain why the proposal or strategy is not in the company's best interest.

Governance and executive compensation policies should also be reviewed pragmatically and tailored to the company's needs and circumstances. The board should be aware of the policies and views of major shareholders and proxy advisory services on these issues, but should not abdicate its role in deciding what works best for the company. The board and the company should, however, be able to explain why they have made the decisions they have made. This process also helps a company's ability to cultivate credibility and long-standing relationships with significant shareholders. In this regard, the support and efforts of independent directors can be particularly helpful.

A more comprehensive outline of matters to be considered in putting a company in the best possible position to prevent or to respond to hedge fund activism may be accessed at this link: Dealing with Activist Hedge Funds.

3. Balancing the Roles of Business Partner and Monitor

The principal-agent theory of corporate governance and the shift towards a shareholder-centric model has diverted attention away from one of the most important roles of a board of directors — its role as business partner to management. Although a board also serves the role of a monitor of management, and must be ready to step in when necessary to exercise that role, in normal times the interests of the company are best served when directors and management can work together as business partners to promote and improve the business, operations and strategy of the company. So long as independent directors are able and willing to assert their independent judgment when it is needed, there is nothing wrong with directors and management developing relationships of mutual respect, trust and friendship. This type of relationship facilitates the ability of directors to have meaningful input into the key business decisions of the company and the ability of management to draw on the expertise, judgment, experience and knowledge of the company's directors. Indeed, if a director does not trust and respect management, it probably means that it is either time for the director to leave the board or, if the view is shared by the other directors, for the company to look for new management.

The governance activism and political narrative of the last several years has focused primarily on the board's role as monitor of management. The emphasis of the independence of directors, the push for non-executive board chairs, the focus on executive compensation and the independence of compensation committee advisors, the growing trend towards the creation of special committees and the engagement of independent advisors to the board in a variety of contexts are all directed towards enhancing the monitoring role of the board. To be sure, the monitoring role is an important one, and there is a place for the use of each of these tools in the appropriate circumstances. But an overemphasis on the monitoring function of the board, and the overreliance on independent advisors to the board, particularly if it comes at the expense of the role of the board as business partner, threatens to create a dysfunctional situation that can undermine the ability of the company's business to succeed and thrive.

4. CEO Succession Planning

The single most important responsibility of the board is selecting the company's CEO and planning for his or her succession. While CEO volatility was down in 2012, with a 10.3% turnover rate, 2011 featured the highest turnover rate at Fortune 500 and S&P 500 companies since 2005, at 12.6%. This compares to an overall average of 11.9% between 1995 and 2012. The front-page publicity surrounding recent turnovers at major corporations — including Apple, Hewlett-Packard, Yahoo!, Citigroup, Lockheed Martin and Best Buy — underscores the need for advance preparation in the event of both expected and unexpected departures.

Succession planning is not a check-the-box activity for boards. In making succession planning decisions, directors should not unduly defer to the current CEO, rely on résumés, or otherwise outsource the process. Instead, the directors leading the process should take it upon themselves to get to know each of the candidates personally. With respect to internal candidates, one step toward achieving this may be greater exposure of senior company officers to the board. Pipeline development should be a key initiative, and internal candidates should be carefully considered. Indeed, promotion from within has often proven to be far more successful than hiring a CEO from the outside. Booz & Company's 2011 CEO Succession Report, for example, found that between 2009 and 2011, CEOs promoted from within the company delivered higher shareholder returns and served longer terms. Boards should also exercise their independent judgment when pressure is brought to replace a CEO due to indiscretions or other perceived inappropriate conduct. In some cases, of course, replacement may be necessary. But a board should evaluate whether the company and its businesses may be harmed by replacing a CEO, as opposed to imposing some lesser punishment, when the indiscretion or inappropriate conduct does not truly mandate removal.

5. Board Composition

Recruiting and retaining a balanced board of directors — with the right mix of industry and financial expertise, objectivity, diversity of perspectives and business backgrounds — continue to be key challenges for boards. Achieving this balance is complicated by a number of factors. First, the emphasis on ultra-stringent standards of independence often comes at the expense of industry expertise and familiarity with the company's business, and boards today have limited flexibility under applicable stock exchange standards and governance activists' "best practices" to manage this tradeoff. Second, the workload and time commitment required for board service continues to escalate; the 2012 Public Company Governance Survey of the National Association of Corporate Directors reported that public company directors spent on average over 218 hours performing board-related activities, compared to the 155 hours reported in 2003. Finally, individuals who possess top credentials, the requisite independence and other sought-after qualities, and who are willing and able to shoulder the substantial time commitment required, may nevertheless be discouraged from serving on boards due to the very real reputational risks of withhold-the-vote campaigns, sensationalist publicity over executive compensation, shareholder litigation and the potential for high-profile product failures or other risk management lapses.

Another hurdle to achieving a balanced board — namely, the lack of gender and other diversity on boards of directors — gained greater prominence in 2012 in light of the European Union's proposal to impose quotas for women directors on boards of EU companies. The law, as proposed, would require women to comprise at least 40% of non-executive directors at Europe's listed companies. The proposal highlights statistics for EU-listed companies: 8.9% of executive board members, 15% of non-executive board members and 3.2% of boardroom chairs are female. The percentages of women on boards of U.S. companies are similar: 16.1% of board members and 2.6% of boardroom chairs.

While diversity, including gender diversity, is an important factor in facilitating a range of perspectives in boardroom discussions, boards should be careful not to overemphasize diversity at the expense of other qualifications. The single most important factor in determining the effectiveness of boards is the competence of those who serve as directors. The ability of the members of the board to work together, and with management, in a collegial and constructive fashion is also key. Legislating one-size-fits-all requirements for boards of public companies is unwise and can have unintended consequences, as illustrated by the emphasis on independence requirements for directors. Determining board composition requires a thoughtful, individualized approach in which all factors are taken into account.

6. Special Investigations

As the financial crisis demonstrated, one of the key roles that a board must fulfill, when and if the need arises, is to provide careful guidance and leadership in steering the company through a crisis. The board should maintain an active role and should not cede control to lawyers, accountants and outside experts. Independent investigations by special committees (or by audit committees), each with its own counsel and, in some cases, forensic accountants and other advisors, pose a particular risk of spiraling out of control without steady oversight by the board. Despite good intentions, the expense of internal investigations can balloon to unreasonable proportions. As we have previously warned (see The Board's Role in Overseeing Special

Investigations), in many instances, internal investigations may ultimately cost a company far more than the relatively minor amounts involved in the alleged misconduct. Noting this fact, Chancellor Leo Strine of the Delaware Court of Chancery opened a 2010 decision by saying, “This is an unfortunate case in which it is clear that the parties have spent far more money investigating and litigating over certain matters than those matters involved.”

It goes without saying that, if there is credible evidence of a violation of law or corporate policy, the allegation should be investigated and appropriate responsive actions should be taken. The board, however, should be mindful not to overreact, and judgment should be applied to determine, among other things, the appropriate scope and objectives of the investigation. For example, while the U.S. Sentencing Guidelines offer reduced penalties to companies that have effective compliance programs and take reasonable steps to respond to misconduct, this does not mean that companies will get credit for going overboard. Once an investigation begins, the board should actively supervise special committees and advisors, and periodic reviews should take place as a “sanity check” on those who are conducting the investigation.

7. Say on Pay

In 2012, the second year of mandatory “say on pay” votes under Dodd-Frank, companies continued to be largely successful in obtaining favorable shareholder votes on their executive compensation. While failure rates remained low — only 53 Russell 3000 companies (2.6%) failed to obtain majority shareholder support — there was an uptick in negative say on pay votes from 2011, during which the same companies saw only 38 failures (1.4%). One factor that clearly influenced the failure rate was ISS recommendations. Where ISS recommended “against” say on pay, shareholder support, on average, was 30% lower than where ISS recommended “for” the proposal.

ISS’s negative recommendations largely resulted from a perceived “pay for performance disconnect.” Such a disconnect exists, under ISS’s voting recommendation policies, where (i) there is a lack of alignment between CEO pay and total shareholder return, as compared to an ISS-selected peer group and (ii) the company’s compensation, from a qualitative perspective, is not sufficiently performance based. ISS’s pay for performance criteria has continued to face criticism by companies and commentators alike, particularly with respect to the peer groups used by ISS to evaluate whether a pay for performance disconnect exists. Indeed, in many cases, ISS’s peer group selection has borne little relation to the peers against which a company might actually assess its own performance. In response, as part of its 2013 policy updates, ISS will take into account a company’s self-selected peer group when choosing companies for the ISS peer group, and it will, to some extent, relax its requirements relating to size of peer companies considered, thereby permitting companies with larger and smaller market capitalizations to be considered peers.

While a failed say on pay vote will undoubtedly bring unwanted negative attention to a company's compensation policies and, by extension, the board's oversight decisions, the legal ramifications are limited. In fact, Dodd-Frank expressly states that the shareholder vote "may not be construed" to "create or imply any change to the fiduciary duties of such issuer or board of directors" or to "create or imply any additional fiduciary duties for such issuer or board of directors." This status quo was affirmed in January 2012, when a federal court dismissed a suit against bank directors arising out of a negative say on pay vote, finding that Dodd-Frank did not alter directors' duties and that a negative vote does not suffice to rebut the business judgment protection for directors' compensation decisions. Similarly, in October 2012, a federal court and a state court separately refused to enjoin shareholder say on pay votes despite allegations of inadequate executive compensation disclosure.

In assessing executive compensation, boards should bear in mind that their ultimate goal is not to secure a successful say on pay vote, but rather to attract, retain and incentivize executives who will contribute to the long-term value of the company. In that regard, although compensation consultants can be a useful source of advice, as a practical matter, they may be particularly sensitized to the publicity surrounding a negative say on pay vote and, as a result, motivated to err on the side of caution and follow the ISS preferred approach as the path of least resistance. Directors should be aware of the executive compensation guidelines that ISS and similar groups promote, but should not allow this to override their own judgments as to the compensation programs that are best for their companies. Directors should also be prepared to participate in soliciting favorable say on pay votes from major shareholders in order to overcome a negative recommendation by ISS.

8. Corporate Governance "Best Practices"

With very few exceptions, governance activists have achieved most of the reforms they have sought to effectuate. According to Spencer Stuart's 2012 U.S. Board Index, 84% of S&P 500 companies have adopted a majority voting standard, 83% have annually elected boards, and 84% of their directors are independent — to name but a few of the more trendy governance issues in recent years. However, those who make their living in the corporate governance industry will undoubtedly continue to push these proposals at smaller companies, and come up with additional requirements and heightened standards to propose with each new proxy season. By way of example, ISS's 2013 corporate governance policy updates tighten its board responsiveness policy and recommend that shareholders vote "against" or "withhold" their votes for incumbent directors who fail to act on a shareholder proposal that received the support of a majority of votes cast in the previous year, as compared to ISS's prior standard which looked at whether the proposal received a majority of *outstanding* shares the previous year or the support of a majority of votes *cast* in *both* the last year and one of the two prior years.

One byproduct of the proliferation and institutionalization of corporate governance mandates has been the advent of the corporate governance board secretary role. In light of the substantial time required to monitor, manage and respond to corporate governance developments — including Rule 14a-8 shareholder proposals, say on pay shareholder outreach campaigns, implementation of the latest SEC and stock exchange requirements and the various governance decisions that must be disclosed and explained in the company's proxy statement — many companies have accumulated a sufficiently critical mass of governance-related work to warrant the creation of a corporate governance board secretary role. If such a role is created, however, care should be taken to ensure that the corporate governance secretary's ultimate objective is to assist the board in pragmatically assessing the merits and drawbacks of corporate governance choices, rather than reflexively advocating the latest ISS recommendations and other purported best practices. While a corporate governance secretary may be able to contribute valuable expertise and advice, directors should make their own reasoned and independent decisions on governance matters that take into account the specific needs of their companies.