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Future of the Board of Directors
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In an effort to think about the board of directors of the future, we need to start with what we expect the board to do today and the rules we have set governing how directors are selected, how they function and how they relate to shareholders – not only the legal rules but also the aspirational "best practices" that we have allowed to influence corporate and director behavior. We also need to look at how corporate management and boards are perceived by the media, the public and elected officials in the post-financial crisis era.

We expect boards to:

- Choose the CEO, monitor his or her performance and have a detailed succession plan in case the CEO becomes unavailable or fails to meet performance expectations.
- Provide business and strategic advice to management and approve the company's long-term strategy.
- Determine the company's risk appetite (financial, safety, reputation, etc.) and monitor the management of those risks.
- Monitor the performance of the corporation and evaluate it against the economy as a whole and the performance of peer companies.
- Monitor the corporation's compliance with legal and regulatory requirements and respond appropriately to "red flags."
- Take center stage whenever there is a proposed transaction that creates a seeming conflict between the best interests of stockholders and those of management, and sometimes even when the conflict is more imagined than real, including takeovers.
- Set the standards of social responsibility of the company, including human rights, and monitor performance and compliance with those standards.
- Oversee government and community relations.

- Determine executive compensation.

- Interface with shareholders.

- Plan for and deal with crises.

- Approve the company's ethical standards and programs and take responsibility for "tone at the top."

- Monitor and evaluate the board's own performance and seek continuous improvement.

We require the board to be made up of a majority of independent directors. While the rules of the stock exchanges require only a majority, the guidelines of many institutional investors and governance advisory organizations have specified a "substantial" majority or a specific percentage. In fact, many major corporations today have boards whose only non-independent director is the CEO, or that have only one other director who is not independent. Further, the definition of independence is periodically adjusted by governance activists and advisory organizations to be more stringent than the definition in the stock exchanges rules.

It is interesting to note that it is not at all clear that director independence is the fundamental keystone of "good" corporate governance. The world's most successful economy was built by companies that had few, if any, independent directors. It was not until 1956 that the NYSE *recommended* that listed companies have two outside directors and it wasn't until 1977 that they were *required* to have an audit committee of all independent directors. In 1966 when the Standard Oil Company added outside directors, the New York Times reported that it would require the board to rethink its schedule of meeting *every day* at 11 AM.

Independence became the touchstone during the takeover era of the 1970's-1980's. Governance theorists were so convinced that any takeover bid at a premium to market was desirable that they viewed takeover defense with deep suspicion and deemed it a result of structural conflict – as if only managers intent on keeping their jobs could justify not selling the company whenever and however a takeover bid was made. The antidote seemed obvious to those who considered all management incapable of seeing beyond their own personal interests: populating boards with men and women with as little connection to the enterprise as possible, and demonizing any board that saw itself as something more than just auctioneers. The ideal became a board with as little or no true “skin in the game” in the sense of a felt connection to the business and its long-term viability, continuity and success.

In addition to independence, we think directors should have relevant business experience, leadership ability and the strength of character to challenge management. Finally, we seek gender and ethnic diversity; availability and commitment such that few if any board and committee meetings are missed; and willingness to serve for compensation that does not fully reflect the scope of the expected commitment and the exposure to litigation and reputational damage when something goes wrong.

At the same time as we have set these stringent expectations for performance and personal qualifications, we have allowed the playing field on which the board of directors performs to tilt in favor of shareholders who seek short-term profits rather than long-term growth. To quote the title of a brilliant speech Vice Chancellor Leo Strine of the Delaware Court of Chancery gave at Stanford University last month, “One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed For The Long Term Unless Their Powerful Electorates Also Act And Think Long Term?”

Underlying the academic thinking about corporate governance is the “agency theory” first put forth by Adolph Berle in 1931. Ever since, academic writers have embraced the concept that shareholders are the true owners or “principals” of the company, and that corporate directors are their “agents,” with the duty to maximize shareholder wealth and carry out the shareholders’ directions. As Profs. Jay Lorsch and Rakesh Khurana of the Harvard Business School said in an interesting paper on executive compensation published this year,

> “Few ideas about business have been as quickly and widely embraced not only by directors and executives, but also by the bankers, consultants, and lawyers who advise them, as well as by the Delaware Court of Chancery. Prominent business organizations switched from advocating a “stakeholder view” in corporate decisionmaking to embracing the “shareholder” maximization imperative. In 1990, for instance, the Business Roundtable, a group of CEOs of the largest U.S. companies, still emphasized in its mission statement that “the directors’ responsibility is to carefully weigh the interests of all stakeholders as part of their responsibility to the corporation or to the long-term interests of its shareholders.” By 1997, the same organization argued that ‘the paramount duty of management and of boards of directors is to the corporation’s stockholders; the interests of other stakeholders are relevant as a derivative of the duty to the stockholders.’”

The combined effect of the agency theory, Sarbanes-Oxley, the stock exchange governance rules, SEC regulations, the Institutional Shareholder Services Company (ISS) and the Council of Institutional Investors (CII) pressure and the corporate governance provisions of the pending financial industry regulation bill is to exalt short-term shareholder interests over that of all the other stakeholders—and of the American economy and the American public. The assumption that empowering shareholders and promoting their interests will lead to better performance and more efficient management of corporations, and that shareholder interests are therefore aligned with those of other stakeholders, is contradicted by the short-term trading objectives of many of the major institutional investors and hedge funds. It was the taking of undue risks in an effort to meet the short-term profits demands of shareholders that was a root cause of the financial crisis.

I might note that in 1979, I published a widely cited article arguing that the stakeholder theory—not the agency theory—should determine the board's fiduciary duties. Although fiercely attacked by the Chicago School of Law and Economics academics, my article was relied upon by the Delaware Supreme Court in 1985 in the famous Unocal case and has subsequently been embraced by legislation in more than 30 states and enshrined in the new British corporation law. Notwithstanding what is now established law permitting boards to reject short-term goals in favor of long-term objectives, institutional and activist investors, and their advisors like ISS, continue to vote for short-term while paying lip service to long-term.

With this as background, we turn to the question of the day, "what will the board look like and how it will operate in the future." Here let me emphasize that these are general thoughts applicable to major public corporations and are in no way intended to be a checklist of best practices or legal requirements. Contrary to the course currently being pursued by Congress, the SEC and the governance activists, one size does not fit all and it is bad policy to impose check-the-box governance.

The Directors. There will continue to be a substantial majority of independent directors on corporate boards. There will be significant gender and ethnic diversity. While we will not prescribe percentages for gender diversity, we will be somewhere between (a) the new UK Corporate Governance Code: "The search for board candidates should be conducted, and appointments made, on merit against objective criteria and with due regard for the benefits of diversity on the board including gender" and (b) the stronger Australian Stock Exchange proposal requiring disclosure of specific diversity objectives and their achievement and (c) the 40% female quota imposed by law in Norway and actively being considered or adopted in other European countries.

The trend to smaller boards will be reversed in order to have a sufficient number of independent directors for the audit, nominating and compensation committees and to add directors who have special expertise and are not necessarily independent. For example, the financial crisis called attention to directors of financial institutions who did not have the expertise to fully understand the risks of complicated derivatives and other hi-tech financial instruments. To remedy the situation, the banking regulators are now insisting that experienced bankers be added to the boards. At Citigroup, Diana Taylor, former N.Y. State Banking Superintendent, became a director last year and last month it was reported that she would chair the nominating and governance committee. Also at Citi, Robert Joss, a former Wells Fargo director and Stanford University Business School dean, became a director and paid consultant. While he does not qualify as an independent director, his appointment to the board makes his experience and expertise available at board and committee meetings as a director and not just as an outside consultant.

A separate risk committee has been mandated for financial institutions and, even if not mandated for non-financial companies, will likely become common at companies where risk plays a significant role. The BP Gulf of Mexico spill, and BP's acknowledgment that it was not prepared for it, followed a BP Houston refinery explosion in 2005 that resulted in a special review, by a committee chaired by James Baker, that criticized the BP board for not properly monitoring the risk of that type of accident. To assist boards and committees with evaluating and monitoring risks and other specialized issues, there will be greater resort to obtaining opinions of expert consultants. Boards will have regular tutorials by both company employees and outside experts. Board retreats for two or three days will have longer agendas to fulfill the need for director education about specialized issues.

It should be noted that while our courts, even in cases involving multi-billion-dollar losses by financial institutions, have continued to adhere to the customary *Caremark*-case standard for determining whether directors have met their duties of care, earlier this month, the

European Commission, in a consultation paper seeking comments on options to improve corporate governance in financial institutions, suggested strengthening "legal liability of directors via an expanded duty of care". The possibility that higher standards of care for directors of financial institutions could be extended to all corporations is real. Specialized committees, use of expert consultants, tutorials and expanded director education programs will go a long way to enable boards to meet even a strengthened duty of care.

Looking out even further into the future, the time demands of board service will result in more use of modern conferencing and communication technology so that travel time is reduced, committees can meet conveniently apart from meetings of the whole board and special meetings with outside consultants can be convened whenever needed. In dealing with important issues and crises, companies will have very frequent special meetings and resort widely to outside experts.

As a result of the increased time demands of board service and the need for larger, more diverse boards with special expertise, director recruiting will become an increasingly critical challenge for many corporations.

Executive Compensation. Shareholder advisory voting on executive compensation will be effective for the next proxy season. "Say on Pay" is here and will continue. Combined with new SEC disclosure rules and greater resort to independent compensation consultants, we will have achieved the unfortunate result of transferring the fundamental role of the board to establish executive compensation to institutional investors and ISS and CII and their compatriots.

Ann Yeager, Executive Director of the CII, in a memo, "Red Flags for Say-on-Pay Voting," posted on the Harvard Law School Forum on Corporate Governance and Finance Regulation, refers to the adoption of say on pay at more than 300 companies in 2010 and goes on to list 10 principal and 15 subsidiary red flags (problematic pay practices) of concern to CII. In effect, a 25 item checklist that boards and compensation committees are instructed to follow on pain of the CII advising its members to vote against the company's compensation program.

Separation of Chairman and CEO. While separation of Chairman and CEO roles is not mandated by the pending financial industry regulation bill, the bill does require disclosure of whether the roles are split—something the SEC has already required companies to discuss in proxy statements. In light of the strong support for separation in the activist governance community and the implicit endorsement by Congress and the SEC, pressure through shareholder proxy resolutions will continue to grow. It is reasonable to assume that in a few years separation will be more widespread.

Shareholder Control. While the financial industry regulation bill no longer requires the stock exchanges to adopt majority voting rules, it continues to authorize the SEC to adopt proxy access. In addition, SEC rules permit proxy resolutions designed to induce or force the company to (a) dissolve takeover defenses, (b) make it easier for shareholders to call special shareholder meetings, (c) authorize shareholders to act by written consent instead of a shareholder meeting and conduct campaigns to obtain full control and (d) enable shareholders to shape director nominating procedures and CEO succession planning. Together with NYSE rules, effective this year, that eliminated broker discretionary voting in uncontested elections, activist institutional shareholders will be more able to heavily influence, if not dictate business actions, policies and strategies at most major public companies. This raises the ultimate questions:

- Will we be able to attract the qualified directors we need in light of the limitation on their ability to take actions and adopt policies that shareholders seeking short-term gains object to?
- Will the pressure for short-term performance lead to the "Eclipse of the Public Corporation" a 1989 prognostication by famed Harvard economist, Michael Jensen?
- Will the pressure for short-term gain result in business decisions that so adversely affect stakeholders and the economy that the government becomes intrusive in the management of public corporations other than financial institutions?

While these are reasonable ruminations, I think that they will not come to pass. What will come to pass is that companies and their advisors will adjust to the reality of the new governance regime and the lives of CEOs and boards of directors will become more challenging. And, hopefully, we will over time realize the drawbacks of conceptualizing corporate governance as primarily a means to discipline managers, to arbitrarily limit the compensation of executives and to provide convenient ways for institutional and activist shareholders to dictate corporate policy in order to achieve their short-term profit interests. Instead, we should recognize that the purpose of corporate governance must be to encourage management and directors to develop policies and procedures that enable them to best perform their duties (and meet our expectations), while not putting them in a straight jacket that dampens risk-taking and discourages investing for long-term growth and true value creation.