November 17, 2010

The Future of Corporate Governance and the Board of Directors

Twenty-five years ago, Institutional Shareholder Services and the Council of Institutional Investors embarked on a crusade to change corporate governance. Since they were formed in 1985, ISS and CII have been at the forefront of the crusade by union and public pension funds, academics, activist shareholders and corporate raiders to create a shareholder-centric governance system. Today the crusade has accomplished virtually every objective that it originally set out to achieve. The shareholder rights movement has steadily pushed forward, spurred by the SEC's shareholder communications rules adopted in 1992, and then galvanized by the Enron scandal in 2001 and the financial crisis in 2008, both of which precipitated extensive legislative and regulatory reforms that encompassed the policies promoted by ISS and CII. Institutional shareholders, hedge funds, activist investors and corporate raiders are today able to exercise considerable influence over both corporate governance matters as well as key business decisions of public companies, and takeover defenses have been significantly scaled back.

In an effort to think about the future of corporate governance and the board of directors, 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 influence corporate and director behavior. We also need to look at how corporate management and boards are perceived by shareholders, the media, the public and elected officials in the post-financial crisis era, and examine the reputational and other non-legal pressures that directors face.

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.

- Plan for and deal with crises, especially crises where the tenure of the CEO is in question, where there has been a major disaster or where hard-earned reputation is threatened by product failure.

- Determine executive compensation, achieving the delicate balance of enabling the company to recruit, retain and incentivize the most talented executives, while avoiding media and populist criticism for "excessive" compensation.

- Interview and nominate director candidates, monitor and evaluate the board's own performance and seek continuous improvement in board performance.

- Provide business and strategic advice to management and approve the company's budgets and long-term strategy.

- Determine the company's risk appetite (financial, safety, reputation, etc.), set state-of-the-art standards for managing risk 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.

- Set state-of-the-art standards for compliance with legal and regulatory requirements, monitor compliance 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, including takeovers, mergers and restructuring transactions.

- 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.

- Pay close attention to investor relations and interface with shareholders in appropriate situations.

- Adopt corporate governance guidelines and committee charters.

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. 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, however, that director independence is not clearly 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 New York Stock Exchange *recommended* that listed companies have two outside directors, and it was not until 1977 that they were *required* to have an audit committee consisting solely of 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.

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.

The combined effect of the Sarbanes-Oxley Act, the Dodd-Frank legislation, the stock exchange governance rules, SEC regulations, and pressure from ISS and other advisory organizations is to exalt short-term shareholder interests over the interests of 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 simplistic and contradicted by the short-term trading objectives of many of the major institutional investors and hedge funds. To quote the title of a brilliant speech Vice Chancellor Leo Strine of the Delaware Court of Chancery gave at Stanford University in May 2010: "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?"

While the upheaval precipitated by the recent financial crisis has not fully settled and the contours of the post-crisis corporate governance landscape are still being shaped, some corporate governance policies have become firmly entrenched and will very likely continue to hold sway, whereas others may continue to develop and/or emerge as particularly relevant to boards of directors. A few thoughts about the future corporate governance and board functioning of public companies are set out below, although each company will need to assess and tailor its policies in view of its individual circumstances.

<u>Director Independence</u>. 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 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 the 40% female quota imposed by law in Norway and actively being considered or adopted in other European countries.

The trend toward 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 high-tech financial instruments. To remedy the situation, the banking regulators are now insisting that experienced bankers be added to the boards.

<u>Board Committees and Director Education</u>. A separate risk committee has been mandated for financial institutions and, even if not mandated for non-financial companies, will likely be adopted by many companies where risk plays a significant role. For example, the BP Gulf of Mexico spill, and BP's acknowledgment that it was not prepared for it, followed a BP 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 or complex 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.

Director Duties. To date 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 year, however, 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." And the possibility that higher standards of care could eventually be imposed not only on directors of financial institutions, but on directors of 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.

Time Demands of Board Service. 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, combined with liability risks, potentially higher standards of care, and the need for larger, more diverse boards with special expertise, director recruiting will become an increasingly critical challenge for many corporations. There will be a significant increase in director compensation in order to meet the increased commitment of time directors will need to make and the increased threat of legal or reputational damage to which they are exposed.

Separation of Chairman and CEO. This is the one key governance change that the governance activists have not yet achieved. While separation of chairman and CEO roles was ultimately dropped from the Dodd-Frank legislation, that legislation does require disclosure of whether and why the roles are split—something the SEC had already required companies to discuss in proxy statements. ISS has proposed to change its policy so that it will support shareholder resolutions seeking separation of the two positions unless there are "compelling company-specific circumstances that challenge the efficacy of appointing an independent chair." 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. In addition to advisory shareholder voting on executive compensation ("Say on Pay") prescribed by the Dodd-Frank legislation and proxy access adopted by the SEC following authorization by Dodd-Frank (presently in abeyance pending resolution of litigation attacking its legality), 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, as well as Dodd-Frank's elimination of broker discretionary voting on executive compensation and other significant matters to be determined by the SEC, activist institutional shareholders will be more able to heavily influence, if not dictate, business actions, policies and strategies at most major public companies.

This review of the corporate governance landscape raises some ultimate questions:

- Will we be able to attract the qualified directors we need in light of the limitations on their ability to take actions and adopt policies that shareholders seeking short-term performance 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 performance result in business decisions that so adversely affect stakeholders and the economy that the government is forced to become intrusive in the management of public corporations or to limit the power of shareholders to influence boards of directors?

While these are reasonable ruminations, I think that they will not come to pass. Instead, companies and their advisors will adjust to the reality of the new governance regime and the responsibilities 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. The September 23, 2010 Report of the NYSE Commission on Corporate Governance recognizes the problem and states the first principle of governance as follows: "The board's fundamental objective should be to build long-term sustainable growth in shareholder value for the corporation . . . ." Hopefully, along with a nascent academic recognition of the problem, the NYSE report presages an evolution that will reverse the unfortunate consequences of the corporate governance developments of the past quarter-century.

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