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Corporate Governance Update: Analyzing Aspects of Board Composition

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As the 2012 proxy season approaches, it appears that certain issues in board composition—the separation of the chairman and chief executive officer (CEO) roles (along with the related issue of the independence of the chairman) and board diversity—are likely to be more prominent this year. As boards consider these and other related corporate governance issues, directors should keep in mind that a corporate board is a complex creature, with company history, personal dynamics, and board structure all contributing to, or potentially undermining, the overall effectiveness of the board. No single factor in board composition will have the same significance at one company as it has at another; boards should seek to adopt best practices that will make them more effective, but this does not mean that governance structures such as the separation of chairman and CEO roles should be mandated. Directors facing pressure from activists should be counseled that it is the board's right and responsibility to determine its own operation, and that it is the board's duty to do so in a way that, in the business judgment of the directors, best serves the company and its shareholders.

Independent Chairmanship

Due to renewed calls from shareholder activists and policy groups for separation of the positions of chairman of the board and CEO, the issue looks to be a major topic in this year's proxy season. The American Federation of State, County and Municipal Employees (AFSCME) has filed proxy proposals to that end at twenty-one large corporations so far in 2012, including high-profile companies such as Amazon, Boeing, Goldman Sachs and JPMorgan Chase.[1] AFSCME is a powerful shareholder activist union, and its focus on independent-chair proposals this year is likely to increase pressure on companies to give the issue serious consideration and perhaps to engage in discussions on the topic with major shareholders.

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[1] See AFSCME Press Release, "Imperial CEOs Targeted as AFSCME Employees Pension Plan Announces 2012 Shareholder Proposals," Jan. 17, 2012.

One organization that has been vigorously promoting independent chairmanship is the Chairmen's Forum, a relatively new group associated with the Yale School of Management that is composed of current and former board chairpersons of North American companies. The Forum's foundational issue is the separation of independent chairman and CEO roles, as outlined in a 2009 policy paper titled, "Chairing the Board: The Case for Independent Leadership in Corporate North America."[2] The Chairmen's Forum issued a model statement last week urging boards to adopt a corporate governance policy stating that the board is expected to be chaired by an independent director and that this principle will guide succession planning and decisions.[3] The model statement also provides that, if "special circumstances" determined by the board require the chairman and CEO positions to be combined, the independent directors on the board will designate a lead independent director to serve until a new, independent chair can be appointed, and the board will explain any such decision to the shareholders.[4] The Chairmen's Forum sees succession planning as "the inflection point in moving to a fresh model of board leadership," according to the press release accompanying the model statement.[5] The Forum last month urged the New York Stock Exchange and the Nasdaq Stock Market to consider adopting listing standards to require the separation of the chairman and CEO roles.[6]

Separation of the chairman and CEO positions is not a new issue in corporate governance as it has been on the corporate governance activist wish list for many years. Virtually all public companies in the United Kingdom and Canada separate the chairman role from the CEO role.[7] That said, mere separation of the roles does not tell the full story of board leadership. One comparative study of boards in the United States and United Kingdom revealed a wide range of possible responsibilities and

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[2] The Millstein Center for Corporate Governance and Performance, Yale School of Management, Policy Briefing No. 4 (2009), *available at* http://millstein.som.yale.edu/sites/millstein.som.yale.edu/files/2009%2003%2030%20Chairing%20The%20Board%20final.pdf("Chairing the Board").

[3] BusinessWire, "Chairmen's Forum Issues Model 'Chair-on-Succession' Policy Statement for 2012," Jan. 17, 2012.

[4] *Id.* Since 2010, public companies have been required under Securities and Exchange Commission rules to disclose their board structure and explain why they have determined that their leadership structure is appropriate in light of their specific characteristics or circumstances. *See* Proxy Disclosure Enhancements, Securities and Exchange Commission Final Rule, adopted Dec. 16, 2009, effective Feb. 28, 2010.

[5] BusinessWire, "Chairmen's Forum Issues Model 'Chair-on-Succession' Policy Statement for 2012," Jan. 17, 2012.

[6] Joann S. Lublin, "Drive to Split CEO, Chairman Roles Gains Steam," WSJ, Jan. 17, 2012.

[7] "Chairing the Board" at 17. All German, Dutch, and South African public companies are required to separate the roles, and most public companies in Australia, Belgium, Brazil and Singapore do so as well. *Id.*

activities under a chairperson's purview.[8] The actual role played by the independent chairman in practice may be determined by the board's framework, the company's history, the personalities and leadership styles of the individuals involved, and myriad other factors, the sum of which may determine whether the separation (or combination) of the roles is most effective and desirable at any given company. The leadership structure itself is not nearly as important as whether it works in practice. As one position paper succinctly put it, after a review of the academic literature, "No structural attribute of boards has ever been linked consistently to company financial performance."[9]

In recent years, the number of U.S. companies that formally separate the chairman and CEO positions has increased significantly. According to one source, 41 percent of S&P 500 boards in 2011 separate the roles, as compared to 26 percent in 2001 and 33 percent in 2006.[10] Similarly, the number of independent chairmen also has been increasing, though the percentage of independent chairs is perhaps surprisingly low by comparison: 21 percent of S&P 500 companies had independent chairs in 2011, as compared to 10 percent in 2006.[11] Given the pressure from governance activists, even with no demonstrable benefit, it appears that these trends will continue. As noted by the Chairmen's Forum, succession is the most likely way for the separation of roles to proliferate, particularly with respect to companies in which the combined role is held by a longtime CEO. Nonetheless, companies are strongly advised to consider what is best for their individual circumstances rather than follow the path of least resistance in corporate governance reform.

In our experience, from a board effectiveness perspective, there is no need to separate the roles of chairman and CEO so long as there is an effective lead director in place. To a very significant degree, the role of the lead director includes many of the responsibilities that are undertaken by an independent chairman of the board.[12] In fact,

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[8] The Conference Board, Director Notes, "Separation of Chair and CEO Roles," Aug. 2011, at 2 (citing Andargachew Zelleke, "Freedom and Constraint: The Design of Governance and Leadership Structures in British and American Firms, Ph.D. dissertation, 2003, Harvard University).

[9] *Id.* at 2-3 & nn.4-6, 13-14. This source proposes the conclusion that "board effectiveness is affected by the chairman's industry knowledge, leadership skills, and influence on board process rather than by the particular leadership structure chosen." *Id.* at 1.

[10] 2011 Spencer Stuart Board Index, at 8, 22, available at http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI_2011_final.pdf.

[11] *Id.* (no data available for 2001). AFSCME has filed at least one proxy proposal, at Janus Capital, on the basis that the already separate chairman is not independent because he was formerly the CEO, though he does qualify under the applicable NYSE listing rules as independent. *See* Ross Kerber, "Exclusive: Union Targets Dual Chairman-CEO Roles," Reuters, Jan. 17, 2012.

[12] *See* Thomas P. Conaghan and Meera V. Popat, "How to Be a Good Lead Director," Boardmember.com, *available at* www.boardmember.com/Article_Details.aspx?id=4338;). For example, the Boeing Board of Directors has determined that its Lead Director will "in consultation with the nonemployee directors, advise the Chairman as to an appropriate schedule of Board meetings and review and provide the Chairman

directors have commented that lead directors and non-executive chairmen fundamentally "do the same things, regardless of which title they carry."[13] Therefore, we do not agree with the proposition that good governance necessitates the separation of the chairman and CEO roles.

Board Diversity

An increasingly prominent issue in the context of board composition is board diversity. Public companies are now required by Securities and Exchange Commission (SEC) rules to discuss in their proxy statements whether the nominating committee considers diversity in identifying nominees to the board, and if so, how it is considered. Further, if a company does have a diversity policy, the rules require disclosure of how the policy is implemented and how the effectiveness of the policy is assessed. The SEC does not define "diversity," noting that some companies may conceptualize diversity expansively and others more narrowly.[14]

The vast majority of S&P 500 companies express their commitment to diversity in terms of age, race, gender, geographic origin, viewpoints and experience, often with an eye toward reflecting the company's various constituencies.[15] Despite that goal, the percentage of women and racial minorities on boards has increased only slightly in recent years. One source reports that the percentage of women directors on S&P 500 company boards has increased from 12 percent in 2001 to 16 percent in 2011, with the percentage of boards having at least one woman increasing from 83 percent to 91 percent in the same time period.[16] The percentage of racial and ethnic minority directors has remained steady over the last several years at around 15 percent.[17]

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with input regarding the agendas for each Board meeting; preside at all meetings at which the Chairman is not present including executive sessions of the nonemployee directors and apprise the Chairman of the issues considered; be available for consultation and direct communication with the Company's shareholders; call meetings of the nonemployee directors when necessary and appropriate; and perform such other duties as the Board may from time to time designate." Boeing, "Duties and Responsibilities of the Lead Director," *available at* www.boeing.com/corp_gov/lead_director.html.

[13] Lead Director Network ViewPoints, "The relationship between the lead director and the CEO" Issue 10 (March 24, 2011) at 3.

[14] *See* Proxy Disclosure Enhancements, Securities and Exchange Commission Final Rule, adopted Dec. 16, 2009, effective Feb. 28, 2010.

[15] 2011 Spencer Stuart Board Index, at 18 (the study included 494 proxy statements filed between May 15, 2010, and May 15, 2011).

[16] *Id.* at 8.

[17] *Id.* at 22.

Historically, justifications for director diversity tended to be moral and social in nature, but the trend has been toward economic justifications as perhaps more convincing and legally appropriate in light of directors' fiduciary duties to shareholders.[18] Yet even these economic, "business case" justifications tend to be bound up with societal-oriented rationales as well, such as the ability of directors from diverse backgrounds to represent the company effectively to various constituencies, to undermine negative stereotypes, or to bring previously unheard perspectives into the boardroom.[19]

As with many elements of corporate governance, such as director independence, empirical evidence is mixed as to whether board diversity increases shareholder value. While some studies show a positive relationship between board diversity and financial performance, others suggest a negative relationship or none at all.[20] In fact, one study concluded that board diversity can have positive economic effects under some conditions and negative effects under others.[21] Another study of diversity on board committees found that "the process through which gender and ethnic diversity impacts financial performance is subtle and complex," that some board functions benefitted from diverse directors, while other functions suffered, and that the type of diversity involved was a significant factor.[22] The sensible conclusion at this point appears to be that, as with so many other elements of corporate governance, each company must examine its own individual circumstances and create a diversity policy that best suits its specific needs and goals, with regular reexamination of the policy (and its results) to ensure that it remains relevant and useful over time. We suggest that boards of directors reexamine their diversity policies annually, perhaps at the same time the board reviews its committee charters and governance guidelines.

Defense Against Activism

The shareholder activist agenda for this spring contains several issues related to board composition and governance. One of the primary agenda items likely will be, as it was last year, proxy access. Under the amended Exchange Act Rule 14a-8, effective as of September 20, 2011, eligible shareholders will have the ability to include proposals in company proxy statements for proxy access amendments to company

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[18] *See* Lisa M. Fairfax, "Revisiting Justifications for Board Diversity," The Conference Board Director Notes, Nov. 2011, at 1-2.

[19] *Id.* at 5.

[20] *Id.* at 2-3 & nn.6, 10-14 (citing numerous studies on the topic).

[21] *Id.* at 2 (citing David A. Carter et al., "Corporate Governance, Board Diversity and Firm Value," The Financial Review 38(1), 2003, at 33).

[22] David Carter et al., "The Diversity of Corporate Board Committees and Firm Financial Performance," Mar. 15, 2007, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=972763.

bylaws.[23] Institutional Shareholder Services has stated that it will make voting recommendations with respect to these proposals on a case by case basis, taking into account company- and proposal-specific factors.[24] One frequently heard rationale for proxy access is that it would enable shareholders to increase diversity on the board, by, for example, nominating directors who would have legitimacy with constituent groups or represent viewpoints not currently represented on the board. It is not, therefore, a stretch to suggest that having a board that includes highly qualified individuals of diverse backgrounds (with "diverse" defined in terms relevant to the particular company's circumstances) may be a defense to some proxy access proposals. Companies should review their disclosures on diversity and board composition in order to make sure that they are clearly communicating to shareholders the board's position and goals in that regard.

In the same vein, having a strong lead independent director (or independent chair), may help fend off criticism and activist efforts to increase board independence. As with other corporate governance issues, the key is for boards to put forth clear, well-reasoned disclosures explaining their positions in such a way that shareholders will understand why they have the leadership structure that they do. Effective, regular communication with shareholders, particularly those who have concerns, remains important; the goal should be, where possible, to address issues before they become proxy proposals.

Ultimately, the board of directors must determine its own structure and operation, and it is the board's responsibility to do so in a manner that best serves the company in its particular situation. The board should take into account all the factors that are relevant in its circumstances and use its business judgment to decide what is best at any given time. The constant possibility of activist attacks is, in the end, only one such factor, and the board must take the long-term view toward increasing shareholder value rather than settle for the short-term relief of avoiding controversy.

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[23] To be eligible, shareholders must (1) have continuously held, for a year or more before submitting the proposal, no less than $2000 in market value, or 1 percent, of the securities entitled to vote at the shareholder meeting; (2) continue to hold the securities through the meeting date; (3) submit the proposal to the company by the applicable deadline (generally 120 calendar days before the anniversary of the mailing of the previous year's annual meeting proxy statement); and (4) attend the meeting to present the proposal. Exchange Act Rule 14a-8.

[24] Institutional Shareholder Services, 2012 U.S. Proxy Voting Summary Guidelines at 21, *available at* www.issgovernance.com/files/2012USSummaryGuidelines.pdf.