

## Restoration project: Respect for the board

*Vital to recovery from the Great Recession is reestablishing confidence in the board's ability to serve shareholder interests. Four factors fundamental to board effectiveness require focus.*

**BY JOHN J. MADDEN**

ONE OF THE MOST striking phenomena arising from the financial and broader economic crisis that brought on the Great Recession is the widespread and increasingly vocal criticism of corporate boards of directors. The criticism comes not only from the traditional shareholder activist community but also from regulators, politicians, academics, and the investing public at large, and centers on claims of boards' failures to adequately serve and protect shareholder interests. While the most severe and widely reported criticism has been focused on some of the country's most well-known financial institutions, the criticism has spread broadly across market sectors.

Despite the substantial reforms adopted earlier in this decade following the failures of companies such as Enron and WorldCom — including the requirements imposed by the Sarbanes-Oxley Act and new stock exchange regulations on the composition and functioning of boards and their committees — and the resulting increased focus by boards on the effective discharge of their responsibilities, the current crisis has brought forward a new and forceful wave of board scrutiny. This enhanced scrutiny has stimulated calls for greater “shareholder democracy” — as investors, regulators, politicians, and market commentators have, to varying degrees, expressed a loss of confidence in the effectiveness of boards in properly serving shareholders' interests. Even the Securities and Exchange Commission, in recently proposing its new regulation on shareholder access to corporate proxy statements for director nominations, prominently cites the “serious concerns about the accountability and responsiveness of some companies and boards

of directors to the interests of shareholders” and the resulting loss of investor confidence.

The clarion call now being sounded for shareholder democracy is focused both on how directors should be nominated and elected, and on the authority they have as directors. As directors are well aware, shareholder activists and others have been urging access to proxy statements, annual election of directors, majority voting in director elections, and separation of the chairperson and chief executive positions for some time, as well as the redemption of poison pills and a say in management compensation. Their efforts to date have met with some significant success — by December 2008 almost half of all S&P 500 companies had made the switch to majority voting, only a third of the Fortune 500 still had classified boards, and less than 20% of the Fortune 500 had poison pills in place. And the SEC's recent decision to eliminate broker discretionary voting in director elections will enhance the influence of activists and institutional, or non-retail, investors. The longstanding, although

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historically largely unsuccessful, effort to separate the roles of chairperson and chief executive in the U.S. has been gaining more support, as have “say on pay” shareholder proposals.

While history shows that periods of excess and crisis in the markets are often followed by reform, the momentum for significant and speedy action can lead to overreaction and inadequate consideration of cost-effectiveness and unintended consequences.

The various initiatives for governance reform currently being pursued, taken together, represent a significant acceleration and expansion of the changes in the relationship between shareholders and boards away from the director-centric model of corporate decision making that has prevailed in the governance of public corporations in the United States for almost a century. And there is no evidence that a more shareholder-centric model, while more democratic in principle, would be more, or even as, effective in building long-term value for the benefit of the shareholders as a whole and in serving the interests of the other constituencies important to a corporation’s prosperity.

Moreover, the relative consistency of the several initiatives would seem to call for thoughtful consideration — the more involvement and influence shareholders have over the director nomination and electoral process, presumably the less involvement and influence they would need in the actual management decision making of their company.

Just as recovery from the current crisis requires restoration of business confidence, an important part of that restoration is the reestablishment of confidence in and respect for the effectiveness of boards in serving shareholders’ interests. Reestablish-

ment of that confidence is necessary as a substantive matter and, as importantly, to temper the drive for broad-based change until the consequences are fully considered.

Accordingly, it is important for boards to acknowledge this changing dynamic and proactively take the steps necessary to restore that confidence and retain the essential role the board has traditionally performed in the leadership and oversight of the corporations they serve.

### Current initiatives for change

In the wake of the widespread board criticism and expressed loss of confidence in board effectiveness,

the most noteworthy initiatives that have been launched are in the following areas:

- **The Shareholder Bill of Rights Act:** On May 19, 2009, U.S. Senator Charles Schumer introduced in the Senate a bill entitled the “Shareholder Bill of Rights Act of 2009.” In doing so, Sen. Schumer said the widespread failure of corporate governance was one of the central causes of the current financial and economic crisis in that “too many corporate boards neglected their most fundamental responsibility — to prioritize the long-term health of their firms and their shareholders and oversee management accordingly.” This legislation would: mandate “say on pay” through annual shareholder advisory voting on executive compensation, and require shareholder approval for executive “golden parachute” arrangements; confirm the SEC’s authority to grant shareholder access to the corporate proxy for director nominations; eliminate classified boards, so all directors would be subject to annual shareholder votes; mandate majority voting in director elections; require separation of the positions of chairperson and chief executive; and require boards to establish separate risk committees.

- **Proxy Access:** On May 20, 2009, the SEC proposed new rules allowing shareholders access to the corporate proxy to nominate directors for up to 25% of a public company’s board. The proposed rules would allow proxy access to shareholders based on a sliding ownership threshold ranging from 1% for the largest companies with market capitalizations over \$700 million to 5% for the smallest companies. The rules would allow shareholders to aggregate their holdings to meet the threshold requirements, would impose a one-year minimum ownership requirement, and call for a certification by the nominating shareholders that they are not seeking a change of control or to gain more than a minority representation on the board.

- **Executive Compensation:** Executive compensation has become a lightning rod for criticism of corporate governance practices. On June 10, 2009, the Obama administration announced the appointment of Kenneth Feinberg as the new “special master for compensation” with broad authority to determine compensation for executives at the seven companies receiving “exceptional assistance” under the Treasury’s Troubled Asset Relief Program (TARP). For other financial institutions receiving federal assistance, he will play an advisory role in setting the overall compensation structure but without fixing specific levels of pay. Treasury Secretary Geithner also outlined his initiative to

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reform compensation practices at all public companies, and the administration issued voluntary compensation guidelines tying pay more closely to long-term performance. Geithner also said the administration will seek legislation giving shareholders more power to vote on executive compensation at all companies and strengthening independence standards for board compensation committees. On July 31, the House of Representatives approved legislation largely based on the administration's proposal providing for, among other things, "say on pay" shareholder votes and enhanced independence standards for board compensation committees and their consultants. The Senate is to consider the subject in the fall.

Taken together, in conjunction with the shareholder efforts mentioned earlier, these various initiatives, if successfully pursued, reflect both an extraordinary foray by the federal government into the field of corporate governance historically regulated by state law and an accelerated shift in the balance of decision-making authority between boards and shareholders. While some of the initiatives certainly have appeal in principle — such as the increased ability for shareholders to participate in the nomination and election of directors — the substantial shift they constitute as a whole is significant and raises important questions about the effect they will have on corporate performance. In any event, the message is clear that boards need to reestablish the investor community and public's confidence in their effectiveness in order to maintain, and continue to perform, the essential role they have in the leadership and governance of the corporations they serve.

### Where to put the focus

In order to restore the market confidence necessary to maintain their vital roles, boards should consider the essential nature of their responsibility and then focus on four key factors fundamentally important to their effectiveness:

- **The Essence of the Board's Job:** The board's fundamental job is management oversight — overseeing the performance of the CEO and the senior management team in order to enhance the long-term prosperity of the corporation. The board is the representative of and fiduciary for the owners of the business — the shareholders — and, accordingly, must focus principally on their interests. Of course, the board needs to consider the interests of other important constituencies, especially employees, just as responsible owners would be expected to. And the board must recognize that its focus

would shift were the company to become insolvent, at which point creditors' interests would come to the fore. Short of that circumstance, directors' primary responsibility is to the owners who elect them. In its oversight role, the board is responsible for the hiring and firing of the CEO, deciding on the CEO's and other senior management's compensation, planning for senior management succession, reviewing and approving the strategic plan for the business and evaluating its execution by management, among other responsibilities — all of which require a solid understanding of the company's business, including its opportunities, challenges, and risks. Other important features of the board's role are providing support and guidance to the CEO and the senior management team, ensuring there is an effective communication line with both senior management and shareholders and, increasingly in the current climate, serving as stewards of the corporation's reputation.

*Boards should ensure there is an effective communication line with both senior management and shareholders.*

- **The Key Factors of Board Effectiveness:** To be effective in performing their essential job, boards must focus their attention on four key factors for board effectiveness:

1. **Honor Your Independence.** Boards should have the integrity, judgment, experience, and courage to act wholly independently. Directors must be able to make the tough decisions in the best interests of the owners of the business and do so independent of their relationships with senior management. Board composition is key — that is, choosing individuals with the requisite personal characteristics — and is more than just meeting the technical requirements of independence under Sarbanes-Oxley and stock exchange rules. Directors need to have the capacity to work together collegially as a board, with the CEO, and the senior management team, but at the same time recognize their essential oversight responsibility on behalf of the shareholders and demonstrate the independence necessary to faithfully serve the owners' interests. Like anyone in an important supervisory or oversight role, directors must support and encourage senior management and incentivize them through properly structured compensation plans. But they must also actively monitor and critically and objectively evaluate performance and make timely decisions on the merits of retention and advancement.

Board leadership and stock ownership can also be important elements reinforcing independence. Most public companies have by now moved to boards comprising a substantial majority of independent directors. And there is a growing trend to separate the roles of chairperson and chief executive, as is more the practice in the U.K. and

continental Europe, although a declining majority of public companies in the U.S. still combine the positions. Where there is no such separation, the lead independent director should have a prominent role in such matters as approving agendas for board meetings, presiding at regular meetings of the independent directors, and otherwise interfacing frequently with the CEO on behalf of the independent directors, as well as following up on issues raised by the independent directors to ensure they are satisfactorily addressed. Having some “skin in the game” through a meaningful personal investment in the company’s common stock also serves as an alignment with shareholders’ interests that has value substantively and in appearance. Being able to act, and appearing to act, for the company’s owners, and independent of the influence of management, is of fundamental importance to a board’s effectiveness, and management must understand and respect this as well.

2. *Know Your Company’s Business.* The board as a group must have a well-developed knowledge of the company’s business and the environment in which it operates. While this seems obvious, we have seen many corporate problems arise that could have been avoided or ameliorated had the board and senior management been more diligent and prompt in their effort to understand the challenges facing a particular line of the company’s business, the efficacy of a strategy being pursued, or the nature and extent of risk being assumed. Each board member need not have the same in-depth knowledge of all aspects of the company’s business, or as extensive as that expected of the CEO. But the board should be comfortable that together the non-management directors understand the business sufficiently to know the company’s principal opportunities, challenges, and risks, and to identify areas requiring closer monitoring or in-depth review. Equally, directors should be satisfied that senior management has command of the important specifics of the company’s operations and will, on their own initiative, bring to the board on a timely basis issues of concern appropriate for board attention.

## Trends in the ‘Top 100’ boardrooms

**Global law firm** Shearman & Sterling LLP’s seventh annual analysis of corporate governance practices, titled “2009 Trends in Corporate Governance of the Largest U.S. Public Companies,” provides data and analysis of the 100 largest U.S. public companies by revenue as ranked by *Fortune* magazine (the “Top 100 Companies”). It is available this year in two parts — *Executive & Director Compensation* (just released) and *Corporate Governance* (due out later this fall). Some key findings from the Shearman & Sterling analysis include:

- Although not required by either the NYSE or Nasdaq listing standards, 86 of the Top 100 Companies have disclosed a mandatory retirement age for their nonemployee directors. As has been the case in each previous Shearman & Sterling survey, 72 is the most commonly selected age for mandatory retirement.

- Of the Top 100 Companies, 65 address the topic of director term limits, but only 5 of the Top 100 have adopted mandatory term limits for their directors. Most of the companies that have addressed but not adopted term limits specifically cite the insight and knowledge that directors who have served for an extended period of time can provide about the company’s operations and practices.

- Over the past few years, the number of board meetings held each year has generally remained high. During 2008, 62 of the Top 100 surveyed held eight or more meetings.

- Interestingly, while the number of Top 100 Companies providing directors with annual cash retainers has remained constant (98%) since 2004, the number of companies paying between \$60,000 and \$150,000 has substantially increased (from 27 in 2007 to 72 in 2008) and the number of companies paying \$60,000 or less has substantially decreased (from 70 companies in 2007 to 25 companies in 2008).

- The number of Top 100 Companies paying a special retainer to the lead or presiding director rose to 55, up from 43 companies in 2008.

- Say on pay shareholder proposals continued to be the most prevalent compensation-related shareholder proposal, with 44 proposals raised at the Top 100 in 2009, compared with 41 in 2008. Of the 44 proposals, shareholders at only 8 of the Top 100 approved the adoption of a say on pay policy this proxy season.

Other findings:

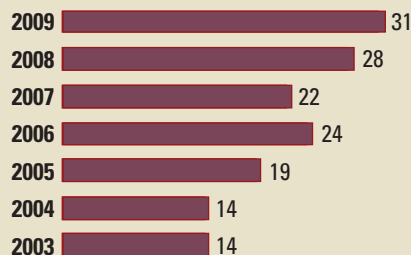
### Majority Voting

By 2009, 75 of the Top 100 Companies had adopted some form of majority voting for director elections.



### Board Leadership

Separate people serve as CEO and chairman of the board at 31 of the Top 100 Companies, but of those companies only seven have adopted an explicit policy of splitting the two offices.



Additional information on the Trends reports is available at [www.shearman.com/corporategovernance](http://www.shearman.com/corporategovernance).

**3. Organize and Operate Efficiently.** To do their job right, the time demands on directors are substantial. While the time required will vary depending on the complexity of the company's business and other factors, directors should generally expect to commit approximately 200 hours of their time annually to their board duties in ordinary circumstances, and significantly more during periods of particular challenges or difficulties facing the corporation. Otherwise well-qualified directors who are unable to devote the requisite time to the job will not be effective directors and should not take on the responsibility. Given the substantial time commitment, boards must organize themselves and operate as efficiently as possible. For one thing, that means deciding on the right size of the board and, in most cases, smaller would seem more effective than larger. While a smaller board places a greater burden on individual directors, with each taking on more tasks that could otherwise be spread out over a larger board population, a smaller board can result in better informed individual directors, encourage a greater sense of individual responsibility, enhance the board's cohesion and possibly its quality, and improve the efficiency and effectiveness of meetings.

Boards should also insist on addressing the issues of greatest importance to the company's business and on having effective reporting systems in place to bring relevant information to their attention on a timely basis, whether in internal controls, key compliance functions, risk management, or other strategic areas. And boards should call for presentations by management to not only focus clearly and cogently on the subjects brought before the board, but also to reflect management's thought process and analysis in arriving at its recommendations and, where relevant, the rationale for its decision to reject alternative courses of action considered in the process.

The mindset here should be to proactively approach the task as owners — to be satisfied that the board is right-sized and right-focused and has in place a robust internal support and reporting system to deliver timely and relevant information for review, analysis, and decision making. It may be worthwhile to recall Warren Buffett's admonition to "beware of geeks bearing formulas" and to underscore the importance of boards being satisfied that they understand adequately the information brought before them and that, where they have questions, senior management has fully vetted the information in advance and is prepared to respond satisfactorily to board probing.

**4. Maintain Effective Lines of Communication.** Boards should ensure that effective lines of communication with the management team and shareholders are in place. Board access to senior management allows directors to obtain crucial information about the business as well as to build open and fluid relationships with, and provide support to, the management team. It also allows senior management to seek appropriate guidance and advice from board members. Establishing and maintaining a communication line with shareholders is of particular importance, although this should be coordinated carefully with the CEO and must be handled to ensure compliance with applicable laws. But it is important for most companies to have a program in place — with a structured rather than ad hoc approach — to ensure that shareholders understand what the CEO and the board are doing to serve their interests and provide shareholders the opportunity, in a constructive and non-adversarial context, to share their views about the company's business or direction with the CEO and the board.

There are various ways in which such a program can be implemented. For example, last fall Pfizer initiated a program of periodic meetings between its board and representatives of its institutional shareholders to listen to their views on governance and executive compensation. While particular approaches may vary, the principle is to establish a forum, appropriate for the company, for constructive communication. Trust and confidence cannot be reestablished without some level of transparency through an effective two-way communications link with shareholders.

### **Erosion of trust must be halted**

There is no blueprint for board effectiveness that can readily be applied to all public companies, as they have varying histories, cultures, shareholder bases, and track records of performance. But it is clear that boards generally need to restore a sense of trust and confidence within the investor community, as well as in the broader body politic. Failure to do so will likely result in further erosion of board authority and power, as well as expanded regulation of the board function, and greater involvement by shareholders in areas of corporate decision making historically vested in the board of directors. ■

*A smaller board can encourage a greater sense of individual responsibility.*

