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Deconstructing American Business II

The key issue for American business today is whether the institution of the corporate board of directors, as we know it today, can survive as the governing organ of the public corporation. Will the migration from director-centric governance to shareholder-centric governance overwhelm American business corporations. The fundamental questions are (1) whether we will be able to attract qualified and dedicated people to serve as directors and (2) whether directors will become so risk adverse that they lose the entrepreneurial spirit that has made American business great. The principal problems that cause concern for the future are:

> ***Pressure on boards from activist investors to manage for short-term share price performance rather than long-term value creation.*** The combination of activist hedge funds and investors who have no interest in long-term value creation puts tremendous pressure on a board to manage for the short-term at the expense of the company's relationships with its employees, customers, suppliers and communities and at the expense of the company's investment in research and development and capital projects, all of which are critical to a company's long-term success.
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> ***Potential for embarrassment of directors from corporate scandals in which they had no active participation.*** Events like the Hewlett-Packard "leak" investigation and "option backdating" investigations at more than 140 companies, including blue-chip companies like Apple Computer and UnitedHealth Group, have led to criticism not only of those at fault but all directors of the companies involved. Media critics and governance watchdogs simplify scandals and assume that all directors are at fault when something goes wrong. Thus, directors risk public embarrassment for any misbehavior at their companies, however diligent the directors may have been.
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> ***The shift in the board's role from guiding strategy and advising management to ensuring compliance and performing due diligence.*** Proliferating lawsuits, certification requirements, and governance rules, as well as the increased threat of personal liability, are forcing boards to spend more time and energy on compliance, due diligence and investigations, and less on the actual business of their companies. This shift in focus tends to create a wall

between the board and the CEO. Professor Jeffrey Sonnenfeld of Yale recently noted that boards' traditional "trusted role as confidante has largely disappeared" because CEOs are wary of sharing concerns with investigative and defensive boards.

The corrosive impact on collegiality from the balkanization of the board into powerful committees of independent directors and from the overuse of executive sessions. Stock exchange requirements for executive sessions of the independent directors and that audit, compensation and nominating committees consist solely of independent directors and the special Sarbanes-Oxley duties for the audit committee have separated boards into distinct fiefdoms each with a different mandate and a different information base. As CEOs and other management directors are excluded from executive sessions and forbidden from serving on key committees, and as these committees have increased in importance, it takes considerable effort to keep a board from becoming polarized and to maintain a shared sense of collegiality and a common understanding of all the issues facing the company.

The pressure to shift control of the company from the board to shareholders. Academics, activist shareholders and shareholder advisory organizations like the Council of Institutional Investors and Institutional Shareholder Services are having increasing success in legislative, regulatory, litigation and proxy resolution efforts to limit the power of the board and increase the power of shareholders. New SEC and NYSE rules have increased the ability of shareholders to conduct a proxy fight or a withhold-the-vote campaign. The success of labor unions and ISS in promoting majority voting has provided an incentive for proxy fights and withhold-the-vote campaigns. At the extreme are proposals that would require a shareholder referendum on all material decisions.

The executive compensation dilemma. If a board fails to recruit excellent senior managers, the directors are subject to criticism for the company's sub-par performance. If the board approves compensation packages necessary to attract and retain top-quality senior managers, the directors are criticized for paying "excessive" compensation. Even compensation based on superior performance is subject to criticism. In addition to the media frenzies of criticism of executive compensation, governance activists are promoting proxy campaigns to require advisory shareholder votes on executive compensation, and the use of withhold-the-vote campaigns to embarrass compensation committee members with whose decisions they disagree.

The demand by public pension funds for direct meetings with independent directors. Public pension funds have been demanding to meet not just with management but with independent directors to express their views with respect to performance, governance, social issues and "political" matters, including, for example, recent calls for meetings with Exxon Mobil's independent directors to discuss global warming.

The publication of corporate governance ratings and report cards intended to embarrass directors. CalPERS's Focus List is one of several governance ratings, watch lists and report cards that are widely publicized; others are published by ISS and The Corporate Library. These ratings are often based on one-size-fits-all governance metrics, such as director independence, compensation practices and takeover defenses, rather than a careful analysis of the needs and interests of individual companies. They are designed to coerce a board into making governance changes to satisfy these self-appointed watchdogs rather than to advance the best interests of the company.

The continuing narrowing of the definition of director independence. As governance activists have stressed the importance of a board made up primarily of independent directors, they have also worked to categorize even minor connections to the company (including minor charitable contributions and relatives holding minor jobs) as impediments to independence. Frequently, a highly-qualified candidate for a board will withdraw from consideration if the candidate is tagged as not independent by a governance advisory organization, even though the candidate meets the NYSE independence test.

The constant cycle of new corporate governance proposals. Shareholder advisory organizations like ISS and CII, as well as politically motivated institutional investors like public pension funds and labor unions, justify their existence and satisfy political motivations, by finding new governance practices to propose each year. Once poison pills have been eliminated, classified boards must go; once classified boards are gone, majority voting becomes a requirement, and so on. The never-ending cycle creates a moving target for what these organizations consider "good" corporate governance, and every year places additional unproductive non-business burdens on boards.

The constantly increasing time demands of board service that restrict the ability of active senior business people to serve on boards. The increasing complexity of the board's role has led to greater time demands on directors, with the result that many active CEOs and other senior business people restrict themselves to only one outside board, if any. The inability to attract CEOs to a board discourages other CEOs to serve and essentially leads to boards where less than half the members are CEOs or former CEOs and therefor are not as qualified as they could be to provide business and strategic advice.

The unpleasantness of filling out extensive questionnaires to enable appropriate disclosures and qualification determinations. To meet legal requirements, corporations must require their directors to respond to lengthy, repetitive and intrusive questionnaires about their business background and relationships, their securities holdings, their charitable contributions, their employment backgrounds, their families, and anything else that may affect governance determinations or be required to be disclosed in a proxy statement or elsewhere.

The demeaning effect of the parade of lawyers, accountants, consultants and auditors through board and committee meetings. A corollary of the transformation of the role of the board from strategy and advice to investigation and compliance is an increased reliance on experts in the boardroom. While it is of course salutary for boards to be well advised, over-reliance on experts tends to reduce boardroom collegiality, distract from the board's role as strategic advisor, and call into question who is in control – the directors or their army of advisors. Recent suggestions that compensation consultants, rather than informed boards, are responsible for "excessive" executive pay is just one example of the perception that boards are ceding control of their companies to outside advisors.

The growth of shareholder litigation against directors as a big business and a type of extortion. While courts, commentators and legislators have long recognized the potential for abusive shareholder class actions, reforms aimed at reducing that potential have not had their intended effect. Shareholder litigation continues to be hugely profitable for plaintiffs' firms, without conferring any real benefits on shareholders generally.

Policies of politically motivated institutional shareholders to refuse to settle lawsuits against directors unless they contribute to the settlement from their personal funds. In the WorldCom shareholder litigation, for example, the lead plaintiff Alan Hevesi, trustee of the New York State Common Retirement Fund trumpeted the settlement as sending a "strong message" that directors will be held "personally liable if they allow management of the companies on whose boards they sit to commit fraud."

The proliferation of special investigation committees of independent directors, with their own independent counsel, to look into compliance and disclosure issues. In today's charged environment, compliance and disclosure problems lead almost inexorably to independent investigations by special committees (or by audit committees), each with its own counsel and perhaps forensic accountants and other advisors. Risk-averse auditors, spurred by the strict standards of the SEC, frequently demand investigations, while the media and many lawyers create the impression that best practices require independent investigations even outside of the purview of the SEC. These time-consuming investigations further distract independent directors from their role as strategic advisors, sour relationships between independent directors and management, and in extreme cases result in the lawyers for the special-committee hijacking the company and monopolizing the attention of directors and senior management.

Directors of large public corporations bear the weight of tremendous responsibility. The situations they face and the decisions they must make are complex and

nuanced and require the willingness to take risk, all the while knowing that failure may have devastating consequences for shareholders, employees, retirees, communities and even the economy as a whole. We cannot afford continuing attacks on the board of directors. It is time to recognize the threat to our economy and reverse the trend.

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