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Is The Sky Really Falling:

Shareholder-centric Corporate Governance

vs. Director-centric Corporate Governance

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In June 2007, Pfizer announced that the independent directors who chair it's three key board committees would meet with 35 of the company’s largest shareholders to hear their concerns. Within hours, one of America's legal legends, Marty Lipton, issued a bulletin to his clients decrying this step as "shareholder activism run amuck" [sic]. I think he actually meant, "amok," as in frenzied, with an intent to kill, not "amuck," which is mired in mud, but either word might fit his thesis. More seriously, he saw it as a big step down a slippery slope toward destruction of the modern corporate model that has been a critical engine of our economic growth for the past century or more. In other words, though Marty is no Chicken Little, he saw the Pfizer announcement as a sign that the sky is indeed falling on the traditional director-centric model of corporate governance and, with that, on the efficiency of the corporate form as a capital raising and economic production model.

Others in the corporate governance dialogue, prominently Professor Lucian Bebchuk of Harvard Law School, argue an opposing brief. In their view, the traditional corporate model has failed, not because of too much shareholder interference with corporate strategy and direction, but because of imperial, over-compensated CEO's and uninvolved boards of directors, who are selected by corporate managers and are not effective monitors on behalf of investors.

Professor Bebchuk, other academics, and a host of activist investor advocates have called for a number of remedies for this supposed failure of the director agency model. These remedies have included calls for:

- direct shareholder access to the corporate proxy to nominate director candidates

- elimination of staggered terms for directors

- substitution of majority for plurality voting in uncontested director elections

- elimination of super-majority requirements for shareholder approval of changes in charter documents

- separation of the board chair and CEO positions
- and corporate reimbursement for dissidents who have partial success in a proxy contest.

Most recently, with increased publicity and negative public reaction about senior executive compensation, activist advocates have called also for an annual, non-binding shareholder referendum on whether the directors did a good job on setting executive compensation – so-called "say on pay" resolutions.

This year, Professor Bebchuk has also submitted proxy proposals to a dozen or so companies asking that corporations establish a procedure whereby any shareholder with a $2000 investment can initiate and adopt changes to the corporate by-laws on <u>any</u> subject, not contrary to federal or state law (whatever that means), through the corporate proxy statement. This is consistent with some of Professor Bebchuk's legal writing in which he has urged that shareholders should have the right to mandate basic changes in corporate direction without either persuading directors or conducting a proxy contest to replace directors. (Since this talk was prepared, Professor Bebchuk has withdrawn these proposals, after the recipient companies asked the SEC Staff for no action advice that they could be excluded from the companies' proxy statement.)

At least one state legislature – that of North Dakota - embraced many of the arguments of the activist community last year by adopting a new "investor friendly" corporate statute, embodying virtually every item on the activist governance list, right down to even prescribing the acceptable terms and duration of a "poison pill."

Interestingly, existing North Dakota corporations are covered by the statute only if they "opt in" to it, and even newly formed North Dakota corporations can opt out of it. The stated purpose of the statute was to attract public companies from out of the state who want to demonstrate that they are investor – friendly. North

Dakota offers this on a bargain basement basis. This is accomplished by a provision in the law that the North Dakota corporate franchise tax can never exceed <u>half</u> of whatever Delaware is charging at the time! In other words, corporations could roll to the top on the "good governance" checklist while racing to the bottom on cost. So far, so far as I know, no corporation has taken up North Dakota's invitation. Perhaps the prospect of litigating issues of corporate law in Bismarck in the winter, before a judiciary more accustomed to dealing with agricultural and natural resources matters, is not appealing, even to corporations that want to prove how open they are to shareholder influence.

So, the question is: who has it right? Is Marty Lipton right to worry that the good governance pendulum has swung so far that we are losing efficient, centralized corporate decision-making, and intelligent risk-taking, to our economic detriment? Or are Bebchuk and others right that corporate directors and "imperial" CEOs have performed so poorly, and with so little heed to investor interests, that they must be subjected to direct and potentially frequent shareholder interventions and discipline.

Looking at our current economic troubles, and at the oft-repeated concern that corporate managers and directors, for the most part, did not see the sub-prime and credit quality issues coming, one might certainly argue that some form of stricter monitoring might have helped. It is not clear to me at all, however, that any of the prescriptions of the shareholder activists would have been effective in this regard. Would more frequent director elections, shareholder amendments to by-laws, annual "say on pay" votes or cheaper proxy contests have made managers and directors more insightful and more conscious of the risks by sub – prime lending and securitization in an overheated, easy money real estate market? I very much doubt it. I think that, in fact, the movements toward shareholder-centrism, director insecurity, and directors who feel compelled to criticize management, might well have increased the pressure on management to produce "good" short-term financial results, quarter after quarter, rather than to focus on longer term strategy and thoughtful assessment of risks.

Early reports indicate that, of the major financial institutions, the one that was most prescient, and has, at least so far, avoided the worst of the problems of the current situation, is Goldman Sachs, which has strong centralized management, a cohesive board and little exposure to takeover risk.

Surely, then, Lipton has a point when he worries that a corporate environment in which management is more monitored and criticized than advised by directors who are selected by, and meeting directly and regularly with, forceful shareholders, may be an environment that does not lead to sound decision-making and effective long-range planning. A management that is always looking over its shoulder may not do a good job of seeing the road ahead and charting a course that avoids potholes and maximizes benefits.

The genius of the corporate business model, as recognized even by Berle and Means in their criticism of unaccountable managers, is that investors can pool large amounts of capital, limiting their liability for loss to the capital they contribute, in an enterprise that is centrally and, presumably, more effectively and nimbly, managed by professional managers. In this model, both the managers, and the directors who monitor them, have fiduciary duties to the investors, and face at least some risk of personal liability beyond their investment if those duties are not met.

Even moderate corporate governance observers, such as former Delaware Chief Justice Norman Veasey and Ira Millstein, who disagree with the level of Lipton's alarm, are concerned that we not upset the historic balance, that in general has worked well, between the limited role and limited liability of shareholder investors and the active role, fiduciary duties and potential liability of managers.

Well, I've told you what other observers of the corporate governance scene think. What, you may well ask, do I think?

First, I think that the meeting between several of Pfizer's independent directors and 35 of the company's largest shareholders, which went ahead a few months after the June 2007 announcement despite Lipton's concerns, was not a "sky is falling" event nor even an emblem of the end of director-centric governance and the traditional corporate economic model.

I think it was a perfectly understandable response to issues at Pfizer on various fronts – executive compensation; product pipeline issues – that had received extensive press attention and no doubt concerned Pfizer investors. Importantly, it was an initiative of the Pfizer board, undertaken to gather information and listen to key investors. It was a listening, information-gathering meeting, not a decision-making forum. And it was, of course, director-centric in that it was not the result of a referendum, nor of a shareholder-initiated by-law, but a decision by the board of directors, not incidentally fully and publicly supported by the Pfizer CEO, Jeff Kindler.

And Pfizer is hardly the only public company that found such meetings useful. The Business Roundtable 2007 survey of governance practices of BRT member companies indicates that nearly 38 percent had informal meetings between directors and shareholders during the year.

Thus, I think director or even shareholder – initiated meetings for the purpose of listening to investor concerns, even to answer questions (so long as they are not a vehicle for selective disclosure of potentially market-moving information), are perfectly appropriate and consistent with the corporate model.

I also am not deeply concerned about the trends to majority voting for directors or declassification of staggered boards. Although I think that a good case can be made that the stability provided by staggered board terms can be beneficial to investors by providing a more stable platform, and better directorial continuity for long – range planning and for dealing with management succession issues, that train has left the station and we will all survive. The success of McDonald's in adopting to changing markets, and in dealing with several unexpected CEO losses due to sudden illness in recent years, may be at least in part attributable to the stability of its classified board. Nonetheless, in my judgment neither the board declassification nor majority voting trends threatens the life of the successful corporate model.

Unlike Lipton, I am also not deeply disturbed by the idea that shareholders might express an after-the-fact view on how well the board is doing in setting executive pay, on the model followed in the U.K. and other countries. I see some downsides in this – primarily the stifling of innovation and homogenization of pay and incentive plans to meet whatever model Risk Metrics / ISS creates – but, in view of the recent concern over pay issues, this may be actually attractive to boards and managers as a way of moving away from undue focus on what is, at the end of the day, an issue of modest importance for most companies.

I am much more concerned about proposals that strike directly at centralized management by the board of directors, including proposals for direct shareholder nominations of board candidates and unlimited power to amend by–laws through the corporate proxy statement, and by corporate funding of proxy contests. Under the new North Dakota law, shareholders could even initiate and adopt an amendment to the certificate of incorporation, the basic contract between investors and managers, without board involvement, and could remove directors virtually at will. These steps would be, in my view, a threat to stable, effective management and to implementation of valid long-range goals for the enterprise.

Such "reforms" are, for me, a step too far down that slippery slope. Such investor "rights" are more consistent with a general partnership than with the corporate form, or even with a limited partnership. Quite legitimate questions should be raised whether investors with such powers should continue to have limited liability when things go wrong in the business or the enterprise engages in unlawful conduct. More important, however, I think such changes create a real risk that boards of directors and CEOs will no longer see themselves as the persons primarily responsible for the direction and success of the enterprise, but rather as mere agents implementing shareholder decisions.

Such provisions are also, at least in part, a dismantling of defenses that have given boards of directors tools to maintain leverage to either say "no" or get a better deal for investors when an uninvited takeover proposal is received. Such steps will clearly increase the leverage of hedge funds and other opportunistic investors, with short term "quick profit and run" goals. And this, in turn, may well lead to defensive, short-term, less than optimal decision making and long–term damage to the effectiveness of the corporate model.

Listening to investors is good. When directors and managers do listen, different voices, and disparate ranges of investor interest from immediate gratification to long – term growth, will be heard. That is to be expected.

However, if corporate governance reform moves beyond listening and thoughtful response, abandoning the traditional, successful model where shareholders do not manage, and their decisions are generally limited to elections of directors and approval of fundamental changes in ownership rights, the economic efficiency of our corporate model may indeed be damaged.

In challenging times, such as those we are in today, I think we need boards of directors who can counsel, warn and challenge corporate managers, in a collaborative manner, rather than directors who are nothing more than agents acting on shareholder instructions or "hall monitors" guarding against management misconduct. In the post - Sarbanes-Oxley environment, there is certainly an important monitoring role for the board, but truly effective boards of directors do much more than monitor management and serve as vehicles for conveying shareholder concerns and desires. They are more than mere "agents," carrying out detailed instructions of shareholder "principals." Rather they are fiduciaries who are, by law, charged to manage or provide for the management of the business and affairs of the corporation. That role is the core concept of the modern business corporation and is central to effective corporate governance and should not be diminished or neglected.