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# Ten Thoughts for Ordering Governance Relationships in 2010

As the 2010 proxy season nears, we encourage both boards and shareholders to rethink the contours of their relationship. We expect institutional shareholders to have greater influence in director elections this year given the increasing prevalence of majority voting requirements and, for the first time, the absence of discretionary voting by brokers of uninstructed shares. Institutional shareholder power will expand further in 2011 if the SEC moves forward with proxy access rules and Congress enacts legislation mandating majority voting and "say on pay." In this environment, boards and shareholders will be well served by considering in an open way how this shift in influence should be reflected in changes in behavior.

***For boards***, the challenge will be to understand the key concerns of the company's shareholder base and get out ahead on these issues. Boards should also consider whether company disclosures and communications can be improved to better inform shareholders and encourage them to make company-specific decisions through a long-term lens. This will require devoting more attention, resources and creativity to communications and relations with shareholders. Boards that are insensitive to shareholder concerns risk bruising election battles, while providing further inducement for the homogenized governance mandates currently percolating in Washington.

***For shareholders***, the challenge will be to apply electoral power on a company-specific basis to position the board as an effective, accountable decision-maker. For institutional shareholders, this requires adequate investment in making voting decisions in light of how the board and the company actually perform rather than taking a "one-size-fits-all" approach to governance structures and practices. Reliance on proxy advisors requires assessment of the advisor's capacity for company-specific analysis. Given the importance of board composition, institutional shareholders (and proxy advisors) need to rethink using electoral votes to protest a single governance practice that does not have a material impact on performance.

We set forth below five areas of focus for boards and shareholders in 2010:

## Part I – Areas for Board Focus

1. ***Rethink engagement with shareholders.*** Shareholder engagement efforts should be designed with two goals in mind: to provide the board and management with candid information about shareholder viewpoints on important topics, and to build the foundation for supportive shareholder relations going forward. To this end, boards should:

    - Review the company's current approach to shareholder relations and communications, considering whether it is appropriate in terms of sensitivity, capability, creativity and resources.
    - Encourage management to move beyond the traditional focus of investor relations programs on the buy-side to more focused outreach and interaction with both traditional analysts and their governance-focused colleagues.

- Consider when and how to involve one or more independent directors in shareholder communications on key issues (caveat: given securities law concerns, boards should adopt clear policies designed to remind individual directors that they should not engage in communications about their company with shareholders, the media or others without first clearing it with the board leader and counsel).
- Review on a regular basis information available from proxy advisors concerning their views, including the policy guidance that informs vote recommendations. The board needs to be able to explain governance practices that deviate from the fairly narrow view promoted by proxy advisors as acceptable.

Shareholder communications start with the company's public filings. Boards should work with management to prepare disclosure that provides transparent, relevant information to shareholders and avoids boilerplate. In instances where board decisions – whether related to company strategy or governance matters – diverge from the known priorities of a significant segment of the company's shareholders, consider whether the company – and specifically the board – needs to do a better job of explaining the rationale for the decision, particularly where the long-term benefits associated with certain decisions may not be immediately obvious. Directors should ask themselves, "What do shareholders need to know to more fully understand the situation the way I understand it?"

**2.** ***Consider board composition in light of current challenges.*** Decisions to nominate and re-nominate candidates to the board will be subject to more intense scrutiny as companies comply with new SEC rules requiring disclosure on a director-by-director basis of the particular experience, qualifications, attributes and skills that led the board to conclude that each person should serve as a director. Nominating committees should work with the board to rigorously review the composition of the board as a whole, including the balance of independence, business specialization, technical skills, diversity and other desired qualities that the directors bring to the board – bearing in mind that a board is more than the sum of its parts and that the right mix of competencies will change as the company evolves and its circumstances change – and refresh the board where necessary.

**3.** ***Focus on risk oversight and review risk management processes.*** The SEC's new proxy disclosure requirements relating to board oversight of risk management – combined with the SEC's recent Staff Legal Bulletin 14E that opens the door to shareholder proposals in this area – will result in greater scrutiny of risk oversight mechanisms (and potentially more shareholder litigation) centered around the board's role with respect to risk. Boards should take a fresh look at their role in risk oversight, bearing in mind that although decisions in this area are a matter of business judgment, their conduct will be judged with the benefit of hindsight. Key risk-related roles for the board include:

- Understanding the risks facing the company as relevant to board decisions regarding corporate strategy;
- Providing oversight of the processes used to identify and manage risk; and
- Managing certain risks – such as those related to executive compensation, corporate governance and delegation to management – that only the board is positioned to manage.

4. ***Review compensation in light of new disclosure rules and shareholder concerns.*** With new SEC disclosure requirements concerning executive compensation and the possibility that "say-on-pay" will be mandated for all public companies in the future, boards should scrutinize compensation programs and understand how key shareholders are likely to react. Shareholders want to know how much executives are being paid over a time period that they can compare, what incentives underlie compensation plans, what perks are being paid and why, what severance and change-in-control agreements are in place, and whether compensation arrangements encourage undue risk-taking.

5. ***Get out ahead of the curve on shareholder engagement and governance reforms.*** Boards should understand concerns of shareholders regarding governance practices, adopting tailored approaches to governance issues that are appropriate given the needs and circumstances of the company, and that reflect a focus on long-term value creation. Thoughtful private ordering on governance issues such as majority voting, independent board leadership, "say-on-pay," takeover defenses and proxy access should help reduce regulatory pressure to adopt mandatory, one-size-fits-all reforms.

## Part II – Areas for Shareholder Focus

6. ***Focus on board composition given its role as the key corporate decision-maker.*** The key decision role of shareholders in corporate governance is to elect a board comprised of persons capable of "managing and directing the affairs of the corporation" in the best interests of the company and all its shareholders. Constructing a board that is capable of effective decision-making requires bringing together a matrix of skill sets, experiences and viewpoints, and then creating a board culture in which the individuals both trust and rely on one another and are able to debate different views and reach consensus in an efficient manner. Shareholders should assess the composition and performance of the board as a whole in considering actions with respect to individual directors. Shareholders who wish to propose director candidates to the board should do so well in advance of the annual meeting to allow appropriate time for board consideration. Shareholders should also carefully consider the board's rationale for recommending to shareholders particular candidates.

7. ***Rethink "protest votes" in director elections.*** In an era when shareholders had little power to affect board composition, institutional investors and their proxy advisors protested various actions and decisions of boards by withholding votes or voting against directors. The number of issues that now give rise to protest votes has risen substantially over the last several years. Typically, institutional investors will follow voting recommendations of proxy advisors that are not based on any significant company-specific analysis of the overall performance of the board in governing the company. With their increased power to effect the composition of the board, institutional investors and their proxy advisors should apply their critical vote in director elections based on a broader view of the board's performance in governing the company.

8. ***Focus on long-term value creation.*** Strong corporate performance over the long-term benefits everyone – shareholders, boards, managers, creditors, customers, suppliers, employees and the public. Institutional investors should assess their own internal incentive structure and consider whether it unduly emphasizes decisions based on short-term stock price performance, which could pressure companies to undertake high-risk corporate

strategies that are unsustainable or otherwise encourage behaviors that put a company's future at risk. (See, for example, the Aspen Institute's "Overcoming Short-termism" paper (September 2009).)

**9.** ***Avoid shareholder proposals that unduly encroach on board or managerial decision-making.*** The SEC's new interpretation of Rule 14a-8(i)(7), Staff Legal Bulletin 14E, now makes it more difficult for companies to exclude shareholder proposals relating to risk and CEO succession. Nevertheless, shareholders should exercise restraint in shareholder proposals to ensure that they do not hamper the exercise of business judgment by the board and management. Directors cannot abdicate their own business judgment regarding the matters entrusted to the board, even if a majority of shareholders has a distinct view on those matters. Limited liability of shareholders is predicated on the company being "managed by or under the direction" of the board and not by shareholders.

**10.** ***Make investor outreach efforts by companies a two-way conversation.*** Shareholders should continue to take advantage of communications efforts by boards and corporate investor relations teams to tell the investor side of the story on performance issues, board quality and governance concerns. But don't discount what is being said on the corporate side of the table. An investor that listens is better able to make company-specific decisions that further its own interests than an investor that blindly follows box-ticking recommendations of proxy advisors. Practices which at first blush seem out of line with "best practice" could have been instituted for a very good reason at the particular company in question (for example, a classified board at a recently spun-off company or an insider on a controlled company's nominating committee).

Several of our suggestions expand on recommendations of the Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles & Responsibilities, which are summarized in the Appendix.

Ira M. Millstein, Holly J. Gregory and Rebecca C. Grapsas

**Appendix: Summary of**
**Recommendations for Shareholders and Boards**
**(Report of the Task Force of the ABA Section of Business Law**
**Corporate Governance Committee on**
**Delineation of Governance Roles & Responsibilities, August 2009)**

*The Task Force Report discusses the roles played by shareholders and boards under corporate law and the rationales for those roles, and provides a context for policymakers, participants in the corporate governance process and the public in considering responses to the current crisis. The Task Force recommends that shareholders, boards and the executives to whom they delegate management authority and those involved in legislative and regulatory reform initiatives give special consideration to the long-term nature of corporate wealth-generating activity and strive to avoid undue short-term focus and pressures that may impede the capacity of the corporation for long-term investments and decisions necessary for sustainable wealth creation. All parties are also encouraged to recognize both the challenges posed and the values contributed by the current ordering of governance relationships in the U.S. publicly-traded corporation under state law.*

*The recommendations are outlined below. The full report is available at [http://www.abanet.org/buslaw/committees/CL260000pub/materials/20090801/delineation-final.pdf](http://www.abanet.org/buslaw/committees/CL260000pub/materials/20090801/delineation-final.pdf).*

**1. We recommend that shareholders:**

- Act on an informed basis with respect to their governance-related rights in the corporation, and for company-specific judgments regarding such matters while taking into account their own investment goals
- Apply company specific judgment when considering the use of voting rights and contested elections to change board composition
- Consider the long-term strategy of the corporation as communicated by the board in determining whether to initiate or support shareholder proposals

**2. We recommend that boards:**

- Embrace their role as the body elected by the shareholders to manage and direct the corporation by: (a) affirmatively engaging with shareholders to seek their views; (b) considering shareholder concerns as an important data point in the development and pursuit of long-term corporate strategy; and (c) facilitating transparency by ensuring that shareholders are informed of the company's efforts toward achieving its identified long-term goals and objectives
- Acknowledge that, at times, the company's long-term goals and objectives may not conform to the desires of some shareholders, and be prepared to explain board decisions nevertheless to pursue such goals and objectives to shareholders and the market
- Disclose with greater clarity how incentive packages are designed to encourage long-term outlook and to reward steps toward achieving long-term strategies while discouraging unduly risky behavior

**3. We recommend that policy makers and regulators:**

- In the context of reform initiatives, understand the rationale for the current ordering of roles and responsibilities in the corporation and assess the impact of proposed reforms on such ordering
- Carefully consider how best to encourage the responsible exercise of power by key participants in the governance of corporations so as to promote long-term value creation
- Ensure that there is equal transparency of long and short, and direct and synthetic, equity positions of shareholders