



Rebuilding Trust: The Corporate Governance Opportunity for 2012

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Concerns about the responsible use of corporate power remain high in the wake of the financial crisis. Although these concerns have been focused primarily on the financial sector, there is spillover to corporations in every industry. Tough economic conditions, slow job growth, political dysfunction and general uncertainties about the future continue to undermine investor confidence and fuel public distrust (with Occupy Wall Street an example). This in turn intensifies the scrutiny of corporate actions and board decisions, and may skew the regulatory environment in which companies compete.

All corporate governance participants – boards, executive officers, shareholders, proxy advisors, regulators and politicians – have both an interest and a role to play in rebuilding trust in the corporations that are the engine of our economy. In our annual reflection, we offer thoughts on how, without the need for regulatory intervention, boards and shareholders can seize the opportunity to rebuild trust and, by doing so, help resolve some of the tensions that are stalling our economic recovery.

Part I – Opportunities for the Board to Rebuild Trust

1. Focus on the long-term. Boards carry out their fiduciary duties in the face of pressures from the market and short-term traders for immediate results, pressures that too often undermine the long-term planning and investment required for a sustainable enterprise. While management must focus on the day to day operations of the company, the board has the ability and responsibility to look forward and consider what is in the best interests of the corporation and its shareholders over a time horizon notably longer than the quarter at hand. The board should bring its objectivity and judgment to issues ranging from dividend policy, strategic direction, risk and executive compensation to corporate social responsibility and ethical culture. When coupled with

a clearly articulated strategy, the board's commitment to the long-term should help a company withstand undue short-term pressures. This requires effective disclosure of board decisions and policies and concerted efforts at shareholder relations and communications, both areas where boards often could focus more attention.

2. Redefine board priorities. The part-time nature of director service combined with ever-expanding expectations about the board's role and increasing regulatory mandates may lead to an unfocused and overly long board agenda. Boards should delegate to board committees, corporate management and advisors those matters that do not require the attention of the full board so that the board can focus on key priorities. Defining board priorities is the board's task, one that should be undertaken in an informed manner with advice from management and counsel but not be delegated to them. We suggest that boards consider an 80/20 rule: Approximately 80 percent of board time should be spent on those issues that are reserved by law to the board, that will benefit from the exercise of fiduciary judgment or as to which management has inherent conflicts, such as corporate strategy and the major risks to that strategy, material transactions, management performance and succession, and executive compensation. The board should also reserve "quality time" for matters of its own performance and composition. This is a simplified list and of course every board will need to work it out based on its own challenges and characteristics, but the key is to maintain significant time for the significant and difficult issues. Leading the effort of redefining board priorities and ensuring sufficient agenda time for priority matters are roles for the board's independent leader – either a separate independent chair or a lead director. We note that the number of companies with separate independent chairs is continuing to rise, and it is now well-accepted that public companies should either have an independent chair or have a lead director with a role that is defined to include a number of tasks that would otherwise typically fall to a board chair.

3. Apply objectivity & "backbone" to fiduciary judgments. Directors must decide for themselves what is in the best interests of the company. Clearly, management has a view that it will advocate, but the board needs to test the underlying assumptions and come to its own conclusion. While undue deference to management is not appropriate, neither is abdication of fiduciary decisions to shareholders. Fiduciary decision-making cannot be abdicated, even if a majority of shareholders have a definite preference on an issue. This may pose challenges when significant shareholders have strongly held views, or when a proxy advisor takes a stance and in effect serves to coordinate support for that stance among its client shareholders. The bottom line is that directors need to be willing to do what they believe is right, even if doing so jeopardizes re-election.

4. Listen to and communicate with (“engage”) shareholders. Success in withstanding pressures for actions that the board does not believe are in the company’s best interest depends on the board’s ability to communicate effectively with shareholders. The starting point is knowing who your significant shareholders are and what concerns them. (It helps to maintain open channels of communication with the persons who have voting and investing authority, and these roles are often split in large institutional investors.) Encouraging feedback generates goodwill and can elicit good ideas. Obtaining a preview of concerns also provides opportunity to avoid acrimony by working through issues in advance. Directors should listen hard to what shareholders have to say and consider any disconnects between the views of shareholders and the board, for example, where a management proposal or a director receives a negative (or not overwhelmingly positive) vote at the annual meeting. Boards should work with management to ensure that board decisions are adequately explained to investors, regulators and other users of corporate information. Disclosure documents should be reviewed with a critical eye towards enhancing understandability and slashing boilerplate. Communication with shareholders (and employees) will become even more critical once the SEC adopts new disclosure requirements relating to internal pay equity and pay-for-performance as required by the Dodd-Frank Act of 2010.

5. Be self-critical. If shareholders are to give boards the time and space to take the long view, and generally defer to and support their judgments, they need assurance that boards will bring objectivity and backbone to judgments about the board’s own effectiveness. Re-nomination decisions need to be based on an active assessment of director performance and whether the director continues to be a strong fit. All directors need to have skill sets that continue to be not only relevant but necessary to the evolving direction of the company’s business and be engaged in board and committee activities at a high level. Board “refreshment” mechanisms such as age limits and term limits should be carefully considered. While they can help to assure compositional change, they are imperfect substitutes for active assessment of individual performance, and they may set an inappropriate expectation of long tenure. Similarly, the annual self-evaluation of the board and its committees provides an opportunity for reflection about areas for improvement. This should not be allowed to become a rote exercise. Consider changing up the methodology from time to time, for example, by every several years taking a deeper dive through an interview method rather than relying on paper questionnaires. No matter what method is used to gather viewpoints from directors, every year the evaluation should result in a focused board discussion of areas for improvement.

6. Pay special attention to “hot button” issues. Boards should make decisions about “hot button” issues in the best interests of the company and persuasively communicate the reasons for those decisions. Proactively discuss any anticipated negative feedback from the proxy

advisory firms on relevant issues. The issues requiring special attention will depend on the company, but for most companies will include strategic direction, risk oversight, executive compensation, proxy access, board composition, succession, board leadership, political contributions disclosure, corporate social responsibility and structural defenses.

Corporate Responsibility. The 2012 presidential election year is likely to bring heightened attention to issues related to corporate responsibility generally and to corporate political power in particular. In 2011, both the number of social and environmental proposals brought by shareholders and the support for these proposals increased. Boards should be prepared for particular scrutiny of their oversight of corporate political spending and should be sensitive to that issue. In addition to calls for greater disclosure of board policies and decisions with respect to political spending, boards should expect calls for greater disclosure regarding corporate impact on natural resources, with an emphasis on water and air quality and supply chain sustainability. Boards should ensure that these topics receive appropriate attention on the board agenda and should keep tabs generally on public sentiment as it relates to the company and issues of corporate responsibility generally. This is an area where the board may be particularly well-positioned to assess the general environment and advise management.

Executive Compensation. Say on pay acted as a “release valve” allowing shareholders to let off steam in 2011, resulting in fewer “withhold” and “against” campaigns targeting individual directors in elections. It will still be high on the shareholder agenda in 2012. To bolster support in the coming year, boards and compensation committees should recognize that many shareholders are looking for them to demonstrate restraint. Expect pay for performance to continue as the primary factor in obtaining shareholder approval, with shareholder sensitivity to pay levels relative to peers and pay increases out of proportion to performance trends. Consider the shareholder perspective on (and public perception of) the company’s executive compensation program and related disclosures, including, how the program matches up the new ISS guidelines (given its influence). Don’t just read a final draft of the proxy statement – advocate early that it explain the company’s compensation philosophy, and the alignment between pay and performance in clear and understandable terms. Finally, be willing and available to follow-up with key shareholders to discuss the board’s approach to say on pay. Boards of companies that failed to receive a majority vote in favor of executive compensation or received a high proportion of negative votes (even though receiving a majority vote in favor) should identify the primary shareholder concerns and take a hard look at whether changes are called for, based on fiduciary judgment.

Majority Voting. Boards should expect a concerted effort from shareholders to extend majority voting to the remainder of the S&P 500 and beyond to the next tier of companies in 2012. Boards at companies that have not yet adopted a majority voting standard, or a director resignation policy

in the event a director fails to receive a majority of the votes, should be prepared to address this issue with shareholders.

Proxy Access. 2012 is the first year in which shareholders may bring proposals seeking bylaw changes to allow proxy access for shareholder nominations of director candidates in competition with the board's own nominees. (Any adopted bylaw changes will not be applicable until the next year.). While public pension funds and union funds are expected to bring a relatively focused set of proposals concentrating on high-profile companies that have had significant governance, compliance or performance issues, individual shareholders involved in the U.S. Proxy Exchange (USPX) and the Norwegian Pension Fund Global (NPIFG) have already submitted a dozen or more proposals. The non-binding USPX proposals generally ask that the board adopt a bylaw to permit proxy access for director nominees from shareholders that have held continuously for two years 1 percent of the company's eligible securities and/or any party of 100 shareholders each of whom satisfy the basic SEC Rule 14a-8(b) eligibility standards (holding a \$2000 stake for one year). The NPIFG's proposals are reportedly binding proposals and also have a low threshold, requiring that a shareholder hold a minimum of 1% of company stock for 1 year. Boards should follow developments in this area closely. Maintaining strong relationships with significant shareholders and understanding and, as appropriate, addressing their concerns continues to be the best preparation for a potential proxy access proposal.

"Vote No" Campaigns. Boards may see an up-tick in the number of campaigns against directors up for re-election. ISS has a fairly long list of circumstances that will cause it to recommend voting against a director in an uncontested election. In addition, "vote no" campaigns may target compensation committee members at companies where shareholders and proxy advisors deem the committee and board unresponsive to the 2011 say on pay vote even where the proposal "passed". Boards should review ISS' recently revised policies early to understand where vulnerabilities may lie so that they can take appropriate action, including, if necessary, targeted shareholder outreach.

Part II – Opportunities for Shareholders to Rebuild Trust

1. Focus on the long-term. Shareholders should give the board and management freedom to make decisions over a long-term time horizon. Focusing on the long-term is particularly critical during a downturn. While plowing resources into R&D and other job creation and growth strategies may restrain the bottom line in the near-term, such investments are necessary to reap rewards for the company and its shareholders – and society – later on. Shareholders may need to evaluate their own decision-making structures and ensure that they are not rewarding high-risk

behaviors, whether through direct investments or through the monies they invest through other entities.

2. Refine shareholder priorities and reduce “noise.” Boards of public companies are bombarded with a wide array of viewpoints about corporate governance and social and environmental issues. Institutional shareholders should identify the two or three issues (in addition to return on investment) that are most important to them and then clearly and consistently articulate their views. Laundry lists of concerns should be prioritized to ensure that the board can hear and focus on the things that are most important to shareholders. These priorities can also help shareholders to ground their approach to voting analysis (see below).

3. Vote responsibly. With power comes responsibility. Where shareholders do not have the resources to become informed on an issue on a company-specific basis, it makes sense for them to generally defer to the board’s recommendations. We note that many may consider this heresy, but presumably most shareholders have invested in a company because of faith in the direction that the board and management are taking the company. Alternatively, they are investing because the company has been included in an index that the shareholder invests in, deferring to the judgment of others. Deference to board recommendations in most instances would allow shareholders to focus scarce voting analytic resources on companies where a significant performance or other red flag issue is apparent. In such instances, shareholders should apply their resources to becoming well-informed prior to voting.

4. Delegate and/or rely on others responsibly. A corollary of the admonition to “vote responsibly” is to delegate or rely on others responsibly. When choosing advisors to assist with voting analysis and recommendations, do so on an informed basis after performing due diligence as to their capabilities. Consider whether they have the resources to provide informed and tailored advice specific to portfolio companies or are unduly reliant on a set of fairly rigid voting guidelines. The more reliant they are on junior seasonal workers who turn over every year, the less likely that they are able to provide rigorous, sophisticated and tailored analysis. If you are having the advisor tailor policies specifically to your specifications, consider using a performance screen and instructing the advisor that so long as the company is performing well and there are no significant red flags (and mere failure to adopt a particular governance policy favored by the advisor shouldn’t count as a red flag), to vote as the board recommends.

5. Speak up, but be willing to listen. Shareholders should share their concerns with boards and should also provide feedback when requested. Shareholders should also be prepared to listen to what boards have to say – communication is a two-way street. Communication can take various forms, from formal meetings conducted in accordance with Regulation FD, to posts on Twitter or

other social media tools. Remember in communicating with a board that other shareholders may have different – and even conflicting – views. Also recognize that some means of communicating lack nuance. An example is the up-or-down vote on say on pay resolutions which provides shareholders with an imperfect forum in which to let the board know how it is doing on compensation and, indirectly, on performance generally. Follow up with concrete suggestions and give the board the opportunity to respond. Recognize that it takes time to make significant modifications to a company’s compensation program. Also, remember that while shareholder views about appropriate compensation should be considered, executive compensation is fundamentally the board’s responsibility.

6. Carefully consider private ordering options. Shareholder proposals relating to proxy access – whether by way of precatory resolution or binding bylaw amendment – should include meaningful ownership thresholds and other qualifications to ensure that director elections proceed in an orderly manner and are not hijacked by special interest groups. Proxy access should be viewed as a last-resort mechanism. Engagement with the company’s nominating committee on board composition should always be the preferred course.