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BOARD OF DIRECTORS

Preserving Balance in Corporate Governance

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

Last year, we wrote about the need to restore trust in our system of corporate governance generally and in relations between boards of directors and shareholders specifically. We continue to be troubled by the tensions that have developed over roles and responsibilities in the corporate governance framework for public companies. The board's fundamental mandate under state law—to "manage and direct" the operations of the company—is under pressure, facilitated by federal regulation that gives shareholders advisory votes on subjects where they do not have decision rights either under corporate law or charter.

Some tensions between boards and shareholders are inherent in our governance system and are healthy. While we are concerned about further escalation, we do not view the current relationship between boards and shareholders as akin to a battle, let alone a revolution, as some media rhetoric about a "shareholder spring" might suggest. However, we do believe that boards and shareholders should work to smooth away excesses

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on both sides to ensure a framework in which decisions can be made in the best interests of the company and its varied body of shareholders.

On the board side, directors need to remain mindful that shareholders have legitimate interests in the governance of the company and this includes communicating their concerns to the board, whether via shareholder proposal or some other method of engagement. To be able to assess and parse shareholder concerns, boards also need to know who the company's shareholders are and appreciate that their interests are not monolithic. Shareholders who seek changes are neither necessarily seeking changes that are harmful or undermine the board's responsibilities, nor are they necessarily seeking changes that are in the company's best interests. Boards must discern, in each particular situation, whether a shareholder is seeking to promote interests that are broadly in keeping with the company's long-term interests and the interests of other shareholders.

In this regard it is particularly helpful for boards to understand who the company's shareholders are as well as their investment strategies and other interests. Are they long-term shareholders or short-term traders? Are they acting in accordance with fiduciary duties owed to beneficiaries? Are they interested in a particular political or social agenda? Are they using a particular issue to push for other changes? This key information is not only in engagement with shareholders but also in exploring how to better communicate corporate strategies to attract the type of long-term shareholders that most companies want. Columbia Law School is in the process of studying a "topography" of investors and their respective interests which should be helpful to boards in this endeavor.

On the shareholder side, shareholders need to appreciate that while their views are important and valuable—and should be taken into account in board decision-making—companies cannot be managed efficiently by shareholder referendum. In the past year two books by prominent academics—Professors Lynn Stout and Stephen Bainbridge—have emphasized this point, and we recommend these books as worth reading. Shareholders also need to think for themselves with respect to how they are going to vote on matters presented to them. Precatory or advisory votes are important in giving shareholders a voice with respect to subjects on which they have legitimate interests but generally lack decision rights, such as executive compensation. In practice, such votes have had beneficial impact in increasing the dialogue and engagement between shareholders and boards. The non-binding nature of votes on precatory proposals underscores that boards should consider the vote outcome but not be bound to take the advised action if directors believe that an alternate course is in the best interests of the company. (Boards in such circumstances should take special care to communicate why an alternative course is preferable.) Shareholders should be especially wary of proxy advisor policies that threaten to make precatory proposals that receive a majority of votes cast effectively *compulsory*, thereby shifting decision-making power from boards to shareholders.

The rapid rise of powerful proxy advisors is the unforeseen—and yet to be addressed (by the SEC)—accelerant in the increasing tensions between boards and shareholders. All too often, shareholders are delegating their voting power to third parties whose business model depends on both attaining ever more influence through the growth of shareholder rights and making voting recommendations on a low cost basis. This leads to continual expansion of the governance practices that the proxy advisors advocate and an over-reliance on rigid corporate governance prescriptions on a one-size–fits-all basis. The coordinating impact and rigid influence of the proxy advisory firms risk upsetting the delicate balance between board and shareholder responsibilities—and may undermine the ability of boards to govern effectively.

We support efforts by shareholders to have their voices heard on governance matters. However, we also believe that there is—and should be—a limit to shareholder power in the interests of efficient and effective corporate decision-making. The board of directors is and should be the locus of most corporate decisions; shareholding is, after all, designed to enable passive investment participation in the company. Shareholders should seek to replace directors when they do not perform well, but shareholders should also give directors a fair degree of deference (or rope). In particular, shareholders should carefully consider whether campaigns to target directors due to a single disagreement about the construction of compensation or the failure to follow a particular governance practice—or even the failure to act in line with a shareholder vote on a precatory or advisory proposal—is consistent with shareholders' interests in having a decision-making body that has the fortitude to withstand short-term pressures and take a long view of what the corporation and its shareholders need.

We appreciate that proxy advisory firms may serve a useful function in summarizing information for shareholders, particularly for shareholders with a large number of investments in their portfolios and limited resources to devote to proxy analysis. Such information should be used to inform individual decisions by shareholders on company-specific issues. But shareholders must appreciate that with shareholder power comes responsibility, and this can include responsible reliance on, or delegation to, advisors. Decisions to utilize the services that proxy advisors offer should be made on an informed basis after appropriate due diligence, especially if the shareholder is an institutional investor that owes fiduciary duties to beneficiaries. Does the proxy advisory firm have the resources to provide sophisticated, informed and tailored advice specific to individual portfolio companies, or does their business model require that they rely on fairly set voting policies that are applied across the board by junior or seasonal workers? (The SEC's interpretive release slated for release in 2013 should make for interesting reading with respect to these issues.)

Notwithstanding the broadening of federal regulation of corporate governance over the past decade, the fundamental legal responsibilities of the board, imposed by state corporate law, have not changed: The board is charged with managing and directing the affairs of the corporation. State law does not dictate with specificity how the board should carry out this mandate, but rather imposes fiduciary duties on individual directors. This allows a degree of board self-determination within the flexible fiduciary framework of prudence, good faith and loyalty. However, while board and director responsibilities have not changed in any fundamental way, from a compliance, disclosure and risk management perspective, more is expected from the boards of public companies than ever before. Boards need to meet the expanding expectations of regulators, shareholders, and the public while maintaining focus on key board responsibilities.

The corporate form enables shareholders to share in the benefits of corporate activity while limiting their potential liability to their investment. Their decision rights may be limited, but their voice and their influence is not. Of course, with power comes responsibility. If shareholders do not have the resources to become informed about a particular company and the issues that it faces, or if there are no performance issues or other red flags that would warrant special attention, it makes sense for shareholders to generally defer to the board's recommendations made in the fiduciary decision-making framework the law promotes. This essential construct of corporate law should be respected as it has served all of us well. Shareholder powers should be exercised to strengthen this construct, not create a playground for special interests.

Our economy relies on the success of our corporations, and the apportionment of governance roles and decision rights by state corporate law has been central to that success. As the ABA Task Force of the Section of Business Law Corporate Governance Committee pointed out in its Report on Delineation of Governance Roles and Responsibilities, "[m]aintaining an appropriate balance between responsibilities for corporate oversight and decision-making is critical to the corporation's capacity to serve as an engine of economic growth, job creation, and innovation." All those involved in the public corporation – shareholders, directors, managers, advisors, counsel and regulators – should ground their activity in a clear understanding of the corporate law roles defined for shareholders and boards and the reasons for those roles.

Preserving the delicate balance between board and shareholder responsibilities is vital to enable companies to maintain focus and efficiently create sustainable long-term value for shareholders, particularly in times of difficult economic conditions.

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