© Yoo Jaechang/TongRo Images/Corbis

Corporate Governance Issues for 2015

In her regular column on corporate governance, Holly Gregory explores the issues that will define the state of corporate governance in the year ahead.

HOLLY J. GREGORY
PARTNER
SIDLEY AUSTIN LLP

Holly counsels clients on a full range of governance issues, including fiduciary duties, risk oversight, conflicts of interest, board and committee structure, board leadership structures, special committee investigations, board audits and self-evaluations, shareholder initiatives, proxy contests, relationships with shareholders and proxy advisors, compliance with legislative, regulatory and listing rule requirements, and governance best practice.

Governance of public corporations continues to move in a more shareholder-centric direction. This is evidenced by the increasing corporate influence of shareholder engagement and activism, and shareholder proposals and votes. This trend is linked to the concentration of ownership in public and private pension funds and other institutional investors over the past 25 years, and has gained support from various federal legislative and regulatory initiatives. Most recently, it has been driven by the rise in hedge fund activism.

It remains unclear whether, over the long term, greater shareholder influence will prove beneficial for shareholders, corporations and the economy. In the near term, however, there is reason to question whether shareholder influence is the panacea that some posited, or whether the current focus on shareholder value and investor protection is at the expense of other values that are central to the sustainability of healthy corporations.

These concerns underlie the issues that will define the state of governance in 2015 and likely beyond, including:

- The long-standing debate about the purpose of the corporation and governance roles.
- Tensions between achieving short-term returns and making long-term investment.

© 2014 Thomson Reuters. All rights reserved.

- The impact of shareholder activism on board decisions.
- Shareholder litigation and the reactive use of corporate by-laws to protect boards.
- Concerns about proxy advisor power and influence.
- Drawing the line between board oversight and management.
- Rebuilding society's trust in the corporation.

THE CORPORATE PURPOSE AND GOVERNANCE ROLES

The corporation is a legal construct that arose as a way to accumulate and devote capital to, and share risk for, large-scale entrepreneurial activities that would otherwise be difficult to fund. Shareholders bear the risk of their investment and receive the residual profit, expressed as an increase in share value or dividends. Therefore, the ability of the corporation to return long-term shareholder value is a key metric for assessing whether the corporation is effective and efficient in its activities.

The purpose of the corporation has been a matter of debate since its formation. This debate centers on whether maximizing shareholder value is the ultimate goal of corporate activity or whether the goal is some other broader societal "good." Where the balance between these interests is defined is relevant to how the corporation is regulated through state corporate law and federal securities regulation, and the role and responsibilities of and limits on shareholders and directors with respect to corporate decisions.

While investor protection is a primary goal of securities regulation, it cannot be viewed in isolation. As a regulatory goal, investor protection has value in that it provides positive value to capital formation and the long-term contributions of viable corporations to the economy. More intentional deliberation about the role of the corporation and its relationship to society is necessary in the dialogue over expanding shareholder influence, and also with respect to rebuilding societal trust in the corporation. These considerations should be a priority for 2015.

A closely related issue concerns the balance in governance roles and responsibilities between shareholders and boards. Two theories of corporate governance failures have emerged in the past 15 years. The first theory is that there is too little active and objective board involvement. This theory is reflected in the Sarbanes-Oxley Act and its focus on:

- Improving board attention to financial reporting and compliance.
- Securities and Exchange Commission (SEC) rules and listing rules on independent audit committees and their function.
- Director and committee independence and function.

The second theory is that there is not enough accountability to shareholders. This concern is expressed by the focus of the Dodd-Frank Act, and related SEC rules and rule interpretations, on providing greater influence to shareholders through advisory say on pay votes and access to the proxy for shareholders to nominate director candidates.

Given federal law and regulations, listing rules, and other related influences, the question that emerges is whether these are altering the balance that state law intentionally provides between the roles of shareholders and the board, and if so, whether that shift is beneficial or detrimental. State law places the management and direction of a corporation firmly in the hands of the board. This legal empowerment of the board, and the implicit rejection of governance by shareholder referendum, goes hand in hand with the limited liability afforded to shareholders.

SHORT-TERM RETURNS v. LONG-TERM INVESTMENT

Management has long reported significant pressures to focus on short-term results at the expense of making the investment necessary to position the corporation for long-term success. Observers point to short-term pressures of financial markets, which have increased with the rise of institutional investors whose investment managers have incentives to focus on quarterly performance relative to benchmarks and competing funds.

These short-term pressures may also be furthered by the increasing reliance on stock-based remuneration in the structure of executive compensation. It is estimated that the percentage of stock-based compensation has tripled since the early 1990s. In 1993, 20% of executive compensation was based on stock, in contrast to about 60% today (*Motivating Corporations to Do Good, The New York Times, July 15, 2014*).

Although boards should be positioned to support management in taking a long-term view and help balance competing interests, boards are also under pressure to focus on short-term results, including from both governance- and financially focused shareholder activism. This activism in turn is supported by proxy advisors who generally favor some degree of change in board composition and tend to have fairly defined, and arguably rigid, views of governance practices.

THE VALUE OF SHAREHOLDER ACTIVISM

As prudent fiduciaries, boards must apply independent and objective judgment in responding to both governance- and financially focused activism. Engaging with activists and other shareholders can provide value, but also has limits (see *Box, Preparing for Shareholder Activism*). Boards must come to their own judgments and cannot simply defer to the wishes of shareholders. Activist shareholders may press for changes to suit particular special interests or short-term goals that may not be in the corporation's long-term interests.

Checklists
Visit **PRACTICALLAW.COM** for checklists, handy timelines, charts of key issues and flowcharts. These Checklists are continuously maintained by our attorney editors.

© 2014 Thomson Reuters. All rights reserved.

Preparing for Shareholder Activism

The ability of a board and management to address activism pressures largely depends on the ability to communicate effectively on long-term strategy, risk oversight, management succession and company performance. Successful communications can be made through the company's investor relations efforts and shareholder outreach, as well as in periodic filings and proxy statements.

To prepare for shareholder activism, the board and management should assess the company's vulnerabilities through an activists' lens, and:

- Identify areas in which the company may be subject to activism.
- Consider the company's positions on those topics and prepare responses.
- Assess the company's defense profile.
- Monitor governance and activist updates to keep abreast of "hot topics."
- Ensure that a protocol (including a script) is in place that details how members of management and directors should respond if they receive a call from an activist.
- Invest in building relations with the company's large long-term shareholders.
- Identify the team of advisors that the board would turn to in an activist situation and discuss these issues with them.

Search Preparing for Shareholder Activism and Shareholder Activism: Rethinking the Approach for more strategies for dealing with activist investors and responding to activist campaigns.

GOVERNANCE ACTIVISM

Shareholder pressure for greater rights and influence through say on pay votes, shareholder proposals and director elections are expected to continue in the 2015 proxy season. Directors need to assess the reasons underlying a shareholder request for a course of action, including efforts to influence the corporation's strategic direction through shareholder proposals on CEO succession, risk management, and environmental and social issues. However, if an issue is one that is reserved by law for the board, director duties may not be abdicated or delegated to shareholders, even when a majority of shareholders have a clear preference on the issue.

The ability of boards to apply objective fiduciary judgment is under pressure from advisory shareholder proposals. The universe of shareholder proposals included in corporate proxy statements under Rule 14a-8 has grown significantly over the years. Proxy advisors will recommend that their clients vote against the re-election of directors who fail to implement advisory proposals that receive a majority of votes cast.

Moreover, in 2015 large institutional investors will use non-binding proxy access shareholder proposals to pressure boards on other issues, including climate change, board diversity and executive compensation issues. It was recently announced that New York City Retirement Systems has filed proxy access proposals with 75 companies to give shareholders a greater voice in nominating board members. In 2014, of the 14 proxy access proposals that went to vote, six received majority support, with an average support of 36.8%.

FINANCIAL ACTIVISM

Financially focused shareholder activism tends to seek relatively immediate returns to shareholders through the sale of assets, payment of special dividends or share buybacks. These activists often use tools of governance activism, such as efforts to seat directors, to achieve their goals. Emerging research suggests that shareholder activism may provide some immediate wealth for some shareholders. However, this may be at the expense of long-term gains.

The debate between Harvard Law Professor Lucian Bebchuk and Martin Lipton on the wealth effects of hedge fund activism provides valuable perspective (see *Harvard's Corporate Governance Blog*, available at *blogs.law.harvard.edu*). Bebchuk argues that hedge funds are not "myopic activists," and instead, bring long-term improvements to the target corporations.

However, a recently published paper from the Institute for Governance of Private and Public Organizations finds flaws in Bebchuk's research (*"Activist" hedge funds: creators of lasting wealth? What do the empirical studies really say?, July 17, 2014*). The paper concludes that activist funds may create some short-term wealth for some shareholders, because investors tend to jump to the stock of targeted companies upon the announcement of activist activity. However, the paper states that there is little evidence of any long-term wealth creation:

> "In a minority of cases, activist hedge funds may bring some lasting value for shareholders but largely at the expense of workers and bond holders; thus the impact of activist hedge funds seems to take the form of wealth transfer rather than wealth creation."

The paper also notes that hedge funds tend to focus on the short-term, with half of their interventions lasting fewer than nine months.

© 2014 Thomson Reuters. All rights reserved.

LITIGATION AND PROTECTIONISM

Corporations today are routinely subject to shareholder litigation which is often paid for by corporations and, by extension, their shareholders. According to an oft-cited paper by Matthew Cain and Steven Davidoff, in 2013, 97.5% of takeover transactions valued at over $100 million resulted in shareholder litigation, up from 39% in 2005. Board decisions and proxy disclosures related to executive compensation are also leading to an increase in shareholder litigation, although on a smaller scale.

Not surprisingly, since even weak shareholder claims pose uncertainty, significant costs and settlement pressures, corporate interest has grown on how to reduce nuisance lawsuits. Recent Delaware court decisions underscore the potential for corporate by-laws, including those adopted by boards, to reduce incentives for the plaintiffs' bar to file such lawsuits. For example, the Delaware Court of Chancery has upheld, at least as a general matter, the statutory and contractual validity of board-adopted by-laws that seek to limit the forum for intra-corporate litigation. The Delaware Supreme Court has upheld the statutory and contractual validity of by-laws that allocate the costs of intra-corporate litigation to the losing party.

Although these court decisions have spurred significant interest in board-adopted by-laws aimed at reducing incentives for the plaintiffs' bar to file claims, caution is advised. Notwithstanding strong arguments in favor of deterring nuisance lawsuits, some shareholders, shareholder rights advocates and proxy advisory firms have expressed disfavor with board-adopted exclusive forum and arbitration by-laws. Moreover, the Corporation Law Section of the Delaware State Bar Association has proposed amending the Delaware General Corporation Law (DGCL) to prohibit Delaware stock corporations from adopting fee-shifting by-laws. However, action on this proposal is currently on hold.

Search Using Board-adopted By-laws to Reduce Corporate Threats for more on the use of board-adopted by-laws to reduce certain threats related to dissident directors and intra-company litigation.

CONCERNS ABOUT PROXY ADVISORS

Over the past decade, the growing influence of proxy advisory firms on shareholder voting, executive compensation and corporate governance practices has caused no small degree of consternation and concern among public companies. In addition to the perceived power of the highly concentrated proxy advisory industry to effectively coordinate shareholder voting, criticisms have been raised, including:

- The general opacity and lack of nuanced analysis underlying vote recommendations.
- Potential conflicts that arise when proxy advisors also provide consulting services to public companies.
- Inherent pressures in the proxy advisory firm business model that appear to cause them to continually push the envelope on corporate governance and disclosure reform.

ISS Policy Changes for 2015

ISS's policy changes for 2015 focus on four main areas and provide:

- A new "balanced scorecard" for evaluation of equity compensation plan proposals.
- A negative bias regarding director elections where boards have adopted unilateral by-law (or in certain circumstances, charter) amendments that ISS views as limiting shareholders' rights.
- A more nuanced analysis with respect to shareholder proposals that call for an independent board chair.
- A modified approach to shareholder proposals relating to political contributions and greenhouse gas emissions.

Federal legislation and the SEC rules and guidance are perceived to have played a role in the growth of proxy advisor influence. Not surprisingly, the corporate community, including The Business Roundtable, the US Chamber of Commerce and the Society of Corporate Secretaries and Governance Professionals, as well as members of Congress and several SEC Commissioners, have pressed the SEC to consider whether additional regulation of the industry is warranted.

In June 2014, the staffs of the SEC's Division of Corporation Finance and Division of Investment Management (SEC Staff) issued long-awaited guidance related to both proxy advisory firms and their investment adviser clients. The guidance, published in the form of 13 questions and answers in Staff Legal Bulletin No. 20 (SLB 20), addressed investment adviser responsibilities for the voting of proxies and diligence considerations regarding the retention and oversight of proxy advisory firms. It also addressed two exemptions to the proxy solicitation rules on which proxy advisory firms often rely.

While the SEC Staff's guidance could cause investment advisers to more carefully scrutinize the capacity of proxy advisors with respect to the quality of the analysis and recommendations they provide or even to reduce their reliance on these services, the guidance does not directly address many of the concerns raised to date.

In November 2014, Institutional Shareholder Services Inc. (ISS) issued its final 2015 proxy voting guideline updates, effective for annual shareholder meetings on or after February 1, 2015 (see *Box, ISS Policy Changes for 2015*). Most notably, the policy changes incorporate a negative bias regarding director elections where boards have adopted unilateral by-laws (or in certain circumstances, charter) amendments that ISS views as limiting shareholders' rights.

© 2014 Thomson Reuters. All rights reserved.

Board Oversight: Key Focus Areas

Boards need to prioritize the focus of their oversight based on the unique circumstances facing the corporation. Although the details will vary across corporations, the main focus should be on:

- Corporate performance and strategic direction.
- CEO selection, compensation and succession.
- Internal controls, risk oversight and compliance.
- Crisis preparedness.
- Shareholder activism and shareholder engagement.
- Board composition, leadership and performance.

While the board has much to attend to, in most circumstances the majority of board time should be reserved for discussions on corporate strategy and performance. A recent Blue Ribbon Commission report of the National Association of Corporate Directors emphasizes the role of the board in providing guidance through the development of a strategic plan through an iterative discussion with management. The board should also give special attention to supporting appropriate long-term investment and prudent risk-taking in the face of significant short-term pressures for immediate returns, or other conflicts.

Although not identified in the draft policy changes that ISS released for comment, ISS will now recommend against directors when the board unilaterally adopts by-law or charter amendments that in ISS's view "materially diminish shareholders' rights or...could adversely impact shareholders." Board actions that could trigger this amended policy include the adoption of fee-shifting or arbitration-only requirements without a shareholder vote. However, ISS has indicated in remarks outside its policy document that it will not recommend against directors in situations where boards have adopted exclusive forum provisions.

Search Lessons for the 2015 Proxy Season for trends emerging from the 2014 proxy season and steps companies can take now to prepare for the 2015 season.

THE LIMITS OF OVERSIGHT

With increasing pressures on directors, understanding the demarcation between providing oversight and managing the corporation can be challenging. This issue has potential implications for director liability. Boards typically delegate day-to-day management of the corporation to the CEO and other corporate officers and, as fiduciaries, may rely on them to perform the delegated tasks so long as that reliance is reasonable. However, continuing assessment of the reasonableness of the board's delegation and reliance are core to the board's oversight role (see *Box, Board Oversight: Key Focus Areas*).

Accordingly, when assessing whether directors have satisfied their fiduciary duties, the focus will be on the reasonableness of the board's reliance on the officers to whom the day-to-day management function has been delegated. The greater the involvement of a director in the day-to-day management of the corporation, the more difficult it will be for that director to stand behind her reliance on the relevant corporate officers and use that as a basis to avoid personal liability. In addition, directors that begin to function in a manner similar to officers run the risk that they will be unable to take advantage of the exculpatory provision typically included in the corporation's articles of incorporation, which by its terms is available only to directors.

REBUILDING TRUST

Corporations create wealth for shareholders, but their contributions to the economy extend well beyond the return of profit. They can provide employment, support innovation, purchase goods and services, pay taxes, and support various social and charitable programs. Given the important role that corporations play in our society, concerns about the use of corporate power and expectations for the board continue to expand, especially related to the oversight of risk management, compliance and social responsibility.

In response, boards need to approach these issues with objectivity and fiduciary judgment. Boards should work with management to ensure that the corporate culture is one that, among other things, encourages employees to come forward with concerns. Boards should assess the quality of the corporation's messaging and communicate at every opportunity that internal reporting is expected, valued and critical to the corporation's success.

Management integrity is also key to building trust with customers, suppliers, employees, regulators and investors. Integrity and trust can be difficult to assess, but should be of particular concern in efforts to focus on the long-term interests of the corporation and its shareholders, balance a host of competing special interests and pressures, and address the expectations of the broader society.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.

© 2014 Thomson Reuters. All rights reserved. Use of Practical Law websites and services is subject to the Terms of Use (http://us.practicallaw.com/2-383-6690) and Privacy Policy (http://us.practicallaw.com/8-383-6692).