

Tom Cole on the New Era in Corporate Governance

Sam Gandhi and Tom Cole

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Sam Gandhi:

For whose benefit should a corporation be governed? That question would get a very different answer 20 years ago. So, what's changed since then? Well. A lot, as we'll find out in today's podcast.

Thomas Cole:

The new era could be best characterized as representing the transition from management-centric decision making to board-centric. I think the CEOs who get it right are those who look at their board and think of it as an asset.

Sam Gandhi:

Would you join a public company board in this era?

Thomas Cole:

Sure. You're dealing with very smart people on very important issues in important institutions in society.

Sam Gandhi:

From the international law firm, Sidley Austin, this is The Sidley Podcast, a podcast that tackles cutting-edge issues in the law and puts them in perspective for businesspeople today. I'm Sam Gandhi.

Hello, and welcome to The Sidley Podcast. We're really happy to be presenting the first of what we hope are going to be many podcasts, and I'm pleased to have, as our first guest, today, Sidley's own Thomas Cole. Tom is a senior counsel at Sidley and was a partner at the firm in our Chicago office over a period spanning four decades and served as Chair of the Executive Committee for 15 years. He is also one of the country's leading authorities on M&A and corporate governance, as well as executive compensation and shareholder activism. I'm also lucky that he's been a mentor and friend to me for many years.

Tom, welcome and thanks for being on the podcast.

Thomas Cole:

Glad to be here.

Sam Gandhi:

You're out with a new book. It's called *CEO Leadership: Navigating the New Era in Corporate Governance*. So what is new about that new era in corporate governance?

Thomas Cole:

The new era could be best characterized as representing the transition from management-centric decision making to board-centric making. That's the new piece. It all really started in the late '80s, that's when the seed was planted for this new era, through important case law focusing on board decision making, like the Van Gorkom decision, better known as the Trans Union case. Then there was the Avon Letter and the founding of ISS, which has a big impact on how institutions interact with corporations. Then, in the mid-'90s, it really picked up steam. Institutional ownership, for the first time, exceeded household ownership of equities of public companies. Corporate governance, in a way, became an industry. Then it was further boosted in the early 2000s with the Sarbanes-Oxley legislation that followed the fall of Enron and other companies.

The new in the new era, getting back to your first question, is really board-centricity in terms of decision making on the big subjects, strategy of succession, risk in major transactions. There's also a new element of greater scrutiny by shareholders in part because there's less diffusion of ownership and in part because there's shareholder activism, which is, in and of itself, its own business model. One of the great benefits of the movement from management-centricity to board-centricity is that managements, while they still run the companies, and have leadership in the companies, have to sharpen their analysis before they undertake a major transaction or a major decision, like a shift in strategy, because they have to make the sale to the board, and by sharpening that analysis and understanding that they're not going to be the final word I think decision making has been enhanced.

Sam Gandhi:

So, do you think that the change in governance has really been reactive to issues or has it been better for management? The question really is, is that these changes from management-centric to board-centric has really been somewhat...you just talked about how reactive it's been to events. Has it ultimately become better for the corporation from a management standpoint?

Thomas Cole:

I think so, for the reason I just gave, which is management has to sharpen its analysis. It's not the final word and also the other big change has been the principal source of disciplining both managements and boards is now the shareholders and potential shareholder activism. In the 1980s the principle discipline was threat of hostile takeovers. That's less of a threat now, and really both boards and managements are reacting to potential shareholder activism.

Sam Gandhi:

So, for whose benefit is the corporation to be governed at this point? There seems to be a diversity opinion on this than in the past, and it seems like it's tied, among other

things, to the rise and expectations of the corporation's need to for social responsibility. How has that kind of changed, or is the shareholder still king?

Thomas Cole:

Well. I don't know that the shareholder has ever been absolutely king, but the question you raise is really the shareholder, stakeholder question, and in many ways when you consider those three different concepts get conflated. What's the purpose of the corporation, to whom are duties owed, and then finally, for whose benefit? The purpose of the corporation, notwithstanding with the business roundtables, to my mind, is to provide goods and services. The purpose of the corporate form, of course, is to facilitate capital formation. Duties, on the other hand, going from purpose to duties, directors and officers have duties to all of the stakeholders. Stakeholders include employees and so on, and not just shareholders, but for the non-shareholder stakeholders, those duties are derived from specific laws, regulations, and contracts. For the shareholders, the duties are much more general, and they're derived from codes of conduct...standards of conduct, called fiduciary duties, so then we get to the benefit.

Corporations are still to be run after satisfying all of these duties to the other stakeholders. They're still to be run for the benefit of the stockholders, and that means maximizing shareholder value in the long-term. That's a somewhat discredited phrase these days, but directors and officers can pursue actions that benefit these other stakeholders so long as there is really any rational connection with the long-term shareholder value, and that's...in some ways things have changed in terms of the rhetoric around the whole subject, but in terms of fundamental legal obligations and the economic considerations there's still...the responsibility of directors and officers is to operate the company for the benefit of the shareholders for the long run.

Sam Gandhi:

So, at Goldman Sachs, the old trader, Gus Levy, used to say we're long-term greedy, right? We didn't go after short-term results, we were long-term greedy, so it sounds like though that the goal of the corporation over the long-term as a shareholder, but in your book, you talk a lot about short-termism and how that's affected boards and management.

Thomas Cole:

There is a problem with short-termism, and in many ways, it's derived from the threat of shareholder activism. Shareholder activism really causes boards and managements to take their eye off the long-term. It's not just shareholder activism, of course, it's the way the markets react to relatively short-term swings in profits, short-term swings in outlook for the near term. But long-term greedy is probably a good term, so long as it's understood to be long-term greedy for the benefit of the shareholders not for the management and the directors.

Sam Gandhi:

So, what other forces are shaping corporate governance in this era that weren't there a generation ago?

Thomas Cole:

The increased influence by institutional shareholders is quite significant, and in some measure that is reflected in pressure from institutions such as Blackrock toward corporate social responsibility. Even though Blackrock says their principal goal is to have returns for their investors, they will note that returns to their investors can be enhanced or diminished, depending upon the entities perspective on social responsibility and how well they deal with various issues, such as safety and whatnot. So that's a big difference. Corporate social responsibility is much more in the fore right now. Although, in some ways, the enemy of corporate social responsibility is the financially oriented activists that are looking for short-term results.

Sam Gandhi:

You and I have talked about the rise of the expectations that shareholders have about having a company, have a great emphasis on social responsibility. What are the highest priorities that shareholders are looking for a corporation to really focus on in that area?

Thomas Cole:

Sure. Well. First of all, not all shareholders are concerned about it, but to the extent, shareholders are concerned about it, and it gets translated into corporate behavior. In fact, it depends on the company, it depends on the industry it's in. Corporate social responsibility for an oil and gas company would be probably more focused...obviously, more focused on environment. Corporate social responsibility for a consumer-facing company—say a consumer-packaged-goods company—that could be reflected in their use of plastics in packaging. Corporate social responsibility for retailers could be reflected in how they deal with employees, particularly part-time employees, whether they're being given a fair shake. So it really depends upon not just the pressure they're getting from shareholders but what makes sense for the company, because, again, corporate social responsibility, while in the short-term might appear to benefit mostly the non-shareholder stakeholders, in the long-term it has to have some connection with the long-term benefit to the shareholders.

Sam Gandhi:

And Tom, in the book, you also talk about the tension between board-centricity and shareholder-centricity and there are a number of constituents who are trying to push for greater shareholder-centricity of the corporation. What are your thoughts on that?

Thomas Cole:

Well, corporations are shareholder-centric in the sense that they ought to be managed as we've discussed, for the ultimate benefit of shareholders after taking care of the other stakeholders, but the notion of having board-centric...shareholder-centric decision making I think is a bad idea. Shareholders are very different than directors. First of all,

they're not fiduciaries. Unless they are dominant or majority shareholders, they have no fiduciary duties, so they can act in their own unbridled self-interest.

Second, they will sometimes push for things and not be around, as we like to say, to eat their own cooking. A shareholder who forces a company to have a buyback that maybe is a share buyback that's at an imprudent level, they don't have to stick around and see how it works out. They just get to sell the shares at perhaps too high a price. Third, they're not an expert. Someone who is a good stock picker may not be expert in the actual operations of the company, so their ideas may not really have that much credibility or relevance. They're not fully informed. Not all information about a company is out there in the public domain, and that's appropriate because there are plans that are highly sensitive, they're confidential, and whatnot, and then finally there's this notion, that some academics have written about, called empty voting, which is they may have the vote but through derivatives and other means they laid off the economic risk.

So, if you take all of those things together, together with the fact that I think board-centricity has been a real positive because of the interaction between boards and management I'm in favor of board-centricity on big issues, but not in favor of shareholder-centricity.

Sam Gandhi:

Your book also spends a lot of time on board members, expectations of board members, and the roles of directors on the board. Has the role of the director changed meaningfully in the last 20 years?

Thomas Cole:

Absolutely, and in some ways, it was captured in the notion of how much time a public company director actually spends on that role. It's much greater. They spend much more time. There are more frequent meetings, there are more frequent special meetings. The role of the board, again, is really an enhanced involvement in major decisions, and one of the most important decisions, of course, is succession, CEO succession. I note in the book our esteemed colleague Newton Minow once told me because he served on any number of public company boards in a way that a senior lawyer no longer does, but in his view 40% of the time CEO succession is botched, and so the directors really have to spend a lot of time thinking about that.

Another element of the role is much greater participation in strategic planning. I remember talking to an old-school CEO who said oh, he would never involve his board in strategic planning because they were too risk-averse. Now the boards are very heavily involved in strategic planning. They will frequently have a strategic planning retreat offsite at least once a year, and strategic planning has become an iterative process. Certainly, the initial thought, the first draft as it were, of a strategic plan should come from the management, but then it iterates between management and the board because a well-selected board with all of the right skills and experiences can make great contributions to the thinking of the management. And again, going to back to a

point I made earlier, because management knows they're going to have to bring these things to the board that first draft, at least as presented to the board, is much sharper than it might otherwise have been.

Sam Gandhi:

So, Tom, in the beginning of the podcast we talked about boards that kind of cross the line into more management and impeding on the role of the CEO. As an advisor to boards, when you see that, how do you pull the board back from doing that?

Thomas Cole:

I can give you a story about that. There was a board member who was the chair of a compliance committee. Now, not all companies have a compliance...a board compliance committee, but this was in a regulated industry, and so it had a compliance committee. This chair of the compliance committee felt that she had hiring and firing authority over the chief compliance officer, and I was asked by the lead independent director to set her straight. Well, I didn't want to make it too personal, so I suggested and said that I give a bit of a board education session for the whole board and not just this one individual. And one of the things I pointed out was that if a board member acts too much like an officer they could lose the protection...very important protection of the exculpatory charter provision, which is that thing in the certificate of incorporation that says a board member will not be held responsible, financially responsible, for breach of the duty of care.

Well, if a board member behaves like an officer, there's at least a theoretical possibility that they will not have the benefit of that provision because it doesn't protect officers, so that's one way to pull them back. Another way, frankly, is not so much for the lawyer to do it as it is for either the lead independent director or nonexecutive chair to just have a bit of a one-on-one conversation. And if all of that fails then sometimes it can come up in an annual board evaluation where the board will be evaluating individual members, or if it's not a board evaluation that does that, it could be the decision of the nominating governance committee annually when they're slating the candidates to serve on the board. And they can talk to the person about you're really overstepping a bit, and the worse overstepping actually takes place when board members go around an accepted protocol or an agreed-upon protocol about getting information from people within the organization. If you have a board member who goes deep into the finance committee, or finance function of a company and asks for an analysis of this or that it can wreak havoc, and so these protocols are fairly important. They're really quite important.

Sam Gandhi:

What do you do in a situation where you feel like the board's not spending enough time?

Thomas Cole:

The classic case would be in considering a major transaction, and in that instance, frankly the lawyer, together...the outside lawyer together with the general counsel with

the consent of the CEO and whoever's the lead independent director simply says we're just going to have to have...we're going to have a series of meetings. I mean, if you sell a public company it's not at all unusual to have 15 board meetings over that issue, and people will show up if you call a meeting.

Sam Gandhi:

You have a great story in your book that you once asked Congressman Michael Oxley, shortly before the enactment of Sarbanes-Oxley, whether he would join a public company board, and he said he would wait a while for the law to work itself out.

Thomas Cole:

I think he said wait until the dust settles.

Sam Gandhi:

Well. Would you join a public company board in this era?

Thomas Cole:

Sure. Although, it's interesting. Folks who had the position that I've had in our law firm, my predecessor I mentioned, Newton Minow, served on any number of boards. These days outside lawyers are not typically invited to serve on a board, but I would serve on a board if they were looking for me as...for business advice. If they simply want legal advice, as I told any number of people, they can rent that. They don't have to put me on the board, but more broadly a lot of folks will ask me, should I serve on a board? Shouldn't I be concerned about financial risk and all of the rest, and my answer to that is, given the suite of protections for corporate directors the reality is, the number of times a director's actually had to write a check is very, very small, very, very small.

Now, you can have reputational exposure, and that's not to be minimized, but the positives of serving on a board are that you're dealing with very smart people on very important issues, and frankly in important institutions in society, because corporate America is really a very important element of our society and can do lots of good things, and with the right boards can avoid doing some of the bad things.

Sam Gandhi:

My guest today is Tom Cole, Senior Counsel and Chair Emeritus of the Executive Committee of Sidley Austin, and he's the author of the newly published CEO Leadership: Navigating the New Era in Corporate Governance. Tom, we talked in the first part about governance, but your book is really focused on CEO leadership and modern challenges to long-term leadership. What are those challenges in the new era?

Thomas Cole:

Well. First, I want to start by noting that in my view, and I reflect it in the book, leadership is more than just management, and I don't mean to diminish the importance of management and execution, but leaders do more than just all of that. So, right now the main challenges to CEO leadership, particularly for the long-term in this new area of

governance are, I would say, three-fold. One is boards that cross the line and go from the proper role of a board into management, or God forbid, micromanagement, and boards are sometimes influenced to do that by their...perhaps by their own biases, but also because they're feeling pressure from shareholders, but boards that cross the line of the management is one of the impediments to CEO true leadership.

The second is the time that's required of CEOs now to deal with boards and with shareholders, and not all of that time is productive, and not all of that time advances business and strategy or allows the CEO to be a leader, and then finally is the activism by financial oriented activists, many of whom are very, very short-term oriented. Some have a much longer perspective, but many are very short-term oriented.

Sam Gandhi:

Why did that happen? Why do you think that changed so much? I mean, we've talked a little bit about the new era and what have been the drivers, but why do you think the perception of what the CEO should be doing has really changed substantially in the last generation?

Thomas Cole:

In fact, I don't know that the perspective of what they should be doing has changed. It's simply the impediments have been put in place to keep them from being able to do it as much. CEOs certainly have to spend much more time and attention on governance matters. I did, in the course of preparing this book, a little informal survey of a bunch of CEOs, and it was nonscientific because I'm not a pollster, but these were folks I knew well and I promised them anonymity and confidentiality and one of the questions is you define governance any way you want but tell me how many hours you spend a year on governance stuff and the range was between 200 and 600 hours a year take a midpoint...or not even a midpoint, 300 hours. That's over 10% of really hardworking person's time that might otherwise be applied to advancing the business and looking out for shareholder interests.

Sam Gandhi:

So, we've talked about how CEO's duties have changed. Have our expectations of what a CEO should really be changed as well?

Thomas Cole:

Well. One of the really positive changes of our expectations is that CEOs are really expected to drive a positive corporate culture. CEOs are expected to set an important tone at the top for compliance, but also to establish a positive culture within the organization, and a positive culture means, of course, showing respect for employees and demanding that of others, but also their own behavior. I mean, if you look at the number of CEOs who have left suddenly in the past, call it, 24 months the number that can be characterized as part of the #MeToo issue is very significant, so CEOs are really expected to be much better role models than perhaps in the past was expected of them.

Sam Gandhi:

Well. Let me ask you another question, which is that if an executive had an opportunity to be the CEO of a public company and came to you and asked you whether you should do that what would you tell them?

Thomas Cole:

I personally would tell them to do that. Now, I had a very interesting conversation with a guy who was the CEO of a public company, and then went into the...and became the CEO of a portfolio company of a private equity firm. He was later, while he was still the CEO of the private company, was invited...was asked by a headhunter if he wanted to be considered to be CEO of the 50-billion-dollar market gap in his industry. He would've been perfect for the job, but his response, after having gone from public to private was, why would I ever want to do that?

Sam Gandhi:

That's a great story? Did he do it?

Thomas Cole:

No.

Sam Gandhi:

No. And he stayed in the private sector?

Thomas Cole:

He stayed in the private sector. Part of this is, what are you interested in, fame or fortune, and if you're the CEO of a public company you might get both. It's much more of a public platform. So, for example, if you were interested in an important social issue, like gun violence/gun control you would have a better platform from which to speak, so then there are a couple of prominent examples. There's Dick's Sporting Goods, but that relevant to their...directly relevant to their business. The other example is Levi Strauss. They don't sell guns, they do blue jeans, right, but their CEO has been very open and a very public advocate about gun control and gun violence.

So, another reason may be to be CEO of a public company is that you're simply going to be more prominent in society, and that can operate to the good.

Sam Gandhi:

So, Tom, in your career describe a CEO that actually gets this right.

Thomas Cole:

I think the CEOs who get it right are those who look at their board and think of it as an asset. I can describe one CEO. This is an entrepreneur, very big personality, owned 20% of a public company, could frankly do whatever he wanted, but he also had assembled a terrific board and he really wanted their advice. He could've been the kind of CEO who came in and said well, I've decided to do this so all in favor, but he didn't

do that. He would literally engage in the Socratic method around the board table and nobody could hide, so that's on the one hand. He also got it right, in terms of shareholders. He was very focused on shareholders.

He would engage with shareholders even before shareholder engagement became a cliché, or an aspiration, perhaps that's a kinder way of putting it, and then finally he was extremely focused on his people and their families. He was a CEO who lost a large group of people on 9/11 and he attended, I think he told me, 100 funerals, so that's a guy who got it right.

Sam Gandhi:

I could talk a lot about this, but we've got to end the podcast at some point, and we've been talking to Tom Cole, Senior Counsel with Sidley Austin and the other author of the new book *CEO Leadership: Navigating the New Era in Corporate Governance*. Tom, thanks for coming on our debut podcast.

Thomas Cole:

It's my pleasure. Thanks for having me, Sam.

Sam Gandhi:

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