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Governing Through Disruption: A Boardroom Guide for 2018

In her regular column on corporate governance issues, Holly Gregory explores the key issues that will require board attention in 2018.



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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.

Boards of directors govern in an increasingly dynamic environment marked by technological and business model disruption, regulatory and enforcement uncertainty, political unrest, and expanding expectations about the company's role in addressing societal problems. Innovative uses of technology are driving changes in competitive conditions, and creating opportunities for inventive companies, but peril for those that are slow to adapt. Interrelated changes in consumer behavior, customer expectations, the supply chain, and the labor market add complexity to governing in a rapidly changing environment, as does the social and political unrest that often emerges in transformational times.

These issues will impact the board's agenda and priorities in 2018, as companies seek to identify opportunities arising from disruption and avoid unexpected risks, and as shareholder activists continue their efforts to influence corporate decisions.

While the challenges facing boards change over time, the responsibilities of the board and the fiduciary duties of directors under state corporate law remain stable, namely:

- The board is the body empowered to direct the company's affairs, and shareholders lack the power under law, and as a practical matter, to govern by referendum.
- Acting with due care, without a conflict of interest, in good faith, and in the best interest of the company continues to be the legal standard by which director action (or inaction) is assessed.

Active engagement with key shareholders is prudent. A company that ignores the impact of corporate actions on constituents or the viewpoints of investors, regulators, business partners, customers, employees, and key observers will not succeed over the long term.

In an environment of expanding business complexity and constituent expectations, the demands for board time and attention are significant. Each board must define its own priorities based on the unique circumstances facing the company. While the specific priorities and their order will vary from board to board, this article outlines the key areas on which boards are likely to focus in 2018, including:

- Oversight of strategic planning to create long-term sustainable value.
- Risk management and crisis preparedness.
- Management delegation, performance, compensation, and succession.
- Effective engagement with shareholders, including activists.
- Board succession planning aligned with changing circumstances.
- Corporate culture and related controls.

The board also should not be distracted from assisting management in focusing on the opportunities and risks presented by technological and business model disruption (see *Box, Disruption and Innovation*) and on providing management forward-looking guidance, with the majority of its time reserved for discussion of corporate strategy and assessing the quality of management performance.

OVERSIGHT OF STRATEGIC PLANNING

Devoting attention to the long-term strategy of the business and the risks related to that strategy is a central board activity. Discussion of strategic issues and associated risks should account for a significant portion of the board's meeting time. To guide corporate strategy and oversee management's performance in a fast-moving time of technological change, the board needs to be technologically savvy, curious, and supportive of change, whether through organic means, such as research and development or reinvention of business models and processes, or through acquisition of technology and disrupters.

The board should 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. This includes:

- Supporting a focus on long-term strategy.
- Approving the strategic and operating plans and related budgets, after active iteration with management and deliberation.
- Monitoring management's performance using preset benchmarks where possible to determine progress in relation to strategic and operating plans and related budgets, and to help provide an "early warning" when a change in strategy or other shift is needed.

The board's oversight of strategic planning is particularly important because investors also are focused on long-term sustainable value creation. Recent letters from the CEOs of BlackRock, Inc., State Street Global Advisors, and The Vanguard Group, Inc. to portfolio company directors emphasize the importance of long-term sustainable value creation and the need for corporate governance practices that support such efforts. (Annual Letter from Larry Fink, Chairman and CEO, BlackRock, Inc., to CEOs (2017), available at blackrock.com; see also BlackRock, Inc., *Investment Stewardship: Our Engagement Priorities for 2017-2018*, available at blackrock.com; Letter from Ronald P. O'Hanley, President and CEO, State Street Global Advisors, to Board Members (Jan. 26, 2017), available at ssga.com.)

For example, Vanguard's CEO identified four pillars the company considers when evaluating corporate governance practices that it believes are important to a company's ability to perform well over the long term, namely whether:

- The board is a high-functioning, well-composed, independent, diverse, and experienced board with effective ongoing evaluation practices.
- Governance structures reflect provisions and structures that empower shareholders and protect their rights.
- The company provides appropriate compensation, including pay that incentivizes relative outperformance over the long term.
- There is effective, integrated, and ongoing oversight of relevant industry- and company-specific risks.

These four pillars guide Vanguard's proxy voting and engagement activity, and boards are well advised to take them into account. (Open Letter from F. William McNabb III, Chairman and CEO, Vanguard, to Directors of Public Companies Worldwide (Aug. 31, 2017), available at vanguard.com.)

RISK MANAGEMENT AND CRISIS PREPAREDNESS

The board plays a key role in assisting management to understand and focus on the risks associated with corporate strategies and the ever-changing business and political environment, determine the company's risk appetite, and devote appropriate resources to risk identification and management activities. Prudent risk-taking requires reliable risk-reward information, which should take into account the key risks associated with the drivers of corporate performance.

Disruption and Innovation

The board should consider several questions relating to the opportunities and risks presented by disruption and innovation, including:

FOCUS AREA	QUESTIONS
Strategy	<ul style="list-style-type: none"> ■ Have we identified and do we understand the sources of disruption and change that are most likely to impact our business in significant ways? ■ Do we understand where the company and its industry are vulnerable to technological or business model disruption? ■ Who in our industry (and outside our industry) is innovating in a manner that could impact our business and industry? ■ What are the strengths we can use to compete? ■ Where do we need to build capacity? ■ What is our plan for innovation or adaptation?
Risk	<ul style="list-style-type: none"> ■ What corporate processes, including controls, are needed to keep pace with innovation and business model change? ■ Do we understand the risks associated with the rapidly changing environment? ■ How do we manage risk relating to political or social issues, and positions that the company may take on such issues that may not be universally held within the company?
Management	<ul style="list-style-type: none"> ■ What is the management team doing to encourage innovation and respond to change? ■ How does our investment in our employees align with innovation and change? ■ Does our management team have the personnel and resources needed to innovate and otherwise respond to a disruptive environment? ■ How does our management team and commitment of resources compare with that of peers and leading innovators outside our industry?
Corporate Culture	<ul style="list-style-type: none"> ■ Does our corporate culture encourage and support innovation? ■ How does (or could) innovation and change impact our corporate culture? ■ What additional processes, including controls, are needed to protect and promote our corporate culture in a time of change? ■ What are the potential social impacts of our efforts to innovate and adapt to change, and are there actions the company, as a good corporate citizen, should consider to soften or ameliorate potential negative impacts?

Identifying and understanding emerging and future risks can be difficult. Boards can also miss the true nature of a risk, for example, by failing to consider the potential reputational damage of a risk that may have little quantitative impact. Key risks that should be of the greatest concern for most boards are those associated with cybersecurity, data protection, legal compliance, and corporate culture. An emerging risk to consider relates to taking a public position (or not taking a public position) on political and social issues, for example, relating to immigration, hate speech, and discrimination.

Issues that ultimately impact corporate reputation can sometimes fail to be noticed at the management level for a period of time, and then come to the board's attention when it is too late to avert a crisis. The board and management should take steps to plan for a crisis to position the company to react quickly and with assurance.

Important action items for the board that relate to risk and crisis preparedness include:

- Determining with management the level of risk exposure that the company is willing accept with regard to its strategy and operations.

- Monitoring management's efforts and the processes and controls related to the identification, review, management, and mitigation of risk.
- Understanding significant risks to the business and how the company is prepared to respond (including periodically reviewing plans for responding to natural disasters, broad failures of the power grid, and cybersecurity breaches).
- Understanding management's efforts to prepare for a crisis, and being ready to become actively involved in circumstances in which management may be conflicted.
- Ensuring the board can act effectively when a crisis occurs by embracing governance structures and practices that support a board culture in which consensus can be readily achieved after full and informed discussion, independent viewpoints are respected and valued, and confidentiality is protected.

 Search [Board Oversight of Cybersecurity Risks](#), [Board Assessment of Compliance Programs](#), and [Corporate Crisis: Board Preparation and Response](#) for more on these issues.

MANAGEMENT DELEGATION, PERFORMANCE, COMPENSATION, AND SUCCESSION

Boards typically delegate day-to-day management of the company to the CEO and other corporate officers and, as fiduciaries, may rely on these officers to perform the delegated tasks, as long as that reliance is reasonable. Continuing assessment of the reasonableness of the board's delegation is central to the board's oversight role.

While directors may be tempted to overstep into management's purview and function at a level similar to corporate officers, directors who do so may lose the ability to take advantage of the exculpatory provision typically included in the company's articles of incorporation. An exculpatory provision may eliminate or limit the personal liability of directors, but not officers, for monetary damages for a breach of the fiduciary duty of care, subject to certain exceptions (see, for example, 8 Del. C. § 102(b)(7)).

The key areas of board focus with respect to delegation, oversight of performance, compensation, and succession planning include:

- Selecting the CEO and clearly articulating the scope of the authority delegated to the CEO, as well as performance expectations.
- Monitoring the performance of the CEO and executive officers and continually assessing whether reliance on these key executives is reasonable.
- Advising and coaching management as appropriate, by providing management with the benefit of the board's collective expertise, but not by dictating actions that are clearly within management's purview.
- Planning for succession of the key executive officers under both normal and emergency circumstances.
- Replacing the CEO when the circumstances warrant.

- Determining appropriate incentives to attract and retain leaders and to align the efforts of key executives with performance expectations, being mindful of how CEO pay compares to not only peers, but also median employee compensation. (This year is the first year in which pay ratio disclosure is required, and boards will need to be prepared to address any adverse reactions from employees, shareholders, and the media.)

 Search [Succession Planning](#) and [Planning for Leadership Succession and Unexpected CEO Transitions](#) for more on the board's role in succession planning.

ENGAGEMENT WITH SHAREHOLDERS

Views on corporate governance are converging in several key areas as institutional shareholders expand their influence on the governance of US publicly traded corporations. For example, corporate governance recommendations issued by groups such as the Investor Stewardship Group, the National Association of Corporate Directors, and signatories to the Commonsense Principles of Corporate Governance emphasize the need to align board composition with strategic direction, factor sustainability considerations into corporate decisions, and resist short-term pressures.

Shareholder activism has long been the province of public pension funds and a few individual shareholders who have pushed to expand shareholder rights through shareholder proposals and negotiated settlements. In the last decade, hedge fund activists have influenced board decisions through more pointed efforts to replace management or obtain board seats. Large index funds are increasingly engaging with companies through letter-writing campaigns and by issuing policy statements that emphasize investors' priorities and areas of focus. While shareholder activism shows no signs of abating, it is prodding greater engagement between companies and their shareholders.

Directors need to understand shareholders' viewpoints and continue to make informed decisions that they believe are in the best interests of the company as they help management focus on corporate resiliency and sustainable performance for the long term. The onus is on boards and senior executive teams to inform and engage with shareholders about corporate strategy, key board decisions, and the rationales for those decisions.

One benefit of building a relationship of trust with key shareholders, based on transparency and understanding, is that these shareholders may be more willing to support the board and management in the face of a shareholder proposal, proxy access nomination, or proxy contest. Boards also should be prepared for an approach by hedge fund activists and if approached be prepared to consider the issues they raise and avoid automatically defaulting to a defensive mode.

In this dynamic environment, it is in the interests of the company for the board to:

- Actively oversee engagement with key shareholders, which should occur on a regular basis and emphasize learning about shareholders' viewpoints and developing enduring relationships.
- Periodically review the company's engagement efforts to determine what is working well and which processes could be improved, and what the company should disclose about its engagement processes and actions taken in response to shareholder feedback.
- Seek to understand how various shareholders' perspectives differ based on their divergent interests.
- Consider and address as appropriate shareholder requests and proposals.
- Stay informed of the perspectives of proxy advisors (without assuming that they necessarily reflect the views of the company's shareholders).
- Consider how various types of shareholder activists are likely to view the company, and its strategies and governance and compensation practices, with a focus on identifying vulnerabilities (for example, pay ratio disclosure).
- Have a plan for responding to a shareholder activist approach that includes studied consideration of the shareholder activist's views.
- Consider whether the company should enhance its disclosures relating to corporate strategy, particularly where the company perceives it may be vulnerable to a shareholder activist attack in relation to its strategy.
- Continue to apply informed and objective judgment.

BOARD SUCCESSION PLANNING

The quality of board governance begins with the composition of the board. Boards need highly competent and committed directors with a combination of expertise relevant to the company's business and direction. The ability to bring objective judgment to bear and to express and consider diverse viewpoints while driving toward consensus are necessary qualities in a director.

Competency and relevancy of expertise are key issues that shareholder activists focus on, and these are also the likely focus for future use of proxy access. Boards need to consider in connection with their annual evaluation and re-nomination processes whether the board comprises directors with the skills, experience, and diversity of background relevant to the company's strategic direction, and attend to refreshment mechanisms. Individual director evaluation should be a component of that consideration.

Specific areas for board activity include:

- Recruiting highly qualified directors with relevant expertise and the ability to commit the requisite time, taking into account diversity considerations (see *Box, Board Diversity Considerations*).

- Considering board refreshment mechanisms, including age and tenure limits and individual director evaluation (through self-assessment or peer review).
- Avoiding treating the re-nomination decision as a foregone conclusion, and instead basing re-nomination decisions on the assessment applied when recruiting directors, as well as assessment of their actual performance.
- Evaluating and attending to issues of board and committee leadership, ensuring that leadership is in place to provide a strong albeit generally supportive counterweight to management.
- Organizing the work of the board, including determining board and committee agendas and information needs, and taking care to ensure that the most important matters receive priority attention.
- Attending to board culture, including processes designed to encourage the expression of diverse views while also ensuring that consensus is developed efficiently. The tone and quality of relations with management and among directors should reflect mutual respect and collegiality, and should support open and constructive discussion.
- Providing compensation for directors that fairly reflects the time and effort that is required of them. However, decisions about director compensation involve inherent conflicts of interest and therefore should also be demonstrably fair to the company.
- Evaluating and discussing board and committee effectiveness, and the effectiveness of board and committee leaders, on an annual basis. The board should consider evaluation of individual directors either as a component of the board evaluation or as a component of re-nomination decisions (or both), and should consider what to disclose about the evaluation process.
- Staying abreast of emerging ideas about best practice trends developing in the proxy season with shareholder proposals and proxy advisor policies. The board should consider this in the annual discussion of board effectiveness and in the annual review of governance principles and committee charters, but ensure that corporate governance is tailored to the unique and specific needs of the company. To the extent the company's practices do not align with best practices, the board should consider providing more robust disclosure regarding why the company's practices are appropriate in the circumstances.



Search [Rethinking Board Evaluation](#) and [Issues to Consider Before Conducting a Board Evaluation: Checklist](#) for more on board evaluation.

CORPORATE CULTURE AND RELATED CONTROLS

In October 2017, the National Association of Corporate Directors published its *Blue Ribbon Commission Report on Culture as a Corporate Asset* (available at nacdonline.org). The report includes ten key recommendations for boards to consider in their efforts to promote an appropriate corporate culture, including:

Board Diversity Considerations

Board composition and refreshment are under increased scrutiny by shareholders (including activists), who are paying closer attention to company disclosures on this topic. It is now common for boards (through the nominating and corporate governance committee) to review the skills of directors against a skills matrix that aligns the board's composition with the company's strategic direction as part of the annual nomination process, taking into account diversity considerations, the desirability of having a mix of tenures, and the results of board, committee, and individual director evaluations. Several large institutional investors have highlighted board diversity as a key priority and may consider diversity in their proxy voting.

For example, in September 2017, New York City (NYC) Comptroller Scott M. Stringer and the NYC pension funds announced the "Boardroom Accountability Project 2.0" with the goal of making large public companies' boards "more diverse, independent, and climate-competent." The NYC Comptroller sent form letters to the boards of 151 companies, seeking information about each board's composition and its processes for board refreshment and evaluation.

The form letter calls for companies to disclose annually a "board matrix" that would indicate each director's skills, experience, age, tenure, gender, race and ethnicity, and

sexual orientation (with disclosure of sexual orientation being voluntary). The NYC Comptroller also seeks to engage with directors about their company's processes for refreshing the board and highlights the following four potential topics for discussion:

- The skills and experiences the board considers most critical, how the company's current directors and nominees best serve its long-term strategic goals, executive succession plans, and risk oversight responsibilities.
- The evaluation process for individual directors, including how underperforming or expendable directors are encouraged to step down from the board.
- How to establish a process for any director search firm retained by the company to contact the NYC Comptroller and other significant investors for suggestions about potential director nominees and organizations that specialize in sourcing diverse director candidates.
- How to establish a more structured process for the NYC Comptroller and other significant investors to recommend potential director nominees to the company's nominating committee on an ongoing basis.

(Press Release, Comptroller Stringer, NYC Pension Funds Launch National Boardroom Accountability Project Campaign (Sept. 8, 2017), available at comptroller.nyc.gov.)

- Establishing clarity on the foundational elements of values and corporate culture, where consistent behavior is expected across the entire company regardless of geography or operating unit, and developing concrete incentives, policies, and controls to support the desired corporate culture.
 - Taking a forward-looking, proactive approach to corporate culture oversight to achieve a level of discipline that is comparable to leading practices for risk oversight and management.
 - Treating active monitoring of the company's culture as a full-board responsibility, with specific oversight activities housed in committees as appropriate, because of the significant interdependencies among corporate culture, strategy, and risk.
 - Regularly reviewing the culture of the whole board and its key committees, both formally (through the evaluation process) and informally (by making time for reflective conversation in executive sessions).
 - Assessing whether the chief legal officer or general counsel (GC) and other officers in key risk management, compliance, and internal control roles are well positioned within management and in relationship to the board to support an appropriate corporate culture.
- Integrating corporate culture into the board's ongoing discussions with management about strategy, risk, and performance, and emphasizing that the way in which results are achieved is as important as whether a given goal is met.
 - Setting the expectation with management that regular assessments of corporate culture will include both qualitative and quantitative information and will incorporate data from sources outside the company.
 - Making corporate culture an explicit criterion in the selection and evaluation of the CEO, and setting the expectation that the CEO and senior leaders do the same in their own leadership development and succession-planning activities.
 - Reviewing the company's recognition and reward systems (including incentive compensation, as well as promotion decisions and other non-financial rewards) to ensure that they reinforce the desired corporate culture and avoid unintended outcomes that could undermine corporate culture.
 - Describing in shareholder communications how the board carries out its responsibility for overseeing and actively monitoring corporate culture.

The fifth recommendation in the report highlights that, as the chief legal officer, the GC advises the company, through the board and senior management, on a variety of matters that

are closely related to corporate culture, including compliance, risk management, internal controls and ethics, and corporate governance. Therefore, the quality of the interaction between the board and the GC has a considerable impact on the board's oversight of, and influence on, corporate culture.

THE GC AS THE BOARD'S "CULTURE ALLY"

A recent report by the Association of Corporate Counsel advocates that the board view the GC as a "key ally and partner in establishing a corporate culture that supports corporate performance without compromising ethical behavior, and legal and regulatory compliance." The report identifies the following indicators of whether the GC is well positioned for this role:

- **The GC reports directly to the CEO and is considered part of the executive management team.** When the GC reports directly to the CEO, the GC is more likely to be included in key business discussions and strategic planning efforts, which:
 - enables the GC to be more effective in advising on legal, regulatory, and ethical risks; and
 - sends a strong signal internally that business decisions are made with consideration of ethical, legal, and reputational impact.
- **The GC has regular contact with the board.** A close working relationship between the GC and the board enables the board to have appropriate influence on the company's legal, ethical, and compliance culture while also helping to support the GC's independence. By cultivating its relationship with the GC, the board supports the GC's ability to provide objective advice in the interests of the company.
- **The GC is viewed as independent from the management team.** The GC must advise the company objectively, and be able to challenge management decisions and raise issues with the board when necessary.
- **The GC advises on issues outside the traditional legal realm, including ethics, reputation management, and public policy.** A GC can be most effective when the GC's advice is not strictly limited to legal and regulatory matters. The GC should also weigh in on "business in society" issues that are increasing in importance and can pose formidable risks to the company. Therefore, the GC should have some responsibility in the areas of public policy, political relations, the media, and social pressures.
- **Business units regularly include the legal department in decision-making.** Not including the legal department in decision-making at the business unit level raises risk that valuable perspective is lost, and sends a message that legal risk, ethics, and compliance are not taken seriously. The GC should have at least dotted-line reporting oversight of attorneys assigned to business units to ensure proper reporting of issues of concern.

(Veta T. Richardson and Mary Blatch, Association of Corporate Counsel, *Leveraging Legal Leadership: The General Counsel as a Corporate Culture Influencer*, at 2, 7-13 (2017), available at acc.com.)

SETTING THE TONE

Internal controls and the compliance and ethics program help set the tone for corporate culture and continue to be an important area for board attention (often through the audit committee). Boards need to:

- Attend to the corporate culture, emphasizing expectations that management and employees will abide by and promote within the company ethical behavior, fair dealing, and integrity.
- Understand and oversee the internal controls and procedures that management has put in place to assure that financial reporting is accurate and the company complies with applicable law and regulation (for more information, search [Internal Control Over Financial Reporting for Counsel: Why Should You Care?](#)).
- Oversee management's efforts to educate personnel about the corporate code of conduct and expected standards of ethical behavior, encourage internal reporting (whistleblowing), monitor compliance, and identify and respond as appropriate to red flags or a series of yellow flags (for more information, search [Model Code of Ethics and Business Conduct for a Public Company](#)).
- Pay special attention to related person transactions and other conflicts of interest that involve members of the board or members of senior management (for more information, search [Related Party Transactions Policy](#)).
- Attend to issues of, and set standards and policies regarding, sustainability and social responsibility, including environmental issues, involvement in the political arena, and human rights.
- Ensure that information and reporting systems and related investigation processes are designed to identify wrongdoing and wrongdoers.
- Emphasize that compliance is strategically important and essential for achieving business priorities and that everyone has personal responsibility for compliance (for more information, search [Developing a Legal Compliance Program](#)).

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