The Many Faces of Corporate Governance

By Mark R. High and Francis N. Rodriguez

> "We can write all the laws we want, but in the final analysis it's going to be the human characteristic…."[1]

Introduction

The boardroom is no longer the holy grail of corporate governance. Corporate scandals at Enron, WorldCom, Rite Aid, and elsewhere have heightened the need for better governance and have resulted in increasing attempts to federalize corporate law. As a result, the governance of companies has moved into the spotlight of public discourse.

This is not surprising. With trillions of dollars in capital sailing the globe in search of investments, shareholders are demanding stronger corporate governance laws. Indeed, we are witnessing what some may call a corporate governance movement. The New York Stock Exchange's (NYSE) recent proposals regulating director independence are one example of this phenomenon.[2] Another example is the Sarbanes-Oxley Act of 2002[3] (SOX). According to President George W. Bush, SOX enacted "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."[4] Through SOX, Congress for the first time directly addressed such matters as the composition, role, and function of the board of directors of public corporations.

In the aftermath of the corporate governance horrors, a flood of articles, laws, and regulations have outlined new standards for directors. Meanwhile, many major corporations have adopted voluntary codes of best corporate practices. This article provides a brief overview of the tension between the various participants in corporate governance and highlights the current developments by focusing on (a) the consequences of SOX, (b) the composition of the board of directors, and (c) executive compensation.

Many Players, Many Developments

Consequences of SOX

In response to historic corporate bankruptcies and scandals involving several major U.S. companies, the major self-regulatory organizations (SROs) and Congress quickly came up with a solution: SOX. SOX has brought about, among many other things, extensive federal regulation that aims to protect investors by enhancing the accuracy, reliability, and transparency of corporate financial reporting. It also increased the responsibility of senior management regarding corporate disclosures. The reaction of the many players in the corporate governance paradigm to SOX has been interesting.

In its infancy, public company officials lightly criticized SOX, perhaps fearing that the Securities and Exchange Commission (SEC) was taking names.[5] Others have praised the act as a valuable government invention, claiming SOX has helped to "improve the tone at the top" of U.S. public companies.[6] This improvement, however, came at a cost. In 2006, Fortune 100 companies paid an estimated $6 billion to comply with SOX.[7] Several critics have questioned strict enforcement of SOX, contending that it is costly beyond any conceivable benefits. Some even question the benefits.[8] Although corporate boards have taken positive steps to increase their oversight in the past few years, operating in a post-Enron world has created negative and unintended consequences for boards. Put simply, as directors have become "more hands-on in the area of compliance, they've become more hands-off in the area of long-range planning, which exposes shareholders to another—potentially greater—kind of risk."[9]

Despite the various effects of SOX, a common theme has recently emerged: acceptance of the corporate governance regime. According to a report by Institutional Shareholder Services (ISS), 71 percent of investors feel that corporate governance is an important issue, and 37 percent of investors are con-

vinced that the most significant advantage of corporate governance is that it will lead to better returns.[10]

Perhaps another unintended consequence of SOX is an upswing in shareholder litigation. A recent study suggested that corporate America was expecting a robust year for securities class action filings in 2008.[11] In response, companies are diligently adopting whistleblower procedures, establishing audit committees, restricting executive compensation, writing ethical codes, and adding independent directors to their boards. As discussed below, regulations regarding the composition of the board of directors have become one of the more interesting developments in corporate law.

It remains to be seen whether corporations will find it difficult to recruit independent directors in light of the increased public scrutiny of, and potential exposure to liability for, board actions.

Composition of the Board of Directors

Director Independence

Corporate boards now play an increasingly active role in corporate governance, particularly where the board contains independent directors. Between 1950 and 2005, the composition of large public company boards dramatically shifted towards independent directors, from approximately 20 percent independents to 75 percent independents.[12] Undeniably, the move to independent directors has almost become a mandatory element of corporate law. Current laws and regulations often require it, and shareholders and the public have come to expect it.

The shift in board composition toward independent directors is due to many factors, including the increased activism of large institutional investors, the passage of SOX, and the higher governance standards adopted by the SROs.[13] Some critics argue that adopting laws or regulations that include detailed definitions of independence or financial expertise seems misguided.[14] Strict adherence to the present definition of a "financial expert" would actually prevent both Alan Greenspan and Warren Buffett from chairing an audit committee.[15] Nevertheless, several interested parties, including the American Bar Association, have recommended that companies adopt governance principles that establish and preserve the independence and objectivity of the board of directors.[16]

There are several upsides to this change. Effective directors are supposed to maintain an attitude of constructive skepticism. They are to ask incisive, probing questions and require accurate, honest answers. They must act with integrity and demonstrate a commitment to the corporation, its business plan, and long-term stockholder value. Yet, the high-profile collapses of a number of large U.S. firms suggest that strong CEOs appear to have exerted a dominant influence over their boards.[17] Naturally, this interferes with the central oversight role required of directors to ensure a healthy system of corporate governance. Independent directors, however, have a comparative advantage for this task.

Although an "independent" director is not uniformly defined, the term generally means a director whose only relationship or connection to the corporation is his or her directorship.[18] Accordingly, independent directors are presumed to be less wedded to management and its visions. Moreover, they look to external assessments of their performance as directors and are less devoted to inside accounts of the corporation's prospects. In these ways, and many more, independent directors are an essential part of the modern corporate governance standard. On the other hand, in addressing the National Association of Corporate Directors Annual Meeting, former Delaware Chancellor William T. Allen made the following remarks with respect to director independence:

> Director independence does not assure that a director will make a better contribution on the board than an insider might make. Independent directors may have less information about the firm and may, in fact, tend to make less brilliant decisions over time than those with a close financial interest in the firm.[19]

It remains to be seen whether corporations will find it difficult to recruit independent directors in light of the increased public scrutiny of, and potential exposure to liability for, board actions. It is clear, however, that independence is accepted as offering to investors some assurance that the governance process has integrity.

Size of the Board

State law has little to say about the size of a board of directors. The majority of states allow the size of the board to be set in the certificate of incorporation or the corporation's bylaws. Some jurisdictions require the board to have at least three members. Many, including Delaware, do not, and a corporation could be run by a one-person board.[20] The Business Roundtable estimates that most large, publicly held companies maintain boards that range in size from eight to sixteen

individuals. In 2003, the average board size in the S&P 500 was 10.9 directors.[21] Although the optimal size of any board depends upon the nature of the company's business, smaller boards are often more cohesive and work more efficiently than larger boards.[22] Hence, we see a movement across the country toward smaller boards, often having only seven or nine directors.[23]

Majority Voting

Majority voting is another powerful trend that threatens to change the composition of the board. Majority threshold voting proposals typically ask boards to require directors to receive a majority of votes cast "for" and "against" to win election. These proposals are being filed at dozens of companies, including many larger firms that have yet to adopt the reform. For example, the United Brotherhood of Carpenters and Joiners of America, which initiated majority voting proposals in 2004, intends to submit nearly 100 such resolutions in 2008. Moreover, ISS reports that 44 percent of S&P 500 companies have already implemented a true majority vote election standard, with many more having in place resignation policies that call on directors to step down if they receive a majority of "withhold" votes.[24] Without a doubt, directors are now "running scared of withhold campaigns, and increasingly ready to make the bargains necessary to avoid being targeted."[25] As the markets decline in the face of recession, directors are also being targeted over executive compensation.

Executive Compensation

Show Them the Money

The directors of corporations have always been expected to oversee the conduct of senior executive officers. Arguably, "[t]he selection, compensation and evaluation of a well qualified and ethical CEO is the single most important function of the board."[26] However, CEO compensation has exploded in the United States. Over the past decade, CEO pay increased 45 percent, during a period when the average salary for an American worker rose just 7 percent. CEOs at 386 of the Fortune 500 companies earned at least $10.8 million in total compensation in 2006, more than 364 times what the average worker earned that same year.[27] The Corporate Library reports, perhaps not surprisingly, that excessive CEO compensation is the principal indicator of governance risk in predicting securities class action lawsuits.[28] Even though this has long been a controversial issue, a sensible remedy has not been proposed.

"Say on Pay" will continue to be one of the most controversial proposals during the upcoming proxy season. This is especially true in cases where the CEO's performance has been mediocre, or the company has experienced a sudden collapse. "Say on Pay" is the catchy nickname for a board policy giving shareholders a nonbinding up-or-down vote on the future pay packages of senior executives. In November 2007, Verizon adopted "Say on Pay," becoming only the second U.S. public company to do so after Aflac.[29] All indications are that these proposals will be more pervasive this coming year, as a shareholder advisory "Say on Pay" vote is likely to be quickly addressed by the new administration, no matter which party wins.

Another solution is to create "an indexing system where pay would adjust based on the company's performance in relation to its peers."[30] Performance-based compensation tied to specific goals can be a powerful and effective tool to advance the business interests of the corporation. That is why an increasing number of companies are opting for pay-for-performance arrangements for CEOs and other top executives. According to a Hay Group survey released in April 2008, this is the first time performance-based plans overtook stock options as the most popular form of long-term incentive compensation.[31] This has also led to the SEC issuing a sweeping set of reforms designed to shed more light on executive compensation.[32] Despite this progress, there is still a widespread public perception of unfairness associated with the perceived ability of executives to cash in stock even as their companies and the retirement savings of their employees have collapsed.

This still happens today. Watching a trio of high-profile CEOs defend their massive pay packages to Congress, even as their companies and shareholders lost billions of dollars as a result of the ongoing financial mess, seems to have become routine. Somehow, collecting around $161 million is justified when a company reports an $8 billion loss and fails to perform.[33] Executives argue that their compensation is tied directly to the performance of the company, via stock and options,[34] and is determined through an independent assessment process. (Yes, it is true—someone else actually approves these lofty pay packages.)

As the markets decline in the face of recession, directors are also being targeted over executive compensation.

Virtually all boards have committees, such as compensation committees, with certain powers and responsibilities. Again, no particular committee structure is mandated by state law. In contrast, companies listed on the NYSE are required to have three committees, including a compensation committee composed entirely of independent directors.[35] The standard of review regarding most, if not all, of the compensation committee's decisions will be the business judgment rule.

There is no bright-line test as to what compensation committees may award CEOs, but there are broad guidelines. Courts reviewing these kinds of director decisions do not concentrate on dollar amounts in isolation. Rather, they focus on process,[36] and process is about due care, loyalty, and good faith. As the *In re Disney Co Derivative Litigation* case makes clear, good faith business judgments should not result in the imposition of director liability, even if those judgments result in spectacular failure.[37]

Evolving Duty of Good Faith?

Good faith is a related, yet unresolved corporate governance concept. While state law remains far from clear regarding whether there is a separate fiduciary duty of good faith, it is apparent that there can be no exculpation for good faith violations.[38] Therefore, although they ultimately prevailed, the deference that the Disney directors showed to its chairman should not be emulated. Given the drastic increases in CEO pay relative to the pay of ordinary workers, such deference may seem misplaced today.

To be sure, directors have wide discretion to make decisions on executive compensation.[39] Yet, as *Saxe v Brady*[40] warns, there is an outer limit to that discretion, where executive compensation is so disproportionately large as to be unconscionable and constitutes waste. While it is inevitable that the main information source for the board is the company's management, directors need to maintain an independent and assertive posture to perform their duties in good faith, and not just with respect to compensation issues. The board must continually monitor the big picture, always asking whether it is involved in the important issues facing the company, and making sure it has access to the information and resources required to review those issues. In doing so, the governance of companies may one day revert back to the boardroom. More importantly, directors will fulfill their central obligation by helping their companies continue to grow and prosper.

Conclusion

The events of the last several years have resulted in significant reforms in our system of corporate governance. While important issues will continue to surface and evolve in a number of areas, we have already witnessed change in the composition of corporate boards, as well as the approach to executive compensation. The effectiveness of these measures will take time to measure. Let's keep in mind that the most important qualifications of successful directors have not changed—integrity, professionalism, and commitment.

NOTES

1. Deborah Solomon, *SEC Acts to Give Audit Panels More Power over Accountants*, Wall St J, Apr 2, 2003, at 17A (quoting William Donaldson, former Chairman of the U.S. Securities and Exchange Commission).

2. NYSE, Inc., Listed Company Manual § 303A.01 (2002) (hereinafter, "NYSE"). "Listed companies must have a majority of independent directors." *Id*.

3. Pub. L. No. 107-204, 116 Stat. 745.

4. The White House, Record of Achievement - Corporate Accountability Reform, *available at* http://www.whitehouse.gov/infocus/achievement/chap9.html (last visited Mar. 5, 2008).

5. For example, one CEO remarked that SOX requires "a lot more documentation," "mak[es] it harder to recruit board members," and "is especially burdensome for smaller-cap firms." Judith Burns, *Is Sarbanes-Oxley Working?*, WALL ST. J., June 21, 2004, at R8 (reporting remarks of Janet Dolan, President and CEO, Tennant Co.).

6. *Donaldson Cites Sarbanes-Oxley Act as 'Valuable Government' Intervention*, 36 SEC. REG. & L. REP. (BNA) No. 44, at 1969 (Nov. 8, 2004) (quoting former Chairman of the SEC, William Donaldson).

7. David Reilly, *Sarbanes-Oxley Changes Take Root*, Wall St J, Mar 3, 2006, at C3.

8. Alan Rappeport, *Report: Financial Fraud a Challenge despite Sarbox*, July 22, 2008, *available at* http://www.cfo.com/article.cfm/11779692 (last visited August 1, 2008). "The Sarbanes-Oxley Act appears to have done a good job at reducing fraud at companies. But for a variety of reasons, losses stemming from financial statement fraud were higher among companies that had Sarbox controls than those that did not." *Id*.

9. Jay W. Lorsch and Robert C. Clark, *Leading from the Boardroom*, Harv Bus Rev, Apr 2008, at 107. Boards are working overtime to comply with SOX and other new reporting requirements. In doing so, "they're overemphasizing committee work instead of harnessing the intellectual power of the whole board to deal with complex matters." *Id*. at 106.

10. Kenneth M. Roberts, *Corporate Governance and The Private Corporation* 5, Symposia, *Beyond Legal: A Business Approach to Corporate Governance*, May 2-4, 2007.

11. Dave Lenckus, *Securities Class Action Risk Expected to Rise*, Business Insurance, Jan. 28, 2008,

available at 2008 WLNR 2105792 (last visited Mar. 5, 2008).

12. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1465 (2007).

13. "Substantially all of the governance guidelines endeavor to ensure that a majority or super-majority of the directors on a board are 'independent' from the corporation and its management." *The Board of Directors*, Corporate Practice Series (BNA) No. 62-2nd , at A-14 (2008).

14. For instance, SOX requires the NYSE to adopt listing standards mandating that listed companies have an audit committee and that such committee be comprised solely of independent directors. At least one member of the committee must qualify as a "financial expert." *See* Joel Seligman, *A Modest Revolution in Corporate Governance*, 80 NOTRE DAME L. REV. 1159, 1170, 1181 (2005) (discussing board independence requirements).

15. Charles Ames, *What Does It Take to Be a Good Director?*, in The Art of Corporate Governance, Thought Leadership from the Pages of Directors & Boards 7 (James Kristie and David Shaw, 2004).

16. See Report of the American Bar Association Task Force on Corporate Responsibility 31 (Mar. 31, 2003) (listing several recommended policies of corporate governance) (hereinafter, "ABA Report").

17. See id at 27 (stating that many corporate boards have developed a culture of passivity, especially with respect to the CEO).

18. Generally, under the standards for a director to be deemed "independent," the board must affirmatively determine the director has no material relationship with the company that would preclude a determination that such director is independent." NYSE, *supra* note 3, § 303A.02(a).

19. E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681, 687 (May 1998).

20. Del Code Ann tit. 8, § 141(b) (2002).

21. Douglas M. Branson, *Still Square Pegs in Round Holes? A Look at ANCSA Corporations, Corporate Governance, and Indeterminate Form or Operation of Legal Entities,* 24 ALASKA L REV 203, 215 (2007).

22. The Business Roundtable, Principles of Corporate Governance 10 (May 2002) (hereinafter, "Business Roundtable").

23. Branson, *supra* note 20, at 215.

24. Subodh Mishra, *2008 Preview: Director Elections*, Risk & Governance Weekly, *available at* http://www.issproxy.com/knowledge/corporate_governance.html (last visited Mar. 14, 2008).

25. Id.

26. Business Roundtable, *supra* note 21, at 3.

27. David Ellis, *Mortgage Mess CEOs Defend Pay*, Mar. 7, 2008, *available at* http://money.cnn.com/2008/03/07/news/newsmakers/ceo_pay/index.htm (last visited Mar. 7, 2008).

28. Ric Marshall, *Predicting Securities Class Actions, 2006 Year-End Update*, Nov. 2006, *available at* http://thecorporatelibrary.com (last visited Mar. 5, 2008).

29. Joseph McCafferty, *The 'Say-on-Pay' Debate Heats Up*, Business Week, Mar 18, 2008, *available at* http://www.businessweek.com/print/managing/content/mar2008/ca20080318_711211.htm (last visited Mar. 25, 2008).

30. Ellis, *supra* note 26.

31. Executive Compensation, Performance-Based Pay Plans gain Favor Against Stock Options Among Top 200 Firms, BNA's Corporate Counsel Weekly, Apr 23, 2008, at 132.

32. Tamara Loomis, *In Shift Toward Performance-Based Compensation, Salaries Out, Bonuses In*, July 25, 2007, *available at* http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1184663194498 (last visited Mar. 11, 2008). "For the first time, the 2006 proxy statements show up front whether bonuses are discretionary or 'nonequity incentive compensation' tied to specific financial metrics such as profits, revenue, or operating income." *Id*.

33. Countrywide Financial's CEO, former Merrill Lynch CEO and ex-Citigroup CEO all testified before the House Committee on Government and Oversight Reform. Stanley O'Neal received $161 million after stepping down as chairman and CEO of Merrill Lynch & Co., despite the fact that the company lost $8 billion during his tenure. Ellis*, supra* note 26.

34. Yet, this gives the CEO a strong economic incentive to manipulate the short-term stock price in order to maximize his or her compensation. In fact, recent studies have found strong evidence of stock manipulation known as "backdating" among CEOs and boards of directors. Steven H. Kropp, *Corporate Governance, Executive Compensation, Corporate Performance, and Worker Rights in Bankruptcy: Some Lessons from Game Theory*, 57 DEPAUL L REV 1, 19 (2007).

35. NYSE, *supra* note 2, §§ 303A.04-.06.

36. See Robert Todd Lang, *Corporate Governance in Privately-Owned Corporations* 6, Symposia, *Beyond Legal: A Business Approach to Corporation Governance*, May 2-4, 2007 ("Courts have increasingly focused on the *processes* a board of directors has in place for making decisions. That is a key governance concept").

37. 907 A2d 693 (Del Ch Aug 9, 2005) (affirming the business judgment rule where the board permitted a payout of $140 million for a short term, fired officer), *aff'd*, 906 A2d 27 (2006); Mark R. High, *Disney Directors Survive Attack on Magic Kingdom, Learning from the Trial Court's Opinion*, Business Law Today, Jan./Feb. 2006, at 18 (analyzing the Disney case).

38. See Del Code Ann tit. 8, § 102(b)(7)(ii) (providing that the certificate of incorporation may include "[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director:…(ii) for acts or omissions not in good faith").

39. Id. § 122(5).

40. 184 A2d 602, 610 (Del Ch 1962).

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