

Boardroom exchange

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This publication provides an overview of the 2008 Directors' College held April 2–4, 2008 in New York City. Directors' College attendance is exclusive to directors of large public companies. Information herein is based on presentations at the 2008 Directors' College. This report is for general information only and does not constitute legal or other professional advice. PricewaterhouseCoopers LLP makes no representations or warranties with respect to the accuracy of this report. Readers should consult with the appropriate professional advisors regarding the application to specific facts and circumstances of the laws, rules and regulations that are referenced herein. This report was not intended or written, and it cannot be used, for the purpose of avoiding US federal, state, or local tax penalties.

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Activist shareholders and the board

One of the most significant concerns for boards today is how to deal with activist shareholders when they come knocking. This section delivers insights from activist shareholders and from CEOs who have been on the receiving end of shareholder activism.

Panel discussion

Activist shareholders: The uninvited guests in the boardroom

The panel was moderated by Francesco Guerrera, US business editor of the *Financial Times*. It included David H. Batchelder, founder and principal of Relational Investors LLC and director of Home Depot, Inc.; William R. Johnson, chairman, president, and chief executive officer of H.J. Heinz Company; Claude Lamoureux, former president and chief executive officer of the Ontario Teachers' Pension Plan; and Jerry W. Levin, chairman and chief executive officer of J.W. Levin Partners LLC and director of Wendy's International, Inc., The Sharper Image, US Bancorp, Saks, Inc., and Ecolab Inc.

Why activist shareholders come knocking

Activist shareholders are a varied breed, each with a particular agenda, but all of them have one thing in common: “We’re trying to make money, first and foremost,” says David Batchelder, founder and principal of Relational Investors LLC. An activist shareholder like Relational Investors isn’t looking for a quick return, in contrast to activists who take large positions in troubled companies and then push for the company to be sold. Batchelder finds this cut-and-run behavior troubling: “I think it is a very negative thing that hurts the reputation of activists generally. We never go into a company on the prospect that we want it to be sold.” Rather, activist shareholders such as Relational Investors and J.W. Levin Partners aim to be a catalyst for change when they go into what they consider a troubled company, generally with a three-to-five-year timeframe in mind.

“We have very specific ideas about what’s wrong with a company that we’re going into and what we need to change,” says Jerry Levin, chairman and chief executive officer of J.W. Levin Partners. Notes Batchelder, “We screen for companies that are underperforming their peers and the S&P 500. Our targets aren’t overleveraged and they have a strong cash flow, but they also have a clear, identifiable problem that’s causing the undervaluation—one that hasn’t been corrected by the board.”

Activist shareholders in the vein of Batchelder and Levin generally make a substantial investment in a small number of stocks, then use their experience, capital, and considerable analytic resources to influence the strategic direction of the investees, with the ultimate goal of driving up the share price.

Boards should not be surprised when activists show up, say Batchelder and Levin. William Johnson, chairman, president, and chief executive officer of H.J. Heinz Company, concurs: “I don’t know that you can ever say you are surprised. If an activist comes knocking, you can bet there’s a good reason. When Nelson Peltz of Trian Fund Management came after us, we knew the stock was undervalued, and we were working to increase the share price.”

Communicating with shareholders: A two-way street

One way companies may avoid becoming an activist shareholder’s target is to actively communicate with their large investors. “I can assure you that the activist shareholders are out there talking to your shareholders,” says Levin. “If you are not talking to your shareholders as well, you are at a significant disadvantage.”

If an activist comes knocking, you can bet there's a good reason.

Keeping shareholders informed about the company's long-term strategy—and the means to get there—is paramount. “You cannot overcommunicate to shareholders today,” emphasizes Johnson. “They are more patient than many of us give them credit for if they understand the company's ultimate goal and strategy. Unfortunately, management doesn't always do a good job of clearly articulating that.” Plus, as panel moderator and *Financial Times* US business editor Francesco Guerrera cautions, a company's story will get told nonetheless, although not necessarily in the way the company would like.

On top of communicating better to shareholders, companies also need to listen better, so that they will be aware of shareholders' concerns. “When Nelson came after us,” says Johnson, “I had my board meet with our top shareholders and really take the time to hear their perspectives, which the board then shared with management.”

But too often management doesn't want shareholders contacting the board, beyond their limited interaction at annual shareholder meetings. Management tends to be especially wary of letting activist shareholders make presentations to directors. Batchelder says that although management is willing to meet with his team, what he mostly wants is an opportunity to sit before the board. The resistance isn't always just from management. “My experience,” says Claude Lamoureux, former president and chief executive officer of the Ontario Teachers' Pension

Plan, “is that a lot of directors are equally unwilling to talk to shareholders.” Ignoring activist shareholders, however, is futile in the long run. “Boards have to understand that the activists aren't going away,” says Levin. “The longer boards resist the process, the less productive it becomes.”

Activist-turned-director: The Goliath in the boardroom

When activist shareholders come knocking, not all of them are looking for board representation. “We don't want to go on your board unless we absolutely have to,” says Batchelder. “Being on the board ties our hands. It takes away our liquidity. We would much prefer to have a good relationship with management and the board, feel that they are addressing our issues, and then sit back and let them do the work.”

There are times, however, that activist shareholders consider board representation critical. “Those are the severe cases,” says Levin, “when going on the board is the only way to bring about necessary changes.” Only through considerable persuasion or a proxy fight, however, do activist shareholders generally succeed in getting board representation. “Not a single company we've approached has said come on board,” remarks Batchelder. Still, of the 23 boards where Relational Investors has representation, just one of those seats was won in a proxy fight. “Every other time,” says Batchelder, “the board ultimately concluded it's better to just work with us.”

In Batchelder's view, boards really have no choice but to surrender a seat: “You have zero chance of keeping us off your board. We're the Goliath when we show up. We will win.” Johnson agrees: “That's right. When Trian Fund Management came after Heinz, my first reaction was to fight, because that is the natural human response. Trian wanted five board seats, and in the end they got two.”

The importance of good team dynamics

No matter the struggle preceding an activist shareholder's arrival on a board, it is important that everyone involved—directors, management, and the activist—bury the hatchet so that a productive working relationship may ensue. Of the boards he sits on, Levin notes, “I've never had anyone say they're going to hold the fight against us.” Batchelder has had much the same experience: “When you actually show up and work with the directors, they are very well-intentioned and want to do the right thing.”

Mutual respect is fundamental to a healthy boardroom culture, says Johnson. “I am a football coach's son, and

my Dad used to say to me that team dynamics ultimately determine the success and failure of your team. It doesn't mean that everyone in our boardroom likes each other. But there is an understanding that we are aligned on the ultimate objective: We all want to create shareholder value. The activist shareholder sometimes has a different way of doing things, so we need to listen. Some of Nelson's ideas have been good, some not so good. But in the end he has added tremendous value to what we do."

In this spirit, Johnson invited Peltz to meet the lead director and committee chairs before attending his first Heinz board meeting. "And then I did something that most CEOs hate: I started that first board meeting with an executive session, shortly into which I left and said, 'Talk to each other and figure out how you're going to work together.' And to the board's and Nelson's credit, they did just that."

Viewing things from 10 feet

One thing differentiating activist shareholders from most other board directors is that the activist tends to come to the boardroom with considerable data and analysis. "They get into a lot more detail than the other board members," says Lamoureux, noting that many activist shareholders have at their disposal a staff that is devoted to doing such research. Johnson says this is certainly true of Peltz: "Most directors look at things from 10,000 feet; activist board members are looking at things from 10 feet."

Nonetheless, fellow board members generally have an easier time than management does in acclimating themselves to an activist shareholder's approach. "I don't hear other directors complain that I have more information or that I have staff analyzing it," says Batchelder. "They understand and appreciate it. But management may feel it is losing

David Batchelder, William R. Johnson



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some control in the boardroom because it is not completely in charge of the flow of information.”

One way to get around that problem is for management and the activist board member to sit down and discuss the information before it is presented to the board. “I have a lot of discussions with Nelson about his ideas before we take them to the board,” says Johnson. It is important, in Lamoureux’s opinion, that activist board members be sensitive to the fact that there is a right time and place to bring up certain matters, with the understanding that the appropriate time and place is not always during a meeting in the boardroom. “I’ve tried to make a practice of being pretty quiet in the boardroom when I see that management is doing something I think is wrong,” says Levin. “I wait to talk to them privately. I have no intention of embarrassing them in the board meeting.”

When heads roll

At times activist shareholders call for the replacement of the CEO, though this is not something they do lightly. “Changing the CEO is a very drastic action and it’s going to cause shareholders to lose money, because invariably the stock goes down after such an event,” says Batchelder. “It also creates a huge disruption in the management team. But if a CEO change is needed, we’ll generally push for that earlier than the other board members. We’re less patient.” Lamoureux notes that when a CEO change looks necessary, it is helpful to have a model of the type of person who is best suited to run the operation: “Often times boards don’t have that sort of mental model.” This is no small consideration, in Levin’s opinion: “It’s all about the CEO when you get down to it. You’ve got to have a great leader in place to drive the strategy.”

In the case of Heinz, says Johnson, it was a matter of Trian wanting the board to hold management accountable. “Even so, it was obvious to me that we had a gun pointed at us,” says Johnson of the situation. “Now the gun is in his holster; but it’s still there and we have to recognize that.”

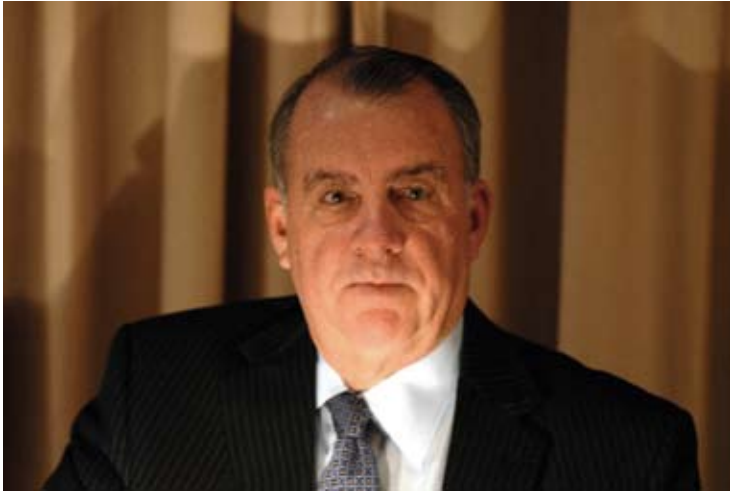
From one end of the spectrum to the other

Although activist shareholders such as Batchelder and Levin do not go into a company for the short term, they do not plan to stick around forever, either. “Doubtless this creates anxiety,” notes Guerrera. Johnson concurs, saying that the first thing shareholders want to know from him is Peltz’s exit strategy: “In many ways our shareholders see Nelson as a positive force. But they also worry about the potential effect of his eventual pullout.” Batchelder says that shareholders needn’t worry: “Institutional shareholders understand what we do, so when we exit they don’t assume we are giving up. We are not giving up; our job is done. They know that we exit only when we believe the company is going to outperform the S&P 500 for the next few years at least.”

Overall, certain activist shareholders can make boards fundamentally better. “I’ve seen a positive change in our board dynamics since Nelson’s arrival, and in the company overall,” says Johnson, noting that Heinz’s board re-nominated Peltz for a second term. But as Guerrera points out, the relationship was a highly confrontational one at the beginning: “It was a very ugly personal fight, insults were flying. Yet you and Nelson have become friends. How did you manage to go from one end of the spectrum to the other?” Says Johnson, “It’s very simple: You look forward, not back. You make it work.”

Keynote address

Seize the day: Dealing constructively with activist shareholders



Robert P. May, chief executive officer of Calpine Corporation and director of Charter Communications

Do the right thing

Throughout my career, I've dealt with activist shareholders on a couple of fronts. One of the things I've learned is that not all activist shareholders are created equal. They come in different shapes and sizes, and often with different agendas. But whenever I think about dealing with activist shareholders, the same overarching principle comes to mind, one that really sums up what leadership is all about. It is fairly simple: Do the right thing.

To do the right thing as a board director at a publicly held company, you need to be truly independent from management, and this may at times involve taking a different position on issues. A director should also have a strong stake in the company's equity. However, my experience as an independent director has taught me that it isn't just about independence and equity. It's also about courage—the courage to make tough decisions and do what's right for the company. Courage is an enormous part of dealing effectively with shareholder activism.

Do your homework

Generally, shareholder activism happens in a very spontaneous way, and management and the board are usually unprepared for it. In anticipating potential shareholder actions, I find it helpful to consider three questions:

1. What are activist shareholders after?
2. What types of companies do activist shareholders target?
3. What should directors and management do when confronted by activist shareholders?

Nowadays, activist shareholders are primarily institutional. They go after companies that they believe are being mismanaged or are underperforming, and companies where they believe the shareholders will vote with the activists if they come up with a compelling story. Other activists may look for a company where they can make a big return through a short-term transaction. They usually want a company to spin off a division, sell assets, buy back shares, or put the entire company up for sale. Because these activist shareholders depend heavily on access to capital, they might find that their ability to carry out such strategies has become limited while current credit market issues persist.

Although different activist shareholders have different agendas, they all believe that their solution for fixing your company is the right one. Some of those solutions may be pretty reasonable, and some might actually work. There are other times, however, that an activist shareholder's vision may conflict with the company's long-term agenda. That is when companies need to brace for a potential fight.

It is important to realize that activist shareholders in a majority of cases don't intend to wage a campaign to overthrow directors or management. Relative to the size and number of their investments, the campaigns they wage are few. But when they do come knocking, what should a company do? First, I would advise that you get acquainted with the lay of the land. You need to know what to expect, especially if you, the directors, are the primary targets. So do your research, understand what attracted the activist to the company. Generally speaking, by doing your homework—and that includes tapping into your network—you can get a pretty good read on an activist shareholder's DNA. Activist shareholders generally don't change their approach or their ultimate tactics. The more you understand their agenda, the

better you will be able to prepare for and manage the situation.

Of course, you will also want to reach out to your advisors; but weigh their input carefully. Do not accept their advice carte blanche. A proxy solicitor may tell you that fights are inevitable. A public relations advisor may tell you to pull back from public appearances. Such advice is conventional, but I'd argue that until you really know what the activist's agenda is, you run the risk of doing damage by following conventional wisdom.

Engage the activist

The only way to reach a productive solution is to engage the activist shareholder. It is important that you try to have a constructive relationship. Ultimately you may differ on how to solve the company's problem, but it is likely you will share some common ground on what that problem is. In my experience, it's a question of degree, not necessarily one of direction.

Engaging the activists entails meeting with them. In this, it is important to bear in mind—and I'm sure your advisors will reinforce this with even greater emphasis—that everything you say to activist shareholders is on the record. There is no such thing as a cozy cocktail conversation or a confidential offsite meeting. Comments by directors can be used in future campaigns against the company, so it's important to stick to your message points during these meetings. Listen a lot, and try not to talk at all. Let your advisors do the talking.

Terms of engagement

Shoot first. Try to define the battlefield before the activist shareholders do. One of the most useless things you can do is to climb down into the bunker, shut the door, and try to win the battle there. By and large, boards and management are much better served by creating the battlefield, defining the way the battle will be fought, and engaging actively in that fight.

All too often, though, I've seen activist campaigns go public and turn into a battle of "we said, you said." Once you're in that dynamic, you might as well fold your tent, because the battle has been lost—at least the public battle. Early on, it may make sense to ask your fellow directors and management team, "What can we do to stop this from becoming a public relations fiasco? Do we need to bring in a third party—a more objective broker—to help resolve the differences?"

If push comes to shove, the board and management may need to ask themselves whether they can stomach bringing one of the activist shareholder's candidates on the board. Several years back, I joined a public company's board as a result of actions taken by an activist shareholder. I was as welcome as fire ants at a picnic. But in the end the board made positive changes and helped turn the company around. I have generally found that most right-thinking people will learn to get along. If you don't, you risk destroying corporate value. On the other side of the coin, a board I served on was confronted by activist shareholders who wanted to change the board. We did not agree to that, but what we did agree to was creating an advisory committee to the board. It showed that we were doing meaningful things to effect change without actually having to bring the advisors into the boardroom and cause disruption. Boards and management need to realize that some fights just aren't worth having, especially if you can find common ground.

At the end of the day, whether there is a fight or a more diplomatic way of resolving matters, it all comes down to the fundamentals of good corporate governance: directors acting independently and courageously, and bringing about change that's right for both the company and its shareholders. With that approach, a board can almost never go wrong.

Courage is an enormous part of dealing effectively with shareholder activism.

Large shareholders and the CEO

Many companies today have at least one large shareholder. How should a company deal with them? Two prominent CEOs—one whose large shareholder has board representation and one whose large shareholders do not—offer their perspectives.

Panel discussion

Large shareholders and other stakeholders: A balancing act

The discussion was between Jay Grinney, president and chief executive officer of HealthSouth Corporation, and William C. Rhodes, III, chairman, president, and chief executive officer of AutoZone, Inc. It was moderated by Charles M. Elson, Edgar S. Woolard, Jr., Chair in Corporate Governance and director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, as well as director of AutoZone, Inc. and HealthSouth Corporation.

Today's shareholder: A known entity

Not so long ago, a public company knew very little about its shareholders. They were an amorphous group. Nowadays a company knows exactly who its shareholders are, especially those owning a significant stake in the company. As panel moderator Charles Elson, director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, notes, "Today, you meet the shareholders, they talk to you, and they shake your hand."

Bill Rhodes, chairman, president, and chief executive officer of AutoZone, Inc., says that this has certainly been his experience. AutoZone's largest shareholder owns roughly 35 percent of the company. "Being able to face someone who has significant ownership and understand his concerns is quite helpful," says Rhodes. "It's far preferable to having an ambiguous group of shareholders whose interests are unknown."

AutoZone's largest shareholder bought a stake in the company in 1998 and sat on the board for seven years. He clearly has been invested in the company for the long haul—behavior that is uncharacteristic of many other shareholders, who tend to stay in the company for only a short time.

Jay Grinney, president and chief executive officer of HealthSouth Corporation, has large shareholders of his own to deal with. None of them holds more than a 15 percent stake in HealthSouth, but roughly 70 percent of the company is owned by 10 such shareholders. But unlike AutoZone's largest shareholder, they are unlikely to hold on to their investment for a decade.

Rhodes cautions that for companies with large shareholders like AutoZone, "It is important for the board and management to remember that the largest shareholders don't necessarily represent the views and needs of every other shareholder." Grinney agrees: "Large shareholders may be more visible and vocal than other shareholders, but a CEO must not lose sight of the remainder of the shareholder population." Rhodes adds, "It also is important to understand that not all large shareholders are activist shareholders."

Communicating with the large shareholder

When a shareholder buys a large stake in a company, it is in management's best interest to get on top of the situation as quickly as possible. "When I was first told that a shareholder had acquired over 5 percent ownership in HealthSouth," recalls Grinney, "I spent that weekend researching the shareholder. It turned out to be an activist hedge fund. The first thing I did on Monday was to pick up the phone and call

Being at the whim of a current shareholder's demands is not good for the company's overall long-term health.

the CEO. I said, 'Welcome aboard, we are delighted to have you as a large shareholder. We want to be as transparent as we can.'" This is the approach Grinney takes with all his large shareholders, but it was not one he had topmost on his mind upon assuming the leadership role at HealthSouth: "When I became CEO, I didn't really think about who the large shareholders were and whether I needed to reach out to them when significant strategic decisions are announced, because I was more focused on turning around the company. Today I do think about those things."

Rhodes notes that in communicating and sharing information with its largest shareholder, AutoZone can take a different approach than HealthSouth; that's because AutoZone's largest shareholder has representation on the board. However, AutoZone also makes active efforts to engage its other shareholders. "We have a number of one-on-one meetings with them," says Rhodes, "so that we can share our strategy and understand their concerns." In HealthSouth's one-on-one meetings with shareholders, directors join in. Grinney says that this gives both parties greater access and visibility. He stresses that what they discuss in those meetings is in the public domain, but says that "it's pretty dense material, and so it doesn't hurt to walk shareholders through it, to really take the time to make sure they understand the strategy, how we are governed, and how we incentivize management."

Weighing shareholder input

Elson wonders whether these open lines of communication result in large shareholders' having input about the company's strategic direction. Rhodes says yes: "Because AutoZone's largest shareholder has board representation, he does have input." He adds that a shareholder with a seat on the board is able to engage real-time in the board's dialogue and debate around significant decisions. Rhodes emphasizes, however, that it is "the overall board that ultimately determines the company's direction, not the largest shareholder in the boardroom."

"Do the shareholders determine what we do?" Grinney asks. "No. Does it help to have their input? Yes, without question." He adds, "If one of our largest shareholders feels strongly about a particular matter, we will listen. For instance, a number of our large shareholders were telling us that we should use our available cash to bring down our leverage. My impulse as CEO is to grow the company. But the chief financial officer and audit committee chair both said, 'Maybe we should listen to the shareholders and look at the balance sheet a little more conservatively.'"

A revolving door for shareholders

"Shareholders come and go," points out Elson. "Even large, influential ones. So how does that impact the way a CEO runs a company?" Grinney has given this question considerable thought: "When people say, 'you need to do this as part of your business strategy, because it is in the shareholders' best interest,' are they talking about the shareholders today, or are they talking about the shareholders one or two or three years from now? That is a real conundrum. I don't think that being at the whim of a current shareholder's demands is good for the company's overall long-term health."

Rhodes agrees: "Although AutoZone has a large shareholder who has invested for the long haul, most of our investors come and go. As CEO, I take the long view; we are not operating this company from a short-term perspective. Therefore, in considering AutoZone's shareholders, I look at them over a continuum. To Jay's point, however, not knowing who will be tomorrow's shareholder or how long today's shareholders plan to stick around is, in my opinion, one of the great dilemmas in the public markets."

Beyond shareholders

Whether they are in a company for the short term or for the long haul, all shareholders are looking to make money. But to be successful, a company has to be about more than making money. "To run a successful business," notes Elson,

“a CEO has to look beyond the interests of the shareholders to the interests of the employees, customers, suppliers, and other key constituents.” Rhodes agrees, “I believe that the three letters in the title CEO is a constant reminder that the top executive represents the interests of customers, employees, and owners.” With respect to employees in particular, Rhodes believes in using ownership in the company as a performance-motivating principle: “Combining the constituencies of shareholders and employees, whether through an employee stock purchase plan or stock options, can go a long way.” But he also recognizes that inspiring employees goes beyond share ownership. “Frankly, if I stand up at our national sales meeting and say, ‘We’re driving these initiatives to create incredible value for our shareholders,’ I’ve lost our team. It has to be about something bigger than that.”



William C. Rhodes, III

Grinney shares this opinion: “At HealthSouth we’ve got employees who have dedicated their lives to taking care of people. If I said to them, ‘The reason you’re here is to exclusively benefit shareholders,’ it’s not going to work. First we have to get them committed to the business of patient care. Only after that does it make sense to stress that we are able to provide this service because people have invested in the company and allowed us to build hospitals and be a part of the community. But certainly it does help if your employees are also shareholders with a financial stake in the company.”



Jay Grinney

“As CEOs, you have a responsibility to manage the company in a way that will ensure there is a tomorrow,” observes Elson. “Part of that entails listening to your shareholders, especially those with a significant stake in the company. I would imagine that is a tough balancing act—inspiring both internal and external constituents, while effectively positioning the company for the long term.” Grinney concedes that it is, but notes that it comes with the territory, “That’s the art of leadership. A CEO has to master that.”

Shareholder activism and the courts

A justice of the Delaware Supreme Court, top legal experts, and a distinguished director discuss how directors can protect themselves from personal liability.

Keynote address

Avoiding the Delaware courts



The Honorable Randy J. Holland, Delaware Supreme Court Justice

I am going to discuss shareholder activists from the perspective of the courts. I know that the board directors among you probably never want to see or hear from me again, at least not in a courtroom, so that will be the focus of my remarks: how not to see me again. With that in mind, I will review how we got to where we are and the role of litigation with regard to shareholders who want to take an active role in things directors would prefer they not be active in.

Fiduciary duties

It starts with the idea that in the Delaware courts we recognize there is a separation of ownership and control. One of the cardinal precepts of Delaware law is that it is the directors, not the shareholders, who manage the corporation. Delaware corporate statute clearly states as much. Nonetheless, the statutory power that directors have carries with it fundamental fiduciary duties.

These duties have been described colloquially as a triad: care, loyalty, and good faith. The two actual duties are care and loyalty. On top of these, directors have an obligation to conduct themselves in good faith. The fiduciary duties operate in a variety of contexts, and both the Court of Chancery and the Delaware Supreme Court try to give directors guidance on these duties in their opinions.

Derivative lawsuits and the business judgment rule

With respect to shareholder activism, shareholders who are concerned about how directors are managing corporations have two methods of redress. One is corporate democracy—the shareholders' right to vote. The second method is for an activist shareholder to bring a derivative lawsuit. And that is primarily what I'm going to address.

In discussing derivative lawsuits, we start with the business judgment rule. The business judgment rule is a judicial acknowledgement that directors manage the company. It presumes that in making a business decision, the directors acted on an informed basis, in good faith, and in the honest belief that their action was taken in the best interest of the company. Directors have this powerful presumption in their favor when they come into a Delaware court. The burden is on the shareholders to rebut the presumption. They do that by alleging that directors did not act with care or did not act with loyalty or did not act in good faith.

Only disinterested directors can invoke the business judgment rule, and that is why you see a lot of debate in the literature and in litigation about who is independent, who is disinterested. If shareholders can show that a majority of the board was "interested" or not independent, the directors are not protected by the business judgment rule.

Disney: A case study

Shareholder activist concerns run along a couple of major themes. One is executive compensation, including severance packages. In that vein, there are useful lessons to be learned from the Walt Disney Company case. The Disney case involved a 37-day trial in the Court of Chancery, where over 1,000 exhibits were introduced. Two events were being challenged by the shareholders in that derivative suit. The first board action in contention was the decision to hire Michael Ovitz as president and to approve his compensation package. The second action at issue was the decision to let him go on a nonfault basis and to award his severance package.

The Court of Chancery denied the Disney directors' motion to dismiss the derivative suit. The judge in the motion said that the complaint alleged facts that, if true, fell outside the protection of the business judgment rule. Those alleged facts were that the Disney directors breached their duty to act in good faith.

The Disney board filed a new motion to dismiss, stating that although the shareholders had raised reasonable doubts about the application of the business judgment rule, the Disney charter's 102(b)(7) provision protected the company against allegations of gross negligence, therefore exculpating it from having to pay monetary damages. The Court of Chancery denied that motion, too, saying that if directors have not acted in good faith or have intentionally engaged in misconduct, they are not protected under the 102(b)(7) provision.

Virtually every Delaware corporation has a 102(b)(7) provision in its charter. If a shareholder files a complaint alleging gross negligence and the corporation has such a provision, the courts are going to dismiss the suit automatically: no discovery, no trial, end of story. However, there's no exculpation if directors intentionally engage in misconduct or do not act in good faith. That is why the Chancellor's ruling in Disney was so significant.

At the end of the trial, the Court of Chancery held that the board's approving Ovitz's employment agreement, hiring him as president, and terminating him on a nonfault basis were all protected by the business judgment rule. This was affirmed by the Delaware Supreme Court.

Lessons learned

Directors can learn a number of lessons from the Disney case:

Be independent. In its opinion, the Court of Chancery concluded that the Disney board created the perception that it was serving a controlling CEO. Michael Eisner had stacked the board with friends and acquaintances who, although not legally beholden to him, supported what he wanted to do almost unconditionally, functioning essentially as passive directors in what had become an unwholesome boardroom culture. The directors didn't appear to be acting independently. A key lesson here is for boards to avoid conducting themselves in a way that would prompt a judge to write the sort of opinion that was written in the Disney case or that would allow such a suit to be brought in the first place.

Stay engaged. Directors must be active and attentive, not complacent. This involves engaging in board discussions, asking questions, and providing constructive criticism where it's needed. In the Disney case, the board let a process go forward in a way that raised reasonable doubts about the board's conduct, even though the doubts ultimately were without merit. You can avoid that situation by staying engaged.

Rely on experts. In the Disney case the courts pointed out that you can rely on expert advice, even if it isn't right, as long as you do so in good faith. There is no requirement that directors actually follow the expert's advice. The point of engaging an expert is to assist the board, not to have the expert do the board's job.

Embrace best practices. The courts also emphasized the significant difference between fiduciary obligations and best practices. While as directors you must fulfill your fiduciary obligations, you're not necessarily going to be faulted if you fail to act in accordance with best practices. Although, clearly, the better your practices, the less likely you'll create an aura of an unwholesome boardroom culture.

Follow a robust board process. The courts expect directors to exercise oversight responsibility and be alert to red flags. The Delaware Supreme Court does not hold directors liable unless there is an utter failure to implement a reporting or information control process. Directors can't prevent criminal conduct and they can't be on the ground everywhere. Instead, the directors' job is to put a reasonable process in place and monitor it. Absent red flags, directors are allowed to assume that the process is working.

Most importantly for directors, the Disney case reaffirmed the strength of the business judgment rule in the Delaware courts. The whole philosophy behind the business judgment rule is to give directors the chance to make money for the shareholders, and that involves taking risks. In the Delaware courts, there is no correlation between director liability and failing to hit a home run. The Delaware courts are not going to second-guess directors; the courts are going to defer to directors, as long as they act independently and make informed business decisions in good faith.

To the extent something goes wrong at the company you serve, you will probably never wind up being personally liable, but you may wind up involved in litigation, having your deposition taken, and maybe even testifying at trial. The Disney directors are happy with how things turned out, but I think if you were to talk to them, they would say they'd have preferred to avoid a firsthand experience with the Delaware courts, and that is what I wish for all of you.

In the Delaware courts, there is no correlation between director liability and failing to hit a home run.

Panel discussion

Director liability: How shareholder activism has impacted boards' legal environment

Moderated by Charles M. Elson, Edgar S. Woolard, Jr., Chair in Corporate Governance and director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, as well as director of AutoZone, Inc. and HealthSouth Corporation. The panel included Rolin P. Bissell, partner, Young, Conaway, Stargatt & Taylor, LLP; Jay W. Eisenhofer, founder and managing partner, Grant & Eisenhofer P.A.; The Honorable Randy J. Holland, Justice of the Delaware Supreme Court; David A. Katz, partner, Wachtell, Lipton, Rosen & Katz; and Shaun F. O'Malley, lead director of Freddie Mac.

Shareholder activism—a judicial perspective

The relationship between directors and shareholders has changed in the past decade. Shaken by corporate scandals, directors have become more actively engaged and independent, while shareholders have become less trusting of management and are increasingly seeking greater say in how companies are run. “The theory used to be that investors weren’t particularly sophisticated and needed the board to protect them,” says Charles Elson, director of the John L. Weinberg Center for Corporate Governance at the University of Delaware. “That’s no longer so.” Today’s shareholders are plenty sophisticated, sufficiently so that boards may feel as though they are the ones in need of protection. Some shareholder activists even come with their own fleet of analysts, armed with data well beyond what typical board members receive. Facing such activists in the courtroom can be daunting.

In its push for greater influence over how companies are run, this new breed of shareholder has effected change: More boards are instituting majority-voting policies with respect to board elections, and some are splitting the roles of chair and CEO, among other reforms. Shareholder activists want still more concessions from corporations, such as greater proxy access, but they have come up against legal roadblocks.

“Corporate democracy is not a plebiscite on all issues,” stresses Justice Randy Holland of the Delaware Supreme Court. “Shareholders simply don’t get to vote on everything they want to vote on.” He adds that until further change is brought about by statute, the Delaware courts will continue to place corporate decision-making primarily in the board’s column of responsibilities. Although this frustrates many shareholders, they are not powerless. As Rolin Bissell of the law firm Young, Conaway, Stargatt & Taylor notes, shareholders of companies that have instituted majority-voting policies can elect different directors if they’re unhappy with a company’s board.

With the rise of shareholder activism and the evolving role of board directors, some legal observers believe that the Delaware courts have begun to alter their perspective. “The Delaware courts have clearly fashioned, through statutes and history, a director-centric model, in which boards moderate and balance the interests of management, employees, creditors, and shareholders,” says David Katz of the law firm Wachtell, Lipton, Rosen & Katz. “Now we’re being pushed in the other direction, toward a shareholder-centric model, in which the shareholders themselves—not the board—preside over decisions that are made in their interests.” Not everyone agrees that a more shareholder-centric model is emerging. “To me this is a red herring,” says

Jay Eisenhofer of the law firm Grant & Eisenhofer. The reforms of the past 10 years are modest in his opinion: “There really hasn’t been a very significant change in the way shareholders exert power at corporations in terms of actual day-to-day results.” He warns that corporate overreaction and resistance to shareholders’ proposed reforms could lead activists down the path of last resort: legislation. “Once the legislative process starts, you don’t know where it’s going to end. It may result in things that none of us will be happy with.”

Directors’ legal environment—friendlier or more dangerous?

If the pendulum is indeed swinging toward greater shareholder power, what does that mean for board directors in a legal context? Is the legal environment more dangerous for them than it once was? Has director liability increased? Or, to put it in the words of Elson, “Do directors have a target on their backs?”

“I think directors are concerned,” says Shaun O’Malley, lead director of Freddie Mac. “There is a palpable sense of dread about all the things that could go wrong.” Eisenhofer sees things differently: “I don’t think there’s any question that the legal environment is friendlier to directors today than it was a couple of years ago. I think there was clearly a reaction to the corporate scandals earlier in the decade, with

courts being more receptive to shareholder claims; but the pendulum has since swung back to where it was.”

Justice Holland does not think directors are at greater risk now, as long as they are independent, disinterested, acting in an informed way, and doing so in good faith: “That is because the business judgment rule is something the courts will respect. By in large, I think now is a very sensible time to be a director.”

To Bissell, whether or not the current atmosphere is friendlier to boards depends on your perspective. “If all you care about is money and your personal liability, I think Jay [Eisenhofer] is right—it’s a very friendly environment, and for the reasons that Justice Holland gave: The business judgment rule is alive and well.” But Bissell warns, “Don’t worry about your wallet; worry about your reputation. More and more, activist shareholders are going to challenge board decisions. And in those challenges, directors’ reputations will be assaulted.”

Protective measures

There are a number of things directors can do to protect themselves from personal liability. Above all, directors should be independent and active, get the right information, consult experts, keep good board meeting minutes, and take a proactive approach to compliance.

Rolin P. Bissell



Rolin P. Bissell, David A. Katz, and Jay W. Eisenhofer



Don't worry about your wallet; worry about your reputation.

Be independent: “Independence isn’t a loose term,” emphasizes Elson: “It has, in effect, become a legal term. If you’re not independent of management, you are in a totally different game from a liability standpoint.” The appearance of independence is not enough, stresses Eisenhofer: “It is a matter of substance, not form.” He notes, for instance, that the courts can encourage boards to get fairness opinions, but if a board doesn’t carefully examine an opinion, doesn’t think independently and question red flags, it isn’t doing its job: “Crossing ‘fairness opinion’ off the compliance checklist doesn’t mean a board is legally protected or acting independently.”

Be active: Directors who are focused and engaged are less likely to be caught unawares by problems in the company or accused of being asleep at the wheel. “Being active does not necessarily mean being antagonistic,” qualifies Bissell. “It doesn’t mean that you have to oppose management or shareholders. What it does mean is that you have to be an active participant in the process.”

Get the right information: Being an active board member entails seeking the right information, not just passively receiving it. It is important that board members feel as though the information they have is sufficient for them to take action. If they are unsure, there’s nothing wrong with reaching out to management or counsel. Directors also should consider the advice of experts; however, relying on expert advice is not a substitute for critical thinking. “The Delaware courts,” stresses Justice Holland, “have been very clear that board members cannot delegate that duty to their advisors. Directors bear ultimate responsibility for making the decisions.” It is generally agreed that boards should be wary of soliciting an overabundance of expertise—for instance, when different board committees retain separate experts and counsel. This can result in the polarization of boards.

Take good minutes: Minutes of board meetings should be prepared soon after the fact and be comprehensive enough to capture the discussion. Directors are advised to read the minutes soon after receiving them, to ensure their accuracy. They are not advised to take their own set of notes or draw up their own minutes. “The length of the notes you take as an individual director,” says Katz, “will probably correlate directly to the length of time you’ll spend in deposition.”

Take a measured approach to compliance: In meeting their compliance responsibilities, boards need to bear in mind that good governance entails more than just satisfying checklists or charters. “Standard checklists and committee charters are not one-size-fits-all,” emphasizes Elson. “They need to be tailored to the business and updated routinely.”

And while some boards may need reminding that checking items off a list is an insufficient compliance exercise, other boards fear they are erring in the opposite direction, spending what they consider an inordinate amount of time on effectively discharging their compliance requirements. Observes O'Malley, "Sometimes I think, 'Can we stop worrying about compliance for a few hours and just talk about the business?'" We spend too much time trying to avoid problems and too little time focusing on shareholder profitability. This is an indirect outcome of shareholder activism, and I think we ought to be concerned about it."

O'Malley is also concerned about how regulatory requirements and shareholders' increasing desire to hold directors accountable is affecting director recruitment: "Four out of five people who are approached to fill a director spot turn it down these days. They don't want to get involved." Katz echoes O'Malley's concern, adding that "A related problem coming out of Sarbanes-Oxley is that directors sit on fewer boards now. Most serve on just one or two. A critical thing you lose when you don't have directors serving on different boards is the cross-pollination effect—learning best practices from one board and putting them into effect in another board. That is a very useful function, and it is disappearing."

The big picture: Doing what's right for companies and shareholders overall

Another concern is that certain activist efforts and reforms may force a company to pursue short-term returns at the expense of its long-term health, or constrain the board's ability to do what is best for the company and for the majority of shareholders. "I'm skeptical of activism when it tries to replace board processes with a more democratic way of making corporate decisions," Bissell says. Shareholder attempts to limit a company's right to use poison pills or staggered boards, for instance, could obstruct a board's ability to increase corporate value in selling the company, says Katz: "Generally at the end of the day the company is sold in either case, but for less value, because the board's hands were tied, which is hardly a benefit to shareholders." And some boards that do have access to those obstructive tools are wary of using them, worried that doing so will trigger an activist campaign. O'Malley suspects board anxiety may run even deeper than that: "I worry that corporations will change things in mere anticipation of what activists may want, without shareholder pressure ever coming to bear or full consideration given to whether such changes make sense for the company overall."

Clearly, different shareholders have different interests, and no one shareholder's agenda should take precedence.

Directors have a legal, fiduciary duty to all shareholders—not just the vocal few, Katz stresses: "And that should remain their focus. Directors need to do what they think is right for the corporation as a whole. At times that may mean doing things certain shareholders do not favor. The best boards I see today are those willing to openly debate issues, hear different perspectives, challenge management and shareholders, but at the same time listen to what activists have to say. They have a robust process. And so at the end of the day the decisions they are making are not going to be second-guessed by the court." It is likely, however, that many of those decisions will still be second-guessed by activist shareholders. Doubtless this will continue to shape the court's perspective and approach, although precisely how remains to be seen.

Hot topics for directors

Directors, major shareholders, and others debate today's hot-button governance issues. Executive compensation, risk oversight, proxy access, and broker voting are among the issues they address.

Panel discussion

Incenting executives under shareholder scrutiny

Moderated by Francis H. Byrd, former vice president of corporate governance at Moody's Investors Service, the panel included Joseph E. Bachelder, III, founder and senior partner of the Law Offices of Joseph E. Bachelder, LLP; Edward A. Blechschmidt, director of HealthSouth Corporation, Lionbridge Technologies, Columbia Labs, and VWR International; Richard C. Ferlauto, director of corporate governance & pension investment at American Federation of State, County and Municipal Employees (AFSCME); Philip R. Lochner, Jr., director of Apria Healthcare Group Inc., CLARCOR Inc., CMS Energy Corporation, and Crane & Co.; Meredith Miller, assistant treasurer for policy at the Office of the Connecticut State Treasurer; and Eric D. Roiter, senior vice president and general counsel at Fidelity Management & Research Company.

Boards continue to come under shareholder fire for CEO pay levels. But designing a CEO pay package that is effectively linked to performance and can withstand outside scrutiny is no small task for the compensation committee. Meredith Miller, assistant treasurer of policy in the Office of the Connecticut State Treasurer, suggests that there is room for common ground: "We strongly support CEOs and other executives getting paid for performance. But pay has to be meaningful. We look at executive compensation as the window into board decisions and as a tool to align shareholder value with incentives built into the compensation package."

"Peer group data that is reasonable, an independent compensation consultant, and appropriate internal equity levels are just some of the important items compensation committees need to be mindful of when designing compensation packages," says Francis Byrd, former vice president of corporate governance at Moody's Investors Service. "But even with careful attention to all these items," he adds, "the compensation committee is the real source of integrity in establishing appropriate levels of CEO pay."

Peer group comparisons: Apples and oranges?

Peer groups are often a critical factor in determining CEO pay. But assembling an appropriate peer group is no small task. "There's a huge amount of judgment involved," says Philip Lochner, director of Apria Healthcare Group Inc., CLARCOR Inc., CMS Energy Corporation, and Crane & Co. "Rarely does a company find a peer group that lines up exactly with its business and its size."

Lochner thinks compensation consultants should take the first crack at composing a peer group, but emphasizes that the compensation committee should not accept carte blanche what the consultant prepares. "The compensation committee should go through the data very carefully to determine whether the proposed peer group makes sense." Ed Blechschmidt, director of HealthSouth Corporation, Lionbridge Technologies, Columbia Labs, and VWR International, agrees: "Compensation committees must not delegate the peer group analysis to compensation consultants. A consultant's role is merely to advise, not make compensation decisions."

"In analyzing a company's peer group, directors need to look for red flags," says Byrd. A "peer" that's considerably larger in size than the company in question is one such flag. "If you're comparing yourself with a company that's three times your size," says Lochner, "you're going to skew the results upward, since larger companies generally have higher CEO pay." Miller adds, "Even when a reasonable peer group is

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determined, comparability is limited. Directors need to take into account that the CEO for the company and the CEOs in the peer group probably accumulate wealth differently from one another, with dissimilar vesting and deferral periods. That makes comparability very difficult.”

Compensation consultants: Is independence important?

Is it necessary for a compensation consultant to be independent of the compensation committee and management? This question is often debated by shareholders, compensation consultants, and directors. “It has even drawn the attention of Congress,” notes Byrd. The panelists generally agree that a compensation committee should use an independent compensation consultant. However, determining what constitutes independence is more difficult.

“Independence of compensation consultants may be hard to address,” Joe Bachelder, founder and senior partner of the Law Offices of Joseph E. Bachelder, LLP, points out. “Objectivity is not something you can easily quantify.” Lochner, however, disagrees: “I don’t think that creating independence from your compensation consultant is particularly tricky. The compensation committee simply has to make sure that the consultant is not doing any other work for the company and must agree at the outset that upon ending the relationship with the committee, the consultant will wait for a specified period before doing any

work for the company’s management.” Eric Roiter, senior vice president and general counsel at Fidelity Management & Research Company, does not think it’s that easy: “Just because a consultant promises not to work for management for a specified period does not mean that individual is independent in the sense of being independent minded.”

CEO recruits: Negotiating with outside talent

Enticing a CEO candidate to join a company involves making an attractive offer, but that doesn’t mean directors need to give everything away. “Directors have to be willing to draw a line,” says Lochner. “At some point the compensation committee must be willing to say ‘enough is enough’. I can’t tell you where that point is, but a director needs to have some sense of it going into negotiations with a CEO candidate.”

Negotiating can be tough when directors are facing the candidate’s attorney. It helps to be prepared, says Bachelder: “A critical part of negotiation is education. Understand what the issues are on each side before you begin talking. Generally there is very little time to negotiate, and so there is pressure to reach a decision quickly.” But hasty decisions might not be in the best interest of the company or its shareholders. Roiter wonders whether a way to alleviate this situation is for a board to conduct simultaneous negotiations with two or three different candidates: “By breaking out of the mold and going on parallel negotiation tracks, a board may be able to ease the time constraint and other pressures.”

Meredith Miller, Eric D. Roiter



Philip R. Lochner, Jr.



In attracting a CEO candidate to the company, the board may need to address the impact of offers by private equity firms. “If you have a CEO candidate who’s a strong operator with a strong track record, I guarantee you that private equity firms are talking to him,” says Blechschmidt. “The base salary at those firms and the substantial wealth opportunity far exceed the compensation package a public company can offer. This is a major concern for public companies.”

But as Rich Ferlauto, director of corporate governance and pension investment at American Federation of State, County and Municipal Employees (AFSCME), points out, “If a CEO candidate walks based on the compensation package, that’s not the CEO you want, anyway. You want a CEO who’s committed to the company, who wants to accomplish something other than be paid a certain amount of money.”

The widening pay gap: Is internal equity a thing of the past?

One source of consternation for shareholders is the disparity between CEO pay and the compensation of other top executives, let alone non-executives. As Ferlauto notes, “The level of inequity between the average-paid person and the CEO is the highest it’s been in 70 years.”

Some shareholders are using standard pay-equity metrics to target companies and ask questions about their policies on executive compensation. Says Miller, “We look at a number of factors in our analyses, including the pay multiplier between the number two person and the CEO.” Lochner agrees that you have to look at a variety of measures and cautions against putting too much stock in one number: “Most companies have a management structure unique to the company. A large multiple might not indicate that something is wrong in a company’s internal pay structure.” Ferlauto adds, “I agree, it is important to look at other factors, like overall management structure and succession planning. The use of multipliers is, by itself, too formulaic. Determining executive pay is much more art than science.”

Bachelder believes it is important to remember that “the difference between CEO pay and that of others on the senior management team reflects the value of the CEO’s leadership and the fact that the CEO is at greater risk.” As Roiter points out, risk moves in two directions: There is an upside and a downside. “If the CEO has taken on a great deal of risk,” says Roiter, “and the CEO delivers, the gap in pay could widen significantly. In that case, perhaps a large gap is not a red flag.”

Miller agrees that the determination of CEO pay should be done differently from the determination of other senior executives’ compensation, but says that “when CEO pay is drastically higher, it questions the level of teamwork at the company. No matter how good the CEO, a successful company requires a team—and the whole team should be fairly compensated.” Blechschmidt warns, however, of unintended consequences: “I think we should be careful of what we wish for. Companies may reduce the internal equity gap between the CEO and the senior management team by increasing senior management’s pay. This would cost the company and shareholders more.”

“Say on pay” unlikely to go away

Not only do shareholders want to know, at a fundamental level, how the compensation committee makes its decisions, many also want direct input into the process. That input is “say on pay”—shareholders’ advisory vote on executive pay. “Let your shareholders have a say,” urges Ferlauto. “Take their temperature. It could lead to a more constructive relationship.”

Bachelder disagrees: “I don’t think executive compensation is something shareholders are suited to have an advisory vote on. They don’t know enough about it. They don’t know what’s involved in the process. I don’t dispute the merit of meeting with major shareholders and discussing compensation with them, but anything beyond that is counterproductive.” Blechschmidt concurs. “Say on pay may be conceptually interesting, but on a practical basis it doesn’t make sense. In an advisory vote, you wouldn’t be sure whether a no vote is really just a vote of no confidence in the company’s leadership, a comment on a perceived lack of leadership in the compensation committee, or a sign of displeasure with the CEO’s compensation.”

Roiter agrees with Ferlauto on this issue: “I happen to think there is wisdom in the crowd. What better focus group can you have than your own shareholders?” He also points out that say on pay could be an effective bargaining tool in compensation negotiations with CEO candidates: “A company could say to a candidate, ‘Look, we’d like to give you what you’re asking for, but we have a say on pay policy and I don’t think the shareholders will go for it.’”

In Ferlauto’s opinion, say on pay is inevitable, whether it be through legislation (which he prefers not happen) or corporate cooperation: “It’s not a matter of if, but when.”

If you have a CEO candidate who's a strong operator, with a strong track record, I guarantee you that private equity firms are talking to him.

Panel discussion

Priority issues for activist shareholders

Moderated by Richard H. Koppes, of counsel at Jones Day and director of Apria Healthcare Group Inc. and Valeant Pharmaceuticals, the panel included John H. Biggs, former chairman and chief executive officer at TIAA-CREF and director of The Boeing Company; James C. Boland, former president, chief executive officer, and vice chairman at Cavaliers Operating Company LLC and director of The Goodyear Tire & Rubber Company, The Sherwin Williams Company, and Invacare Corporation; Thomas J. Kim, chief counsel and associate director of the Division of Corporation Finance at the US Securities and Exchange Commission; Patrick S. McGurn, special counsel at RiskMetrics Group, ISS Governance Services unit; and John C. Wilcox, former senior vice president and head of corporate governance at TIAA-CREF.

Today's directors know that shareholders are keeping a close eye on boards' decisions—and are not hesitant in challenging them. Shareholders are focusing on the board's role in risk oversight as a result of the large write-offs from the fallout of the credit market situation. They also are questioning whether executive compensation levels are truly tied to performance, and whether shareholders can have a greater voice in approving such packages. And shareholders want an even greater say in director elections. Time will tell whether these issues ultimately need some form of regulatory involvement to be resolved, or whether the companies and shareholders can reach consensus on their own.

Managing risk and the unknowns

“Risk management continues to be at the top of the boardroom agenda,” says panel moderator Richard Koppes, who is of counsel at Jones Day and director of Apria Healthcare Group Inc. and Valeant Pharmaceuticals. Recent corporate accounting scandals, stock option backdating investigations, and large write-offs resulting from the fallout of the credit market situation have drawn shareholder criticism and sharpened directors' focus on risk management practices.

“Risk management is a major responsibility of the board,” says Jim Boland, former president, chief executive officer, and vice chairman of Cavaliers Operating Company LLC and director of The Goodyear Tire & Rubber Company, The Sherwin Williams Company, and Invacare Corporation. “You may have hundreds of potential risks, but you can't anticipate and plan for each one. You need to focus on a manageable group of critical risks that could adversely impact your business or ruin your reputation.”

Since risk management is no small task, who should be responsible for its oversight? Boland feels that the board has the ultimate responsibility for overseeing corporate risk. He adds, “The audit committee can serve as a facilitator to ensure that the appropriate risks are brought to the attention of the board.” John Biggs, former chairman and chief executive officer at TIAA-CREF and director of The Boeing Company, recommends an equitable division of labor when it comes to risk management. He suggests assigning each board committee to oversee different types of risk: “Operational risk, for instance, would rest with the audit committee, while credit risk and reputational risk could be assigned to a specially formed risk committee or to the full board.” He adds, “One of the boards I used to serve on established a senior management group that was devoted strictly to looking at certain transactions that might compromise the company's reputation. One criterion for special scrutiny was an extremely profitable transaction.

If the profits were that good, it meant the transaction warranted a second look.” Boland believes that another good approach to risk management is to have a chief risk executive who has ultimate supervision of the enterprise-wide risk effort: “A senior executive who reports to the CEO can take a broad view of the enterprise risks across a company’s various silos, getting them to work in concert to ameliorate risk management.”

Even with a robust risk management approach, there is still the difficulty of trying to know what you don’t know. As Biggs puts it, “How do you get people to identify the risks that nobody else has thought about? That is the real challenge of risk management.”

Proxy access: Deciding who sits in the boardroom

In 2007, the SEC amended its rules on shareholder proposals related to proxy access, clarifying that companies can exclude from their proxy materials shareholder proposals that relate to procedures for nominating or electing directors. Thomas Kim, chief counsel and associate director of the SEC’s Division of Corporation Finance, says, “The Commission’s action protects investors by ensuring that the proxy contest rules apply in election contests.”

Some directors worry that if shareholders gain access to the proxy, the specter of losing their seat in a possible proxy contest might deter potential and incumbent board candidates from serving on boards. Not everyone sees it that way. Says Boland, “I’m not certain that this issue would make director candidates hesitate to go on boards. What I am concerned about, however, is the additional regulatory compliance issues that would result for companies if activist shareholders were allowed to place director nominees on the ballot. It would entail extra time and effort. Companies are already devoting substantial attention to regulatory issues.”

Kim says the SEC may reconsider the matter. He emphasizes that in its reconsideration, the SEC will likely look not only to protecting investors, but also to respecting the boundaries between federal and state law. Kim also encourages companies and shareholders to work together to determine a fair resolution to the proxy access issue.

John Wilcox, former senior vice president and head of corporate governance at TIAA-CREF, agrees that this approach makes sense: “I think shareholders and companies should handle this issue the same way majority voting was handled, by looking at the fundamental concerns on both sides. Chances are they can find common ground.” Patrick McGurn, special counsel at RiskMetrics Group, ISS Governance Services unit, sees a less rosy picture: “Quite

Majority voting will continue to be the lynchpin of shareholder power.

James C. Boland



frankly, I think it is more likely that there will be a legislative and regulatory one-size-fits-all solution. I guess we will have to wait and see.”

Majority and broker voting

“In the meantime,” says McGurn, “short of revised proxy access rules, majority voting will continue to be the lynchpin of shareholder power. I think, going forward, shareholder proposals will fade into the background and, increasingly, the election of directors will be where the rubber meets the road.” Majority voting policies have taken quick hold among companies in recent years, giving shareholders an important means of sending a message to management and directors.

Tied to both majority voting and proxy access rulemaking is the issue of broker voting. “Broker voting is a significant issue,” says Koppes. “It can amount to 25 percent of the vote in every election, and those votes are generally cast in favor of management.” The New York Stock Exchange proposed a rule in 2006 to prohibit brokers from voting these shares without client-specific instructions in uncontested director elections. The SEC has yet to approve the proposed rule.

Thomas J. Kim



“I have never seen an issue sit in the hopper as long as this one,” says McGurn of the proposed rule. “One could argue that the SEC is holding the broker voting issue hostage to the larger proxy access rule.” Kim rejects that notion, saying, “There are so many moving pieces in the proxy access/corporate governance discussion. The issue of broker votes has not been a primary issue at the SEC. Maybe that will change as time passes.”

“With any luck,” says Wilcox, “the broker voting issue can be resolved without regulator involvement, much like the majority voting issue was addressed.” Kim thinks this could happen and notes that there has already been some movement in that direction: “Several brokerage firms have recently implemented proportional voting, a practice whereby brokers vote the shares of clients who have not cast their votes, in the same proportion as the clients who have.” Wilcox sounds a note of caution about brokers’ taking their own initiative in a regulatory void: “That kind of mirror voting basically violates the one-vote rule and makes it possible to trump shareholders who send in voting instructions. Hedge funds, for example, could easily manipulate the situation, putting their shares in a brokerage account with the intention of influencing the votes of the uninstructed shares. There are better and less controversial solutions out there.”

Executive compensation: The buck stops with the board

Shareholder activists have been very focused on CEO pay, increasingly holding directors accountable for executive compensation levels. In McGurn's view, companies that want to avoid shareholder action over executive compensation need to deliver on three fronts: performance, transparency, and accountability. "If one or more of those areas is unsatisfactory, there's a good chance the company will hear from its shareholders." To Biggs, the matter is even simpler than that: "CEOs are paid too much." He admits that not everyone would agree with him, but says that certainly retired CEOs would. "The levels are way too high. That poses a real reputational problem for a business."

The buck stops with the board, says Boland: "The board has a critical role in setting executive compensation and making certain that CEO pay is based on performance. Typically, the board delegates the review to the compensation committee; but it is critical that all directors understand the compensation process—what decisions are made and why they are made." The important thing, stresses Boland, is that directors believe the process will withstand outside scrutiny.

Of course, much of that goes out the window when the CEO is recruited externally. And the price goes up considerably, too. As Wilcox observes, companies save considerable money in CEO pay by investing time and effort in succession planning.

Whether a CEO is hired internally or from outside, says Biggs, contracts should be avoided: "They are a real problem." He admits, however, that contracts are sometimes a necessary evil—for instance, when a company wishes to hire an outside person who would have to forfeit significant equity wealth and therefore would not join the company without the protection a contract affords. "But limit the contract," stresses Biggs. "Once the person's first contract expires, don't give him another one. And, whatever you do during the contract negotiation process, don't throw caution to the wind out of sheer fatigue. At the end of a long search process, when the candidate's lawyer is asking for everything you can imagine, stick to your guns. Remember, the compensation needs to be justifiable to your shareholders; otherwise, you may run into some serious problems down the line."

Proxy advisors: Wielding power or exerting influence?

Another controversial matter is that of proxy advisors. "Nothing drives boards and management to distraction like the issue of proxy advisors and their disputed role," says Koppes. In defense of his profession, McGurn insists that the role of proxy advisors is largely misunderstood. "There is a myth out there that somehow institutional investors will vote in lockstep with their proxy advisors," he says. "This is simply not the case. We merely advise, providing useful data and analysis. I can tell you that every one of our clients overrides our recommendations on a regular basis." A recommendation he urges companies not to override is this: "Go to the shareholders directly and find out what's on their minds. That's the only way to really figure out what's going on."

Companies save considerable money in CEO pay by investing time and effort in succession planning.

Candid roundtable discussions

A series of closed-door roundtable sessions facilitated by prominent directors and board advisors offers an opportunity for directors of large companies to exchange views with other directors about the most pressing issues facing audit, compensation, and nominating/governance committees today.

Audit committee roundtables

Moderators: Raymond J. Bromark, director, CA, Inc. and Patrick M. Gray, partner and US leader of the Corporate Governance group, PricewaterhouseCoopers LLP

Of the topics discussed in these roundtable sessions, the one receiving most attention was risk management, with particular focus placed on boards' perceived failure to ensure that management identified in a timely manner risks related to the credit markets. Although participants acknowledged that oversight of risk management rests with the audit committee (primarily due to New York Stock Exchange rules), they believe that the board overall should play a key role in this process.

Risk management approaches

It was clear from the discussion that all directors on the board—not just those on the audit committee—are actively involved in the risk oversight process. Participants shared several effective approaches to risk management, noting that they are continuing to refine them. One director said that his company established a committee that is devoted solely to risk oversight and comprises the chairs of each key board committee—audit, compensation, and nominating/governance. Another director described how management inventories all key internal risks and then, based on type, assigns each risk to a specific board committee to oversee. Yet another director told of how the board he sits on allocates risk oversight by business division. Participants noted that special attention is often paid to IT-related risks, due to their pervasive and complex nature, with one director emphasizing the importance of articulating those risks in “plain English.”

Fair value measurement concerns

Directors discussed their views about moving to the new fair value measurement standard for certain assets and liabilities. A number of directors voiced their concern about the difficulty of determining fair value when there are wide fluctuations in the market and unusual circumstances such as the turbulence in the credit market. They were concerned over the audit committee's additional responsibility to oversee management's judgment in this area and over the subjectivity in using the company's internal data to value assets and liabilities. Another director shared a concern that

members of management might use fair value accounting, and its underlying assumptions, to manipulate numbers in a way that would favorably impact their incentive compensation.

Moving to IFRS

US transition to International Financial Reporting Standards (IFRS) did not appear to be a pressing issue for roundtable participants. They felt that with mandatory conversion to IFRS still years off, companies have plenty of time to prepare for it; meanwhile the audit committee has more immediate matters to address. The roundtable moderators suggested that companies might nonetheless want to start focusing on IFRS now and begin contemplating a transition plan. They noted that the SEC has already allowed non-US companies to file their financial statements under IFRS without reconciling them to US GAAP.

Updating the board

One participant asked, “How much information should the audit committee give the full board?” Roundtable participants generally agreed that simply distributing minutes to the board is not enough. One director said she believes it is the obligation of the audit committee chair to brief the other board members on all significant agenda items, walking them through the committee's agenda and any significant actions and decisions.

Compensation committee roundtables

Moderators: Frederic W. Cook, founding director of Frederic W. Cook & Co.; and Arthur C. Martinez, former chairman and chief executive officer of Sears, Roebuck and Co. and director of PepsiCo, Inc., Liz Claiborne, Inc., IAC/Interactive Corporation, and International Flavors & Fragrances Inc.

Shareholders and the media continue to carefully monitor CEO pay levels and compare how those pay levels stack up against those of other executives. This was the key focus of the compensation committee roundtable sessions—specifically, how to create a CEO compensation package that would withstand outside scrutiny and motivate and retain the CEO. The discussion emphasized that a key driver in determining CEO pay is peer group data, and stressed the importance of the compensation committee owning that data.

Peer group data

Director participants generally agreed that a peer group should consist of about 20 companies that are of comparable size to the company, although, they acknowledged that finding such a group is not always easy. One director suggested that in the face of this difficulty, companies look at where the talent flow is in the business or industry, rather than focus exclusively on company size: “Ask yourself, ‘Who are we hiring from, and who’s hiring from us?’” One participant also stated that compensation committees need to keep an eye on the number of larger companies included in peer data, since they typically skew the peer group average upward. Another director advised compensation committees to first determine the CEO’s pay based on the company’s performance, and only then compare that number to the peer group data to determine whether it is reasonable.

Internal equity among management

The roundtable participants generally agreed that the CEO’s compensation should be aligned with that of other top executives. In the ensuing discussion, they shared their approaches to improving internal equity at their companies. One participant suggested that the top two executives under the CEO be compensated at 60 percent of the CEO’s total compensation. Another director said that at his company the CEO’s salary is two to three times that of his top five direct reports. The moderators cautioned that these are simply guidelines and executive compensation is not a science; each committee needs to consider what is appropriate for the company.

At-risk compensation

Roundtable participants also shared general guidelines on how much of the CEO’s compensation should be fixed in

salary, and how much should be at risk. One director opined that compensation should be no more than 25 percent salary, with the remaining 75 percent at risk. Another director recommended a 500-point formula for CEO pay: 100 points for salary, 100 points for target bonus, and 300 points for long-term initiatives. The moderators again cautioned that these are merely guidelines for compensation committees to consider.

Performance metrics

In discussing the measures companies use to determine CEO pay, directors stressed the importance of using the right metrics. The roundtable participants generally agreed that companies should strike a balance between financial and non-financial metrics. One director cautioned committee members to manage the number of metrics, since too many metrics may make people uncertain of the ultimate goal. Another director shared the compensation committee’s concern over the accuracy and reliability of the metrics data used to make compensation decisions, noting that the audit committee played a role in overseeing this information. With respect to addressing cases in which unusual events affect compensation, another director said it might make sense for metrics to be based on performance that is operationally driven.

Role of compensation consultants

Everyone agreed that the compensation committee should consider hiring an independent compensation consultant who reports directly to the committee. There was also consensus that the role of the independent consultant should be limited to transferring knowledge (e.g., letting the committee know what’s in the ballpark) and giving advice to the compensation committee. In no case should the consultant be making executive compensation decisions for the company—that responsibility rests solely with the compensation committee.

Stock options

Unanimous sentiment was that it is a mistake to pull back from stock options. One participant characterized the stock option as “the finest equity derivative ever invented,” saying that corporate accounting scandals gave stock options an undeserved black eye.

Nominating/Governance committee roundtables

Moderators: Julie Hembrook Daum, practice leader of the North American Board Services practice at Spencer Stuart; Charles M. Elson, Edgar S. Woolard, Jr., Chair in Corporate Governance and director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, as well as director of Autozone, Inc. and HealthSouth Corporation; and John F. Olson, senior partner, Gibson, Dunn & Crutcher

Much of the roundtable discussion was premised on the fact that, today, fewer board members are active CEOs. Many boards limit their company's CEO to one outside directorship—in large part because of the significant commitment of time and effort. As the recruiting pool continues to shrink, boards need to become more proactive in their search for candidates and feel comfortable recruiting one to two levels beneath the CEO.

Recruiting below the CEO level

Recruiting director candidates below the CEO level is challenging, because these candidates are largely unknown outside their organizations. Roundtable participants discussed the critical importance of conducting thorough background checks on candidates and performing other due diligence before extending an offer. One of the moderators also noted that the nominating committee should create and periodically revise a list of the skills and qualities that need to be present in board candidates if the board is to remain well-rounded and effective. This list is valuable when searching for potential board candidates.

Recruiting a replacement CEO

Roundtable participants talked about the challenge of recruiting a replacement CEO, the board's lengthy process of identifying the right candidate, and designing an attractive compensation package to recruit that candidate. Directors agreed that the best way to avoid this onerous process is to focus the current CEO on management succession to identify and develop possible candidates within the company. One director shared that the board includes succession planning as a frequent topic on its agenda during executive sessions to make certain that the succession plan is being followed.

CEO-Chair split

Overall, roundtable participants agreed there is no one-size-fits-all solution to splitting the CEO and chair roles. One participant who is a CEO stated his preference for also serving as chair of the board, saying that many of the chair's responsibilities overlap his CEO responsibilities. Directors said that, in the case of companies that divide the roles of chair and CEO between two individuals, it is important that the person serving as non-executive chair have the right personality—someone who is a leader, but not so domineering that he or she usurps the CEO's role.

Dealing with ineffective directors

A key concern voiced by the roundtable participants is how to deal with ineffective directors. For the most part, ineffective directors fit into two broad categories: the overbearing and the disengaged. Participants agreed that for directors in either category, the first step should be coaching, not expulsion. By monitoring performance and offering timely feedback, directors may be able to help struggling colleagues improve. It also was agreed that if such colleagues continue to flounder, the chair of the nominating committee should discuss the matter privately with the individual. Many times, a mutual decision is reached for the individual to resign from the board.

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