

#38 The Growing Challenge of Boards: The Evolving Model

Accusations of lax corporate governance and a lack of engagement with external stakeholders has prompted ever-increasing government intervention at the federal and state level and raised the bar on board oversight, structure and shareholder communications.

This regulatory intervention has arguably driven more changes in corporate governance practices in the last five years than in the previous 50. At the same time it has sparked an unprecedented flow of shareholder proposals that has created new pressures on boards and their directors and new concerns about the potential long-term influence of activist shareholders.

The increasing politicization of corporate governance portends even more change and a need for the board to improve communications with parties to the reform process as divergent as the SEC, activist as well as so-called passive shareholders – who many directors recognize as “a silent majority” – and others. What remains unanswered is how an evolving model of corporate governance should reshape the board agenda and future dialogue about the most effective roles for directors, shareholders and regulators.

Since 2002, **John J. Castellani** has served as president of the Business Roundtable, an association of chief executive officers of leading U.S. companies with \$4.5 trillion in annual revenues and more than 10 million employees. Its member companies comprise nearly one-third of the total value of the U.S. stock markets and represent over 40 percent of all corporate income taxes paid. During his tenure, Castellani has gained exceptional perspective working with the Business Roundtable’s 160 CEO members as they’ve struggled with corporate governance and the changing business, regulatory and socio-political landscape, which affects us all.

Consider that 80 percent of Business Roundtable members’ boards of directors are at least 90 percent independent. Nearly all of these vaunted corporate boards make an Executive Session part of every board meeting. Over 90 percent of them have adopted majority voting and all of them have either a lead or presiding director. And the amount of time these boards’ directors are investing on board issues now ranges from a minimum of 250 hours up to a previously unfathomable 800 hours per year.

Castellani outlined the myriad emerging governance challenges during Boardroom Consultants’ 38th Topic Luncheon at The Chicago Club on April 2, 2008. This event included the participation of some three dozen experienced board leaders.

Shareholder Proposals Changing The Board Agenda

John Castellani suggests that the corporate governance agenda will continue to evolve and become more complex and political as shareholder proposals (up 20 percent year-over-year in 2007 and projected to rise at a similar pace in 2008), SEC enforcement activity and government regulation at the state level and within the Congress of the United States continue to mount.

The conundrum boards now face, he contends, and the stark reality for directors is this: **“What we seem to be doing is stumbling towards a different [governance] model without knowing the definition of where we’re going nor the consequences of what happens if and when we get there.”**

Castellani says CEO tenure among Business Roundtable member companies has fallen to about four years. “Boards are changing CEOs more rapidly than board members are buying new cars,” he says. Further, he adds, the implications of rising CEO turnover are more alarming “considering that enforcement from the SEC and actions by state attorneys general continue to grow from a relatively controllable level to a very high level now and is maintained at a high level.”

Further raising the stakes on corporate governance is an explosion of shareholder proposals. “Now, you’ve got the normal precatory proposals that are driven by people who

have been frustrated by the public policy process, and so whether it's getting onto nuclear power or taking action on global climate change or adopting standards for ethical treatment of animals," Castellani explains, those will also keep boards focused on external relations.

"But what has also come is a tremendous expansion by people who are shareholder activists who have something else in mind than good corporate governance. Many of them are the unions, so you will see in this season, or you have seen already, union-based proposals, 55 of which are filed on "Say on Pay," Castellani says.

"Quite frankly," he adds, "public executions of chief executive officers would pass the House and Senate if it were in a piece of legislation, but it's more than **'Say on Pay.'** **'Say on Pay' is the wedge issue. It is the vulnerability that we as Corporate America have given all of the activists to attack the fundamental nature of our corporate governance system.**"

Shareholder Activists Target The Proxy Process

Castellani contends that the most significant contest that looms on the government reform landscape is the battle for proxy access and activist shareholders' interest in using the proxy as their access point to shape the future composition of the board of directors.

"The big one that they want is access to the proxy for the purposes of nominating directors, a deal that they would have taken two years ago, three years ago, and when the SEC proposed it for the umpteenth time—and they have been looking at it for nearly 40 years," Castellani says.

"Wherever groups who couldn't get what they wanted somewhere else see this kind of vulnerability, they're going to use the proxy process to get what they want through the proxy process, and they're not going to back off from that," he explained.

"I think that that leads not only board members but boards in and of themselves to begin to think of themselves in a risk management context that is much broader than just the products that they have, that includes...the potential for failure, the compensation of the senior management, their own actions, their own makeup and activity, and their own structure because every vulnerability will be attacked by people who, for whatever reason, just want to change what you do."

Further, Castellani adds, "What we viewed as very dangerous and they viewed as very desirable was offered last year, a very similar deal by the SEC, and they decided not to take it. They opposed it because they think next year the SEC will

be much more favorably disposed, and so you will see the potential that directors who are nominated by Nominating Committees of the board, all of whom are independent directors, will be running in competition with director candidates who are nominated by shareholder groups owning a relatively small, but significant percentage of the stock, whether it's 3, 4, or 5 percent. I don't know, but 5 percent ownership seems to be the upper limit."

Looking to the future, Castellani doesn't see any reason to believe the interest of activist shareholders to leverage the proxy process to advance their own special agendas will diminish. It will, on the contrary, only escalate because of such parties' frustration with the pace of reforms originating in Congress or within the SEC.

"They have every intention of using [the proxy process] and combining it with like-minded people to make fundamental change in the way boardrooms operate, and therefore, bring fundamental change in the way boardrooms are constructed and how boards of directors indeed are elected," Castellani says. "We started with staggered boards, we went through poison pills, we went through separation of the chairman and the CEO or the creation of a lead director. It never seems to be enough because their objective is not necessarily good corporate governance. **Their objective may be social, their objective may be political, but clearly their objective is more and more influence over boards of directors.**"

The director's job, will, as a result, evolve into one that is far more political than it has ever been, with individual directors subjected to far greater pressure by narrow constituent groups seeking something specific from the company's activities. Director candidates may be subject to so-called 'withhold campaigns' or the direct opposition of a director candidate nominated by shareholders with a significant minority ownership.

"So you all will have to turn into political animals, and there's a problem in turning into a political animal when we have no idea what it means to you and what it means to the model and the company," Castellani forecasts. "But there are 535 people who sit in Washington who have their jobs because of a political process, most of whom, with the exception of the two senators and one congressman from Delaware, think that's not such a bad way to run any institution, and so certainly you can run a company that way."

It is already clear that the politicization of the board nominating process, and of corporate governance in a broader context, he says, will influence directors and boards for a long time to come.

“I’d like to tell you that this could be beaten back and this could be changed, but I don’t believe it will,” Castellani says.

“I believe that this is the direction that governance is going, and I believe in order to understand it, in order to be prepared for it, you all as directors and directors everywhere, and people who are involved in finding directors are going to have to more and more think of [the structure and function of the board of directors] in a political context.”

Where We Go From Here

Having digested Castellani’s stark assessment of the growing influences on board governance, one director asked the guest speaker, “If you’re on a board, shouldn’t you be talking with your major shareholders?”

Castellani acknowledged that an overall lack of ongoing engagement between boards and significant shareholders has contributed to the current state of affairs. **“When we’ve seen companies that go out and communicate more extensively and more regularly,”** Castellani replied, **“both sides felt it was very, very productive because they laid out what they were thinking of doing and the institutional investors laid out what they were thinking of doing...The general feeling is that it seemed to have worked very well.”**

Another director asked, “As you look 10 years out, assuming that this happy scenario unfolds, what kind of people would you expect to be in this room 10 years from now? What would the boards look like? What kinds of people would be serving on those boards?”

Castellani replied: “I think you have to ask yourself if you meet the current requirement for what a good board member is, which is somebody who is smart, somebody who is active, somebody who’s got the time to dedicate to some very, very difficult jobs at even the best of times, and people that have the responsibility to represent all shareholders. You have to ask yourself why would anybody who meets that profile run in a competitive race.” One rather political consideration for directors will be how they relate to people who ultimately join the board but who are likewise beholden to the specific constituency who campaigned for their spot on the board. “I would see a board that would become more and more risk averse and more and more beholden to individual constituents,” Castellani observed.

Then again, some of those individuals might bring a truly political background to the role. “The group that I run into the most who desperately want to be on boards of directors are people who used to be in the United States Congress and either were beaten or retired,” Castellani says. “And they regularly come and see me and say, ‘Can you help me get on boards?’”

Asked by yet another director why anyone would want to be the CEO of a public company given the attractiveness of private equity leadership, Castellani replied: **“All of the folks I know and all the folks you know better than I do around the table love the private equity space. It’s tougher because that board and those investors are a lot tougher and a lot more insistent, but at least it’s done in a way that everybody has the same objective.”**

Closing Thoughts From Boardroom Consultants

- The age of the passive shareholder may be coming to an end, so boards and directors need to invest the time and resources required to ensure that they have in place the most effective and responsive practices possible.
- They must consider how to operate in an increasingly politicized debate over corporate stewardship and oversight.
- Directors definitely need to spend time with their major shareholders.
- Boards must find creative communication strategies to engage with the silent majority of shareholders that tends not to take an activist position but which, nonetheless, can be a partner to the board when political and other pressures begin to distract the board from its core agenda.
- Directors must understand that executive compensation has become a critical wedge issue and that more due diligence must be applied to the management succession process and existing pay practices, especially those relating to severance and departure packages.
- The current challenges facing the board require a new set of proactive directors who can engage with management, shareholders, regulatory bodies and others to pre-empt the kind of divisive governance contests that can erode confidence in the board’s governance structure and practices.

About Boardroom Consultants

Boardroom Consultants is the first firm to specialize exclusively in director recruitment and board services with close to 400 successful director placements, numerous board assessments and governance consulting assignments for leading business organizations.

Boardroom Consultants draws on the collective knowledge of an Advisory Board composed of former chief executives to provide consultative services important to superior board performance. As trusted advisors to clients, Boardroom Consultants provides discreet, objective board assessments, succession planning, and other services that make boards valuable assets.

Boardroom Consultants supplements its extensive experience and unmatched expertise in building high-performing boards with the research and support resources available from Slayton Search Partners, a respected and fast growing leader in retained executive search.

Boardroom Consultants and Slayton Search Partners share a common commitment to provide a wider pool of exceptional candidates, for the boardroom and the executive suite, typically a multiple of what the large firms can deliver.

This distinctive approach enables Boardroom Consultants and Slayton Search Partners to make the search experience a **Limit-less**[®] opportunity for building superior organizational leadership for both boards and management. We believe it's the right model for the future.

www.boardroomconsultants.com

www.slaytonsearch.com