

**“THE ALLOCATION OF RESPONSIBILITY
BETWEEN DIRECTORS AND SHAREHOLDERS”**
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I. CONSIDERATION OF VARYING (AND SOMETIMES CONFLICTING) GOVERNANCE THEMES.

- The compliance Board versus the strategic Board: a dichotomy?
 - Serving directors know they need to do both well.
- Shareholders as owners: many types; many agendas.
- Board composition: is this the root of today’s problems with Board performance?
 - If you don’t like the output, look at the input, *i.e.*, who is being elected to Boards.
 - The Board composition model to date has been boards dominated by a management perspective, as the preferred profile for independent directors has primarily been successful executives.
 - Diversity of perspective is important, as is industry experience and knowledge. Note Citigroup’s restructuring of its Board to add financial expertise.
- Board performance shortcomings.
 - Executive compensation, options back-dating, risk assessment and shareholder interaction being four significant examples.
 - Incomplete/misleading disclosure, lack of adequate executive succession planning, inadequate CEO evaluation, and poor Board leadership being four other examples.

- Demands for greater shareholder participation in the governance process – is this an attack on the director-centric model of governance, or simply a manifestation of shareholder frustration with attempts to open a dialogue with directors on matters of shareholder concern?
 - ❑ Majority voting.
 - ❑ Declassification of Boards.
 - ❑ Poison pill limitations.
 - ❑ Proxy access for director nominations.
 - ❑ Say on pay: a shareholder advisory vote on executive pay.
 - ❑ Shareholder resolutions on a variety of subjects.
 - ❑ Greater dialogue between Boards and shareholders on a range of corporate matters.
 - ❑ Broker voting limitations.
- Debate about the need for additional corporate regulation; congressional proposals; comments by Presidential candidates; the tension between state versus federal regulation of corporations and corporate conduct.
 - ❑ Executive compensation as a lightning rod for much of the political debate.
 - ❑ Government intervention in the financial markets and the harm done to broad employee/owner stakeholders of financial services companies as a strong motivator for federal legislation; a socio/political/economic environment resulted in Sarbanes-Oxley and Dodd-Frank.
- Criminalization of corporate misconduct.

II. SHAREHOLDERS' PRIMARY EXPECTATION: BOARDS TAKE CORPORATE INTEGRITY AS THEIR NO. 1 RESPONSIBILITY.

- What shareholders need most from Boards of Directors and senior management is assurance of an organization's integrity in the broadest sense – which would include assurances regarding the organization's continuing viability as an enterprise; values which embrace ethical conduct, legal compliance; sensitivity towards risk, reward and the creation of sustainable value.

Specifically:

- ❑ That the Board of Directors is uncompromising in the selection, evaluation and retention of directors of high integrity and skill, who are knowledgeable about,

- ❖ State corporate laws require that corporations be managed by or under the direction of a Board elected by shareholders.
- ❖ The Board determines the authority delegated to management, and is responsible for oversight as to management's exercise of that authority.
- ❖ Board's oversight responsibilities include direct authority over CEO selection, evaluation, compensation, termination and succession, and oversight responsibility regarding the CEO's selection, evaluation, compensation, termination and succession of his/her direct reports.
 - Shareholders have sought to address the failure of Boards to address their concerns about executive compensation by seeking a non-binding advisory vote on CEO compensation, an objective accomplished in the 2009 Dodd-Frank legislation.
- ❖ Boards have direct responsibility, but not exclusive authority over the selection of directors through their power to recommend director nominees to the shareholders. Implicit in a Board recommendation for election of directors should be the application of the duty of care to the nomination process, e.g. an assessment of the needs of the Board and an evaluation of the qualities, skills and performance of Board-endorsed director nominees. Rules of the Securities Exchange Commission now require that companies disclose the qualifications of directors and comment on why each director is suited to serve on a particular board.
 - Boards have been criticized by shareholders for deferring to management's views on director selection, failure to appropriately review and evaluate candidates being re-nominated and failure to consider the interests of shareholders in the director selection process.
 - Shareholders have sought to redress this by seeking the ability to nominate candidates directly through access to company's proxy material. The SEC is currently engaged in rule making on "proxy access."
 - Shareholders are seeking to redress the lack of effective director evaluation through proposals to require that directors must be elected by a majority vote of shareholders attending an annual meeting at which a quorum is present. Many public corporations have included "majority vote" provisions in their bylaws.
- ❖ Board composition is central to concerns about director performance.
 - Citigroup has restructured its Board. Critics of the Board had noted a troubling lack of financial expertise on the Board given that Citigroup's

- Issues surrounding complex securities highlights the needs of Boards for a level of expertise that can understand risk and critique strategy particular to the specific company and industry, and also access the resources to provide the analysis and expertise necessary to enable the Board to make informed contributions and judgments about strategy and specific actions. Board access to information and analysis of management proposals that comes from sources other than management is not only critical but a measure of Board-management relations, Board independence and Board intelligence (about the questions that need to be asked, the matters which need further analysis and the limits of the directors' expertise about particular subjects).
- That the Board of Directors is uncompromising in the selection, evaluation and retention of executive management of high integrity and skill, dedicated to the organization's integrity and performance.
- That the Board and senior management recognize their joint roles in assuring that the organization has, and practices, values that support a culture of integrity, fairness, trust, and high performance. A culture that values integrity and ethical behavior begins with the tone at the top. The tone at the top begins with leadership at the Board and senior management level.

A key element in leadership is trust. Boards and senior executives must be extremely sensitive to the signals they send to the stakeholders and employees of the organizations they lead. Signals to shareholders include responsiveness to shareholder director nominees, proxy proposals, governance standards, views on executive compensation, etc. Signals to employees include who is selected for Board service, who is hired/promoted to serve as a senior executive, what behaviors are endorsed or permitted at the Board, management and staff levels, how people are rewarded, and how employees, suppliers, customers, shareholders and other stakeholders are treated.

- That the public disclosures and comments of senior management and the Board have integrity and are reflective of the true state of the company's affairs.

Shareholders have been critical of management disclosures related to write-offs by financial services companies where statements by management have sought to allay investor concerns about future write-offs only to be followed by another round of substantial write-offs.

- That senior management, selected and regularly evaluated and compensated by the Board, would above all responsibilities see that the company's business was conducted in a manner which would serve rather than detract from its integrity.

- That a corporation’s advisors and consultants, including lawyers and accountants, will act to protect the organization’s integrity, and take important issues to senior management and the Board of Directors to assure that they are acted on appropriately.

Once again accountants’ assessments of financial risk in the course of the audit of many financial services companies, and audit committees’ oversight of risk have been faulted by shareholders with a resulting surge in litigation.

- That the compensation and benefits paid to Board members and senior management, which directors alone approve, will not in actuality or perception co-opt their judgment, compromise their independence, detract from the corporation’s integrity, or have a corrosive effect on the company’s culture. Behavior and actions which negatively impact integrity and culture undermine the company’s ethics and compliance initiatives.

This subject is and will continue to be a critical shareholder issue, which will be used to advocate for governance reform until Boards and their compensation committees assert more oversight and control. The stock option backdating, spring-loading and bullet-dodging, mega grants, large compensation packages for executives (and in several cases large severance packages for terminated executives) whose companies have suffered substantial losses and asset write-downs have been focal points of shareholders’ executive compensation discontent, and heightened concern about whether Board compensation committee decisions in fact reward or overlook failure. This situation has furthered shareholders’ distrust of management and of Boards’ oversight capabilities. Many large shareholders see their only remedy as gaining more control over Board composition, thus shareholders’ advocacy of “proxy access” rules.

- That directors and management will seek to avoid actual or perceived conflicts of interest which would detract from the integrity of the company and its governance, and if they occur that they will be dealt with promptly and appropriately.
- That management has in place compliance, and risk identification, assessment and mitigation procedures and processes that will give management and the Board early warnings of activities that would threaten the integrity of the company – and when the warnings come that management and the Board will review and resolve the issues. In the case of the Board, if it is determined that an independent assessment/investigation is required, that the matters would be independently assessed/investigated without restrictions that might compromise the investigation.
- ❖ The massive losses suffered by a number of financial services companies have called into question Board performance of its risk oversight responsibilities

- That the corporation's financial statements have integrity – in other words that they can be clearly understood and relied on by those responsible for assessing the financial condition of the company for purposes of investing in it and doing business with it – *e.g.*, its financiers, shareholders, employees, suppliers and customers, and various regulatory authorities.

Once again, off-balance sheet entities and accounting rules were, and are being, utilized by a number of the financial services companies to obscure the true financial condition of these enterprises.

- The bottom line of governance is that the ultimate authority for the governed entity (the “governing authority” in the language of the Revised Federal Sentencing Guidelines) is responsible for the entity’s integrity. In many of the past and current corporate failures Boards also “failed” because they did not take responsibility for the organizations’ integrity. The directors did not see the organizations’ integrity as an extension of their own integrity – and ultimately that is the critical point.

III. SHAREHOLDER CONCERNS ABOUT BOARD/DIRECTOR PERFORMANCE FUEL THE DRIVE FOR GREATER PARTICIPATION IN BOARD COMPOSITION, DIRECTOR ELECTIONS, AND EFFECTIVE MEANS OF HOLDING BOARDS/DIRECTORS MORE ACCOUNTABLE. AN ANALYSIS OF THE COMMON DENOMINATORS UNDERLYING MANY OF THE CORPORATE SCANDALS/FAILURES FROM THE EARLY 2000s TO DATE SUGGESTS THE FOLLOWING:

- Many directors don’t understand what it means to be a fiduciary.
- Directors often don’t truly understand their oversight roles, nor do they understand how to balance their oversight of culture, ethics and legal compliance with their oversight of, and contributions to, strategy (which by definition includes assessment of risk and opportunity.)
 - They may be good managers, but they are not always good overseers.
 - Many do not understand that governance is different from management, requiring different perspectives, skills and processes.
- Many Boards don’t thoroughly assess organizational, governance, business, financial, legal and personnel risks.
 - This has become a critical issue, and a focus of plaintiffs’ attorneys, in connection with the losses in the financial services industry.
 - This is an issue of Board expertise and courage.

- Non-management directors are sometimes intimidated by management, uncritically reliant on the views of management and advisors, or passive. This was apparently the case in the U.S. corporate scandals in the early 2000s and has been a factor in the recent financial crisis.
 - ❑ Blind faith in the CEO and management team.
 - ❑ Belief that if the company hires a well credentialed CEO, CFO, name accounting firm, law firm or investment banker, etc., the directors can rely without oversight or inquiry. That isn't the law in the U.S..
 - ❑ Failure to probe management recommendations and the advice of lawyers, accountants, consultants, etc.
 - ❑ Failure to get to know second and third tier employees.
 - ❑ Failure to effectively evaluate CEO performance, and to interact with the CEO regarding evaluation of senior management.
 - ❑ Failure to effectively evaluate Board and individual director performance, and follow through on needed Board/director performance improvements.
 - ❑ Allowing management to terminate, silence, ignore those in the organization who raise alarms/questions about corporate strategy/decisions.
- Failure to understand/monitor the corporate culture.
 - ❑ Result was, in many cases, a culture of “me first,” arrogance, greed.
 - ❑ Result was a culture where people didn't bring concerns about wrongdoing forward.
 - ❑ Tight control of information; development of information silos.
 - ❑ Discouraging dissent; over valuing conformity with the “CEO view.”
 - ❑ Exempting high performers from compliance with the values and policies of the organization.
- Failure to appreciate the signals Boards send about the values and ethics of the organization.
 - ❑ Who is recruited for the Board.
 - ❑ Who is hired as CEO. Who the CEO hires/promotes into senior management positions.

- ❑ How management is compensated versus how management compensates the employee base.
 - ❑ What behaviors are rewarded. What behaviors are sanctioned (or not sanctioned).
 - ❑ There were reports that Goldman Sachs avoided some of the substantial sub-prime losses because it was hedging sub-prime risk to Goldman's capital while continuing to sell sub-prime-backed securities to customers. The SEC sued Goldman Sachs over this issue. Goldman settled the litigation and has settled litigation with others over its selling and business conduct practices. In the wake of public criticism Goldman convened a Board/management committee to examine and make corrective recommendations about Goldman's business practices.
- Failure to appreciate and use the oversight tools at their disposal.
- Failure to observe good governance practices.
 - ❑ Board is passive, not a proactive overseer.
 - ❑ Board members don't embrace their responsibilities; don't exhibit commitment, judgment, leadership, courage.
 - ❑ Directors co-opted by pay, perks, relationships - i.e., not sufficiently independent or objective. Many of the directors were hand-picked by the CEOs and were friends, had business relationships, served on each others' Boards, etc.
- Committee failures.
 - ❑ Governance: re Board composition; director independence and performance; Board and committee evaluation; CEO and director succession.
 - ❑ Compensation: excessive CEO and senior management compensation (including bonuses, perks, benefits, and retirement and severance payments and benefits); stock option issues; poor CEO evaluation and senior management oversight.
 - ❑ Audit: financial statements (these are the company's statements, not the auditors); compliance; stock options, off-balance sheet and various other risk exposure issues.
- Insensitivity to conflicts of interest.
- Failure to understand and perform legal duties.
 - ❑ Oversight.
 - ❑ Good faith.

- Care.
- Loyalty.
- Compliance.
- Failure to embrace Board/director education.
 - Insufficient knowledge about governance, its practices and processes.
 - Insufficient knowledge of the company and industry.
 - Insufficient knowledge of their duties and their liabilities.
 - Insufficient knowledge of corporate strategy.
 - Insufficient appreciation of business risks and corporate vulnerabilities generally, and with respect to various corporate activities specifically.
 - Lack of appreciation for, and often resistance to, the importance of continuing education to enhance their directorship knowledge and skills.

IV. SOME THOUGHTS ON HOW BOARDS MIGHT IMPROVE GOVERNANCE AND OVERSIGHT TO ADDRESS SHAREHOLDER CONCERNS AND IMPROVE SHAREHOLDER RELATIONS AND VALUE:

- Understand that governance is a discipline different from management. It's about the Board's proactive; vigorous oversight, examination of and contributions to strategy; being a valued resource to management in times of opportunity and crisis, etc. It's about being attuned to shareholder and other stakeholder concerns, engagement with shareholders and other stakeholders, engagement with management on company performance, and performance of its own duties to serve the best interests of the company. And because this is at the heart of effective governance, a major challenge is developing excellence in governance.
- Board performance starts with Board composition. If there's dissatisfaction with Board output (performance) then Board input (composition) needs to be examined. In addition to management, a variety of voices, perspectives and skills are needed on today's Boards; *e.g.*, analyst, risk assessment, human resources, stakeholder relations, government relations, institutional investor, internal audit, regulatory, compliance, legal, accounting/finance and governance.
- Right behind Board composition is Board organization and leadership. Ineffective leadership is the result of, and further results in, ineffective Boards and committees. Independent Board leadership is important, whether in the form of an independent chair, presiding director or lead director, but if the Board does not have one or more persons who understand, and are skilled at, the role the result can be a divided,

- Recognize that integrity is everything. It is the root of stakeholder and public confidence in a company. Organizational integrity starts at the top, i.e., the Board of Directors and senior management.
- Recognize that Board oversight of the corporate culture is critical. Boards must understand and take responsibility for the corporate culture. In this regard Boards must assure that the Board and management have appropriate leadership committed to, and accountable for, an ethical, legally compliant culture that effectively assesses, monitors and mitigates risk as part of its business strategy and business operations.
- Boards must take more responsibility for compensation, perks and incentives, retirement and severance pay. This subject continues to inflame shareholders, politicians and regulators. The media and a number of institutional shareholders and governance commentators have flogged this subject for years. And it's critical that Boards do a better job. Disclosures of compensation levels and perks paid to senior management continue to attract the attention of regulators, politicians, labor representatives and shareholders.
 - Boards must be more aware of the corrosive effect on the corporate culture, particularly trust, which can result from poor compensation practices at the Board and management levels. In this regard the issue is not just the amount of compensation; it is the incenting of certain performance. Boards should review compensation plans for senior executives and other managers to assure improper behavior is not incentivized.
 - Boards must realize that excessive director and executive compensation, and a failure to align executive compensation with company performance, reflects poorly on their independence, integrity and judgment.
 - The bottom line is that Boards must assure that management establishes the compensation and incentives for any group in the context of an overall compensation philosophy for the organization which is in fact, and perception, fair.
- Boards must carefully assess actual and perceived conflicts of interest. Conflicts of interest in general, but particularly involving directors, senior management and key advisors, must be carefully assessed, and independent advice sought where necessary. Like the compensation issues, unresolved or poorly resolved, conflicts of interest reflect badly on Boards' independence, integrity and judgment, and can have a corrosive effect on the corporation's culture.
- Boards must pay more attention to the organization's human capital. Boards have always accepted responsibility for the organization's financial capital. They must devote equal attention to the organization's human capital.

- Boards should participate with management in developing and maintaining key shareholder interaction policies and practices. Boards must improve shareowner communications, seek an understanding of shareowner concerns and views on a variety of governance issues, including input into the director nomination process and company performance issues, and demonstrate a willingness to engage with shareowners and their representatives on these matters. Avoidance is no longer workable, and the consequences of avoidance will range from legislation to increased numbers of shareholder proposals and more contention between Boards and shareholders. Delegating shareowner communications to management is problematic.
- Directors must pay close attention to their core duties: care, loyalty, good faith, compliance and oversight.
 - Care in every decision. Be informed. Directors shouldn't approve matters they don't understand. Real or perceived pressures shouldn't overshadow the duty to make an informed judgment.
 - Loyalty. The interests of the organization always come first. Directors shouldn't use their position or the confidential information they gain for their or others' benefit. Boards must avoid being compromised by compensation or benefits which could actually, or be perceived in hindsight to, compromise their judgment.
 - Good Faith. Directors must act in good faith. In most states, directors may not be indemnified by the organization if their act or failure to act was not in good faith.
 - Compliance. Pay attention to the company's governing documents, policies and agreements, and the laws and regulations to which the company is subject. It is difficult to enforce a company's code of conduct and standards of legal compliance if the message of compliance doesn't start with the Board and senior management, both in terms of emphasis and conduct.
 - Oversight. A Board's job isn't to manage; it's to vigorously oversee and evaluate management. The CEO reports to the Board, not the other way around. An adversarial relationship with management is counterproductive. Collaboration is essential. But personal relationships and Board compensation and tenure can't be allowed to obscure the need for vigilant oversight.
- Boards must strive to understand risks, pay attention to warnings and confront problems promptly and forthrightly. Policies and procedures for assessing and monitoring risks are essential, and directors must assure that they are in place and functioning well. Warnings need to be heeded and promptly investigated. Investigation means a thorough effort to obtain all relevant information, using independent resources where necessary to assure objectivity. Board and audit committees of financial services companies are being held increasingly accountable for risk assessment failures.

- Once again, in the face of substantial write-downs in the financial services sector shareholders are asking where was the Board? A case in point is the reported stepping down of Citigroup's audit and risk committee chair as a result of shareholder dissatisfaction with the committee's failure to identify and oversee risks that resulted in Citigroup's huge losses from its sub-prime debt exposure.
 - Risk is not simply a compliance-related activity; it's integral to strategy. It's the other side of opportunity. If Boards don't have the skill sets needed to assess management's view of risk and opportunity they should consider adding directors with the necessary skill sets and/or seeking independent, outside assistance.
 - Boards must also be proactive in addressing the boundaries of management authority. It is inconceivable that any of the Boards of the financial services companies that suffered the substantial losses thought that they had authorized management to take the level of business risk that might place the viability of these enterprises in question or require the level of recapitalization that has been needed to maintain enterprise viability.
- Boards must use the tools at their disposal to effectively execute their oversight responsibilities.
 - Selection of capable directors, known to be ethical and screened for past legal and ethical issues, knowledgeable about governance, oversight and business, who have the skills, time, energy, knowledge, judgment, leadership and courage to effectively discharge their responsibilities.
 - Selection of a CEO, known to be ethical and screened for past legal and ethical issues, who is experienced and committed to building a corporate culture that is ethical and compliant, and holding the CEO accountable for the development of that culture.
 - Selection of independent Board leadership with the knowledge and skills to assist the Board in meeting its responsibilities.
 - Periodic independent assessments of the company's culture, ethics, values and compliance, and the effectiveness of training programs designed to instill appropriate corporate values, familiarize employees with the company's ethics and compliance expectations and assure those expectations are met.
 - Insistence that management have in place processes and procedures for preventing and detecting violations of laws, regulations, company governing documents and company codes of ethical conduct, and for assessing risk and risk mitigation, followed up with oversight over, and periodic assessment of, the efficacy of those processes and procedures.
 - Oversight over the evaluation, hiring, firing and compensation of employees who are key to assessing and shaping the corporation's financial reporting, human resources, risk assessment, ethical and legal compliance environment, e.g., the

- ❑ Independent contact with key corporate advisors: outside counsel, independent auditors, various consultants.
 - ❑ Engagement of the independent auditors and compensation consultants; oversight over management’s engagement of outside legal counsel and other key advisors to assure that the loyalty of these advisors is to the company and not the personnel at the company who engaged them.
 - ❑ Engagement of independent counsel and consultants to advise the Board, or Board committees, on matters with respect to which the Board requires a “second opinion” or advice from a service provider who is not regularly engaged to serve the company under management’s direction.
 - ❑ Use of tools such as business intelligence and balanced scorecard software to assist with monitoring.
 - ❑ Use of corporate and outside investigatory and research resources to scan backgrounds of key people and organizations.
 - ❑ Use of search firms to assist with the identification and screening of director and CEO candidates.
- Transparency is good; obscuring reality is bad. Transactions, schemes or practices which make it difficult for those who rely on the company’s business and financial information to clearly understand that information must be questioned. Boards need to be increasingly aware that if third parties’ decisions are made based on potentially misleading omissions or information, litigation and government investigations may ensue.
 - Targets are good; quarterly earnings obsessions are bad. Agreed that plans, targets and accountability are good. But not when the targets are unrealistic or the pressures or incentives to achieve them so great as to result in deliberate distortions, or the use of “cutting edge” accounting practices which in effect misrepresent financial results.
 - Monitor corporate disclosures. Boards are increasingly aware of the organization’s responsibility for accurate, complete disclosure to banks, creditors, insurance companies, government tax and regulatory authorities, the securities markets (in the case of publicly-held companies or organizations which issue publicly-held debt) and others who rely on or require the organization’s business and financial information. Boards must be aware of the many ways in which the corporation provides information, e.g., public comments by management, management conduct, media interviews, press releases, websites, broadcast or directed email, regulatory agency filings and a multitude of forms and applications for other third parties.

- Monitor external information sources such as analyst reports, positions taken by proxy advisors, competitors' public disclosures and advertising, blogs, websites, chat rooms, etc.
- Boards should monitor the governance views of business, shareholders, institutional investors, proxy advisors, legislators, regulators, governance commentators, and contrast those views with the corporation's governance policies and practices.
- Boards must be extremely conscious of the signals they send to the organizations they govern. Signals which come from their own conduct, who they nominate as directors, who they hire as the CEO, what conduct they endorse, what values they espouse directly and indirectly, how they deal with behavior which is antithetical to those values, and situations which test those values – it's about the culture of the organizations for which they are ultimately responsible.
- Boards and management should be very selective in opposing corporate reforms and governance practices advocated by responsible stakeholders. Blanket opposition to Sarbanes-Oxley, a law which focused primarily on improving the integrity and reliability of financial statements, or Dodd-Frank which, among other topics, focused on a number of governance practices, was, for the most part, counter-productive from a shareholder and public relations perspective.
- Directors need to be schizophrenic. Vigilant overseers of management on the one hand, and effective, constructive collaborators with management on the other.
- Boards must focus on protecting the reputational value of their organizations. Reputations take years to build and moments to lose. For most organizations their reputations and goodwill are among their most valuable assets. Boards must be alert to individual and organizational conduct which may compromise a company's reputation for integrity and trustworthiness with its various stakeholders. As we've seen the consequences of a breach of trust can be brutal.
- Embrace good governance practices. Good governance in actuality, not just in appearance. The Boards of many organizations which have been in the news were populated with individuals with excellent credentials. Often the appropriate governance documents and Board structures are in place. However, good governance is about organization, process, education and **EXECUTION**. And finally **EVALUATION** -- evaluation of management, principally the CEO, evaluation of the Board, and evaluation of directors.