Legal Backgrounder

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202.588.0302

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CORPORATE GOVERNANCE REFORMS SHOULDN'T WEAKEN DIRECTORS' ROLE

by

Timothy Hoeffner and Katayun Jaffari

In the wake of high-profile scandals involving Enron Corporation and WorldCom, Inc., there has been an extraordinary level of activity focused on strengthening corporate governance. These actions have centered primarily on creating independent decision-making and developing processes to ensure that officers and directors take informed action.

Some recent actions go a step further. Most notable are current Securities and Exchange Commission (SEC) proposals addressing shareholder nominations for directors and certain recommendations made by former SEC Chairman Richard C. Breeden, the Corporate Monitor at WorldCom. These proposals and recommendations would transfer specific decision-making powers from corporate directors, who have been selected for their expertise and are legally required to act fairly, to individual and institutional shareholders, who can reasonably be expected to act based primarily on their own interests. These ideas constitute an overreaction and are based on the flawed premise that recently disclosed weaknesses in a few corporations dictate that directors are not well suited to making decisions in the best interests of a corporation and its shareholders.

This LEGAL BACKGROUNDER summarizes the pending SEC proposals and Mr. Breeden's recommendations, and highlights the dangers of implementing these standards.

The Case for Director Responsibility. Generally, state laws place responsibility on corporate boards to exercise oversight of managers and to approve matters of significance to the corporation. There are sound reasons for charging directors with those duties. First, directors are selected by shareholders, based on their expertise and business experience, to represent the interests of all owners. Second, directors can reasonably be expected to focus on the interests of the company and its shareholders, as directors are subject to fiduciary duties of care, loyalty and good faith, and are prohibited from unfair self-dealing. As a result, courts and others have given deference to the decision-making processes of corporate boards of directors. Shareholders, in contrast, are generally free to act in their own interests, and are under no legal duty to act in the best interests of their fellow shareholders, nor in the best interests of the corporation. Shareholder interests may include maximizing short-term gains to the detriment of long-term shareholder

Timothy Hoeffner is a partner, and **Katayun Jaffari** is an associate, with the law firm Saul Ewing LLP.

value, or adopting an agenda that may favor an individual or group of shareholders, to the detriment of others.

SEC Proposal: Security Holder Director Nominations. The first effort to reallocate power to shareholders is set forth in proposed SEC rules regarding shareholder director nominations. The proposed rules would allow long-term shareholders with significant holdings to place shareholder nominees for director in company proxy materials. *SEC Proposed Rules 34-48626* (Oct. 14, 2003). The stated goals of the rules, which were proposed in response to frustration expressed by certain shareholder groups such as pension funds, are to (1) give shareholders a more effective role in the director election process, and (2) develop more responsive board members.

The rules, as initially proposed, would require a company to include in its proxy materials information about shareholder nominees to a board. The requirements, however, would only be triggered by the occurrence of one of two events at an annual shareholder meeting: (1) shareholders withheld 35% or more of the votes cast from at least one of the company's nominees for election to the board and for whom the company solicited proxies, or (2) a proposal, submitted by shareholders holding more than 1% of the company's voting securities for at least one year, which the company became subject to through a shareholder nomination procedure, receives more than 50% of the votes cast. If either event occurs, the company would be required to include the shareholder nominations in its proxy materials for the annual meeting in the year following the meeting at which a triggering event occurred.

Once a company receives the shareholder nominees, it must make two determinations: first, whether the nominating shareholder is qualified under the rule to make the nomination, and second, whether the nominee satisfies the criteria of board membership under controlling state law, federal law or any applicable rules of a self-regulatory organization such as NASDAQ or the NYSE. If both conditions have not been satisfied, the company must notify the nominating shareholder, who then has an opportunity to evaluate the company's conclusion and to respond. On the other hand, if the company determines that the conditions have been satisfied and thus decides to include information in the proxy statement supporting its own nominees or opposing the shareholder nominee(s), it must give the nominating shareholder an opportunity to submit a statement for inclusion in the proxy statement. If the company chooses not to include such a statement, the nominating shareholder may not include his statement.

While SEC Chairman William Donaldson acknowledges that the proposal has received extensive criticism, he believes shareholder input in nominating procedures is extremely important and that a middle ground in the process is imperative. Currently, the SEC is evaluating a proposal that would allow companies to avoid including shareholder nominations in proxy materials so long as companies reach an agreement with shareholders on a replacement director.

Neither proposal should be adopted. Each idea would unjustly shift the responsibility of governance and selection of potential directors to shareholders — a shift that is troubling for a number of reasons. First, directors as a general consideration are more experienced in matters of corporate governance and have detailed information concerning a corporation's goals and

strategies. Thus, directors are best able to identify the company's needs and nominate qualified individuals to serve those needs. By involving shareholders in the nominating process, the corporation would not retain the benefit of carefully reasoned, unbiased decision-making. Second, directors nominated by a specific group of shareholders may feel beholden to that group and, ultimately, may make decisions consistent with the nominating shareholder group's views to protect their own positions. By permitting one shareholder constituency to unduly control the nominating process, the rules create the opportunity for significant conflicts of interest for directors serving the interests of the nominating group, rather than the interests of the entire body of remaining shareholders. Since the director who has been nominated by one shareholder constituency may have an agenda that differs from that of the other board members, the election of a shareholder nominee could also "threaten the cohesion that is indispensable to an effective board of directors." *Statement of Stephen A. Adland, Chairman, Corporate Governance Task Force, the Business Roundtable, submitted to the Securities and Exchange Commission,* Mar. 10, 2004, http://www.sec.gov/spotlight/dir-nominations/adland032004.htm.

Critics of the proposal, including organizations such as the American Bar Association and the U.S. Chamber of Commerce, argue that the SEC simply does not have the authority to implement the proposed rules. Former Chief Justice E. Norman Veasey of the Supreme Court of Delaware has publicly commented that the SEC proposal raises a federalism concern. He questions whether the SEC, as a matter of policy, can grant shareholders a substantive right when the creation of "that right intrudes upon and may be in conflict with corporate internal affairs that are the province of state law." *Letter of Honorable E. Norman Veasey, Chief Justice Supreme Court of Delaware to Director Allan L. Beller, Division of Corporation Finance, Securities and Exchange Commission,* Mar. 11, 2004. This criticism highlights the conflict between the proposed rules and long established rules of state law which support control of the nomination process by directors.

The Breeden Report. A second example of the reallocation of corporate governance responsibilities to shareholders arose from the WorldCom controversy. The Honorable Jed S. Rakoff, of the Southern District of New York, named Mr. Breeden to the position of Corporate Monitor at WorldCom and charged him with the task of creating a new set of corporate governance guidelines for WorldCom. As the result of a settlement agreement with the SEC, Mr. Breeden's report, "Restoring Trust," has become the binding governance system of the company. Many of his recommendations seek to turn over the responsibility for many of the decisions that have traditionally been left to the business judgment of directors to those with more personal interests, namely shareholders. The transfer of power is extraordinary, given the steps taken by WorldCom to avoid future problems, including the selection of board members lacking any connection to the alleged corporate fraud. The following examples demonstrate the problems inherent in many of Mr. Breeden's recommendations to transfer power to shareholders.

Corporate Governance Constitution. Mr. Breeden's report suggests placing all of a company's corporate governance provisions in the company's Articles of Incorporation, rather than in the company's by-laws and internal charters, so that the Articles become the "Governance Constitution of the Company." Once the corporation places the provisions in the Articles, however, the board of directors will be unable to amend those provisions without first obtaining

shareholder approval. This approach dramatically limits the flexibility that is not only desirable, but perhaps necessary to permit the board of directors to act in the best interests of the corporation in situations where it would be impractical to obtain shareholder approval. For example, consider the plight of a company which is subject to the listing standards of NASDAQ, the NYSE, or another self-regulatory organization. It would be extremely costly and wasteful to call for a meeting, solicit proxies, and obtain shareholder approval to adopt a governance standard that is prescribed by the self-regulatory organization.

Electronic Town Meeting. Mr. Breeden suggests the creation of an electronic "town meeting," offering shareholders an online forum to discuss issues of concern. Any resolution supported by a shareholder holding at least 1% of the company's voting power would be entitled to place any bona fide resolution on the website for consideration by shareholders. Any proposal that receives a minimum number of votes as established by the Governance Committee would be placed in the company's annual meeting proxy statement. This proposal reverses the fundamental principles of corporate governance by substituting shareholder judgment for director judgment and allowing shareholders to dictate to directors what issues to address and how to resolve them.

Dividend Policy. Mr. Breeden's report proposes that a company publish its intentions regarding dividends and seek shareholder consent to any change in that policy. He further recommends that the company pay a targeted minimum dividend each year (i.e., 25% of the corporation's net income). Although he recognizes that the board will require some flexibility in this area, Breeden explains that distributing dividends could force companies to raise financing on the open market for large acquisitions which will ensure more frequent outside scrutiny of a company's finances. This proposal drastically hinders the board's ability to manage the company's cash resources in light of all relevant considerations, including taxes and the cost of capital, and reflects an unduly skeptical view that all companies require outside scrutiny.

Conclusion. The SEC proposals and Mr. Breeden's recommendations are an overreaction to a small number of very large corporate scandals, and seem to be based on the premise that corporate governance would somehow be "better" if shareholders had a more direct voice in the process. It is more likely, however, that the problem lies with the very limited number of individuals at a few companies who have manipulated and abused their positions of power. In addition to turning upside down long-standing, sound and fundamental principles of state corporate law, the proposed SEC rules and the recommendations of the Breeden Report would transfer power to precisely the wrong constituency — the shareholders — who have neither the legal obligation nor the demonstrated ability to look beyond their personal concerns and consider the interests of all of the shareholders.

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