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CORPORATE GOVERNANCE 2.0

We need to return to first principles rather than meander toward "best practices."

by Guhan Subramanian

Although corporate governance is a hot topic in boardrooms today, it is a relatively new field of study. Its roots can be traced back to the seminal work of Adolf Berle and Gardiner Means in the 1930s, but the field as we now know it emerged only in the 1970s. Achieving best practices has been hindered by a patchwork system of regulation, a mix of public and private policy makers, and the lack of an accepted metric for determining what constitutes successful corporate governance. The nature of the debate does not help either: shrill voices, a seemingly unbridgeable divide between shareholder activists and managers, rampant conflicts of interest, and previously staked-out positions that crowd out thoughtful discussion. The result is a system that no one would have designed from scratch, with unintended consequences that occasionally subvert both common sense and public policy.

Consider the following:

- In 2010 the hedge fund titans Steve Roth and Bill Ackman bought 27% of J.C. Penney before having to disclose their position; Penney's CEO, Mike Ullman, discovered the raid only when Roth telephoned him about it.
- The proxy advisory firm Glass Lewis has announced that it will recommend a vote against the chairperson of the nominating and governance committee at any company that imposes procedural limits on litigation against the company, notwithstanding the consensus view among academics and practitioners that shareholder litigation has gotten out of control in the United States.
- In 2012 JPMorgan Chase had no directors with risk expertise on the board's risk committee—a deficiency that was corrected only after Bruno Iksil, the "London Whale," caused $6 billion in trading losses through what JPM's CEO, Jamie Dimon, called a "Risk 101 mistake."

DISPENSING WITH EARNINGS GUIDANCE WOULD MITIGATE THE OBSESSION WITH SHORT-TERM PROFITABILITY. COMPANIES SHOULD PROVIDE ANALYSTS WITH LONG-TERM GOALS INSTEAD.

- Allergan, a health care company, recently sought to impose onerous information requirements on efforts to call a special meeting of shareholders, and then promptly waived those requirements just before they would have been invalidated by the Delaware Chancery Court.
- The corporate governance watchdog Institutional Shareholder Services (ISS) issued a report claiming that shareholders do better, on average, by voting for the insurgent slate in proxy contests; *within hours,* the law firm Wachtell, Lipton, Rosen & Katz issued a memorandum to clients claiming that the study was flawed.
- The same ISS issues a "QuickScore" for every major U.S. public company, yet it won't tell you how it calculates your company's score or how you can improve it—unless you pay for this "advice."

We can do better. And with trillions of dollars of wealth governed by these rules of the game, we must do better. In this article I propose Corporate Governance 2.0: not quite a clean-sheet redesign of the current system, but a back-to-basics reconceptualization of what sound corporate governance means. It is based on three core principles—principles that reasonable people on all sides of the debate should be able to agree on once they have untethered from vested interests and staked-out positions. I apply these principles to develop a package solution to some of the current hot-button issues in corporate governance.

The overall approach draws from basic negotiation theory: Rather than fighting issue by issue, as boards and shareholder activist groups currently do, they should take a bundled approach that allows for give-and-take across issues, thereby increasing the likelihood of meaningful progress. The result would be a step change in the quality of corporate governance, rather than incremental meandering toward what may (or may not) be a better corporate governance regime for U.S. public companies.

PRINCIPLE #1

Boards Should Have the Right to Manage the Company for the Long Term

Perhaps the biggest failure of corporate governance today is its emphasis on short-term performance. Managers are consumed by unrelenting pressure to meet quarterly earnings, knowing that even a penny miss on earnings per share could mean a sharp hit to the stock price. If the downturn is severe enough, activist hedge funds will start to become interested in taking a position and then clamoring for change. And, of course, there are the lawyers, ever ready to file litigation after a big drop in the company's stock.

It is ironic that companies today have to go private in order to focus on the long term. Michael Dell, for example, took Dell private in 2013 because, he claimed, the fundamental changes the company

Idea in Brief

THE PROBLEM
Good corporate governance has been hindered by a patchwork of regulation and policy making and the lack of an accepted metric for determining success. The result is a system with unintended outcomes that occasionally subvert both common sense and public policy.

WHY IT HAPPENS
The debate about corporate governance is characterized by shrill voices, a seemingly unbridgeable divide between shareholder activists and managers, rampant conflicts of interest, and rigidly held positions.

THE SOLUTION
Corporate Governance 2.0 is a back-to-basics reconceptualization of sound corporate governance. It's based on three core principles:

- Boards should have the right to manage the company for the long term
- Boards should install mechanisms to ensure the best possible people in the boardroom
- Shareholders should have an "orderly" voice

needed could not be achieved in the glare of the public markets. A year later he wrote in the *Wall Street Journal,* "Privatization has unleashed the passion of our team members who have the freedom to focus first on innovating for customers in a way that was not always possible when striving to meet the quarterly demands of Wall Street." The idea that "innovating for customers" can be done more effectively in a private company is deeply troubling; public companies, after all, are still the largest driver of wealth creation in our economy.

To allow managers at public companies to focus on the long term, Corporate Governance 2.0 includes the following tenets:

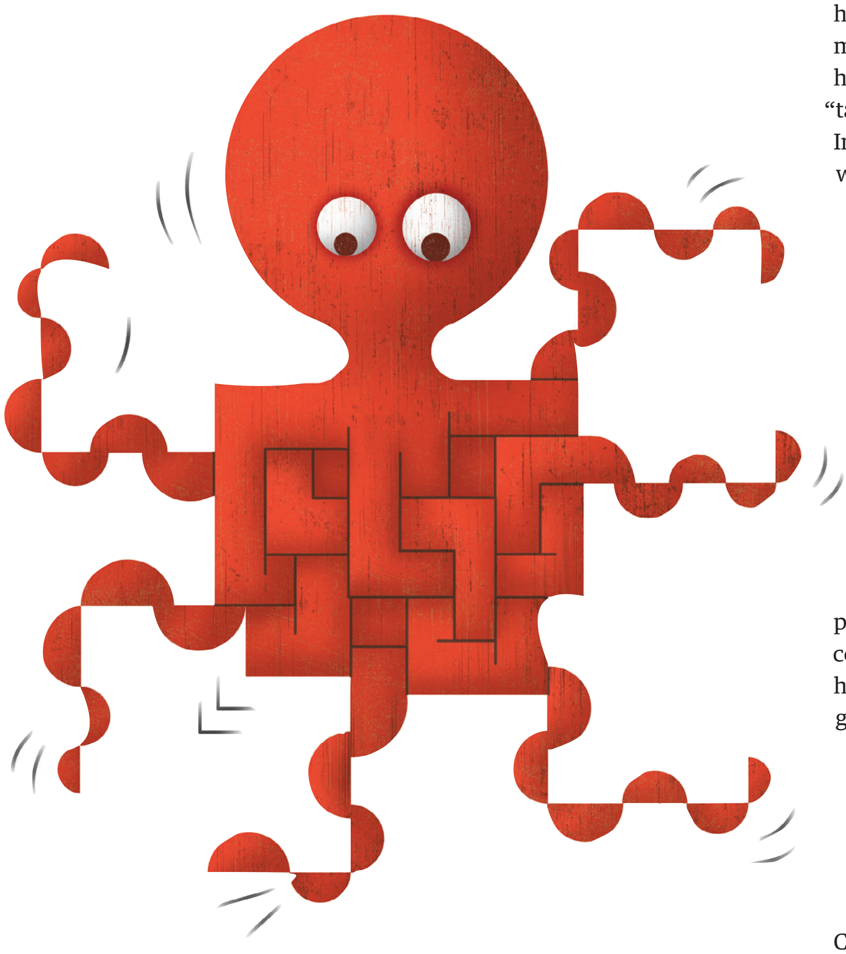
End earnings guidance. With holding periods in today's stock markets averaging less than six months, short-termism cannot be avoided completely. Nevertheless, dispensing with earnings guidance—the practice of giving analysts a preview of what financial results the company expects—would mitigate the obsession with short-term profitability. Earnings guidance has been in decline over the past 10 years, but many companies are nervous about eliminating it for analysts who have come to rely on it. Research shows that the dispersion in analysts' forecasts increases after companies stop giving guidance—presumably because analysts are no longer being fed the answers to the questions. With less consensus among them, the stock market reacts less negatively when earnings are lower than the average view, thereby mitigating the pressure for quarterly results. Instead of providing earnings guidance, companies should provide analysts with long-term goals, such as market share targets, number of new products, or percent of revenue from new markets.

Bring back a variation on the staggered board. When a board is staggered, one-third of the directors are elected each year to three-year terms. This structure promotes continuity and stability in the boardroom, but shareholder activists dislike it, because a hostile bidder must win two director elections, which may be as far apart as 14 months, in order to gain the two-thirds board control necessary to facilitate a takeover. In my research with Lucian Bebchuk and John Coates, of Harvard Law School, I find that no hostile bidder has ever accomplished this.

As shareholder activists gained more power in the 2000s, the number of staggered boards in the S&P 500 fell from 60% in 2002 to 18% in 2012. The trend is continuing: In 2014, 31 S&P 500 companies received de-staggering proposals for their annual meetings, and seven of those companies preemptively agreed to de-stagger their boards before the issue came to a vote. The result of this trend is that most corporate directors today are elected every year to one-year terms (creating so-called unitary boards).

It is virtually tautological that directors elected to one-year terms will have a shorter-term perspective than those elected to three-year terms. This is particularly true because ISS and other proxy advisory firms have not been shy about using withhold-vote campaigns to punish directors who make decisions they don't like. One director attending a program at HBS told me that his board had decided against hiring a talented external candidate for CEO who would have required an above-market compensation package. Even though he was the best candidate, and even though this director thought that he'd be worth the money, the board did not move forward in part because of concern that ISS would recommend against the compensation committee at the next annual meeting. With a staggered board, ISS would have recourse against only one-third of the compensation committee each year, because only one-third of the committee members would be up for reelection.

Of course, shareholder activists make a strong case that a staggered board may discourage an unsolicited offer that a majority of shareholders would like to accept. But this drawback would be avoided if the stagger could be "dismantled," either by removing all the directors or by adding new ones. A staggered board that could be dismantled in this way would combine the longer-term perspective of three-year terms with the responsiveness to the takeover



marketplace that shareholders want. It would give ISS recourse against individual directors, but only every three years rather than every year. A triannual check would allow longer-term investments (such as the superstar CEO mentioned above) to play out, and would be better aligned with long-term wealth creation than an annual check on all directors.

Install exclusive forum provisions. In our litigation-prone system of corporate governance, plaintiffs' attorneys (representing shareholders who typically hold only a few shares) look for any hiccup in stock price or earnings to file litigation against the company and its board. Plaintiffs' attorneys are especially attracted to major transactions, such as mergers and acquisitions, because of corporate law that is friendly to litigation in this arena. Any public-company board announcing a major transaction is highly likely to be sued—sometimes within hours—regardless of how much care and effort its members put into their decision. It is anyone's guess how many value-creating deals are deterred by this "tax" that the plaintiffs' bar imposes on the system. In fact, a board that goes forward with a transaction will often deliberately keep something in its pocket—such as a disclosure item or even a bump in the offer price—to be given up as part of a quick settlement so that the plaintiffs' attorneys can collect their fees and the deal can proceed.

It is not only the frequency of claims that causes concern, but also where they are brought. A U.S. corporation is subject to jurisdiction wherever it has contacts—its headquarters state, its state of incorporation, and states where it does business. Plaintiffs' attorneys take advantage of this fact to bring suit in multiple states—particularly those that permit a jury trial for corporate law cases. The prospect of inexperienced jurors deciding a complex corporate case leads many companies to settle in a hurry. This kind of blackmail is bad for corporate governance and society overall. Exclusive forum provisions permit litigation against a company only in its state of incorporation. For companies incorporated in Delaware, which are the majority of large U.S. public companies, this means the case would be heard before an experienced and sophisticated judge on the Delaware Chancery Court rather than an inexperienced jury.

Yet despite these clear benefits, shareholder activists have expressed knee-jerk opposition to exclusive forum provisions. Glass Lewis has threatened a withhold vote against the chair of the nominating and governance committee of any board that installs one without shareholder approval. The argument is that the prospect of multistate litigation will make directors pay more attention. But most directors do not need the sharp prod of a jury trial for them to want to do a good job. Exclusive forum provisions give plaintiffs' attorneys a fair fight in a state where the rules of the game are well established. In exchange for such a provision, boards might consider renouncing more-draconian measures, such as a fee-shifting bylaw that forces plaintiffs to pay the company's expenses if their litigation is unsuccessful.

Corporate Governance 2.0 asks the functional question: What goals are the activists, governance rating agencies, boards, and everyday shareholders all trying to achieve? The answer is clear: insulation from frivolous litigation, but meaningful exposure to liability in the event of a dereliction of duty in the boardroom. In the old days, activists and their allies agreed on this shared goal. In the late 1980s, when most U.S. states enabled boards to waive liability for certain breaches of fiduciary duty, ISS encouraged directors to take up the invitation, on the understanding that they should be focused on shaping strategy and monitoring performance rather than worrying about shareholder litigation. Corporate Governance 2.0 would return to this old wisdom through exclusive forum provisions. Directors would be accountable for their actions, but only as judged by a corporate law expert. The result would be greater willingness among directors to make longer-term decisions, without fear of a jury's 20/20 hindsight.

PRINCIPLE #2

Boards Should Install Mechanisms to Ensure the Best Possible People in the Boardroom

In exchange for the right to run the company for the long term, boards have an obligation to ensure the proper mix of skills and perspectives in the boardroom. Shareholder activists have proposed several measures in recent years to push toward this goal—principally age limits and term limits, but also gender and other diversity requirements. According to the most recent NACD Public Company Governance Survey, approximately 50% of U.S. public companies have age limits, and approximately 8% have term limits. ISS is urging more companies to adopt such limits, and if history is any guide, boards will give the idea serious consideration.

Activists and corporate governance rating agencies are motivated by a sense that boards don't take a hard look at their composition and whether the skill set on the board reflects the needs of the company. Too often directors are allowed to continue because it's difficult to ask them to step down. But age and term limits are a blunt instrument for achieving optimal board composition. Anyone who has served on a corporate board knows that an individual director's contribution has little to do with either age or tenure. If anything, the correlation is likely to be positive. As for age limits, directors who have retired from full-time employment can devote themselves to their work on the board. And as for term limits, directors will often need a decade to shape strategy and evaluate the success of its execution; moreover, directors who have been in office longer than the current CEO are more likely to be able to challenge him or her when necessary. Yet these are precisely the directors who would be forced out by age limits or term limits.

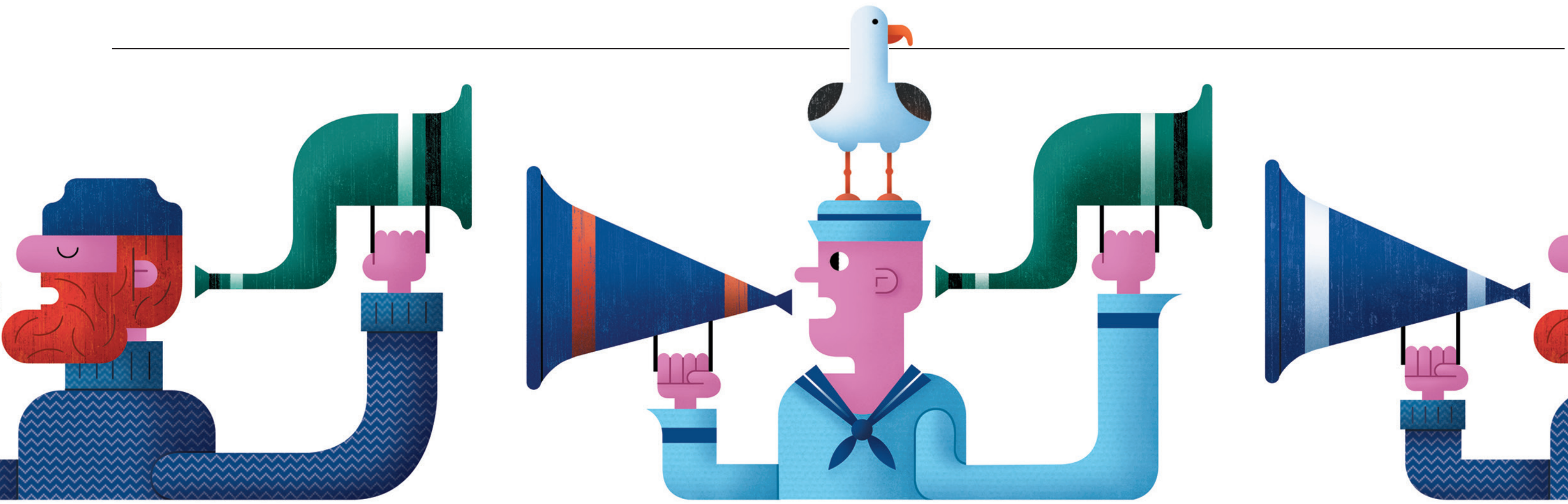
Corporate Governance 2.0 would approach the issue of board composition in a tailored manner, focusing more on making sure that boards really engage in meaningful selection and evaluation processes rather than ticking boxes. In particular it would:

Require meaningful director evaluations. Many boards today have internal evaluations conducted by the chairman or lead director. Although these evaluations are well-intentioned, directors may be unwilling to disclose perceived weaknesses to the person most responsible for the effective functioning of the board. A Corporate Governance 2.0 approach would engage an independent third party to design a process and then conduct the reviews. The

Different Views on the Issues

How shareholder activists, board defenders, and Corporate Governance 2.0 compare on the key issues raised in this article.

	SHAREHOLDERS	BOARDS	CORPORATE GOVERNANCE 2.0
Earnings guidance	Yes	Mixed	Replace with long-term goals
Staggered boards	No	Yes	Staggered board that can be dismantled
Exclusive forum provision	No	Yes	Yes
Age and/or term limits	Yes	No	Meaningful board evaluations
Shareholder proxy access	Yes	No	Should be considered as a backstop
Defensive measures generally	No	Yes	"Orderly voice"
Poison pills	No	Yes	"Advance notice" pill



process would include grading directors on various company-specific attributes so that they and their contributions were evaluated in a relevant way.

In Corporate Governance 2.0, director evaluations wouldn't just get filed away. They would be shared with the individual director, with comments reported verbatim when necessary to make clear any opportunities for improvement. They would also go to the chairman or lead director, to provide objective evidence with which to have difficult conversations with underperforming directors.

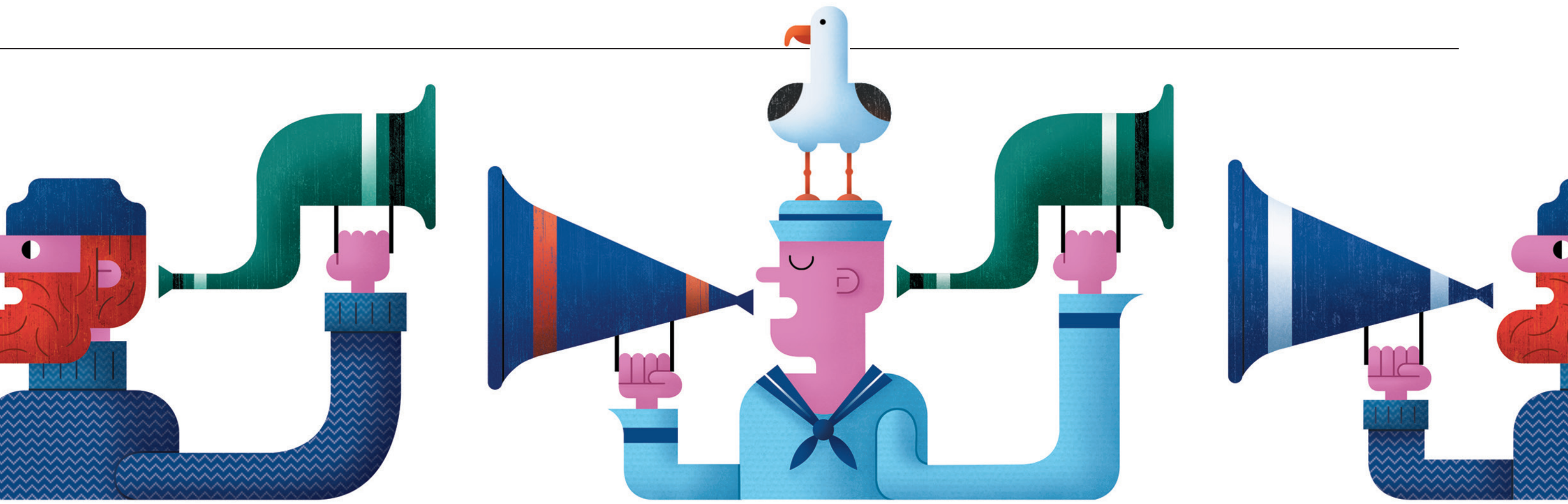
ANYONE WHO HAS SERVED ON A CORPORATE BOARD KNOWS THAT AN INDIVIDUAL DIRECTOR'S CONTRIBUTION HAS LITTLE TO DO WITH EITHER AGE OR TENURE.

Meaningful board evaluations would also have more-subtle effects on board composition and boardroom dynamics. Foreseeing a rigorous review process, underperforming directors would voluntarily not stand for reelection. Even more important, directors would work hard to make sure they weren't perceived as underperforming in the first place.

Consider shareholder proxy access. Under such a rule, shareholders with a significant ownership stake in the company would have the right to put director candidates on the company's ballot. For the first time in corporate governance, a company proxy statement could have, say, 10 candidates for eight seats on the board. Hewlett-Packard and Western Union, among other companies, have implemented shareholder proxy access over the past two years.

The Securities and Exchange Commission tried to impose proxy access on all companies in 2010, but the D.C. Circuit Court of Appeals invalidated the move. The SEC has since allowed companies to implement it on a voluntary basis. My research with Bo Becker, then at HBS, and Daniel Bergstresser, of Brandeis, shows that a comprehensive proxy access rule would have added value, on average, for U.S. public companies. The company-by-company approach is not as good as a comprehensive rule, because qualified directors may gravitate to boards that don't offer proxy access; nevertheless, it should be considered a backstop to rigorous director evaluations.

Implementing a proxy access rule would help ensure the right mix of skills in the boardroom. For example, if J.P. Morgan had a proxy access rule, it seems likely that it would not have lacked directors with risk expertise on the risk committee at the time of the London Whale incident. More than a year before that event, CtW Investment Group, an adviser to union pension funds, highlighted the point: "The current three-person risk policy committee, without a single expert in banking or financial regulation, is simply not up to the task of overseeing risk management at one of the world's largest and most complex



financial institutions." With a proxy access regime, either the board would have put someone on the risk committee with risk expertise, or a significant shareholder could have nominated such a person, and the shareholders collectively would have decided whether the gap was worth filling.

This is not to say that if JPM's risk committee had included directors with risk expertise, the London Whale incident would have been prevented. As is well known, primary frontline responsibility for managing risk exposure at JPM belongs to the operating committee on risk management, whose members are high-ranking JPM employees. But the odds of identifying the problem would certainly have been higher in a proxy access regime.

Only in the aftermath of the debacle did the board add a director with risk expertise to the risk committee. Of course, it should not take a multibillion-dollar trading loss to put people with the right skill set on the JPM risk committee. A shareholder proxy access regime should be considered as a supplement to meaningful board evaluations, to ensure the right composition of directors in the boardroom.

PRINCIPLE #3

Boards Should Give Shareholders an Orderly Voice

Today, when an activist investor threatens a proxy contest or a strategic buyer makes a hostile tender offer, boards tend to see their role as "defender of the corporate bastion," which often leads to a no-holds-barred, scorched-earth, throw-all-the-furniture-against-the-door campaign against the raiders. As George "Skip" Battle, then the lead director at PeopleSoft, put it to me in the context of Oracle's 2003 hostile takeover bid for his company, "This is the closest thing you get in American business to war."

Consider the more recent case of CommonWealth REIT, one of the largest real estate investment trusts in the United States. As of December 2012, CommonWealth's properties were worth $7.8 billion against $4.3 billion in debt, but its market capitalization stood at only $1.3 billion. Corvex Management, a hedge fund run by Keith Meister (a Carl Icahn protégé), and the Related Companies, a privately held real estate firm specializing in luxury buildings, saw an investment opportunity in CommonWealth's poor performance. In February 2013 they announced a 9.8% stake in CommonWealth and proposed acquiring the rest of the company for $25 a share. This offer represented a 58% premium over CommonWealth's unaffected market price.

The Corvex-Related strategy for unlocking value at CommonWealth was relatively simple. CommonWealth had no employees; it paid an external management company to manage the real estate assets. This company, Reit Management & Research, was run by Barry and Adam Portnoy, a father-and-son team who also constituted two-fifths of the CommonWealth board. Corvex and Related believed that internalizing management would eliminate conflicts of interest within the board, align shareholder interests, and unlock substantial value. Their investment thesis boiled down to three words: Fire the Portnoys.

Would the plan unlock value at CommonWealth? The board was determined not to find out. Despite having given shareholders the right to act by written consent, it imposed onerous information requirements that made it impossible, as a practical

FURTHER READING

To learn more about corporate governance, you can read these articles at HBR.org.

"Where Boards Fall Short"
Dominic Barton and Mark Wiseman

"The Case for Professional Boards"
Robert C. Pozen

matter, for them to do so. The board also lobbied the Maryland legislature (unsuccessfully) to amend its takeover laws to protect the company. Perhaps most egregious, the board added a provision to its bylaws declaring that any dispute regarding the company would be heard by an arbitration panel, not a Maryland court. After 18 months of arbitration hearings and sharply worded press releases, Corvex and Related finally replaced the CommonWealth board with their own nominees in June 2014. Today CommonWealth (renamed Equity Commonwealth) trades at about $25 a share, compared with about $16 before the offer.

CommonWealth's board took the typical scorched-earth approach, but it shouldn't be like this. The principle of "orderly shareholder voice" involves a different conceptualization of the board's role—to guarantee a reasonable process whereby shareholders get to decide, rather than to defend the corporate bastion at all costs. Even when a board genuinely believes that the competing vision is mistaken (which is true in the vast majority of cases), its fiduciary duty—contrary to popular belief—does not require preventing shareholders from deciding. In a Corporate Governance 2.0 world, the directors would campaign hard for their point of view but leave the decision to the shareholders.

"Orderly" is a critical qualifier, because some shareholders are undeniably disorderly. With the steep decline of poison pills, which block unwanted shareholders from acquiring more than 10% to 15% of a company's shares, hedge funds and other activist investors can buy substantial stakes in a target company before they have to disclose their positions. Recall the case of J.C. Penney: Because it did not have a poison pill in 2010, Roth and Ackman could secretly buy a 27% stake. The company put them on the board, and Mike Ullman was replaced as CEO by the Apple executive Ron Johnson, who planned to give Penney a younger, hipper look. The strategy proved disastrous, and the stock price dropped from about $30 to as low as $7.50 over the next two years. Johnson was forced out in 2013—and replaced by none other than Mike Ullman.

In theory, companies are protected against such lightning-strike raids by the SEC rule that shareholders must disclose their ownership position after crossing the 5% threshold. But they have 10 days in which to do so, and nothing stops them from buying more shares in the meantime. This is exactly what happened in the Penney case. By the time Roth and Ackman had to make the disclosure, they had bought more than a quarter of the company's shares.

The relevant rule dates back to the 1960s, when 10 days was a reasonable amount of time. Today, of course, 10 days in the securities markets is an eternity, and no one designing a disclosure regime from scratch would dream of giving shareholders such a long window. (European countries have substantially shorter windows.) Nonetheless, shareholder groups have resisted change, on the rather questionable grounds that the Roths and Ackmans of the world need sufficient incentive to keep looking for underperforming targets.

Under a Corporate Governance 2.0 system, boards would get early warning of lightning-strike attacks. One way to do this would be with what I call an "advance notice" poison pill—a pill with a 5% threshold but also an exemption: Any shareholders that disclosed their positions within two days of crossing the threshold would avoid triggering the pill and could continue buying shares without being diluted. John Coffee, of Columbia Law School, and Darius Palia, of Rutgers Business School, have proposed a similar version of self-help, which they call a "window-closing" poison pill. Either kind of pill would give directors fair warning that their company was "in play" before the bidder could build up an unassailable position.

TODAY A CHANGE in corporate governance usually occurs when ISS threatens a withhold vote against the board unless certain reforms are implemented. Corporate Governance 2.0 takes a proactive approach that achieves the same (desirable) goals in a holistic and better way. Managers actively engage with shareholders from a functional perspective ("What are we all trying to achieve?") rather than an issue-by-issue reactionary perspective ("Should we surrender, or do we fight?").

In this article I have applied the three fundamental principles of Corporate Governance 2.0 to provide a package solution to certain hot-button issues in corporate governance today. A board that wants to adopt this solution could do so unilaterally in many jurisdictions (including, for the most part, Delaware), though in general it would be better advised to adopt Corporate Governance 2.0 through a shareholder vote.

Other hot-button issues will emerge in the future. The most recent version of ISS's QuickScore, for example, includes 92 factors, any of which could become the next pressure point against corporate boards. Rather than evaluating each of these innovations incrementally, boards should hold up future proposals to the same three principles of Corporate Governance 2.0.

RATHER THAN DEFEND THE CORPORATE BASTION AT ALL COSTS, DIRECTORS SHOULD GUARANTEE A REASONABLE PROCESS WHEREBY SHAREHOLDERS GET TO DECIDE.

This shift is vital in the United States, where the power of shareholders has increased over the past 10 years and the natural instinct of boards is to simply cave to activist demands. A Corporate Governance 2.0 perspective is critical outside the U.S. as well, particularly in emerging economies where companies are trying to achieve the right balance of authority between boards and shareholders in order to gain access to global capital markets. Over the long term, a Corporate Governance 2.0 perspective would transform corporate governance from a never-ending conflict between boards and shareholders to a source of competitive advantage in the marketplace.

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