Corporate Board Elections and Internal Controls

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Questions and answers, chaired by Roberta C. Ramo, Shareholder, Modrall, Sperling, Roehl, Harris & Sisk P.A.; 1st Vice President, The American Law Institute

Roberta C. Ramo: I would make one comment myself, as a board member, about a motivation that Marty alluded to, but hasn't been mentioned directly. And that is I think there is in the United States, in the current world, enormous desire by directors to select new board members who are superbly-qualified colleagues.

That's a great motivation; they want to make sure that they are adding to their boards people who are qualified, not only in terms of their background and in terms of their judgement, but people who have a great deal of integrity, because it's not so easy to see that quality on a résumé. So as you go about finding superb people to add to boards, I think that is underestimated these days – the great desire of the board members themselves to have added to their group of people doing all of this analysis and undertaking this great responsibility for the shareholder, people that they know are going to be up to the task in every way. So that's an interesting motivation that I think was probably in many boards all along, but now is magnified by looking around and seeing people who on the surface were very well-qualified directors of companies that had disastrous results in many ways.

So, ladies and gentlemen, let us go to questions and a little discussion of things. Let me first go to questions from the floor.

Question: Stephen Hochman, Counsel, Friedman, Wittenstein & Hochman: My question relates to how we can make boards of public companies – for-profit companies – adopt some of the safeguards and some of the practices of not-for-profit boards of companies that have no shareholders. As you know, most not-for-profit boards – I'm thinking of hospital boards – have basically self-perpetuating boards, so we have no shareholders. But one thing we do have is that the boards hire the CEOs. And it would be totally inappropriate for a CEO to recommend to the nominating committee of the board somebody who should be on the board. Recently in the case of Morgan Stanley, they said all but one member of the board was recommended by the CEO. How do we set up a system that basically prohibits or doesn't allow CEOs to have any input in the nomination process?

> **Robert Mundheim:** Well, I'm not sure that I take the view that CEOs should have no input into the nominating process. It seems to me the critical point is that you've got a nominating committee composed of independent directors, and that they conduct their ultimate deliberations and make their choice in an executive session. But they certainly ought to be able, and it is relevant, to take recommendations and comments from a variety of sources, which probably would include the CEO and might also include shareholders. One of the things a nominating committee also ought to look at, as you indicated in your comment, Roberta, is collegiality in the boardroom. Because if you've got a very tension-filled, disruptive atmosphere, it's going to discourage a lot of people and distract from doing the business of the board. That's not the kind of situation in which you normally want to spend a lot of your time. And I don't think it's very effective. Wouldn't you think that's appropriate?
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> **Martin Lipton:** I agree completely and have nothing to add to that.

James H. Cheek: The only thing I would add is there's a difference between having input from the CEO and having the CEO handpick the choices. And I think that what has happened in the actual nomination process over the last two or three years, at least in my practical experience, is that it has really moved away from the CEO being able to control that process or dictate it. And there is much more independent involvement of directors and, on the point Roberta made, directors are very interested in having well-qualified colleagues in their effort. And the effort is a delicate balance of these forces, which encourages good decision-making and good corporate performance. And that requires all three acting in a non-combative way, but in an appropriate way, given their individual sets of responsibilities.

Klaus Hopt: Well, it's basically the question of independent directors, and of course there is a big movement to have that, this movement is very strong in theory, both economists and lawyers. In practice in Germany, it's getting slow, and as I told you, if you have a split board of half labour and half shareholders, then things get more difficult. And if you have a parent company, or block holders, who want to have some influence on that, they have in Germany, who vote on behalf of the people. If you have independent directors there, somehow the people fear that they couldn't steer the company any longer. So the independent director principle, is certainly something for dispersed ownership. If you have labour codetermination, and if you have them on family-owned companies and block holders, things become very difficult. And that's why the European Commission was very careful, not to have a directive on that, but just a recommendation, so we slowly work our way in the same direction, but it's difficult.

Guido Ferrarini: Yes, I could just say one thing about the nominating committee, I mentioned before, that this is a big issue now, whether we should introduce nominating committees in concentrated ownership companies. And of course, there is big resistance from controlling shareholders. They do no want to go through a nominating committee. And I can understand the issue of course. My compromise solution would be non-executive directors, who are non-independent, who are directly nominated by the controlling shareholders whereas independent directors should still be appointed through a selection process, which is run by a nomination committee, made of independent directors. So this might be finally, the solution.

Espen Eckbo: Just briefly, on the non profit part of your question, I think what you just said, means the non profit, as an organisational form, is probably the worst you can have, because you don't get shareholders, you don't have anybody picking boards in a way that's consistent with maximising the value of the firm. Some non profits compete in markets with other for-profits, like some hospitals for example, and they have certain constraints put on them, causing them to act much like a for profit organisation. But if you do not face that competitive constraint, I would say, it is probably best to avoid the non-profit form.

Question: Harvey Bines, Partner, Sullivan & Worcester LLP, Boston: Picking up on something that Professor Eckbo said, my concern is unintended consequences. I understood you to be saying, and frankly agree with you, that what we're seeing right now, is at least in part a reaction to the protective measures that were adopted by boards in the 70s and the 80s. But now we are moving toward a situation in which you have directors who are being elected because they represent a constituency, rather than the shareholders as a group. Because particular shareholders, activist shareholders, have a particular issue and their basic way of relief, besides outright selling their shares, is to get their representatives onto the board. In my own experience, particularly in private companies, where shareholder constituencies are separately represented, frequently you wind up with disagreements over policy in the company. I think all of our experience is that boards that tend to act like legislators, rather than as a collegial group of overseers of corporate performance and overseers of the CEO's and management's performance, tend to create problems for the success of the firm as a whole. So this is the long way of saying, I wonder whether you could comment on whether what we're seeing right now is setting the stage for a different set of problems – recognizing it's very difficult to generalize – this concern of whether we're going to wind up having constituent representation in the United States, which will reflect some of the problems that we've seen on the European side, with mandatory constituent representation. Thank you.

Espen Eckbo: Well, I certainly hope that we're not going to move in the direction of codetermination type of rules. Now in terms of constituencies, in Europe, where you have plenty of large majority stockholders, the conflicts in Corporate Governance are more between majority and minority stockholders, than between stockholders and management and boards. As to institutional owners, who themselves are always minority shareholders, they are certainly active in the US, but also in Europe. These institutions clearly they have a point of view. Shareholders can be an unruly bunch, and when they are closer to the firm, it is going to cause some of those issues that you are bringing up. However, I don't see why we should discourage such activism, as the alternative is worse.. If you subscribe to the view that shareholders actually own the firm, they also have certain rights to elect directors and to have representation. Even if an institutional investor who may own one percent of the stock, has a certain opinion how the firm should be run, this shareholder still needs to collect a majority of the other shares, to get its point of view implemented. In the creation of a majority, you will probably eliminate some of the more extreme points of view. Institutional investors probably have as different opinion as anybody else, so they also need to work hard to get to a consensus.

Question: Steve Lehman, SVP & Principal Legal Counsel, Corporate, Reuters America LLC: This is a somewhat similar question relating to the election process, but not focusing so much on the constituency aspect. It's interesting to contrast the election process that we're talking about for corporate boards, certainly in the United States and maybe even more so in the European Union, with the political process, which is usually founded on having two or more candidates for each position. Everyone has touched on it a little bit – the lack of choice aspect of the election mechanics in corporate boards, or the simple yea or nay, up or down vote aspect of it. Is having meaningful choice among more than one candidate an important part of a reform of the election mechanic?

Martin Lipton: I think we have to keep sight of the fact that what we want to do is attract competent people as directors of companies. We put a lot of responsibility on corporate directors and the system imposes responsibilities, and as Roberta indicated, directors want to be involved with other people who are doing a conscientious job at being directors, so I know very few people who want to run in a contested election for director. The biggest difficulty today is to attract people to serve as directors. That's one of the big problems that existed with the shareholder access rule; it had a deterrent effect on people being willing to stand for election if they thought they were going to be in a competitive situation. I think the system that we have today works quite well with the independent nominating committees and shareholders having the fundamental ability if they're really unhappy, to withhold votes. You have to distinguish between the lack of performance aspect of this and the petty issues with respect to corporate governance. Most of this activity is in connection with these corporate governance issues. I'm much more sympathetic to a system that makes it easy to change

management where there's been a significant failure of performance. That's what I think the system ought to focus on, performance, not on the current academic favorites with respect to corporate governance rules.

Robert Mundheim: The notion that the political system is the model for corporate governance – that I think can't be right. Klaus, in looking at the codetermination system and how in fact the supervisory board acts when you have that kind of constituency representation, I think it will be useful to talk a little bit about how it actually works – how the supervisory board system works – because that's potentially the non-collegial board model. How do the supervisory board people make it work?

Klaus Hopt: I'll give you two examples. In normal times, when the company is running very well, somehow people work things out, and you don't see very many differences. However, as a first example, some years ago Volkswagen wanted to open more plants in Brazil. That was an issue in the board, and the labor supervisory board members didn't like it, of course – they wanted their people and their jobs in Germany. Somehow a deal was made that either no additional plant – or not such an important plant – would be opened in Brazil. As another example, labor codetermination has a very concrete influence on picking the CEO. Normally you don't see this because it does not really show up in the elections but behind the scenes. Another Volkswagen man, Bernhard, was previously with Daimler Chrysler, and was supposed to be one of the successors in the restructuring. But the trade unions were effective in blocking that, so he went from Daimler Chrysler to Volkswagen. Now I think that trade unions in Volkswagen have the same problem. So you have two concrete examples of the influence of this labor codetermination.

Robert Mundheim: But I was thinking more about the process. I'll tell you what's on my mind. I sit on the board of a German company, on the supervisory board, and we do not have codetermination because of the number of employees. We have very full, open discussions about everything. We're now worried about the fact that we may get enough employees that we're going to have to become a different type of supervisory board. What's concerned us is, are our discussions going to be the same and will it matter?

Klaus Hopt: Again, you are completely right, the problem is twofold. Usually the labor people on the board feel very responsible to their own people there. They want to inform them, and secrecy is a real problem in that respect. Sometimes the trade union members on the board, if they are very strong, they say, well, we just don't care about what's actually in the law. It has never really been enforced and usually it's difficult to find out who broke secrecy, but it's a real problem. Another problem: if you have labor people on the board and you really want to criticize the CEO, it's kind of difficult. You don't want to do that. Instead, you would do it as a shareholder member or in a different way via the chairman of the board, who then has talks. So it is true that free discussion is somewhat limited.

Espen Eckbo: I just have a brief comment on the issue of contested elections. I'm not sure I understand the argument, because we're living in a competitive world. It's like saying, Tuck offers me a professorship, but I won't take it if they're looking at other people too. Why is there a negative connotation to having two or three people running for the same board seat? Each nominee represents its own shareholder group. Why is that a problem? If you're telling me that directors today do not want to run for fear of competition from directors, then I'm actually getting a little worried.

Question: Jean-Aymon Massie, Chairman of the French Corporate Governance Association: I would like to apologise for my bad English. I will liken that my [unclear] from my French experience in the general meeting. The shareholder control, the board of directors, or supervisory board, and the members of the board, members of the supervisory board control, CEO, all the executive committee, separate of the [unclear]. Do you agree that not many committees, to do reports in the general meeting, to disclose about the activity of the nominating committees. Like audit committee, like remuneration committee, these committees have to do a report in the general meeting, on the behalf of the board of directors. Do you agree when you elected the members of the board, you pronounced about the charter of the board of the directors, and about the internal rule of the board of directors. In France we recently adopted a charter of the board of directors. I can't translate, but the first principle is, all the directors elected are [unclear] to represent all the shareholders, and they have to walk in the social interest of the corporate [unclear] This way, you could prevent conflict. Do you agree with this point, from the last three years in the general meeting, the shareholders gave a larger delegation of the power, of the members of the board. In the process back to the [unclear] but I don't know if you know yourself, the members of the board, to do a report the year after, on the [unclear] of this delegation of the power, I don't know, that is the main problem. Thank you very much.

Roberta Ramo: Let me restate what I think I understand the question to be into two parts. One is, how open is the nominating committee and how open should it be in reporting to the board publicly about its work. Secondly, is it possible, even when you have constituents electing members to the board, that they understand that although they're elected by a constituent, once they sit on the board, they are sitting there for all of the shareholders. We have a similar situation in arbitration matters often in the United States, in which you may have party arbitrators who are chosen by a specific party, but the arbitration board decides at the very beginning whether the party arbitrators are sitting there, in a sense as neutrals, chosen by particular parties. Or they're actually going to report back and it's clear before any deliberations are made exactly what they're going to do. So, on those two, let's start on how open nominating committees are. Jim, you might speak about that a little bit to start with.

James Cheek: That's a point that has been much discussed, and the SEC has made a number of changes recently in the proxy statements that go out before the general meeting of the annual meeting in which the nominating process and the opportunity to participate in that process are required to be discussed in a fair amount of detail. So there's becoming more transparency. I would not say that it is yet a fully transparent process, but I think that the sensitivity of the transparency affects the process nominating committees are going forward with. The second point, which he asked about in terms of the charters of the boards, typically in this country, is found in corporate governance guidelines and principles adopted by the board, and most all that I've seen have the concept that the board is to act in the best interest of the corporate entity and the shareholders as a whole. So I think it's a well-understood concept in most boardrooms.

Espen Eckbo: Just on the second point, I don't really trust multi-constituency boards to maximize shareholder value. How do I get to that point of view? To me, a governance system is like a fire station. The test of the system is when there's a fire. Specifically, I've seen examples in Scandinavia, where the company from a profitability point of views should close plans, and where at that point, the unanimity concept breaks down.

There is no longer a uniform constituency in the board, they are starting to make decisions based out of self-interest, as much as out of shareholder interest. So, in practice it probably does not work.

Klaus Hopt: Well, nominating committees in Germany and all over Europe are developing rather quickly, but up to now own reports of the nominating committee in the general assembly has not been the custom. That may slowly come, but it's not yet there. Secondly, acting in the interest of all shareholders is fine, even though it's a problem for labor and sometimes also for different groups of shareholders who may have different interests. But what I would have a problem with is the theory that the board should act in the social interest whatever that means. It is true this theory is common in Germany as well. According to it, the board should also act in the interest of labor, maybe of the general public, and maybe even of the environment. The problem with this is that in the end this gives the directors complete liberty to do what they want and to justify it as part of their task.

Question: Allan Roth, Rutgers University: The emphasis you've given on improving corporate governance through greater power to the shareholders, doesn't that emphasize the financial interest, since the shareholder groups are increasingly institutional investors who have a financial interest? And doesn't that encourage the non-economic-investor groups to vie for seats on the board to reflect the non-economic interest that they want to pursue and increase the likelihood of having constituent representations and the kind of political board that Bob was saying doesn't work too well? So, by putting the emphasis on the shareholder interest, as you have, don't we create the potential for the problems that we're trying to avoid?

Espen Eckbo: It's not that the shareholder interest is inconsistent with maximising the well being of all the other constituencies in the firm. The issue in Corporate Governance is whether these other constituencies should have a seat on the board. That's the structural question. Like Milton Freedman once said, the social responsibility of a company is to make profits. In doing so, you protect the other constituency, or the firm, as well.

Robert Mundheim: Marty outlined for you some functions of the board and I really do think that the touchstone is, will the people elected and will the system of election end up allowing appropriate monitoring of performance, monitoring of law compliance, advising the management on strategy, and dealing with crisis. Allan, I would have thought that you can imagine that a constituency board member might be able to advance those purposes, but often you would have questions about how the group works together to fulfill its functions.

Guido Ferrarini: I sit on the boards of two large Italian listed companies, which have a voting mechanism for corporate elections similar to cumulative voting. This mechanism allows for different constituencies to be represented on boards, particularly institutional investors. My experience is positive. We have lively discussions, but there isn't any real risk of break-up. Everyone brings his own views and the system runs smoothly.

Martin Lipton: As much as I don't like to admit it, I have once or twice lost a proxy fight. I can assure you there's nothing more dysfunctional than a board with one or more constituencies represented on it, and it always ends up with rump board meetings, trying to exclude, however much it may not be the legal way for the board to function. But there it is. As a practical matter, what happens is that the majority, usually the management group of directors, meet separately, and the board meetings themselves become very formal situations. Collegiality is the key to a successful board, and if you don't have it, you don't have a successful board.

Klaus Hopt: As part of the trans-Atlantic dialogue, I would finally say that we clearly have many problems like yours in the United States, especially problems between the board and the shareholders. However, the majority/minority stockholder problem is very important. And that leads to a lot of different practical and legal problems, such as minority shareholder protection, piercing the corporate world, the relationship between the parent corporation and ist subsidiaries, and as a consequence a law for groups of companies such as the one the EU is trying to start. So keep both in mind: many similar problems, but also different ones.

James Cheek: I think that the financial shareholder interests have by default given way to the governance activist shareholder services, who control much of the vote that actually gets cast. So the elections really aren't about establishing a constituent director, they're about other issues and about imploding in the board room a particular issue or particular governance practice that they want to see implemented in that corporate entity.

Espen Eckbo: I'm advising the Norwegian Petroleum Fund, which is now almost $200 billion. They are actually moving away from relying exclusively on these external shareholder services, as they have decided to become more active themselves in the Corporate Governance area.

Roberta Ramo: Well, this has been, for one director, an enormously enlightening morning, and I thank you all very much. And now we have the Fed to thank, for putting a lie to the idea that there is no such thing as a free lunch.