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Tough corporate reforms still being dodged

By Ira Millstein

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After two years of corporate governance reform, it is time to take a close look at how management, boards and shareholders have risen to the challenge of upgrading directors' accountability and responsibility.

My impression is that management does not like reform and so complies and complains, resists, or merely goes through the motions. Boards seem willing to adapt but are burdened and not yet sure how. Small shareholders are concerned but

helpless. A few institutions take voting seriously and try to be responsible; others fulminate and demand contested elections to unresponsive boards. At least the turmoil is keeping reform on the public agenda.

Management never much liked boards. Directors were a nuisance, to be fed and tolerated. They were easier to tolerate when the chief executive could handpick the board by selecting cronies, acquaintances, harmless academics and, if absolutely necessary, a few women and minorities. So much the better if the chief executive was also chairman of the board charged with supervising him. That cosy relationship changes when the board is scrutinised for its independence and qualifications and seeks to define its own processes. It may slip completely out of control when a lead director tries to set the agenda or an independent chairman sits at the head of the table. And matters are even worse when the independent directors hold a "secret" meeting without the chief executive. It would be counterintuitive to expect many in management to embrace such reforms happily.

Directors, in turn, used to be content to have a good dinner with a peer group, chat amiably about current events, attend an hour or two of corporate "show and tell", and then add another prestigious corporate name to their curriculum vitae. Board service begins to be difficult when you have real duties to perform, have to pay attention to unpleasant risks and financial figures, and spend more time on committees. The job becomes harder still when it is clear that you could be sued for lack of "good faith" without knowing precisely what that means and, worse yet, held up to ridicule by politicians, unions or the media. No wonder, then, that directors are trying to protect themselves by putting more pressure on management and demanding more advisers (with strict no-conflict rules) and better directors' and officers' insurance.

But even if most boards are trying harder, are they really rising to the toughest issues? For instance, are boards resisting the view that executive pay is a management responsibility, subject only to board review? Is remuneration geared to short-term maximisation of shareholder value or to long-term ownership? In many cases, performance in these areas still leaves a lot to be desired. Some boards may be doing all right on the form but not yet on the substance.

A few years ago, some institutional shareholders began to express dissatisfaction with board performance. This proved insufficient for academics, legislators and the public. They started to see institutions as having a responsibility to elect boards that would improve performance. But shareholders have found they have little leverage; their power to elect board members other than those recommended by directors is limited, unless they are prepared to embark on an expensive proxy contest. The result has been frustration for shareholders, despite efforts by many boards to solicit suggestions from, and be responsive to, shareholders on the question of board nominations.

For the moment, we appear to be in a stand-off over how shareholders will acquire more power to choose directors. Institutions want the Securities and Exchange

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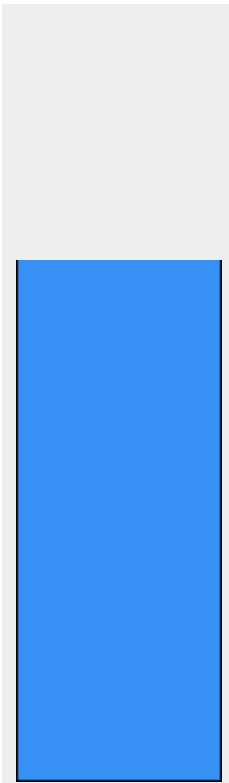
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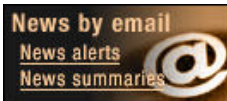
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Commission to give them the right to have a contested board election cheaply under certain circumstances. But contested elections would be intolerable for managements and boards, especially at a time when boards are struggling - in the face of some management resistance - to get to grips with new responsibilities.

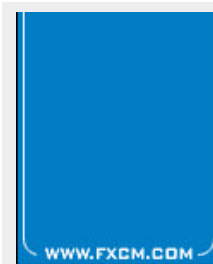
The solution that I and a few others have suggested - and which is presumably still going through the SEC mill - is to change the voting rules. Today a director can be elected by just one vote, even if all the other votes are withheld. The board's proposed candidates always win. We urged a rule that a director should be "elected" only if he or she received a majority of all votes cast, including votes cast as "withheld": in other words, a withheld vote would become a "no" vote. If the director was not so "elected", the board would have to nominate someone else at a new election. Such a system would put pressure on boards to take greater care in selecting director candidates, while avoiding contested elections.

US corporate governance reform is thus in a state of "becoming". Everyone - managements, boards, shareholders - seems dissatisfied, for different reasons. Maybe this is where we should be nearly two years after the Sarbanes-Oxley corporate reform act. After all, if everyone is complaining, reform has probably started on the right lines.

The writer, senior partner at Weil Gotshal & Manges, the law firm, is visiting professor at Yale School of Management

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