New York Law Journal
Corporate Governance
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An ALM Publication
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MONDAY, NOVEMBER 30, 2009

PERSPECTIVE

Pushing Back on Pressure for **Independent** Board **Chairs**

WHILE THE PUNDITS are declaring that the recession is over and the financial crisis has been abated, part of the aftermath is the continuing demand for corporate governance reforms by Congress, the SEC and activist investors in response to the perception that governance failures led to, or at least failed to mitigate, the crisis.

BY NING CHIU AND RICHARD TRUESDELL

There has been no shortage of proposed legislation, regulation and other sources of pressure designed to enhance accountability for boards of directors. An area being discussed as an important step in changing governance is for all companies to split the combined roles of the CEO and chairman of the board, and instead appoint independent board chairmen to lead boards.

The movement gained momentum from the majority support that a precatory shareholder proposal received at Washington Mutual last year. It was further inspired when the Millstein Center for Corporate Governance and Performance at Yale begin advocating for the widespread adoption of independent board chairs as the right board leadership structure.[1] The movement reached a crescendo when Ken Lewis lost his board chairmanship as a result of a binding shareholder proposal at Bank of America's annual meeting of shareholders in April.

To great fanfare this summer, Senator Charles Schumer (D.-N.Y.) introduced the Shareholder Bill of Rights[2] in the Senate and Congressman Gary Peters (D.-Mich.) introduced the Shareholder Empowerment Act[3] in the House of Representatives.

Both legislative initiatives represent extraordinary intrusions by the federal government to define the governance structures of boards of directors at U.S. public companies. The bills would require all companies to adopt, among other things, majority voting, annual elections, proxy access, say on pay and independent board chairmen.

The inclusion of independent board chairs to this list of significant governance practices elevates the view that having an independent board chair is a necessary element of an effective board structure, without confronting important distinctions among boards and the companies that they oversee. Senator Schumer also recently urged Ken Feinberg, the Obama administration's "pay czar," to impose additional governance changes at the seven companies that received exceptional government assistance, including the appointment of independent board chairs.

Not a Clear-Cut Issue

Separating the roles of the chairman and CEO is not always the equivalent of appointing an independent board chairman.

Though there may be two different leaders, the chairman often has an affiliation with the company, such as being its former CEO. According to RiskMetrics, while 45 percent of major U.S. companies had separate individuals serving as chairman and CEO as of June 2008, which is 20 percent more than 2000, only 38 percent of those separate chairmen were independent.[4]

Although usually the standard setters in other areas of corporate governance developments in recent years, the S&P 500 companies trail the small- and mid-caps, with only 11 percent of large-caps having independent board chairs compared to 18 percent at mid-cap companies and 22 percent at small-caps.

Shareholder proposals recommending that boards appoint independent chairs receive lower levels of shareholder support in comparison to other governance proposals.

On average, 31 proposals during the 2009 proxy season received 36 percent in favorable votes, with majority support at four companies. That represents more than a 6 percent increase over 2008 results and more than an 11 percent increase since 2007, but is still much less than the 45 percent average favorable support by shareholders for say-on-pay proposals, 56 percent for majority voting proposals and 63 percent on proposals asking for annual elections of directors.[5]

The lack of a clear mandate from shareholders, expressed through their votes on the matter, makes the potential federal government interference even more questionable.

It has been reported that Senator Schumer expressed surprise that the call for an independent chair in his bill received the most resistance from companies, but the absence of large-scale shareholder support and lack of adoption by major companies reflect the fact that this is particularly ill-suited for the "one-size-fits-all" model of corporate governance that many seem to believe represents "best practices."

Asking all companies to appoint independent board chairs is different from efforts to change the process and structure by which shareholders can hold directors accountable through elections, such as proxy access, majority voting and annual elections. It is also unlike say on pay, which would give shareholders a means to assess board decisions about executive compensation after the fact.

NING CHIU *is counsel and* RICHARD TRUESDELL *is a partner at Davis Polk & Wardwell LLP.*

Whether or not a company should have an independent board chair directly affects the internal governance of boards, including board operations and the dynamic interaction among directors. The type of board leadership structure has a less tangible but more personal impact compared to the other proposed governance reforms, which could be substantial for some boards and almost meaningless for others.

For those reasons, how directors of a particular company should govern themselves to be most effective seems best left to be decided by each board, to reflect the composition of individuals with different experiences, skills and qualifications coming together to work as a group. Boards should have sufficient flexibility to take into account the needs of the company, including its size, as well as the history and personalities of the board members in making this decision.

Center of the Debate

An independent board chair is undoubtedly a meaningful part of corporate governance for many companies. The debate is centered on whether this form of board leadership should become mandatory for the thousands of US public companies, or even whether this framework should operate as a default model from which companies can deviate only with special reasons.

Analyzing the views of those in favor of requiring independent board chairs requires an understanding of the problems that an independent board chair is supposed to solve.

Advocates insist that, since the role of the board is to oversee management, having the same person act both as the head of the board and the head of management creates an inherent conflict of interest. Being a board chair, however, is not equivalent to being the CEO of the board.

The other directors do not report to the chairman. Each director has the authority to oversee management, and can wield influence and power without needing to first go through the CEO. Just as having an independent board chair would not neutralize the views of other directors, having a CEO who also chairs the board does not mean that other board members would acquiesce to such leadership without appropriately challenging and questioning the CEO regularly. Otherwise, a board would never be able to terminate the employment of a CEO who also acts as the board chair.

There are alternatives available to facilitate additional director communications without the CEO present, such as during regular nonmanagement executive sessions or through a lead independent director. The focus on conflicts of interest are valid, but there seems to be an operating assumption that companies with combined CEO and board chairs represent complacent boards dominated by imperial CEOs.

Another reason cited for appointing an independent board chair relates to the responsibilities of the positions of CEO and board chair.

Advocates assert that a CEO's duties as the leader of the company would leave little time for the CEO to lead the board as well, so an independent board chair is seen as desirable to fill the void left by having a CEO devote all of his or her energies to running the company. This would suggest that CEOs should be prohibited from undertaking any other outside engagements.

> The desire to seek **simple fixes** for the perceived problems that caused the economic meltdown ignores the fact that the **complexity** surrounding the possible causes of the crisis demands **tailored** and **refined approaches** to corporate governance.

However, CEOs currently find time to act as directors on other boards, or to become actively involved in nonprofit organizations or business associations. Given that the role of an independent board chair is not intended to constitute a full-time commitment, it should be reasonable that some CEOs do have the time to effectively lead boards and manage the company.

Both sides of the debate raise similar concerns about potential operating pitfalls, but those opposed to mandating the practice view the hurdles as insurmountable obstacles, while the other side believes that they are quite manageable.

Having an independent board chair raises the possibility of widespread confusion over lines of authority at the company and duplicative leadership roles. This may create tensions between the chair and CEO, or even cause disruptive power struggles, particularly if the independent board chair believes it is necessary to become involved in a company's day-to-day operations.

Many contend that these types of problems are far too likely to occur, especially given the strong personalities that the two leadership positions would likely attract, and that those difficulties outweigh the potential benefits of having an independent board chair. Others assert that these problems can be resolved by clearly dividing and defining the two separate roles to ensure that they are clear and distinct and designed to create little, if any, overlap.

It would be useful to know whether this governance issue has any effect on a company's bottom-line results, but empirical studies attempting to tie company performance to the presence of an independent board chair are inconclusive at best.[6] Any incremental value from the existence of an independent board chair is unlikely to be discernable from a company's business results.

Management professors at Wharton in 2004 examined the statistical studies that have compared companies with combined and split CEO and board chair positions, finding that the board leadership structure has no bearing on corporate financial performance. Notably, the Wharton review was conducted because the idea of separating CEO and board chair roles was at that time receiving greater attention as an important corporate governance advancement as a result of the corporate scandals in 2002, even though both Enron and WorldCom had separate board chairmen.

There are disagreements even in the United Kingdom, where the vast majority of companies have separate board chairs as a result of a "comply or explain" governance model, about whether the combination of the roles in one person has important advantages that are being lost.[7]

Lead Independent Directors

Lead independent directors are being appointed to address the interest in enhancing independent oversight of management and the need to ensure that board members receive the right amount and quality of information in a timely manner.

A strong lead director can act as a liaison between the CEO and the other board members, including becoming involved with setting the board agenda, facilitating board discussions and communicating regularly with management.

Appointing independent lead directors became popular after the New York Stock Exchange modified its original proposal to split the CEO and chair position in 2002, in a compromise, to instead require that a presiding director chair nonmanagement executive sessions. While the NYSE allows the presiding role to be rotated among the independent directors of the board, more than half of the S&P 1500 companies now have lead independent directors.[8]

The number of lead independent directors increased as a result of RiskMetrics' policy that if a company has a lead independent director who assumes a lengthy list of specific obligations and meets other criteria, RiskMetrics will recommend voting against a shareholder proposal calling for an independent board chair.[9] The National Association of Corporate Directors has indicated that the goals of independent board leadership and improved board performance can be accomplished through the appointment of lead independent directors.[10]

A lead independent director is not intended to be a replacement for an independent board chair. This is most starkly represented by the disparity in compensation for the two roles.

A recent survey indicated that the median amount of extra compensation that an independent board chair receives relative to other directors was $180,000, compared to only $25,000 for a lead independent director, at the 100 largest NYSE companies.[11] Instead, the growing presence and roles of lead directors are in response to shareholders' growing demands for additional independent board oversight over management and heightened director accountability.

Reasons to Split the Roles

Companies that currently combine the positions of CEO and board chair may find reasons to split the roles upon the occurrence of major events.

For example, appointing an independent board chair might make sense for a company facing a crisis situation and it is perceived, whether fairly or not, that additional or new leadership is critical. An independent board chair could be available to help communicate with shareholders and regulatory agencies if needed. All seven companies over which Ken Feinberg has authority with respect to compensation currently have independent board chairmen, several of whom were appointed this year during the financial crisis.

In contrast to the draconian approach in the proposed federal legislation, the Millstein Center policy briefing acknowledges that its advocacy of independent board chairs as a default position does not mean that companies with combined CEOs and board chairs should undertake to immediately amend their board leadership structures.

In addition to having an independent board chair when a company encounters a crisis, boards should evaluate their form of leadership on a regular basis, and the best opportunity to carefully consider whether to split the positions could be during succession planning discussions. An independent board chair may be helpful when transitioning company leadership to a new CEO.

Some have suggested that such a board leader is particularly likely to contribute valuable experience if the new CEO has not previously served in a similar capacity. The benefit of this particular expertise for an independent chairman is sparking a new trend of companies seeking former CEOs for those positions.[12] Succession planning also represents an ideal time to evaluate the possible risk that separating the functions could make recruiting CEO candidates more challenging, a concern that executive search firms have raised.[13]

New Disclosure Rules

In disclosure rules likely to effect the 2010 proxy season, the SEC will require companies to disclose their leadership structure and why they believe that it is the best one, including whether and why they have chosen to combine or separate the CEO and board chair positions.[14]

The SEC proposal indicates that different leadership structures may be suitable for different companies and cites factors such as the size of a company, the nature of its business, or internal control considerations. Many were relieved that the SEC did not propose a rule following the UK "comply or explain" model, which would require companies to explain whether they have independent board chairmen, and if not, why not. That approach, which has been suggested in some comment letters, could have contained an implicit assumption favoring the independent board chair leadership structure.

It is helpful that the SEC proposal has a balanced requirement that recognizes different leadership structures are appropriate, depending on a company's specific situation. The ability of companies to choose their own leadership structure was further reinforced by the legislation Senator Dodd (D.-Conn.) introduced on Nov. 10, 2009.[15]

The Dodd bill included all of the elements of Senator Schumer's Shareholder Bill of Rights but in modified form with respect to certain of the provisions, including having companies publicly disclose why they have the same, or different persons, acting as chairman and CEO instead of mandating independent chairs for all companies.

Unfortunately, those actions are unlikely to stem the escalating pressure calling for independent board chairs. This focus is becoming another proposed solution to the desire to seek simple fixes for the perceived problems that caused the economic meltdown, ignoring the fact that the complexity surrounding the possible causes of the crisis demands tailored and refined approaches to corporate governance.

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