FIN536 CORPORATE GOVERNANCE

Lecture 7 The Board of Directors (1)

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TODAY'S AGENDA

- Board of Directors: Duties and Liability
- Board of Directors: Selection, Compensation, and Removal

1.1. RESPONSIBILITIES

- The board of directors has a dual mandate:
  - Advisory: consult with management regarding strategic and operational direction of the company.
  - Oversight: monitor company performance and reduce agency costs.

- Effective boards satisfy both functions.

- The responsibilities of the board are separate and distinct from those of management. The board does not manage the company.

1.1. RESPONSIBILITIES

- Selected advisory and oversight responsibilities:
  - Approve the corporate strategy
  - Test business model and identify key performance measures
  - Identify risk areas and oversee risk management
  - Plan for and select new executives
  - Design executive compensation packages

1.1. RESPONSIBILITIES

- Selected advisory and oversight responsibilities:
  - Ensure the integrity of published financial statements
  - Approve major asset purchases
  - Protect company assets and reputation
  - Represent the interest of shareholders
  - Ensure the company complies with laws and codes

1.2. INDEPENDENCE

- Boards are expected to be independent:
  - Act solely in the interest of the firm.
  - Free from conflicts that compromise judgment.
  - Able to take positions in opposition to management.

- "Independence" is defined according to regulatory standards.

- However, independence standards may not be correlated with true independence.

- Requires a careful evaluation of board member's biography, experience, previous behavior, and relation to management.

1.3. OPERATIONS OF THE BOARD

- Presided over by chairman: sets agenda, schedules meetings, coordinates actions of committees.

- Decisions made by majority rule.

- To inform decisions, board relies on materials prepared by management.

- Periodically, independent directors meet outside presence of management ("executive sessions").

- Directors report spend 20 hours per month on board matters. While a typical meeting lasts between 2 and 6 hours, some last as long as 8 hours

1.4. BOARD COMMITTEES

- Not all matters are deliberated by the full board. Some are delegated to subcommittees.
- Committees may be standing or ad hoc, depending on the issue at hand.
- All boards are required to have audit, compensation, nominating and governing committees.
- On important matters, the recommendations of the committee are brought before the full board for a vote.

1.4. BOARD COMMITTEES

- Audit committee
  - Oversight of financial reporting and disclosure
  - Monitor the choice of accounting policies
  - Oversight of external auditor
  - Oversight of regulatory compliance
  - Monitor internal control processes
  - Oversight of performance of internal audit function
  - Discuss risk management policies

1.4. BOARD COMMITTEES

- Compensation committee
  - Setting the compensation of the CEO and other executives
  - Set performance-related goals for the CEO
  - Determine the appropriate structure of compensation
  - Monitor the performance of the CEO relative to targets
  - Advise the CEO on compensation for other executive officers
  - Setting board compensation
  - Hire consultants as necessary

1.4. BOARD COMMITTEES

- Governance/ Nominating committee
  - Evaluating the company's governance structure and processes
  - Identifying, evaluating, and nominating new directors when board seats need to be filled
  - In charge of leading the CEO succession-planning process
  - Manage the board evaluation process
  - Manage the CEO evaluation process

1.4. BOARD COMMITTEES

- Specialized Committees
  - Executive
  - Finance
  - Corporate social responsibility
  - Strategic planning
  - Investment
  - Risk
  - Environmental policy
  - Specialized Committees
  - Science & technology
  - Legal
  - Ethics / compliance
  - Mergers & acquisitions
  - Employee benefits
  - Human resources / management development

Prevalence of specialized committees:
- Finance: 34%
- Corporate social responsibility: 11%
- Science & technology: 6%
- Legal: 4%
- Environment: 4%

1.5. DIRECTORS TERMS

- Duration of Director Terms
  - One to Three-year term
  - Staggered board (63% in 2002, 50% in 2009, 7% in 2014)
  - On average 7 years in US

- Two main election regimes:
  - Annual election: Directors are elected to one-year terms.
  - Staggered board: Directors are elected to three-year terms, with one-third of board standing for election each year.

1.5. DIRECTORS TERMS

- Director Elections
  - In most companies, directors are elected on a one-share, one-vote basis.
  - Shareholders may withhold votes but not vote against.
  - Four main voting regimes:
    - Plurality: directors who receives most votes is elected, even if a majority is not obtained.
    - Majority: director must achieve majority to be elected, otherwise must tender resignation.
    - Cumulative: shareholders can pool votes, and apply to selected candidates (rather than one vote each).
    - Dual class: different classes of shares carry different voting rights (disproportionate to economic interest).
  - Typically, only one slate of directors is put forth for election; in a contested election, a dissident slate is also put forth.

1.6. LEGAL OBLIGATIONS: FIDUCIARY DUTY

- Duty of Care
  - It requires that a director make decisions with due deliberation
  - “Business judgment rule”

- Duty of loyalty
  - It lays out procedures for a board to follow when a potential conflict of interest may exist

- Duty of Candor
  - It requires that management and the board inform shareholders of all important information

1.7. LEGAL ENFORCEMENT

- Fiduciary duties are enforced by judicial intervention:
  - Injunction: court order that the board refrain from a specific action.
  - Damages: requirement that the board pay for losses sustained

- Under the "business judgment rule," the court will not second-guess a board's decision if:
  - The board followed reasonable process
  - The board took into account key relevant facts
  - The board made the decision "in good faith"

- "Good faith" requires that the board act without conflicts of interest and not turn a blind eye to issues for which is it responsible.

1.7. LEGAL ENFORCEMENT

- Under securities laws, directors have a legal obligation to disclose information to the public.
- In general, the company is required to disclose all "material information" – information that an investor would consider important in the evaluation of an investment decision.
- The board relies on external and internal auditors to ensure that material information is adequately disclosed.

1.7. LEGAL ENFORCEMENT

- Securities laws are enforced through private lawsuits and government authority's actions.
- Private lawsuits are led by investors who claim to have been harmed by a violation.
- In order to be found in violation of securities law, the court must find that a disclosure to the public contained a material misstatement or the omission of material information, and that the misstatement or omission was the cause of loss.
- A director cannot be held liable unless the misstatement or omission was intentional or the result of recklessness

1.8. DIRECTOR INDEMNIFICATION AND INSURANCE

- Director liability is reduced by three mechanisms:
  - Exculpatory provision: company charter excuses director from liability for unintentional negligent acts.
  - Indemnification: agreement that company will pay for costs associated with lawsuits (if director acted "in good faith").
  - Director and officers insurance (D&O): insurance contract that covers litigation expenses, settlement payments, and in some cases damages.

1.8. DIRECTOR INDEMNIFICATION AND INSURANCE

- D&O insurance
  - Cover litigation expenses, settlement payments, and amounts paid in damages
    - Side A: when indemnification is not available
    - Side B: reimburse a corporation for its indemnification
    - Side C: reimburses a corporation for litigation costs

- In 1980-2005, only 12 cases requires outside directors to make out-of-pocket payments
  - Black, Cheffens, and Klausner(2006)

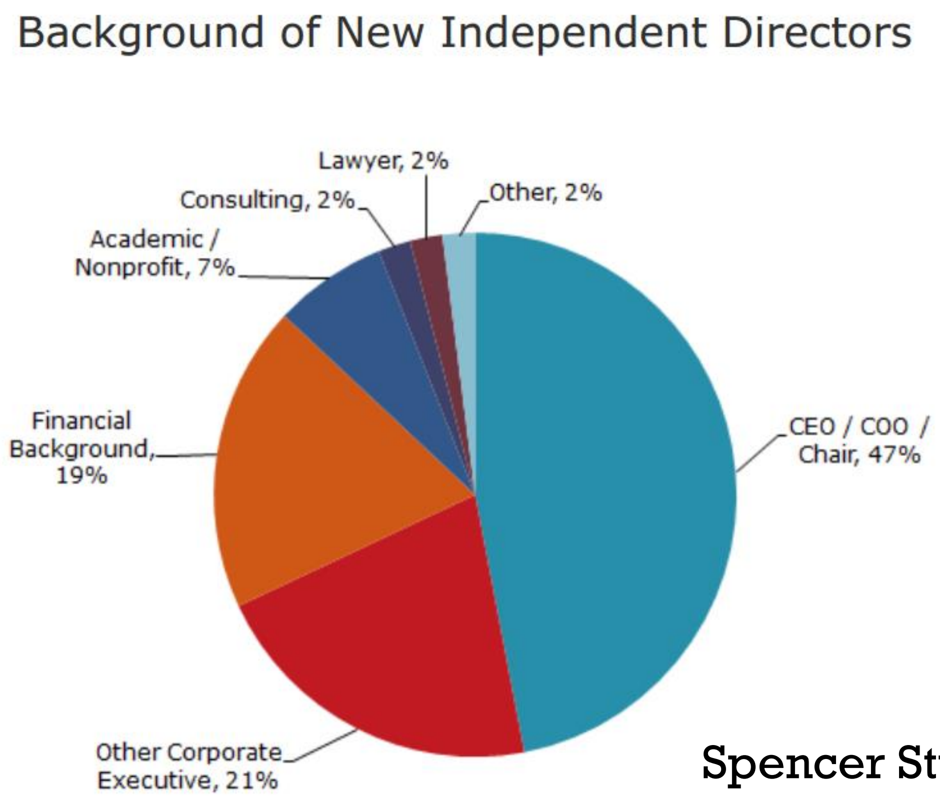
2.1. MARKET FOR DIRECTORS

- Among public corporations in the U.S.:
  - Total number of directors: 50,000
  - Average tenure on board: 7 years
  - Average mandatory retirement age: 72

- Directors tend to retire voluntarily.
- Only 2 percent of directors who step down are dismissed or not reelected.

2.1. MARKET FOR DIRECTORS

- Directors have a mix of managerial, functional, and specialized backgrounds.



Spencer Stuart (2007)

2.1. MARKET FOR DIRECTORS

- Are there enough "qualified" directors?
  - If supply > demand, companies should have no trouble identifying and recruiting qualified candidates.
  - If supply < demand, board quality will suffer. Inadequate supply need not be broad-based; it may be concentrated in specific areas.

- 56%of directors believe there are not enough qualified directors.

- Directors most difficult to recruit include ethnically diverse (57%), women (50%), technological expertise (45%), and international expertise (42%).
  - Corporate Board Member and PricewaterhouseCoopers (2009)

2.1. MARKET FOR DIRECTORS

- Active CEO: Most important criterion for recruiting

- Do directors with current CEO-level experience increase or decrease board quality?
  - (+) Active CEOs have managerial, industry, and functional knowledge.
  - (-) Active CEOs are busy. Can they manage their own company and still have time to advise and monitor another?

- Recently, the number of active CEO-director has declined

- More than half (53%) of new independent directors are retired senior executives and professionals, compared with 39% of new directors in 2009.
  - The majority of first-time directors, 61%, are active executives.

2.1. MARKET FOR DIRECTORS

- International experience is important as companies enter new markets.
- Directors with this knowledge help the board understand strategy, operations, finance, risk, and regulations.
- Directors may have contacts with government officials, suppliers, manufacturers, distributors, and customers.
- Evidence suggests there is insufficient supply of international directors.
  - Among U.S. Directors: 27% have worked abroad, 9% were educated abroad, 7% are foreign born.

2.1. MARKET FOR DIRECTORS

- Companies need directors to advise on specific areas.
  - Research, development, and production
  - Turnarounds and restructuring
  - Regulations and law
  - Mergers, acquisitions and divestitures

- In some cases, board advisers or board observers are invited to attend board meetings for this purpose.

- When does the company need permanent board representation with specific knowledge? When should this be done on a temporary or advisory basis?

2.1. MARKET FOR DIRECTORS

- Companies seek diverse directors when they believe diversity of personal perspective contributes to board deliberations or decision making.

- Diverse groups have low representation in the senior ranks of corporations.

- If CEO experience is preferred background for a new board member, ethnic minorities and females will be slow to obtain director positions.

2.1. MARKET FOR DIRECTORS

- Female representation among new directors rose from 24% in 2013 to 30% in 2014, the highest level we've seen.
  - In 2009, women represented 17% of new directors.

2.1. MARKET FOR DIRECTORS

Board composition	2014	2009	2004	Comments
Average board size	10.8	10.8	10.8	Stable
Independent directors	84%	82%	80%	Increased
Average age of independent	63.1	61.7	60.5	Increased

New independent directors	2014	2009	2004	Comments
Women	30%	17%	24%	High Demand
Active CEO	22%	26%	33%	Fewer active senior executives
Retired CEO	19%	17%	11%	Continues to grow
Financial backgrounds	20%	18%	24%	Consistent source
Other corporate executives	23%	21%	12%	Doubled

2.2. DIRECTOR RECRUITMENT PROCESS

- Director recruitment is a responsibility of the nominating/ governance committee.
  - Identify needs of company.
  - Identify gaps in director capabilities.
  - Identify potential candidates, either through director networks or with professional recruiter.
  - Rank candidates in order of preference.
  - Meet with each candidates successively and offer job.
  - Put before shareholders for a vote.

- Director recruitment differs from CEO recruitment in that candidates are ranked in order before interviews take place.

2.3. DIRECTOR COMPENSATION

- Compensation must be sufficient to attract, retain, and motivate qualified directors.

- Compensation covers time directly spend on board matters, cost to keeping schedule flexible to address urgent issues, and financial and reputational risk from corporate scandal or lawsuit.

2.3. DIRECTOR COMPENSATION

- The average total compensation for S&P 500 directors is $263,748 in 2014.
- More than half of director compensation comes in the form of equity.

(Median)	Revenues > $20bn	Revenues $1-$2.5bn
Annual-Retainer	$ 80,000	$ 45,000
Committee Fees	$ 10,500	$ 16,200
Non-Retainer Equity	$ 105,800	$ 57,800
Total Director Comp	$ 229,900	$ 132,600
% Equity	45%	46%

Hewitt (2010)

2.3. DIRECTOR COMPENSATION

- Companies pay fees for serving on committees.
- Fees are intended to compensate for time, expertise, and potential risk of committee role.

(Median)	Revenues > $20bn	Revenues $1-$2.5bn
Audit Retainer	$10,000	10,000
Audit Meeting Fee	2,000	1,500
Audit Chair	20,000	12,500
Comp Retainer	9,500	5,000
Comp Meeting Fee	2,000	1,500
Comp Chair	15,000	8,250
Nom/Gov Retainer	9,000	5,000
Nom/Gov Meeting Fee	2,000	1,500
Nom/Gov Chair	10,000	7,500

Hewitt (2010)

2.4. DIRECTOR OWNERSHIP GUIDELINES

- Many companies require directors to maintain minimum ownership levels of company equity.

- Equity ownership by directors is intended to improve the alignment between their interests and those of shareholders.

- Equity ownership guidelines may be stated as a specified number of shares, dollar value, or a multiple of the annual cash retainer.

2.4. DIRECTOR OWNERSHIP GUIDELINES

- There are potential drawbacks to equity ownership guidelines.
  - Directors are not managers.
  - Directors might become risk averse (e.g., fail to approve long-term projects if near-term expenditures reduce stock price).
  - Directors may make decisions from standpoint of personal benefit rather than professional judgment.
  - Ownership guidelines are not calibrated to personal wealth, and so may have varying impact on directors.

- The research evidence is mixed on whether equity ownership by nonexecutive directors improves firm performance.

2.5. BOARD EVALUATIONS

- The entire board, committees, and/or individual directors are evaluated for effectiveness in carrying out responsibilities.

- New York Stock Exchange rules require board evaluations; evaluations of individual directors are not required.

- Evaluations may review the composition and skills of the board, meeting structure and process, effectiveness in setting strategy, effectiveness in monitoring performance, and director relations with each other, management, and shareholders.

2.6. REMOVAL OF DIRECTORS

- A company may replace a director for a variety of reasons, both good and bad:
  - (+) Requires new skills and capabilities on the board.
  - (+) Company wants to "refresh" the board.
  - (+) Director wishes to retire.
  - (+) Director reaches mandatory retirement age.
  - (-) Director is negligent or performing below expectations.
  - (-) Director has irresolvable disagreement with other directors or management.

- Shareholders often do not know the real reason a director leaves the board.

2.6. REMOVAL OF DIRECTORS

- The process for removing a director is complicated.

- The board does not have the power to remove a fellow board member. It must either:
  - Wait to replace the director at the annual meeting.
  - Encourage him/her to resign.

- Shareholders, too, have limited rights to remove directors.
  - Pass special resolution, if they can demonstrate cause.
  - Vote for removal, if election is by majority voting.

- Does this reduce accountability?

2.6. REMOVAL OF DIRECTORS

- What evidence is there that companies and shareholders benefit from board turnover?
  - Studied board turnover and shareholder returns for the S&P 500
  - Companies that added three or four new directors in a three-year period outperformed their peers.

2.7. OTHER TRENDS

- Boards are increasingly likely to place limits on directors' ability to serve on other boards.
  - 75% of S&P 500 boards have established some restriction on other corporate directorships for their board members, compared with 55% in 2006.

- More than one-quarter of S&P 500 boards (28%) have a truly independent chair — a nonexecutive director or a former executive. (9% in 2004)

- Boards have reduced their number of meetings since 2009. Boards met an average of 8.1 times, compared with an average of 9.0 meetings five years ago.

ACADEMIC RESEARCH

- Adams, Hermalin, and Weisbach (2010), The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey, JEL
  - It's a survey paper, meaning it summarizes the important studies in the literature of board of directors and discusses pros and cons of different views
  - Very good place to start if you are interested in doing research on board of directors

ACADEMIC RESEARCH

- Hermalin and Weisbach (1998), Endogenously Chosen Boards of Directors and Their Monitoring of Management, AER
  - Builds a theoretical model where CEO negotiates with the board on his job vs election of directors
  - CEO is hired, and first performance outcome is available after a period
  - Board updates its estimate on CEO's capabilities, and can replace the CEO if it wants to.
  - The CEO negotiates the board over the vacant seats, and if the negotiation is unsuccessful, the CEO is replaced
  - The board only obtains private signal once the negotiation is done, and the board may decide to replace the CEO
  - Then the second performance outcome is available

ACADEMIC RESEARCH

- Hermalin and Weisbach (1998), Endogenously Chosen Boards of Directors and Their Monitoring of Management, AER
  - CEO turnover is negatively related to performance. This relationship is stronger when the board is more independent
  - After poor performance, the probability that an independent director will be elected rises
  - Board tend to become less independent over the course of CEO's tenure
  - Management turnover is more related to accounting (earnings) performance than stock returns

ACADEMIC RESEARCH

- Ahern and Dittmar (2012), The changing of the boards: The impact on firm valuation of mandated female board representation, QJE

  - Firms optimally choose board members to maximize firm value
    - Upon the announcement of new regulation that firms must have at least 40% of female directors, stock prices fell significantly for those firms that did not have any female director
    - New female directors were younger and had less CEO experience
    - Firms grow in size, make more acquisitions, and perform poorly in accounting measures