

A New Approach To Building Shareholder Value

by Steven M. H. Wallman

The past few years have seen a major shift in the fiduciary relationship between shareholders and their boards of directors. The cleanup of corporate scandals brought new demands for more investor power over boards and governance policies. Traditional corporate governance sees this as a “zero sum” game—power taken away from the board is gained by shareholders. What if the reality of governance is not that simple, and fiduciary oversight actually *improves* the more it is shared?

The 2005 proxy season was an interesting one. We can certainly say it was less contentious than the tumultuous 2004 season when votes of at least 15 percent were withheld from 468 directors at 258 of the S&P 1500 companies. This year saw somewhat less confrontation and somewhat more dialog between management groups and investors.

At the same time, though, shareholders are quite concerned with preventing the real and perceived abuses of fiduciary responsibility that, unfortunately, have become one of the most visible features of corporate America over the past several years.

In decades past, the fuel that inflamed shareholders was social concerns or resistance to takeovers, or labor and management battles. Today, the concern driving much shareholder activism is the ongoing revelation of corporate scandal—abusive self-dealing by executives, breaches of trust, and failures of management and directors to respect the fiduciary obligations they have undertaken. These same concerns have driven legislative activism aimed at solving corporate problems, such as the Sarbanes-Oxley Act, and enhanced enforcement from state and federal regulators and criminal authorities.

While the corporate scandals of recent years have been very real, they also have shifted the lens

through which we see corporations and, in so doing, they have changed our perceptions of business. In a certain sense, the corporate scandals and all of the publicity surrounding them created a feeding frenzy. Things that previously would have been called mistakes now are called fraud. Prior actions that might reasonably have been viewed as civil violations now are prosecuted as criminal actions.

Pendulums shift, and balance will be restored by responsible policymakers, to the extent there are real excesses. Yet, there is no doubt that something miserable has tainted the corporate sector. Too many breaches of trust have accumulated too quickly for the public not to take notice or care, or not to believe that more must be done to correct the situation.

Shareholder activism has steadily increased, but what has it actually achieved to protect and enhance shareholder value? Unfortunately, and this must change, the answer appears to be “not much.”

Over the last two decades, shareholder activism has steadily increased. Traditional proxy advisory groups and other watchdogs, with much to care about and strong voices, have overseen corporate actions, called management to answer and flexed regulatory as well as market power to monitor and improve corporate America.

Yet what did this activism achieve to protect and enhance shareholder value? Unfortunately, the answer appears to be “not much” to prevent wrongdoing by corporate executives. In fact, after two decades of

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activism and attention, what we have seen lately are some of the most spectacular governance failures in American business history. What went wrong?

Shareholder concern with external oversight of corporations obviously is not the problem. Activism is important and necessary if it is usefully directed. Legislative concern, especially after scandals that have done so much to damage the capital markets and diminish shareholder value, also is a required response. It never has been shown that business can function effectively and for the benefit of shareholders and society without external oversight. Three-quarters of a century ago, some may have thought that the markets would be better and more efficient without the Securities and Exchange Commission, but almost no one could reasonably think that today.

Laws and regulations, with the potential, of course, to destroy an economy, also have the potential to make it far more efficient. The trick is to do it right. That is why good corporate governance and oversight are so essential to achieving the goal of a better corporate America. Efficient markets, alone, are not capable of ferreting out bad corporate managements. But aside from laws and rules, the question is: How do you achieve better oversight through effective shareholder activism?

The definitions of “good” corporate governance have been decided by a small number of proxy advisory firms, and they are largely proscriptive, one-size-fits-all formulas.

Shareholder oversight, like legislative oversight, can be guided by one of two general approaches: a proscriptive, rules-based approach, or a goal-directed, principles-based approach.

In the arena of shareholder oversight, the great majority of efforts have followed the proscriptive approach. For all practical purposes, the definition of what constitutes “good” corporate governance has been decided by a small number of proxy advisory firms and governance advocates. Their methodologies often take on proscriptive—actually formulaic—approaches.

These organizations largely established definitions of what constitutes “good” governance:

□ Separation of a chairman’s and CEO’s roles (regardless of the potential internal issues that can cause);

□ Absence of staggered boards (even though many boardroom observers believe they actually foster independence and a longer-term board perspective);

□ Absence of “poison pill” provisions (even though their merits in increasing shareholder value and permitting a company to run an effective auction are relatively undisputed); and the list goes on.

Advisory firms and others in the governance community have applied these “best practices” judgments to the analysis of corporations’ proxies across the board. They have assumed that a specific set of corporate governance initiatives is (or is not) inherently beneficial for all companies. Thus, a specific recommendation for a particular issue should be applied to the voting of all corporations’ proxies, all of the time.

This “one-size-fits-all” approach simply does not work to improve corporate governance. There was a time when such an approach was the only feasible one. Sifting through the proxy statements and other documents for 5,000 or 10,000 companies, and making informed and thoughtful judgments on a company-by-company basis, would simply not have been possible, at least not for a reasonable cost. The only solution was to take a one-size-fits-all approach and hope for the best.

However, times have changed. Technology now allows for a company-specific approach that is thoughtful and takes into account the nuances and performance of particular companies.

Still, the one-size-fits-all approach remains accepted by many investors and their advisors even though this approach can be detrimental to the interests of the shareholders it is meant to serve. Instead of directing shareholders’ attention to “matters that matter,” these policies actually deflect attention away from them. The result: oversight is not as effective as it could be, even after the scandals of the past few years.

Numerous academic studies have attempted to

justify a “best practices” approach. Proof has been sought for causal connections between corporate performance and specific management structures, board compositions and other structural elements of corporate governance. The results of these studies generally have been inconsistent and frequently contradictory.

One of the most comprehensive and scholarly papers to examine the relationship between corporate governance and corporate performance was published last year by Professor David F. Larcker of the University of Pennsylvania’s Department of Accounting and Professors Scott Richardson and Irem Tuna of the University of Pennsylvania’s Wharton School.

Their study evaluated 39 individual corporate governance indicators, such as board size, anti-takeover provisions, numbers of directors who served on other corporate boards, etc. A further analysis refined these indicators into 14 governance “constructs.” These, in turn, were correlated to a broad spectrum of metrics that positively (or negatively) influenced shareholder value across a range of actual corporations. Some of these metrics were equity analyst recommendations, accrual choices, debt ratings and yields, corporate over-investment, class action lawsuits and accounting restatements.

What are the findings of this intriguing and sophisticated research?

“We find that our corporate governance constructs have only modest explanatory power for explaining managerial choices or firm valuation... Moreover, the signs of the statistically significant coefficients are frequently unexpected. For example, in our analysis of corporate debt ratings and non-directional measures of abnormal accruals, we find that firms with large boards and anti-takeover provisions (typically considered to be indicators of “bad governance”) tend to have better debt ratings and lower abnormal accruals.

“Our overall conclusion is that the typical structural indicators of corporate governance used in academic research and institutional rating services have a limited ability to explain

managerial decisions and firm valuation. These results imply either that corporate governance is of modest importance or the available indicators are not especially useful for measuring corporate governance.”

We at *PROXY Governance* do not believe that corporate governance is of only modest importance, either to the creation of shareholder value in specific companies or the creation of investor confidence, market-wide. However, we do believe that the available indicators of corporate governance have been misunderstood and misused when applied in a one-size-fits-all model. This approach to the analysis and evaluation of corporate governance suffers both from a determination to have all companies follow the same practices, and a misunderstanding, actually almost a naïve view, of which practices are “best.” That is simply not efficient at stimulating the growth of long-term shareholder value.

The traditional corporate governance discussion assumes a zero-sum game—what management loses, shareholders must “win.” The logical extension of this is that shareholders can increase the value of their investments by taking “power” from managements and boards.

Additionally, the traditional corporate governance discussion assumes the shareholder/management relationship is a zero-sum game. Thus, what management loses, shareholders must “win,” and vice versa. The logical extension of this assumption is that shareholders can increase the value of their investments by taking “power” from managements and boards—that is, stepping into their roles. This reaction is not surprising. When you mistrust someone, you do not give them much leeway.

This is a trust issue. Shareholders feel they cannot trust boards after the accounting malfeasance, corporate failures, and exorbitant or self-dealing pay practices that we have just seen. Shareholders feel they cannot trust any board because they do not know where the next shoe will drop. Unfortunately,

but understandably, a few bad apples taint the whole barrel. This perception of breach of trust has the potential to infect all companies and their relations with their shareholders.

Consequently, advisory firms and some investors have at times adopted a micromanagement-oriented approach to their analysis and voting. They attempt to use their voting powers to influence, in considerable detail, how corporations set their priorities and run their businesses.

Applying the zero-sum game concept to the relationships among shareholders, managements and boards is flawed thinking in a number of ways. Most importantly, it is a poor model because it misses the point that shareholders, managements and boards are not on separate teams. They actually are on the same team, and *should* all share the same goal—creating value.

Rather than fighting with management over who gets a bigger piece of the power pie, shareholders should seek oversight that expands the value of the corporation.

The corporation is the engine of shareholder value creation, and shareholder value grows as the value of the corporation grows. Consequently, rather than fighting battles with managements and boards over who gets a bigger piece of the power pie, shareholders are best served by corporate oversight aimed at expanding the value of the corporation. To achieve that kind of productive relationship, directors and managers must earn back the respect and trust of their shareholders.

To achieve a better governance model, we must turn to a goal-directed, principles-based approach. The focus must not be on gaining “power” for shareholders or managements, but on increasing long-term shareholder value. This approach leads to assumptions and practices that differ markedly from those used in traditional governance analyses which focus on power, not value.

Building value is accomplished individually and uniquely by each corporation and its management

and board. Therefore, proxy issues need to be analyzed on a company-specific basis. Although there obviously are exceptions, as a general matter, no specific set of corporate governance initiatives are (or are not) inherently beneficial to *all* companies, *all* of the time. Proxy proposals have to be judged in the context of each specific company’s performance, its board structure, its executive pay structure and other factors.

For example, a “poison pill” provision may be a shield used by a weak management to protect itself. Or, it may be a useful tool to help a strong management implement a critical restructuring that involves short-term pain, but which will position the company for long-term growth. Only company-specific analysis can determine which is the case and provide voting recommendations that will support the creation of long-term shareholder value.

Company-specific evaluation requires a portfolio manager’s approach to proxy analysis. Like the portfolio manager, the bias must be towards corporate performance, and a portfolio manager’s standard tools for performance measurement should be used. That is, a company’s performance should be evaluated not in a vacuum, but relative to peer companies in its industry over some reasonable period.

From a governance perspective it is actually important to ask “what have you done for me lately?” A company that used to be great and now is so-so needs to be examined to determine why. A former laggard that is now becoming a star similarly needs to be given some room to keep growing. We measure whether a company’s performance has improved or deteriorated relative to its peers over the past three to five years. If the company has underperformed, but is improving, we evaluate the rate of improvement to determine if a genuine turnaround is underway.

Alternatively, if the company historically has matched or exceeded its peers’ performances, but its current performance is rapidly deteriorating to an underperforming level, we would seek a satisfactory explanation from management. Simply put, there needs to be a comprehensive assessment of whether the corporation is building or diminishing shareholder value.

Shareholders should look to the directors for action—and hold them accountable if none is forthcoming.

When a corporation's performance consistently has been worse than that of peer companies, shareholders should expect a board to implement change, or have a very good explanation for why management is on the right track. Where change is warranted, it could be demonstrated through new management, a change in business strategy or other factors. Shareholders should look to the directors for action—and hold them accountable if none is forthcoming.

At Hewlett-Packard earlier this year, for example, we saw a company that had failed to execute its business strategy and consistently underperformed its peer companies. The board took action to dismiss the CEO and sought a successor who could improve the company's performance and increase the value of its shareholders' investments. As a result, the directors were rightfully viewed as having acted when needed.

Shareholders applauded pure executive pay-for-performance criteria, but corporate scandals have recalled the old adage “beware what you wish for.”

Ensuring that management is fairly, and not overly, compensated is another critical part of the shareholders' oversight function. Shareholders understandably question board oversight when executive pay is out of “sync” with corporate performance. Pay-for-performance concepts are the right approach to guide voting recommendations on executive compensation issues. However, a CEO's performance and pay, again, need to be benchmarked against that of CEOs in peer companies.

In the past, shareholders applauded pure pay-for-absolute-performance criteria. The product of this approach, however, recalls the old adage “be careful what you wish for.” Tying the CEO's compensation to stock price, for example, sets the CEO's and senior management's sights on one thing and one thing only.

As we have seen, it creates a very powerful incentive for a whole variety of unintended consequences, including schemes designed solely to boost the stock price—at least for a while.

More intelligent compensation design is needed to include a variety of factors that promote long-term corporate wealth and shareholder value, not just current stock price. That is what compensation committees are for. They are there to oversee the pay structure, and ensure that the associated performance objectives match the business strategy of the corporation.

When compensation committees fail to perform this task effectively, they, too, should be held accountable. The practice of some who vote against broad-based stock plans designed to motivate all employees simply because executives are getting paid too much makes little sense. The vote should be aimed at those on the board who *authorized* the excessive executive pay.

For years, many investors and proxy advisory firms have been focused on and making voting recommendations based on the minute details of stock option plans that include mid-level employees. Instead, they should have been evaluating the real issue of whether the executives running corporations are performing well, and whether they are being paid too much or too little for the performance they deliver.

Another area deserving attention is director compensation. Directors are doing a good deal more than they ever have, but they also should be held accountable more than ever for failing in their oversight roles. If they make self-dealing decisions or authorize excessive executive pay, they should not expect to continue in office. However, when they do their expanded job well, they should also expect to be reasonably paid. Director pay, arguably, should be going up, as excessive executive pay should be coming down.

How does this goal-directed, principles-based approach prompt us to evaluate proposals for declassifying corporate boards? If the concern is that the staggered board might be used as an anti-takeover device, then focus on the director removal provisions, not the classified nature of the board.

A staggered board can foster open and frank boardroom discussion, since directors who know their terms will extend beyond the next annual meeting (and frequently beyond the current CEO's tenure) can be more confident in their dealings with management. Some of our more venerable institutions, like the Senate and the SEC, have staggered boards. If the real purpose of a declassifying proposal is simply to send a message that shareholders are dissatisfied with the corporation's performance, the message would be stated more clearly by a vote on the directors who are up for election.

This year's hottest proxy issue, majority voting, is a complex issue that deserves the serious study it is receiving. It seems inherently right that no director who cannot win a majority of shareholder votes should be seated. At the same time, the concept raises many thorny issues, one of which is the ability of shareholders to use a "withhold vote" under the plurality voting system to send a director or board a message that they need to change their ways, without actually putting them out of office. That ability is lost in a majority voting system in which shareholders are shooting with real bullets instead of blanks.

Numerous other issues, including how majority voting could be practically implemented (on a company-by-company basis; through corporate law on a state-by-state basis) should be examined to ensure that if majority voting does move forward, it truly serves the interests of shareholders.

Likewise, in the case of socially responsible investing proposals, the primary test of merit should be whether the proposals will enhance or harm long-term corporate and shareholder value. For example, will adopting or failing to adopt the proposal have an effect on the company's reputation or competitiveness? If it is enacted, will the proposal be likely to accomplish what it seeks to do—and is there value in what it seeks? Will it support the company's performance, or will it be burdensome without providing an appropriate return?

The ultimate truth that underlies the goal-directed,

principles-based approach to corporate governance is that the legitimate goal of shareholders is to see the value of their investments increase. Achievement of this goal is not enhanced by arbitrary, flavor-of-the-month approaches to proxy voting recommendations. It can best be achieved by selecting qualified and capable executives and board members, ensuring that they are properly paid, and providing the appropriate oversight. Then, let them do what they are paid for—creating shareholder value.

Directors should focus on putting the right members of senior management in place and overseeing the corporation's strategic direction to ensure it supports the creation of shareholder value. Senior management should focus on developing and executing the strategies that will push the performances of their corporations above that of peer companies in their industries.

As for shareholders, they should monitor the performances of the corporations they own, comparing them to peer companies. They should advocate for changes to corporate boards and top management when performance consistently lags the peer group, or when conflicts arise or self-dealing is evident.

Shareholders do not serve their own interests when they attempt to take strategy and tactics out of the hands of corporate boards and managements. They serve their interests best when they zealously oversee boards with the goal of eliminating self-dealing and excessive pay, and replace boards and managements that are unable to increase value for shareholders over the long term.

The shareholder-board-management team is like any other human organization: it functions best and generates the greatest value when its people understand their jobs and do them well. It all starts with trust in the system and trust in the people operating under it. Decreasing the shrillness of discourse and treating all participants as knowledgeable folks trying to do the right thing will go a long way. Managements have to rebuild that trust; shareholders have to be willing to let them do it. ■