

US Corporate Governance: From the Frying Pan Into the Fire?

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Three significant trends mark the last decade in corporate governance, and they have only accelerated over time: (i) the dismantling of structural provisions that some shareholders believe insulate directors from accountability; (ii) a more searching inquiry by shareholders into board composition; and (iii) an increased focus on environmental, social and governance (ESG) matters.

Although the reasons behind these trends and the mechanisms employed to further them are varied, some quarters place the blame, at least in part, on the shareholder proposal process and proxy advisory firms. They view the potential adoption of recently proposed SEC rules relating to these two areas as a welcome rebalancing of a system out of equilibrium. In contrast, others believe the adoption of the proposed rules would muffle a critical voice — that of shareholders — in a governance ecosystem in which they play an important part. Regardless of one's perspective, the rulemaking process and its aftermath may portend a period in which directors' positions are more precarious than ever.

Structural Changes Relating to Director Accountability to Shareholders

The structural-change trends are not new. For companies in the S&P 500 index, the vast majority of boards of directors are subject to election on an annual basis, rather than on staggered terms, and directors in uncontested elections are required to submit their resignations if they fail to receive a majority of votes cast. A substantial majority of S&P 500 companies provide shareholders with a proxy access right, to date virtually unused, that allows shareholders to have a limited number of competing board nominees appear in the company's proxy materials. In addition, a substantial majority of those companies provide shareholders the right to call a special meeting, and at many

companies the ownership thresholds required to exercise that right have been lowered over time.

These changes have been achieved through “private ordering” — the notion that private parties are best-positioned to order their affairs — rather than by SEC mandate or stock exchange rule. However, the shareholder proposal process played a significant role in building momentum. In many cases, once trends become well-established and investor voting policies and patterns become clear, the shareholder proposal process becomes secondary. At that point, with the outcome of a vote fairly predictable, investor-engagement or letter-writing campaigns, sometimes with the implicit threat of a shareholder proposal, can achieve the same outcome.

Also contributing to these structural trends are proxy advisory firm voting policies that recommend against directors at newly public companies that have disfavored governance provisions, such as classified boards or supermajority voting requirements for shareholders to approve charter or bylaw amendments. In addition, the threat of being labeled by proxy advisory firms as “unresponsive” to a majority-supported shareholder proposal, with the related risk of a recommendation against directors' reelection, gives “teeth” to what are otherwise nonbinding votes. Accordingly, it is difficult to envision the structural changes occurring to the same degree and at the same pace as has occurred in the absence of the shareholder proposal process and proxy advisory firm voting recommendations.

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Focus on Board Composition

Investors have become keenly focused on whether companies have the “right” directors in the boardroom, paying particular attention to director skills and experiences, diversity, tenure and overboarding (*i.e.*, serving on an excessive number of public company boards). The focus on director skills has taken the form of an emphasis on disclosure, including a campaign by the New York City Comptroller, launched in 2017, calling for the disclosure of a skills matrix to more easily understand the skills represented in the boardroom and identify gaps. According to one survey, 75% of *Fortune* 100 companies included a skills matrix in their 2019 proxy statements. Many large institutional investors have been vocal advocates for increasing board diversity and, as of July 2019, no S&P 500 companies have all-male boards. In addition, the New York City Comptroller recently launched a campaign for boards to adopt a “Rooney Rule” policy requiring that the initial lists of candidates considered to fill board seats or identify external CEO candidates include qualified female and racially/ethnically diverse candidates. Average director tenure and the mix of tenures on a board have become common proxy disclosures and discussion points with investors who believe that “lengthy” director tenure may compromise board independence, represent stale skill sets and impede increasing board diversity. Finally, the adoption of limits on the number of public company board seats a director may hold — as part of proxy advisory firm voting guidelines and the voting policies of large asset managers and other investors, as well as by companies themselves — has reduced the number of boards on which many directors serve, resulting in public companies needing to expand the pool of potential directors.

In contrast to the structural changes described above, the shareholder proposal process and proxy advisory firm voting

recommendations have played a less prominent role in bringing about these changes. Although shareholder proposals have addressed these matters, particularly on disclosing a skills matrix and increasing board diversity, the vast majority of these proposals have been withdrawn following company engagement with the shareholders and company adoption of enhanced disclosures or policies. Proxy advisory firm policies on director diversity and overboarding arguably have been less impactful than — and in some cases have lagged behind — voting policies and engagement on these matters by large asset managers such as BlackRock, State Street and Vanguard.

Environmental, Social and Governance

The level of ESG-focused investment continues to grow, and ESG funds continue to form. ESG investing takes a variety of approaches, such as making investments in companies viewed as positively addressing environmental or social issues, choosing to exclude from portfolios companies in certain industry sectors viewed as problematic, or integrating ESG data into an assessment of risk-adjusted returns to make investment decisions. The growth of ESG investing has caused a proliferation of ESG ratings and scores, which are often based on incomplete or incorrect information and employ a wide variety of methodologies. Due to investor demand and a need for companies to tell their own ESG stories, 86% of S&P 500 companies have chosen to publish sustainability or ESG reports, according to the U.S. Chamber of Commerce.

On the shareholder proposal front, for the third year in a row, environmental and social proposals represented the largest category of proposals submitted, many of which were withdrawn following company engagement with the proponents. Median shareholder voting support for these proposals continues to increase,

with approximately two dozen receiving majority support over the last two years. These majority-supported proposals span a wide range of topics, including climate change and other environmental issues, political and lobbying expenditures, workforce diversity, gun safety and opioids.

A related debate has been taking place among companies, investors, politicians, academics and others concerning whether corporations have a responsibility to stakeholders other than shareholders. The Business Roundtable issued its “Statement on the Purpose of a Corporation,” in which the signatory CEOs committed to delivering value to all stakeholders, including customers, employees, suppliers, communities and investors. Some interpreted the statement as a way to avoid accountability to shareholders, while others viewed it as simply a statement of good business practices and a reflection of what companies were already doing. As we have previously written, the shareholder primacy rule applicable to Delaware corporations has sufficient flexibility for directors to consider nonshareholder stakeholder interests so long as the board, in its business judgment, determines that the action being taken has a sufficient nexus to shareholder welfare. (See [“Social Responsibility and Enlightened Shareholder Primacy: Views From the Courtroom and Boardroom”](#) and [“Putting to Rest the Debate Between Corporate Social Responsibility and Current Corporate Law.”](#)) In light of the upcoming presidential election, expect the debate about the role of business in addressing societal issues to continue. In 2018, for example, presidential candidate Sen. Elizabeth Warren introduced the Accountable Capitalism Act, which would require companies with more than \$1 billion in revenue to obtain a federal charter stating the company’s “purpose of creating a general public benefit,” defined as “a material positive impact on society resulting from the business and operations” of the company.

In the case of environmental and social (E&S) matters, the shareholder proposal process has played a clear role in increasing company-shareholder engagement on these topics, as evidenced by the withdrawal of a significant number of proposals and the increasing number of proposals that achieve majority support. Proxy advisory firm voting recommendations may have some impact on the margins. Nevertheless, the primary driver of change in this area stems from the significant growth in ESG-based investing, and that growth is expected to continue for the foreseeable future, as upcoming generations of investors appear to have a greater interest in socially responsible investing.

In fact, these trends may accelerate rapidly following BlackRock's January 2020 announcements relating to ESG and sustainability. In his annual letter to CEOs, titled "A Fundamental Reshaping of Finance," BlackRock's CEO Larry Fink stated that BlackRock's "investment conviction is that sustainability- and climate-integrated portfolios can provide better risk-adjusted returns to investors." In a companion letter to clients, BlackRock stated its belief that "sustainability should be [BlackRock's] new standard for investing" and that it would be significantly expanding its sustainable investing client offerings and further integrating sustainability into its investment processes.

SEC Proposals, Investor Reaction and Possible Impact

In November 2019, the SEC proposed rules relating to the shareholder proposal process and to proxy advisory voting recommendations. (See "[SEC Proposes Amendments to the Proxy Rules Regarding Shareholder Proposals and Proxy Voting Advice](#).") The period for public comment on the proposals extends into February 2020. Some business groups, such as the U.S. Chamber of

Commerce, have voiced support for the SEC's proposals, while investor groups, such as the Council of Institutional Investors, have been critical.

Although it may be difficult to predict the precise impact or unintended consequences of these proposals, if adopted, two things are clear: Both the shareholder proposal process and proxy advisory firm voting recommendations will remain part of the governance landscape. On the margins, some proponents may become ineligible to submit proposals and some proposals may not achieve enough voting support to be eligible for resubmission. Perhaps shifts will occur with regard to the particular shareholders submitting proposals and the particular companies receiving them. In addition, although some of the largest asset managers have expanded their internal governance analytical teams, investor demand for proxy voting advice will remain. Proxy advisory firms may have to enhance their procedures and incur more costs, which likely will be passed on to investors, but they will continue to offer voting advice, which will continue to not always align with companies' recommendations.

Nevertheless, the impact may be that some shareholder concerns no longer make it onto the company ballot with an opportunity for shareholders to express their views. How will shareholders react if, in fact, they feel stifled? Arguably, providing investors with an ability to voice concerns at the ballot box has proven beneficial in another instance — when investors were given the chance to express their displeasure regarding executive compensation issues with say-on-pay votes, negative votes against members of compensation committees decreased. If investors are displeased with a company's record on an issue that might otherwise have been expressed through a shareholder proposal vote, they may simply choose to vote against directors more frequently.

In fact, if investors have fewer opportunities to raise concerns via the shareholder proposal process, those concerns may take the shape of "vote no" campaigns against directors. Furthermore, as investor focus on ESG continues to evolve, "vote no" campaigns may revolve around ESG issues. For example, in 2017, the New York City Comptroller launched a "vote no" campaign against a director at an energy company that had publicly embraced reducing greenhouse gas emissions because the director allegedly had a history of climate change denial. Although that example presented an unusual fact pattern, investors might launch similar campaigns based on a company's ESG record rather than advocate for ESG changes through submission of a shareholder proposal.

Moreover, having achieved proxy access rights at a substantial majority of S&P 500 companies, investors might simply nominate a candidate with stronger ESG credentials. When announcing his campaign advocating for disclosure of a skills matrix, the New York City Comptroller tied the information to informing investors' use of proxy access. Although that phenomenon has not yet been seen, perhaps changes to the shareholder proposal process could increase the risks of proxy access nominations.

Directors face challenges navigating the business landscape of disruption, artificial intelligence, cybersecurity and trade wars, among other issues. Understanding what ESG matters are material to a company's business and how to address them in a way that creates long-term value is an additional challenge. Potentially entering a phase where those ESG questions play a heightened role in director elections, and maybe even in proxy contests, will only make those challenges more difficult and directors' positions more precarious.