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Protect the value proposition

If most directors are earnestly at work on behalf of the shareholders, why are there so many reform proposals that could potentially diminish the effectiveness of boards?

By Frank Aquila and Jenne Britell

In the wake of the fallout from the financial crisis, pressure is mounting for further corporate governance reform.

Corporate governance is not just designed to avert the next disaster. In modern capitalism there is a distinct separation of *ownership*, the shareholders, from *control*, the board of directors and senior management. The cornerstone of U.S. corporate governance, indeed its core principle, is reliance upon the board of directors to act on behalf of the shareholders.

The willingness of investors to purchase a corporation's shares is based not only on the performance of the business but also on the trust in that corporation created by effective governance. Studies have shown that over time, companies with independent boards of directors produce greater returns on shareholder equity, achieve higher profit margins, and return more capital to their investors than competitors without independent boards. For us, that is the value proposition in good corporate governance.

Although some corporate governance proposals focus on measures designed to increase shareholder influence, many proposals go well beyond traditional governance concepts. Corporate proxies and Congressional bills are replete with proposals on executive compensation, social responsibility, global warming, sustainability, and political contributions.

It has long been the premise of American capitalism that profit and return on investment to shareholders are the primary indicia of business success. With that premise as a guide, corporate governance mechanisms should be designed to increase, rather than decrease, the likelihood that directors will be able to enhance the corporation's capacity to create value for its owners.

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What the best do

What many reform proposals fail to recognize is that adherence to rules alone does not equate to effective corporate governance. Adding value requires qualitative, as well as quantitative, actions by directors.

As anyone who has spent time in a boardroom knows, the characteristics of a good director and an effective board are both readily apparent and rather illusive. Most directors are serious and dedicated individuals who seek to do a good job for the corporation and its shareholders. Independence, personal integrity, and commitment to board service are essential for any director. While these characteristics may be the irreducible minimum, the best directors bring much more to the boardroom.

The best directors leverage their experience while working collectively with other directors and management. The best directors spend time learning about the company and its business. They anticipate changing strategic needs while addressing the cogent issues of the day. These directors are focused

on strategic imperatives while providing critical oversight. The very best directors show flexibility and the ability to change perspective as the economic and competitive landscapes change.

Boards that have a critical mass of good directors, working with management and following best practices, are able to deliver on the value proposition. In our experience, most boards are effective and working on behalf of their shareholders.

Why all this 'reform'?

So, if most boards are earnestly at work on behalf of the shareholders, why are there so many corporate governance reform proposals that could potentially limit effective directors and diminish the effectiveness of boards? We believe that there exists at least three reasons:

• First, some in the media find it convenient to explain negative outcomes as the consequence of directors' failure to act. Aided by hindsight, these reporters, expressing themselves in sound bites, have conveyed the impression that harm has been caused by governance lapses even when corporate governance has not been at fault, or even relevant, to the particular problem.

• Second, directors who act appropriately in the shareholders' interests rarely speak out in their own defense. Nor, unfortunately, do directors seek out legislators and regulators to provide them with a better understanding of the workings of the boardroom. Most directors still hold to the traditional view of "discretion is the better part of valor."

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• Third, rules are written to prevent egregious behavior rather than to foster excellence. As we have experienced over the last eight years, this premise is clearly evident in some aspects of the Sarbanes-Oxley Act. It is simply easier to draft rules aimed at preventing bad behavior than it is to develop a system that encourages good behavior.

For corporate governance to deliver on the value proposition, boards also need to recognize and balance the legitimate interests of all stakeholders. Few businesses can achieve long-term profitability and growth if they are at war with employees, consistently violate the law, or are in conflict with the communities in which they operate. Boards of directors need to recognize the legitimate and changing roles of all corporate constituencies, just as they recognize and act on changing market needs.

If we go beyond the basic corporate governance principles that have worked so well, we risk damaging good and effective governance and its positive influence on the corporation along with it. The farther corporate governance strays from the core, the less likely it is that directors, and the corporations they oversee, will be able to fulfill their fundamental mandate of increasing shareholder value while providing economic growth for society. In short, we risk losing the value proposition. ■

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