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Board Composition

Seeking: Corporate Board Candidates With Industry Knowledge, Board Diversity

Boards that do not have directors with industry expertise run the risk that shareholders will use proxy fights or proxy access proposals to “run competing slates of directors,” said Charles M. Elson, director of the University of Delaware’s John L. Weinberg Center for Corporate Governance.

Activist investors increasingly are making compelling, logical arguments that boards are not functioning properly because they lack members with industry expertise, he noted during a June 15 webcast sponsored by PricewaterhouseCoopers LLP groups and the Weinberg Center. Elson added that these arguments are grabbing the attention of large institutional investors, who often make the difference in proxy fights.

“If you have a choice between candidate ‘A’ who is simply independent and candidate ‘B’ who is independent and understands [the industry], B is a lot easier to choose,” he said.

Elson and his co-panelists discussed ways to address board composition issues like expertise, as well as diversity.

‘Management Captured Board.’ Last year, Elson and Ann C. Mulé, associate director for the Weinberg Center, co-authored an article on the dangers of searching for directors without considering whether they have knowledge of the company’s business or industry (12 CARE 1686, 12/12/14).

They found that these companies are at risk of having a “management knowledge-captured board”—where the board is comprised of independent outside directors who may be inadvertently and unknowingly deferring to the chief executive officer, particularly on decisions that require industry knowledge.

During the webcast, Elson said that when an independent board has no idea what management is telling them, directors cannot effectively do their job.

Mulé added during the webcast that this issue is particularly important because industry expertise is critical to understanding competitive threats and strategic opportunities.

Becoming More Mainstream. According to Mulé, industry expertise has always been important, but some recent activist fights have thrust this issue into the spotlight.

Elson noted that not only were some of these recent campaigns successful, but they also sparked the atten-

tion of a corporate community that was not focusing on this issue.

He added that a lot of large institutional investors are now focusing on what skill sets are necessary to populate an effective board, instead of more traditional topics like staggered boards and poison pills.

Mulé pointed out that some activists are no longer just choosing directors affiliated with their own hedge fund, but instead opting for qualified candidates with industry expertise and other important functional skills.

What is interesting is that years ago these highly qualified individuals may not have agreed to stand on a dissident slate, she said, adding that a real takeaway is that being associated with an activist investor is becoming more acceptable and mainstream.

Board Diversity. The panelists also discussed another important board composition topic: boardroom diversity.

Kayla Gillan, a leader at PwC’s Investor Resource Institute, said this is one area where there is a huge gap between investors’ and directors’ views, as well as among directors depending on their gender.

Gillan observed that investors point to lack of focus by the board to increase gender diversity, whereas directors said they were either unaware of diverse candidates or think there are an insufficient number of qualified candidates.

According to PwC’s “2014 Annual Corporate Director Survey,” female directors were far more likely to believe diversity is important, with more than 60 percent “describing gender diversity as very important, compared to only one-third of males.” The report additionally found that more than 40 percent of female directors “describe racial diversity as very important versus only one-quarter of their male counterparts” (13 CARE 1017, 5/15/15).

Gillan said the industry seems to be heading in the right direction on this issue, citing recent reports that show progress in increasing boardroom diversity. However, she added, when considering that the majority of directors on boards are men and that men don’t think gender diversity is important, that creates an environment where a lot of change likely won’t happen quickly.

Part of the solution is being deliberate and understanding that companies need to put diversity in their search programs, she added. This includes reconsidering screens that eliminate qualified candidates.

Mulé added that one of the consequences of focusing on industry expertise is that it will widen the pool of qualified directors to include more diverse candidates.

Board Refreshment. However, for many companies, obtaining more diverse boards with expert directors may not be possible without effective board refreshment practices, according to Elson. This is a way to get diverse directors on board that can do their jobs effectively.

He said the most effective way to achieve board turnover is through age or term limits.

Board evaluations are ineffective and problematic because sometimes they are used to drum perfectly valid viewpoints that challenge the majority, he said, whereas age and term limits provide a neutral, fair way to rotate the board. He added that any term limit beyond 15 years is probably too long.

PwCs Investor Resource Institute and its Center for Board Governance, along with the Weinberg Center sponsored “Current Issues Related to Board Composi-

tion: Avoiding the Crosshairs.” The presentation was provided for general informational purposes only.

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PwC’s 2014 Annual Corporate Director Survey is available at <http://www.pwc.com/us/en/corporate-governance/annual-corporate-directors-survey/assets/annual-corporate-directors-survey-full-report-pwc.pdf>.

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