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Via U.S. Post & Email

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Dear Adrian and Ira,

I want to join everyone else in thanking you for such a splendid contribution to our collective understanding in *The New Agenda for the ICGN*. The narrative flow and historical scholarship are splendid. What sets this piece apart is the utter honesty with which you treat the uncertainties and vagaries that plague our field. The paper has stimulated me to confront again one of the major conundrums in our field. As you summarize part one (emphasis added to your text throughout) **as the linchpin connecting investors and management, boards are necessarily the point of focus.** {14}

The almost desperate focus on Board, as presently structured, as the *sine qua non* of effective corporate governance persists. Discussion about boards of directors is always confusing. There is no general agreement on the optimum scope of board functioning and responsibility. Indeed, in a current book Jay Lorsch and Marty Lipton conclude: "It is not an exaggeration to say that directors operate in a vacuum as to the purposes boards ought to be pursuing."¹ The range of possible director concern can be, therefore, as narrow as compliance with law and as vast as the human imagination. At what point in this spectrum can directors be satisfied as having discharged their "linchpin" responsibility. **Boards should be urged to**

¹ Restoring Trust In American Business, (American Academy of Arts and Science, 2005) at p. 74

assure themselves that their responsibilities are realistic and capable of being fulfilled, not just enumerated {27}. Yes, but is the scope of their accountability to be entirely within the definition of boards?

Peter Drucker has long raised the question as to whether the current standard of board functioning is so unsatisfactory as to require structural change. - "Whenever an institution malfunctions as consistently as boards of directors have in nearly every major fiasco of the last forty or fifty years it is futile to blame men. It is the institution that malfunctions."² In the years subsequent to Drucker's characterization, the inability of any portion of the governance structure to deal effectively with holding top management to account - the "smoking gun" being executive compensation - compels the conclusion of continuing systemic board failure. If the shareholder cannot hold the CEO accountable for his compensation, he has no right to assume that he exercises effective accountability in any other area.

Notwithstanding much talk of recent reform in the US, it is well to understand that we are "[l]eft unaffected and decidedly non uniform re many other important components of the new consensus view, including the composition, selection, and authority of the board of directors as a whole, the composition and authority of other board committees, and the development and content of codes of business conduct and committee charters."³

No matter what ultimately emerges as a generally accepted definition of optimum scope for board responsibility there is a continuing fixation that some majority of the directors should be found to be "independent". Analysis of previous board malfunction is virtually overwhelmed by the insistence on yet larger majorities and more extensive definitions of "independent" - "At present the consensus view as to corporate governance best practice is so dominant that it is difficult even to suggest that further empowerment of an independent monitoring board may not be the solution to the current round of corporate scandals and flagrant abuses. Nevertheless, after watching independence and empowerment ratcheted up and up and up for 30 years, our conclusion is that enough is now enough. It is time to recognize that other best practice models of corporate governance need to be evaluated..... The point is that by turning the corporate board into the 'monitor' of corporate management, we do not appear to have been able to stop the scandals and flagrant abuses, and we may well be losing the vision, advice, and competitive perceptiveness that a good board should be providing the CEO. Surely there must

² Drucker, Peter, "The Bored Board," in *Towards the New Economy and Other Essays*, (Harper & Roe, New York 1981), 110

³ Harris, Alton B and Andrea S., *Corporate Governance Pre Enron, Post Enron, Corporate Aftershock The Public Policy Lessons from the Collapse of Enron and other Major Corporations*, Ed. By Christopher L. Culp and William A. Niskanen, (John Wiley & Sons, 2003),49,71

be better ways to deal with the consequences of the separation of ownership from control in the modern corporation. The time has come, we believe, to think outside the consensus box."⁴

The dominant characteristic of today's board is its capacity to self-perpetuate. **"Boards are, in fact, still self-perpetuating, absent a calamity."**{16} The only individuals presently capable of election are those whose names are placed on the company proxy card and prospectus. We need to ask at the outset: "Can any participant in a self-perpetuating process be considered to be 'independent' of those making the appointment?" Both those who have served on boards and those scholars who have pondered this question know the answer to be negative. There is always a reluctance to confront, embarrass and combat someone who has conferred a favor; there is always reluctance to join a club just to attack it, irrespective of the issues involved. My own experience is, inadvertently, instructive. It was my practice as an "independent" director of Tyco to communicate directly and privately with the CEO/Chairman my reservations about board functioning. I abstracted some portion of this correspondence and published it in Nell Minow's and my case book.⁵ April 21, 1992 - "The beginning of the meeting in Wisconsin, I asked the "insiders" to leave so that the Board could better consider the question of compensation. The insider directors neither addressed my request nor did they leave. This put me into a most difficult position. Either I had to press my point, which would tend to introduce a confrontational element into our board culture for the first time in my experience, or acquiesce. In doing the latter, I am conscious of having tolerated, even encouraged, a coerced and impoverished discussion of the compensation issues. I, personally, tried to make clear as tactfully as possible that I have been very uncomfortable with the level of compensation to "X". Candor tends to get lost in politeness..." A later suggestion of mine that the Board formally assess its effectiveness resulted in my being asked to leave the Board. The outcome is history and hardly an endorsement for the efficacy of what I think clearly was "independence" in a director.

Unhappily, all of the definitions of independence have their principal impact – not in assuring meaningful independence – but in providing a safe harbor to accommodate "reliable" nominees. Under virtually all of these painfully wrought legalisms, the board ultimately has the authority to determine whether "conflict of interest" has a material adverse impact on the corporation and, therefore, whether an individual is "independent", thus embedding the culture of self-perpetuation.

Corporate America has opposed even a scintilla of suggestion that shareholders participate in the nomination of board candidates. Former SEC Chairman Donaldson's proposal for token shareholder involvement was so plainly

⁴ Ibid, at 78

⁵ Monks, Robert A.G. and Minow, Nell, Corporate Governance, 3rd Ed. (Blackwell, 2004) at p. 504

unsusceptible of leading to the election of a director that one is bewildered by the violent rhetoric of opposition. The usual reason adduced for this vehemence is the essentiality of maintaining the confidentiality and collegiality of board functioning. Sherlock Holmes would look further, but we need not do so here.

Perhaps, it is time to recognize that a fundamental and irreconcilable conflict exists in the perception of what boards should do and how they should be constituted. Our efforts to achieve functionality within the context of the traditional single board can be understood as the metaphoric inability to square a circle. We cannot hope to make progress until - once and for all - we face up to the reality that a self selecting board cannot ever meet the very real needs for independence at critical points in the governance structure. At the risk of offending Aristotelian purists, let me attempt a syllogism:

Independent directors are essential to good governance
Directors selected pursuant to a self selecting process cannot be
considered in any meaningful way to be independent
Therefore, good governance requires something other than a board of
self selected directors.

A solution might be to recognize that there is no solution logically possible within the framework of a single board - there are some board functions that utterly depend on collegiality and confidentiality; there are other board functions that absolutely require the undisputed "independence" of director. Why not base the design for governance structure on the incompatibility of collegiality and independence. A self perpetuating board might be the optimal instrument for strategy, succession and compliance. **It has been suggested that boards focus primarily on strategies to maximize the long-term sustainable value of the company...** {27} Indisputable independence seems essential in those areas where conflict of interest between shareholder and managements are inescapable. The current board design might be ideal for strategic guidance and executive appointment and succession. **Without the threat of active and engaged shareholders, the entire corporate system lacks its basic foundation.** {17} Enabled shareholder involvement might prove the best way to discharge governance responsibilities involving conflicts of interest.

A beginning point might be a shareholder proposal I first put to Exxon Mobil a dozen years ago. In order to enable the initiative of shareholders, I proposed a new Shareholder Advisory Committee at the 1992 Exxon Annual Meeting, the full text of which follows: which the SEC required the company to include in its proxy.

RESOLVED: To adopt the following new by-law:

Article IIIA

COMMITTEE OF SHAREHOLDER REPRESENTATIVES

1. The corporation shall have a committee of shareholder representatives consisting of three members. The committee shall review the management of the business and affairs of the corporation by the board of directors and shall advise the board of its views and the views of shareholders which are expressed to the committee. The committee may, at the expense of the corporation, engage expert assistance and incur other expenses in a reasonable amount not to exceed in any fiscal year \$.01 multiplied by the number of common shares outstanding at the beginning of the year. The committee shall be given the opportunity to have included in the corporation's proxy statement used in its annual election of directors a report of not more than 2,500 words on the committee's activities during the year, its evaluation of the management of the corporation by the directors, and its recommendations on any matters proposed for action by shareholders.

2. The members of the committee shall be elected by the shareholders by plurality vote at their annual meeting. Elections of members shall be conducted in the same manner as elections of directors. Each member shall be paid a fee equal to half the average fee paid to nonemployee directors, shall be reimbursed for reasonable travel and other out-of-pocket expenses incurred in serving as a member, and shall be entitled to indemnification and advancement of expenses as would a director.

3. The corporation shall include in its proxy materials used in the election of directors nominations of and nominating statements for members of the committee submitted by any shareholder or group of shareholders (other than a fiduciary appointed by or under authority of the directors) which has owned beneficially, within the meaning of section 13(d) of the Securities Exchange Act of 1934, at least \$10 million in market value of common stock of the corporation continuously for the three-year period prior to the nomination. Nominations must be received by the corporation not less than ninety nor more than 180 days before

the annual meeting of shareholders. The corporation's proxy materials shall include biographical and other information regarding the nominee required to be included for nominees for director and shall also include a nominating statement of not more than 500 words submitted at the time of nomination by the nominating shareholder or group of shareholders.

4. Nothing herein shall restrict the power of the directors to manage the business and affairs of the corporation.

5. This Article IIIA shall not be altered or repealed without approval of shareholders.

This new committee, authorized by a by-law amendment {possibly it would work better as part of the corporation's charter}, would consist of three paid representatives elected by the company's largest institutional shareholders; it would be funded with a penny a share by the company itself, and have a right to meet with the company, involve itself as it saw fit in company affairs and publish its views annually in the proxy statement. This is one way to deal with the adverse problems of "collective action" or "free riding" and to make possible economically rational involvement by conscientious fiduciaries **Institutional investors must first overcome the collection action - and related free rider - problem that plagued earlier reform efforts. {28}** and other shareholders. It would enable shareholders to deal directly with issues involving conflicts of interest.

I am more comfortable with this analysis respecting American companies as I lack directorial experience in PLCs. Even though the practical problems of realizing even a smidgen of what optimistically might be viewed as correct analysis are stupendous, it is sometimes helpful to have clear statement of what one is trying to achieve.

Your friend,

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