Forty years of corporate governance

What we have today is nearly unrecognizable from that of 1976. By Howard Brod Brownstein

Howard Brod Brownstein is president of The Brownstein Corporation, a nationally known turnaround management and restructuring firm headquartered in the Philadelphia area. He has served as an independent corporate board member for publicly held and privately owned companies for over 40 years, and currently serves on the boards of A.M. Castle & Co., PICO Holdings Inc., where he is audit committee chair, and P&F Industries Inc., where he chairs the nominating & governance and the strategic planning & risk assessment committees. He is president of the Philadelphia Chapter of the National Association of Corporate Directors and as an NACD Board Leadership Fellow he is a regular speaker at national organizations.

In the spring of 1976, I was honored to publish an article in the very first issue of Directors & Boards. My article, "Audit Committees and Lawyer-Auditor Conflicts," had grown out of my final paper in the JD/MBA program at Harvard from which I'd just graduated. It explored the tension between, on the one hand, a company's duty to disclose contingent liabilities, including actual or threatened litigation that might have a material financial effect, and on the other hand, the attorney-client privilege and the company's understandable desire not to engender otherwise avoidable litigation or embolden litigants. FASB 5, "Accounting for Contingencies," had just been promulgated the prior year, and attorneys, auditors and boards of directors were struggling to deal with these competing considerations, which clearly impacted corporate governance as it then existed. *(See accompanying sidebar for an excerpt from the article.)*

The ensuing 40 years have seen a coming-of-age in corporate governance. With many exceptions of course, back then the typical board of directors was less a force for risk oversight and managerial accountability and more a supra-management layer for box-checking the requirements of corporate existence, often composed of long-serving "old boys club" members, concerned more with holding off "corporate raiders" than with such current topics as strategy, risk, compliance, management succession, etc.

Fast-forward to 2016, and the corporate governance of today is nearly unrecognizable from that of 1976. "Best Practices" in governance are referred to regularly, and are steadily evolving. "Shareholder Activism" has gained general respectability, with many large institutional investors creating "governance departments" that are increasingly willing to listen to activists, and in some cases, join in their causes. Long-serving board members might be seen as an asset, but the need for "board refreshment" is becoming a countervailing and possibly greater force. Corporate governance now enjoys far more recognition and importance in the mind of investors, regulators and executives alike than 40 years ago. Whereas management formerly led, and boards and shareholders followed, increasingly boards are expected to lead by being involved in formulating (or at least deciding upon) strategy, and then monitoring management's performance in implementing that strategy.

Academic commentators do not agree upon the forces that led to the corporate governance of today or their relative importance, but among those mentioned are:

- The Penn Central Securities Litigation in the early 1970s following that railroad's landmark bankruptcy, wherein the SEC sued directors for failing to oversee management properly.

- The Foreign Corrupt Practices Act, passed by Congress in 1977 in response to reports of widespread corporate bribery in other countries.

Continued on page 24

IN MY 'DAY JOB' AS A TURNAROUND MANAGEMENT PROFESSIONAL, I HAVE SEEN HOW GOOD CORPORATE GOVERNANCE ADDS VALUE AND REDUCES RISK.

Continued from page 20

• The SEC's lengthy hearings in 1977, resulting in requiring publicly traded firms to disclose director independence and the use of board committees.

• The late Senator Howard Metzenbaum (whom I once had the honor of meeting) pushing for legislation providing increased focus on shareholder rights in federal securities regulation, roughly contemporaneously with the extension of consumerist efforts led by Ralph Nader and others to the accountability of large companies, moving corporate governance into the mainstream of government policy, eventually resulting in a series of laws and regulations that still continue to develop.

• Groups such as the American Bar Association (of which I am currently serving as programming co-chair of its corporate governance committee), the American Law Institute, and the New York Stock Exchange leaping into the fray with study groups and white papers, along with law school academics, resulting in "Corporate Governance" eventually becoming a recognized field of study, and listed practice area of most major law firms.

Howard Brod Brownstein

• The advent of LBOs and "corporate raiders," the often-criticized payment of "greenmail," etc.

• The rise of institutional investors and pension funds, and their growing proportional share of shareholdings, providing a more focused and vocal force in "shareholder democracy," and leading to the establishment of such groups as the Council of Institutional Investors (CII) and the National Association of Corporate Directors (NACD), as well as additional laws and regulations strengthening the rights of shareholders.

• Increasing focus on executive compensation and its relationship to company performance and its alignment with shareholder interests, eventually leading to "say on pay" regulations.

• Increasing emphasis on growing long-term enterprise value, as opposed to meeting quarterly earnings projections and dividends, as even iconic companies became acquisition targets, and as economic globalism revealed contrasts between how American companies were managed versus their competitors in Germany, Japan and, especially, China.

• A corresponding convergence by foreign companies to adopt more American-style corporate governance, as they increasingly sought capital from U.S.-based or multinational sources and responded to such events as the Asian stock market crash of 1997.

• Economic crises such as the dot-com bubble and the Great Recession, and such failures as Enron — spotlighting corporate governance as a (possibly overestimated) contributing cause, and resulting in legislative "fixes" such as Sarbanes-Oxley and Dodd-Frank, which are considered to have had some beneficial effect, but also to be overbroad.

• Litigation — which has replaced baseball as the national pastime — has developed into one of the main tools utilized to make

Continued on page 26

THE PAST 40 YEARS HAVE SEEN A COMING-OF-AGE IN CORPORATE GOVERNANCE.

Continued from page 24

boards accountable, just as boards are required to hold management accountable.

(See Brian R. Cheffins, "The History of Corporate Governance," European Corporate Governance Inst., 2012, in which many of the above developments are suggested.)

Governance matters

The result of all of these forces and trends after 40 years has been a widely held conclusion, especially among institutional investors, that "corporate governance matters" and can often lead to a higher share price, among other benefits.

In my "day job" as a turnaround management professional, I have seen how good corporate governance adds value and reduces risk, and have witnessed many instances where better governance would likely have led to a far better outcome for shareholders and other stakeholders. In particular, having at least some board members who are truly independent — not just meeting the SEC bare minimum definition, but having little or no connection with any insider or shareholder, social or otherwise, and who are therefore likely more willing to "speak truth to power" — is critical, including in privately-owned and even family-owned businesses, and non-profits as well.

While it's impossible to predict accurately the future trajectory of corporate governance, the strong likelihood is that the trend toward stronger corporate governance — and the general perception that this is good for companies and the economy — will continue. ■

First-issue guidance on how to protect yourself

Ed. Note: As Howard Brod Brownstein mentions in his main article above, he wrote an article for the very first issue of *Directors & Boards*. Following is a passage from that article, "Audit Committees and Lawyer-Auditor Conflicts" [Spring 1976].

Most directors are aware of the perils of being party to a "material misstatement" in their company's public financial reports, but few realize that directors are already caught up in a dangerous crossfire between auditors and outside counsel in the debate over the reporting of contingent liabilities, which could lead to a Hobson's choice of directors' liability for deficient public disclosure on the one hand, or damage to the confidentiality of their company's relationship with counsel through excessive disclosure, on the other.

It is ultimately the director's responsibility to see that his company complies with disclosure obligations. The purpose of this article is to make directors and their advisors aware of the underlying issues, and to help them to manage their lawyers and auditors (both inside and outside). If a balance is to be struck to harmonize the ownership interests of the shareholders with both the letter and spirit of compliance regulations, it should be the directors who establish the standards of weight.

These issues are too broad to undertake complete exposition in this paper and our inquiry will be limited to the study of one symptom of the difficulty of resolution of these issues —lawyers' responses to auditors' requests for information. We will set forth what directors can and should do to protect themselves and their company. In addition to prescribing steps which directors should take, this article provides background for the director in areas which may be unfamiliar to him, such as: the danger of a qualified auditor's opinion, no matter how minor the qualification; the process of auditing contingent liabilities; the scope of the lawyer-client privilege; and the consequences of abdicating responsibility and letting others handle the problem.