

# A new kind of captured board

*What we should be worrying about: the ‘management knowledge-captured board.’*

BY ANN C. MULÉ AND CHARLES M. ELSON

IT MAY SEEM OVERLY OBVIOUS, but we will say it anyway. Boards of directors need people who know what they are doing. They also need people who have the objectivity to then follow through and make the best decisions for shareholders. What boards need are *industry-expert* independent directors.

We believe, as longtime governance advisors, that this issue is critically important. It is essential that most publicly traded U.S. companies have one or more independent directors with industry expertise represented on the board. Recent academic studies, Delaware litigation, and activist shareholder campaigns — and reason — support this view.

Good-governance advocates have long sought to dismantle the “management-captured board,” in part, by stressing the importance of board independence. Sarbanes-Oxley, Dodd-Frank, and the stock exchange corporate governance listing standards have largely codified an intensified board independence regime for public companies. The underlying belief was that board independence would strengthen a board’s ability to challenge management as appropriate from both a board monitoring and advising perspective. As a result, when seeking to fill a board seat many U. S. boards have searched for director candidates who are current or former CEOs or other C-suite executives who were “independent” without regard as to whether or not that individual was knowledgeable about the company’s business or industry.

Consequently, some boards are now comprised of all independent outside directors — none of whom possess industry expertise — and an inside CEO who is the only director with industry expertise. In our view, this situation presents a real danger of another type

of management-captured board: the “*management knowledge-captured board*.” In this situation, the independent board members may be inadvertently and unknowingly de facto deferring to the CEO, particularly as to decisions that require a deep knowledge of the industry or industry risk.

## Attribute most in demand

Directors and governance commentators are beginning to focus on this issue. A recent survey by PwC and a joint survey by Deloitte and the Society of Corporate Secretaries & Governance Professionals found that the most sought after new director attribute is industry expertise. Simon Lorne, former general counsel at the U. S. Securities and Exchange Commission, discussed in *DIRECTORS & BOARDS* last year the importance of director industry expertise and whether the focus primarily on director independence has been misguided. An NACD Blue Ribbon Commission on Director Professionalism has supported the view that each public company’s board should have one or more members with appropriate and relevant industry-specific knowledge. Large funds are concerned as well. Anne Simpson,



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director of corporate governance at the California Public Employees' Retirement System, commented to the *Wall Street Journal* on a board of a company that was experiencing regulatory problems which she believed exposed the lack of hard-core industry expertise on the board, stating: "It's like asking a bunch of dentists to perform brain surgery."

Good governance has long recognized the importance of director independence, director equity ownership, and a vigorous and responsive election process. Director industry expertise should be added to that list. This critical issue of board composition needs to be discussed and debated in all boardrooms throughout the country.

#### Activism's influence

Recent shareholder activism has demonstrated that having independent direc-

tors who possess industry expertise is an achievable goal. As such, there is no reason for boards not to ensure that they have the proper expertise and can therefore ask the right questions, add value to strategic discussions and be engaged in the most critical issues for the company. The 2013 proxy contest at Hess Corp. is a clear example of this and may be the prototype of an escalating trend in investor activism (*see sidebar*).

Similar activist campaigns are not uncommon.

Activist investors increasingly are relying on executive search firms to fill their slates. The move reflects a demand for sophisticated directors whose skills have been carefully considered during the selection process.

Independence in itself is not sufficient for nomination to an activist slate; the directors added in activist campaigns often have significant industry experience as well. Starboard Value settled with Office Depot, an office supplier, and three new directors were added to the board; one of them was the former vice chairman of Staples, a major industry competitor. In 2012, investment advisor HealthCor Partners Management LP succeeded in convincing Allscripts Healthcare Solutions to add three new directors, each with substantial industry experience. In a similar vein, Citigroup, reacting to this environment of enhanced scrutiny of director qualifications, bolstered its board capabilities by appointing the former head of Ernst & Young and the former CIO of General Electric. These additions were made to strengthen the audit committee and provide strong oversight and expertise for important operations and technology initiatives.

#### Litigation

A board may be better positioned in the event that certain litigation occurs if it has independent directors with industry expertise. In a May 2013 Delaware Court of Chancery decision, *In re Plains Exploration & Production Company Stockholder Litigation*, the plaintiff stockholders were seeking a preliminary injunction to enjoin the proposed merger of Plains Exploration & Production Co. with Freeport-McMoRan Copper & Gold Inc. The

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## Highlights from the Hess case

In early 2013, an activist hedge fund, Elliot Management, acquired a 4% stake in Hess Corp. and began clamoring for significant changes in board composition. In letters that were sent by Elliot to Hess's shareholders and filed with the SEC, Elliot expressed its concern about what, to us, appeared to be a management knowledge-captured board:

- "While the independent directors on the Hess board are accomplished in their fields, none (as in *zero*) have operating experience in the oil and gas industry."

- "By nominating five highly accomplished executives with substantial expertise and deep experience, we hope to provide shareholders an alternative to the poor performance and lack of accountability currently at Hess."

- "Leaders of this caliber would be a welcome addition to the board of any company. To Hess, they bring substantial, relevant experience in areas where the Company sorely lacks counsel and oversight."

Before the Elliot proxy fight, Hess had no directors with industry

expertise on its 14-member board. Eventually, Hess and Elliot settled hours before the annual meeting of shareholders and decided to offer a slate of candidates that consisted of three of Elliot's nominees and six of Hess's new nominees. At the end of the five-month proxy fight, Hess now had five directors with industry expertise among its 14 members.

This case highlights two important points:

1. If a company is not performing well as compared to its peers and its board has zero directors with industry expertise it may be vulnerable to shareholder activism similar to what happened at Hess.

2. Although many claim that it is difficult to find directors with industry expertise, Elliot was able to find four industry experts and Hess was able to find three within a short timeframe. A majority of these directors were former or retired oil industry executives from other energy companies. Retired industry executives are a rich segment of potential board members for companies to target.

— Ann Mulé and Charles Elson

plaintiffs claimed that Plains had failed to obtain the best available sales price in the merger (and also that it had not provided adequate proxy disclosures). Plains defended its actions in part by pointing to the fact that some of its directors had substantial experience in the industry, and could, as a consequence, be expected to have made an effective judgment as to fair value.

Vice Chancellor John Noble, in his opinion, agreed with them: “As the record reflects, the Director Defendants did not shop Plains or engage in a pre-agreement market check because they were focused on completing a deal with Freeport or going forward as a stand-alone company. Both options were financially attractive. One consequence of a single-buyer negotiation strategy is that it requires a board to rely more extensively on its own knowledge and the knowledge of its financial advisor in determining whether the proposed transaction is priced fairly. Arguably, neither option provides a robust determination of market value. . . . Plains has suggested that its directors, most of whom had significant experience in the oil and gas industry and as directors of Plains, were fully capable of making an informed decision. Although it is difficult from the record to assess whether the Board possessed impeccable knowledge of Plains’ business, the directors’ relevant expertise and experience support a reasonable inference that they were informed and competent to make an appropriate decision.”

The Plains board relied on the knowledge of its longtime financial advisor, Barclays PLC, and its own knowledge as a board. Vice Chancellor Noble found that the oil and gas industry expertise of the Plains directors supported a reasonable inference that they were capable of determining whether the transaction price was a fair one.

While not all boards may be faced with situations similar to the one faced by the Plains board, it would seem prudent for a board to have industry expertise represented in the event that a disputed situation arises.

### Academic studies

Recent academic studies have found that independent director expertise is positively associated with better monitoring, operating performance and shareholder value. In a forthcoming piece by Professors Cong Wang, et al. in the *Journal of Financial and Quantitative Analysis*, it was found that industry experience on the audit committee was associated with a reduced likelihood of fraud and earnings management and that industry expertise on the compensation committee generally

resulted in lower CEO compensation. It was also found that industry expertise on the board resulted in an increased likelihood that poorly performing CEOs were promptly dismissed and that those companies typically received higher returns on diversifying acquisitions.

In the paper “Do Independent Expert Directors Matter?” by Professors Ronald Masulus, et al., the authors state that their evidence suggests that independent expert directors have both the incentives and the industry-specific knowledge to more effectively monitor and advise CEOs than independent non-expert directors. The authors show that more powerful CEOs tend to avoid independent expert directors. They conclude that this is likely due to the fact that even though CEOs may like the improved firm performance due to better advising, they do not like the increase in the monitoring intensity associated with the appointments of independent expert directors. If a CEO’s goal is to have a “management knowledge-captured board” it may be to his or her advantage to have a board consisting of all independent directors, none of whom has industry expertise.

### A real risk

The management knowledge-captured board is a danger that boards should avoid. The only way to avoid “knowledge capture” is for one or more of the independent board members to be sufficiently equipped with industry knowledge to be able to appropriately and effectively challenge management. The cure for this is the industry-expert independent director.

The argument that the activist will make — that the board is not functioning properly because it does not have any board members with the requisite industry knowledge and experience to effectively oversee management — can be quite compelling in its logic and simplicity. All boards and governance committees should carefully review this issue. Shareholders are increasingly focused on the importance of independent director industry expertise. Boards that do not focus on this issue run a real risk those shareholders will do it for them. ■

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*One study concludes that more powerful CEOs tend to avoid independent expert directors.*