

The Government's giant shadow in the boardroom

Having regulators as a shareholder — and even sitting on the board — puts the independent directors in a troubling fiduciary situation: the government's objectives may conflict with the traditional goal of shareholder value creation.

BY CHARLES ELSON AND NICHOLAS J. GOOSSEN

The role of the government as a shareholder is in and of itself highly problematic. Yet, even more troubling to investors is the notion of the government as a member of the company's board of directors. The issues created by the government as a shareholder are only magnified when the government has more influence on the company's decision making through board membership.

Whether by direct representation or significant involvement in the nominating process, the government can have much influence over board function. It also has a major impact over corporate direction, focus, and director conduct. The government as an investor does not consider shareholder wealth maximization as its primary goal. The principal objective of the government is to bolster societal benefits, usually in the form of jobs and political rewards for the investment it is making. When the government is heavily involved in the corporate decision-making process, these incentives conflict with the traditional goal of shareholder value creation.

Thus, where the government demands and receives some form of board representation, the representatives find themselves in a troubling fiduciary position. Such representation creates three major problems. They include conflicting obligations imposed upon the government's representatives themselves, disruption to the ordinary function of the remaining directors,

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and, finally, an increased mistrust in the ability of the board to maintain the best interests of the public investor as they carry out their responsibilities.

Markedly different objectives

The government-anointed director is caught in a precarious position. A government's investment in a corporation differs markedly from that of the other shareholders. Governments are political creatures and make investments to meet political objectives such as job preservation or, in the case of the financial crisis, economic stabilization. Long-term investment return is not a primary, or perhaps even secondary, goal.

The government has the incentive to demand changes in corporate strategy to meet its own objectives, without regard to its impact on ultimate shareholder return. The notorious case involving political pressure on General Motors to keep certain facilities open to preserve jobs in a particular congressional district is a significant example of this problem. The governmental representative director is under tremendous pressure to support the demands of his or her sponsor.

Unfortunately, all directors, regardless of how they were selected, are subject to the same historic legal fiduciary obligation of making decisions that protect and ultimately enhance shareholder value. Actions that are contrary to this obligation run counter to the law and general investor expectations.

Therefore, the governmental director is in a fiduciary bind — constrained by law to support shareholder wealth accretion and yet, by appointment, to meet their sponsor's political expectations. This is an impossible position to occupy and incapable of effective resolution. Additionally, such a director's actions to support politically expedient yet value-destructive corporate activity leaves that individual open to potential legal action by the other shareholders on classic loyalty grounds. They are, in proverbial terms, "damned if they do and damned if they don't."

Governmental representatives on corporate boards are also problematic for the appropriate functioning of the remaining directors. Their presence creates a different tone in the boardroom. They do not merely represent a particular investor, but the sovereign whose ultimate power and influence is overwhelming in any setting. To dissent from their dictates does not involve merely disagreement with an investor's viewpoint but opposes the will of a nation, with

obvious potential consequence. The remaining board members have the real fear that the government, through regulatory fiat, may thwart their will or mandate their replacement should they be non-compliant with its goals.

The role of the government in various financial institutions, following the financial crisis, bears this point out well. The presence of such directors is stifling at best and suffocating at worse. With government delegates present, the other directors are under extraordinary pressure to accommodate them by making decisions considering the government's incentives — not those of the other shareholders and the corporation to whom they are legally bound.

Fueling greater mistrust

The final problem presented by the governmental director is external to the board in nature. When the government is an investor, its presence and purported influence over corporate affairs is widely expected and known to the other investors. With direct board representation, this influence becomes even more apparent.

Since the government's political objectives are generally detrimental to long-term shareholder value, this involvement is troubling to the investing community. The presence of governmental directors, whose significant influence is presumed, only fuels greater mistrust of the ability of the board to effectively promote greater efficiency and productivity on the part of management. This has a potential deleterious effect on share price and the corporation's ultimate success.

While the governmental director faces and creates obvious difficulties for the corporate organizations that they serve, the bigger issue concerns the government's financial involvement in the private sector altogether. For example, some have argued that government investment and board representation in Volkswagen led to the problematic culture and misalignment of incentives that created the current crisis the corporation faces.

Governments as equity holders and occupiers of board seats are, any way you look at it, bad news for their fellow corporate directors and, ultimately, the investing public. ■

THE GOVERNMENT-ANOINTED DIRECTOR IS CAUGHT IN A PRECARIOUS POSITION.

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'We have no good ways of handling this'

What happens when you start tinkering with a board's fiduciary duties to achieve other ends?

Ed. Note: The ramifications of having the government as a shareholder and possibly a board member are little understood or focused upon in the field of corporate governance. In conjunction with his exploring this topic for the main article above, Charles Elson assembled and moderated a panel of distinguished leaders in law and business to analyze the spectrum of issues that the topic raises. The resulting panel discussion was titled "The Government as Regulator and/or Shareholder: The Impact on Director Duties." It was held in October 2015 at the University of Delaware, under the auspices of the John L. Weinberg Center for Corporate Governance and co-sponsored by The Clearing House Association. Following are key observations made by each of the panel members.

What about the goal of profit maximization?

At first blush, the topic of government as shareholder seems to involve banking institu-

tions. But when you think about it, the government owned General Motors; the government owned AIG, an insurance operation; and the German government was a significant shareholder in Volkswagen, with the state of Lower Saxony owning about 20% of the company and having two board seats — which with the scandal over emissions rigging raises the question of whether it was a government agenda for the full employment of the citizenry of Lower Saxony that superseded any fiduciary agenda. Your goal as a director is profit maximization for your investors. The government, as a shareholder or significant regulator, may have different goals. What happens when the government's goals do not coincide with your goals? How, as a director, do you work through that?

— Charles Elson, Professor and Director, Weinberg Center for Corporate Governance

New drivers of board agendas

There are many different dimensions to this

topic. One aspect that we at The Clearing House have been focusing on is evaluating the impact of the cumulative regulatory requirements imposed on the board of directors of a banking group. These requirements, which are intended to serve public policy objectives, increasingly are driving board agendas of many financial companies and, therefore, in practice, are raising a new set of policy issues, such as what should boards of major financial institutions be focused on. Directors and officers at financial institutions are being confronted with the challenge of setting very busy agendas and priorities in line with both regulatory responsibilities as well as what may be characterized as the more traditional corporate law responsibilities to serve as a fiduciary to the company and to the shareholders. Having the most qualified and dedicated directors serve on the boards of our major financial institutions is a shared objective for the government, industry, and investor communities as well as the public at large.

— Gregg L. Rozansky, Managing Director, The Clearing House

Regulators have their place, but . . .

It is a question of who you are elected by. I am elected by the shareholders of JP Morgan, so that is who I work for. The bank has 180 regulators around the world. They have a function, and I respect that function. I spend a lot of time with the regulators. They are like everybody else — you have to communicate with them, just as you have to communicate with your shareholders. So while the regulators have their place, the 10 independent directors on the board have been able to run the company for the shareholders and, so far, the shareholders have rewarded us.

— Laban P. Jackson Jr., Chairman and CEO, Clear Creek Properties Inc., and Director, JPMorgan Chase & Co. (where he serves as Chair of the Audit Committee)

AIG's instructive lesson

The AIG bailout by the government was a unique set of circumstances but offers an instructive lesson. In setting up a trust to oversee its ownership of the AIG shares — I became a trustee of that trust — the government recognized that it is not a good idea to



Weighing in on the government as shareholder/board member are panelists (left to right) Collins Seitz Jr., Michael Wiseman, Peter Langerman, Giovanni Prezioso, Charles Elson, Mary Schapiro, Edward Rock, Amy Borrus, Rolin Bissell, and Laban Jackson Jr.

be supervisor, regulator, and owner because of the inherent conflicts in that arrangement. The trust structure was designed to separate out the ownership of the shares from the regulatory oversight. That was a smart move from a legal standpoint and from a business perspective because it preserved the differentiation between your roles as an owner and a regulator. Even the government understands that the shareholder primacy notion has to be maintained and that you really can't have the same person sitting in the regulatory seat and in the ownership seat.

— Peter A. Langerman, Chief Executive Officer, Franklin Mutual Advisors LLC

Preservation of safety and soundness

Putting aside the question of whether it would ever make sense for government representatives to sit on a corporation's board — an idea I find very problematic — there does not have to be inconsistency or conflict between the *goals* of government and the goals and duties of the board of a regulated entity. Business has lived with intense regulation for many decades in areas of health and safety, environment, labor, consumer/investor protection and others. The regulation of banks and systemically important financial institutions (SIFIs) has brought a new level of intensity to the role of supervisors with regard to how boards are functioning in terms of their strategy, operations, risk and oversight. My experience has been that there are lots of areas of common concern between regulators and the boards of financial institutions. Both want to preserve the safety and soundness of the institution and enhance shareholder value in sustainable ways. So while boards and management might recoil at the intervention of supervisors in areas that have traditionally been thought of as management's prerogative — for example, payment of a dividend or engaging in a stock buyback or other decisions impacting the level of capital — such involvement may be entirely appropriate and will make our financial institutions stronger, a goal that can be shared both by the board of directors and the regulators.

— Mary Schapiro, Advisory Board Vice Chair, Promontory Financial Group LLC, and former Chairman, U.S. Securities and Exchange Commission



Amy Borrus and Giovanni P. Prezioso: 'When the government takes a significant ownership stake in a company, its ultimate goals may be different and much broader,' says Borrus.

Enhancing the tension

While I agree that there is a fundamental alignment between the interests of the regulator and the corporation — ultimately, both want the enterprise to prosper — I'd argue that in today's environment, particularly in the financial services industry, there is for better or worse an even closer alignment. That's because of the nature of the regulation and the intense scrutiny by the regulatory community. Regulators are making it quite clear to the board that their concerns are to be met. And frankly, in a troubled institution, the directors as a practical matter probably think more about their potential liability to the government and the ways in which they can be pursued by the government than they do any other potential sanction that could be taken against them. That's just human nature. I also question the implications of the regulatory community focusing more on macroprudential regulation — looking at not just whether a particular firm is run in a safe and sound manner but whether it is run in a way that fosters the overall health of the financial system. The more we turn to using regulatory policy to advance macroprudential goals, the more we are enhancing the tension between the regulatory system and the interests of the shareholders of that particular institution.

—Michael M. Wiseman, Partner, Sullivan & Cromwell LLP

'What does the government want?'

When I am counseling companies and directors, what we end up talking a lot about is, "What does the government want?" In the last few years since the financial crisis, the degree of discretion given to the regulators makes it not so obvious what the government wants. There is not always agreement among the people who work at the regulatory agencies — even at the one where I am an alumnus, the SEC — about what needs to be done. The reason this is important is because when you are thinking about such issues as fiduciary duties and making business decisions, inherently there are risk trade-offs. If you look at what happened with the acquisition of Merrill Lynch by Bank of America in the financial crisis, how much of that deal was to achieve regulatory objectives is a really important question. If you were a director of Bank of America at the time, there was no one from the regulatory community who was going to come in and say, "Hey, this was the right fiduciary decision" — and take the responsibility for it. What's incumbent on the governmental community is to be clear about what its objectives are and to be willing to say in a clear way what it wants companies to do. That would make it a fairer trade-off on both sides of the risk equation.

— Giovanni P. Prezioso, Partner, Cleary Gottlieb Steen & Hamilton LLP, and former general counsel of the SEC



Delaware Supreme Court Justice **Collins J. Seitz Jr.**: 'In a highly regulated industry, it will not benefit the shareholders in the long term for the board to be picking a fight with its regulator.'

'Get in and get out'

The Council of Institutional Investors has a large and well-developed body of member-approved corporate governance best practices but none actually speaks to a director's fiduciary duties when the government is a significant owner or regulator. While the Council believes that it is appropriate for the government to exercise strong oversight of institutions that receive big dollops of federal assistance, this presents a real conundrum for shareholders. A director's duty of loyalty to shareholders is paramount; directors, generally speaking, are supposed to act in the best interests of the company's shareholders. When the government takes a significant ownership stake in a company, its ultimate goals may be different and much broader, which could take directors' attention away from maximizing shareholder value. The Volkswagen scandal is a cautionary tale of the risk to shareholders when the government is a significant owner. So while investors recognize that there are times when regulators have to step in, I think I am on safe ground in saying that Council members are interested in seeing the government get in and out as quickly

and efficiently as possible.

— Amy Borrus, *Interim Executive Director, Council of Institutional Investors*

What's different this time

It is not just a 'regulatory thing' that we're analyzing but a 'troubled company thing.' You don't see the government coming in and trying to buy 51% of Apple and telling Apple how to run itself. What we're looking at is the government as regulator and/or shareholder and/or lender/guarantor. The government has interests as a creditor in many of these troubled financial institutions. When you get into the troubled company area, a creditor's interests tend to diverge from the interests of the stockholders — so you have this additional tension. Delaware corporate law deals with this tension in its Section 303, which says basically to the extent there is a conflict between what Delaware corporate law requires and what the federal bankruptcy law requires, bankruptcy law wins. In bankruptcy, corporate governance as we know it would be suspended, but that suspension is for a temporary period, so nobody gets that bothered. What's different this time is that the federal government has come into a number of these institutions where it is a shareholder and it gives no indication that it is ever going to leave. If the regulators are going to stay, then we're going to have to figure out how the governance works with them in the house for an extended stay.

— Rolin Bissell, *Partner, Young Conway Stargatt & Taylor LLP*

The danger of 'crowding out'

Government as regulator is a perfectly traditional role. We have traditional ways of regulating and traditional ways of challenging government regulation. The Government as controlling shareholder is fundamentally different and, in the United States, extremely rare. It raises a whole host of issues that we do not have decent structures to handle. When the government as controlling shareholder makes the firm do something that serves a governmental interest but is not calculated to maximize firm value, our existing structures of accountability are ill suited to the challenge. Moreover, when you start tinkering with a board's fiduciary duties to achieve non-corporate ends, you run the

risk of undermining a system that has been developed over decades that works tolerably well by mixing in a variety of concerns that do not fit within the classical fiduciary duty construct. Additionally, when you impose a variety of regulatory burdens or regulatory responsibilities on the part-time independent outside directors, you will crowd out many of their traditional functions and responsibilities such as acting as a sounding board on corporate strategy.

— Edward B. Rock, *Saul A. Fox Distinguished Professor of Business Law, University of Pennsylvania Law School*

Of Delaware law and the government shareholder

In what I think of as three buckets, the first bucket is the ordinary regulatory environment whereby directors need to comply with the law. If directors are doing their best to comply with what the regulators are asking them to do, everyone can be thought of as working in the spirit of profit maximization for the benefit of the corporation and, therefore, the shareholders. Then you have a second bucket, what I call a corporate trauma bucket, which includes companies that are on the cusp of collapse or have liquidity problems or may not be complying with minimum capital requirements. With those you are not going to be talking a lot about fiduciary duties but about survival. The fiduciary duty, as a matter of primacy, is to do what the government wants so you can get the institution back on its feet, with the shareholders and creditors benefiting in the long term. The third bucket is the post-trauma bucket, which is where some institutions are right now. Speaking practically from my experience with AIG, the government as shareholder post-trauma basically is going to be able to tell the board what it needs to do. [Ed. Note: Prior to joining the Delaware Supreme Court in 2015 Justice Seitz was a litigator with a Wilmington law firm who represented the AIG board.] In a highly regulated industry, it will not benefit the shareholders in the long term for the board to be picking a fight with its regulator. In such a situation, Delaware law fiduciary duty principles are not well suited for dealing with the government as shareholder.

— Collins J. Seitz Jr., *Justice, Supreme Court of Delaware*