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The Case Against Stock Ownership Requirements for Directors

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During the last several years, the adoption by public corporations of stock ownership guidelines for nonexecutive directors has become increasingly prevalent. Generally, these guidelines provide for share ownership equal to a specified multiple of the board's annual cash retainer. Proponents of such measures believe it is important that directors have a significant equity investment in the corporation in order for their interests to be "aligned" with those of the corporation's stockholders. In general, the proxy disclosure for companies that have adopted such guidelines recite this "alignment of interests" as the basis for the recommendation by their boards or governance committees with little or no further discussion or analysis as to the actual impact of such guidelines on board or corporate performance. I do not believe the case for this premise has, in fact, been made and in my dual roles as a securities lawyer practicing in the public arena for more than 25 years and a member of the board of directors of a Fortune 500 company for the past six, I have come to believe that the potential pitfalls of stock ownership guidelines for directors may outweigh any perceived benefits.

I trace my view on this issue back to an experience I had as a young associate at an IPO boutique firm. I bought a few hundred shares of one of the firm's clients, a development-stage biotech company. Several months later the stock was trading up three points and, after confirming that I was not in possession of any material nonpublic information, I sold my shares. I was pretty content with my small profit until several days later when this issuer was featured on the television program "Wall Street Week." I arrived at the office the following Monday morning to a ringing phone. It was Nasdaq inquiring as to why the issuer's stock had opened more than 20 points higher than its prior close and whether trading should be halted. I remember the difficulty in stepping up to my role and responsibilities as legal counsel while thoughts of lost riches pounded in my head.

I learned something about myself (and human nature) that day and have chosen never again to own stock in a company for which I act as legal counsel. While the roles of a securities lawyer and a board member are not identical, there are certain essential similarities, including the duty to provide guidance and advice without regard to self-interest. The ability and desire of an advisor to act responsibly and do the best job possible does not derive from an "alignment of interests" that theoretically results from stock ownership but rather from an understanding and appreciation of the fundamental function, role and responsibility of the position, which the vast majority of board members (and attorneys) take seriously and perform professionally. However, there are some circumstances in which that ability and desire have the potential to be compromised that make imperative the avoidance of potential conflicts of interest and/or the loss of true independence that can arise when an individual has personally meaningful holdings in a company he or she is tasked with advising.

In 2006, when Nasdaq published its final rules setting forth the standards for director independence, it chose not to include a prohibition against any particular level of stock ownership. In fact, the related Interpretive Materials

includes a statement of Nasdaq's belief that stock ownership by *itself* (emphasis added) does not preclude a board finding of independence. It seems that the drafters of the rules recognized the concern on the part of some that being a substantial equity owner of a company could, under certain circumstances, impair a director's ability to act independently in the exercise of his or her duties. On the basis of the belief that "one size does not fit all" Nasdaq's guidelines make it clear that a board's affirmative determination regarding the independence of its members should be fact-based and take into consideration any relationship which the board believes would interfere with a director's exercise of independent judgment. One of the shortcomings of stock ownership guidelines is that they generally do not provide flexibility for differences in personal values, temperament, risk tolerance or finances.

There are many examples one could point to where a board member's independent judgment might be impaired as a result of having a significant personal equity stake in the company. One of the most obvious is in the case of a company within the zone of insolvency whose board must evaluate important financial and strategic alternatives, including whether to pursue a bankruptcy filing. Under Delaware law, the board of directors of an insolvent corporation owes a fiduciary duty to all of its stakeholders. There is at least an apparent, and quite likely, an actual, conflict of interest involved when directors, facing the total loss of their equity investment in the company, are required to act in the best interests of the company's creditors. Likewise directors' judgment could be impaired in determining whether to support a proposed action such as an acquisition of assets or a business, that, while in the best long-term business interests of the company, is likely to have an adverse impact on the stock price in the short or medium term. This becomes particularly problematic for directors with a near-term need or desire for, or an expectation of, liquidity over the near term either because they have personal financial constraints or are approaching the end of a long tenure on the board. This latter point will only be compounded as corporations adopt term or age limits as part of their overall corporate governance initiatives.

A vested interest in a company's near-term stock performance raises a related potential downside to mandatory stock ownership guidelines for nonexecutive directors. Over the last several years, a rash of financial irregularities uncovered at publicly traded companies has focused the public's attention on the inherent problems associated with an entity's focus on short-term stock price rather than long-term business fundamentals. The substantial increase in findings of earnings "smoothing" or other management and revenue recognition irregularities arose, in part, from management's perceived need to meet disclosed projections and/or analyst expectations or risk a precipitous drop in market value. Similarly, management's desire to profit from short-term fluctuations in the market price of their company's securities lead, in part, to the widespread incidences of option backdating. Some companies have attempted to address this unhealthy fixation on share price by announcing that they will no longer provide quarterly forecasts to the street. Other companies have made a concerted effort to helping the public understand their long-term goals. Given the lessons learned, and the fact that an effective director must be able to weigh the long term against the short term without regard to self interest, it seems counter-productive for companies to be taking steps that could result in making share price more of a focus for their directors.

This brings me to what perhaps is the most significant drawback to the public of mandatory stock ownership requirements for non-executive directors--its adverse impact on board diversification. America's corporate boards have long been criticized as being overwhelmingly rich, white, and male. Efforts aimed at recruiting women and people of color have been met with strong support from stockholder advocacy groups and the public. Likewise, both stockholders and corporate governance experts have advanced the notion that a board comprised of individuals with a wide range of abilities, interests and expertise is critical to the long-term success of a company. A requirement that directors own a significant equity stake in the companies on whose boards they sit could set these efforts at diversity back enormously. Companies will be able to attract and retain only those individuals with the financial wherewithal either to make a substantial long-term equity investment in the company or bear the potentially significant tax burden upon the vesting of restricted stock grants. Furthermore, in order to avoid the conflict of interest and independence problems discussed earlier, board members will need to have the financial ability to make the requisite additional personal portfolio investments to ensure that they do not hold a disproportionate interest in the company they are tasked with overseeing. Unless stock ownership requirements can be tied to net worth and the hardships of compliance alleviated, individuals with more limited finances, who

may include accomplished academics, practicing lawyers, technology experts, salespeople, consumer advocates and other highly qualified individuals, will be precluded from serving as board members, thereby depriving management, directors and stockholders of the important insights, perspectives and experiences they might bring to the table. Boards cannot achieve genuine diversity without being able to accommodate economic diversity.

In conclusion, while there is undoubtedly increasing movement towards implementing stock ownership guidelines in the largely unexplored yet persistent belief that this will improve board (and, implicitly, corporate) performance, unless and until empirical support for this premise is presented, corporations need to be mindful one, that stock ownership, in an of itself, does not necessarily lead to exemplary behavior and may, for some individuals, under some circumstances, impair judgment and the ability to act independently, and two, that they can result in a barrier to the achievement of true board diversity.

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