CHAPTER 1

Introduction to Strategic Governance and Internal Governance Actors

BOX 1.1 Strategic Governance Challenge: Chaos in the Board Room

According to a recent survey of 341 chief marketing officers, chief marketing officers (CMOs) spend 68.5 percent of their time "managing the present" and only 31.5 percent "preparing for the future." The survey took place before the COVID-19 pandemic, making it especially telling since strategic marketing is meant to focus on developing initiatives that help build future competitiveness. This type of short-termism, research suggests, has been a rising trend among top management teams for decades. Executives, after all, must increasingly contend with pressures from performance-oriented governance actors such as activist shareholders when making strategic decisions. Some researchers, however, do not consider this trend problematic, asserting that company executives must manage firms for long-term value creation and short-term performance. Under this view, corporate leaders who avoid these twin imperatives do so at their peril.

While boards of directors are duly bound to act with care and loyalty and without conflicting interests for the benefit of shareholders, activist owners among the shareholders pursue returns without necessarily regarding long-term strategic visions, often playing a powerful role in short-termism.

One recommendation for short-termism includes "reward long-term investors" by creating more tiers for tax breaks for long-term investors because the current taxing system rewards trading securities rather than owning companies for the long term. Board members may also align executive compensation with long-term results to motivate them to carry out visions for the long run. These proposals typically try to address governance challenges due to activist shareholders steadily gaining influence on corporate strategic decisions, often forcing election of their board candidates to provide direct inputs into major strategic decisions.

In March 2020, for example, activist hedge fund Impala Asset Management LLC filed documents nominating two directors to Harley-Davidson's board. Impala investors also called for replacing then-CEO Matthew Levatich, who had shifted the firm's marketing focus to a more diverse customer base with Harley's "More Roads" campaign, away from its traditional base of 35- to 60-year-old Americans who buy expensive motorcycles. While Harley holds approximately 50 percent of the US market share in this segment, in recent years the company had been losing sales to bikes produced by BMW, Ducati, and Triumph. According to Impala, the management change was "needed because the current board wasn't proactive enough to address the poor performance," noting that, in 2019, Harley Davidson underperformed its peers and missed its unit shipping guidance for a fifth year in a row, even while Levatich's pay had been raised to more than $11 million, a figure higher than any he had been paid since taking over in 2015. In February 2020, a new CEO, Jochen Zeitz, was abruptly put in place due in part to the pressure of Impala as Levatich stepped down, and Zeitz is refocusing Harley on its traditional business.

In addition to pressuring for reshuffled management, activist shareholders may also use what are known as "wolf pack" strategies. Hedge fund activists team up to foster a common agenda, often forcing firm leaders to boost short-term performance at the expense of the interests of long-term investors and other stakeholders. Such pressures have a compounding effect. One director notes: "From dealing with multiple crises, to being sued, to orchestrating spinoffs, buyouts, and mergers, to dealing with activists, these all bring their own set of challenges." The director makes the point that tough issues, once outlier events, have become commonplace as company leaders come under an increasingly "hot spotlight" from multiple stakeholders, forcing directors to answer more quickly and proactively.

We have written this book to enable practitioners to navigate the new, ever-more challenging governance environment. Managers and board members urgently need up-to-date, sophisticated comprehension on what we call strategic governance: the tools and orientation to fully understand and then manage the increasingly chaotic world of corporate governance and strategic decision-making.

Sources: Campbell, P. (2020). Managing tough issues in the boardroom. https://boardmember.com/managing-tough-issues-in-the-boardroom/, accessed July 13, 2020; Coppola, G., & Weiss, R. (2020). Harley-Davidson gets an unlikely rider. *Bloomberg Businessweek*, July 27, 8–10; Sampson, R. C., & Shi, Y. (2020). Are US firms becoming more short-term oriented? Evidence of shifting firm time horizons from implied discount rates, 1980–2013, *Strategic Management Journal*, forthcoming; Welch, D., Deveau, S., & Coppola, G. (2020). Activist battling Harley's board urges focus on core riders. *Bloomberg*, www.bloomberg.com, March 20; Christie, A. L. (2019). The new hedge fund activism: Activist directors and the market for corporate quasi-control. *Journal of Corporate Law Studies* 19 (1): 1–41; Moorman, C., & Kirby, L. (2019). How marketers can overcome short-termism. *Harvard Business Review Digital Articles*, www.hbs.com, 2–5; Thomas, L. (2019). Stop panicking about corporate short-termism. *Harvard Business Review Digital Articles*, www.hbs.com, 2–4; Porter, M.E. (1992). Capital disadvantage: America's failing capital investment system. *Harvard Business Review* 70 (5): 65–82.

How many corporate governance teams are equipped to face the strategic challenges spurred by the cross currents within the contemporary activist environment? Authentic strategic governance must go beyond simply making a set of decisions in response to a specific issue, and move toward a comprehensive approach for dealing with activist governance actors. Although activists are mostly found outside the firm, more are working from the inside upon the election of activist representative board members. As activist governance players proliferate and refine new techniques (as those described in the Strategic Governance Challenge Box 1.1), top executives and boards of directors must make critical strategic decisions, often under conflicting pressures. Top managers face the difficulty of needing to move the company forward while managing the challenges to their leadership from outside stakeholders, many of whom hold leverage over firm ownership voting rights, wield power to marshal governance advocates, and exert influence over the views of journalists and analysts.

The Harley-Davidson case that opens this chapter stands as a powerful example of how activist shareholders, the primary initiators of activist campaigns, often try to gain control of a company or replace management. But the activist may force major corporate change through other ways, such as by demanding divestitures and selloffs.[1] Announcements to sway the strategic decision-making of a board and CEO have significant influence on stock prices.[2] Activist announcements often impact stock market analysts' views, prompting changes in analysts' buy or sell recommendations, which may influence a firm to change its strategy.[3]

Generally, hedge funds and activist pension funds originate this kind of activism. But, as we will see in our book, other corporations also engage in external governance campaigns through hostile takeover attempts for corporate control or by buying noncontrolling block ownership. Even shareholder governance watchdogs, such as the Institutional Shareholder Services (ISS) and Glass Lewis, as well as government regulators such as the Securities and Exchange Commission, may take actions that demand a strategic response. To manage these types of external governance actors, a firm's internal governance team needs to understand how to best interact with these actors and how to make strategic decisions that will respond to or counteract their targeting, while at the same time capitalizing on the expertise and experiences that these external influencers provide. Boards and managers must also prepare to handle legal interventions, as activist shareholders increasingly turn to the courts in efforts to maintain shareholder rights and value. Responding to these actions is proving expensive; the price of director and officer (D&O) insurance, for example, rose by 104 percent in the United States in the first quarter of 2020 compared with the same period a year earlier. The price rose by 255 percent for the same timeframe in Australia.[4]

The board of directors serves as a firm's central internal governance mechanism. Directors monitor management, provide advice on major strategic decisions, and direct employment relationships especially by selecting top executives and establishing executive compensation structures. Meanwhile, owners, especially institutional owners, are the main external governance mechanism for publicly traded firms. Historically, top executives have largely held control over major strategic decisions as boards only symbolically monitor, providing merely a "rubber stamp" on the critical strategic decisions.[5] Although this tendency continues, especially in countries with large family-controlled diversified business groups like in India and many Asian (South Korea, Japan, Taiwan) and Latin American countries,[6] change is occurring quite drastically in Western countries, especially in the United States and United Kingdom. Activist investors, who exercise their voice about strategic decisions and executive compensation, drive the change. Their central approach consists of buying significant stakes of shares to seek control of firms or to use the proxy voting system to place activist investor representatives on boards of directors of targeted firms. Activists lobby corporations for corporate governance changes along with proxy intermediaries and governance watchdogs such as ISS and Glass Lewis. Government policy and associated agencies have also fostered more shareholder power and transparency through increased regulation as with the Sarbanes-Oxley (SOX) and Dodd-Frank Acts. These combined forces have increased the potency of shareholder activism, especially when other institutional investors (even index focused institutional investors) follow the lead of the activists.[7]

Although the activism noted above has caused turmoil among firms' board members and top management teams, the practice has created more intense governance and has given more voice to shareholders on strategy issues. For instance, activists have pursued more long-term compensation packages, which has created pressure for improved performance. Yet the greatly added pressure to perform has led some firm leaders to "cook the books," contributing to more financial fraud.[8] Another indirect effect of activism impacts areas such as supply chains and market power, such as when a firm targeted by activists causes pressure on suppliers, especially those heavily dependent on the target for a large portion of their sales, to reduce costs.[9]

These increasing and sometimes severe impacts of shareholder activism explain the burgeoning number of academic treatises on corporate governance, usually defined as a set of mechanisms used to manage stakeholder relationships, establish rules to determine and control enterprise strategic decision-making, and distribute the returns from investments.[10] At its core, corporate governance seeks to help ensure effective strategic decisions, facilitate the firm's strategic goals, and foster stakeholders' cooperation to achieve those goals. However, though the goals may be straightforward, the practice can prove difficult because of the many potentially conflicting interests of the various stakeholders.

Although substantial research examines the impact of these influences on governance outcomes, such as executive compensation,[11] less focus occurs on the effects that governance actors have on the various areas of organizational development, including corporate strategy (such as acquisitions and divestitures), competitive strategy, global expansion, and stakeholder policies like more socially responsible and nonmarket investments. We aim to provide strategic governance recommendations and direction for executives as well as board members to understand antecedents that trigger interaction between firm executives and activist governance actors, what the consequences of responses might be, and possible strategic actions that firm executives and governance actors might take under specific strategic governance situations. Such guidance might become particularly important when conflicting influences arise among executives, board members, and outside governance stakeholders during key strategic decisions. We lay out the organization of our book in Figure 1.1. Our discussion of internal governance mechanisms in this chapter will proceed to an exploration of external governance mechanisms in Chapter 2, followed by an examination of the direct effects of governance actors in the following chapters on specific strategies and strategic decision-making and the indirect effects on other stakeholders, including competitors, suppliers, and customers, while tracking the impact on focal firm performance and shareholder returns.

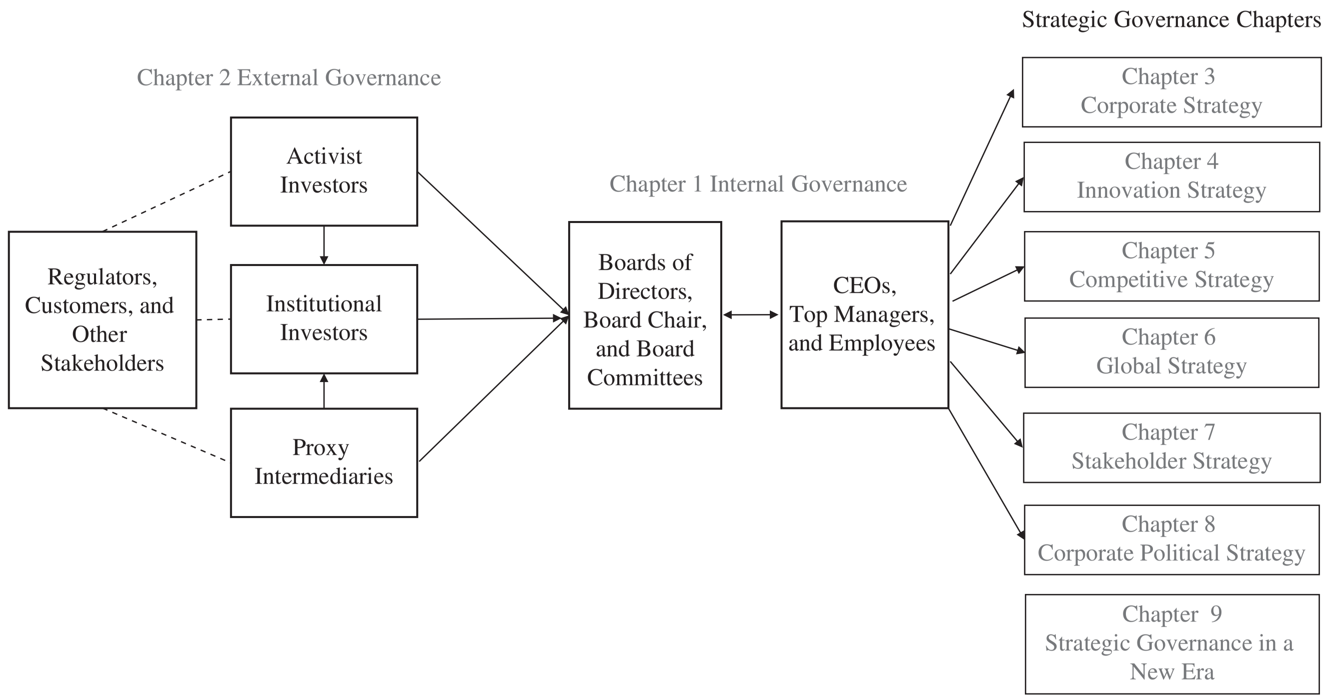

FIGURE 1.1 Understanding and managing the strategic governance challenge.

INTERNAL GOVERNANCE

Although corporate executives are responsible for making a myriad of strategic decisions that contribute to a firm's competitiveness and performance, their choices are constrained by internal corporate governance actors such as the board of directors and employees. While much has been written about internal governance, especially about boards, no systematic analysis exists on how internal governance actors influence strategic decisions. We examine relatively unchartered territory by examining the actors' impacts on decision-making, beginning with an analysis of the different board attributes and tools that directors use to govern firm executives and shape decisions. Our discussion will include a look at how employees, as another important internal stakeholder, can also shape corporate governance and strategic decisions.

Corporate governance, though more challenging than in the past, is critical to firm success. Under its scope, directors make the vital decision of selecting an appropriate CEO to guide the strategic direction of the firm. If the board makes an unwise choice, not only in selecting but also in setting the compensation of the strategic leader, shareholders and stakeholders all suffer. As such, effective leadership succession plans and appropriate monitoring and direction-setting efforts by the board of directors contribute positively to a firm's performance. Boards face unforeseen circumstances, as in the need to replace a CEO due to financial misconduct. In this case, research shows that directors tend to choose a successor with a degree from a religious university, since such a choice has been shown to reduce the likelihood of misconduct.[12] Similarly, when KPMG, one of the big four accounting firms, was questioned by the Internal Revenue Service and found culpable of engaging in inappropriate tax shelters for years in the late 1990s and early 2000s, the directors of the company hired a new CEO, appointed a former judge onto its board, and established board committees focused on fostering better professional ethics and risk compliance norms through its operations committee. Likewise, they pursued vigorous ethics and risk training for all employees.[13] Their efforts saved KPMG from suffering a fate similar to Arthur Andersen, a former "Big Five" accounting firm that ceased to operate due to the Enron fiasco.

In addition, choosing an outside versus an inside CEO (one who is currently employed at the firm) can lead to more strategic risk taking for the organization, but such increased risk taking can result in performance extremeness.[14] Increased strategic risk taking is analogous to swinging for the fence in baseball (trying to hit a home run). Although Babe Ruth set home run records, he also set record strikeouts at the plate. Appropriate executive compensation also influences risk taking. Too much emphasis on CEO stock options leads to excessive strategic risk taking and can lead to some good performance, though poor performance (striking out) is more likely.[15]

PURPOSES FOR BOARDS OF DIRECTORS

A board of directors is a group of individuals elected by shareholders whose primary responsibility is to act in the best interests of stakeholders, particularly owners, by formally monitoring and controlling the firm's top-level managers. Board members reach their expected objectives by using their powers to set strategies and policies for the organization and reward and discipline top managers. The work of boards, though important to all shareholders, becomes especially important to a firm's individual shareholders with small ownership percentages since they depend heavily on the directors to represent their interests.

Unfortunately, evidence suggests that boards have not been highly effective in monitoring and controlling top-level managers' decisions and subsequent actions.[16] This problematic conclusion may be even more prevalent in emerging-market countries. However, large differences exist in the arrangement of governance systems between developed and emerging markets around the world. The Strategic Governance Highlight (Box 1.2) provides an illustration of how boards conduct strategic governance in Europe, Japan, and China. Although insider-dominated boards still prevail in much of the world, the trend is changing, especially in developed countries like Germany and Japan, but also in emerging market countries like China.

As noted earlier, among emerging countries and historically in the United States, inside managers dominate boards of directors. Yet, we concur with the widely accepted view that a board with a significant percentage of its membership composed of the firm's top-level managers provides relatively weak monitoring and control of managerial decisions. Under such a board, managers sometimes use their power to select and compensate directors and exploit their personal ties to implement strategies that favor executive interests. In 1984, in response to this concern, the New York Stock Exchange (NYSE) implemented a rule requiring outside directors to head the audit committee. Subsequently, after the SOX Act was passed in 2002, other new rules required that independent outside directors lead important committees, such as the audit, compensation, and nominating and governance committees. Policies of the NYSE now require companies to maintain boards of directors that are composed of a majority of outside independent directors, as well as to maintain fully independent audit committees.

But while the additional scrutiny of corporate governance practices has led boards to devote significant attention to recruiting quality independent directors,[17] the emphasis on outside directors has led to 40 percent of boards having only one inside manager on the board: the CEO. This scenario produces another less-than-ideal dynamic that leads to less monitoring of executive

BOX 1.2 Strategic Governance Highlight: Boards in Europe, Japan, and China

Corporate governance is of concern to individual firms as well as nations. Although corporate governance reflects company standards, it also collectively reflects the societal standards of countries. Standards are changing, even in emerging economies, such as in the level of independence of board members to enact practices for effective oversight of a firm's internal control efforts. Since firm leaders seek to invest in countries with national governance standards that are acceptable to them, especially when expanding geographically into emerging markets, national governments pay attention to corporate governance.

German firms with more than 2,000 employees are required to have a two-tiered board structure that places the responsibility of monitoring and controlling managerial (or supervisory) decisions and actions in the hands of a separate group. All the functions of strategy and management are the responsibility of the management board. However, appointment to management falls under the responsibility of the supervisory tier, while employees, union members, and shareholders appoint members to this supervisory tier. Proponents of the German structure suggest that it helps prevent corporate wrongdoing and rash decisions by "dictatorial CEOs," making the board more stakeholder- versus shareholder-dominant. However, critics maintain that the structure slows decision-making and often ties a CEO's hands during strategy development and implementation. The corporate governance practices in Germany makes it difficult to restructure companies as quickly as in the US. Also, because of the role of local government (through the board structure) and the power of banks in Germany's corporate governance structure, private shareholders rarely have major ownership positions in German firms.

As in Germany, banks in Japan have an important role in financing and monitoring large public firms. Because the main bank in a *keiretsu* (a group of firms tied together by cross-shareholdings) owns a large share position and holds a large amount of corporate debt, it has the closest relationship with a firm's top-level managers. The main bank managers provide financial advice to firm leaders and also closely monitor managers, although they have become less significant in fostering corporate restructuring. Japanese firms are also concerned with a broader set of stakeholders than are firms in the US, including employees, suppliers, and customers, because of their group ties. Moreover, a *keiretsu* is more than an economic concept—it, too, is a family-like network. Some believe, though, that extensive cross-shareholdings impede the type of structural change that is needed to improve the nation's corporate governance practices. However, recent changes in the governance code in Japan have been fostering better opportunities for improved shareholder monitoring.

China has a unique and large economy, mixed with both socialist and market-oriented traits. Over time, the government has done much to improve the corporate governance of listed companies, particularly in light of increasing privatization of businesses and the development of equity markets. However, the stock markets in China remain young and in development. In their early years, these markets were weak because of significant insider trading, but with stronger governance, they have improved. There has been a gradual decline in the equity held in state-owned enterprises while the number and percentage of private firms have grown, but the state still relies on direct and/or indirect controls to influence the strategies that firms employ. Even private firms try to develop political ties with government officials because of their role in providing access to resources and to the economy. Political governance—control mechanisms used by political actors to achieve their political objectives—permeates listed firms in China. In fact, oftentimes political governance supersedes corporate governance. At times, executives and boards must satisfy government-mandated social goals above maximizing shareholder returns. Such a model sets up potential conflicts between the owners, particularly between the state owner and the private equity owners of such enterprises.

Along with changes in the governance systems of specific countries, multinational companies' boards and managers also evolve (see Chapter 6). For example, firms that have entered more international markets are likely to have more top executives with greater international experience and to have a larger proportion of foreign owners and foreign directors on their boards. These encounters tend to shift governance systems toward more stakeholder-oriented systems in the United States and more shareholder-oriented systems in Europe and China and other emerging market countries.

Sources: Shi, W., Aguilera, R., & Wang. K. (2020). State ownership and securities fraud: A political governance perspective. *Corporate Governance: An International Review* 28 (2): 157–176; Aguilera, R. V., Valentina, M., & Ilir, H. (2019). International corporate governance: A review and opportunities for future research. *Journal of International Business Studies* 50 (4): 457–498; Oehmichen, J. (2018). East meets West—corporate governance in Asian emerging markets:

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decisions by the board,[18] since monitoring becomes more focused on financial control rather than strategic control, especially without sufficient insider managers to properly inform the outside members about the intricacies of long-term strategic decisions and how they are implemented.[19] In fact, such boards (with the CEO as the only insider) pay the chief executive excessively, have more instances of financial misconduct, and have lower performance than boards with more than one insider.[20] Boards should seek balance to be sufficiently knowledgeable and achieve the most effective approach to fulfilling their purpose over time in representing stakeholder interests. Next, we take a closer look at board characteristics, monitoring, and setting executive compensation to further understand strategic governance.

BOARD STRUCTURE AND PROCESS: EFFECTIVE BOARD STRATEGIC CONTROL AND MONITORING

Mainly driven by the argument under agency theory that top managers have too much power and thereby use the firm for better perquisites (such as compensation), board members abide by an institutional norm holding that governance should be focused on control and overcoming potential managerial malfeasance, which is often labeled as the *audit culture*.[21] Too focused on auditing, board members may not sufficiently emphasize the need for stewardship and providing strategic advice. As boards are primarily formed to oversee the decision-making processes of corporations, while CEOs and the top management teams are in charge of decision management,[22] strategic governance should center on better use of the human and social capital of board members to improve, and not just watch over, strategic decision-making.[23]

Because of the audit culture found on many boards, outside directors have not been used fully to contribute to strategic decision-making. However, outside board members can help shape the content, context, and conduct of strategy formulation.[24] According to a survey by Russell Reynolds Associates,[25] boards of companies that exceeded total shareholder return (TSR) compared to relevant benchmarks for two or more years in a row spend more time on forward-looking, value-creating activities such as strategic planning and review and oversight on major strategic transactions, and less time on audit or compliance activities than their fellow directors on other boards. As a result, "the emphasis on board independence and control may hinder the board contribution to the strategic decision-making."[26]

Board Chair

To facilitate better strategic governance, we examine the relationship between the board chair and the chief executive officer. As mentioned, the audit culture prompted by agency theory[27] creates a relationship between a CEO and a control-oriented chair marked by distance and authority. This relationship does not always need to be solely control-oriented and can have a collaborative approach in which the board chair provides strategic advice. For example, when Hewlett-Packard split into two companies, Meg Whitman became CEO of Hewlett-Packard, Inc., and at the same time board chair of Hewlett-Packard Enterprise. She said in a CNBC interview: "I know the role of the chairman, and I know how it is different than the role of the CEO. The chairman is not there to run the company. The chairman [role] is to help the board be productive, help the CEO be successful." As Whitman suggests, the chairman may play a supportive role to the CEO, providing a close source of advice and guidance.[28] Also, separating the CEO and chair roles (as opposed to cases in which the CEO is also the chair), as Whitman did, may enhance CEO–board collaboration by reducing the demands on the chief executive's time, allowing the CEO to specialize in managing the firm's strategy and operations.

Although many firms still assign the chairman position to the CEO to provide a unitary authority structure,[29] some scholars under the agency theory advocate for separate roles to provide better control of management.[30] Having the positions as separate roles with a collaborative board chair can provide both improved strategy and better board leadership. Research supports this conclusion, finding that board chairs can provide significant value (up to 9 percent improved firm performance) through advice and counsel, legitimacy, information linkages, and preferential access to external commitments and support.[31] This approach proves particularly beneficial when firms face fast-changing external environments such as in high technology firms. In essence, by providing improved strategic governance, board chairs can add significantly to firm value.

Board Committees

Board members who chair key board committees can also add to firm value through their approach to strategic governance.[32] In fact, the importance of board committees has grown over time due to increased legal requirements and the growing complexity of the business environment.[33] Research tells us about the overall board structure or board member demographics, such as functional backgrounds and ages, but not so much about the detailed work of directors that mostly occurs in committees. In particular, all boards, especially in Western cultures, have committees that identify new board members and facilitate CEO search processes (nominating and governance committees), set executive compensation (compensation committee), and oversee financial reporting (audit committee). These three dominant committees are today required by public stock exchanges and the SOX Act. The SOX Act additionally requires that they be headed by independent outside directors—those that are not inside managers and have no stakeholder affiliation (such as legal representation or customer or supplier relationship). The three committees, part of the audit culture, function to protect shareholders and other stakeholders from managerial malfeasance. Managers should not have the power to nominate board members that supervise their decisions, set their own compensation, or make aggressive or fraudulent accounting decisions.

In theory, shareholders appoint directors. In practice, however, shareholders simply ratify director candidates selected by the board's nominating committee, although the proxy voting process has become increasingly complex due to activist discontent.[34] As described in more detail in the Strategic Governance Highlight (Box 1.3), activist board members are elected to targeted boards and often represent *wolf pack* hedge funds who have teamed together. These board members push for share price increases and other activist agenda items, which may come at the expense of other stakeholders. The nomination process is hence critical in making appropriate director appointments, as the

BOX 1.3 Strategic Governance Highlight: How Did Boards Become More Activist-Oriented?

The 1980s was known for hostile takeovers and the use of junk bonds to facilitate large takeovers by corporate raiders. This period inspired a book and movie titled *Barbarians at the Gate*, which chronicles the takeover by Kolberg, Kravis, and Roberts (KKR) of RJR Nabisco in a stunning $24 billion deal. However, in the early 1990s, the market for corporate control became dampened after the collapse of the junk bond market and the jailing of Michael Milken and the failure of his firm, Drexel Burnham Lambert.

In the late 1990s, institutional investors, such as pension funds and mutual funds, became more active. Although institutional investor activism rose in this period, the market for corporate control declined because of defensive actions by boards that largely insulated firms from pressure. But activist hedge funds stepped in with more offensive actions. In the 2000s, activist hedge funds began to nominate unaffiliated board members and influence their election to boards. One legal observer called this approach *quasi-control* because it uses board power rather than just ownership voice, as pension fund holders had used in the 1990s, although it falls short of actual corporate control. When activist fund representatives fill one or more board seats, their influence often leads to the replacement of significant corporate managers, such as the CEO or CFO, and the replacements often favor the strategic decisions preferred by the activists.

In *wolf-pack activism,* funds ready for aggressive campaigns team together with other activist investors. This tactic may include securing minority board representation (especially by way of negotiated settlement), which represents a much cheaper alternative to engaging in a proxy contest or pursuing a hostile takeover. In this manner, activist hedge funds can pursue a number of different companies compared to focusing their efforts entirely on one or two targets. As such, the amount of capital that they need to invest in specific target companies has gone down over time.

What regulatory and other changes occurred to allow for an atmosphere of wolf-pack activism? Changes in Securities and Exchange Commission regulations and the entrance of shareholder proxy advisory intermediaries facilitated the changes. The SEC enacted a proxy access rule in 2010, though it was later vacated by the US Court of Appeals for the District of Columbia Circuit in 2011. However, in recent years, many S&P 500 companies have adopted proxy access bylaws, which usually allow shareholders who hold 3 percent of the shares of a company for at least three years the ability to nominate directors without going through a proxy contest. Rather than risk a proxy contest, firms have allowed more access to the nomination process. In fact, 88 percent of the board seats won in 2016 were achieved through settlement agreements rather than proxy contests, compared to 70 percent in 2013 and 66 percent in 2014.

Proxy advisory intermediaries, such as Institutional Shareholder Services (ISS) and Glass Lewis, have enabled the power of other institutional investors, often in support of the activist shareholders. Because institutional investors are significant shareholders, often having shares over the SEC 3 percent rule, they hold power to nominate directors directly during the proxy voting process. And because institutional investors frequently follow large proxy advisor voting recommendations, activist investors team with these intermediaries to get their board members elected. Under SEC rule changes and proxy advisor power, firm leaders are more likely to settle with activist shareholders and support a campaign for minority board representation rather than risk a negative vote in a proxy contest.

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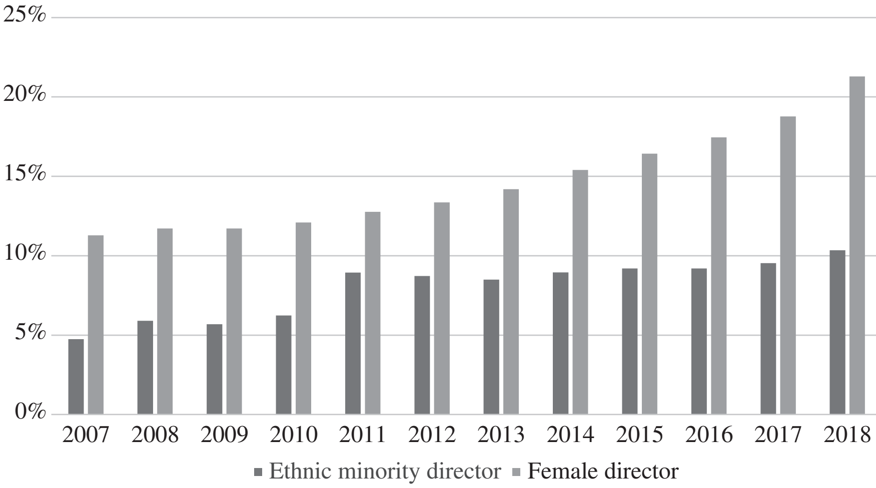
effectiveness of the board with regard to its monitoring role depends on the quality of the board members selected.[35]

For board members to affect strategic governance, the same standard applies. Corporations often replace one or more directors each year. Each replacement represents a chance to shape the board to meet the corporation's strategic needs. An unexpected death of one director can shape corporate acquisitions strategy, which indirectly shows the impact on strategy that even one director can have.[36] Not surprisingly, nominating committees increasingly seek board members with specific functional expertise, such as



Note: Data taken from the ISS Director database and calculation based on a sample of 1,814 firms that have belonged to the S&P 1500 index. Ethnic minority director refers to the percentage of African American, Hispanic, and Asian directors and female director refers to the percentage of female directors.

FIGURE 1.2 Board diversity of S&P 1500 firms.

in labor, environmental, compensation, or public policy. For example, when a firm is experiencing operational problems, appointing a chief operating officer (COO) or CEO with operational experience from another firm helps the appointing firm to improve its performance.[37]

Nomination committees may also seek directors to match diversity characteristics of customers or to extend operations into global markets. Diversity may improve board effectiveness. Growing evidence suggests that board gender diversity is associated with a number of desirable organizational outcomes, such as avoidance of securities fraud,[38] more vigilant monitoring of the top management teams,[39] more ethical firm behavior,[40] and higher accounting-based performance and stock market returns.[41] As Figure 1.2 shows, boards have become more diverse over time in regard to appointing more females and ethnic minority members. But these positives are stymied if, for example, solely one woman is placed on a board as a token to create institutional legitimacy.[42] Recognizing the positive effects of diverse membership on boards, institutional investors are using their power to push companies to appoint more women and minorities. For instance, BlackRock, a large mutual fund manager, suggested that diverse boards "make better decisions" and that it planned to focus on the issue in discussions with company leaders ahead of annual meetings.[43] Yet we note that diverse demographic characteristics do not always mean that the new "diverse" members will have diverse opinions as current board members. For example, directors are inclined to select a demographically different new director who can be recategorized as an in-group member based on his or her similarities to them on other shared demographic characteristics, and such recategorization also increases demographically different directors' tenures and likelihood of becoming board committee members.[44] We also note that board demographic diversity can be detrimental to unity among members, making firms become attractive targets for hostile stakeholders; interestingly, as a result, firms with a more demographically diverse board are more likely to be targeted by activist investors, presumably because boards are unable to form an effective coalition against activist investors.[45]

The nominating and governance committees—sometimes held as a single, combined committee—carry out important functions. The governance committee can conduct a management audit, assessing the capabilities and potential of the company's board and management team, and suggest training to sensitize the directors to environmental, regulatory, or diversity issues that affect strategy. Such an audit focuses board attention on human assets and helps plan changes in leadership. In fact, succession planning forms another crucial issue under the purview of the governance committee. When a CEO is dismissed or moves to another firm, a board of directors without a strong succession plan may scramble for a replacement, which may lead to serious strategic consequences. Many boards have authorized their nominating committees to seek out potential executive talent to avoid shocks upon surprise departures. Some boards hold an annual joint session of the compensation committee, the nominating and governance committees, and the executive committee to discuss succession planning and executive resource development. Another important issue lies in appointing qualified board committee chairs. When highly qualified chairs are passed over and less qualified members receive chair appointments, the selections can lead to a negative board climate,[46] which also may affect strategic governance. To avoid pitfalls from inadequate chair appointments or succession shocks, directors should formalize succession processes that can improve their information collecting and processing abilities and give rise to a greater quantity and quality of qualified chairs and CEO candidates.[47] The following example demonstrates the hazard in not having a succession plan in place.

In mid-2020, leaders of Cerberus Capital Management, a private equity firm holding more than 5 percent ownership of Commerzbank, the second largest German bank, sent a letter to the board chair that the bank "has not presented a coherent strategy and has failed to implement even its own progressively less-ambitious plans." Cerberus heads wanted to name two new supervisory board members to encourage significant changes to Commerzbank's supervisory board, management board, and the strategic plan. One month later, over disagreements with Cerberus (the bank's second largest shareholder), Commerzbank CEO Martin Zielke announced unexpectedly that he would step down from his position. The abrupt announcement came as a surprise and reduced the value of the firm, while the departure left a governance void at the bank.[48] Compared to German competitor Deutsche Bank's 1 percent loss, Coomerzbank shares fell 26 percent, when a new CEO was appointed in September 2020.[49]

Although board committees supervise managerial incentives and behavior, the relationship between committee chairs and top managers does not have to be adversarial. In fact, the compensation committee sets appropriate incentives so that the top managers, especially the CEO, will work on behalf of shareholders and stakeholders to create a strategy and make strategic decisions that will build both firm growth and stakeholder wealth. Pay structure for the top management team by the compensation committee creates a definite strategic governance issue.[50] A large pay differential among top management team members can give rise to problematic social comparison, since a smaller number of officers may get large pay packages, whereas others receive less.[51] Large pay dispersions can generate less cooperative teamwork and less effective overall strategy implementation, ultimately leading to lower firm performance. For instance, a large pay gap between CEOs and non-CEO top executives provides strong incentives for the latter to resort to misconduct as a means of outperforming others.[52] Relatedly, high pay dispersion among employees in R&D groups leads to less innovation,[53] which is especially detrimental to firms in the pharmaceutical industry or other industries that depend on innovation for continued profitability. Collective incentives focused on the top management team can also influence how much the whole firm will focus on corporate social responsibility issues.[54] Also, by setting the pay culture for the firm, not only for top managers but for employees overall, the compensation committee influences strategic implementation throughout the organization.

Audit committees may likewise influence strategy, albeit at times indirectly. As noted earlier, boards with a majority of outside directors depend on financial outcomes to judge firm performance, or what is labeled *financial control*.[55] Comparatively, a strategic control emphasis allows for the evaluation of strategic situations subjectively, based on the quality of board member strategic comprehension during decision-making. If no one on the audit committee can help inform outside board members to understand the strategic contingencies involved, their sole dependence on their accounting and financial orientation will likely affect the firm's strategy, since managers will take actions that involve less risk, such as more unrelated diversification.[56] That is, if managers feel that they are judged on financial outcomes alone rather than on the upfront agreement of the board (or committee) on the quality of their decisions using strategic controls, they are likely to seek to diversify the firm to reduce their employment risk (see Chapter 3).[57]

Business-level strategy (strategic positioning within the same industry) is also affected by these control systems. In a classic strategy book titled *Organizational Strategy, Structure, and Process*,[58] two polar business-level strategies are defined: defenders and prospectors. Defender strategies target stable and defensible market domains, seeking to solve the engineering problem by focusing efforts on producing and distributing goods and services in the most efficient and cost-effective manner possible. Alternatively, prospectors pursue strategies that tend to compete by continually finding and exploiting new product and market opportunities, seeking to establish strong product reputation and market dominance through product innovation and market development. Prospectors take risks, which enable them to quickly respond to new opportunities and changing competitive landscapes. When a firm pursues a less aggressive, more predictable, and stable strategy (such as those generally pursued by defenders), the audit committee can rely more on financial control, judging executives based on their achievement of financial objectives[59] and an appropriate tax strategy.[60] However, a prospector firm audit committee may need to allow executives to take on more risk. Directors should therefore make sure that the audit committee is structured with the right members to fit the business-level strategic approach that the firm pursues to enable proper strategy execution (see Chapter 4).

The most beneficial background for audit committee members and the optimal committee practices may differ between industries and even with the board as a whole; firms in high-technology industries with rapid change will need to have more emphasis on strategic control than more stable industries.[61] In addition to industry, the stage of the firm in its lifecycle or its strategic focus may also affect optimum governance characteristics and processes.[62] A small, young, rapidly growing firm with high institutional ownership, for example, may benefit more from directors with industry expertise and from a greater focus on serving, as in an advisory source to management. Conversely, a large, established firm in a declining industry, with a widely dispersed shareholder base, may benefit more from directors with financial expertise and a board more focused on its monitoring role.

EMPLOYEES AS INTERNAL GOVERNANCE ACTORS

Employees constitute an important group of internal stakeholders for firms. Employees not only provide human capital critical to sustain a firm's daily operations, but also play an essential role in maintaining and expanding customer bases. The impact of employees on corporate governance varies significantly across the world. In the United States, the key channel for employees to participate in governance occurs through employee stock ownership plans (ESOPs).[63] ESOPs are investment vehicles through which employers make tax-deductible contributions of cash or stock into a trust, whose assets are allocated in a predetermined manner to employee plan participants.[64] By 2016, around 6,624 ESOPs and ESOP-like plans were active in the US, holding total assets of nearly $1.4 trillion, according to the National Center for Employee Ownership.[65]

By making employees owners, such ownership can lead to a convergence of interests between employees and shareholders.[66] Ownership gives employees a voice in corporate governance through their voting power, which can prevent firms from maximizing the interests of shareholders at the expense of those of the workers.[67] Yet in the United States, although employees can influence corporate governance through their ownership, they typically do not have board representation,[68] leaving employees with little say in boardroom discussions. As a result, directors often compromise employee interests to satisfy the interests of shareholders in firm decision-making.[69] To address this issue, several pieces of federal legislation have been introduced to grant employees the right to sit on corporate boards. For example, the Reward Work Act introduced by US senator Tammy Baldwin would empower workers by requiring public companies to directly elect one-third of their company's board of directors and reduce open-market stock buybacks.[70]

As shown in the Strategic Governance Highlight (Box 1.2), Germany and other Western European countries have a two-tier board consisting of a board of directors and a supervisory board. In this system, the law guarantees employee representation on corporate boards of directors as a recognized fundamental worker right. Employees can vote for representatives in supervisory boards under corporate law, which is often referred to as *co-determination*. Like many Western European countries, China requires publicly traded companies to have a supervisory committee. Such a committee must include employee representatives elected by personnel through an assembly of some or all employees, or by other means. Although employee representation on boards does not necessarily lead to higher profits and faster growth, it can inevitably change the power dynamics of corporate boards,[71] leading directors to pay closer attention to worker interests when making strategic decisions.

CHAPTER OVERVIEWS

As illustrated in Figure 1.1, we provide an overview of the book's organization, focused on introducing strategic challenges that boards of directors face and how to overcome them. In this beginning chapter, we presented the concept of strategic governance, seeking to illustrate that boards of directors and the top management team are confronting a more intense governance situation in which prominent stakeholders pursue goals beyond board monitoring, seeking to affect corporate and business level strategies. Reinforcing this idea, a recent survey of board of director members by PwC, a large accounting advisory firm, rated strategic oversight as the most important aspect of a board member when that member engages in direct communications with shareholders.[72] In the following chapters, we will clarify how boards and other governance actors affect a range of strategies.

Chapter 2, a companion chapter to internal governance (Chapter 1), overviews external governance actors in the United States and other countries. External governance actors consist of institutional investors, activist investors, financial analysts, business media, short sellers, suppliers, customers, rating agencies, and regulators. We go more in depth on how these actors influence changes in strategic governance, not only through the board of directors but also through their advocacy and direct intervention.

Chapter 3 investigates the role of governance actors in corporate strategies including diversification strategy, mergers and acquisitions, alliances, and divestitures. We also provide guidance on how corporate executives can manage conflicting governance actor demands when making corporate strategic decisions.

Chapter 4 examines how governance actors affect internal innovation investment and corporate entrepreneurship with a focus on entering new product markets through internal innovation, corporate venture capital, joint ventures, and direct acquisitions. Here, we likewise discuss how to leverage governance actors to best foster innovation and enter a new product market.

Chapter 5 focuses on the influence of governance actors on competitive strategies, such as the pursuit of differentiation versus cost leadership strategy, competitive aggressiveness, and competitive complexity. We introduced some of the influence on competitive strategies in regard to the audit committee's prospector- versus defender-oriented strategies. We will go more in depth and explore how company leaders can leverage governance actors to create better competitive strategy.

The global business environment has dramatically changed in the new competitive era. In Chapter 6, we provide an overview of the role that governance actors play in shaping firms' strategic choices for global expansion. Directors and top managers may also find ways to manage the governance influencers to increase the success of global strategies.

In Chapter 7, we discuss how governance actors shape firms' management of key stakeholder relationships, such as customers and suppliers, besides shareholders. We provide our guidance on leveraging internal and external governance actors to design successful stakeholder relationship strategies.

Corporate political strategy pertains to managing relationships with government actors. Firms can invest in lobbying, make political campaign contributions, and appoint directors with political ties to foster relationships with government actors. In Chapter 8, we explain the role of governance actors in corporate political strategy and how these actors can best be managed to facilitate an effective corporate political strategy.

In our final chapter, Chapter 9, we conclude with a summary of the strategic challenges that boards of directors face and provide additional recommendations for dealing with these challenges. We emphasize the growing governance issue under disruptive innovation associated with platform strategy such as that of Amazon, Apple, Uber, and many others, as well as digitalization. We also discuss policy implications and emerging trends at the interface of governance and strategic decisions.

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