

TOPIC: A ROUNDTABLE SERIES FOR CEOs AND DIRECTORS

#37 The Growing Challenge of Boards: The Evolving Model

The confluence of myriad governance challenges that surfaced only several years ago in response to scandal and lax corporate governance has induced government intervention at the federal and state level and raised the bar on board oversight, structure and external relations.

This intervention has arguably driven more changes in corporate governance in the last five years than in the previous 50. It has also sparked a continuing surge in shareholder activism that has created new pressures on boards and their directors.

The increasing politicization of corporate governance portends even more change and a need for the board to improve communications with parties to the reform process as divergent as the SEC, activist as well as so-called passive shareholders – who many directors recognize as “a silent majority” – and others. What remains unanswered is how an evolving model of corporate governance should reshape the board agenda and future dialogue about the most effective roles for directors, shareholders and regulators.

Since 2002, John J. Castellani has served as president of the Business Roundtable, an association of chief executive officers of leading U.S. companies with \$4.5 trillion in annual revenues and more than 10 million employees. Taken together, its member companies comprise nearly one-third of the total value of the U.S. stock markets and represent over 40 percent of all corporate income taxes paid. In the course of those years, Castellani has gained exceptional perspective working with the Business Roundtable’s 160 CEO members as they’ve struggled with corporate governance and the changing business, regulatory and socio-political landscape.

To put these challenges into clearer perspective, consider that 80 percent of Business Roundtable members’ boards of directors are at least 80 percent independent. Nearly all of these vaunted corporate boards make an Executive Session part of every board meeting. Over 80 percent of them have adopted majority voting and all of them have either a lead or presiding director. And the amount of time these boards’ directors are investing on board issues now ranges from a minimum of 250 hours up to a previously unfathomable 800 hours per year.

Castellani covered the waterfront of emerging governance challenges during Boardroom Consultants’ 37th Topic Luncheon at The University Club in New York on January

15, 2008 and engaged leading experts such as Ira Millstein, senior partner in the international law firm of Weil, Gotshal & Manges LLP and senior associate dean for corporate governance at the Yale School of Management; Henry Kaufman, president of Henry Kaufman & Company, former vice chairman of Salomon, Inc.; and David Swinford, president and CEO of Pearl Meyer & Partners, among others.

Changing How Boards and Their Directors Operate

John Castellani suggests that the corporate governance agenda will continue to evolve and become more complex as shareholder proposals (up 20 percent year-over-year in 2007 and projected to rise at a similar pace in 2008), SEC enforcement activity and government regulation at the state level and within the Congress of the United States continue to mount.

“The conundrum that I think we all face is either we are reforming to the wrong model or something else is going on here,” Castellani says. “My [premise] is that something else is going on here and it is going to fundamentally change, if it hasn’t already changed, the way that a director and a board of directors operates.”

When you step back from today's governance debate, he explains, one can see clearly that there are three different groups trying to impose their influence on the corporate government process. All of them harbor some frustration over the public policy process and now view the proxy process—including the director nominating process—as the vehicle to usher in the systemic reform they desire.

These special interest groups include individuals and groups like those promoting governance reform to counter the effects of contemporary issues such as global climate change and nuclear power; academics interested in the intellectual debate related to the best interests of corporate shareholders; and those who consider governance reform an ideal way to influence and gain power for the positions they currently hold. These latter interests, Castellani says, include unions and politically appointed or elected stewards of a wide range of pension funds. Save for the academics, he adds, the groups now exerting pressure on the governance function are very political.

“What I see happening from this unique nexus of business and politics is the corporate board process turning into a political process,” Castellani argues. “My [argument] and what I wanted to lay out for discussion today is, if I am right, then you all ought to have the impetus to develop the political skills that you see being applied in the political process at any level.”

Castellani says that boards should assess the vulnerabilities of their board governance policies and practices as well as their individual board directors. Politically charged issues such as excessive CEO pay—a wedge issue for many activist shareholders and special interest groups—and industry-specific challenges (for example, think global warming for oil companies) or even union pension fund representation by a company have already made some boards easy targets. Increasingly, boards and directors that fail to address these vulnerabilities will become even bigger targets.

“My predicate is that this doesn't end, in fact [this activist governance environment] gets more active, it gets more political, and that you as board members and boards of directors have to become more and more involved in thinking about it from a core, basic, hard-knuckle political standpoint,” Castellani says. Boards must understand who their base constituent is, who they can rely on, who the shareowners are that agree with what they are doing and in fact will stay with them in the long-term if directors are meeting expectations. It's also important to consider whether the board has a base [of support] among company employees and management.

“Work the advocates, or at least understand them,” Castellani advises regarding the new parties to this increasingly political process. “Don't be surprised by something that happens. I think more and more, you're going to have to understand where your potential adversaries are and engage them to try to defuse them. You have to prepare to be active during the proxy season and that means communication...You're going to have to go around and influence those people who influence the votes. You're going to have to evaluate [your potential exposure to] all of those vulnerabilities.”

A Common Objective

Ira Millstein, a leading advocate for improving corporate governance practices, says in response to Castellani's presentation that it is unusual to have found himself “99 percent in agreement with the Business Roundtable” given his past skirmishes with the group over the best route to more effective board stewardship.

Millstein contends that much of the pressure now facing boards on issues of board access, executive compensation and board leadership stems from a general lack of communication with the very people whose interests they are supposed to represent.

“I think every company in the United States knows who their major shareholders are. I think each one of you around the table could put your finger on exactly the eight or 10 people who own enough stock to make something happen in your company. Those are the people you want to communicate with,” Millstein says. “I would spend my time with the traditional, now concentrated shareholders of your companies. These are the people that you want to be with...One of the things which I'm urging as hard as I know how is communication. It's time. You can beat a lot of these issues if you talk to your shareholders.”

Millstein says it's becoming increasingly important for boards to motivate the silent majority of shareholders who tend not to take on advocacy roles but who nonetheless are equally frustrated by poor board oversight. So how, exactly, can a board do that?

“I think first, you have to take the major irritations out of the system so that [shareholders] will not be angry at you for anything other than the fact that you may have failed in your business, for which they are entitled to be angry,” Millstein says. “But in general, the thing that people will be angry about is compensation, which is the hot-button issue, and you really ought to pay attention to it. Nobody but the

board of directors can solve the compensation issue. There's no law that's going to be passed, it can't be passed. We tried that once, it was a fiasco. There's no way to do that."

Millstein says it is time for boards to take another look at compensation, especially at the perceived largess of CEO severance, or so-called "packages on departure." The key moving forward, he explains, will be for boards to invest more time on this issue so they can arrive at a defensible position, and one that may actually put them ahead of shareholders with regard to 'Say on Pay.'

Long a supporter of splitting the chair and CEO roles, Millstein acknowledges that his view has failed to resonate. But he nonetheless suggests that boards can gain more credibility in the eyes of key constituents if they appoint someone with a truly independent interest to a board leadership role.

"If you're going to have a board leader, don't have him or her be a phony board leader," Millstein argues. "Make sure you have a leader who's empowered to lead, who has something to do with the agenda, who has something to do with the information flow to the board, who really is more than just a token you've put into your proxy statement to indicate that you're a good board. [Shareholders] can see through all of that, depending upon who you put in as your board leader."

Senior Management's Responsibilities

Building on the points raised by Castellani and Millstein, Henry Kaufman reminded the attendees that senior management has a major role to play in keeping the board continually tied into the investments it's making, the risks it's assuming and the markets the enterprise is serving or attempting to reach.

"It's absolutely incumbent on management to constantly educate the board on what businesses they're in and how those businesses are run. Some of them are simple businesses and others are very complicated businesses," Kaufman observes. "Some of them take a while to run down a company and some of them take two years to run down a company. I think much more emphasis has to be put on the management's responsibility to continually update the board about what they're doing."

But, Kaufman goes on to explain, "That doesn't relieve the board of understanding as well—and particularly in the finance and the audit committees—where they ought to be probing and looking and hunting and seeing what the

problems are, what the potential problems are and so forth and so on. But everything goes to the sky until it doesn't any more and that's just a human failing, for goodness sake."

Kaufman noted that we should not dismiss the responsibility of the boards and senior management of financial institutions in the area of risk management.

"I think the senior management of major financial institutions partly became a captive of their environment and a captive of middle management," Kaufman says. "They became a captive of middle management because the market was securitized, there was a huge volume of trading potential, underwriting potential and the middle management pushed to take more and more risks."

The senior management of those institutions, he adds, became captive because if they didn't go along, they might have lost some earnings, might have lost market share and, if earnings didn't elevate, risked losing the support of discontented stockholders. "The senior management did not have an intermediate view that overlooked the activities of middle management," Kaufman says. "It was lost in the process."

Kaufman questioned whether the boards of major financial institutions have the technical competence to oversee the risk-taking that was taking place. That is because, in his estimation, such risk-taking involved quantitative analytical techniques, involved middle management activities and involved practices outside the experience of many board members because they have been so long removed from the activities that have been going on in financial institutions.

But board directors can help usher in positive change if they have the stomach to tackle these challenges. "I think there has to be much more information flow, much more expertise in the board of major financial institutions than we have at the present time," Kaufman says. "And it just can't be a former CEO of a manufacturing entity that is going to sit on the board of a major financial institution and sit in on the finance committee, over the risk committee. It won't work. And I think those are the problems that boards have to reconsider and reassess themselves."

Putting Compensation In Perspective

Compensation consultant David Swinford put the luncheon discussion squarely on the challenges boards must confront in order to avoid shareholder contests over what is perceived as excessive executive compensation.

“We are very inclined to accept large amounts of money being paid to people who have made money for us and we are very inclined to accept large amounts of money paid to people who we can look at and say that these are responsible, good, admirable people. They’re the kinds of people we want leading our companies,” he adds.

Further, Swinford contends, “I don’t think it’s too hard to explain [retired ExxonMobil Corporate CEO] Lee Raymond to shareholders. I think it’s very hard to explain him to certain elements of society who are very concerned about societal wealth distribution. I think we have an issue as to how we as directors and advisors to boards deal with those societal issues.”

But, Swinford adds, “You can’t run your company around whether or not it should be an egalitarian society or a Horatio Alger society or capitalistic society. You can prevent the abuse. I think that’s where we really have to focus and I think, John, you had it right and Ira, you had it right when you talked about compensation in dealing with the sort of abusive situations, most of which are severance-related.”

Another issue that boards and directors will need to balance is compensation through the lens of undue risk. “We have an awful lot of people who are very successful in our society because they’ve managed to bail out at the right time, having taken undue economic risks,” Swinford says. “I think that’s going to be the new area of debate, where somebody has benefited tremendously by what turns out to be a tremendous economic issue for all of us.”

Closing Thoughts From Boardroom Consultants

The practice experience of our Boardroom Consultants advisors and the perspectives of the thought leaders who engaged in this discussion about the evolving model of board governance lead us to these implications:

- The age of the passive shareholder may be coming to an end, so boards and directors need to invest the time and resources required to be credible defenders of current board governance practices. They must also consider how to play in an increasingly politicized debate over corporate stewardship and oversight.
- Boards must find creative communication strategies to engage with the silent majority of shareholders that tends not to take an activist position but which, nonetheless, can be a partner to the board when political and other pressures begin to distract the board from its core agenda.

- Directors must understand that executive compensation has become a critical wedge issue and that more due diligence must be applied to the management succession process and existing pay practices, especially those relating to severance and departure packages.
- The current challenges facing the board require a new set of proactive directors who can engage with management, shareholders, regulatory bodies and others to pre-empt the kind of divisive governance contests that can erode confidence in the board’s governance structure and practices.

About Boardroom Consultants

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Boardroom Consultants draws on the collective knowledge of an Advisory Board composed of former chief executives to provide consultative services important to superior board performance. As trusted advisors to clients, Boardroom Consultants provides discreet, objective board assessments, succession planning, and other services that make boards valuable assets.

Boardroom Consultants supplements its extensive experience and unmatched expertise in building high-performing boards with the research and support resources available from Slayton Search Partners, a respected and fast growing leader in retained executive search. Through Slayton, Boardroom Consultants identifies emerging leadership talent of men and women at the director level.

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