

Board Governance Series

VOLUME II

2003

A KEY EDUCATIONAL RESOURCE FOR TODAY'S BOARDS OF DIRECTORS



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Corporate
BOARD MEMBER
magazine

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Corporate Board Member and **The NASDAQ Stock Market** are proud to present volume II of our director education resource, the **Board Governance Series**. This series is centered around informational webcasts designed to educate corporate directors on issues and trends that are important to forward-thinking public companies. The webcasts feature top board advisers from some of the country's most prestigious companies as they offer advice on best practices for key corporate governance issues. This **Board Governance Series** supplement is a published collection of the most recently released webcasts.

In today's environment, there is no shortage of critically important topics on which corporate boards need assistance to better fulfill their fiduciary duties. We invite directors to access any of our series partners' websites highlighted in this supplement to gain valuable board governance advice. The response to volume I of the series was overwhelmingly positive, and we believe volume II will be of equally great interest to directors seeking guidance for the challenges ahead.



A handwritten signature in black ink, appearing to read 'TK Kerstetter'.

TK KERSTETTER
President
Corporate Board Member



A handwritten signature in black ink, appearing to read 'Robert Greifeld'.

ROBERT GREIFELD
President and CEO
The NASDAQ Stock Market

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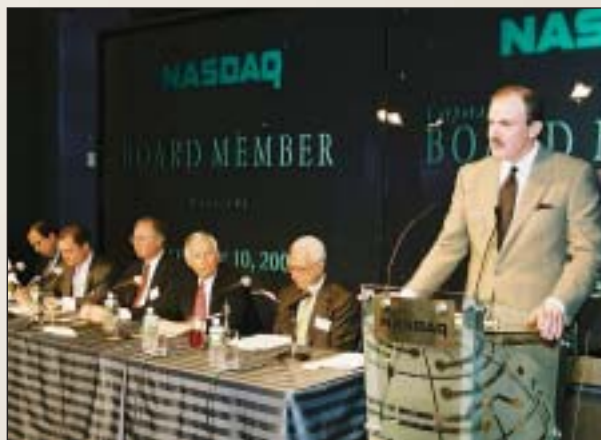
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What Every Director Needs to Know about D&O Insurance, Part II

John W. Keogh, president and CEO of National Union Fire Insurance Company of Pittsburgh, PA, a member company of the American International Group, Inc., outlines the issues directors must bring to the table in order to shed light on their D&O policy's fine print.

In earlier webcasts, we discussed some of the board issues affecting the current D&O insurance environment. Now that you realize there are some very important and specific points that require you to take an active role in understanding how your D&O policy responds, I would suggest that the following issues be brought up at your next board meeting.

Bankruptcy

The first issue is bankruptcy. How would your D&O policy respond if the company on whose board you serve filed for bankruptcy? The issue is an important one. There have been several recent cases where companies have gone bankrupt and the bankruptcy courts have ruled that the D&O policy is an asset of the bankrupt estate. In other words, the policy doesn't belong to the individual directors. In those cases, whether the D&O policy will pay the losses or potential losses stemming from allegations against individuals is in question. This is not exactly what most directors anticipated when they were told they had a D&O policy.

Financial Restatement

The second point to consider is how your D&O policy would respond if your company were to restate its financials. There have been several cases where companies have restated their financials and the D&O carriers have subsequently declared that such restatements are an admission of fraud—in effect, saying the fact that a company had to restate its financials is akin to admitting that the financials were bogus. In that situation, D&O carriers have actually rescinded or attempted to rescind coverage. So directors should have comfort that their D&O policy will respond if the company restates its financials.

Fraud

A third issue to focus on is how the policy will respond if a fellow director commits fraud. Will that jeopardize your coverage? Will the policy pay out on behalf of that individual? In other words, will the policy proceeds pay the defense and settlement costs for someone who committed fraud, thereby wiping out the entire limit of coverage and leaving you without any additional protection?

Misrepresentation

Another area to be concerned with is how your application for D&O insurance is represented to D&O carriers. If information is misrepresented, there's the potential for coverage to be rescinded and for the contract to be voided. This has happened in several high-profile cases where individual directors and officers were left without protection. Directors should ask who is preparing the information for the D&O carriers and make sure they review the completed application and are comfortable there is no material misrepresentation of information.

For example, look at life insurance. If you were an 85-year-old smoker diagnosed with lung cancer and given a year to live, probably one of the first things you would want to do is buy more life insurance. You'd find when you apply for insurance that if you represent yourself correctly as 85 years old and about to die, not many carriers would be interested in providing life insurance for you. On the other hand, if you lied to the carrier, telling them that you were a healthy 30-year-old, many carriers would offer you life insurance. The problem with that scenario, not surprisingly, is that when you die, the insurance company will realize that you are indeed 85 years old and very sick and deny coverage, and



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“With record levels of settlement values being witnessed across a broad array of industries, what may have been adequate a year or two years ago in terms of limits of insurance may not be adequate today.”

there would be no payment of life insurance proceeds. The same is true of any other insurance product. In the D&O world, there have been several cases where companies that were, frankly, 85 years old and about to die represented themselves to insurers as being 30 years old and very healthy. And unfortunately, when they died, the D&O carriers refused to pay.

Coverage

Another question directors should ask about their D&O insurance is what else and who else is covered by the policy. Over the years, there have been additions to D&O policies for everything from errors and omissions coverage to employment practices protection for the company, each of which could account for claims being paid and limits being diluted for losses that have nothing to do with your behavior and your acts as a director and/or officer.

Limits

An additional area to focus on is whether there are enough limits provided under your current D&O policy. With record levels of settlement

values being witnessed across a broad array of industries, what may have been adequate limits a year or two ago may not be adequate today.

A good benchmark is when there is loss of market capitalization from a stock drop, the average settlement is about 15% of that loss. In other words, if your company had a stock drop and loses a billion dollars of market cap, the likely settlement on the shareholder suit would be in the \$150 million range.

Solutions

The good news is there are solutions to all these scenarios. The insurance industry has responded over the past several months with new products and solutions addressing the issues and concerns that I just described. In summary, being a director of a company is an important and worthy role; unfortunately, it's a role that comes with risk. Evaluating that risk and knowing how to safeguard your personal assets is critical. Directors need to understand how the company they serve and its D&O policy will protect them in all situations.

Six Questions Directors Should Ask about Their D&O Policy

- 1 How will it respond if your company files for bankruptcy?
- 2 How will it respond if your company were to restate its financials?
- 3 How will it respond if a fellow director commits fraud?
- 4 How is your D&O insurance application represented to D&O carriers?
- 5 What else and who else is covered?
- 6 Are there enough coverage limits?

Board Guidelines for Recognizing and Managing Financial Distress

Martin J. Bienenstock, partner at Weil, Gotshal & Manges LLP, discusses ways to detect financial distress and the critical path directors must take to stamp out these problems before a crisis develops.

Although financial distress can evolve gradually at public companies and has sometimes even been predicted in the marketplace in newspapers and trade magazines, it more frequently arises by surprise. For instance, Texaco suffered a \$12 billion judgment in Texas state court in the early 1980s. That was a shocker. Similarly, if a pharmaceutical company finds its medicines on supermarket shelves are contaminated, the company has virtually no warning. In other situations, such as when a company is heavily leveraged and the economy is sliding into a recession, financial distress may be discovered earlier. But it most often happens in a sudden manner that cannot be reasonably anticipated by management.

What are a director's responsibilities in detecting financial distress?

No board wants to think that it will confront financial distress, but all directors have, by virtue of their duty of care, some obligation to develop systems aimed at detecting problems in time to solve them. One way to detect such problems is to have a system where management is periodically responsible for identifying the material internal and external risk factors to the company and reporting on their status to the board. These risk factors range from having a key employee whose loss might impair the company's key product development to an external factor such as illiquidity in the capital markets so the debt can't be rolled over. The importance of this can't be overemphasized. Directors should not delude themselves into thinking that compliance with Sarbanes-Oxley will carry out their duty of care. That's like a fire alarm going off after the fire starts. Sarbanes-Oxley was designed to make sure that we disclose problems once we are aware they exist. Directors need systems to find problems

so they can be fixed before they become life threatening.

What should directors do if they sense potential trouble?

When directors see a problem on the radar screen that was not anticipated in the business plan and that could impair the company's performance, they should determine what I call a critical path. They need to figure out how long the company can continue to operate at a steady rate or within certain norms before the problem starts impairing its ability to operate. This critical path may turn out to take months or years, or it may take weeks or days, but they really need to find out how long they have to deal with the problems. Once they've figured that out by developing a conservative business plan that doesn't make overly optimistic assumptions, they need to ensure they have the expertise on board to deal with the existing problems—financial, legal, accounting, public relations, marketing, employee relations, investor relations—from every perspective.

Are any special skills desirable when dealing with signs of financial distress?

When a company realizes something could impair its ability to operate, the typical director who has not been through a distressed situation will not usually anticipate the speed with which a problem can cause a company to go into what some call a "death spiral." For example, within weeks of a *New York Times* article explaining that Ames Department Stores might be experiencing problems, it had to file Chapter 11 bankruptcy. The same thing happened with Caldor and Kmart. This is because there is a sequence of events, almost like a domino effect, that is very hard to stop. For instance, if a company's vendors hear that it might



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have financial problems, they may not ship goods anymore because they are worried about bankruptcy. The company obviously can't sell goods that are not on the shelves. Therefore revenue falls, causing the company to go into default under its credit agreements. In the meantime, customers will go into the store and realize that they can't find what they want to buy, so they will start going

the company's constituencies as well as the community it operates in, and frequently has a financial impact of billions and billions of dollars. To be adequately prepared to deal with distress, even healthy companies need systems to monitor the factors that pose the most material risks to their company. This not only helps directors comply with their legal duties of care, but also increases shareholder value,

“ Even healthy companies need systems to monitor the factors that pose the most material risks to their company. ”

to its competitors. Employees will hear about these problems, and the best ones will find jobs with competitors. This death spiral can occur really fast, so directors need to either already have the expertise to anticipate these problems and solve them before they occur, or they need to retain the expertise to do so.

Summary

The crux of the matter is that the value of a company may be hundreds of times its liquidation value. Between its equity value and its debt value it could have a market capitalization of billions, whereas its liquidation value may be millions. And it's not just money that's at stake. If a company degenerates and loses its ability to operate profitably, it will affect the lives of employees and creditors, the communities in which the company operates, and the overall competitive environment. So the importance of a board detecting problems early and dealing with them so as to preserve the company's value is crucial, both to

because if the board can identify the risks, frequently it can diminish or sometimes even eliminate them altogether. When directors actually detect a problem of a material nature, they need to understand how a going concern can quickly degenerate into a death spiral as well as the level of expertise that is needed to prevent that from happening. They need to know how to deal with their lenders, vendors, investors, and employees, and if they don't already have these skills in-house, they need to retain advisers, sometimes crisis managers, who can act as coaches to help prevent a death spiral from occurring. While the directors are dealing with this type of situation, they need to examine all their alternatives in a completely dispassionate way. They need to look at whether they can solve the problem internally, whether they need to look for a strong merger partner, or whether they can do an out-of-court exchange offer of debt to equity or the like. They also need to consider Chapter 11 if the prospects of succeeding at the other alternatives are relatively small.

Insights into CEO Succession

Boards must see to it that their company has a CEO succession plan. Thomas J. Neff, chairman at Spencer Stuart U.S., gives an overview of the board's responsibilities in ensuring the incoming CEO is the best candidate for the job.

The board's most important role is to ensure there is uninterrupted leadership of the company and its top positions. Therefore, the board needs to work closely with the CEO to make sure there is ongoing assessment and development of the talent required to move into the top positions in the company.

Is there a standard succession model?

Succession models differ with each company depending on several factors including whether it has a single line of business or multiple lines, like GE. There are also internal and external possibilities. Obviously an internal selection is ideal. The selection generally will happen internally, unless there is a crisis. If there is a crisis, boards are often forced to search outside, and, in most cases, executive search firms will work with them to determine the best solution.

What are the best practices in CEO succession?

First, this is a continuous and ongoing process and one the board needs to be actively engaged in, reviewing the top players in the organization several times a year. It's also a team effort with the CEO, but, ultimately, it's the board that must make the final decision. The board needs to hold the CEO accountable for developing talent in the organization. In fact, as succession for the top job nears, the CEO should have a succession plan and some of his or her compensation should be directly related to achieving those objectives. And although the full board is responsible for succession, the compensation committee usually deals more intensely with the issue since it evaluates not only the CEO, but is also apprised of how the top management team is doing and is responsible for compensating that team. So the compensation committee is the logical

place for succession discussions to take place. If a company must look externally, a board will occasionally organize a search committee, which usually includes the head of the compensation committee along with a few experienced, broad-gauged executives or other board members who can work with that person during the selection process.

How is the CEO search conducted?

Many boards have not had to face the task of selecting a new CEO, particularly from outside the organization, which can be somewhat traumatic. Some questions to ask would be not only what's involved, but how long will it take? Obviously, if a company is in trouble or if the CEO has been removed, the board needs to find a new CEO as quickly as possible. There have been situations where we have been able to find a terrific CEO within two months, but a CEO search usually takes four to six months to have an orderly process and ensure that a slate of qualified candidates is developed. For the most part, these are individuals who obviously meet the criteria but are well placed where they are. You should only talk to people who have been successful in their jobs. There is a filtering process to narrow a list to one individual. And since these people are gainfully employed, coordinating travel schedules with board members could take considerable time. So it's not only a matter of several meetings with the lead candidates, there is also the due diligence that must take place, which can add a couple of weeks to the process. And then there is contract negotiation. In many cases the individual will retain a lawyer, some of whom are very experienced in putting together CEO packages. This can also add weeks to the project.



THOMAS J. NEFF
Chairman
Spencer Stuart U.S.

What are the succession challenges?

There are signals that the succession process is going to be difficult at a company. If it's not in the company's culture to regularly evaluate talent, then there may be cause for concern about the outcome. Sometimes the CEO won't let go. There will be a clear indication of that if one or more contenders are eliminated by the CEO, or even fired. If the board is not engaged in the process, then the outcome of succession is going to be in doubt. If you are a board member of a company without a succession plan, then you need to insist that the CEO

In summary, the board needs to ensure that a succession process is in place. It needs to work closely with the CEO to evaluate internal talent, and it needs to hold the CEO accountable for making sure that talent is developed to the point that someone can be selected to be the next CEO. If that talent is not available internally, the board needs to take the lead in looking externally for the best candidates. Ultimately, it's the board's responsibility to ensure that the new CEO is the best person to lead the company.

“**The board needs to hold the CEO accountable for developing talent in the organization.**”

develop one, not just for the CEO position, but also for the top layer of management. If a succession plan didn't exist before, regular reviews of the current plan will be necessary. Who are potential candidates? What are the plans to develop those individuals into more rounded executives who could assume the top job?

What is the CEO's role?

Best practice today dictates that the CEO not be on the search committee but available to help assess candidates, meet the final candidates, and provide his or her perspective on how the company is doing and what the organization's needs are. But the board must make the decision regarding the CEO's role; it is no longer the CEO's choice.

When the Pendulum Swings Too Far: Good Governance vs. Excessive Oversight

Richard M. Steinberg, of the corporate governance practice at PricewaterhouseCoopers LLP, outlines the unintended consequences of corporate reform and the areas in which directors are operating too much in a check-and-balance mode.

It's clear that a vast majority of boards had shortcomings before the new rules were enacted. Many boards were passive, showing too much deference to the CEO and top management, and insufficiently monitoring management's performance. A great deal of the new rules—Sarbanes-Oxley, the SEC requirements, the New York Stock Exchange and NASDAQ proposals—are positive. For some boards, it has simply confirmed their current performance as best practice, and they don't need to change much. But as we look back over the last year at the changes that many boards have enacted, we find some real unintended consequences. For those boards, the pendulum has swung too far, and they are operating too much in a check-and-balance mode.

Compliance

One important change in the last year is that many boards are taking much more of a compliance role. They are emphasizing the kinds of things that are required by the new rules—the independence of boards and the independence of the governance, audit, and compensation committees. They are starting to hold private meetings. They are identifying the audit committee financial expert and paying a lot of attention to financial reporting and internal controls. They are spending more time overseeing the function of internal and external audit. They've taken much more of a check-and-balance role on management's performance. Experience has shown, however, that boards that pay too much attention to those types of compliance issues may lose sight of their roles of bringing knowledge-based insight to management and of providing needed guidance, judgment, and direction.

Form over Substance

Another key area is the issue of board form over substance. There's been a tremendous amount of attention during the last year to issues of structure: board and board committee size; committee composition; committee charters; board guidelines; frequency and length of meetings; and the content of minutes. All of these are important, but frankly, they are enablers. They enable the board to do the right thing in effectively carrying out its core responsibilities. These core responsibilities are:

- participating in strategy development
- keeping members apprised of significant risks and ensuring management has a risk identification and management process
- making sure performance metrics are correct and aligned with strategy
- ensuring that the tone at the top of the organization is correct with appropriate focus on integrity and ethics
- CEO compensation and succession planning
- and making sure that the board is functioning as a cohesive, effective team.

These are core responsibilities. A board cannot substitute improving structure for carrying out the real substance of what it needs to do.

Board/CEO Relations

An area where we've seen significant change in the last year is in board/CEO relations. Clearly, on the part of many boards there's been a power shift. In some cases, the board has taken back much of the authority that it had abdicated to management. But we've seen too many boards go from one extreme to the other—from being passive to rather confrontational. There needs to be a healthy balance and constructive challenging of the assumptions and directions that management sets forth.



RICHARD M. STEINBERG
Corporate Governance
PricewaterhouseCoopers LLP

“Boards need to make sure management is acting with integrity, not just talking about it.”

Interestingly, some positives have emerged in this area. There have been offline conversations among individual directors and between directors and the CEO. In the past, that was seen as entirely inappropriate, but those types of discussions enable directors to feel empowered to bring up issues at meetings that otherwise might not be brought forth. There needs to be a clear understanding on the part of boards and management as to the issues on which the board provides input and advice, including those issues the board is prepared to challenge, debate, and provide direction on, and those issues where the board actually makes decisions. There are still a number of those areas where the board, in fact, makes the final decision on key issues. At the end of the day, you don't want a we/they relationship. The board is ultimately going to rely on management to carry out the strategy and to add shareholder value. So in addition to monitoring, you want a good partnership between the board and top management.

Ethics and Integrity

Another very important consideration is the ethics and integrity of the organization. Many boards and companies have long understood that having ethics pays. Ethical companies attract the best customers, the best suppliers, and the best employees because they all understand the importance of ethics. Due to the new rules, there has been a great deal of attention during the last year to the adequacy of the codes of conduct and communication channels. In fact,

Sarbanes-Oxley requires the audit committee to ensure that there is an open channel for employees to bring forth issues and concerns and take them upstream. These two areas are certainly very important, but, there should also be a focus on taking a broad-based look at how management instills a culture of ethics and integrity, as some proactive boards have done for a long time. To do that, you need to go beyond the code and the channel. You need effective communication of the content of that code, along with training, and you need to determine the extent to which employees truly embrace the philosophy. Are they comfortable with providing information? Do they know that there will not be reprisals? Do they know that appropriate disciplinary action will be taken when necessary?

Boards also are focusing very heavily on the actions of top management. Our experience is that management's actions, even behind closed doors, become known very quickly throughout the organization. Boards need to make sure management is acting with integrity, not just talking about it. And, of course, the board's own actions send a message to management and throughout the organization that it is acting with integrity as well.

Risk Taking

Taking risk is another area where we've seen the pendulum swing in the last year. Before the new rules, there were probably too many boards that allowed their managements to take risks that were deemed inadvisable or did not seem to be prudent, because the board

had not been focusing sufficiently on risk. There are now boards that have gone to the other extreme and have become risk averse because of the concerns about personal reputation and liability. There needs to be a balance, as companies are in business to take risk. Boards need to make sure that there is an enterprisewide risk management process in place so that management is identifying, analyzing, measuring, and managing risks appropriately. The board needs to be comfortable with management's risk appetite, and it needs to make sure that risk tolerance throughout the organization is aligned with that risk appetite and that both are properly measured. Ultimately, the risk taking needs to be aligned with company strategy and its implementation, and the risk/return ratio must make sense.

Summary

During the last year, we've seen change on the part of many, if not most, boards. Some changes have been positive, but many have focused on issues of form and structure, which are important, but are truly only enablers. What really matters is what goes on inside the boardroom—that the board is providing high-quality guidance, counsel, and direction to management. At the end of the day, what it is critical is that the board is effectively carrying out its fiduciary and oversight responsibilities.

Emerging Trends in Corporate Governance

TK Kerstetter, Corporate Board Member president, interviews Edward S. Knight, executive vice president and general counsel for The NASDAQ Stock Market, on trends affecting today's corporate governance environment.

There's been a great debate about splitting the roles of the CEO and the chairman on a public company's board. We'd like to hear your views on that.

It's consistent with the notion that the public expects and that our market and other markets are demanding: that companies have more independent advice at the board level—independent from management. To have a board chairman who is not a member of management underscores that the board is being led in an independent fashion. It is not necessarily something that's for every company, though. It depends upon the available pool of directors, the nature of the company, and whether it makes sense in terms of management and the strategic challenges a company faces. Incidentally, the NASDAQ board has just taken the step to separate the CEO position from the chairman position. But again, it is not something that we prescribe in our rules. It's part of the process that we hope every company will go through in examining its needs, its board's strengths, and the best way for its board to function and serve its shareholders. It's one option that many boards should consider, though.

Corporate Board Member has received feedback over the last couple of months relative to CEO/board communications. There is a contingent that believes that communications have improved in the sense that Sarbanes-Oxley and the listing requirements have brought the board and management closer together. There is probably a slightly larger contingent that believes that the use of outside advisers or outside counsel to aid compliance has actually hurt internal communications. What's been your experience?

We are going through an adjustment stage as people try to understand all

the nuances of Sarbanes-Oxley and the implications of the new listing standards that NASDAQ and other markets have proposed. So there is some natural confusion out there. I think it would be a mistake, though, for boards to move away from management and not be able to rely upon the advice they get from them. They should look at it objectively and at arm's length, but the purpose of our listing standards and Sarbanes-Oxley is not to drive a wedge between managements and boards. It's to clarify their function—the role of management to run the company on a day-to-day basis and the role of the board to oversee that effort and to help provide strategic advice and to perform other functions that are critical to shareholder expectations.

Ethics has been on the tip of many people's tongues relative to what's happening in today's boardrooms. How is that translated for public companies?

It obviously is a topic that is current not just in the securities area, but across our society. In these increasingly complex times, given the challenges that we face in daily life, ethics is something that we must keep uppermost in our minds and maintain as a high value in our culture. In boardrooms today, though, it's particularly important. It's not something you can legislate. It's a product of leadership and thoughtful guidance by the institutions that guide our professions, from the American Bar Association to the accounting industry to your organization, which has taken a lead in terms of guiding boards of directors as to best practices. We try to communicate with boards and give companies guidance about these issues. But it's important that we, as a society, talk about and maintain ethics as a high priority going forward.



EDWARD S. KNIGHT
Executive Vice President
and General Counsel
The NASDAQ Stock Market

Another issue that has hit the boardroom is director recruiting, particularly those directors who subsequently would be expected to serve on the audit committee. What have you observed about this phenomenon?

First of all, it underscores a principle that should have been clear—being on a board of directors isn't necessarily for everyone. People need to think carefully before they accept such a position. The additional responsibilities that the law and the listing standards now place on directorship clearly are discouraging some from taking it on, and that is a challenge companies around the country are dealing with in recruiting new directors. In the end, though, individuals will come forward. There is

As a director, what should I be looking for from the exchange in the future?

All we can promise investors, directors, and companies is a fair marketplace—a place where investors believe they will be treated fairly, where companies believe they are listed fairly and that their investors are treated fairly, where liquidity can be found, where participants can capitalize on products and projects in a fair manner and gain wide access to the capital markets.

We at NASDAQ are looking at ways to make our market more efficient and fair to all investors on a daily basis because in the end, that serves directors and everyone who participates in the capital markets well. Directors in

This process should not seem like an exam; instead, it should be something where they have access to the right answers and the right people to help them do their job better.

“ I think there is a belief that we are doing the right thing, but there will be a need to search wider and deeper for directors who have special skill sets, particularly in the audit committee area. ”

a desire to implement these new rules in a robust fashion. I think there is a belief that we are doing the right thing, but there will be a need to search wider and deeper for directors who have special skill sets, particularly in the audit committee area. There is no doubt that individuals are deciding that they do not want to serve on the audit committee. There are some who should not serve on the audit committee. And the fact that people are taking more care is probably in investors' interest in the long run.

particular, though, have a need to understand our rules better. We are working with organizations such as *Corporate Board Member* to ensure that we are reaching out to directors to educate them about our listing standards and about how our market operates. That is a difficult task now because of the complexity of the changes, but it's one we are committed to. We are looking at new ways to reach directors, whether it be through the Internet or through conferences. We want them to know that we are a resource for them to understand how they should fulfill their responsibilities.

Recognizing the New Risks of Serving on a Corporate Board

William A. Cotter, chief underwriting officer and senior vice president at National Union Fire Insurance Company of Pittsburgh, PA, a member company of the American International Group, Inc., reviews the impact Sarbanes-Oxley is having on director risk.

In previous webcasts, we've taken the opportunity to speak about D&O liability and the importance that directors should place on understanding their policy. We've reflected on a *Corporate Board Member* survey conducted at the end of 2002 in which 48% of directors surveyed said they had actually turned down a board position because the risk involved was too great. As the industry primarily responsible for assuming the risk of directors, we thought we would share our experiences and estimations as to the risk that directors face today, the impact of Sarbanes-Oxley, the significance of all these corporate governance discussions, and how we view risk management in this environment.

Plaintiffs' Bar

The first thing I'd like to discuss is the impact Sarbanes-Oxley will have on directors' risk. Obviously we are very supportive of the goals of Sarbanes-Oxley and the goals of good corporate governance. What we are concerned about, however, is the potential for the law of unintended consequences to come into play. And by that I mean there is some confusion in the legal community as to what various measures within Sarbanes are going to mean and what the real needs of companies and of management are in this environment, which may lead to an opportunity for the plaintiffs' bar to exploit some of these unintended consequences. Sarbanes-Oxley has extended the statute of limitations in which private securities litigation can be brought against directors. There is a lot of focus within Sarbanes-Oxley on the role of independent directors and the role of audit committee members and the financial expert. What we don't know is how the private bar is going to respond. What strategies are its members going to adopt? We have

already seen a clear change in the dynamic of the courtroom. Judges are people, too. They read the newspapers. They are impacted, as are the rest of us, by what they read in the papers.

In certain jurisdictions at the appellate level, we've seen that judges are much more apt to reverse lower-court dismissals of securities litigation because they believe that plaintiffs deserve a stronger opportunity to prove their case. And what that is telling us is the very real possibility that in this litigious environment, the courts and the lawyers are going to view directors and officers as guilty until proven innocent. We may well see an increase in frivolous litigation given a recent *Wall Street Journal* poll that reported 67% of prospective jurors agreeing that executives will lie to increase profits. That is going to be a very opportunistic and expensive legal environment for directors to be operating in.

Accounting and Legal Concerns

We are also seeing the dynamic of conservatism in the accounting industry as its members are going back to companies and second-guessing themselves on auditing decisions. We are witnessing concern in the legal community about whether the noisy withdrawal of Sarbanes-Oxley is going to be put into effect as well as concern about the potential for conservatism within the legal community in advising management to second-guess their prior decisions. When you add in the requirements of whistle-blowing, another unintended consequence is that whereas before the concern was that directors weren't getting enough information, now they may be getting too *much* information. There could be a struggle with materiality of this information overflow and how they



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Chief Underwriting Officer
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Group, Inc.**

disclose and deal with that. So that's another concern we have in this environment.

Compliance Costs

The last impact of Sarbanes-Oxley I'd like to discuss is the overall cost of compliance. Clearly it is going to be very expensive to put new measures in place to be compliant with Sarbanes-Oxley and the various corporate governance initiatives that are being proposed by the stock exchanges or by experts. We are hearing that companies are struggling with that cost. Obviously the cost of D&O insurance needs to be

statistics: Over the past seven years, almost 20% of all publicly traded companies have been sued in a securities class-action case; almost 15% of all publicly traded companies have filed a restatement of their financials in the past six years; and just over 10% of all publicly traded companies have filed for bankruptcy in the past six years. There is real risk for directors in today's environment. But given that risk, there are defenses. There is still the business judgment rule. Critical to that rule is the fact that you can't just have processes; you can't just check off governance metrics. Directors need to

“**What that is telling us is the very real possibility that in this litigious environment, the courts and the lawyers are going to view directors and officers as guilty until proven innocent.**”

considered, but our concern when looking at implementing good compliance procedures for Sarbanes-Oxley is that companies may view these initiatives and Sarbanes-Oxley purely as an expense as opposed to viewing the true value that they can bring to management and to the board in helping them govern that company.

Director Risk

In answering the question “How risky is your board seat?” the answer is “It is risky.” Just to give some general

ask difficult questions, directors need to be actively involved, and directors need to understand the business operations of their companies. So much focus today is being placed on compliance that directors are not focusing on the most important aspect of their job—effectively managing the business.

Understanding the Board's Role in Risk Oversight and Crisis Management

Gerald S. Backman, senior partner at Weil, Gotshal & Manges LLP, discusses the intrinsic role risk oversight and crisis management play within a company's corporate governance system.

Risk oversight is the process by which the board of directors, or the audit committee in conjunction with the board of directors, attempts to identify the risks inherent in the business or to which the business may be subject and develops policies and procedures in an effort to control those risks. There are many types of risks to which a business may be exposed. Thus, it is important that the board not only have an awareness of these types of risks but also gets management to filter the right type of information to the board so that it can fulfill its oversight function and management can implement a successful risk management program.

In defining risk management and crisis management, the question to ask is where does it fit into the overall corporate governance scheme? Some seem to think that you only have risk management and crisis management if you first have good corporate governance. I view risk management and crisis management as part of good corporate governance; they go hand in hand.

For example, many of the new listing requirements indicate that the audit committee is responsible for reviewing the policies and procedures that have been developed by management and the board for controlling risks and dealing with crises. You can't have good corporate governance without policies and procedures to deal with identifying and controlling risk. And when a crisis does occur, how do you deal with that crisis and avoid the spiraling effect of the situation getting much more serious and effectively putting the company out of business? It's all part of the same reporting process that's in place in other areas of the company to help management bring information to the board. These reports identify risks, deal

with them, go through worst-case scenarios, and recommend procedures for what to do if a crisis should occur, notwithstanding all the controls and risk management oversight that's already in place.

In order to distinguish risk management from crisis management, I view them as two sides of the same coin. Risk management involves trying to identify and prevent risks. Crisis management comes into play when that risk you thought was avoidable becomes unavoidable. And once a crisis occurs, how do you deal with it? That's crisis management. So the two go hand in hand, but they are separate steps in the process.

What are examples of company risks?

One clear area of risk is accounting fraud. It must be controlled and identified as a potential risk, and policies and procedures must be developed—ones that have become much more familiar now due to Sarbanes-Oxley and the new accounting rules. Other types of risk are those that may be beyond the company's control—such as 9/11, an earthquake, a fire; in short, events that can occur in the life of a corporation and create serious risks to the business. The loss of a major customer and changes in technology are further examples.

There is a broad spectrum of potential risks. One of the hardest tasks is identifying those risks at both the board and management level, and then determining how to monitor, control, and deal with them as they occur so that they don't take the board by surprise and become a crisis that must be dealt with on an emergency basis.



GERALD S. BACKMAN
Senior Partner
Weil, Gotshal & Manges LLP

What happens when unavoidable events occur?

If the unavoidable does occur, a lot depends upon the nature of the entity and the event as to how it's handled. Smaller companies may have different ways of dealing with unavoidable risks than larger companies, and a lot of it may be cost driven. But for starters, you must have a set of procedures to determine what will be done if an event takes place. For example, identifying the lead director or some other independent director as the party in charge of the process. You

the independent directors if you will, the ability to get that process going without necessarily having to wait for management to approve or disapprove it. Again, the goal is to avoid the spiraling effect that can result from one problem leading to more serious problems. You may have an SEC investigation of an accounting problem. Then the company may find itself subject to a Justice Department investigation on top of disclosure problems to the public and on top of potential problems with creditors and its credit rating, the availability of

gap in your organization's corporate governance program. Furthermore, whatever rating there may be of a corporation's governance policies will have to include risk management and crisis management.

“One of the hardest tasks is identifying those risks at both the board and management level, and then determining how to monitor, control, and deal with them.”

also need a good public relations identification so that you can get assistance from experts in how to publicize the crisis and to deal with the public's fear of it. You may need different types of advisers depending upon the nature of the risk. So if it's a financial problem that's come into play, you go to the auditor or someone in auditing. If it's a legal risk, major litigation, or an environmental problem, there are advantages to bringing in a law firm that's skilled in crisis management in that particular area to deal with the problem. There are also expert crisis managers who are trained in coming into an organization and assisting the board in managing the process. One of the advantages of Sarbanes-Oxley is that it empowers the audit committee to retain independent advisers using mandatory company funding, thus giving that committee,

financing, liquidity problems, etc. The situation can mushroom and before you know it, you're talking to your bankruptcy advisers. So a lot depends upon the particular problem, the size of the company, the scope of the risk and the crisis involved, and whether a small group can act quickly to decide how best to manage the crisis.

Summary

I think that risk management/risk oversight and crisis management are intrinsic to the corporate governance system within a particular organization and must be viewed as part of the total process. All the pieces must blend and fit together. Various aspects of the ongoing governance requirements will lead you to include risk management and crisis management as part of the process. Without them, you are going to have a significant

Guidelines for Conducting Board Evaluations

Susan S. Boren, partner at Spencer Stuart, outlines the many factors directors must consider when drafting and implementing a successful board evaluation.

Boards are thinking about and beginning to conduct board self-assessments because they are being pressured both from the outside and inside. The stock exchanges are presenting them with guidelines that suggest this is something they need to do on an annual basis, and from the inside, directors are thinking about how to become more effective. With everything that's going on in the world of governance, boards are looking to best practices to understand whether they are meeting the standards. Finally, we are seeing companies turn toward board evaluations because independent shareholder groups are starting to rate boards, and one issue they are looking at in determining whether a board is effective is whether it conducts an annual board evaluation.

Who Initiates a Board Evaluation?

When a board decides to conduct an evaluation, the initiative may come from the CEO, who thinks it would be a great idea. It may come from responsiveness to outside forces or from individual directors who think it's time to look at how they are performing. The person (or persons) responsible varies depending on the board's structure. Sometimes it falls to the governance committee to initiate and implement a board evaluation. If a board has a lead director, that person may take responsibility for launching a board evaluation. In some cases, though not as much recently, the CEO will take responsibility. As we look at the importance of board independence, board members are beginning to take this on as their responsibility, either through a committee or a lead director.

Keys to Board Evaluations

During a board evaluation, one of the first and most important aspects is

board size and composition. Is there the right number of directors and are the right people sitting around your board table? Size has become a bigger issue given the new requirements from the exchanges. If you don't have enough independent directors on your board, you can't really staff your key board committees. There are now three required committees—audit, governance, and compensation—and each needs at least three independent directors. Therefore, you have to look carefully at size and make sure that you have enough directors who can bring the skills you need to those committees.

Board Committee Structure and Charter

When boards are considering the effectiveness of their committee structure and looking at the charters of those committees, it's important to recognize that much of the board's work gets done in committee. To organize that work, it's important to have the right committees based on the business and on the company's issues. Beyond the three key committees mentioned above, some companies find it's important to have other specialized committees.

Equally important to which committees a board has are the following: Do those committees have a charter that reflects the appropriate work to be done? Have the committees divided the work so that there isn't redundancy in the charters? Are the committee members clear about their accountabilities? The only way an evaluation works effectively is if you are judging yourself against something. In the case of committee charters, it's a great thing to go back to in your board evaluation and ask, "Have we accomplished what we said we were supposed to?"



SUSAN S. BOREN
Partner
Spencer Stuart

Board Agendas

Board agendas is an area of board evaluations that's sometimes overlooked, yet it can be key to the board's effectiveness. If the right agenda items are there at the outset, the board tends to have the right kinds of discussions. Board members are pretty good at following instructions; they talk about what's on the agenda. And if that agenda includes only those issues that look backward and feature reports on things that happened in the last quarter, then that's what takes up the board's time. We encourage boards to look at each agenda to ensure that there is time for discussion, so that directors have the opportunity to

could change the way individual board members participate in a discussion. Many times in a board evaluation, it will come out that several directors dominate discussions. By having that as part of the evaluation and looking at the quality of boardroom discussion, you can often get at relationship issues on the board, which will lead you to a fuller discussion of issues and broader participation by all directors.

Quality and Timeliness of Materials

It's interesting that a board's performance can be so affected by the materials that are provided to directors and the timeframe in which they are

such a way that not only audit committee members can understand the company's condition, but the entire board has some insight into the company's performance.

Level of Director Participation

One thing that often comes from a board evaluation is a sense from some directors that there are a few directors who give a lot and some directors who give very little. The real value of a meaningful board evaluation is coming to terms with the expectations of directors and gaining a better understanding of whether or not each director is filling a role. It's quite clear that not every director offers the same

“**The real value of a meaningful board evaluation is coming to terms with the expectations of directors and gaining a better understanding of whether or not each director is filling a role.**”

interface and build off of one another's thought processes, and that a good portion of the meeting is related to looking forward and focusing on the company's strategy and direction.

Quality of Board Discussion

In looking at board performance, directors will often focus on the quality of discussion in the boardroom or in committee meetings. The point is to ask, “Are we really adding value? Are we advisers to the CEO and the management team? Are we talking about things that matter?” Often there will be things that can be learned from the evaluation that could change the way topics are teed up to the board or

provided. But it's been proven that if board members have the right amount of information at the right time, they are generally motivated to make good decisions and their discussion can be enhanced by the preparation they've done prior to the meeting. A complaint that often comes from board evaluations is that directors receive too much information. One of management's accountabilities should be to not send a five-pound book, but to send a one-pound, meaningful book that includes the issues on which it really wants some guidance from the board. The other issue that is important in looking at board materials is to make sure that the financial information is presented in

thing to a board, but what's most important is that each makes a meaningful contribution. The level of engagement is gauged both by attendance and participation, but there needs to be recognition that each director has an individual contribution to make based on functional experiences, current responsibilities, or simply the wisdom that he or she brings to the board table.

Relationship to CEO

There are several sensitive issues that boards must address as they get into board evaluations. One of the most important is the board's relationship with the CEO. It's a fine line. It's a

relationship-based issue that has to do with whether or not board members are independent and willing to challenge ideas brought before them, yet supportive of the management team that they've put in place. Taking a hard look at whether the board is achieving that balance is one great benefit of a board evaluation. This is an area where directors need to ask the CEO for input about what's going to be most helpful to him or her in doing the evaluation. But some of the most meaningful discussions coming out of board evaluations are around the issue of "Do we have a supportive and challenging relationship between management and the board?"

Strategic and Succession Planning

Planning is another major issue in a board evaluation. Most boards are looking carefully at their role in both helping management set company strategy and in succession planning. I'd like to address those separately.

Boards are less clear about their role in strategic planning. A strategic plan is often formulated and initiated by management and brought to the board for input and approval. The point at which the board gets engaged in that planning process is individual to each company and depends on the culture of the management team. Boards are really struggling with the right place to get engaged and the right amount of input to have in the whole strategic planning process. Many directors are finding that if they set the proper tone, it also gives them the opportunity to engage with the management team in a way that helps them deal with succession planning, because they have exposure to management and management's thinking.

Boards have a clearer understanding today that they are accountable for succession planning. There should be no question in any director's mind

that that is a part of the board's responsibility. The board evaluation, however, can help directors discuss what that plan looks like, whether they are on track for executing a successful succession plan, and, if not, what the board needs to do to get there.

Effectiveness of Executive Sessions

Boards are learning to sit in executive session without the CEO and talk about things that matter. A key aspect of a board evaluation can be to really talk about whether directors are satisfied that they are doing what needs to be done in those sessions, talking about the right issues, and not letting them deteriorate into a gripe session or other nonproductive conversation. Executive sessions can be short and crisp, but they can also be the most important part of a board meeting, if it is during that part of the meeting that directors are candid with each other about their feelings regarding what's happening in the company, how management is doing, and how the board as a team is doing in supporting management.

Summary

A meaningful board evaluation is time well spent by directors and can go a long way toward improving a board's effectiveness. Putting a board evaluation together is as important as the evaluation itself. Asking the right questions will get at the right issues and elicit the right kinds of responses from directors.

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