



Corporate Board Member's 2007 Academic Council discusses the board's role in succession planning, the use of inside and outside advisers, and the new environment for executive compensation.

Emerging Trends in Corporate Governance



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To ensure the company's leadership and vision remain steadfast, boards need to take control of succession planning, giving full consideration to both inside and outside candidates before the unforeseen occurs.

Photography by Mike Kentz

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Editor: Deborah Scally
Copyeditor: Kimberly Crowe
Art Director: Allie Lankford
Production & reprints: Amy Sewell

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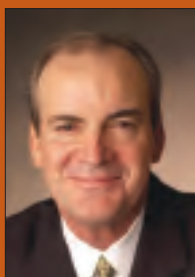
STEVEN HALL
& PARTNERS
EXECUTIVE COMPENSATION

Dear Corporate Director:

The relationship between the CEO and the board involves a strong sense of trust as well as consensus about the long-term vision of the company. Engaging in direct, honest dialogue is vital to this relationship—especially about sensitive matters such as succession planning and executive compensation. This year, SEC regulations aimed a bright light on these areas, creating a feeling among many directors that they are working under a microscope. It is vital that boards have the right tools to help them deliberate critical issues and make sound business judgments.

Earlier this year, the *Corporate Board Member Academic Council* met to discuss three crucial issues that corporate directors address on an ongoing basis: succession planning, executive compensation, and the use of board advisers. In each session, our panel of leading academics, bolstered by expertise from our sponsors, PricewaterhouseCoopers, Spencer Stuart, and Steven Hall & Partners, shed light on critical questions facing today's boards. The resulting roundtables featured in this supplement offer our panelists' clear reasoning on best practices for good governance.

With this in mind, we hope the 2007 Emerging Trends in Corporate Governance supplement will serve as an invaluable resource to both new and experienced directors.



TK Kerstetter
President
Corporate Board Member



Catherine L. Bromilow
Partner and U.S. Leader for
Corporate Governance Practice
PricewaterhouseCoopers LLP



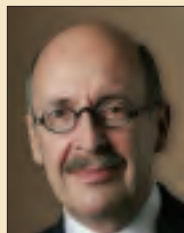
John S. Wood
Senior Director
Spencer Stuart



Steven E. Hall
Managing Director
Steven Hall & Partners

2007 Academic Council

Corporate Board Member formed the Academic Council to identify emerging trends in America's boardrooms through council roundtables, interviews, and selected research. The council is composed of the leading academic authorities on board governance, representing some of the country's most prestigious universities, graduate programs, and corporate governance centers. Our belief is that directors, officers, educators, and students will benefit as we strive to be the premier journal and Web source of thought leadership on corporate governance and board issues.



William T. Allen
Director, Center for Law and Business
Nusbaum Professor of Law and Business
New York University



Sheli Z. Rosenberg
Adjunct Professor
Kellogg School of Management
Northwestern University



David O. Beim
Professor of Professional Practice,
Finance and Economics,
Columbia Business School
Columbia University



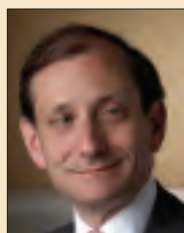
F. Daniel Siciliano
Executive Director and Lecturer in Law
Stanford Law School
Stanford University



B. Espen Eckbo
Tuck Centennial Professor of Finance
Director, Center for Corporate Governance
The Amos Tuck School of
Business Administration
Dartmouth College



Robert B. Thompson
New York Alumni Chancellor's Chair in Law
Vanderbilt University Law School
Vanderbilt University



Charles M. Elson
The Edgar S. Woolard Jr. Chair of
Corporate Governance,
John L. Weinberg Center for
Corporate Governance
Lerner College of Business & Economics
University of Delaware



Michael Useem
William and Jacalyn Egan Professor of
Management and Director of the Center
for Leadership and Change Management
Wharton School
University of Pennsylvania



Steven N. Kaplan
Neubauer Family Professor of
Entrepreneurship and Finance
University of Chicago Graduate
School of Business
University of Chicago



Stephen M. Wallenstein
Executive Director,
Duke Global Capital Markets Center
Professor of the Practice of Law,
Business & Finance
Duke School of Law and Fuqua
School of Business
Duke University



Jay W. Lorsch
Louis E. Kirstein Professor of Human Relations
Harvard Business School
Harvard University



empathy*

by arthur baines

"I think one of the key things that I learned while I was in Cameroon, West Africa was the importance of breaking down the barriers between my personal and professional life. The only way I'm going to build sustainable relationships is to let others see my vulnerabilities, to take the time to listen to people, and to understand who they are and attempt to share with them those things that make me human."

Arthur Baines took part in the PricewaterhouseCoopers Ulysses program dedicating his time and talents to an AIDS prevention program in Cameroon. He is a principal in our Firm.

See Arthur's story, and learn how the lessons of life are the lessons of business at pwc.com/upclose

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Turning Up the Heat on Compensation

Issues such as say-on-pay, disclosures from CD&As, and pay for performance have made the compensation committee a target of intense shareholder and public scrutiny.

David O. Beim
Columbia University

Sheli Z. Rosenberg
Northwestern University

F. Daniel Siciliano
Stanford University

Steven E. Hall
Steven Hall & Partners

TK Kerstetter
Corporate Board Member magazine

There was widespread speculation that there would be fallout in the form of media attacks or shareholder uprisings when the proxies' CD&As were released, but so far, we haven't experienced that. What is your perspective on what has transpired so far, and why do you think most people expected such a negative reaction?

Sheli Z. Rosenberg: I agree—the reaction has been much less than people anticipated. But there's a lot of data and very little information. You can read those proxy statements until you're blue in the face, but it is difficult to get real meaning out of them. For instance, you can't tell whether there are grants from prior years; therefore the numbers look inflated for this year. You need to have people's prior histories incorporated in their present histories. I do think, at a later time when there are specific issues that crop up, people will go back to these proxies and use them in a way that probably will create more trouble than information. But for this particular season we're not going to see a lot of negative publicity, because there's just too much information to deal with. There is also the risk of conveying people's activities in a way that is sufficiently negative, such that you will have CEOs and other executives who are starting to get rid of long-held stock or options and lowering the amount of ownership they have because of the numbers that are reflected. I think that's a very bad thing for a company, and it's a direct reaction to these rules.

Steven E. Hall: I agree; the number of calls from reporters and the number of inquiries from people is almost nonexistent this year compared to what it was in the past. If we want to look at the bright side of it, maybe what's happened is we've shown what's behind the curtain, and it wasn't that exciting. Also, companies had a year to plan, and I've never seen so many companies decide to give up country clubs and company cars and the like—the types of benefits that previously have been lightning rods for negative reaction. I agree with Sheli—I had one CEO who had an enormous amount outstanding of in-the-money stock options and had been deferring loads of money into pay who said, "I'm not going to do it anymore." When he saw the first draft of the rules, he started exercising options and cleaning out his deferrals, and that was not

what anybody intended these rules to do. When we talk about "CEO engagement," we shouldn't have CEOs worrying about what the public outcry might be over what they've earned or things that were properly granted in prior years.

In general, I had expected two lightning rods from the rules. One was going to be the CEO's far right column on the summary comp table. We've not heard a lot of noise on it, but there's a lot of confusion. Even those of us who work constantly with those numbers can't figure out what anybody was paid anymore unless we spend an awful lot of time doing the review. Short-term bonus and long-term bonus are mixed together, and this can create a lot of misinterpretation. The other area was the change-in-control numbers, but even those haven't generated a lot of excitement. So either we've all really gotten used to it, or everybody's just saying, "It's too much work to go through at this point."

I believe the SEC needs to step back and take another look at the rules. I think it made a great first effort, so if it could now fix some of the areas that aren't working, we might have something that's more usable in the future.

F. Daniel Siciliano: It's too early to conclude what the reaction will be. But just for argument's sake, I'll offer a contrarian viewpoint on what is emerging. First, realize that you don't feel real trouble for a while; it starts at a very small level, and then at some point it explodes. So we may be in the phase where things are percolating; we just haven't felt them hit yet. Here are a couple reasons why. First, in the context of a relatively strong economy, all of the criticism and focus is somewhat blunted. But if the economy goes south, or unemployment spikes, or something happens and we end up with a real stagflation, I think people will suddenly pay a lot more attention to the disparities in wealth and compensation. Second, how many of [we academics] actually subscribe to *USA Today* instead of the *Wall Street Journal*? I would argue that, to understand the dynamics on the ground, we may be reading the wrong newspapers. Part of what has happened is that the media coverage of compensation is starting to create a broader base of

knowledge for the average person on the street. Congress may pick up on that trend, so that could be a risk.

David O. Beim: I agree with Dan—I think there is more attention to this than we may realize and more shock about it than we may realize. I keep track of news clips on the subject, and almost every day there is an article in some newspaper on somebody’s pay package. Some of these articles are very critical, and they’re not all in small-town papers. So I think there’s plenty of concern about these numbers, and they’re getting picked up in lots of places. Also, both the *Wall Street Journal* and the *New York Times* had special supplements on executive compensation in early April, based on these new numbers. Even the *Wall Street Journal*, which is pretty rock-rib Republican and pro-business, was quite critical of boards’ inattention to this issue and was very concerned that boards not be complacent. There’s a real risk that those of us who live in this [academic] world get kind of immured to these enlarged numbers and say, “Oh, it’s another \$30 million. We’ve seen it before.” And yet that’s a huge amount of money, and to ordinary people out on Main Street around the country, it’s a shocking amount of money.

Rosenberg: I would like to add one point. The original question dealt with these new rules, but I would argue that compensation as a lightning rod has been growing for a number of years. This is not a new issue. As to whether these new rules have incited any greater kinds of explosions, I still don’t believe it. I do believe compensation itself is a sensitive issue, and I think we’re seeing a distinction made now between the amount of money the CEO makes and how much the others that are disclosed make that shows the numbers are outrageously disparate.

Let’s discuss say-on-pay proposals and congressional intervention on the issue of determining executive pay. Say-on-pay has the

potential to make all of our other worries seem small in terms of what it could mean to today’s corporations. Could you provide a foundation as to how say-on-pay proposals work, and then tell us how you think this issue will impact compensation committees and boards?



STEVEN E. HALL

Hall: Increasingly, there is an initiative to give shareholders the right to, at a minimum, voice their views on executive pay. This can vary from voting in general terms to voting yes or no on a package. Right now we have a structure that has a board of directors elected by shareholders. We have a compensation committee that’s designated out of the board, and its responsibility is to administer compensation for the CEO and other executive members of the organization. So the issue

becomes, is that committee doing a good job? Many of the people who like to say the world is coming to an end say board members are all friends of the CEO or are all in the CEO’s pocket, but that’s not the case. Or they say the directors don’t pay any attention to how pay is administered or understand the program, but that’s not the case. Or they’ll say the board members generally don’t care and just want to give the money away—but that’s not the case. I’ve never seen

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STEVEN E. HALL
STEVEN HALL & PARTNERS

compensation committees spending as much time, going through as much angst, and undergoing as much diligence as they are going through now to arrive at what they believe to be the best form of compensation. The CEO no longer designates the process. In fact, I’ve actually known CEOs to be dismissed from a compensation committee meeting, then seen the committee go into executive session so that it can design a long-term incentive plan while the CEO is out of the room, and afterward bring him back in and tell him: “Here’s your new incentive plan.” That’s kind of a

scary prospect. The idea of shareholders being able to vote—right now it’s a nonbinding vote—is just the beginning of a slippery slope that will lead to chaos as we go through the process. But I don’t see it turning back, and it could lead us to shareholders actually having an up or down vote on pay packages.

Siciliano: This is a hard issue. Again, I don't mean to be the contrarian, but I think boards have to get in front of this issue, because if the board takes the initiative and crafts a strategy that tries to satisfy the aims of the activist institutional investors, then it is no longer in the position of appearing as low-hanging fruit in terms of someone showing up and trying to tell the board how it's going to do say-on-pay. In the end, however, I think that's usually a bad idea, all things considered. But let me make one argument as to why it might sometimes be a good idea, and that concerns the way most boards, in my experience, search for a new CEO. It's a little like how you should not shop for a house, that is, to show up with your significant other and gush and say, "We've been searching for six months. We looked at 38 other houses, but this is the best house we've ever seen."

And you go around and talk about the remodeling, and then you turn to the owner and say, "By the way, how much is the house?" This is how we sometimes place new CEOs, and it puts the board in a very difficult spot. You must have give and take. So I would say, if you're looking to try to balance the scales in terms of a negotiated outcome, something needs to be done to further empower the board. The board should get in front of this and say, "We paid this willingly, deliberately, on purpose, and we would do it again."

Beim: I think we have less to fear from say-on-pay rules than most people imagine, and my best evidence for that is the fact that they already exist in some other countries. England instituted a say-on-pay law in 2003. It was followed soon thereafter by the Netherlands and Australia. More recently Sweden and Norway have instituted say-on-pay laws. So we have to begin by asking ourselves, what experiences have those countries had? England has had the longest experience, and it does not appear that the law has limited the rise in executive pay. Pay there has gone right on increasing despite the law. But the laws in these countries have had interesting and important effects in changing the mix and the tone of the discussion. The first thing that everybody agrees on is that it has greatly improved communication between shareholders and boards,

which is long overdue. I think the reason we've come to this in the U.S. is because boards haven't gone out of their way to explain what they're doing or why, and there's a lot of mystery surrounding their actions. So when a big number pops out, nobody's quite sure where it came from. Therefore, having a dialogue between the large institutional shareholders and the compensation committee is a very constructive step, and it goes a long way toward defusing the kind of outrage that might someday result in a serious revolt against the board. So that's one beneficial effect that's occurred.

In terms of the institutional consequences on pay itself, two things have happened that are notable. The first is that there is now a closer link between pay and performance. These discussions with institutional shareholders have resulted in a closer binding together of pay with performance results, and in general, a lot of people

believe that that is a valuable thing to do—that it does seem appropriate to pay people well when they do well, and less well when they do less than well. If that connection can be made, it would seem to indicate a good outcome. There certainly has been a stronger connection of pay with performance in the U.K. The other thing that's happened is that severance has virtually disappeared. The way it works in England is the board files a remuneration report to be presented at the annual meeting and asks the shareholders to vote on their opinion of the report. It's an advisory vote, so if it is voted down, the board doesn't necessarily have to withdraw it, but usually it will voluntarily do so. In the case of GlaxoSmithKline, which was the first one out of the box, there was actually a vote against the remuneration report that forced the board to go back and reconsider. It wasn't legally required to do so, but the board felt morally obligated to go back and reexamine it. It turns out

when they started talking to the institutional investors, the area that had given them the most distress was the severance arrangements. Many institutional investors—and many finance professors—think that a large severance pay is unnecessary. Most of the CEOs that we are concerned with are reasonably well off to begin with, and most of them should be willing to take a certain amount of

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F. DANIEL SICILIANO
STANFORD UNIVERSITY



F. DANIEL SICILIANO

risk in the world. So to guarantee that they get a massive payment if they get fired strikes many people as truly the embodiment of paying for failure, and therefore is the strongest hot button related to the issue.

Rosenberg: I take some exception to what's being discussed. I don't know of any company I'm affiliated with where there isn't a strong continuing relationship between management and the institutional investors. And there are ongoing discussions that include, but are not limited to, compensation. As we move toward pay for performance, we set standards. A number of those standards involve information that I don't think is, or should be, in the public realm. So my concern with a shareholder vote is that it is aimed at the individual investors who have the least amount of information and who might not fully understand, without a great deal more information being put out, what the standards are for pay. I find this very troubling.

Hall: I'm curious as to how much of the whole issue of pay is purely an issue of pay as opposed to a power struggle. Institutions all have different goals, but it becomes very clear that if you want to control what the company is doing and where the company is going and what management is doing, get the board and management in the vice of compensation, and you can get them to sing a lot of different tunes you'd like to hear. I wonder, though, whether that's truly in the best interests of all shareholders, as opposed to just a limited group of them.

Beim: That kind of behavior hasn't, at this point at least, been noticed in the five countries that have instituted say-on-pay. You don't see that kind of extortion or that kind of power shift. I do think there is definitely a secular shift toward more power for shareholders, but I'm not aware of any abuse of say-on-pay so far.

Siciliano: It's clear that we're afraid of what might be, versus what anyone is actually observing. I think directors are nervous that someone's going to show up in a concerted, organized fashion and say, "It's unjust,"

and that "to pay someone this much, on the basis of equity and justice, you should move forward in the following way." I don't think we've observed that particularly, but it's a part of what makes boards nervous, and it is something that deserves continuing debate.



SHELI Z. ROSENBERG

I'd like to turn the discussion over to the topic of pay for performance. In the past, people have benefited by the tide rising as a whole, and some have done very well with little substantive performance to substantiate their income. How do you look at the board's progress in terms of getting its arms around performance pay in the last two years?

Beim: All boards are wrestling with this issue, which is one that no board should lose focus on.

Many of them, though, leave large amounts of wiggle room in their formulas, and that wiggle room is often taken advantage of in a down year. So let me say a couple things about this. First, you don't want to have a single metric, because there is no single metric that is so good it trumps all the others. Stock price is one, but it can be manipulated, as we saw in the round of scandals about five years ago. I think the best practice is to take the company stock relative to its peer group. So relative stock performance should be a component, but not the only component. There should be several components that are more related to the actual

operations of the company, things that are more directly under the control of the CEO, because the CEO cannot in any direct way control the stock price—and you certainly don't want that. Second, I think a large puzzle surrounds the subjective factor. What do you count? How much weight do you give it? And how do you keep it from swamping the formula? So I think the board has to say, "Perhaps 75% of the compensation is going to be according to the formula, and

25% will be subjective." As to the subjective aspect, I don't think the board needs to explain much to the shareholders. It could say, "This has to do with certain behaviors inside the company that [the directors] would rather not make public record. There are certain forms of self-management and self-conduct that we've

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SHELI Z. ROSENBERG
NORTHWESTERN UNIVERSITY

asked our CEO to engage in that would not be right to disclose publicly, but we reserve the right to put 25% of his compensation on some sort of scale that we can be totally arbitrary on.” But for something like 75%, I think you’ve got to have a basket of metrics of which relative stock performance would be one, along with three or four others.

One other thing I would suggest is that you don’t want to have anything that has a break point where one magic number triggers a large amount of money—no cliff vesting, no “If you hit this target, then everything doubles.” It’s much better to have a scale of relative performance and then a scale of pay against those targets, rather than a single goal that gets you a pot of gold.

How would you rate the compensation committee’s performance in the last two years relative to getting its arms around pay for performance?

Rosenberg: It’s getting better, but I don’t think comp committees are there yet. I think they’re struggling with it mightily, and I don’t think we necessarily know where it should wind up. The reason everybody is struggling is because there’s not a real clear answer as to where to go in the future. We’re all trying to figure out where that is, and I think the trend is still murky.

Hall: I believe there have been dramatic changes. One of the big changes we’ve observed has been the method for setting performance criteria, and the actual performance metrics, whether it be on a short-term basis or a long-term basis. What I was always amazed at for many, many years is how you’d show up at the comp committee meeting, and members would first make decisions on bonuses based on the prior year, and then second, they would set the performance goals for the next year. You’d look through the board agenda and you’d find that later in the day, or on the second day, either the whole board or a committee was going to be having a meeting where they were going to agree to the business plan for the upcoming year. So they had it backwards in terms of what they were doing. I don’t see that happening much anymore. In fact, what we’ve seen is more cross-pollination. We’ve had some clients, when it comes to setting goals or making decisions on what the metrics should be, bring in members of the finance committee, or the whole board, or have joint meetings of committees within the board, in order to give everybody better input and perspective. So I think the process is getting much better.

I do struggle with the relative performance criterion, though I understand why it’s out there. This whole idea of relative stock performance is on its second wind. It was around about 15 years ago, but got pushed aside

because people weren’t happy with the results. You can look at certain industries, regulated utilities being one, where almost every company is using relative total shareholder return as a performance criterion. What I struggle with, at times, is that the board then almost says, “I’m not going to have to make this decision. The market will make the decision for me.” This is opposed to having a situation where you decide on the number of grants and the number of stock options you’re going to give based on an expected value and then saying, “This is what you will get if you meet your business plan over the next three to five years, which includes where we think earnings should be, what our PE should be, and, therefore, where our stock price should be.” We’ve actually got a way of building a performance plan like this as opposed to using the Black-Scholes model. So maybe we need a different way of figuring out what these restricted shares are worth. What are options worth? And what expected value do we anticipate will come out of them? My problem with the relative performance is that it’s tough to get a group of peers that are the same, and you find that even if you’re looking at industries like regulated utilities, you have some that are teetering on the edge of bankruptcy. You see others that have gone into bankruptcy and now can do many things because they’ve eliminated their debt. Meanwhile, a company that’s chugging along with good performance is just getting clobbered by other companies that are crashing and burning and then rising out of the ashes, but on a relative basis aren’t paying out that well. However, boards want the relative performance criterion, or comp committees want it, because it’s what shareholders expect.

Siciliano: Let me comment narrowly on relative performance issues and then get to the bigger picture. There’s a technical limitation on skewing too much emphasis toward relative performance. What I mean is, it’s likely that your management, and particularly your CEO, has enough industry insight to understand that the game may be wrapping up. So one of the problems with having relative performance on the way down is that your CEO isn’t appropriately incented to say, “I have good news and I have bad news. The bad news is our industry is coming to an end. The good news is I have a way out.” That conversation is less likely to be prompted early enough and in a constructive way if you have relative performance, such that if your company lands on the concrete floor last, your CEO is protected along the way.

A bigger issue is that although compensation committees are making great strides, by and large, their financial and technical expertise as board members is insufficient. What I mean by that is the following: You might have stock-based and benchmark-based performance criteria, but a

sophisticated model is going to need other things. Board members often cannot map for you on paper how to determine the cost of capital and EVA (Economic Value Added) and how that is different from cost of equity or return on equity.

So my biggest observation is that if we want to try to solve the difficult question of pay for performance, we first have to start investing more in the skill levels of the actual comp committee members. I think they're up to it—these are all smart people. But it's a huge gap that needs to be addressed.

Beim: You mentioned EVA, and I think that is a very good case in point. If there were one internal metric that is better than the others, it's probably that one, where you take operating income and subtract the cost of capital. It does require assigning the cost of capital, which is a complex exercise, but nevertheless, if you get people educated and hire a consultant who can do it fairly and at arm's length, I think that would be a terrific addition to any such formula.

Siciliano: And the company really has to understand what it all means. I think it's possible, but I think the directors need to understand it, even if they must hire a very talented consultant. Otherwise, you're shifting too much of the responsibility to someone else who just shows up and says, "This flavor of strategy is the right one." One suggestion is to investigate the various directors' education programs, including the Directors College, to try to bolster that skill set and move forward.

Beim: Sheli said that one of the trends is a trend toward equity-based pay, and I believe that's true. Within that, there's a trend toward using more restricted stock and fewer options, which I think is very healthy. The trouble with options is they're not symmetrical, and it's probably better to align with the

shareholders more fully by having a downside as well as an upside. Furthermore, we've seen backdating—manipulating stock prices to get a short-term gain on options. So for lots of reasons, I applaud the trend toward the use of restricted stock.

Hall: I commonly think of restricted stock as a time-vested vehicle. In other words, if you fog the mirror at the end of the time, the payout is yours. That was the first stopping point from options. Where we're going now is adding in performance vesting, which reflects the new accounting rules. Quite honestly, if you add the performance vesting, I think we've really got good vehicles.

Siciliano: Pay for performance, I think, begs the question of what kind of performance do you actually want? People often have a very specific idea of the company, and yet there's no average company. At any given moment you might want a catalyst who needs to make an all-or-nothing bet as a CEO. Or you might want a facilitator who just needs to continue what was going on; a caretaker in an industry where you're bidding your time to wrap it up and be acquired. My main point is some comp committees, before their board has come to terms with this, start trying to craft pay for performance before everyone has really agreed on what kind of performance they want.

Rosenberg: I would like to add that it is the comp committee's obligation to come up with not only a person's compensation, but a philosophy of compensation for the company. One of the things we haven't said is that you need to come up with a philosophy that a number of employees can understand, and as a result, although EVA may be and perhaps is one of the best

markers, it is difficult to understand at a lot of different levels.



DAVID O. BEIM

"To have a dialogue between the large institutional shareholders and the compensation committee is a very constructive step, and it goes a long way toward defusing the kind of outrage that might someday result in a serious revolt against the board."

DAVID O. BEIM
COLUMBIA UNIVERSITY

The Role of Inside and Outside Advisers

Advisers can be a valuable resource for the board on matters outside their realm of expertise. But they are no substitute for a trustworthy management team—or the directors' own good judgment.

William T. Allen

NYU Center for Law and Business

Robert B. Thompson

Vanderbilt University

Stephen M. Wallenstein

Duke University

Catherine L. Bromilow

Pricewaterhouse Coopers LLP

TK Kerstetter

Corporate Board Member magazine

If a board has a knowledge gap on a topic that is a major consideration for the corporation, such as information technology, what principles should guide it with regard to seeking outside advisers?

Stephen M. Wallenstein: Recourse to outside advisers should be more the exception than the rule. This principle goes to the duty of care of the board. Normally, in the kind of situation you've described, the board should ask about the process senior management has gone through to arrive at the conclusion that board action is necessary. In an IT situation, the company often will have engaged an outside adviser, especially given the magnitude of the expenditure involved. So rather than contract its own outside adviser, the board should try to get more information from management, or from the IT department. One way to do this, in the course of board meetings, is to have a discussion about IT strategy. Another way is to bring in someone to talk about general IT strategy during a board retreat. But for a board to resort to an outside adviser to examine or question a tactical concern, or the implementation of a business process, sets a bad precedent. If the board is unsure and doesn't have the confidence in management, perhaps it has the wrong management team in place, in which case the issue should be whether it should replace management, rather than question a specific decision by bringing in an outside adviser.

Catherine L. Bromilow: Stepping back for a moment, if this really is a major expenditure, ideally the first time the board hears about it is not when it is being asked to approve the expenditure. In most scenarios, if you peel back the onion, management has been up-front with the board about the need and the status of the project. So the board should be apprised of these things, on an ongoing basis, before management gets to the stage where it's asking for approval of the expenditure. In particular, if the board wants more education, then perhaps a special session to help directors understand the technology would be useful. But at the end of the day, the board needs to understand what the business need is, what the business solution is, how IT supports that business solution, and have the confidence to make the decision.

The board can't outsource the decision—directors have to make it themselves. And if the IT manager or senior manager can't explain the need in "business speak," then the board shouldn't approve the expenditure until the directors are satisfied that it is the right thing to do.

William T. Allen: I'd like to underline the distinction between a legal obligation to do something and what is good practice and judgment. First, with respect to legal liability, you can't answer the question of when the board must look for legal assistance in an abstract way, because the general obligation of the board is simply to act like a reasonable person would in similar circumstances. Boards are usually composed of generalists. Now, while we often want to put a board together with a portfolio of particular skills, most boards still will be made up principally of men and women with general business knowledge. It's not necessary for them to have detailed knowledge of the research agenda, or of the details of an IT project, or of entering the Brazilian market, for instance. However, it is necessary for them to be informed and exercise good faith judgment. For a long time, the law has made it quite clear that directors are protected legally when they rely on managers and experts in the company so long as these experts were reasonably selected. So unless directors have reason to think that management has a bad or incorrect motive, or is grossly misinformed, they're protected legally in relying on management reports.

Robert B. Thompson: There's no question there's been a dramatic upsurge in advisers to boards. Litigation committees have their own lawyers, boards have their own consultants, and more recently, audit committees and compensation committees are doing the same. This trend has provoked a real concern that it has degraded the board process or, even worse, diverted the board from advising on strategic concerns with management and running the business to other things. Is this the direction in which the board ought to be going—reaching out and seeking independent advice? I would answer that question by looking at whether management has a conflict of interest such that the board might want to have its own independent advice as opposed to the company's

advice. The example regarding an IT decision is not like a merger, a transaction by law at which the court would look to see what the board did in terms of its own advice. It is not a question of whether the board has a system in place to check the accounting. Those are the situations where we've seen the most compelling argument for independent advisers to the board. This is an operational decision, where the board ought to oversee what's going on, but also ought to trust management in terms of what it's doing to develop the information for the decision. And if that process appears to be working, if there's not a red flag that suggests some problem, the board might well be satisfied with not having independent advisers and instead handling this within what might be called the ordinary, operational decision-making process of the company.



CATHERINE L. BROMILOW

I agree this issue doesn't legally obligate someone to bring in an outside expert, but often management is in a mode to pitch a proposal. Shouldn't the board be sensitive to that situation so it doesn't bet the institution without some objective criteria?

Thompson: I would subscribe to the premise that when the presentation is from an officer who is in sales mode, the board ought to be skeptical in terms of asking questions, particularly when it's a "bet the enterprise" situation. So the question is, how do you get more information?

Do you have an expert advising management who provides you with an oral report? Do you get a written report from that expert? Are there red flags in the report that make you want to get more information? How far in advance do you get the written material? There are a number of steps boards ought to take, but the hard part of your question is, how far do you go? In your

IT example, do you want the board's experts trailing behind management's experts? Normally, no, but in a bet-the-firm situation that involves extraordinary change, I think the board should take steps commensurate with the degree of risk that's being taken, which could include seeking advice beyond what the officer has presented to the board.

Allen: Look, everybody is always trying to sell everyone else. Directors have to be skeptical. Just because an officer comes to the board with a proposal and naturally wants the board to say yes, that doesn't make it a good one. Also, as we've all said, when it feels uncomfortable, the board is free to go outside.

There is a cost to it, though, and a significant governance cost beyond the hundreds of thousands or millions of dollars of fees that are generated. You can't answer this question in the abstract beyond saying that boards can, if they're sufficiently uncomfortable, go outside. You can pose it as a bet-the-company question, but the implication is going to be that directors should be cautious about going outside to get advisers. Now, this could be a billion-dollar IT contract, and if I'm on the General Electric board and I've got a great, high-quality inside team making reports, I probably don't need to go out and double-check it. We don't want a system in which we're telling directors of U.S. companies to build more process to get information directly from outside advisers in the ordinary course of business. In doing so, we would create an implicit cost in running companies that we don't know how to measure, and it may be quite significant. So generally, unless you have reason to think that the reports you are getting are inadequate, there's no need to go to outside advisers.

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PRICEWATERHOUSECOOPERS LLP

When we see outside advisers come in, such as when there's a restatement and the board hires an outside lawyer to advise it personally and hires another audit company to come in and reaudit the company's books, usually governance becomes extraordinarily costly and difficult. So when you bring in an outside law firm that regards its only business as protecting outside directors from every possible risk of liability, no matter how small, the directors, who are naturally risk averse,

become hyper-risk-averse. So I think we may do injury to American business if we encourage directors too readily to turn away from management and move toward outside advisers.

Bromilow: If the proposition for this major IT project is really a bet-the-firm proposition, then you would

hope it's the kind of thing that's been thoroughly hashed out with the board from a strategy perspective, and not just hastily shoehorned into a board meeting. It should have been thoughtfully considered, maybe at a separate strategy retreat where there was some discussion and the board had a chance to go back and forth with management. Directors also should not be looking at this one project as the only proposal. Rather, they should consider other options—the pros, the cons, the risks—so that by the time the board sees the proposal again, perhaps with a lot more specificity, it has already vetted the concept. That's the first element. The second element concerns the board's experience with management. For example, if past IT projects haven't been delivered on time and on budget and have resulted in major disruption, then the board wouldn't have a high degree of trust in management. But if you have a large, well-controlled company and you have skilled managers who are on top of the project and have credibility with the board, then directors may not need to do anything else.

Wallenstein: I agree with Bill that you create a very dangerous precedent by relying on outside advisers. As Catherine said, a bet-the-firm situation should be clearly vetted in strategic retreats, over the course of several meetings between the board and management. And as I said, if you don't have faith in management, you probably shouldn't have this management team.

In general, I see three situations in which the board would look to outside advisers. One is in regard to fraud, illegality, or conflict of interest involving management and the board. The second is a bet-the-firm transaction in a major acquisition. The third, of course, is in response to very serious litigation. In the litigation or merger situation, the board might look to outside advisers, though it could look to the company's advisers, unless it believes the outside law firm, investment banker, or auditing firm is conflicted. In the first situation, where you have a conflict of interest or illegality involving management, it becomes trickier, and in that case, you might want to look to an outside adviser because of the conflicts. But in terms of a normal business decision, even one that's bet-the-firm, if the process has been vetted, if the issues have been discussed in strategic retreats, and if you trust management, then it seems to me you have to go with what's proposed.

Let's talk about board culture for a minute. Is it possible we'll get to a point where we have directors who are brought on the board to cover certain disciplines? And if so, will we lose the true chemistry of the full board? What do you think is the board's most important cultural attribute?

Thompson: A board is designed to work collectively, not individually. It's not a hierarchy; it's a collective being. That said, chemistry is essential, because the group has to work together. If the board is dysfunctional, it can't perform the tasks we want it to do. Given that, I agree with Bill's earlier statement that board members usually are generalists, and even though we try to get variances geographically and in expertise, we can't get away from the fact that this has to be a collective enterprise—we can't delegate IT to one person. You can do that in a hierarchy—but that's not what a board's supposed to be. So it's important, as you form a board and as you work with a board, to keep your eye on the chemistry. This takes constant nurturing and support, so if it's not working, you have to reform it. If you have to trade off particular expertise to get an effective group dynamic for advising and monitoring management, that's the way I would opt.

Allen: Corporate governance is an art, not a science. There is a fundamental tension between the board collectively exercising its judgment and turning to individuals with expertise. It seems that the real source of the problem you refer to is not so much the desire to have a range of talents on the board, but rather the emphasis on having independent directors in control of the important committees: audit, compensation, and governance. Once you give those committees such heavy responsibility, and you increase the workload of the board as an institution, inevitably there is going to be a tendency for everyone outside the audit committee not to be seriously engaged in the work of that committee; the same can be said for the compensation and governance committees. That, to me, is the primary reason the board becomes divided as an entity. Now, I think there's probably an essential balance. Getting independent directors involved is a good step, as is having these key committees made up entirely of independent directors. But consequentially, others will tend to rely on them. So while I wouldn't want to back away from that, I think you have to keep an eye on that balance by having the board leadership make sure that at the board meetings, there's enough time to fully discuss committee reports and so forth.

Bromilow: I'll use an analogy of the audit committee. Post-Sarbanes-Oxley, boards had to start identifying whether a director was an audit committee financial expert and naming that person in the proxy. But we still expect other audit committee members to care about accounting and reporting, and not abdicate their responsibility to the financial expert. Similarly, if you look for someone who can be your IT expert, do you expect that individual to be the only person who's asking the tough questions on the subject? I'd be very reluctant to advise a board to bring on a person with only a specific skill set if that person also can't

function more generally and cohesively with the board and fulfill some other role beyond subject matter expertise. And if I were an IT expert, I wouldn't want to be in the position of, in effect, making the IT decisions for the board.

Wallenstein: Let me take a slightly contrarian view. I think you're describing a dichotomy between collegiality and expertise that does not necessarily exist. If you have a corporation that's highly involved in international activities, or highly involved in IT activities, a board should look for expertise in the same way it looks for a financial expert. I don't think you have to name that person in the proxy statement, and I don't think that person alone will make the decision or be responsible for an IT issue or an international issue, but I certainly think that different strategies in companies, operating in different markets, and so on, really call for a certain amount of expertise. Just because you have that expertise doesn't mean you're not going to be able to get along with your fellow board members—I just don't see that dichotomy. In the future, I think we're going to see greater reliance on experts, such as looking for CTOs from other companies to sit on boards to provide their knowledge.

We started this question by inferring that the technology area is one in which boards feel very exposed. Maybe 10% or 15% of boards think they have the right expertise in this area. So why not try to find somebody who's technologically oriented and even has an IT background? And why should you necessarily assume that that person is not going to be collegial and not going to be able to get along with everyone else? So I guess I'm in favor of looking for specific expertise, just as you would look for specific expertise in a financial expert. Of course, the directors have to be independent, but one of the challenges of independence is how do you get your hands around what the company is engaged in if you are completely independent? One way to address that is to have the necessary expertise on board to help evaluate what the company is doing.

Bromilow: I think that one of the challenges, though, with some people who have deeper expertise but who haven't necessarily served on a board before, is understanding what a director's role is and not going in and managing the process.

Wallenstein: That's why they need to attend board education programs. Something like 35% of directors chosen are first-time directors. There are already a large number of directors who have not served on boards before; therefore, I'm not sure how big an issue that really is.

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WILLIAM T. ALLEN
NEW YORK UNIVERSITY

Has any of this, whether because of a knowledge gap or because they are seeing it as important, created the need or the desire for boards to create special committees rather than go to outside experts?

Bromilow: Boards do establish other committees—such as risk

management committees, which are generally required by banking regulators, or public policy committees—often in response to an issue that the company believes is a significant risk. We've seen companies that are involved in the food distribution business, for example, viewing food safety as such a key issue that they establish an ongoing committee to better monitor the issue. One of the advantages of setting up a separate committee like that and not having it under, say, the audit committee, is the fact that on one of these special committees you aren't restricted by independence rules. Thus you can have a member of management who has operational responsibility for that area on the committee to provide more insight.

Wallenstein: I agree, I think there's a lot to be said for a separate risk management committee. I think the audit committee is overburdened with responsibilities, and a risk management committee can deal

with whatever the specific issues are for the company.

Thompson: In my view, special committees create tension. When the committee hires advisers and then the advisers come in, make a presentation, and dominate the board meeting, you get the sense that the advisers are setting the agenda, not the board



WILLIAM T. ALLEN

members. I think you have to link the two issues we've discussed: having a special committee and the use of advisers. Special committees have been common in boards for 40 years. In the '70s, special committees were an agent of reform, so to speak, and then, as the use of special committees moved into the '80s, they became a very effective vehicle for insulating management from challenges in court. If you had a special committee, the Delaware courts, in particular, were willing to respect what that committee did. So this was an effective way to deal with litigation. Fast forward another couple of generations and it's not surprising that special committees are being formed again. I think the debate today is how much of corporate board meetings do we give over to special committees, and does that mean we are giving a larger percentage of board meetings over to advisers who are not board members? There's a broad spectrum of firms that have gotten into the advising business. Some are very good, and some are not so good. So it raises concern about how board meetings are being handled. I think there's a place for special committees, particularly for conflict-of-interest issues, such as in large M&A transactions, but less so in operational questions. So as we look to special committees, we need to make sure we are framing the issue as whether it is a committee of the board plus advisers, and whether that is going to help us or not.

Allen: I would agree with most of what has been said. Designing its committee structure is one of the first governance functions of the board, and there is no standard template, except for the currently mandated three committees. But each company will likely be faced with recurring problems of a certain type and importance, so it may wish to have special committees for those. You can design whatever

committee you want that will help you function as a board. The tension comes when you must decide whether to put issues in committees or before the full board. I wouldn't think that, for many companies, you would want to delegate to a special committee an operating issue, for example. If you do this, I think it's a signal that something is not working. If you have to

delegate to the board to get involvement at that level, for an issue that's essentially a management job, then something has gone wrong.

Could each of you talk about the pitfalls directors should be aware of when using outside advisers?

Also, when does it become the right time to say, "This is where I could use some help"?



ROBERT B. THOMPSON

Thompson: I think any decision maker always worries about being judged after the fact, in hindsight, when you have to make the decision in present time, with foresight. That's human nature. But there is a difference between worrying about ultimate exposure to liability and doing what makes good sense. Delaware law, which is the most developed, gives a very broad berth to relying on

experts. There's a specific statute that says directors can rely upon experts, and the only requirements are good faith and that you reasonably believe that the issue at hand is within the expertise of the person who is the expert. So from a liability standpoint, there is a lot of room to be able to rely upon experts if necessary. In one sense, that is a comfort and can be a firewall to protect you from worry. But the ultimate question is, is it useful or not? Directors know that experts can be wrong, that the resulting decision and process may not be any better with an expert involved, so you've got to decide whether it's useful to go

beyond what you have from management, beyond what you have from the company's experts, beyond what you have in the boardroom. I think that situation is not going to be the normal case for operational decisions, but it could be the case, particularly when there's a conflict, or when there is an extraordinary transaction like a merger, or if there is a red flag that has shown up that you should respond to. So those are three examples I would cite of when you should be looking

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VANDERBILT UNIVERSITY

for outside assistance.

Allen: If a board was faced with an operational decision of such significance that it wanted further expert information, it should ask management to arrange for that because the board isn't in a position to manage that kind of relationship with outside experts.

Consider management buyouts, for example. The board has to interview law firms and banks, then hire one. It's a very complicated situation that consumes a great deal of directors' time. So if we're talking about an operating decision—one for which the board needs more information—I think the sensible thing to do is to go to the CEO and say, "We don't feel comfortable yet. We want more information, so please recommend a couple of firms that could go out and do an independent study."

And then let management manage the general counsel and let the chief information officer manage the financial side of it. The board can make sure that the contract is reasonable and so forth, but beyond that, directors can be pulled into what is clearly management of the company. Moreover, if a board selects the outside expert and it makes the contract, then it's going to have to supervise the effort, so then, in effect, it's managing the company.

Bromilow: If we leave aside these sort of special investigations, or a management buyout, and if it is up to the board's discretion, then I agree with much of what Bill said—if the board really does want some additional advice, it should go through management to get a short list of potential firms or advisers to work with. The board may want to make the final selection, but it can also set some parameters around things like the independence of the consulting firm. For example, if the board wanted independent advice, it probably wouldn't want the same firm that management was planning to use to implement the solution. Depending on the nature of the issue, if the board is driving the choice, then it should have an understanding and an agreement on some of the key milestones and deliverables and roughly what the fees are going to be. The other important thing, particularly in a scenario where management doesn't necessarily want the outside adviser engaged, is for the board to ensure that the chosen firm is getting the information it needs and has access to members of management. That way, when it does come back with a decision or a recommendation to the board, it's based on full information. At the end of the day, whether the board

is using an outside firm because it has to or just because it wants to, the board can't delegate that decision. It's still the board's decision, so it has to be comfortable with it.

Wallenstein: Let's not forget that the board, in its ordinary course, relies on outside advisers. The audit committee relies on external auditors, the compensation committee relies on compensation

consultants, and the governance, or nominating, committee relies on outside counsel. So there is substantial input from outside advisers, and in many of these situations, the existing outside adviser can be trusted to provide good advice, or indicate where you might find needed advice. To bring in an additional party, as Bill said, requires a lot of interviewing, a lot of time, a lot of expense, and it has the potential to fracture the board

or fracture the relationship between the board and management. It also indicates a lack of trust. Furthermore, the board needs to avoid getting into a situation where it's managing the process, so I think the idea of asking management to supervise the process of hiring another outside firm and having it make a report is often a better approach than the board hiring an outside consultant itself.

To conclude, what questions do you have that you wish corporate governance research would answer?

Thompson: I think the big evolving issue is between directors and the role of institutional activist shareholders, and whether that is changing the boardroom dynamic from what we've seen for the last 30 years. More specifically, we have to figure out how often shareholders are going to be part of regular board discussions, as opposed to an extraordinary discussion on, say, a takeover. Partly this has to do with the technology shareholders now can use to communicate, compared with 10 years ago. I

also think shareholders are having a role in governance that is not the traditional role, though we haven't figured out what that is yet. For those reasons, directors cannot assume that they can run the company independent of shareholders the way they did 20 or 30 years ago. So we need to figure out what

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DUKE UNIVERSITY



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that new shareholder role is, because we can go too far and have too much shareholder involvement. But no matter what, we're going to have more than we had 20 years ago.

Allen: What interests me are the empirical connections between various governance practices and the production of long-term wealth, a topic we don't know very much about. We seem to realize that our heavy reliance on director independence really doesn't relate very much to performance—either accounting performance or financial performance. There's some indication that certain antitakeover devices are associated with lower financial performance, but recent financial literature suggests that there's a real causation problem. It may be the case that the companies that underperform are the ones that put in antitakeover provisions, rather than the antitakeover provisions causing the underperformance. So we really don't know a lot about this very critical issue, the connection between governance and performance, at a time, as Bob says, in which we are fundamentally changing the institution.

Wallenstein: I think the relationship between shareholders and the board is a very important, evolving situation. Issues like say-on-pay, majority voting, staggered boards, the removal of poison pills, the influence of hedge funds and private equity funds on boards, as well as the value of contested elections and the pressure some shareholders are bringing are all relevant. I think the tricky thing for boards is to distinguish between shareholder demands that potentially create long-term value for the company, which deserve response and should engage conversation, and those demands that are related to short-term stock performance and are a form of greenmail like we saw in the 1980s. How you get at that is another issue, but I think research on that and the relationship between shareholders and the board is going to be extremely important going forward.

Bromilow: One of the most interesting topics is the question of who do directors represent and who are the shareholders? For example, with securities lending, where you have institutional shareholders who may be long-term shareholders who have loaned out their securities in the securities lending program, do we know who is voting at proxy time? Sometimes, as far as I understand it, both may be, in effect, voting their shares, but then who should be voting and who are the directors really representing? That would be the one question I would love to see some research on.

The other area for research is one that's a little further down the road, and it involves the new executive

compensation disclosures. If we look at how past attempts to limit or control pay have had the unintended consequences of increasing it, it would be interesting to understand what impact the current, and much more extensive, disclosure on executive compensation is going to have.



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Be Prepared: The Board's Role in Succession Planning

To ensure the company's leadership and vision remain steadfast, boards need to take control of succession planning, giving full consideration to both inside and outside candidates before the unforeseen occurs.

Charles M. Elson
University
of Delaware

Jay W. Lorsch
Harvard Business
School

John S. Wood
Spencer Stuart

TK Kerstetter
*Corporate Board
Member* magazine

Nearly 40% of the directors we surveyed in our most recent *Corporate Board Member/ PricewaterhouseCoopers LLP What Directors Think* study said their board was "somewhat effective" or "not effective" at completing a management succession plan. Based on that response, what steps should boards be taking to become more effective at this task?

Jay W. Lorsch: You need to ask yourself, "Why are we facing this condition?" before you ask what boards can do about it. The problem is that most boards have too much to do, and matters of management succession and management development often seem deferrable. So the first thing directors need to do is to take succession seriously and put their money where their mouth is. They need to devote time to it, including adequately assessing the performance of the current CEO. They should also look at the internal candidates and make sure they're getting the developmental experiences that will prepare them potentially to take over the company. So that would be my first recommendation, to take the job seriously and to really devote the time to doing the job well, even though you don't see any immediate urgency to the situation.

John S. Wood: The CEO succession process historically has been run by CEOs who dictate the timetable and often determine who is under consideration. But CEOs have been under siege recently, and all sorts of additional scrutiny and pressures have befallen them. As a result, they're less likely to spend time thinking about their own exit, and boards are showing some reluctance to address the topic as well. So, when is a good time to do it? When things are going well? If the CEO is under siege, the directors don't want to further threaten him or her by bringing up the subject. But it must be brought up; indeed, it has to be discussed. There are many situations—some of them unforeseen—that require the board have someone to go to. Yet sometimes directors are afraid of alienating certain members of management if they choose that person ahead of time. Even so, we suggest the board pick up the mantle of responsibility to get it done. Ken Freeman wrote a Harvard Business School article about CEO succession that said it's a joint venture

between the CEO and the board, where the board owns it and the CEO works with the board to help execute it, which seems like a pretty good construct.

Charles M. Elson: In life there are two kinds of decisions: those that are important and those that are urgent, and boards tend to defer their time to those that are urgent over those that are important. That's just a natural human tendency. CEO succession is one of those issues that is very important, but oftentimes isn't deemed urgent until something happens. The succession process can be of two types: First is a planned succession, such as a retirement, when you know it's going to happen and the date is certain. The second is the at-need, or the surprise succession, such as when someone dies, gets sick, or is recruited elsewhere. So how do you deal with each of those situations? With a planned succession, the board needs to be thinking about it in advance of the occurrence. The process should be board driven, with some input from the outgoing CEO, but the key is the board must pick the successor, and this issue needs to be considered on an ongoing basis, not just before the CEO is about to retire. The surprise succession is a bit more complicated, and the best way to plan for that, frankly, is to have identified several individuals within the organization who could take over if necessary on an interim as well as permanent basis. There are a number of companies where we've seen that this has worked rather successfully, which is really critical to the board.

Studies show that many CEOs are not comfortable discussing succession. What is the chief executive's role in CEO succession, and how should a board monitor that dynamic?

Wood: The CEO should be comfortable having the conversation, but it should be an objective process that brings up the topic. If the board just throws it out there, the CEO may feel threatened. So we like to see it mandated that a committee of the board regularly bring up this topic, perhaps offsite at a strategy session. The bottom line is, the CEO runs the business. So the board needs to make the CEO comfortable about having this discussion. We actually advise our CEO recruits to bring it up at a board

meeting. Maybe not at the first one, but by the second or third board meeting, we suggest they walk in to the board and say, “Let’s talk about my successor.” It’s viewed as a sign of strength, that the new CEO is assuming responsibility. Boards universally feel comfortable when it’s brought up in that manner, but it doesn’t always happen that way.

Elson: Well, no one likes to admit their own mortality, and I think that’s the problem with bringing up the issue with the sitting CEO. But just because he or she is unwilling to talk about it doesn’t mean the issue shouldn’t be confronted. It has got to be confronted. Typically, it takes place either in the compensation committee or in governance committee meetings, but it’s something you have to be thinking about on a regular basis. It’s also why at board

meetings, it’s effective to have not just the CEO present, or even the CFO, but other officers of the company, so directors get a sense of the talent base within the organization. That has to be on every director’s mind. I’ve been in a couple of situations where we had a CEO terminate with very little notice, and obviously, in those cases, the company has to go on. Fortunately, in those instances, it was something we’d been thinking about a bit, and we were ready to respond effectively because we understood the talent base within the organization. But again, it’s not something that should be CEO driven. It has to be board driven—that’s the issue. As a board, you have to ensure that the CEO reports on a regular basis on potential successors. That’s prudent. If a CEO is unwilling to discuss it, then that is a situation the board must remedy.

Wood: One of the advantages of having the responsibility reside with the compensation committee is that you can actually link the CEO’s compensation to his or her effectiveness at having a succession plan—we’ve seen boards do that. That’s a good way to get the CEO’s attention, at least.

Lorsch: While I think Charles and John are right that no one wants to talk about his or her own mortality, I think the issue is broader than that. People are

uncomfortable talking about the possibility of their own failure. It’s understandable that CEOs don’t want to discuss this. So the board has to take responsibility for it. I think the way boards should do that, at the most fundamental level, is to have a calendar of issues they’re going to consider during the year, and one of those things should be management development and

management succession, so they have a regular review process. Fundamentally, I think that gets the CEO off the spot. And if it’s an ongoing process that is part of the annual calendar, it starts the moment the CEO walks in the door. In this way, I think you have the best probability of getting the CEO to do his or her part of the job. And the CEO does drive the process—he or she knows who the candidates are and chooses who moves from this job to that job, and so on, so you want to understand the CEO’s

thinking. He or she may not be right, but at least the board should have the benefit of the CEO’s thinking, and then it can make its own determination as to whether the CEO is correct. So the important thing is first, be very insistent that the process be there on the board’s part and second, drive it from the very beginning of the CEO’s tenure.



JOHN S. WOOD

“CEOs have been under siege recently, and all sorts of additional scrutiny and pressures have befallen them.”

JOHN S. WOOD
SPENCER STUART

Charles, you made reference to where on the board this responsibility lies. In your minds, where is the most logical place for this responsibility to be housed among the board committees?

Elson: It’s typically in the compensation committee. This makes sense because the members of this committee negotiate with the CEO over compensation and are familiar with compensation programs in the organization. That being said, it doesn’t mean it has to stay in that committee. You have to have, perhaps annually or semiannually, as part of a structured, full-board meeting, a discussion on succession. In other words, the comp committee may be thinking about this throughout the year, but at least once a year it’s discussed among all the board members, which is prudent.

If you don’t want it in comp, I think the other effective place for succession is in the nominating/governance committee. But either way, the point is not that it’s in a committee, but that the whole board, on a regular

basis, devotes a certain period of time at a board meeting to considering this issue. You're not going to map out an entire succession plan at those sessions. In reality, succession, other than via retirement, occurs in lightning-fast and unexpected ways. So even the best-laid plans in this area don't always pan out the way you think they will. On the other hand, having a spectrum of people identified—in the case of a quick resignation, illness, or death—means that you're able to move quickly. You should be able to get someone in there on an interim basis within a matter of hours or days. Filling the position permanently may take a bit longer, but the key is to allow the organization to survive the shock of a sudden removal of leadership.

Lorsch: While you may want to start it in a committee, I really believe succession planning is the responsibility of the whole board. I think one of the unfortunate byproducts and unintended consequences of Sarbanes-Oxley is the extent to which we rely more and more on committees to do the work of boards. If you believe, as I do, that the idea of a board is based on the premise that you have a group of people with diverse skills and abilities who are going to look at problems and issues, then you want to get the full board involved in any significant issue, whether it's strategic or whether it's an issue of management succession. Also, when I say it ought to be on the board calendar, I'm suggesting there ought to be at least one meeting a year where succession is the primary issue on the agenda, where the full board understands what's going on and has the ability to contribute, ask questions, and make recommendations about how things should change. I feel very strongly that if you don't put the whole board on it, you're making a big mistake.

Wood: Succession planning is by no means a static process. The notion of semiannual discussions is a good one, because board members change, management teams evolve, and the requirements of the CEO—the nature of the competencies that the CEO requires—evolve. If you're doing a thoughtful, longer-term plan, members of management will contend for the position, ideally, but they can change, too. The board needs to keep track of that, and not just have a plan in an envelope in the CEO's drawer that says, "Open only if needed." It's a vibrant process, and it needs to be actively maintained.

That's a perfect segue into our next topic. Could you discuss the thought process and dynamics behind developing internal candidates versus attracting external candidates? Is going outside more difficult? Do you compromise anything by promoting inside candidates?

Wood: You need to understand what talent you have on the inside, which requires undergoing a fairly objective assessment. Often the CEO reports on how members of his team are doing. But the criteria the CEO is using to assess and measure them may or may not match what is most important for the future, compared to the strategies of the past. If the business has all been going in a certain direction and requires a certain skill set, then that should be the one assessed internally. With regard to inside versus outside, I actually think you can do both. We're seeing more and more cases of external benchmarking during the CEO succession process, whether it's during the planning process ("How do our guys compare to the outside? What do they look like?") or the actual recruitment process. This helps when there may be strong internal candidates, and yet board members believe it's their responsibility to assess the best on the outside and then make a judgment between the two. So it's not an either/or situation anymore. In the majority of our CEO recruitments, we also have an internal candidate that we assess and report back on.

Elson: For a long time, boards got kudos for going outside and recruiting superstar CEOs. But a lot of the superstars flamed out dramatically, so the view that has now taken hold—and correctly so—is that these superstars were overblown and that the boards made a mistake going outside, ignoring internal talent, and seeking out a very expensive person to save the company. That said, I don't think you should look only internally, either. For years, many large companies went internal, and I think their growth and development became stultified because they never brought in anyone with a new idea. If you are homegrown, you know the organization, but oftentimes it's hard to innovate in an environment you helped create. So there's something to be said for going outside. The key has to be balance. In certain circumstances in a company's history and development, an internal candidate makes a lot of sense, and that's why you must continually develop a really strong bench. Where you get into trouble is when you've relied on a superstar, and the superstar effectively destroys the rest of the bench, so there's no one left but the superstar. Then when that person disappears, you do have a problem.

In my view, the critical thing is the board itself. The board has to be independent of the CEO as well as large equity holders in the company—with experienced individuals who have the business sense to understand the difference in a company's growth cycle and not be afraid to either look outside or stay within, depending on the circumstances.

Lorsch: There's no question that, over the last few years, we, the business community, seem to have

gravitated toward the outsider as the best choice. The arguments for the outsider usually are that the person, as Charles suggested, will bring about change—if that’s what’s needed. I’m not sure that’s a valid argument, because there are plenty of examples of people who get promoted from within who also bring about change. However, the question is, do you have the talent inside to lead the company? Even if you have a well-constructed succession plan and think you have the right person inside, you still need to look outside. It’s a good benchmarking exercise.

But I want to come back to the board, because I think, fundamentally, before the board goes out and starts looking for anyone—inside or outside—it has to have a sound idea about where it thinks the company should go over the next five to 10 years. And the problem with most American boards is they don’t have a clue. They suddenly need a CEO, they rush out to get someone, and all the while they’re looking in the rearview mirror. But they have to look to the future. So the first thing the board needs to do is ask, “Where do we want this company to go strategically, and, therefore, what kind of talent do we need?” Then they can look inside and outside. That’s the process I would use, because otherwise you’re picking someone based on reputation and what worked in the past, and that’s not the way to do it. One advantage, incidentally, of picking an insider is you’re probably going to pay less. There’s significant evidence that today’s compensation problems would be solved if we only hired insiders, because the people that really get involved in competitive battles for more money are generally outsiders.

I want to say one other thing. There is an idea that every company can run a horse race, in the manner of a GE or Procter & Gamble, where you have 10 great executives running big businesses, and they’ll pick one of them to be the next CEO. The reality is that most American companies are not in that situation. Most medium-sized companies have one CEO running the company and one or two other general managers who have the breadth of experience needed to run the company. So in essence, you have created something that looks more like a

relay race, not a horse race. What I mean by that is if you pick someone to be the chief operating officer to run the basic business, and he or she reports to the CEO and everyone else is off on the periphery, you have established that person as the heir apparent. There’s nothing wrong with that, but you ought to be clear that that’s what you’re doing, and that the board is comfortable when that decision is made. It’s important to recognize the reality of the number of viable candidates a medium-sized company can really have.

“Even if you have a well-constructed succession plan and think you have the right person inside, you still need to look outside. It’s a good benchmarking exercise.”

JAY W. LORSCH

HARVARD BUSINESS SCHOOL

You bring up an interesting issue in regard to determining the vision of the company. One might argue that if the CEO is on the board, there can’t be multiple visions, because the CEO plays a major role in where the company is headed. So when you have an internal candidate, he or she is probably continuing the same direction

and vision. But won’t that create a challenge when the board is trying to set the vision?

Lorsch: First, I want to be clear. I don’t think it’s a valid conclusion that an insider is necessarily going to do what his or her predecessor did. There’s too much evidence to the contrary—take Jeff Immelt at GE. He clearly has moved that company in a different direction, and he’s not alone in doing so. I think if you get a good internal candidate, one of the things you need to understand is, what is his or her idea about where the company should go? To your other point, I think the fundamental question for any board to ask—even more important than who will be the CEO—is: Where are we trying to take the company over the next five to 10 years? What are we trying to do? If the board doesn’t have an idea about that, then I think it’s going to have a hard time picking the next CEO.

Wood: I agree, the number of times we are retained to find a CEO where there is not a clear

vision is remarkable. It’s actually one of the main reasons the board has to go outside in the first place. The process we like is to interview the directors individually, asking each of them where they think the business is and where it should go. It’s striking how often they don’t agree. Sometimes you ask six directors and you get eight opinions—it’s remarkable! But that’s



JAY W. LORSCH

OK. I would rather learn that a board isn't in agreement on a vision for the business up-front and have that disclosed, so that candidates know the directors need someone to help them figure it out. That then becomes a selection criterion for recruiting the CEO.

Elson: The CEO is not simply managing the operation—he or she is also there to set the operation's future, with the review and consent of the board. But that's why you look for the best possible talent to run the organization. It isn't just running the organization; it's also figuring out where the organization is going or should be going. That's vision, and that's what you look for in a CEO. That's behind the whole notion of centralized management in a public company. The board is not there to run the company day to day. The board is there to monitor management and make changes in vision or strategy if necessary. But you have to give the CEO running room. There may be situations where a company, in the view of the board and management, is on a steady course, and the issues are more operational than visionary. So sometimes you want a great radical visionary, and other times you want a good operator. Frankly, the best candidate is someone who combines the two, but unfortunately, there are not many of those.

Lorsch: There's just one other thing that is implicit in this discussion. These things depend on the situation of the company. If it's a company that's really going gangbusters—doing very, very well with a bright future—then you have one kind of succession problem. If you're in a situation where the company has not been doing well—where the shareholders are unhappy—the board is likely faced with a need for change, which is another type of problem. If the board doesn't know where to go, then you have to get someone who will help it figure that out. If the board has a sense of where the company needs to go, then it's going to pick someone who will lead the company in that direction. All of those things are plausible scenarios in the real world, but the board needs to understand the succession process in terms of the performance of the company and in terms of its clarity about what it wants from the next CEO.

Elson: I agree—boards aren't the visionaries. Management, led by the CEO, is the visionary, theoretically. The board is there to make sure the CEO acts appropriately in carrying out the vision. I think it has to be centralized in one person. It's very hard to be visionary as a collective body. On the other hand, it's much easier to monitor as a collective body. But I think vision is something that should come from a single person.

Looking ahead, what issues do you see emerging in the area of management succession? Are boards going to take more control? What is your forecast?

Elson: Given today's governance thrust, I think boards are going to take a much more active role in this area than in the past. Thirty years ago, boards were policymaking and advisory bodies to the CEO. The CEO dominated the company. It was "my company; my board; and my succession." The board was sort of the parsley on the fish, so to speak. It gave the CEO moral support and helped with making policy and giving good advice, but as far as steering the operation—forget it. Today, though, the role of the board has changed. It's actually reverted more to its original role, which was that of hiring management, firing management, and monitoring in between, as well as directing the company. As this role becomes more important, obviously succession rises in importance. No longer is it the responsibility of the one person who directs the show to pick his or her successor. It's now incumbent on the board to actually stand up and oversee the course of the operation. So in my view, given the changing role of the board and the rise in importance of corporate governance, number one, boards will be taking a much more active role in the succession process, and number two, succession planning will become a regular part of what they do.

Lorsch: If I had a crystal ball, I'd be a pessimist and say I'm not sure much is going to change very quickly. But let me talk about my aspirations. I think Charles and I have a slightly different view on this. I think we need to get boards to take responsibility for the leadership of their companies. That doesn't mean they run their companies on a day-to-day basis, or even a week-to-week basis, but to the extent that American companies are going to become great again, boards need to say, "This is where we want this company to go, and this is how we're going to get there, and this is the kind of person we need to lead the company." I'm convinced that's what we need. But I'm not optimistic that it's going to happen. I think you're going to hear more and more people preaching this because too many American companies are in trouble, and too many boards are concerned that they've been sidetracked into becoming compliance bodies and making sure Sarbanes-Oxley is working. I think directors are itching to figure out how to get into a stronger leadership role, and if we can get that movement started—that's a big if—but if we can get that movement started, then we're going to see more attention paid to the selection of the CEO.

Wood: Well, I think for a lot of the reasons we've talked about, boards are going to end up assuming a great deal of responsibility for CEO succession

planning, but I think it will evolve and come full circle back to the CEO. I think CEOs will recognize that it's their responsibility to get it right. It's expensive to go outside, and it can be disruptive. Sometimes change is good, and you need it. That's what outside consultants are for. But if the CEO really has ownership, he or she is the one who should be charged and feel the responsibility to deliver. And I'm more optimistic than my colleagues about that happening the right way, because I think we're in the midst of a sea change with respect to the leadership style of CEOs. We've had a long history of fairly imperial CEOs. They were revered and put on a pedestal. Everyone took care of them, and that was the way it was done. But we're seeing a change in leadership style. A.G. Lafley [Procter & Gamble]



CHARLES M. ELSON

and the aforementioned Jeff Immelt are two very high-profile CEOs, but they are CEO servants. They take care of their constituents. They actively seek them out. Their attitude is much more like professional services managers. It's a much more complex job now, but I'm optimistic about the role of the CEO. I think we're going to breed a generation of good leaders who will make it easier for boards to address succession planning the right way.

Lorsch: That's very optimistic. I hope you're right.

To finish our session, I'd like to ask a general question. Looking at the bigger picture, what questions do you have regarding corporate governance that you wish research would answer?

Lorsch: More than anything else, and this is my own personal view, we need to get a clear understanding of the relationship between shareholders, the board, and management. The fact is, we live with so many fictions and so many misunderstandings that I think it would be very healthy to have a clear picture of who the shareholders are, what their expectations are, and how they relate to the board and management. I think once we have that picture, we might be able to think about some ways to reengineer the system to give

shareholders a better voice with regard to what's happening in the companies in which they hold equity. At the moment, we have a very confusing mosaic of what's going on out there. As a consequence, boards don't quite know how to respond to shareholders and managements don't quite know how to respond to shareholders. To a large extent, I think this confusion is responsible for all the current angst about short-term management of American companies. There's been a lot of research about management. But the true understanding of shareholders in this country, I think, is really pathetic.

Wood: I think it's going to get very messy determining who is a shareholder. We're seeing a blurring of the line between private equity ownership and public companies. Recently, KKR bought a company in

which they've left an estimated 27% of the equity available for current shareholders to buy at the purchase price. Does that create both a public and private company? What is the oversight responsibility in that situation? We say these are private investors, but CalPERS is one of the world's largest investors in corporate America, serving a broad and very public constituency. What rule does it have? Is it the person at CalPERS who oversees the investments that controls the fate of all these people? Do they have a line of sight on that? In another recent case, a large private equity firm is considering selling a portion of itself to its investors. And Blackstone is ready to move forward with an IPO portion of its business. There are a lot of things like that happening today. How do we provide protection and oversight from abuse in the future? It's going to get more interesting, more complex—and it's going to get messier.


"In reality, succession, other than via retirement, occurs in lightning-fast and unexpected ways. So even the best-laid plans in this area don't always pan out the way you think they will."

CHARLES M. ELSON
UNIVERSITY OF DELAWARE

Elson: If this were five years ago, I would be interested in empirical work on the relationship between effective

oversight and board independence, and the relationship between effective oversight and board equity ownership. I would like to see some work done on the relationship between accountability and freer board elections. I think the whole notion of how boards are elected is certainly controversial now—both the method of election and the method of nomination.

I'm curious as to whether or not a more open or vibrant election process would actually produce greater accountability and greater results. In other words, would a more democratic election process, modeled effectively on the political system, create the kind of accountability we're looking for? Delaware law, interestingly enough, and its reluctance to involve itself in disputes between shareholders and boards, is predicated on free election— the notion of that if you don't like who is in power, you can always replace them. Well, a free election has been a bit of fiction in this country for a lot of reasons. The question is, if we move toward more vibrant elections, would we see an increase in accountability that would meet what the Delaware court is suggesting has gone on all along? I think some empirical study in that area would be very, very helpful to shareholders and to the courts as they sort out their role in mediating disputes between investors and boards.



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