CHAPTER 1

A Sturdy Framework

You have worked hard your entire career, reached the pinnacle of your profession, obtained the respect of your peers and community, assured yourself financial success, and are recognized as an outstanding alumni by your alma mater. Then you get a call to take on a new job that is time consuming, will test your character, and can destroy your reputation and wealth. As unappealing as that sounds, it happens every day and many do not hesitate to answer the call.

The offer of sitting on the board of directors for a public company is often viewed as the culmination of a successful career. The self-esteem, social recognition, and business networking opportunities might be all that come to mind when such an offer is made. Smart executives will also carefully consider the risks. They assess the health of both the business and the board. They evaluate whether they can truly contribute as a director. They recognize that if they accept, the job will require homework to make certain that they are prepared to perform their duties according to the highest principles and implement practices that will protect their reputation and ensure their professional survival.

The problem, however, is that newly appointed directors typically have not prepared themselves for this role. As successful executives, many believe that they have all the requisite tools and knowledge necessary (and could likely teach others a thing or two). In reality, a directorship is a job that takes preparation, requires a thorough understanding of governance practices and responsibilities, and requires a different mindset than that of management. Directors are representing stockholders and, as such, must possess a certain amount of professional skepticism in executing their duties. Failure to do so is a breach of the most sacred business covenants: duty of care, good faith, and independence. The purpose of this chapter is to introduce a framework that will enable directors to approach their job in a way that minimizes their risk and maximizes their impact.

There are certain board facts that all potential directors should grasp, namely, that being a director is:

- **Time consuming.** Most boards in the S&P 500 hold just under eight meetings per year on average.[1] Some board committees meet frequently. Audit committees not only meet more frequently than other committees, they also carry more responsibility.
- **Risky**. If the company comes under attack for illegal or even unethical behavior, a director's reputation could be forever tarnished. If related decisions are deemed to lack good faith, they can be financially damaging as well.
- **Not as profitable as you might think**. While compensation at larger companies can be significant (and is increasing to attract reluctant candidates), the amounts usually pale in comparison to the individual's net worth. For smaller company directors, their net worth may not be comparable, but neither is the compensation.

Nevertheless, there are benefits to becoming a director. Most of these are quite obvious. There is the respect and other psychic rewards associated with being selected to serve a company. An invitation to be a director is often viewed by many as reaching the pinnacle of the business world—your acceptance to the "club." A directorship can result in business and social networking contacts not otherwise available. Many directors enjoy the mentor role involved in helping to guide a company to greater prosperity. This is not to suggest that these rewards are not worth the liability associated with becoming a director. In fact, there are legitimate concerns that many qualified candidates conclude outweigh the rewards. It is suggested that potential directors need to do their homework to make certain that they are joining a healthy board that supports transparency and acts in the best interests of stockholders.

It is critical for the health of our public companies that quality directors continue to provide them with the benefit of their experience.

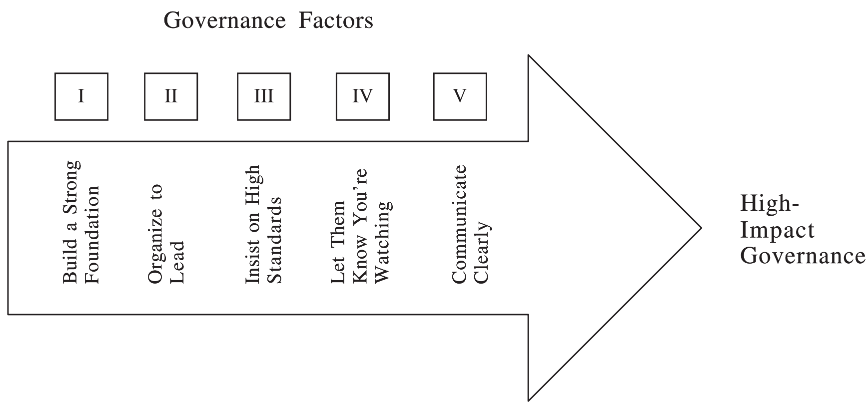

EXHIBIT 1.1 High-Impact Governance Framework

As such, directors not only need information, but a framework that will help guide and provide confidence that they are doing all that they can to reduce their personal risk by championing rock-solid governance practices. The High-Impact Governance Framework is such a device designed with a view toward providing the power tools that conscientious directors seek. The framework contains the strongest concepts currently available and is unapologetically black-belt grade with the director's well-being at heart. It consists of five governance factors: Build a Strong Foundation, Organize to Lead, Insist on High Standards, Let Them Know You Are Watching, and Communicate Clearly (see Exhibit 1.1).

GOVERNANCE FACTOR I: BUILD A STRONG FOUNDATION

We begin our journey by placing our initial focus on building a strong governance foundation. This includes a brief legislative history to put current events into proper context. Having the right board structure can be important to good process, so "board basics" will be introduced to serve as the bedrock for the governance structure. In this section, we also cover director "independence," "good faith," and the "business judgment rule" as it relates to director liability and ways a board can mitigate risk.

GOVERNANCE FACTOR II: ORGANIZE TO LEAD

Once our foundation is established, Factor II will help us organize to lead. A board can lead without proper organization, but it only makes the job more difficult. We will evaluate the role of the audit committee and explain why an intelligent director candidate should interview the CFO and the outside auditor among others before taking on such a responsibility. Even if you do not intend to sit on the audit committee or consider yourself a financial expert, this is a critical step. It is important to form an opinion regarding the aggressiveness of management's financial policies. A high-level discussion regarding the company's revenue recognition, reserve, and financing policies can tell a director much about management's approach to business. Motivated candidates should also interview the general counsel regarding any pending legal or regulatory issues. For instance, you do not want to learn at your first board meeting that the company's sole product is being contested for violating a patent. We will explore a number of red flags that directors can familiarize themselves with prior to interviewing the external auditor and general counsel.

There has been no shortage of compensation scandals. Directors are coming under increasing fire for their lack of oversight and understanding of the compensation plans covering their executives. Given the amount of recent litigation and negative press, a potential director should always attempt to determine if there are any compensation issues forming. We will examine both faulty remuneration plans and the components of a strong plan.

Most director nominees understand how they were selected for board service. Nevertheless, we will study components of a strong nomination process and the risks of directors selected through the good old boy network. One of the country's best corporate matchmakers will share her experiences and an action plan that helps boards identify that perfect candidate. We will examine when committees, other than audit, compensation, and governance, might be appropriate and highlight one committee to be avoided.

GOVERNANCE FACTOR III: INSIST ON HIGH STANDARDS

A board can follow all the right rules, check all of the governance boxes, and still preside over a rapid financial meltdown of stunning proportions. This happens because a premium is placed on process over culture and social systems. The path to high-impact governance requires that the board insist on high social standards. This includes establishing the right culture, not just in the company, but also in the boardroom. Building a strong culture is more than issuing a statement of values or code of ethics; it is the result of a prolonged program of communication and action that clearly delineates behavioral boundaries and rewards desired activities. This "soft subject" is worthy of even the most hard-nosed boards. A strong, ethical culture can overcome a number of governance sins, and directors have a vested interest in supporting steps to embed such a culture in order to keep their personal liability to a minimum. Together, we will explore the social characteristics of boards that work well together and how they are able to set and enforce the proper "tone from the top." Finally, we will evaluate desired board behaviors and ways to reinforce them, some structural, some not. This includes conducting executive sessions without unnecessarily upsetting the CEO and the importance of populating a balanced board with the people you need to succeed. We will further examine what qualities effective directors and their boards possess (and why a nominee should also determine who else is on the board), their background, their ownership stake in the company, and the board's relationship to management to determine if it is sufficiently independent to ensure healthy debate and decision making.

GOVERNANCE FACTOR IV: LET THEM KNOW THAT YOU ARE WATCHING

Even a well-organized and socially healthy board can falter if it does not possess strong oversight skills. Techniques for board supervision and monitoring will be reviewed in this part of the book. We will address risk analysis, operational oversight, and even monitoring management's compliance with corporate policies. We will also cover a subject that interests most directors: the issue of shareholder access and corporate defenses and what to do when hostile forces find your boardroom.

GOVERNANCE FACTOR V: COMMUNICATE CLEARLY

Boards can do all the proper things, but if they do not succeed in communication, particularly to regulators and investors, their good actions will be lost in the noise of negative perception. Governance Factor V focuses on how to comply with the new communication requirements imposed by Sarbanes-Oxley and the U.S. Securities and Exchange Commission (SEC).

What should a director do when, despite his or her best efforts and the efforts of other board members, things go wrong? Much depends on the type of crisis and the board's measured reaction. Therefore, we will cover some crisis management steps that directors can take to protect themselves and the shareholders they represent.

It will become clear that many procedures presented in this book are required, while others are considered best practice. Furthermore, some best practices are controversial. Opinions will be given on these subjects. However, it is less important that you agree with the personal position of the author on these issues than you are made aware of the vigorous debate being waged. Each side of an argument is provided to some degree so that you can begin to develop your own position if you have not already done so. I must also point out that, although I work for one of the most respected law firms in the world and a recognized leader in the field of corporate governance, the opinions contained in this book are my own and not necessarily those of Weil, Gotshal & Manges, the corporate governance group, or any other practice of the Firm. We all try to find the best approach to these heavy issues, and the more knowledgeable voices there are to join the debate, the better the opportunity to make the most informed choices.

In the end, good governance requires a team effort between honest management and a board willing to offer their experience to challenge, counsel, and guide. In the final chapter, a call to service is proposed and why you are needed is explained. After reading this book, you will be ready to answer the call. Once you are fully informed, the question becomes, will you want to serve?

A final note: at the end of each chapter, a summary of key concepts is presented. These issues and objectives may prove to be a useful reference as you perform your oversight duties. The following are the key concepts for this introductory chapter.

KEY CONCEPTS

- Learn to:
  - Build a strong governance foundation.
  - Organize to lead.
  - Insist on high standards.
  - Let them know you're watching.
  - Communicate clearly.
- Prepare to spend the time it takes to do the job.
- Understand the risks of serving.
- Serve for altruistic reasons. Do not serve solely for the monetary rewards, you may be disappointed.

ENDNOTE

1. Spencer Stuart, "Spencer Stuart Board Index 2003," *SpencerStuart.com*. http://www.spencerstuart.com/research/boards/739/ (17 November, 2004).