Boyden

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Board of Director Series:

The Changing of the Board

Boards In Crisis: Part One

Failures in governance contributed significantly to the global disruption of markets and economies in 2008.

We need to rethink and reshape corporate boards in order to improve their ability to oversee organizations that operate in complex and competitive business ecosystems. The first priority for boards is to refocus on shareholder value and restore shareholder trust.

Boyden global executive search

And

John Levy of Board Advisory

Table of Contents

Boards In Crisis: Part One

Introduction

The Changing of the Board is a series of four papers about the challenge of finding new directors for organizations that operate in today's increasingly complex business environment. These papers explore the challenge of practicing corporate oversight and governance in a world of change. It is an issue of critical importance to the many clients Boyden serves around the world.

Making boards (and those they serve) more successful has become a priority for all who participate in today's global markets. That includes shareholders, stakeholders, corporations, and customers – and the capital markets as well. The four papers that constitute ***The Changing of the Board*** offer fresh insight on how to construct boards that work. The series begins with a concise overview of why boards fail. It explains the meaning and value of board independence. And it describes the strategies needed to move boards from focusing on compliance to creating competitive advantage.

Boards in Crisis, the first paper in the series, focuses on corporate boards: past, present, and future. Years of reform have improved the capability and performance of boards. But not enough. The recent global crisis – and especially a failure of boards to manage risk and compensation in financial services – indicates a need for deeper and more thoughtful changes in the practice of corporate oversight and governance. This first paper explores the reasons, both historical and contemporary, why shareholder interests have not received the attention they require.

Today the "fight for the soul of the board" continues as many shareholders seek more independent boards, often asking that the positions of CEO and Chairman be separated. While both legislation (Sarbanes-Oxley) and regulation (requirements of NASDAQ and the National Association of Security Dealers) now mandate that "independent" directors fill key board positions, those directors may still see themselves as led by the CEO and his team. From the shareholder's point of view, the goal is to ensure boards act as trusted agents on behalf of shareholders. CEOs and company insiders often want to retain control of board agendas and board membership in order to minimize opposition to their management decisions. Research suggests that companies do, in fact, become more profitable and achieve higher stock prices when their boards are more independent and less controlled by internal management.

Shareholders were the big losers in the recent market collapse – inspiring them to become more engaged in company affairs. The SEC recently voted to propose a comprehensive series of rule amendments to facilitate the rights of shareholders to nominate directors to run against company-selected slates. This is another step in reducing the conflicts of interest which often undermine the commitment and effectiveness of boards in overseeing company management. New research indicates that hybrid boards – combining shareholder-supported directors with management-aligned directors – are more successful in improving company results and increasing shareholder value than traditional CEO-controlled boards.

Some boards, like that of Costco, have proven very successful in proactively steering their companies toward continuing success. Much progress has been made in moving from ceremonial boards to working boards. The next challenge is to develop strategies to move boards beyond mere compliance to providing new levels of value. The board of Costco, for example, is clearly an equal partner with internal management, and the results have been excellent. Leading thinkers such as Ram Charan, author of the acclaimed books *Boards that Work* and *Boards that Deliver*, believe that building a great board may be the next big corporate advantage – and one of the few competitive advantages that may be sustainable over many years.

Corporate boards must do a better job of delivering on the now centuries-old promise to protect and increase shareholder value. A primary goal is building honest collaborative

"Boards own a large share of the responsibility for the good governance and management of companies. It's time they step up and do a better job of that"
Dinesh Mirchandani, Managing Director, Boyden India

"Too often boards have not represented shareholders. And directors have waited too long to push back when they have doubts about management decisions"
Sarah Stewart, Principal, Boyden Pittsburgh

relationships with internal managers, including occasionally temperamental CEOs; so they can work together to find better ways to successfully navigate the accelerating complexity of twenty-first Century business environments.

Former Secretary of Labor Robert Reich makes our future shockingly clear in his new book *Supercapitalism*. The global marketplace will only become more competitive, more complex, and more unforgiving. Companies no longer have time to waste on any activity that will not improve products or generate profits.

I. Corporate Boards In Crisis

What happened to our companies and our world between January of 2008 and today?

The simplest way to comprehend the economic meltdown of 2008 is to view it as a domino effect that occured on a global scale.

Instantaneous global communication, business complexity and hyper-competition all came together to drive unrealistic business expectations, models, and strategies. Those, in turn, generated unintended and out-of-control consequences.

- A continuing market emphasis on short-term profitability distracted many companies from focusing on long-term sustainability.
- A need to deliver on projections of short-term profitability helped create a global market for financial derivatives. (Warren Buffet warned markets early in 2003 that derivatives were "financial products of mass destruction.")
- Supposedly sophisticated risk management systems failed to identify and mitigate the potential downside of what appeared to be a booming market.
- Business ethics were deemed irrelevant and pushed aside in many companies.
- Control systems (governing institutions, regulators, and corporate boards of directors) were gradually eroded, compromised, and eventually overwhelmed.

Tipping points were passed. The dominos began to fall.

First, the large financial enterprises that were the foundations of the economy began to totter then fail. As those institutions failed, other interdependent corporations collapsed. The demise of companies, one after another, capsized whole sectors. Whole economies were affected. The domino effect quickly crossed national boundaries.

Soon we found ourselves in a world of pain.

The underlying causes and ultimate effects of these events will be studied for years. But there is no denying that too few corporate boards were prepared to deal decisively with critical events of this size, speed, and complexity. Too many CEOs and boards were late in recognizing and mitigating risks.

For most of us, governance is invisible until it fails. The scope of the failure tells us the scope of the change required to prevent similar failures in the future.

Few are comfortable with fundamental change. But no one wants to see another year like 2008.

On the surface, governance appears simple. Boards are responsible for overseeing company compliance, strategy, execution, and results. Many believe the buck stops with the board when companies falter and shareholders suffer.

Beneath that apparently simple surface, however, lurk historical issues that have made it more difficult for directors to do their jobs. Boards have been held responsible for corporate governance, for oversight of management and business operations, and financial results, but too often directors were not given the access, tools, and support required. Until 2002 (and the passage of Sarbanes-Oxley) boards were not truly empowered to access the information they needed to do their job. By 2008 many boards had still not changed culture and practice enough to utilize their new powers.

The SEC, in announcing recent proposals to strengthen shareholder participation in board elections, noted that the economic crisis "has led many to question whether boards of directors are truly being held accountable for the decisions that they make; whether boards are exercising appropriate oversight of management; whether boards are appropriately focused on shareholder interests; and whether boards need to be held more responsible for their decisions regarding such issues as compensation structures and risk management."

Not everybody is critical of everything that happens in the boardroom. "Boards have generally done a better job than people give them credit for. One of the major problems is that the expectations of stakeholders are often unrealistic," states John F. Levy, CEO of Board Advisory, a member of the board of directors of five public companies, and a frequent author and speaker of boards and corporate governance. While some commentators and shareholders believe that directors are responsible for company results regardless of what is happening in the business environment, many professionals who work with boards say the public has unrealistic expectations of what directors can accomplish. "The role of the director is not well understood. It doesn't matter how intelligent, dedicated or competent they are," says Levy. "No director can be everywhere and do everything within a company. Board members are not 'supermanagers.' Their role is oversight, not management."

Everyone wants boards to be better. And many boards ***are*** better. Directors have been working longer hours than ever before. Many boards are now more persistent in asking questions and demanding answers. But, as the financial events of 2008 continue to remind us, boards simply have not been better enough.

That is why institutions responsible for maintaining regulatory guidelines for corporate boards of directors must rethink and refine frameworks for governance in order to ensure corporate boards are properly staffed and fully resourced. In addition, boards must be encouraged to become more diligent in carrying out their duties. Changing regulations will not change results unless boards and directors change their behavior as well.

"You need to be capable of deep, mature thought and the persistence of action to influence change as a board member," says Dinesh Mirchandani, Managing Director of Boyden India. "This is a responsibility that falls squarely on the next generation of board members." But who will identify and recruit that next generation? How long should boards wait to make changes? And what are the most urgent concerns?

"The most critical role for boards now is to restore trust," says John Levy. "That is what we need to do. We need to get that fixed."

II. A Brief History: Fighting for the Soul of the Board

Ideally, CEOs and independent directors should be working together to restore trust by improving shareholder value. Sometimes they do. More often they do not. For decades there has been a battle over who controls the board, who sets board agendas. In too many cases, that battle has been between the CEO and the shareholders.

Corporate investment structures were introduced four hundred years ago to facilitate long-term investment in enterprises with substantial capital needs. The first such entity was the Dutch East India Company. In exchange for providing long-term capital, investors received partial ownership in the form of "shares" which could be sold when they wanted to cash out. Investors thus became "shareholders." Later legislation provided corporations with separate identity and rights in perpetuity. This model proved highly successful in attracting capital and in driving the growth of businesses over the next few centuries.

Initially, directors were shareholders elected by their peers to oversee the investment. The practice of selecting well-known members of the business community to be fair third-party observers was introduced shortly thereafter. Professor Robert Tricker, the author of *Corporate Governance – Principles, Policies and Practices* published by Oxford in 2009, says their role was to assure shareholders that investments were properly utilized, so shareholders would trust companies with their money. In practice, however, directors were appointed by senior management and so rarely disagreed with them. Being a director paid well for duties that were largely ceremonial.

The genius of the board system is that it established third-party governance in order to override the self-interest of management and individual shareholders in favor of assuring safety and fairness to all shareholders. Without such oversight, capital markets could not exist. But there is a fundamentally unresolved issue in the system: ***"The Principal-Agent Problem."*** The principal (in our case the shareholder) depends on payment to the agent (for this purpose the director and the board) to motivate the agent to perform the activity desired by the principal.

The difficulty is the principal (shareholder) lacks sufficient knowledge of what will motivate the agent (the director and the board) to perform the required service (watching out for and growing shareholder value). Equally difficult for the principal is that while the agent knows what the agent has done, often there is not enough information for the principal to understand if the activity was actually performed and if so, how well. The Principal-Agent problem continues to be a fundamental issue for shareholders and boards. The realistic shareholder entertains a healthy suspicion that their interests are not being protected.

Amazingly, virtually no one paid much attention to boards of directors until 1971 when Harvard Professor Myles L. Mace published *Directors: Myth and Reality.* This classic study revealed directors did not, in fact, establish the policies of the firm, rarely chose the CEO, rubber-stamped compensation decisions, and were not inclined to ask tough questions. Tom Flannery, Managing Director of Boyden Pittsburgh says, "The days of rubber stamping are rapidly coming to an end as independent directors begin to flex their muscles and adopt best practices in corporate governance."

Sarah Stewart, a Principal with Boyden Pittsburgh, and an expert in governance issues, agrees. "Not many CEOs have the confidence to come to a board without having all the answers in place. But that's what it really takes. It's critical to bring the board in earlier. It's an act of courage for a CEO to do that. But that's the only effective way to involve a board in strategy and also get the benefit of the directors' collective experience."

Boyden's Mirchandani believes the problem exists in India as well. "Board members here have too often functioned as 'yes-men' of the Chairman, CEO or promoter. Satyam [a leading Indian outsourcing company that for years signficantly inflated its earnings and assets] is a clear example of that."

The Chairmen's Forum, an influential group of more than 50 current and former board chairmen, recently endorsed a new report which suggests that separating the roles of CEO and Chairman of the Board is essential to "restoring market trust in the enterprise." Published by Yale's Millstein Center for Corporate Governance and Performance, *"Chairing the Board"* says independent board chairs are the best way to compel CEOs to focus on shareholder issues and to curb senior management conflicts of interest. The report emphasizes that "managing the board is a separate and time-intensive responsibility."

In the UK the number of CEOs chairing the board has been reduced to only 5% of FTSE 350 companies. A study in Canada showed two-thirds of public companies were already using independent board chairmen by 2003. According to ***"Chairing the Board"*** the US has been slower to take this key step towards reforming boards. ***BusinessWeek*** recently identified 16 percent of US boards as having truly independent chairmen in 2008. The magazine said many non-executive chairs were actually either ex-CEOs of the company or otherwise related to internal management, and thus might lack full independence.

Boyden's Stewart emphasizes that "whoever controls the board agenda controls the board. Boards have been and must be more vocal about what it is they want to work on."

III. Shareholders Get Enraged and Engaged

Millions of shareholders suffered significant losses in the 2008 meltdown of world markets. Some lost as much as half of the previous value of their equities. Enraged shareholders can and do become engaged shareholders. Shareholder activism existed long before the events of 2008, but recent events have caused activists to assert more independent control over boards.

Shareholder advocates believe the best way to assure that boards focus on protecting shareholder value is to put directors in place who are committed to doing just that. Board fights are expensive and hard to win, but shareholders have had enough victories in the past to allow researchers to measure how shareholder-focused boards perform. Studies indicate shareholders fare significantly better when boards become independent enough to make shareholder interests their most important priority.

"Corporate Governance and Equity Prices," a study by Gompers, Ishii and Metrick, showed that firms with stronger shareholder rights (associated with independent boards) were more profitable and had higher stock valuations. Firms where boards and policies were controlled by CEOs tended to be less profitable and had lower stock valuations. This appeared to be because CEO-controlled boards tended to be more expansive, making more corporate acquisitions and having higher capital expenditures.

Recent SEC proposals to strengthen shareholder participation in board elections should make it easier for shareholder-sponsored directors to run against director slates chosen by company insiders. The new regulations require sponsoring shareholders to own a not-insignificant share of company stock, but they will add another way to move boards to have more independence. It is interesting to note that a study that tracked the performance of 120 hybrid boards (boards which mix independent directors with traditional directors selected and supported by company management) formed between 2005 and 2008 demonstrated that hybrid boards of directors are able to increase share values faster than traditional boards.

IV. Transforming Boards for Competitive Advantage

"Every board is different," emphasizes Boyden's Stewart. "That's because every company is different." But it is clear that fixing board problems is on everybody's agenda. A recent McKinsey Quarterly report on the state of the corporate board indicates boards are becoming more active, engaged, and striving to make significant efforts to reform. Boards surveyed by McKinsey are reviewing current company performance, risk, and financials. They are approving strategy. And they are tracking progress against strategy. Directors who say they want more time to focus on strategy, are directors who are becoming increasingly ambitious about providing more value to companies. They also would like to spend more time developing talent for succession planning.

Independent directors complain of being frustrated by an inability to obtain a broader range of information. Too often, they are not allowed to seek information from employees lower in the company hierarchy. Theoretically independent directors have a right to question any employee, but sometimes senior management discourages direct contact. The question is how can boards do a good job of oversight without access to all crucial information?

Ram Charan described the path boards follow in evolving from simply being competent to providing high value services for companies. He says the initial changing of the board involved moving it from ceremonial status to "liberated" status where it could play a more significant role in governance. Sarbanes-Oxley assured boards would now have access to information, but relationships between board and management are often negotiated and formal. In these circumstances, board governance is done mainly through compliance activities.

New opportunities are created as boards enter a third phase Charan terms "progressive." This is characterized by increasing dialogue and trust between independent directors and senior management. Charan says self-assessment processes are used to work though performance and partnering issues. Transparency begins to improve as information now tends to be made available in more useful forms. Directors are thus able to learn how the business really runs. They finally have enough information to have more relevant discussions with management.

Though CEOs may not admit it, says Joseph Daniel McCool, author of the recent book ***Deciding Who Leads***, CEOs can use all the help they can get. "I think there are a lot of global companies that cannot be led by one person alone. The CEO role has become too complex, too global, and too demanding for individuals. Individual executives need to have the courage and honesty to acknowledge they can't do it all." Today's management is in great need of board perspective, experience and balance in order to determine how to continually improve strategies and operations.

Virtually all companies now struggle to catch up to the growing complexity, speed, and globalization of business. As boards and CEOs are active partners more often, the potential for new value and new ways to create competitive advantage increases. Reich points out that most components in business value chains are now rapidly commoditized. Markets are becoming level playing fields, resulting in extreme levels of hyper-competition between companies desperate to find ways to differentiate themselves from competitors. An evolved board is positioned to help do just that.

Overcoming the historical issues, empowering boards and working through conflicts with CEOs all require significant and sincere effort. Many organizations aren't willing to devote the effort. The events of 2008 revealed too often companies lack boards able to make a difference when times got tough. But boards that are able to evolve to a higher level of play, boards with directors who are able to establish respectful collaboration and a level of trust with the C-Suite will themselves become a significant competitive advantage for their companies.

As the recent McKinsey survey shows, many directors are hungry for the challenge. They are absolutely prepared for the changing of the board.

Boyden's Board of Director Series

This Boyden paper *Boards in Crisis* is the first of a sequence of four on The Changing of the Board.

Better Directors for Better Boards, the next in this series focuses on the changing world of the board director. Traditionally board membership was largely a well-paying ceremonial job reserved for friends of management. Since legislation and listing regulations introduced in 2002 and 2003, directors are expected to do real work. Most have additional responsibilities including serving on board committees, like auditing or compensation. As pressure (and sometimes bad publicity) increases, many board members choose to leave boards early. This paper includes a special interview with "Director X," an experienced board member serving as a Director of two high profile companies, who provides a surprising and unique look at what really takes place in the boardroom in a crisis. Director X describes how the responsibilities of directors changed, including the bad and the good, and what shifted the day Sarbanes-Oxley became law.

Boards recognize that in the future they will need different kinds of board members than those who served in the past. Gone are the "feel good" celebrity directors. In the future, boards will increasingly require experienced directors with solid knowledge of relevant business domains — and companies will seek candidates who are tech-savvy, and have expertise in new areas such as risk management and business continuity. As more directors resign early, there will be a growing shortage of qualified candidates. In addition, it may be even more difficult to find new directors if director liability is increased. What this means is that "The War for Talent" has finally come to the board room. Companies will increasingly rely on retained search to find directors capable of helping a board become a competitive advantage.

The third paper in the series is ***Why Ethics Are Not Optional.*** The work of a board member always begins with a deep understanding of the unique duties of directors, both legal and ethical. The board is responsible for understanding, defining, and maintaining ethical frameworks to guide all employees and agents of the company, as well as circumscribing company business practice. Creating an ethical "tone at the top" turns out to be one of the most important duties of directors. Leading by example is the most effective way to assure an ethical organization.

History has shown what can happen when a board like the Enron board (then considered one of the best boards in America) sets ethics aside whenever senior executives ask. An interview with John F. Levy, CEO of Board Advisory, who often consults for compromised companies and troubled boards, describes how returning to ethical frameworks enables companies to restore shareholder trust. Levy, a participant in authoring ***"The Changing of the Board"*** series, emphasizes that the value of rebuilding customer trust and company reputation will always far exceed the cost and effort of doing so. It is clear that good ethics is good business.

Boards Get Real is the fourth and final paper in Boyden's series. It explores the new ability of boards to obtain independent resources. Boards may be still be hesitant to use them, but for the first time in history, boards finally have significant opportunity to practice the oversight that has long been promised. Something as simple as assuring accurate reporting of quarterly results has been surprisingly difficult. There is also the ever-present temptation to over-state business results in order to trigger bonuses. Nearly 1200 public companies in 2005 had to restate business results (as opposed to 270 public companies five years earlier). Nothing compromises the trust of capital markets and shareholders more quickly than inaccurate reporting of business results, but board members themselves lack time to assure accurate reporting.

Few members of the public are aware that boards have direct responsibility for preventing, discovering, and investigating significant fraud associated with company employees, agents, or customers. Until 2002 and the passage of the Sarbanes-Oxley legislation (as well as additional requirements established by stock exchanges), boards of directors lacked sufficient resources to accomplish this. Passage of the much-criticized legislation is considered by many experts to be the most successful act of empowering US corporate boards in the history of corporate governance. Sarbanes-Oxley gave boards the legal responsibility to assure business information was correct and business operations legal. But it also allowed boards the right to retain outside auditors and other resources to report directly to the board.

The question remains why, if boards now have sufficient external support to provide real oversight, did so many prove ineffective in the financial crisis of 2008? It appears "the changing of the board" will require more than legislation and regulation. Companies, boards and individual directors must all be willing to make the commitments and changes required to protect shareholders and capital markets.

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About Boyden

Boyden is a global leader in the executive search industry with more than 70 offices in over 40 countries. Founded in 1946, Boyden specializes in high level executive search, interim management and human capital consulting across a broad spectrum of industries. For more information, please visit www.boyden.com.

About John Levy and Board Advisory

John F. Levy is Chief Executive Officer and principal consultant for Board Advisory, a consulting firm that assists public companies, or companies aspiring to be public, with corporate governance, corporate compliance, ethics, financial reporting, and financial strategies. Mr. Levy has 30 years of progressive financial, accounting and business experience, including having served as Chief Financial Officer of both public and private companies.

As a frequent speaker on the roles and responsibilities of board members and audit committee members, Mr. Levy has authored "Focus on Corporate Ethics: Legal and Ethical Responsibilities of Board Members," a course on the ethical and legal responsibilities of board members initially presented to various state accounting societies.

For additional Information about Board Advisory and John Levy, visit boardadvisory.net

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