



FOLEY & LARDNER LLP

Corporate Governance Reform: *What's Next?*

General Session Panel Discussions

**FOLEY & LARDNER'S
2005 NATIONAL
DIRECTORS INSTITUTE**

BOARDROOM BEST PRACTICES

Overview

The Sarbanes-Oxley Act (SOX) is having a significant effect on the way corporate boards are composed and operated. Corporate boards are becoming more independent of the CEO, more aggressive in their evaluation of executives, and more diversified with regard to skills and experiences of board members. Traditional notions about the role of the board and board members' relationships with the CEO are being questioned and challenged because of several high-profile boards' failure to monitor and prevent major corporate scandals.

Traditionally, the CEO handpicks a board of directors. Board members are often selected from a relatively small pool of people who are already CEOs or directors of other corporations. Often, directors sit on multiple boards with one another, and share social connections with each other and the company's CEO. The resulting lack of independence is seen as a key reason that boards have failed to adequately fulfill their governance role. Today, shareholders and regulators are demanding a higher level of accountability by corporate boards. Directors must reconsider their role in order to meet this evolving standard.

At the fourth annual Foley & Lardner LLP National Directors Institute (NDI) held March 10, 2005 in Chicago, a panel entitled "Boardroom Best Practices" featured discussion by prominent corporate leaders on how well-functioning boards can be assembled and operated. The knowledgeable panel discussed a variety of topics that should be on the minds of all corporate directors and executives. Three notions were consistently mentioned throughout the discussion:

- Independence. Business interrelationships that prevent directors from thinking objectively in the best interests of the company must be avoided. Even the appearance of a conflict of interest is harmful to the company.
- Constructive disagreement. The board must not be a rubber stamp for the CEO. The board dynamic should allow and encourage constructive dissenting discussion.
- Diversity. The board should be composed of directors who fit specific needs of the company rather than a group with the same skills, experience, and perspective of the CEO.

These should be the guiding principles for developing an effective board of directors. The following paragraphs summarize the panelists' discussions on specific issues directors and executives should carefully consider.

The Board Is Both an Advisor and a Monitor

The board has a dual role as advisor and monitor. The specific characteristics of a company and its current environment will dictate which role is primary at any given time. For example, a company in an early growth stage may require a board that is more focused on advising by developing a growth strategy and providing access to industry networks. On the other hand, an established company, or alternatively a company operating in a hostile corporate environment, may need a board that provides credibility with regard to governance. This illustrates the important point that there is no one-size-fits-all solution for creating a corporate board.

The Board Should Be Composed of a Group That Adds to Value to the Company

The nominating committee should offer candidates who fulfill the specific needs of the company. There are some basic characteristics that all boards should possess:

- Board members should work well with each other
- Boards should welcome independent thought and dissenting viewpoints
- Board members should possess a variety of skills and experiences

Within these broad parameters, there is room for a company to tailor its board of directors to meet its specific needs. For instance, a company might require experience in a certain industry, business process, or geographic region. A company also may be looking for skills in business combinations and restructurings, technology issues, intellectual property, product branding, or personnel issues. Seeking these skills in director candidates provides value-added diversity on the board.

The rules of certain self-regulatory organizations such as the New York Stock Exchange (NYSE) and National Association of Security Dealers (NASD) also have impacted board composition by requiring a certain proportion of the board to be “independent” directors. In general, under the NYSE and NASD rules, listed companies must have a majority of independent directors. An independent director must have no material relationship with the listed company (other than as a director), nor can the director have had a material relationship in the last three years. These restrictions also apply to a director’s immediate family members. In addition, the NYSE requires the nominating/corporate governance and compensation committees to be composed entirely of independent directors. The NASD requires the audit committee to be comprised exclusively of independent directors.

One result of this focus on board composition is that the board recruitment process is becoming more transparent. CEOs are yielding some responsibility for director recruitment to the nominating committee. In trying to tailor the board to meet specific needs, nominating committees are being more diligent about investigating director candidates' backgrounds. In addition to finding directors with desired skill sets, nominating committees want to avoid candidates whose credibility or independence is suspect.

The Role of a Lead Director or Non-Executive Chairman

The creation of a lead director responds to the fact that the chairman's role and the CEO's role are quite different. The chairman is the boss of the board and has primarily a governance role. The CEO is the boss of the business and has primarily a management role. Although there is a common goal, the two positions must necessarily emphasize different means of achieving that goal. It can be difficult for one to effectively steward the governance and business management functions of a company. As recent history shows, governance sometimes loses out. One response has been to create a position of "lead director" or "non-executive chairman." Panelists were generally more supportive of the idea of a lead director because that position tends to have less authority than a non-executive chairman.

Lead Director

Two arguments supporting a lead director were offered. First, the use of a lead director offers a focal point for dissenting opinions. If the lead director has a good relationship with the CEO, he or she can collect and funnel dissenting ideas to the CEO without fear of retribution. The fact that there may be a need for such a person is indicative of a problem whereby directors do not feel comfortable offering dissenting opinions. It was suggested that directors get paid to speak their mind, and should simply do that, but the practical matter is that not all directors feel they are in a position to challenge the status quo. Formally appointing a lead director is one way to respond to the concern directors may have about being singled out as a dissenter. Secondly, a lead director can help the company avoid the perception of the obvious conflicts of interest that arise with a combined chairman/CEO. An credible lead director can relieve pressure on the company to separate the chairman and CEO positions.

A strong argument against a lead director is that it creates confusion in the chain of command. A related issue is whether a retired CEO should remain on the board of directors. Panelists were generally opposed to retired CEOs being directors of their old companies precisely because it confuses the chain of command. There was a strong consensus that establishing a clear chain of command is vital to a corporation's success. Each company must decide for itself whether a lead director would be a valuable position to institute.

When a lead director is appointed, often this person runs the board meetings, focuses communications to the chairman and the CEO, and helps present dissenting opinions. Typically, however, the lead director has no authority to set the meeting agenda. It is important that if a lead director position is instituted, the position is formally acknowledged, most likely in the by-laws, and that the position have formal responsibilities and authority.

Term or Age Limits Are Poor Corporate Governance Mechanisms

Term and age limits are a blunt tool for excising directors who are not fulfilling their responsibilities. Participants agreed that the ideal solution to deal with an ineffective director is for other directors to remove him or her from the board, presumably by having the nominating committee refuse to offer them for re-election. However, most panelists acknowledged that it can be difficult for directors to make such a difficult decision with respect to people with whom they have working and social relationships. When directors are unwilling to make the decision to remove a colleague, term or age limits may be an appropriate alternative.

There are at least two specific drawbacks to instituting term or age limits. First, it may cause a company to remove directors who are still very effective. Second, it gives directors a reason not to make the difficult choice of removing an ineffective colleague. Regarding age limits, there are many directors who can be effective beyond the age limits, which typically range between 65 and 75 years of age. Regarding term limits, it often takes a director a significant amount of time, perhaps several years, before he or she has a sufficient understanding of the company to be maximally effective. A term limit that is too short forces a company to remove directors exactly when the director is most useful.

Board Evaluation

The evaluation of boards of directors — and individual directors in particular — is an issue with general support. However, panelists agreed that the techniques to carry out the idea need significant development. The current system of evaluation applied to boards and individual directors, if done at all, is too ambiguous. In addition, there is a culture of check-the-box instead of critical assessment of strengths, weaknesses, and overall contribution to the company. The role of the board of directors is less formalized than the role of executives, which makes objective evaluation difficult. As research develops effective methods for evaluating directors and boards, those methods should be incorporated into a company's best practices.

For More Information

To learn more about “Boardroom Best Practices,” feel free to contact the session speakers.

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