WINNING THE RACE
FOR INDEPENDENCE IN THE BOARDROOM

by Joe Griesedieck and Caroline Nahas

Just when corporate governance and the scandals that brought the topic to the front pages were becoming yesterday's news, word came that a group of former directors at WorldCom, the telecommunications company whose bankruptcy was the largest in history, had agreed to contribute $18 million of their own money to settle a class-action lawsuit brought by investors. If companies thought it was more difficult to recruit independent directors before, events like these won't make it easier any time soon.

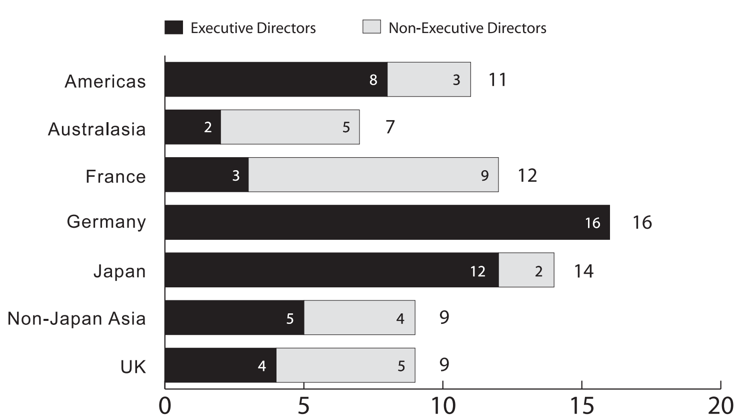
Managing governance issues is now part of everyday corporate life. The Sarbanes-Oxley Act, which imposed numerous corporate governance requirements on U.S. corporations, has been in place since 2002. Similar legislative or regulatory actions have occurred worldwide. Corporations have integrated new or more stringent practices into their governance models and are ready to begin focusing more fully on running their businesses. But one problem remains. Director candidates who meet independence and professional capacity requirements are harder to find, and competition for qualified individuals is fierce.

THE INDEPENDENT DIRECTOR TREND

In the U.S., the New York Stock Exchange (NYSE) and NASDAQ now require listed companies to have boards comprised of a majority of independent directors. Nominating and compensation committees of NYSE companies must have only independent members, while NASDAQ allows these bodies to be either fully independent or contain a majority of outsiders. The Securities and Exchange Commission (SEC) and the exchanges require an all-independent audit committee, with the added proviso that members be "financially literate."

The trend toward independent director-dominated boards is global. The governance changes spurred by the Higgs and Smith Reports in the UK and the Bouton Report in France are driving companies to increase representation by independent directors. Korn/Ferry's 31st Annual Board of Directors Study, released in late 2004, reports that UK and French boards increased independent representation, on average, by one such director in 2004. The survey also shows that independent directors tend to dominate Australian boards. This may be, in part, because 96 percent of Australian companies have embraced the Principles of Good Corporate Governance established in 2003 by the Australian Stock Exchange.

MEAN NUMBER OF BOARD MEMBERS IN 2004*



*Source: *Korn/Ferry International 31st Annual Board of Directors Study*

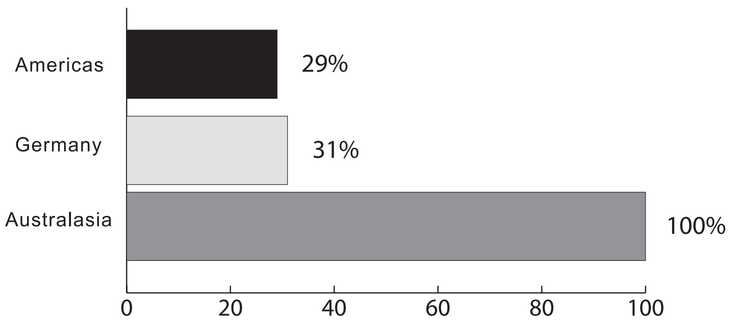
So, professionals who have solid business backgrounds and are free of various types of corporate "relationships" find themselves in hot demand. But corporate directorships are no longer viewed as necessarily desirable, making life difficult for boards seeking new blood.

IT'S A RISKY JOB

According to Korn/Ferry's Board of Directors Study, *all* Australasia board respondents had declined director invitations in 2004 because they believed the risk was too great. Thirty-one percent of directors of German boards refused for the same reason, almost triple the 11 percent who answered this way in the previous year's survey. The percentage of respondents in the Americas declining board directorships because of perceived risk has doubled since the Sarbanes-Oxley Act became law, jumping to 29 percent in 2004 from 13 percent in 2002.

For many directors, this apprehension was reinforced by a 2004 court case decided in Delaware, in which a judge ruled that officers and directors with specialized expertise can be held to a higher standard than other directors in litigation. A shareholder suit alleged that the board of Emerging Communications, Inc. and a majority shareholder undervalued the company when the majority owner took the company private in 1998. The judge agreed and also found two board members liable. One director, a securities analyst, had "significant experience in finance and the telecommunications sector" and should have known the price was unfair, according to the judge. The other director, an attorney who worked for the majority owner, was also deemed to be not independent.

% OF DIRECTORS DECLINING DIRECTORSHIPS DUE TO RISK IN 2004*



*Source: *Korn/Ferry International 31st Annual Board of Directors Study*

Another example of the increasing risk factor involved in board service is the shareholder suit against directors of Walt Disney Co., who were accused of negligence in the hiring and firing in the mid-1990s of Michael Ovitz, who received a $140 million severance package after serving as the company's president for a little more than one year.

THE CANDIDATE POOL SHRINKS

Adding to the difficulty of director recruitment is the decline of so-called "professional" directors, i.e., individuals who sit on six or seven boards. The third annual "What Directors Think" study, conducted in 2004 by *Corporate Board Member* and PricewaterhouseCoopers LLP, finds that 43 percent of chief executive officers and 29 percent of outside directors have had limits imposed on them regarding the number of additional board seats they may hold. This compares to 2003 figures of 33 percent and 16 percent, respectively.

Shareholders, particularly institutional ones, are paying close attention. Institutional Shareholder Services, Inc. (ISS), an international provider of proxy voting and corporate governance services, recommends withholding votes from directors who sit on more than six boards. In its 2004 policy statement, the organization says: "In view of the increased demands placed on board members, ISS believes that directors who are overextended may be jeopardizing their ability to serve as effective representatives of shareholders."

Academic studies of the link between board composition and corporate fraud are adding fuel to the fire. In the May/June 2004 issue of *Financial Analysts Journal,* three finance professors argue that boards of companies that were accused of committing fraud between the years of 1978 and 2001 were less independent than those of no-fraud companies. Additionally, the study finds that the presence of an independent audit committee reduces the risk of fraud. Yet defining independence is often subject to interpretation, causing some candidates to decline a directorship rather than subject themselves to what they perceive may be unfair or unwarranted scrutiny. It is reminiscent of so-called "attractive" political candidates who opt out of consideration for office for similar reasons. The increasingly common practice raises this concern: have we become so diligent in pursuing possible conflicts that, taken to the extreme, we have depleted and marginalized the candidate pool and, consequently, failed in our mission to improve our boards?

THE RULES OF INDEPENDENCE

While establishing the independence of directors is challenging, there are some guidelines. In the U.S., the NYSE and NASDAQ listing standards define independence. In general terms, the standards require that a director must have had no business relationship with the corporation for a minimum of three years, and they describe the types of family/business relationships that are prohibited.

In the UK, the Combined Code on Corporate Governance, revised by the Financial Securities Authority in 2003, places a five-year limit on a business relationship in order for a director to be considered independent. And companies must prove independence. In most countries, corporations must disclose the criteria used to determine independence.

IS ANYONE REALLY INDEPENDENT?

In today's environment of mergers and acquisitions and the global marketplace, meeting the independence rules is truly challenging, chiefly because the probability of high-level executives having had some type of business interaction is so high.

Retired executives are logical director candidates, both for their business acumen and their ability to dedicate time to the job. Indeed, Korn/Ferry's Board of Directors Study finds retirees in 95 percent of today's *FORTUNE* 1000 boardrooms, compared with 88 percent in 1994, when the trend was to have more sitting CEOs as board members.

Recruiting retirees to serve on audit committees, however, is problematic. Retired audit partners have immediate conflicts if their former employer is the corporation's current or immediate past auditing firm. Additionally, a retiree's former employer may be soliciting a corporation's business, an effort that could be compromised if a retired partner is on the board.

It's not surprising, therefore, that respondents to the study say director recruitment is tougher today. Twenty-nine percent of Americas respondents report it is "very difficult" or "difficult" to find candidates with the SEC-required financial expertise, and 37 percent say it is hard to attract candidates with sufficient general management expertise.

"Several decades of cutting executive development programs, promoting specialists to executive roles, early retirements and non-traditional management structures (i.e., dot coms) have left a void affecting governance," the study notes. "An intimate understanding of the interrelatedness of all business functions, operations and constituencies is needed in the boardroom."

RECRUITMENT'S NEW RULES

Despite the obstacles, it is possible – through planning and effort – to recruit highly qualified directors. The best results will occur when boards and nominating committees are realistic about the recruitment process.

Director candidates may genuinely be interested in board service, but they are not job applicants and should not be treated as such. Corporations need to court these candidates and keep in mind that with often demanding, full-time jobs, these high-level executives cannot be expected to participate in numerous rounds of interviews or meetings.

Boards and their nominating committees must also accept that it will take longer to identify and qualify candidates, and they should be prepared for refusals. We have detected a definite increase in the number of executives who have made the personal decision to avoid directorships or limit them to one or two. Consequently, it is best to begin the search process early.

Organizations may find that working with a third party during the search process is an effective way to manage expectations of the board and of candidates, and also to keep the search focused and on track.

ONE . Recruit Broadly

With the competition for qualified director candidates remaining strong, the nominating committee and its advisors will need to be more creative in identifying potential directors. They should look beyond their company's industry and think *expansively* about possible candidates.

Often, the presidents of sizeable corporate divisions are good candidates. In our experience, these individuals, while less seasoned than top CEOs, are nonetheless well prepared. Their employers often look favorably on directorships for division chiefs because they see such activity as leadership development. While it is important to have two or three sitting CEOs on your board, adding a more diverse mix of skills and experience to the group creates a tapestry of talents that will serve your organization well. The key is to assess the strengths and skill gaps of your current board, as well as your company's future challenges and opportunities, and then design your new-director profile to meet those needs.

TWO . Know your candidate

Shareholders, regulators, the news media and others will scrutinize your director selections, so reference checking is essential. We have found that it is most effective to focus on a candidate's board service record. When they served on another board, did they attend meetings regularly? Did they assimilate well into the organization's culture? Questions like these can be answered by individuals with whom the candidate served on other boards.

If a prospective director has no prior board service, you may need to rely on information obtained through confirming their independent status and their personal reputation.

Ascertaining a candidate's fitness for board service requires tact and sensitivity to existing board and business relationships. In the past, nominating committees often relied on recommendations from current or past board members when selecting prospective directors. But everyone recognizes that this is no longer enough. Here again, a third party may be helpful in overcoming the reference checking challenges.

THREE . Make a compelling case

Boards and their nominating committees need to accept that they will likely have to sell the prospect on board membership. To do this successfully, you will need to articulate clearly what is expected of a director in your corporation, so that the candidate has full understanding of their responsibilities.

To prepare a compelling case for joining your board, learn as much as possible about a candidate's background and interests, in order to tailor your approach. After studying your candidate, demonstrate how your business fits with their personal and professional interests. Show how this individual can contribute to your board. Discuss the opportunities that board service offers this individual in terms of personal and professional growth. Be clear about your company's track record of ethical behavior, and rest assured that prospective directors are doing as much due diligence as you are.

Nominating committee members must be fully engaged in courting the prospect and willing to make themselves available for meetings, including those requiring travel to the candidate's location. The CEO plays a critical role in director recruitment. Not only does the CEO have to approve of the candidate, but the prospect must also feel confident about the top executive's leadership ability. Arranging a face-to-face meeting between the candidate and CEO can be the deciding factor in whether an individual joins a board.

Recruiting directors is no longer a "hand-shake" business requiring modest effort. Yet every cloud has a silver lining. By taking a more studied approach to selecting directors, nominating committees will find more qualified candidates. This, in turn, will result in a better functioning board, a factor that weighs heavily on a company's long-range success.

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Korn/Ferry International, with more than 70 offices in 35 countries, is the premier provider of executive search, outsourced recruiting and leadership development solutions. Based in Los Angeles, the firm partners with clients worldwide to deliver unparalleled senior-level search, management assessment, coaching and development and recruitment outsourcing services through its Futurestep subsidiary.

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