CORPORATE GOVER

Independent and informed directors can help a company deliver

1. Building Boards That Perform

BY ROBERT E. HALLAGAN AND DENNIS CAREY

When the concept of independent boards was developed, it was envisioned that boards would not just protect shareholder interests but also become a strategic asset and source of continuous competitive advantage for their companies.

As the years progressed, however, some boards fell short, failing to add or even damaging shareholder value. Other boards performed admirably as fiduciaries and monitors of performance, but little more. And then there is the gold standard: elite, high-performing boards that do much more than mundane corporate caretaking.

The National Association of Corporate Directors Blue Ribbon Commission on Board Evaluations and Board Effectiveness, co-chaired by Ken West and Robert E. Hallagan, addressed this in 2012. The commission decided early that boards could not be evaluated in a vacuum, seeing a need for a framework for high-performance boards to benchmark.

That framework includes inner and outer circles. It starts at the core with the board's commitment "to be a valued asset of the company, measured by the contribution we make — collectively and individually — to enhance shareholder value," and ends in the outer circle — a company that is maximizing long-term shareholder value.

Every activity within the circles must contribute to organizing a board in a manner that ensures maximum shareholder value. It also clearly establishes the premise that if a company is a chronic underachiever, the board must be held accountable.

The key elements in our framework are based on common sense, nothing revolutionary. Though the standards are simple in concept, even a potentially high-performing board can become derailed if it fails to pay consistent attention to the details. It is the role of the governance committee and board leader to ensure a relentless focus on all elements.

The Right People

What competencies, diversity of thinking styles and interpersonal skills go into making a board that stands out as a top performer? Companies' strategies change and so must the talent on the board. Our approach is rigorous and similar to starting a search for a new CEO. The starting point is the strategic plan. What will drive shareholder value? What does the company have to do extraordinarily well? What are the toughest challenges to execute, and what are the biggest and most complex decisions? From this analysis we can project what the board agenda will be, how a board will add value, and, more specifically, the skills that will add the highest value on a continuous basis.

Two examples of boards we have built recently illustrate this point:

Delphi — After four agonizing years, Delphi came out of bankruptcy with new owners: two highly successful hedge funds — Elliott and Silverpoint — and General Motors. They were excited about building a "best in class" industrial products business and wanted a board to bring this perspective to

NANCE

superior shareholder value in this fast-changing digital era.

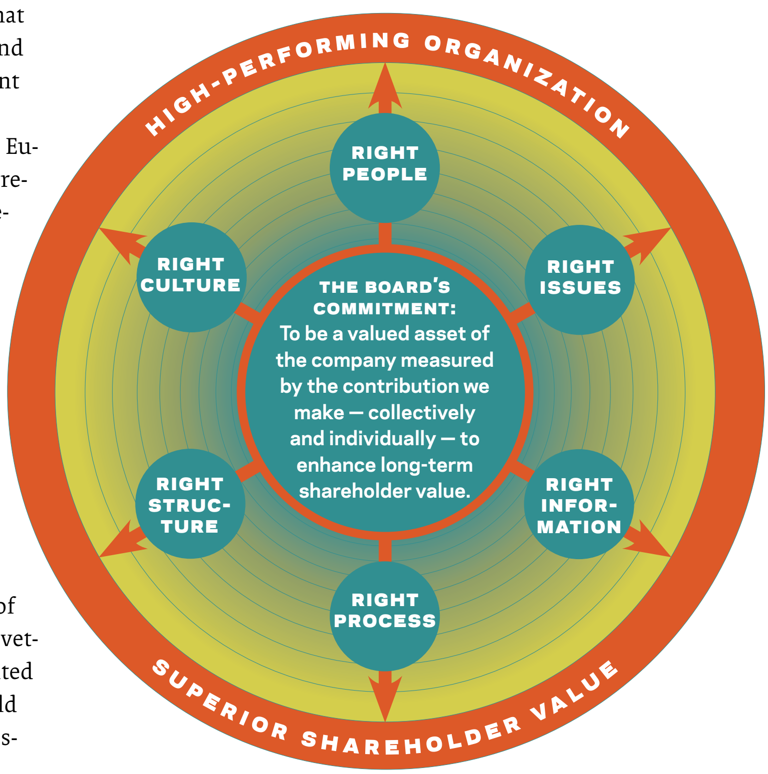
the company in a respectful manner. Once we convinced Jack Krol, the former CEO of DuPont and chairman of Tyco, to serve as non-executive chairman, we continued around the table with executives bringing an extraordinarily diverse set of skills. All met three critical requirements:

- a markedly successful history of making good decisions,
- interpersonal skills that thrive in a team environment to maximize group dynamics,
- time to be fully engaged and enthusiastic about Delphi.

The board has four successful CEOs from companies that specialize in industrial products; world-class technology and human resources executives skilled at innovation and talent management; a highly respected industrial products CFO, and a former Goldman banker, as well as executives from Europe and Asia. Delphi is clearly on a path to bolster shareholder value, and we can proudly give a long list of value-added contributions by the board.

Lehman Brothers Holdings — Another powerful example is Lehman Brothers, the largest bankruptcy in history and a black eye for the financial community. As a requirement to emerge from bankruptcy, courts ordered the holding company to appoint seven new directors to oversee the liquidation of Lehman assets. A committee of stakeholders from around the world was formed to select the seven. This large and diverse search committee had to spell out a list of skills that could maximize the $70 billion of assets that would be used to pay creditors. Before candidates were reviewed, the exact role of the board was debated and the complexity of the task fully vetted by stakeholders. After more than 25 candidates presented their backgrounds, the committee projected how each could add value and complement others on the board. Next questions: Who would fit best in the team dynamics and who had the time and enthusiasm to become fully engaged? We wanted no "body fat" — everyone should be pulling their oar with the same intensity. Now one year later, the stakeholders benefit from this high-performing board.

Most boards obviously do not have a fresh start like Delphi and Lehman, but each board should have a succession plan that calls for constantly examining future challenges



It's the Right People: N.A.C.D. Panel Concludes

Left to right: Robert E. Hallagan, John A. Krol, Owen D. Thomas and Curtis J. Crawford.

Paul Morse

What distinguishes a high-performing corporate board of directors from the also-rans? A blue ribbon commission of the National Association of Corporate Directors set out to answer that question.

Their conclusion: Boards that are committed to self-evaluation, which expect to be held accountable with the goal of achieving high performance, deliver superior shareholder value over the long term.

With 800 directors in the audience, Robert Hallagan of Korn/Ferry International moderated the opening panel for the N.A.C.D.'s annual conference on building high-performance boards in October 2012, meeting in National Harbor, Md. Hallagan, the vice chairman and managing director of board and CEO services at Korn/Ferry, led the discussion, outlining the findings of the N.A.C.D. commission.

John A. Krol, chairman of Delphi Automotive and director of Tyco International; Owen Thomas, chairman of Lehman Brothers Holdings; and Curtis J. Crawford, director of Xylem, provided real-life examples of the commitment to top performance.

Jack Krol, well known for rebuilding Tyco after the scandal that led to a prison sentence for ex-CEO Dennis Kozlowski, is the former chairman and CEO of DuPont. He was called upon more recently to help Delphi Automotive emerge from bankruptcy.

"After you recruit the right people for the board, you need to tell them what a high-performance board looks like," Krol said. The commission has drawn a map for moving forward: Make the commitment to be a high-performance board by focusing on and identifying talent gaps. Chemistry and collaboration are two of the most important drivers of a high-performing board. Attracting the right talent for the board is difficult. Companies must be clear about what will add value and apply the same discipline in succession planning that they demand for the company's leadership team. "We could not attract the right talent, so we settled for" — is a statement not made by high-performing boards. Once the exact talent is identified, they are likely to wait one — sometimes two years — before the right director becomes available

Right Issues

Highly motivated talent must not be wasted. Imagine assembling these all-star Delphi and Lehman boards and then having board meetings consist just of management presentations or random topics. Sarbanes-Oxley and now Dodd-Frank have unfortunately made many boards averse to risk, spending too much time on compliance issues.

It is the responsibility of the board leader working closely with the CEO to be sure the agenda is rich in content — with a majority of time dedicated to topics most closely aligned to what drives shareholder value: sophisticated and prudent risk-taking and outsmarting the competition.

The Right Information

Unfortunately for shareholders, many companies have consistently been low performers. Is it possible that their board members want to do a good job, but are not getting adequate information? Korn/Ferry researchers are trying to understand how information barriers affect a board's performance.

High-performing boards demand more than financial numbers, using a balanced scorecard approach that includes critical elements such as product and service quality, customer trends, talent, competition, innovation, total enterprise risk, ethics and corporate culture. The right information supports focusing on the right issues.

At the annual conference, N.A.C.D. President and CEO Ken Daly raised the issue of asymmetrical information, noting that boards may get incomplete or incorrect guidance from company executives. Directors relying solely on management's word may not have the full details to make wise and informed decisions. In various case studies of troubled com-

• the right people,
• the right culture,
• the right information,
• the right issues,
• the right process,
• and the follow-through.

Krol cautioned against relying only on the director candidates' paper credentials. "Pay close attention to their record of accomplishments and how they work with others. Talk to them. Get to know them. Will he or she be a team player? "

Owen Thomas became chairman of Lehman Brothers Holdings in December 2011, after heading Morgan Stanley's Asian and real estate divisions. Thomas and the other six board members are working to close the books on the largest corporate bankruptcy in history. Part of that task is to return some portion of Lehman's $70 billion in illiquid assets to claimants who are owed $350 billion.

"Of our seven-member board, only two have full-time jobs," Thomas said. He and his fellow board members have extensive experience in the types of assets that Lehman owned, Thomas' expertise being in real estate. "We are an engaged group of directors. We have a finite mission. We're not in business in perpetuity. We are using each director's expertise to work through these assets."

Curtis Crawford was a member of the ITT board when the conglomerate decided to split into three companies. "We named three new CEOs, all promoted from within. We had an inventory of talent to draw from. Working closely with our recruiting firm, we recruited approximately 15 new directors for the new boards, drawing on a half-dozen former board members for ITT." Crawford said 30 percent of the new boards are minorities or women, and 10 percent live, or have lived extensively, outside of the U.S.

"Lessons learned for us were, 'Work closely with your recruiter. Identify the critical characteristics of the board members for each board and make them non-negotiable. Don't look in the same old places for talent,' " said Crawford.

"Had we limited our search to the people we know, we would have missed out on some amazing talent," Crawford said. "You have to commit to spend quality time with your recruiter to zero in on opportunities."

Hallagan emphasized that once the talent is in place, high-performing boards take it to the next level. "You've got to help directors learn the company. The board dialogue is too important and strategy today is too demanding for directors not to have a keen understanding of the company."

"The chemistry between the CEO and chairman and lead director has to be good," Krol said. Both need a shared commitment to high performance. "If there is not agreement on that commitment, there is very little progress that can be made."

Thomas says the Lehman Holdings board takes pains to use its talent wisely. "We have a six-month window to do our work. You can be sure that we quickly identified what each of us should be doing. We meet weekly. We keep the agenda tight, picking the right issues. We can't waste anyone's time."

Before joining the Lehman Holdings board, none of the directors knew one another. Hallagan asked how they came together to form a strong work group. "It's the little things you do," said Thomas. "We've gotten to know each other as people. We had an outing with our wives. And the seven board members have dinner together once a month without any program."

Curtis says the process requires much more of the directors than merely touring a worksite together. "All of us consider ourselves new."

panies, CEOs have been found to have withheld information from their boards.

Given their responsibility for oversight, directors need to acknowledge that asymmetric information is inherent in the boardroom and create a process to identify when that risk has become too high. Directors must ask themselves if they are getting the information they need to make decisions. If not, do they ask for additional information and receive it? As one director told us, like Ronald Reagan, we need to "trust but verify." On occasion boards will need to seek outside information or analysis. The best boards use this privilege judiciously.

At the same time, directors cannot go overboard. Providing additional information eats into managers' schedules. CEOs can become concerned that supplying more information may be blurring the line between management and oversight. "Nose in, fingers out ," meaning it's O.K. to be inquisitive, but it's not O.K. to run the business, is a good reminder for board members.

Directors recognize the information-rich world in which they operate. Each year it becomes more challenging to obtain, study and understand relevant information . As we tell directors, it's important to understand the company's strategy, its competitive position and the environment in which it operates.

The Right Process

As we continue to move through the framework, the heavy lifting is done, but flaws in the board's process, structure and culture can still hobble performance.

Important process considerations include:

• Continuous clarification of the board's role versus that of management — Directors must know where the boundary lies and understand that the line sometimes shifts in crises.
• Decision-making authority —Too little authority may render the board ineffective, and misunderstandings can cause unnecessary friction with management.
• CEO/board relationship — What is being done to ensure this is a trusted, respectful and open relationship? Is a thoughtful process for evaluating, mentoring and developing CEOs in place?
• Meetings — Are the right items on the agenda, in the right order, with quality time allocated for discussion? Is the

quality of time for hearing presentations low compared to active discussion?

- Executive sessions — Are closed-door meetings used effectively? Do they include feedback to the leadership team?
- Board succession planning — High-performance boards are constantly planning for succession of leadership talent.

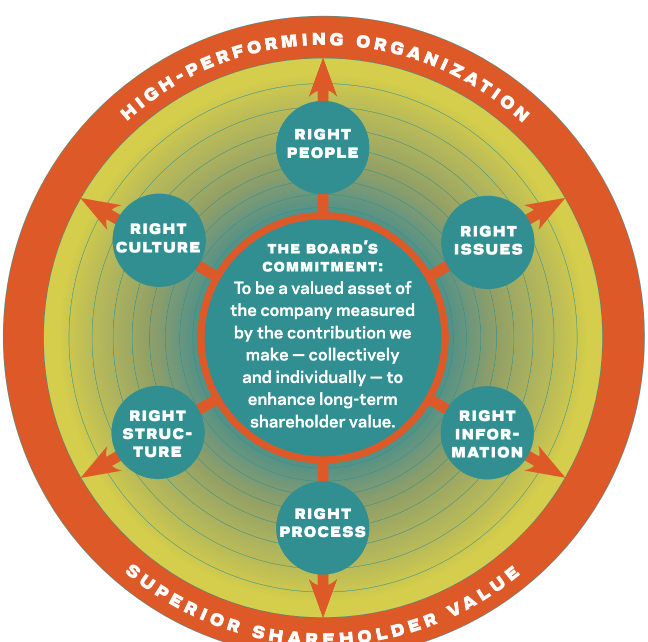
The Right Structure

If you had the luxury of building a new board from scratch, what structural components would you consider to optimize group dynamics, decision making and performance?

Size — As a general observation engagement, accountability and decision making are best in a small board environment. This necessitates no room for "extras" and that each board member has skills and competencies that can add value in multiple areas.

Terms, Age Caps, Term-Limits — There are always exceptions and each board must leave room for flexibility, but there is also strong evidence that continuously refreshing a board with new "high-performance" thinkers is a "best practice." Long-term continuity and institutional knowledge are precious, but it is also worthwhile to debate whether, for example, the second 10 years a board member serves are as valuable for shareholders as the first 10 years.

Board Leadership — Commitment to strong, engaged, independent leadership is a requirement for high-performing boards whether it takes the form of a non-executive chairman or lead director. Equally important is clear definition of the role and selection of the right leader. Some board members do not make good board leaders. Knowing this and establishing a thoughtful process to ensure the board has strong choices is important. We have seen numerous times when boards were not prepared for leadership succession, and picking the wrong leader has created serious problems.



Committees — We believe committees are an important part of the board structure. Since 2003, the Sarbanes-Oxley Act brought about the requirement for independent audit, compensation and governance committees. We suggest, however, that the effectiveness of each committee needs to be evaluated. All boards have audit committees, yet we have seen numerous midcap companies assign the compensation and governance committee responsibilities to the full board, which has resulted in enhanced efficiency and information flow.

Compensation — We want a board that is highly motivated to ensure a company is on the path to maximize long-term shareholder value. Ideally, we want this board to be an important part of each director's activities, not forgotten between meetings. If we expect this level of engagement by successful executives — who have choices — compensation must be motivating and aligned to performance.

Right Culture

As we complete the framework, we arrive at the glue or "energy drink" that allows highly skilled executives to thrive and work efficiently as a team. It is a culture of trust and openness, all egos in check and all opinions heard and respected. Critical issues are surfaced, thoughtful debate and disagreement is common and decisions are enhanced — the leadership team is excited by the energy at board meetings and motivated by their debate and encouragement. Skills and competencies on the board are continuously aligned to the future challenges of the company, and there is no entitlement mentality. All board members take their responsibility to shareholders seriously and feel they must "earn the right" to be reelected.

As role models for the company's leadership team, they are in a constant mode of self-examination and continuous improvement and want rigorous board evaluations done on a regular basis. They strive to be a "best in class" board and want to stand tall directly in front of shareholders.

All this is common sense. But having observed hundreds of boards we know only a small percentage are truly high performing and a continuous source of competitive advantage; many boards are doing a majority of things right, but few are "hitting on all cylinders" all the time. It is hard work that demands focus, commitment and enlightened leadership. It is a journey as much as a destination. N.A.C.D., the world's premier education organization for directors, and Korn/Ferry are dedicated to continue our work on high-performing boards and are delighted by our clients' commitment, pride and intense desire to improve. The art and science of building a high-performing board is evolving. We are learning from each other and look forward to our engaged conversations.

Robert E. Hallagan is managing director of board and CEO services for Korn/Ferry International, Inc. Dennis Carey is vice chairman of board and CEO services of Korn/Ferry International.