The Buck Stops at the Boardroom
Outline

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Course Agenda
- Ostrich Awards
- Eagle Awards
- "The Buck Stops" Perspective
- Manage Board Composition
- 10 Commandments for the Board (tools)
- Director Bill of Rights (tools)
- Board-Management Relationship

The Honest Directors
- Are all the honest, well-intentioned, and experienced directors following best practices in corporate governance?

Ostrich Awards
Dubious Distinctions in Corporate Governance

- Never attribute to malice what can adequately be explained by dubious decision making
- **Why the Ostrich?** Bird known for sticking its head in the ground

"Tip of the Iceberg" Ostrich
- Winner: Board of Home Depot
- Dubious Distinction: Board's failure to have the CEO's successor in place cost the company a great deal of money because they had to go outside for a so-called superstar.
  - *New York Times, June 28, 2003*
- Best Practice: Plan ahead…start on "day one"…desperation is not a good negotiating technique.
- P.S. Nardelli got a $210M severance after his 5 years -stock down 12% vs. Lowe's up 173%...replaced by Exec-V.P. (Frank Blake) who joined HD in 2002

"Stacked Deck" Ostrich
- Winner: Richard Grasso, former Chairman/CEO, NYSE
- Situation: Mr. Grasso argued that he shouldn't be blamed for his own high pay, "It's not my fault, I didn't do it. The compensation committee did it."
  – *Wall Street Journal, September 26, 2003*
- Dubious Distinction: "Both the nominating and compensation committees of the board included either friends of Mr. Grasso or directors with links to him."
  – *New York Times, September 26, 2003*
- Best Practice: Nominating and compensation committees should be independent and not "stacked decks."

"Sword of Damocles" Ostrich
- Winner: NYSE Compensation Committee
- Dubious Distinction: Five of nine members of compensation committee are executives of companies regulated by NYSE.
- Best Practice: Don't get on a board if you have a conflict of interest from the start.

- Sword of Damocles: Compensation committee members could be reluctant to challenge or object to compensation packages fearing retribution against their companies from NYSE as regulator.
  -New York Times, May 9, 2003

"One Step Forward…Two Steps Back" Ostrich

- Winner: Board of Oracle
- Dubious Distinction: Chair/CEO Ellison gives up Chairman title and remains CEO…Board elects Oracle CFO as Chairman.
  - New York Times, January 13, 2004
- Best Practice: Even though CFO will resign CFO position, Chairman should be independent.

"We're Waiting…We're Waiting" Ostrich

- Winner: Roy Disney, director, Walt Disney Company
- Dubious Distinction: In his three page resignation letter delivered to Michael Eisner (Chair/CEO), Mr. Disney complained that "Mr. Eisner had done little to revive the company over the last seven years and [Mr. Eisner] *still had not decided who would be his successor.*" - *New York Times, December 1, 2003*
- Best Practice: Board, not the CEO, picks the CEO's successor.

"The Envelope Please" Ostrich

- Winner: Board of Walt Disney Company
- Dubious Distinction: "Directors have never seriously discussed [CEO] succession; instead, Eisner keeps the name of his choice in a sealed envelope in his desk."
  - Business Week, December 15, 2003
- Best Practice: Board has no one to blame but themselves for not addressing succession.

"The King-Maker" Ostrich

- Winner: CBS TV
- Dubious Distinction: "Mr. Redstone has chafed at the management structure introduced by the [acquisition of CBS], which left him CEO but gave Mr. Karmazin operating control for three years... Also, until then, Mr. Redstone can't change the makeup of the board and can't fire Mr. Karmazin without the support of 14 of the board's 18 members." *–New York Times, January 20, 2003*
- Best Practice: Board should not negotiate away its duty of care concerning board makeup and its simple majority for decision-making (i.e., terminating an executive).

"Who's on First…What's on Second?" Ostrich

- Winner: Wall Street Journal & New York Times
- Dubious Distinction: "Some Tyco investors may mount a proxy fight unless the company replaces **every director who served UNDER the former CEO**"
  -Wall Street Journal, August 21, 2002
  -New York Times, November 11, 2002
- Best Practice (and the law): CEO serves under the board, not the other way around.

"All in the Family" Ostrich

- Winner: Board of Coolbrands International - ("Chipwich Ice Cream") Toronto ($150M)
- Dubious Distinction: "Management's near total domination of the board is a real issue." Five of six board members are management or family.
  - New York Times, September 15, 2002
- Best Practice: Majority of board members independent – no management, family, friends, consultants, vendors, suppliers.

"Potted Plant" Ostrich

- Winner: Steve Case, Chairman, AOL Time Warner ($41B)
- Dubious Distinction: "Mr. Case had taken on a purely advisory role. In an unusually passive arrangement for a chairman, Mr. Case has made himself available for consultation but has effectively ceded control to (the CEO)." *- New York Times, July 22, 2002*

- Best Practice: Chairman must proactively lead the board and the CEO…Board controls the company…not CEO.
- Brendan Sullivan (Oliver North's lawyer in Iran-Contra hearing): "I'm not a potted plant. I'm here as the lawyer…that's my job."

"Don't Be Like Mike" Ostrich

- Winner: Oakley, Inc. ($500M)
- Dubious Distinction: Michael Jordan was on the board while endorsing Oakley sunglasses under an endorsement contract that expires in 2005.

  – New York Times, December 24, 2002
- Best Practice: Board members should receive no compensation other than director compensation.
- Footnote: Jordan resigned from Board

"Out-of-Sight…Out-of-Mind" Ostrich

- Winner: Dana Corporation ($9B - auto products)
- Dubious Distinction: Chairman/CEO and none of the other 12 directors attended annual shareholders meeting. Outside attorney presided at meeting at his office 430 miles from company headquarters. May be "the only company whose chairman skips his own meeting."
- Best Practice: Chairman and directors should attend to increase shareholder involvement in company.
- Andrew Grove, Chairman, Intel: The absence of directors at meetings is "incomprehensible to me. I don't sense an enthusiastic pursuit of the fundamentals of corporate governance even today. I see a reluctant, minimalist approach, staying one step ahead of the regulators more than anything else."

  -New York Times, May 11, 2003
- P.S: Home Depot 2006 Shareholder Meeting – Chair/CEO Nardelli only director of 11 member board to attend.

"0 for Whatever" Ostrich

- Winner: U.S. Senator Ernest Hollings, board member U.S. Air Force Academy
- Dubious Distinction: Has been on the board for 13 years and NEVER attended a meeting.

  - Denver Post, June 15, 200
- Best Practice: Attend at least 75% of board meetings per year…be there in person, not on the phone…and if you miss more than 25%, have a good reason.

"No Refunds" Ostrich

- Winner: Sanjay Kumar, Chair/CEO, Computer Associates
- Situation: "Mr. Kumar announced the ouster of three financial executives involved in the overstatement of 2000 revenue and that [the company] was working very hard to set the gold standard in corporate governance."
- Dubious Distinction: Mr. Kumar's 2000 bonus of 80,000 shares and $3.2M cash (as COO) was based on inflated profits, but apparently Mr. Kumar has no intention of returning any part of the bonus.

  - New York Times, October 10, 2003
- Best Practice: If you don't deserve it, return it, especially since the overstatement occurred while you were COO and the company is trying "very hard to reach the gold standard in corporate governance."

"Ben and Sam"
(Case Study)

Ben, Chairman and CEO of **Bigco**, is enjoying coffee outside the school auditorium during intermission of his son's junior high school play, when **Sam**, Chairman and CEO of **Smallco** (a financially troubled and much smaller competitor of Bigco), casually engages Ben in conversation about how well their sons are performing in the play.

Moments later, the auditorium lights flicker, and Ben, not wanting to miss the beginning of Act II, politely tells Sam goodbye and hurriedly begins to return to his seat when Sam suddenly taps Ben on the shoulder

and says: "Hey, I just thought of something . . . Smallco is interested in buying all the stock of Bigco for cash at 10% over book value . . . What do you think?" Ben, who knew that Sam had paid civil penalties for securities violations to the SEC at least twice and that Sam had a reputation for "shooting from the hip," could only shake his head in bewilderment and tell Sam "to get lost."
Ben returned to his seat, enjoyed the remainder of the play, forgot the incident, and never said anything to anyone. Neither Ben nor Bigco heard anything from Sam or Smallco again. However, Ben smiled to himself when he read in the Wall Street Journal two months later that Smallco had filed for bankruptcy liquidation and that Sam was going to be indicted for securities fraud.
How well did Ben handle the situation?

"Gatekeeper" Ostrich

- Winner: Joseph Magliochetti, CEO, Dana Corporation
- Dubious Distinction: Dana CEO refused to consider $2B buyout proposal from competitor made during telephone conversation with competitor CEO. Dana CEO did not inform Dana board of proposal.
- Dana's Explanation: Proposal was just a casual suggestion that did not require him to inform the board.

  – New York Times, July 9, 2003
- Best Practice: Even though CEO legally may not be required to inform board of a "preliminary indication of interest" to purchase the company (vs. written offer to purchase), the board should consider establishing guidelines for the CEO regarding which types of indications of interest should be disclosed to the board.

"James Carville Would Be Proud" Ostrich

- Winner: Jeffrey Amman, Gen. Counsel, Siebel Systems
- Situation: Siebel agreed to reimburse shareholder (Teachers Retirement System of Louisiana) up to $900K in legal fees to settle lawsuit in which Siebel agreed to change its executive compensation practices and improve disclosure of executive and director pay.
- Dubious Distinction: Mr. Amman said "as a company, we have always been committed to high standards of corporate governance and disclosure practices. So we are happy any time that we have the chance to enhance those practices. The settlement gave us the opportunity to do so."

  – New York Times, August 27, 2003
- Best Practice: Enhance your corporate governance practices without paying millions in legal fees. Be "happy" by avoiding costly litigation and doing what's right.

Eagle Awards
Excellence in Corporate Governance

"Meet the Shareholders" Eagle

- Winner: Andrew Grove, Chairman, Intel ($26B)
- Excellence: "Intel…plans to have the independent directors who head the boards' audit and compensation committees deliver reports at its annual shareholders meeting"…near its headquarters…hundreds of shareholders expected…meeting should last two hours.
- Mr. Grove: "I am trying to find my own way in getting a stronger board and stronger shareholder involvement on the issues. If you're not utterly insensitive to matters, you have to agree that shareholders are getting more active and restless. They want more say. I don't think that's a bad

trend. I want to go halfway and inform the shareholders about what we do and how we do what we do." -*New York Times, May 11, 2003*

- P.S.: Compare 2006 Home Depot shareholder meeting in which only Chair/CEO attended. No reports…shareholders limited to one question and one minute per question…large digital clock kept time…if exceeded one minute, shareholders stopped by "big strong men, some wearing Home Depot aprons."

"Don't Show Me the Money" Eagle

- Winner: Teachers Retirement System of Louisiana
- Excellence: Lawsuit settlement provides that Siebel Systems will advise shareholders of specific criteria used by compensation committee to determine executives and directors pay, will add one board member and allow fund to have significant input in selection, and expand compensation, nominating and corporate governance committees from 2 to 3 members.
- Comments: "Settlement represents a shift in balance of power between shareholders and management. We went through a long period where shareholders didn't interfere with management. The lawsuits are not just to recoup money anymore – they involve forcing the companies to change their practices."

  - *New York Times, August 27, 2003*

"Ark of the Covenant" Eagle

- Winner: EDS
- Situation: Most corporations do not disclose financial covenants. "Its very difficult to understand a company's liquidity position from reading the financial statements."

  – Moody's Investors Service
- Excellence: EDS… "described its covenants in its most recent quarterly statement, spelling out what its minimum net worth must be, how the figure is calculated and what would occur if a covenant were violated."
- Company: It was a strategy of new management "to give investors a better understanding of our business and to build confidence."

  - *New York Times, October 31, 2003*

"Options Not an Option" Eagle

- Winner: Microsoft
- Excellence: Will no longer grant stock options, relying instead on restricted stock awards vesting over 5 years to help pay its 50,000 employees. Also, beginning in 2004, will expense all equity based compensation (including previously granted stock options).
- Rationale (from Steve Ballmer, CEO): Hoped that company would bring its employees' interests more closely in line with those of shareholders. In the past, employees generally sold stock as soon as possible. Under the new stock ownership plan, he hoped that more [employees] would continue to own shares of company stock.

  - *New York Times, July 9, 2003*
- Comments: "The golden age of stock options is over"

  – Wall Street Journal.

  "Restricted stock requires fewer shares, provides a better retention hook, and can't go underwater"

  – Towers Perrin

"One Riot…One Ranger" Eagle

- Winner: Ralph Whitworth, outside board, Waste Management ($5B)
- Excellence: "When he was called in (as a director for WM) in the wake of the accounting scandal in 1998, a serious illness on the part of the CEO brought in to fix things forced Whitworth to take charge.

  He demanded the resignations of three top executives who had sold stock just months before an earnings miss. With two other board members, he set up shop at the Houston headquarters, meeting

with a crisis team every day at 5 p.m. for 90 consecutive days, as an army of 1,200 accountants scoured the company's books…all while recruiting a new CEO and resetting company strategy."

- TIAA-CREF Corporate Governance Director: "It's a great success story and one of the most dramatic turnarounds in governance…It's when you have a company crisis that something has to happen, or the company can just go down."

- Business Week, October 7, 2002

"Feel Good" Eagle

- Winner: Eight executives at Interpublic Group ($6B)
- Excellence: After some bad years, gave up more than 1.2M "underwater" stock options with some earmarked for lower level employees…Also canceled long term cash incentive plan for senior management.
- Former Chair/CEO: "I feel good about that."
- Chair/CEO: "I've chosen to lead by example."
- Situation: …in only a few instances have executives agreed to relinquish options, notably at the Charles Schwab Corporation.

- New York Times, May 21, 2003

"Groundbreaking" Eagle

- Winner: Victor Grijalya, Chairman of the Board, Hanover Compressor Company ($1B – NYSE)
- Excellence: Pushed for governance reform in settling securities-fraud lawsuit that included permitting Hanover shareholders with more than 1% of company stock to nominate two independent directors to the company's slate. Believed to be a first among public companies.
- Comments: "Groundbreaking…Goes to the heart of corporate power…Shareholder democracy has a real chance here."

- USA Today, May 14, 2003

"Belching in the Boardroom" Eagle

- Winner: Warren Buffet
- Situation: In his annual shareholders letter, Buffet stated that the problem with corporate boards is the "boardroom atmosphere" in which board members want to be accepted as part of the group and avoid asking tough questions. The result is passive boards.
- Excellence: In his letter, Buffet goes on to say that for a board member to question a mega-grant of stock options to a CEO would be "like belching at the dinner table".
- Extrapolation: OK to "belch in the boardroom".

"Lone Wolf" Eagle

- Winner: One outside director, Medtronic ($6.5B)
- Excellence: Lone dissenting vote among 12 directors to approve acquisition…calls Chair/CEO after meeting to re-argue his case…Chair/CEO reconvenes telephonic meeting to discuss acquisition. After discussion, other directors agree to vote against acquisition.
- Chair/CEO's comments: "Later, I told (him) how much I admired his courage and willingness to stand against the board." *-Wall Street Journal, November 19, 2002*
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"The Buck Stops" Perspective

Empowering Today's Boards

- Developed passion for a strong, proactive board as board member and EVP of Gordon Jewelry Corp. (passive, weak "All in the Family" board)
- Boards need to know how much power they've always had.. and how and when to use it
- Advocate a strong, proactive board (10 on a 10 scale) so they know how powerful they are… so they can make an informed decision how proactive they want to be…they decide what's best for the company
- A lot of "gray area" in corporate governance…pro's and con's

- "On beyond Sarbanes-Oxley"…Good Enough for Govt. Work Not Enough

Get an "A"

- Board must be a strategic asset…where individual directors help maximize long-term shareholder value
  - **Get an "A"**…not just a passing grade

The Buck Stops Here

- On President Truman's desk [sign]: "The Buck Stops Here"
  - sign should be in every boardroom in America
- Bottom Line: Directors blame themselves
  - ignoring shareholders or
  - permitting mismanagement or fraud
- First Question: Where was the board?
- First and best line of defense against mismanagement

Forget Lerach's "Kind Word and a Gun"

- Justification: "corporate governance at gunpoint"
  - Class action securities litigation forces company to adopt "best practices."
  - "…oftentimes more is obtained with a kind word and a gun, than a kind word alone." *– William Lerach at 2001 Institutional Shareholders Association Meeting*
- Two kinds of directors
  - Forget the plaintiffs' lawyers
  - Know your job and then just do it

Manage Board Composition



"When I said I didn't want a bunch of yes-men, I didn't mean I wanted a bunch of no-men."

"Bring It On" Eagle

- Winner: Jeff Rodek, Chair/CEO, Hyperion
- Situation: "One danger is that directors get too aggressive, attempting to dictate to management rather than performing an oversight role. But some CEOs say they relish a board that can ask tough questions and bring different perspectives and expertise to the job."
- Excellence: Mr. Rodek: "If your board members aren't pushing back, you've got the wrong board…it's not always comfortable." *-USA Today, July 31, 2002*

"Independent" Director Criteria

- ALL independent directors should:

- Commit: 100-200 hours year (preparation, travel, attendance) – 350 hours for audit chair (unless on Worldcom audit comm: 3-5 hours per year).
- Act independent (not just "be" independent)…independence is psychological…"material relationship" test inconclusive…psychological test?... Heart check?
  - "Helpful **skeptic**" = "I don't know"…."Let's talk about it"
    - Assume nothing…question...encourage discussions…suggest alternatives…be respectful of other opinions…bring "constructive friction."
  - Have **courage** to ask necessary questions and to admit that you may lack knowledge or understanding, to overcome intellectual intimidation, and to be the "Lone Wolf."
  - Trust their "gut" (or intuition)
- Have integrity and business "smarts."

"Some" Director Criteria

- At least SOME of all directors
  - Track record of contributing and implementing a successful corporate strategy (either as an executive or a board member)
  - Extensive knowledge of the business and industry
  - Diversity:
    - Strong, narrow skills and operational experience
    - Minorities, women, younger

"Young and Restless" Eagle

- Winner: Weyerhaeuser ($18B)
- Excellence: "…Appointed Nicole Piasecki, 40, to its board. Ms. Piasecki, VP for business strategy and marketing for Boeing Commercial Airplanes…is 18 years younger than the next-youngest person on the Weyerhauser board."
- Weyerhauser CEO: "In the old days, you normally looked for almost exclusively CEOs – the been-there-done-that type folks…now, we're looking more for specific skills. Nicole is one of Boeing's senior people in marketing and sales."
- Head of board practice at Spencer Stuart: "The traditional pool of candidates has dried up…board appointments used to be for people who made it…now, they're going to look for people who are almost there."
- Columbia MBA professor: "(Younger directors) are looking at the clock, they have things to do…they're much more brusque about calling it the way they see it."

  - *New York Times, February 2, 2003*

"Give H.R. a Chance" Eagle

- Winner: Select Comfort ($1B market cap) and Alpharma ($1B revenue)
- Excellence: Named top HR officers at General Mills and Avon to their respective boards.
- Rationale: HR professionals are experts in talent assessment, leadership development, compensation,organizational change and effectiveness, and employee motivation and retention.

  - *Vice Chairman, Heidrick & Struggles*

"Gender Irrelevant" Eagle

- Winner: Robert Lipp, Chairman, Travelers Property Casualty Corp.
- Excellence: After spin-off from Citigroup, Lipp needed to rebuild board and recruited seven directors, including three women. One, who was a semi-retired venture capitalist with a finance background who was named to the audit committee, said: "I've been involved in building lots of companies…Bob knew I could ask the right questions." – *Business Week, December 22, 2003*

Women on the Inside Track

- Governance reforms have put a premium on financial expertise requiring boards to recruit directors from finance and accounting where high level women are represented in larger numbers than at CEO level
  - "Financial experts" = usually someone with CFO or audit-partner experience
    - Largest 500 companies: 7% of CFO's are women (vs 1.6% of CEOs)

        - Deloitte & Touche: 16% audit partners are women
    - Financially savvy directors…finance and auditing career tracks have been more favorable to women

Current CEOs as Directors

- Harder to find
    - Fewer current CEOs after M&A activity
    - Damaged reputation if join a board and something goes wrong on that board
    - Minimal time for outside activities (limit one outside board)
    - Ask current board for permission – often denied

Director Candidate Pool

- "C" titles: CEO, CFO, COO, CTO, CIO, CAO
- "D" titles: Division President, Division CFO, HR Director
- "V" titles: Vice-President
- Financial, accounting and legal experts
- Professional directors (i.e., retired CEOs not ready for golf course)
- Everybody else (i.e., university presidents, retired military brass, hospital administrators, etc.)
- No "Trophy" directors (i.e., William Webster…person with high visibility and great reputation but unqualified)

"Debit is the Side Toward the Window" Ostrich

- Winner: William Webster, former CIA and FBI Director and former Federal Judge
- Dubious Distinction: Served as chairman of audit committee of U.S. Technologies even though having no accounting experience… "Audit committee decided not to thoroughly investigate external auditors' report of material weaknesses in internal control and financial and accounting infrastructure"…Company now facing fraud charges. - *New York Times, October 31, 2002*
- Best Practice: Accounting novices need not apply to audit committee.

"You Gotta Have Friends" Ostrich

- Winner: Jeff Rodek, Chair/CEO, Hyperion
- Dubious Distinction: Mr. Rodek says that to fill [director] openings previously, he would just "go to my rolodex and call up my friends." - W*all Street Journal, August 29, 2002*
- Best Practice: Nominating/corporate governance committee finds directors, not CEO
- Comment from Heidrick & Struggles recruiter: "It used to be our contact was always the CEO of the hiring company…now, on 50% of the (director) searches I'm doing, the head of the nominating committee has taken charge of the process" - *USA Today, July 31, 2002*

The Right Reasons to Get On-Board

- **"We owe it to America to take the job."**
  – *Daniel Burnham, Chair/CEO, Raytheon Company, January 14, 2003*
- "Hottest game in town played by top professionals…learn from and exchange ideas with the best"
- "Satisfaction of applying my accumulated experience…not using it anymore would be a crying shame"
- "CEOs get better perspective and ideas from serving on other boards…see how other CEOs do it"
- "Fascinated with the company…want to be associated with it"
- "Ultimate networking opportunity"
  – *USA Today, July 31, 2002*

"But I Watched *America's Most Wanted*" Ostrich

- Winner: William Webster (again)
- Dubious Distinction: Mr. Webster says he "did not do any due diligence" on (U.S. Technologies' CEO), but instead relied on the advice of friends who were also involved in the company.
  – *Wall Street Journal, November 12, 2002*
- Best Practice: Do independent due diligence before joining a board.

Due Diligence by Prospective Directors

- Time commitment (how many board & committee mtgs., in town or out of town, on how many other boards)
- Financial/Legal health? (hire your own accountant/atty at company expense)
- Controls, systems and procedures (investigations or shareholder litigation within last 5 years?)
- CEO/senior management performance (right CEO? succession plan?)
- Board ACT independently? (CEO also the Chair? Presiding or Lead director?)
- Board responsive to shareholder concerns? (shareholder requests and proxy initiatives)
- Director Protections…enough D&O insurance and corporate indemnities?
- Enough general liability insurance?
- Director orientation program/director education program?
- Board's expectations of the prospective director? (manage expectations)

Due Diligence by Prospective Directors

- Consider meeting the right people
    - Chair, Lead Director
    - CEO, CFO, COO and other officers
    - Chairs of audit and other committees
    - Other directors, former directors
    - External auditors, internal auditors
    - Outside counsel, inside counsel

Due Diligence by Prospective Directors

- One director wouldn't accept the board seat until he sat in on two board meetings to convince himself that the board was up to snuff.
- One director sent a team of financial experts to the company recruiting him. They took over a week to examine its accounting procedures before he was satisfied and agreed to join.

Director Exit-Strategy

- Board's discretion
    - Offer resignation if change in personal circumstances
        - Any significant change (i.e., health reasons)
        - Change in principal job responsibilities
    - Every 1-5 years, corporate governance committee formally reviews each director's continuation on the board
        - During review, require each director to confirm desire to continue as board member
    - Peer evaluation: every 1-5 years, individual directors rank each other and share info without using names of who ranked whom
        - "One-on-One" with chairman, presiding or lead director: Your colleagues say you're not carrying your weight. If you don't improve, you will not be put up for re-election.

Director Exit-Strategy: Mandatory Retirement &Term Limits

- Reasons FOR:
    - Refreshes board with new people and new ideas
    - Mandatory removal of under-performing directors
    - No "feelings" involved
- Reasons AGAINST:
    - Mandatory and arbitrary removal of directors whose contributions have increased over time because of more insight into company and operations as a whole
    - Board's job…don't give away your power

10 Commandments for the Board

(As a Group)

Commandment #1

- Know your job and then just do it
  - Two overall duties of the board
    - Duty of care
    - Duty of loyalty

"Homeco" Case Study(Duty of Care)

Homeco, incorporated in Anystate, USA, is a $10B (sales) manufacturing company with its entire operations in Homerville, Anystate. Homeco employs over 25,000 of the town's 50,000 residents but almost all residents owe their livelihood to Homeco. The large majority of Homeco's customers and suppliers are in the USA.

Homeco's business is great and has always been great ever since its founder, Homer K. Homer, started the company in 1909 in his then tiny hometown of Homerville (pop. 642). In fact, because of Homeco's generous support of the community and the influence of Homer K. Homer's descendants (who maintain key management and board positions at Homeco), Homerville is the consensus pick as the finest small town in America in which to live and Homeco is rated the best company in America for which to work.

However, Homeco's stock price has always traded at a significant discount to book value ever since it went public over 30 years ago. **Offshore Co**. has decided to remedy that disparity and has made a final offer to purchase all of Homeco's stock in a fully financed all cash transaction at **$40 per share** (current price $16; historic high $20; book value $25).

Offshore Co. will move all of Homeco's operations offshore and fire all Homeco's employees which will turn Homerville into a ghost town and decimate the lives of all its residents (employees and non-employees alike). Also, Offshore Co. will replace all of Homeco's domestic suppliers with foreign suppliers and will focus all of Homeco's sales and marketing efforts on developing new foreign customers to the detriment of Homeco's current domestic customers.

Many of Homeco's suppliers, large customers, and thousands of Homerville residents have already begun continuous picketing outside Homeco's headquarters in Homerville protesting the planned sale and local, state, and federal officials are all against the sale as well, but there are no regulatory objections and shareholders have been doing back-flips over the possible sale to Offshore Co. The only other viable bidder, **White Knight Co**., will keep all of Homeco's operations, suppliers and customer base intact, but its final offer of a fully financed all cash transaction is only **$30 per share**.

The Board has decided to accept either the Offshore or White Knight offer. Which should they accept and why?

- Duty of Care
  - Maximize long term shareholder value by maximizing corporate profits and by treating employees, customers, suppliers, creditors, and community well
    - Treat non-shareholders (i.e.,stakeholders) well and shareholders benefit
  - But how to treat stakeholders in sale of Delaware company
    - Buyer to fire all the employees and move operations off-shore
  - How to maximize sales price on sale of company? Price or certainty?
    -*"Bird in the Hand," Wall Street Journal, 1989*
    - $37.50 "take it or leave it" unconditional vs. $39 "rubber-stamp" conditional
- Duty of Loyalty: Company comes first. No exceptions.
  - "Conflicts of Interest": a director, officer or employee's private interest interferes in any way (or appears to interfere) with the corporation's interests as a whole
    - "Safe Harbor" - Get written board approval if "just and reasonable" to corporation (interested director doesn't participate in discussions or voting)
    - May lose "independent" classification of the director and invite scrutiny of transaction…Is it worth the risk?

Commandment #2

- Exercise Ultimate Authority
  - The Buck Stops in the Boardroom
  - Since they have ultimate responsibility for everything that happens or doesn't happen at the company, use their matching authority
  - Oversee, but don't manage
  - Day-to-day operations belong to senior management

Commandment #3

- Oversee by establishing controls, systems and procedures ("CSPs")
  - Ever worry if you have good I.T. security? You better, just like you worry about financial security.
  - Make sure CSPs are in place, emphasized and enforced for EVERY area of your company.
    - Financial, operations, legal compliance, emergency response plans, conflicts of interest
  - Human resources example: $90M judgment in CA against Farmer's Insurance for misclassifying "non-exempt" employees as "exempt"
  - Make sure CSPs are periodically evaluated and updated
  - "Process, process, process" (in board decisions)

Commandment #4

- Delegate Duties and Rely on Reports and Advice from Management, Counsel, Auditors and other Outside Experts.
  - You can't and shouldn't try to do everything yourself. Delegate day-to-day operations to officers. Hire accountants, attorneys, and technical, compensation, and I.T. security experts as needed.
  - Outsiders biased?
    - Fear losing company's business if they speak their mind?
    - Personal relationship with management?
  - Qualify them, be prepared, probe, ask questions about assumptions, processes, and substance…and if you don't understand or agree, don't approve it.
    - Trust your gut…

Commandment #5

- Act only as a full group at a meeting or by unanimous written consent without a meeting.
  - Telephone meetings OK but be careful about discussing issues that are hard to follow on the phone (i.e., accounting issues or mergers).
  - Written consent for simple matters that need no discussion or to confirm previously agreed action.
  - Unlike officers, individual board members have no authority to act for the corporation (unless "deputized").

Commandment #6

- Own Strategic Plan and Annual Operating Plans
  - Give input to, review, revise, understand and approve these plans prepared by CEO and senior management and hold them responsible
    - Primary risks to business plan identified and prioritized?
    - Who monitors risks on a current basis?
  - Committed or involved ("bacon or eggs")
  - Help them stay on track and make adjustments to the annual plans and budgets as needed
  - Great topic for board executive session

Commandment #7

- Take "Cradle to Grave" responsibility for key executive management (i.e., CEO and other "chief" titles?)
  - Find, hire, compensate, evaluate, plan for successors, and if necessary, terminate

- Selection, compensation and evaluation of CEO is the single most important function of the board?
- Absolute right to terminate employment contract but could be liable for damages:
  - "Boards really aren't very compassionate. The moment the board decides that somebody else can get this thing done for them, we will be out of here the next day." – Harry Stonecipher, in 1999, as President of Boeing
  - "Due process" before "the next day"
- Succession plan a great topic for executive session

Commandment #8

- Consider setting limits on CEO's authority
  - Nature abhors a vacuum, and so do CEOs. If you don't set limits, you have no one to blame.
  - Controversy: Just trust the CEO or establish a line?
    - "Line" creates clear understanding (maintains "checks and balances" and avoids wasting board's time).
  - Legal "low-bar": only board issues stock, declares dividends, hires/fires officer, etc.
  - Raising the bar?:
    - Acquisitions (Tyco: $50M, $100M, $200M)
    - Major litigation
    - Major strategic alliances
    - Commitments more than "X" years or "Y" dollars
    - Material changes to operating plan and budget, insurance coverage
    - Selection of legal counsel (for corp., for board, for committee)
    - Preliminary indications of interest (vs. formal written offers)

Commandment #9

- Get "unfiltered" information for decision making
  - Are you getting the whole story or just CEO's input ? Tone at the top?
    - CEO consider board an adversary, a subordinate, a nuisance or a strategic resource? (talented peers with a "hat pin")
    - "Mushroom" board? "Southern board?
    - CEO as gatekeeper…more accurate information to board?
  - Get the facts, all the facts, and not just from the CEO
    - Other management
    - Outside counsel, auditors and other experts
    - Analysts and media reports
  - Corporate governance committee (or Board Chair) responsible for overseeing information pipeline

Commandment #10

- Evaluate each director, the Board and its committees
  - You wouldn't keep slackers on the sales force. Why do it in the boardroom?
  - Board position is not permanent.
  - Corporate governance committee responsible for overseeing annual evaluation
    - Get right mix of skills and experience.

Director Bill of Rights
(For individual directors)

Director Right #1

- Right to participate in board and committee meetings and make informed decisions
  - Put items on the board meeting agenda

- Have key employees and advisers make presentations and answer questions at meetings
- What if Chair objects to above requests?
- Get information at least a week in advance to have enough time to prepare and request more information
- Speak-up at meetings, no "potted plants"

-Challenge Lou Gerstner?

- "Some people in and out of the company say Mr. Gerstner is the real power on the (Bristol-Myers Squibb) board. When he was in charge of I.B.M., Mr. Gerstner used aggressive accounting techniques to strengthen operating results, and some say he is not about to punish Mr. Dolan (Chair/CEO, Bristol-Myers Squibb) for being aggressive himself"
  -New York Times, May 18, 2003
- Everybody's equal in the boardroom
- Director orientation & education helps cure two year "quiet period"

Director Right #2

- Right to inspect
  - Corporate documents and corporate property, nothing is sacred
  - Hard copy, soft copy, electronic copy, plant and equipment, if it exists, you can see it
    - Examples:
      - Don't have to "leave the papers"
      - "Top-secret" government information
  - Limitation: give management reasonable time to comply

Director Right #3

- Right to communicate
  - Talk to anyone with or without management present, including employees, shareholders, accountants, attorneys, or any outside advisers or consultants
    - Recommend including management in any director meeting with shareholders
  - Remind the other party that as a director, you're there to ask questions and listen…not to advise or instruct (no individual authority)
  - Minimize "information disadvantage" by asking around…get different opinions…appreciate what you don't know…slow learners OK…"black and white" issues rare…3,000 hrs. vs. 200 hrs.
  - Limit: Can't be disruptive. Advise CEO of significant contacts with senior management

Director Right #4

- Right to do extra work between Board meetings
  - Examples:
    - Contact senior management and visit offices and plants without corporate executives present
    - Review competitors' SEC filings
    - Review best corporate governance practices at other similar companies
  - Minimize "information disadvantage"
  - Maximize oversight between Board meetings
  - Share information with the Board at each meeting
  - Get information outside of Board meetings and away from management's influence

Director Right #5

- Right to dissent and resign
  - Dissent in board meetings is required
  - Unanimity vs. majority
  - "12 Angry Men"…required viewing
  - Tell 'em who you are and what you stand for, but if they won't cooperate, get the heck out of dodge
  - What if just one Enron director resigned

- Form 8K leverage…pressure on board

-Don't Just Sit There

- "Even if you're on the right track, you'll get run over if you just sit there" -*Will Rogers*

Thank You!

Contact Information

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