Lead Director Network
ViewPoints
Issue 5 December 11, 2009

The lead director's role in succession planning

Introduction

The fifth meeting of the Lead Director Network (LDN) was held in Washington, DC, on November 18, 2009.[1] Members discussed two topics: succession planning and corporate governance reforms. This *ViewPoints* considers both topics, in two separate sections, beginning with succession planning.

ViewPoints reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before, during, and after meetings are not attributed to individuals or their companies. Quotations from the meeting are shown in italics.

The lead directors who participated in the meeting included:

- Frank Blount, Presiding Director at Caterpillar and Lead Director at KBR
- Peter Browning, Lead Director at Nucor
- Dan Carp, Non-executive Chairman at Delta Air Lines
- Dan Feehan, Presiding Director at RadioShack
- Karen Horn, Presiding Director at Eli Lilly
- Phil Humann, Presiding Director at Coca-Cola Enterprises
- Bob Kidder, Chairman at Chrysler and Lead Director at Morgan Stanley
- Linda Fayne Levinson, Presiding Director at Jacobs Engineering Group and Lead Director at NCR
- Senator Sam Nunn, Presiding Director at Dell
- Jack O'Brien, Lead Director at TJX Companies and non-executive Chairman at Cabot
- Ken Powell, Lead Director at Medtronic
- Mike Sullivan, Lead Director at Constellation Energy Group

King & Spalding partners participating in the meeting were:

- J. Kelley, Partner, Corporate Practice Group
- Chris Wray, Partner, Chair Special Matters and Government Investigations Group

[1] The LDN brings together a select group of lead directors, presiding directors, and non-executive chairs from *Fortune* 500 companies for private, candid discussions about ways to improve board governance. For the purposes of this network, the term *lead director* is used to refer to all three titles – lead director, presiding director, and non-executive chairman – except where otherwise stated.

Executive summary

Members agree that succession planning, for both the CEO and the top management team, is a fundamental and critical board responsibility. They also agree that there is no single approach to succession planning that will work for every company. Members' views on CEO and management succession planning are summarized below and covered in more detail in this report:

- **CEO succession: emergency plan** *(page 2)*

  LDN members believe it is critical for all companies to draft an emergency CEO succession plan and to review that plan annually. But they disagree on the specificity of these plans. Some companies have a very detailed plan; other companies have a less formal plan.

- **CEO succession: orderly, long-term plan** *(page 3)*

  LDN members agree on the importance of having a long-term succession plan that has been carefully developed over months and years. This plan generally defines the roles and responsibilities of the board and management, gives a timeline for CEO succession, assesses future business needs, lists the wanted attributes and experiences of the next CEO, creates opportunities for board members to interact with CEO candidates, and provides for open dialogue between the board and the current CEO about the process.

- **CEO succession: specific roles and responsibilities** *(page 6)*

  Members agree that the board – either in full or through a committee – has primary responsibility for developing and executing the CEO succession plan. The lead director also plays a vital role in CEO succession planning, aggregating feedback on candidates and driving the board to consensus. The CEO's perspective on candidates is an important contribution. Members also agree that if a company hires a search firm to help with the succession process, the lead director or a committee of the board should manage the company's relationship with that firm.

- **Management succession** *(page 9)*

  In addition to being responsible for CEO succession, boards also provide oversight and support for the wider management succession process. LDN members report that boards often develop relationships with the top 20 or so senior executives over a period of years, relying on the company's management development program to ensure that lower-level executives are developed properly. The board's role is to review the program regularly to be sure it is working satisfactorily.

CEO succession: emergency plan

LDN members believe that CEO succession is a fundamental and critical board responsibility: *"If one person can mess up the company, it's the CEO. Changing the CEO has a material impact on the company. You have to be ready for an emergency and the long term."* Another member highlighted the far-reaching implications of an inadequate CEO succession plan: *"One of our CEOs resigned, and we were not prepared for it, and the company is no longer around as a result of it."*

The goal of the emergency plan is to ensure that the company continues to operate smoothly in the event of a sudden CEO absence. All member companies have an emergency CEO succession plan: *"Of course we have a very senior person who could run the company in the emergency situation."* Most boards discuss their emergency plan on an annual basis: *"We have a fulsome discussion with the board once a year on the emergency succession plan."*

The level of specificity of these emergency plans varies:

- **Detailed approach.** One member described his company's in-depth approach to preparing for an emergency CEO succession: *"We have a pretty formal process at my company to develop a 'black book' with some outside consulting help. This black book basically has processes in place, step-by-step, with everything that needs to happen – i.e., who drafts press releases, all the filings, who's responsible for contacting whom, who has what legal responsibility. It includes a complete review of charters and bylaws."* Another member described a similar approach: *"If the CEO gets hired away, that is the same as our hit-by-the-bus scenario. We have a black book. And the board has chosen a board member who would step in as interim CEO, and then we'd start a search [for the next CEO]."*
- **Informal approach.** Boards that adopt an informal approach are satisfied that a successor is in place in case of an emergency and that management is prepared to move forward without a detailed document. One member explained: *"We have an emergency plan in place. We have talked through what [management and the board will] do and what happens in an emergency."*

CEO succession: orderly, long-term plan

LDN members agree that successful companies have a well-developed, long-term succession plan in place: *"Long-lasting, successful companies seem to have a great track record of succession planning … They've worked on it for years and years, and the pipeline is full."* That thinking is confirmed by a recent study, which concluded that "a board that approaches succession planning years before the anticipated need is clearly on the right path."[2]

The board develops the company's long-term CEO succession plan over a period of months and years. The process is ongoing and systematic throughout the year. One LDN member said: *"We touch on CEO succession planning as an agenda item at every board meeting."*

[2] Heidrick & Struggles, *The Board of Directors' Role in CEO Succession Planning* (Chicago, 2009), 12. Available at http://www.heidrick.com/NR/rdonlyres/162BDFFE-CD60-48B7-B69C-A98BDC7FD40C/0/HS_CEOSuccession.pdf.

Issues that can impact the long-term succession plan:

- **CEO age and tenure.** If the CEO is young, a company may feel less urgency about preparing for CEO succession: *"If your CEO is [under] 55 and the company is performing well, there's no sense of urgency."* As one member explained: *"Our young CEO runs a very lean management team … We do have a hit-by-the-bus scenario, but that may not be the best time to start a long-term succession process."*

- **Company size.** Members agree that smaller companies often have smaller talent pools than larger companies do: *"The problem with a smaller company is you don't have as extensive an internal talent base."*

- **Company performance.** Boards speed up their succession planning process when a company is performing poorly: *"When times are good and you have a good CEO, you are less disciplined about putting a succession plan in place than when things are bad."*

- **Company culture of management development.** A tradition of development often distinguishes more robust succession processes. Said one member: *"If you don't have a strong tradition of development at your company, it makes [CEO succession planning] harder."* Another member added: *"We have a strong tradition of robust development at our company. [Succession planning] is a part of our culture."*

- **Board decision to test external candidates.** *"Boards have fallen into the error of thinking it's their fiduciary duty to look for the best external athlete."* Another member expanded on this point: *"There's this mentality that boards haven't done their job if they haven't tested their internal candidate [against] outside people."*

- **The internal "horse race."** *"We had two great candidates, and they nearly destroyed the company. The plan [to have them compete] seemed perfect, but their rivalry nearly destroyed the company."* Members tell us that the incumbent CEO plays a critical role in ensuring that senior leaders in the company maintain productive relationships during the succession process: *"The CEO's responsibility is to be the adult in the room and make sure these horse races don't get out of control."*

Members agree that the ideal long-term plan should focus on identifying and developing internal candidates for the CEO position. According to LDN members, if the board is *"doing its job, you will have terrific internal candidates in place, and you won't have to go outside."* The *Harvard Business Review* found that 80% of the current *Fortune* 100 CEOs were selected from within their companies' ranks.[3]

[3] Dennis Carey, Dan Phelan, and Michael Useem, "Picking the Right Insider for CEO Succession," *Harvard Business Review* 87, no. 1 (January 2009). Available at http://hbr.harvardbusiness.org/2009/01/picking-the-right-insider-for-ceo-succession/ar/1.

The importance of promoting from within was confirmed in a 2001 study of executive failure, which found that the average failure rate for recruited executives in their first year was between 40% and 50%.[4] More recently, another expert reported that 58% of new executives hired from the outside fail in their new position within 18 months.[5]

Core elements of long-term succession planning

Members identified seven core elements of an effective succession planning process:

- **Clear roles and responsibilities.** Strong, clearly defined board leadership is critical to the CEO succession planning process: *"Once the process began … the board was in control at that point. We all knew what we had to do, and so did our CEO."* According to one management consulting firm, if board members and the CEO "are unclear about what work would be required … who would be involved, and what roles they would play," the succession plan is going to suffer.[6]
- **A timeline for CEO succession.** Although succession planning is an ongoing topic for boards, LDN members report that their boards formalized and expanded their discussion of succession planning once a clear timeline for the CEO's departure was established. One member described the evolution: *"At the outset, [our CEO succession planning] was semi-formal. For the first year and a half that I was on the board … we'd meet and review internal candidates at almost every board meeting. Once we knew the CEO was leaving, we defined a much more formal process."* After a new CEO has been chosen, some companies execute the change in leadership within a matter of months, whereas other companies put the succession plan into action over a period of years.
- **An assessment of future business needs.** Board members must weigh a variety of complex factors when evaluating potential CEO candidates. One member noted: *"You have to look at what the company is experiencing and what it will experience over the next few years and how the [business] environment is changing."* A recent *Forbes* article stated: "The board has to evaluate myriad factors – the company's strategic positioning, the condition of the industry, various macroeconomic variables … What it takes to lead a turnaround, for example, can be quite different from what it takes to lead a global expansion."[7]
- **Consensus on the attributes and experiences of the next CEO.** Members believe it is important that boards reach a consensus on explicit characteristics of the CEO's successor. One member said: *"Boards should be very clear about what sorts of challenges and tasks the company will face in the future, and then these challenges should be explicitly stated in the specifications for [CEO] candidates."* Another member stated: *"Boards sometimes look more at attributes of style than the actual experiences*

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[4] Carl Robinson, "The Number 1 Reason Executives Fail in New Jobs," Advanced Leadership Consulting (2007). Available at http://www.leadershipconsulting.com/the-number-1-reason-executives-fail-in-new-jobs.htm.

[5] Clark Waterfall, "7 Reasons CEOs Fail," BSG Blog (BSG Team Ventures), March 25, 2009. Available at http://www.bostonsearchgroup.com/blog/7-reasons-ceos-fail/.

[6] Mark Nadler, Carlos Rivero, Steve Krupp, and Richard Hossack, "Overcoming the Obstacles to CEO Succession Planning," *Oliver Wyman Journal* 26 (Spring 2009), 43. Available at http://www.oliverwyman.com/ow/pdf_files/OWJ26-5_CEO_Succession.pdf.

[7] Stephen A. Miles and Nathan Bennett, "How the SEC Just Changed Succession Planning: Part I," *Forbes,* November 17, 2009. Available at http://www.forbes.com/2009/11/17/succession-planning-sec-leadership-ceonetwork-search.html.

a person has and how [he or she has] performed coming up through the ranks. [To avoid focusing on style,] boards should agree on objective criteria." A third member added: *"The board figured out the leadership potential and profiles of the top candidates for CEO. Later, as we kept meeting, we would pull out [our description of the CEO role] and get some view of how [candidates] fit those leadership characteristics."*

- **Familiarity with potential CEO candidates.** Members agree that the board should engage formally and informally with candidates for CEO in various settings: *"Internal candidates [for CEO] were agreed upon early on [by the board]. We knew them well. There were a lot of decision points."* One member added: *"There are the informal dinners, but there are also [opportunities for interaction] at board meetings and off-sites."*
- **Open dialogue between the board and the CEO.** One summary of best practices in CEO succession planning suggests that "an open and ongoing dialogue should occur between the CEO and the board on the topic of succession planning."[8] LDN members agree: *"At one board, the CEO announced that he had made a decision that we thought was clearly a board decision … Having that discussion [about the CEO succession process and the CEO's preferences] with the CEO is very important."* Another member stated: *"The CEO supported one candidate who we thought was not the best candidate, so we had to talk through that."* In addition, communication between the CEO and the candidates is vital: *"The CEO took some time to speak to the candidates. We didn't take the [official] vote on the next CEO until a telephone meeting four days later, to give the outgoing CEO time to do his work."* And one member noted: *"The outgoing CEO had an opportunity to develop a communication plan with the CEO-elect."*
- **Retiring CEO serving as chairman.** Once a transition takes place, some members suggest that the outgoing CEO chair the board for a time: *"Our former CEO stayed on as chairman … We defined this period of time and his role very clearly."* A 2005 study by the National Association of Corporate Directors (NACD) on CEO succession recommended that the outgoing CEO stay on the board as chairman for a transitional period of 6 to 18 months.[9] An LDN member who had been promoted to the CEO position elaborated on the benefits of having a former CEO act as chairman: *"The generation of leaders coming up now has very little governance experience. For me, it was crucial that the former CEO ran the board for 10 months while I figured out my CEO role."* However, other members raise the possibility of conflict between a former CEO who stays on as chair and the new CEO. One member recalled: *"The new CEO asked for an executive session with the board and said, 'I can't do this job while the chairman is still on the board.' We passed a policy that said no former employee can be on the board."*

CEO succession: specific roles and responsibilities

The board, the lead director, and the CEO each has specific and important responsibilities in the succession process.

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[8] Nadler, Rivero, Krupp, and Hossack, "Overcoming the Obstacles to CEO Succession Planning," 45.

[9] National Association of Corporate Directors, *The Role of the Board in CEO Succession* (Washington, DC, 2005), 15.

The board's role

While members are clear that the board is responsible for the CEO succession plan, they are less clear on whether the full board or a board committee should lead the process.

- **Full board.** For most LDN members, the full board plays a critical role in guiding the long-term CEO succession plan: *"At our company, the entire board, not the governance committee, ran the process."*
- **Board committee.** At some companies, individual committees of the board assume primary responsibility for the CEO succession plan, particularly in emergency scenarios. One member described how it worked: *"The governance committee ran this process. We had very little time to get this done – we interviewed four candidates as a committee with the same set of questions. We invited the entire board to come into the process, but they didn't ask questions; they just observed. The board knew all these candidates, but [the governance committee] led the process."*

The lead director's role

Lead directors are responsible for a variety of critical tasks in CEO succession planning, including interviewing potential CEO candidates, collecting feedback from a variety of sources, aggregating performance evaluations from senior management, and holding conversations with the CEO about his or her preferences.

In particular, members emphasize the subtlety required when bringing the board to consensus on an internal CEO candidate: *"We couldn't push the board to do it overnight. We had to work the board overtime because some people were uncomfortable with certain decisions, i.e., external candidates or search firms."* The lead director also helps create a support structure for the incoming CEO: *"I worked with the new CEO and helped him get familiar with the company."*

In one company, the lead director smoothed the transition by mediating between two directors who volunteered to be the interim CEO while the board conducted a search for a permanent CEO: *"We had two possible people on the board who had the time and had been operators and could be the interim CEO, and both of them wanted it. I talked to a lot of directors and found where the majority vote was, and tried to smooth it over."*

The lead director also reports the board's final decision to the CEO. As one member said in a previous conversation, *"At a recent board meeting, we met with two internal CEO candidates and had lengthy conversations with them as a whole board. I facilitated that discussion as the lead director, and our CEO wasn't there at the meeting. When the CEO came back into the board meeting, I told him our preference, and he agreed."*

The CEO's role

One member described the evolution of the CEO's participation in CEO succession planning: *"The way it used to happen is the CEO would put his successor's name in the desk drawer. Well, forget that. The* *whole board has to be engaged … You've worked through an understanding of whomever you've agreed on and what the process is."*

The CEO's input is an important part of a thorough succession planning process: *"The CEO had been involved in assessing all candidates and given us his point of view on the candidates."* At most companies, the CEO contributes to the internal candidates' annual performance reviews. In addition to providing performance assessments, the CEO can support the succession process by examining the nuances of the candidates' leadership abilities: *"Our current CEO tried to figure out who the organization would follow. He discovered the organization didn't have anywhere near as much faith in his choice [as he had hoped]."*

Often the CEO offers input in the later stages of the process: *"We purposely asked our CEO not to give us his recommendation until the last minute,"* related one member. Another stated: *"The board meets independently, without the CEO, in every board meeting and says, 'How do we feel now [about the CEO succession candidates]?'"* In one instance, the company's CEO chose not to back any candidate and instead left the decision entirely to the board: *"The CEO refused to provide his preference. He only gave us their performance appraisals."*

The role of search firms and external consultants

As part of the CEO succession planning process, many companies hire search firms or external consultants. The lead director or a committee of the board is often the primary point of contact for the outside firm.

Members say that search firms and external consultants can best support the CEO succession process by:

- **Benchmarking internal candidates.** *"We used an external search firm to benchmark our internal candidates."*
- **Augmenting assessments of internal candidates.** *"We had them do independent assessments of our internal candidates and use external benchmarks. The firm worked independently with the CEO in terms of his level of comfort with the candidates. That yielded a product."*

However, many members are skeptical about the value of external search firms and consultants: *"We had a disappointing process with hiring an external firm. There was a big disconnect between [its] conclusions and the conclusions of the board."*

Another member cautioned against benchmarking internal candidates with external candidates. Hiring external search firms often increases the chances of naming an external successor, a slippery slope that troubles LDN members: *"The failure rate of external succession is very high. And evidence shows more and more companies are going outside."* One member noted: *"It puts you on the slippery slope. That's not to say you can't stay with the internal candidate, but the outsiders have a vested interest in pushing for the external candidate, and they can always find reasons why your internal candidate doesn't measure up to all of the strongest points of some of your external candidates. It takes a very strong process to reverse and stay with your internal candidates once you begin the process with external advisers."*

The SEC's change of approach to succession planning

On October 27, 2009, the SEC's Division of Corporation Finance released Legal Bulletin 14E.[10] This bulletin supports shareholders who want to put a proposal in the proxy for greater transparency around CEO succession plans. One article explained it this way: "The language used in the guidance reveals the growing concern with which the SEC views the matter: 'One of the board's key functions is to provide for succession planning so that the company is not adversely affected due to a vacancy in leadership. Recent events have underscored the importance of this board function to the governance of the corporation.'"[11]

Members tell us that the bulletin, like proposed disclosure requirements concerning board leadership, would not alter their companies' internal succession planning process in any substantive way. Said one: *"It's hard to argue against greater disclosure."*

Management succession

The CEO, as head of the company's management team, leads the senior management succession and development process, monitoring candidates on an ongoing basis. The board also plays a key role in the oversight of senior executive succession by interacting with senior executives on an ongoing basis.

Members agree that the board can reasonably interact with the top 20 to 25 operating executives on a regular basis. One member said: *"The board has to know all the operating leaders (roughly 18 to 20 people). Our goal is to have the board know who is running the company and have a pretty good sense of the best candidates."*

Members underscore that the board's relationships with top executives *"take years"* to develop. One member explained: *"We only have six board meetings a year. We can't go larger than 25 people into the organization. It's a multi-year process of just getting to know those 25 people."* Senior executives present to the board at board meetings throughout the year: *"We try to have [senior executives] attend almost every board meeting."* However, there are limitations to this approach: *"How much can you really learn about someone who is walking you through a PowerPoint deck?"*

Boards rely on the company's management development process to develop executives beyond the top 20 to 25 leaders: *"You have to trust that you have a good pipeline and talent development system in place."* According to the NACD's study on CEO succession, one company has the CEO and senior management team spend a full day each year looking at the top 50 positions in the organization. Then the CEO updates the board on executive development.[12]

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[10] Securities and Exchange Commission, Division of Corporation Finance, "Staff Legal Bulletin No. 14E," October 27, 2009. Available at http://www.sec.gov/interps/legal/cfslb14e.htm.

[11] Stephen A. Miles and Nathan Bennett, "How the SEC Just Changed Succession Planning: Part I," Forbes, November 17, 2009. Available at http://www.forbes.com/2009/11/17/succession-planning-sec-leadership-ceonetwork-search.html.

[12] NACD, *Role of the Board in CEO Succession,* 21.

Members describe several specific methods board members might use to engage senior executives:

- **Conduct site visits.** To gain more in-depth knowledge of senior leaders, individual board members often conduct site visits. One member said: *"If you watch how the senior executives interact with people in a factory, you can learn about whether they're respected and have natural leadership ability, and you can't get that out of a presentation."* But any plans to visit a site should be made with the full knowledge and support of the CEO: *"Site visits are important, but of course all of this is planned through the CEO's office."* In addition, directors must be aware of the signals they are sending during these visits: *"You have to be very careful; people read signals. If you're going out as a director, you've got to be a really good listener."*
- **Attend management meetings.** Directors can attend management meetings and observe senior leaders interacting with their own teams: *"I go to all the management meetings, so I've gotten to know 20 to 30 people on a first-name basis. You can't do this in a year; it takes time."*
- **Request background on key leaders.** One member described his company's approach: *"Many of our board members are new to the board, so we present them with a one-pager at every board meeting on the company's regional managers, with their photo, their bio, their history within the organization."*

Conclusion

One LDN member underscored the importance of succession planning, describing successful succession planning as *"part of our legacy to the company."* Members are devoting more time during board meetings and executive sessions to succession planning: *"We are spending more time discussing succession in board meetings. What we're doing is rotating certain subjects and dealing with other subjects less frequently."*

A robust succession process helps put a company on track for sustained, long-term success, but members emphasize that no single approach to succession planning works for every company. Instead, the board, lead director, and CEO must work together to tailor the planning process to the company's specific needs. Members continue to refine the CEO succession planning process on an ongoing basis.

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ViewPoints

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The lead director's perspective on corporate governance reforms

Introduction

In the wake of the financial crisis, Congress and the SEC have proposed a number of corporate governance reforms. LDN members are largely in agreement that proxy access changes are the most troubling of the potential reforms. Members also voiced concerns about the aggregate effect the reforms – including proxy access, majority voting, and the elimination of broker discretionary voting – may have on corporate boards. One member observed: *"The cumulative effect of these provisions is what concerns me."*

Over dinner, John Castellani, president of the Business Roundtable, joined the meeting and shared perspectives and research on public attitudes toward business and pending corporate governance reforms. Mr. Castellani has given permission for his comments to be attributed. For further information about *ViewPoints*, see "About this document," on page 6.

Executive summary

The following summarizes four aspects of corporate governance reforms that were discussed at length at the meeting on November 18:

- **Proxy access** *(page 2)*

  Members are deeply concerned about the consequences of proxy access. In particular, they are worried that proxy access could contribute to "short-termism," give undue influence to proxy advisory firms, and trigger unnecessary costs.

- **Say on pay** *(page 3)*

  Members expect Congress eventually will mandate that all publicly traded corporations implement say on pay, and they are concerned about the effectiveness and usefulness of the law.

- **SEC disclosures on leadership** *(page 4)*

  The SEC's proposed leadership disclosures would require companies to explain in proxy statements why they have chosen their type of leadership structure. LDN members would argue that a company's needs at any point in time dictate its leadership structure and would prefer to use concise summaries in the proxy statement.

- **Board responses to corporate governance reforms** *(page 4)*

  Members believe that boards can address proposed reforms by communicating directly with external stakeholders about the consequences and potential detrimental effects of the reforms. In general, though, members would caution boards not to spend a great deal of time or energy on these changes. They would like to see boardroom energy focused instead on corporate strategy, succession planning, and other critical internal processes and issues.

Proxy access

In October 2009, the SEC postponed a vote on its controversial proxy access proposal, Rule 14a-11, ensuring that the rule will not be in effect for the 2010 proxy season.[1] However, LDN members believe the SEC will implement proxy access for the 2011 proxy season. Mr. Castellani confirmed this: "We will get proxy access – in some form – in 2011."[2]

In multiple conversations with Tapestry Networks, senior leaders from the shareholder and analyst community stated that a majority of shareholders will employ proxy access only in extreme circumstances where both performance and governance issues are present.

Despite recent academic research that concluded that one dissident director on a board actually can improve corporate performance,[3] LDN members assert that proxy access could:

- **Disrupt and distract corporate boards.** Members are concerned about the possibility of a contested board election disrupting the corporate board and about the election of an activist nominee to the board. One member stated: *"I am nervous about … the disruption [contested elections] would cause for a number of boards and what kind of directors would transition onto the boards."*
- **Increase the influence of proxy advisory firms.** *"The power of [Institutional Shareholder Services] and proxy advisers is my greatest concern. There is an overlap between proxy access and the growing power of proxy advisers."* In addition, members are frustrated with the approach proxy advisers take. One member explained: *"It's a very rules oriented, non-listening approach."* Another member agreed: *"Even if you have clawbacks and every other long-term-oriented incentive plan, if you have overhangs [of shares that may be issued in employee benefit plans], they'll vote against you. That lack of thoughtfulness is concerning."*
- **Strengthen some shareholders' short-term focus.** *"Many portfolio managers have a one-year perspective. They're not averse to creating issues that maybe result in short-term value. They're measured on the quarter [instead of by the year] … It's not as consistent a long-term shareholder view as you'd think."* This short-term perspective can be detrimental to investors and companies. A September 2009 report released by the Aspen Institute found that a focus on quarterly earnings "can

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[1] See the Appendix for details on the SEC's proxy access proposal and other pending rules and legislation.

[2] In October 2009, the House Financial Services Committee reported favorably on the Consumer Financial Protection Agency Act (HR 3126). The House version of the bill reaffirms the SEC's authority to implement proxy access, while the Senate version requires the SEC to implement proxy access within 180 days of passage. For more on the bills, see Melissa Klein Aguilar, "Congress Goes Full Bore on Governance Legislation," *Compliance Week,* November 17, 2009.

[3] In May 2009, the Investor Responsibility Research Center (IRRC) Institute released a comprehensive analysis of the impact of insurgent shareowners on corporate boards. According to the study, "Among the ongoing businesses evaluated following the creation of hybrid boards [boards formed when activist shareholders elect dissident directors but do not win full control of the boards], total share price performance for the 39 months from the three-month contest period through the three-year anniversary of the hybrid board averaged 21.5%–17.8 percentage points higher than peers." See IRRC Institute, "First-of-a-Kind Study Finds Shareholder Value Increases Under Hybrid Boards" (press release, May 25, 2009), http://www.irrcinstitute.org/pdf/PR_5_25_09.pdf.

harm the interests of the shareholders seeking long-term growth and sustainable earnings … [which] may put a corporation's future at risk."[4]

- **Increase corporate costs.** In May 2009, Target defeated an activist shareholder's attempt to replace four of its directors. The company and the shareholder "spent at least $25 million for high-priced lawyers, bankers, public relations advisers, and proxy solicitors, not to mention valuable time trying to persuade shareholders of their respective positions."[5] Commenting on Target's proxy battle, one member said: *"If you're in a contest [with an activist shareholder], cost is going to become an issue. You also need to be thinking about management time and board time."*

Of the various consequences of proxy access, intended and unintended, the most important to members is the likely increase in the influence of proxy advisers. One member observed: *"ISS's power was really given to it by the institutional shareholders. They're outsourcing this because they don't have the time, and they're letting some small set of people set the rules … And then the hedge funds can use them as they choose to."*

Another member was more sanguine about the influence of proxy advisory firms: *"People in government may say, 'Would you rather have a regulatory regime?' The answer is 'No, we probably don't want to do that' … What is the alternative to ISS?"*

Say on pay

Members agree that say on pay is coming: *"It's a reality for every company now."* Mr. Castellani concurs: "Say on pay will pass – no question." In July 2009, the House of Representatives passed the Corporate and Financial Institution Compensation Fairness Act (HR 3269), which includes a say-on-pay requirement for all public companies. The Senate is expected to approve the bill in 2010.

LDN members see say on pay as a blunt, ineffective instrument for shareholders to express dissatisfaction about a company's compensation plans. LDN members also worry that shareholders might use say on pay as a tool for expressing dissatisfaction with other company issues – stock performance, business strategy, or social responsibility, for example.

Still, one member acknowledged that say on pay was fueled by legitimate public anger about corporate pay practices: *"Corporate pay was out of line. Risk-reward structure was out of line. We have to admit that corporate pay had gotten out of line."* Another member concurred: *"Part of what has come about [in terms of corporate governance reform] is for legitimate reasons, i.e., Enron and the financial crisis. There's more than a populist tone to this. There were excesses and legitimate issues."*

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[4] Aspen Institute, *Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management* (New York, September 9, 2009), 2. Available at http://www.aspeninstitute.org/sites/default/files/content/docs/business%20and%20society%20program/overcome_short_state0909.pdf.

[5] Zachery Kouwe, "Target's Shareholders Strongly Reject Dissident Slate, Ending Divisive Proxy Battle," *New York Times,* May 28, 2009. Available at http://www.nytimes.com/2009/05/29/business/29target.html.

SEC disclosures on leadership

In July 2009, the SEC proposed new rules regarding enhanced disclosure in proxy statements. The SEC would require companies to explain in proxy statements the reasoning behind their choice of leadership structure and their decision to combine or separate the principle executive officer and board chair positions. A company with a combined CEO and chair would have to explain whether and why it has an independent lead director and, if it does, the role he or she plays in the organization's leadership.

Members insist that the ideal leadership structure varies from company to company depending on circumstances: *"On one of my boards, we've had four different leadership structures – two of our CEOs had the chairman title and two of them did not. And each situation worked very well. You cannot legislate what will work for all companies; it depends on the situation."* Members said their explanation of their leadership structure will reflect the company's leadership needs at a specific time.

Although LDN members acknowledge the need for some level of disclosure, they believe it is crucial to maintain flexibility. Members recommended:

- **Providing concise, minimal summaries in the proxy statement.** *"I would go [for] the minimal approach, at least initially, realizing [that] over time you can disclose more and more. I wouldn't volunteer the maximum approach because you open up a Pandora's box."*
- **Maintaining flexibility.** *"Boards need to retain their flexibility. I've been on boards where you really need to separate the CEO and chairman, and I've been on boards where you don't."*

Board responses to corporate governance reforms

Many LDN members have responded to pending corporate governance reforms by increasing board-shareholder communication and identifying and eliminating potential areas of conflict with activist investors, such as poison pills, gross-ups, perquisites, plurality voting, and staggered boards. However, members caution against investing too much time in analyzing possible reforms.

Increasing communication with shareholders

Members highlighted a recent trend of increased communication between directors and shareholders: *"Five years ago, CEOs didn't want directors talking to shareholders. But with the [proposed] provisions and recent changes, CEOs are now much more comfortable with it, as long as it's organized."*

As boards also have become more comfortable with increased shareholder communication, LDN members are addressing corporate governance reforms directly with key stakeholders. One member stated: *"I know proxy access is coming. Two of the boards I'm on have started making deeper contact with the shareholders and talk about more than just the strategy of the company – for example, to address compensation."*

The lead director or the chair of an appropriate board committee is often the point person for external shareholder communication. In addition, members agreed that board members who are also former CEOs are ideal candidates to lead external communication: *"Usually it's former CEOs [who talk to shareholders] because they're more sensitive to what they should and shouldn't say."*

The exact process and the point of contact for shareholder communication vary by company. For instance, one member said, *"We assume proxy access will happen, so we've been going over all the bylaws to ensure that the bylaws don't cause complications if proxy access comes on. We are trying to determine a way for only the 'right' directors to be able to talk to the shareholders and for figuring out who those 'right' directors are."* In addition, members caution against having multiple board members communicating with shareholders: *"You can't have 12 to 13 directors talking to shareholders. We restrict it to committee chairs or the lead director."*

Finally, LDN members recognize the importance of adhering to Regulation FD (fair disclosure) when engaging shareholders. One member said: *"If you bring along a lawyer, you can make sure you're not violating Reg FD."*

Managing boardroom discussion

Shareholder-board communication is critical, but it is only one component of the board's responsibility. Some lead directors are now shifting the board's focus from pending corporate governance reforms toward internal issues: *"I am trying to keep some of this out of the boardroom. Given the business environment and coming out of this recession, time is very important on issues like strategy and succession planning."*

Another member agreed: *"You need to be careful about spending too much time on these corporate governance reforms. Personally, we're not spending too much time understanding the nuances of the reforms. Once the board gets a quick update, we go back to strategy, CEO succession, and other important issues."* One member summarized the group's consensus: *"The biggest issue is trying to get to the issues that really matter."*

A discussion with John Castellani

Mr. Castellani joined members for dinner and offered the following observations:

- **There is a disconnect between the way the general public defines good performance and the way investors and management define good performance.** "The public defines good corporate performance primarily in terms of job creation, good ethics, high-quality products and services, and responsibility in the community … At the end of the list is the company's financial performance and stock price. Those are the views that are driving the regulatory view of performance. Investors and management, of course, would put the last two – financial results and stock price – at the top of their list. That mismatch is what we're seeing right now."

A discussion with John Castellani *(continued)*

- **There is a misconception in Congress about how boards operate.** "Congress thinks [boards] are a constituent-based group. Congress does not understand the responsibility boards have for all shareholders. [Members of Congress] don't understand board operations … They assume how they operate is the way you operate. They think that the board is a body that represents individual constituencies, as in 'by a vote of 8 to 3 the board approved investment in Brazil, but by a vote of 5 to 6, additional capital expenditures were rejected.' Few understand how a corporation actually operates."

- **There is a misconception in Congress about the dynamic between directors and the CEO.** "Congress still views corporate directors as hand-picked and beholden to the CEOs. [Members of Congress] believe [boards] work for the CEO and don't operate independently. I've heard that from members of both parties … But the median tenure for CEO members of the Business Roundtable was 4.2 years last year, so it's obvious boards are replacing CEOs."[6]

Conclusion

The financial crisis and the resulting public outcry and tide of corporate governance reforms have dramatically complicated the work of the lead director and corporate boards. Some potential outcomes of this turbulent period include increased influence of proxy advisory firms, the disruption and distraction of corporate boards, short-term focus by shareholders, and growing corporate costs. Some board members anticipate increased board-shareholder communication in response. All effective directors are approaching this turbulent period with calm and rationality, addressing corporate governance reforms where appropriate, while also maintaining focus on the company's pressing strategic and organizational issues.

About this document

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the issues confronting lead directors. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* is encouraged to share it with those in their own companies and with their colleagues at other companies. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The Lead Director Network ("LDN") is sponsored by King & Spalding and convened by Tapestry Networks. The LDN is a group of lead independent directors, presiding directors, and non-executive chairmen drawn from America's leading corporations who are committed to improving the performance of their companies and to earning the trust of their shareholders through more effective board leadership. The views expressed in this document do not constitute the advice of network members, their companies, King & Spalding, or Tapestry Networks.

[6] In the last five years, all but two LDN members have undergone a CEO transition at one of the companies where they serve as lead director.

Appendix

Legislation

The Financial Regulatory Reform Bill – Sponsored by Senator Christopher Dodd (D-CT)

- Status: Senate Banking, Housing, and Urban Affairs Committee chairman Christopher Dodd is working on a comprehensive bill that would contain most of the key elements of the administration's regulatory reform plan. On November 10, Chairman Dodd introduced the draft legislation, which is intended to "revamp huge swaths of the nation's financial regulatory system, consolidate agencies and create three new federal offices."[7] In late November, Chairman Dodd asked key members of his committee to split off into bipartisan working groups in an effort to make progress on financial reform legislation.[8]
- Summary: This bill would merge the four bank regulatory agencies (the Federal Reserve, the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (OCC)) into a single "superagency." In addition, the bill would reduce the power of the Federal Reserve. The Fed would lose authority over banks, as well as its ability to regulate mortgages and credit cards. The legislation also includes a nonbinding say-on-pay vote and tighter oversight of the derivatives market. Earlier this year, the White House had considered a proposal to consolidate banking regulators, similar to Senator Dodd's recommendations, but opted instead for a less sweeping measure to merge only the OTS and the OCC.

Wall Street Reform and Consumer Protection Act (HR 4173) – Sponsored by Representative Barney Frank (D-MA)

- Status: House Financial Services Committee chairman Barney Frank (D-MA) introduced a comprehensive financial reform bill on December 2. Composed of various reform bills approved independently by the Committee earlier this year, the House plans to approve this comprehensive bill in December.
- Summary: This bill includes five major financial reform bills approved by the committee earlier this year, including measures to establish an independent executive agency to oversee consumer protection for all financial services, allow shareholders a non-binding say on pay vote, regulate derivatives markets, and improve investor protections.

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[7] Silla Brush, "Skeptical centrists greet Senator Dodd's sweeping financial regulatory reforms," *The Hill,* November 11, 2009. Available at http://thehill.com/homenews/senate/67287-skeptical-centrists-greet-dodds-sweeping-reforms.

[8] Victoria McGrane, "Senators to pair up on financial reform," *Politico,* November 24, 2009. Available at http://www.politico.com/news/stories/1109/29872.html.

Consumer Financial Protection Agency Act (CFPA) (HR 3126) – Sponsored by Representative Barney Frank (D-MA)

- Status: The bill was passed by the Committee on Financial Services by a 39–29 vote on October 22. Chairman Frank vowed to push forward aggressively on this bill, and included it in the Wall Street Reform and Consumer Protection Act the House plans to consider in December.
- Summary: This bill establishes an independent executive agency to oversee consumer protection for all financial services. In September 2009, Representative Frank modified the draft legislation, extracting a requirement that companies providing financial products offer a "plain vanilla" option, such as fixed-rate mortgages or no-frills credit cards. In addition, the bill explicitly exempts certain businesses, such as securities, commodities, investment, and general insurance products, from CFPA oversight.

Shareholder Bill of Rights Act (S 1074) – Co-Sponsored by Senators Charles Schumer (D-NY) and Maria Cantwell (D-WA)

- Status: Referred to the Senate Banking, Housing, and Urban Affairs Committee.
- Summary: This bill has three main provisions: an annual advisory vote on executive compensation and golden parachute agreements, proxy access, and new listing standards for stock exchanges. The new listing standards include requirements for chair independence, annual elections, majority voting, and risk committees. Senator Schumer is seeking inclusion of this language in the financial reform legislation being drafted by Senator Dodd.

Corporate and Financial Institution Compensation Fairness Act (HR 3269) – Sponsored by Representative Barney Frank (D-MA)

- Status: Passed in the House by a vote of 237 to 185. Included in the Wall Street Reform and Consumer Protection Act legislation currently pending in the House.
- Summary: The Compensation Fairness Act includes an annual advisory say-on-pay vote and independence requirements for compensation committee members and compensation advisers. In addition, all financial institutions with more than $1 billion in assets would need to disclose to federal regulators the structure of their compensation packages and would be prohibited from providing compensation that encourages "inappropriate risks." The bill also requires that the Government Accountability Office conduct a study analyzing the relationship between executive compensation structure and excessive risk taking.

Shareholder Empowerment Act (HR 2861) – Sponsored by Representative Gary Peters (D-MI)

- Status: Referred to the House Committee on Financial Services.
- Summary: The Shareholder Empowerment Act is similar to the Shareholder Bill of Rights, but proposes some additional restrictions on executive compensation. The Shareholder Empowerment Act requires majority voting, proxy access, and the creation of an independent chairman. The bill also requires independent compensation advisers for the compensation committee, clawbacks for unearned

pay, improved disclosure of compensation targets, and restrictions on severance pay. Like the Schumer bill, this bill also requires that the SEC adopt rules pertaining to an annual say-on-pay vote for all public companies. The bill is unlikely to receive committee consideration given House approval of the Compensation Fairness Act (HR 3269). Chairman Barney Frank has said he is interested in some of its provisions, but would not take any action on the Peters bill until after the House completes action on the broader financial reform legislation.

US Treasury's Investor Protection Act of 2009

- Status: In July 2009, the US Department of the Treasury released draft legislation called the Investor Protection Act of 2009. The bill has not yet been introduced in Congress. However, Representative Frank's Compensation Fairness Act has incorporated most of the language from the Department of the Treasury's proposal.
- Summary: This act would require an annual advisory say-on-pay vote for all public companies and would take steps to ensure that US public companies' compensation committees are independent. The act would significantly enhance the SEC's enforcement powers by establishing consistent standards for those who provide investment advice about securities, enhancing incentives for whistleblowers, and making permanent the SEC's Investor Advisory Committee.

Regulation

SEC rule proposals

- Status: The comment period for the SEC's proposed rules closed on September 15, 2009. SEC officials indicated that they hoped to have final rules on disclosure requirements in place before the 2010 proxy season. The SEC has postponed a vote on the controversial proxy access proposal. It originally hoped to vote on the plan as early as November 9, 2009. SEC chairman Mary Schapiro has said she is committed to holding a vote on these rules by early next year.
- Summary: The SEC's proposed rules would grant shareholders proxy access to nominate up to 25% of a company's directors provided shareholders meet certain minimum ownership thresholds.[9] The SEC also has proposed changes to the proxy rules requiring Troubled Asset Relief Program recipients to provide an annual advisory say-on-pay vote. In addition, the SEC proposed rules that would require better disclosure of executive compensation at public companies, board leadership structure, the qualifications of directors, potential conflicts of interest that could affect compensation consultants, and the alignment of compensation policies with risk taking. Finally, the SEC has approved a New York Stock Exchange measure to eliminate broker discretionary voting for all director elections.

[9] For large accelerated filers with more than $750 million in traded securities, the minimum holding requirement would be 1%. For accelerated filers with $75 to $750 million in traded securities, the minimum holding requirement would be 3%. For non-accelerated filers with less than $75 million in traded securities, the threshold would be 5%.