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Seven Smokin' Hot Buttons

by Laura J. Finn

With economic turmoil in 2009 and many shareholder rights expected to be legislated in 2010, board members have an ever-increasing number of things to think about and plan for. Say-on-pay, majority voting, elimination of staggered boards, shareholder nomination of directors, and the trendiest word of late, risk, are examples of what's on directors' minds. The seven biggest worries right now? Take a look.

Risk—*Managing it, what it is and isn't, and committees that should and shouldn't handle it.*

The word risk has a broad range of meaning, and the term is bandied about in corporate America as much as healthcare is in Middle America. Yet, risk shouldn't be reduced to a buzzword or a single committee, but rather it should be considered as a managed process that is discussed yearlong. "Directors are asking, 'What's my job? How do I get my arms around risk, and what's management doing to mitigate risk?'" Keith Higgins, partner, Ropes & Gray LLP, tells Corporate Board Member. "Directors have to talk to the CEO and get the CEO to put risk analysis on every agenda. All the math whizzes built great risk models and they were not maybe as predictive as people thought."

Moreover, risk management should not be viewed in and of itself. Bernard C. Bailey, chairman, LaserCard Corp., a secure ID provider, and director on the boards of EF Johnson Technologies, Telos Corp., and Spectrum Control, doesn't look at risk management as something you put into a separate box. "It permeates every function within the enterprise—legal, operational, financial, liquidity, marketplace, fraud," he says, emphasizing that the risk conversation has to be expanded to the whole board. "There is tremendous value in integrating the board and getting collective wisdom," he opines, noting that the board has a heightened role in knowing its fiduciary duties and understanding its commitment to risk management oversight. "We have to be careful we're not jumping on another 'trend' called risk management, and that you don't just put a committee together."

Just because boards are spending more time on risk management, shareholders shouldn't expect companies to stop taking risks, or for risk to disappear. Sullivan & Cromwell partner James C. Morphy says he worries that in some cases, risk management might be marginalized by the fact that it's been given its own label. "Like a lot of things, 'risk management' now has a name and has become its own 'topic' instead of something that was simply assumed to be part of the decision making process. But I worry about casually bandying about these types of highly generalized labels," he says, noting that some references to risk management may sound as if

the risk disappears. “Business is built on taking risks and we shouldn’t lose sight of that. You want business plans to be well thought out and the risks weighed, but, at the end of the day, there is risk – no matter how much thought and planning goes into it. It’s inherent in business. People have to use the term and apply with this reality attached to it,” he cautions.

So how should a board examine risk and feel comfortable taking on some level of managed risks? “Understand where the vulnerabilities are. There’s a sense of discomfort among directors when they’ve seen so many companies get into trouble with problems that weren’t even on the radar,” advises Catherine Bromilow, partner, Corporate Governance Group, PricewaterhouseCoopers LLP. “Talking about risk with management is best – you need the whole board to hear [those discussions]; and you need compensation and audit committees to interact around risk.” In board meetings, Julie H. Jones, partner, Ropes & Gray LLP, recommends that directors view themselves as activist directors. “It’s hard to figure out the questions you’re not asking, so ask lots of questions and pull on every thread you can.”

The Long Arm of the Government – “Uncle Sam Wants You” – not to say the s-word

Potential government involvement in the companies of corporate America is a huge concern for boards. Tom Kolder, president, Crist/Kolder Associates, an executive search firm, says he’s heard the “s-word, socialism” thrown around by a lot of boards. The real difficulty, according to Charles M. Elson, The Edgar S. Woolard, Jr. Chair in Corporate Governance, Center for Corporate Governance, Lerner College of Business & Economics, University of Delaware, is the uncertainty issue. “The issue is that no one knows the extent of the federal intrusion into the boardroom and what extent it may or may not take and the effect on management oversight. Regulatory reform proposals overwhelm any other concerns.” The skeptics of federal oversight offer a strong argument. “We can’t legislate ourselves out of a problem that we behaved our way into – and that’s what we did. Ignoring the day-to-day management, other business issues [those are behavioral problems], and legislation won’t fix that,” argues Bailey. Grant Thornton’s Managing Partner of Public Policy and Corporate Governance Trent Gazzaway agrees. “What we missed leading up to the financial crisis was the right people asking the right questions. Without more effective questioning and answering, we’re really just papering over the problem. I don’t argue against the proposals on the table, there are pros and cons, but there is no way to legislate to ask the right questions.”

In addition to legislation that would directly affect board members, there are also other potential changes on the table right now – healthcare, financial reform, labor management, climate change, and energy – that management should be aware of. “There are lots of bills pending. Directors need to ask about legislation and how it will impact their company,” says David A. Cifrino, partner and Co-head of the Public Companies Group, McDermott, Will, and Emery LLP. “The implications of government involvement is a huge concern for many boards,” agrees Bromilow.

Executive Compensation – To restructure or not to restructure?

While some companies already have say-on-pay in place, in all likelihood, there will be a mandate on every public U.S. company to give shareholders a say-on-pay by the 2011 proxy season. Ropes & Gray’s Higgins, who often writes on executive compensation, is vehemently

against. “Boards have got to have a structured dialogue with shareholders, particularly long-term shareholders. I hate say-on-pay; I think it is the bluntest instrument imaginable. It’s not a substitute for dialogue; it is not a very useful way to foster dialogue.” But Irv S. Becker, national practice leader, Executive Compensation Practice, Hay Group, disagrees. “One advantage of say-on-pay is creating a dialogue between management, the compensation committee, and institutional investors.” Another upside is that the say-on-pay is just that, a say, not an absolute. Still, how many companies want a room full of angry shareholders at the annual meeting? However, one disadvantage, according to Becker, is that say-on-pay “could potentially force directors to make decisions in line with what institutional shareholders want but not in line with best interests of the company long-term.”

To prepare for government changes to executive compensation, Kolder says companies are now actively looking for directors who understand compensation to join boards. “We are seeing increasingly that boards are asking us to find senior HR leaders to be valuable contributors in boardroom to lead compensation and benefits committees.”

Economic Uncertainties & Preparing for the Future – “Cash is King”

“I think first and foremost what’s on directors’ minds is the business and what do they need to do to prepare for the future, in terms of growth and profits, while addressing what needs to be done now in order to deal with the down turn,” says Sullivan & Cromwell’s Morphy. While the economy is showing signs of recovery, board members should still be asking themselves, “how do you guide your company in the most challenging business condition?” suggests Ropes & Gray’s Jones. Board member Bernard C. Bailey thinks that during these times, “companies are still looking at really managing the balance sheet and capital structure of companies. How do you manage balance sheet, cash flow, and liquidity of a company? I believe that goes beyond the audit committee because it deals with some of risk assessment.”

During these uncertain economic times, “cash is king,” declares Cifrino, of McDermott, Will, and Emery LLP. “Companies need to be vigilant about liquidity. I find that [public] companies need to be proactive in ensuring liquidity for their companies. Lenders are not in a mood to be generous in terms of lending. Boards should push management to explain what’s the plan now. Develop a strategy to deal with retooling the balance sheet, do what you can to assure liquidity. It’s all about cash generation.”

Shareholder Relations – Getting cozy with the activists

Gone are the days of smiling, nodding, and ultimately ignoring your shareholders. Patrick McGurn, special counsel, RiskMetrics Group, says the coming changes aren’t “the full plate we thought, but there is plenty to deal with. All eyes are on Washington to see legislation on a variety of SEC rule proposals and which ones will be in place for the next proxy season.” To be successful this coming proxy season, companies will need to be clearly communicating with their shareholders leading up to filing their proxies. “Companies that have constructive dialogue with their shareholder bases will be well positioned. Impending annual meetings with people that can vote you down on things that are not your fault [is a worry],” Jones of Ropes and Gray says, noting that the best way to combat no votes is talking with your shareholders ahead of time. Stephen Wallenstein, director, Directors’ Institute, and Senior Fellow,

Department of Finance, Robert H. Smith School of Business, University of Maryland, agrees, warning, "Directors have to listen more to what shareholders are thinking. We've gone from a time when shareholders didn't even vote their shares or voted with management to a time of activism. We have to be careful the pendulum doesn't swing too far in the other direction because shareholders are diverse (hedge funds, institutional investors, and so on)."

Cifrino foresees a stormy proxy season. "The amendments to Rule 452 [which ends broker discretionary voting] combined with activists agitated about compensation and majority voting creates the perfect storm. So wake up and pay attention to who your shareholders are and what they're concerned about." But at the same time, experts say, make sure there is balance. "The boardroom is not a democracy. The board has to make decisions and we need to give them the freedom to do that," says Grant Thornton's Gazzaway.

Focusing on the Role of the Board – *What's my job?*

With shareholders demanding more access to the boardroom, it's important to remember what the board's role truly is and what its duties are. To whom are board members beholden? Bailey doesn't believe that the board is necessarily a representative of the shareholders. "Is it the role of the board to represent shareholders – [and if so,] at whose expense? Lots of shareholders are short-term shareholders. Many don't even know what they are investing in. So the real responsibility of the board is to the company, to create long-term shareholder value." Moreover, creating shareholder value comes from having a strategy in place, another concern for boards. "Boards should be involved in co-creating the strategy," says Michael Kohlsdorf, who sits on the board of Standard Register, a document services provider. He believes that boards should ask themselves some very important questions around strategy. "What business are we in? What business should we be in? Do we own the core?" Bailey agrees. "How do you create real shareholder value in this marketplace? It comes from creating strategy. As stock price has receded, some boards are stepping up and saying, how do we create long term, intrinsic shareholder value?" Now is the time for boards to look hard at their structure, dynamic, and efficiency, and figure out how to implement changes, if need be.

Succession Planning – *Most Important, Often Overlooked*

"Boards always say they don't spend enough time on succession planning," says Stephen Wallenstein, That's true, according to the 2008 What Directors Think study, cosponsored by PricewaterhouseCoopers LLP and Corporate Board Member, which shows that just 53% of directors said they are effective at planning for management's succession. Forty one percent stated they would like to spend more time on succession planning. So why don't they? "If you were to sit down with a board during the course of annual planning exercises and listen, talent and human capital will always be at the top of the list. If you talk to these same people [on a random day], there are half a dozen very critical business items, with human capital taking a back seat to immediate concerns. On a daily basis it is pushed to the back burner but when you take a big picture look it's a top issue," according to Tom Kolder. Despite having critical issues to deal with on a daily basis, boards still must focus on succession planning, meeting internal candidates, and talking about succession regularly, as a process, to make the idea less awkward for the current CEO. "It's imperative to make sure the next generation is going to be as strong or stronger than the current group," Kolder stresses.

What should boards be doing to plan succession? Wallenstein suggests that board members “get to know internal candidates who are potential successors. Be involved in professional development, and make sure there’s a succession plan. He concedes that management often resists that very thing. “It’s hard because there are hard questions to ask. Have a process in place. A process is less threatening [for the CEO].”

While each of these seven hot buttons is time consuming and complex, directors need not panic. Overall, says Gazzaway, “It’s important to note that there is room for improvement in corporate governance but the vast majority of companies are well run. In tough times, boards are doing a good job and making good decisions.” And there is a silver lining in spite of the added concerns. “Speaking quite generally, director jobs, even though they have become more difficult in certain respects, are fundamentally still the same,” Morphy points out. It’s true. Board members are responsible for overseeing management, asking the right questions, and making the best decisions they can make. Doing their fiduciary duty remains the board’s constant role.