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The Power Corporate Directors Now Wield

By John Rehfeld

Ed. Note: This is Part I of a two-part series. Part II will appear in the December issue of Directors Monthly.

Director Summary: The author examines the increasing power and independence of corporate boards by discussing three key tools of corporate governance: the lead director and regular executive sessions; governance/nominating committee empowerment; and compensation committee empowerment.

Corporate Boardroom, 1998

"I'm CEO and chairman, for pity's sake. I run this board. The next time you vote, remember the rule of modern corporate governance."

"What's that?" asked the newest board member.

"You've got to go along to get along," said the CEO and chairman. "I put you on this board, and I decide your compensation, too."

Eight Years Later

"I may be CEO and chairman, but now we have a lead director to help the board focus and function, and even she can't influence the votes around here. Just remember the new rule of modern corporate governance."

"What's that?" asked one of three new directors on the reconstituted board.

"You're here for your independence as much as for your experience and brains," said the CEO and chairman. "Now, how can I help you advance the best interests of this corporation?"

The Six Tools of Corporate Governance

The pendulum has swung away from corporate boards populated by directors beholden to the CEO for their positions and compensation. The changes following Enron, WorldCom and other collapses of oversight have restructured boards to empower and require directors to be effective decision makers. They support and advise their CEOs: they certainly don't report to them.

Only recently have public company boards recognized the potential power of the six most significant tools of corporate governance:

1. The lead director and regular executive sessions
2. Governance/nominating committee empowerment
3. Compensation committee empowerment
4. Audit committee empowerment
5. Regular CEO performance evaluations
6. Regular board performance evaluations

These tools are several years old. Recent regulations from Congress, the SEC, and the listing exchanges, as well as activism from shareholder groups, have substantially strengthened their potential impact. However, the challenge of harnessing these tools to their greatest effect for the benefit of the company and its stakeholders continues. This, article the first of a two-part series, will explore three of these tools: best uses of the lead director; how to most effectively use the governance/nominating committee; and how to strengthen the compensation committee.

Best Uses of the Lead Director

More and more, boards are appointing a lead director. A recent example occurred when Hewlett-Packard's board replaced independent board chair Patricia Dunn with the CEO, Mark Hurd. However, to maintain separation, HP named another independent director, Richard Hackborn, to the new position of lead independent director.

Often, CEOs who also chair their boards are reluctant to relinquish the chairman's coveted title. The author is lead director of two public companies whose boards wished to give a single *independent* director more power and influence over the board's agenda and meeting objectives. In both companies, the CEO did not want to give up the "chairman" title for fear the marketplace and employees would perceive the action as a demotion. Much to their credit, both CEOs embraced the idea of transferring most of the chairman's authority to an independent lead director.

The creation of a lead director position is increasingly found to be a palatable solution.

As lead directors continue to supplement the role of the former executive board chair position, watch for a more independent, more powerful board.

This way an independent, non-executive director works with the CEO and the other board members to set the agenda, establish priorities and manage the allocation of board time. Thus, the CEO has no more influence over the board than does any other director.

Chairing Regular Executive Sessions

This is one of the most useful functions a lead director can perform. Neither the CEO nor any other directors who are also executives of the company attend executive sessions. The lead director sets the agenda for these sessions and keeps the meeting moving. The lead director also sees to it that these executive sessions realize each director's expectations. Run properly, they promote frank discussion among the directors, and when they are conducted as a normal part of board business, any erroneous connotation of crisis is eliminated.

Asking the lead director to chair the executive committee also gives the board a unified voice to communicate to the CEO on the board's behalf. The lead director and CEO should have a constructive and collegial, but independent relationship. That way, the board's communication of any issues or concerns about the CEO comes directly and honestly from someone of respect and influence with the CEO in a non-threatening format. The lead director's private meetings with the CEO should immediately follow every executive session.

Lead Director Responsibilities to the Entire Board

The lead director also creates the agenda for full board meetings, and the best lead directors are expert at focusing the entire board on the right issues, prioritized correctly. The lead director also ensures that each full board meeting meets the CEO's expectations, as well as the expectations of the other board members. He or she identifies and separates decisions that need to be made by the full board from those that should be made by specific committees or the CEO. Avoiding such confusion prevents the board from wasting time dealing with things it need not.

With the agenda comes the lead director's responsibility for seeing that all directors receive (or have access to) the accurate and timely information necessary for informed participation in each board and committee meeting. Certainly, the board, rather than the CEO, should control the information it needs and receives.

Governance/Nominating Committee Empowerment

Cronyism is the practice of favoring one's friends and associates by appointing them to positions because of their loyalty, rather than their qualifications. Under cronyism, the highest director qualification is loyalty to the person who gave the director his or her seat on the board. Today, director loyalty is—or should be—shifted to the company and its shareholders.

The Delaware Chancery Court's decision regarding Disney highlighted the practice of board cronyism when it observed, "Michael Eisner… hand selected directors and stacked his board… with friends and other acquaintances." The practice handcuffed the board in its decision-making. Eisner stretched the outer boundaries of CEO authority—forcing his stacked board to vote his way. He did this by prematurely and publicly announcing his hire of Michael Ovitz complete with a compensation package that included $140 million in severance pay before the board had approved it. Just 14 months later Eisner fired Ovitz, obligating Disney to the same $140 million liability.

An effective governance/nominating committee could have stopped Eisner. A board can use the governance/nominating committee's power to its best purpose by populating it with truly independent directors. Take care that these important members are not throwbacks from a bygone era who were appointed by the CEO/chairman.

The governance/nominating committee should recruit and interview candidates for board positions. The CEO and independent board chair or lead director should be allowed to participate in the interview process as well. However, the final decision must always rest with the full board. The recent trends in corporate governance have given governance/nominating committees more control over the board's composition, decision-making capabilities, and director qualifications than ever before.

The governance/nominating committee also approves the charters of the board's various committees—a role that has also become increasingly important. The best boards draft these charters with care, update them as circumstances require, and always follow them to the letter. The committee charters delineate the what, when, who, and how of each committee's responsibilities. As the courts have proven, the first place attorneys for aggrieved shareholders look for fault is in the board's overall approach to corporate governance and in the committee charters.

Compensation Committee Empowerment

The investor public most vocally criticizes the compensation committee. Its actions are the most visible and easily understood. Besides, the dollar amounts involved in CEO and director compensation make great press.

Gain the investor public's confidence with independence in fact, but also with the *appearance* of an independent compensation committee. The entire compensation committee should be composed of non-executive, independent directors. The governance/nominating committee—not the chairman or the lead director—recommends prospective compensation committee members to the board, and the full board appoints them.

Not to belabor the Mouse, but just one of the problems Disney's compensation committee encountered was the presence of Eisner's personal attorney as the compensation committee chair. He appeared independent because he worked for an independent law firm. However, a material amount of his income was dependent on his personal loyalty to Eisner—he was anything but independent because of his client affiliation. Whether or not Disney's compensation committee acted independently of Eisner, it certainly didn't look like it did. This later became a key point in the derivative shareholder suit against Disney's directors, claiming breach of fiduciary duty.

Give strength to the compensation committee by making it responsible for setting the total compensation (salary and bonus) of the CEO, the CEO's direct reports, and the board. But don't stop there: often deferred compensation, options, and other equity programs; incentive compensation and employee retirement plans are just as lucrative as cash compensation. The compensation committee should administer all compensation for the CEO, his/her direct reports and the directors. And while the compensation committee doesn't always do the performance evaluations, they should always provide recommendations on any resultant compensation adjustments.

Best practices in the compensation arena require that the committee make informed decisions. Make the compensation committee responsible for understanding competitive compensation and trends for all those under its jurisdiction. Obtaining this information usually requires engaging an outside expert. Get one. The same standards of independence apply for the compensation committee's experts as for any other board committee—no prior history of working for the management team and no promise of future assignments from management.

Finally, it's good practice for the compensation committee to produce an annual report on the company's executive compensation. Include the results in the annual proxy statement in compliance with SEC and stock listing authority requirements.

Future Trends to Watch For

As lead directors continue to supplement the role of the former executive board chair position, watch for a more independent, powerful board. As old directors cycle off the board, and the governance/nominating committee recruits new directors to replace them, boards will gain even more power. Over time, this will shift loyalty of the board members to the shareholders and the governance process rather than to individuals. ■

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Directions with Mark Goulston

If something is within your grasp, you're not reaching far enough.

-Leonard Kleinrock, PhD, Chairman, Nomadix, Chairman TTI/Vanguard, inventor of the Internet Technology

Of all the honors he has received as the "real" creator of the Internet, the one that means even more to him is his Eagle Scout award. As a child growing up in Manhattan, Kleinrock loved being a Boy Scout. He worked hard to reach the level of Star Scout and when he made it, his Scoutmaster, Mr. Spinner told him: "Len, if you really work at it, I believe you can become the first Eagle Scout this troop ever had." That seemed out of reach, especially for a city-bound kid living in Manhattan. But Kleinrock set his mind to it, earning more than the necessary 21 merit badges, and in 1951 became his troop's first Eagle Scout.

That challenge directed much of the way Kleinrock has lived. It told him that when you challenge yourself by selecting a goal that seems out of reach, it is possible to achieve it if you work hard enough. And when you discover you can do that early in life, it empowers you to keep stretching yourself into worlds and wonders that you might never think of reaching for. It's all about not giving up if you want something badly enough.

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