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Effective Corporate Governance in Turbulent Times

By Patrick J. Swanick

**The moment is ripe for directors
to engage in more active oversight.**

Whether you serve as a director of a publicly traded company, a pre-IPO firm, or a privately held enterprise, no one will dispute the necessity of good corporate governance. However, defining exactly what that entails gives rise to many answers and opinions. As companies focus on perfecting their governance practices, common sense, practical judgment, and appropriate attention to detail sometimes get left by the wayside.

Prior to the implementation of Sarbanes-Oxley and the increased governmental scrutiny of public companies, a board position was often viewed as an honorary duty or a mere business formality. While directors have always had fiduciary responsibilities and the legal duties of care and loyalty, the time commitment and level of involvement in the firm's activities were certainly far less than current requirements. Today's director has real work to do, with solid accountability, which calls for a more pragmatic mindset in the boardroom.

In response to the volatility and turbulence of the present day, corporate directors are encouraged to approach their responsibilities and examine boardroom dynamics

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in a new light. This article provides a practical commentary on several critically important, yet sometimes overlooked, board issues.

Know Your Shareholders

When investors decide to support a particular company, they usually have well-defined investment objectives. As an independent director, it's essential to know who has taken an ownership position in the firm and what the owners expect to gain from their investment. What were the key factors that attracted the investors to the company? How well-aligned is the company's strategy with the goals of its shareholders? What are the investors' expectations for realizing a financial benefit? For instance, a company planning to execute a multi-year corporate strategy should first ascertain if its shareholders have the patience to wait for the payback.

In companies large and small, public and private, communications with shareholders must transcend basic regulatory requirements and standard disclosures. Unhappy owners can sidetrack even the best of companies by publicly agitating for changes to the board or executive management structure, or by demanding revisions to the corporate strategy. To avoid such distractions, the board and the CEO must understand the motivations and expectations of the shareholder base. Equally important, as the shareholder mix changes over time, the company must remain vigilant and fully understand the goals of its new stakeholders.

An astute investor once told the CEO of the company in which he had invested: "You have my money, so you have my attention." That sentiment should be reciprocated to shareholders by the company's board and executive team. Today's business environment calls for a much tighter linkage between boards, executive management, and the owners they serve. The dialogue between shareholders and their company should be frequent, candid, and properly aligned to insure mutual success.

Ask the Dumb Questions

From our earliest days in school, all of us can recall being told: "There is no such thing as a dumb question." However, as we've embarked upon our professional careers, we sometimes suppress asking legitimate questions out of a fear of appearing stupid. For some reason, we convince ourselves that we must be the only person in the meeting who doesn't fully understand the issue being discussed. As a result, the right questions don't get asked, appropriate deliberations don't take place, and a "herd mentality" facilitates an uninformed corporate decision.

During the past year, the fall of many public company CEOs has been well-documented and widely publicized

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in the press. The failure of boards to fully evaluate and justify their fiduciary decisions is the subject of countless shareholder lawsuits and increasing regulatory scrutiny. In today's unprecedented business climate, there is one common theme among the companies that have been shamed by a fall from grace: Not enough challenging questions were asked by directors, so there was an insufficient understanding of policies and strategies sanctioned by the board.

Directors must make due inquiry to obtain the necessary data to enable informed decisions. For current and former board members and executives of today's troubled firms, a second chance to ask those seemingly dumb questions would be appreciated. Unfortunately for these tragic situations, there are no do-overs.

Challenge Your Executive Management Team

In many boardrooms, the relationship between the company's board and its executives is too close and cozy. The best boards challenge their management teams on various levels of content and competence. These executives work for and report to the board, and the board should unilaterally represent the interests of the shareholders.

Directors should ask: Is the corporate strategy well thought out and can it be defended when probing questions

Director Summary: The last few months have provided many lessons for good governance. The author, a CEO and director, shares practical guidance for directors to earn and maintain the trust of their shareholders, participate in active oversight, and sustain and grow their companies in the marketplace.

are asked? Is there a well-defined scorecard that measures and tracks the elements that drive increased shareholder value? How are business risks identified, quantified, monitored, and mitigated? Do the compensation plans encourage appropriate professional behaviors and foster productive interpersonal relationships among the executives?

Oftentimes, the best advice and counsel can come from a critique of an executive's soft skills. How well does the executive communicate the company's key messages to various audiences? Do C-level officers inspire confidence, trust, and loyalty? Do the executives operate as a cohesive team, or is each individual an independent silo looking out for his or her own self-interests?

Many of today's newer CEOs have not had the benefit of formal management training programs that once were the staple of professional development in corporate America. While an executive may have an abundance of on-the-job experience, proactive tutoring by board members can be invaluable. The board's consistent mentoring, measuring, and challenging of the executive team takes time and courage, but yields significant benefits.

Test Yourself: An Independent Director's Checklist

- What is the thirty-second "elevator pitch" that succinctly describes the company's business, its corporate strategy, and its differentiating factors?
- Who are the company's largest shareholders and what are their investment objectives?
- What industry sector(s) does the company focus on and who are the major clients?
- What are the main drivers of revenue and expense for the company?
- What are the primary threats to the company's sustainable, profitable growth?
- How often do you ask tough and challenging questions?
- How frequently do you ask the "dumb questions" when you really don't fully understand the topic?
- Do you have sufficient information to make informed board-level decisions?
- How well do you know the executive team, including their corporate responsibilities, professional credentials, and individual goals?
- How effectively does your board function as a team?
- What are you doing to promote better cohesiveness among board members?
- Do you spend an adequate amount of time fulfilling your own board responsibilities?
- Given an unpredictable and unprecedented operating environment, what actions are you now taking to enhance your effectiveness as a corporate director?

Dig Beneath the Surface—Especially in Good Times

Among its fiduciary duties, the board has a primary obligation to ensure the sustainability of the enterprise, in good times and bad. In times of prosperity, fewer challenging questions are asked, when that is precisely the time to question the resiliency of the company's success. While no one wants to be the naysayer when good times appear to be rolling along, good corporate governance (and common sense) requires that the contrarian questions be asked. Is the corporate strategy really working, or has the company found a temporary niche that is making the income statement shine?

As a clear example of 20-20 hindsight, take a look at the enormous fallout from the subprime lending practices. When revenues and profits were soaring, no one questioned how large mortgage loans would be repaid by borrowers with inadequate incomes, poor credit histories, and inflated real estate valuations. Under the spotlight of current scrutiny, these business practices are now deemed absurd, yet they routinely occurred at scores of previously well-respected financial institutions.

Today, we ask how common sense evaporated and how this mess could have taken place. The answer is clear: Directors and managers became inebriated with apparent success, but never questioned the underlying factors driving the numbers, let alone the sustainability of these business practices.

Validate Your Internal Controls

When President Ronald Reagan was negotiating the mutual drawdown of nuclear weapons with the former Soviet Union, he articulated his views on internal control and risk assessment with a noted phrase: "Trust, but verify." These three words also define the role of directors concerning the duty of care. While some may interpret Reagan's catchphrase as a lack of confidence in the other party, this tactic is simply an appropriate form of due diligence and a clear assignment of accountability for everyone involved.

The rapid failure of many financial institutions in recent months underscores the importance of effective internal controls and detailed risk assessments. A post-mortem of these corporate implosions will show that the risks within these organizations were known by many, but communicated to few. Executive and board-level decision makers should have known more.

Insist on Risk Assessments for All Board Decisions

Many decisions require board approval and oftentimes items are approved with precious little discussion and no risk assessment whatsoever. If the issue must be handled at the highest level of authority in the corporate chain,

the topic must also receive proper deliberation, elaboration, and review.

Management must clearly define the organization's risk management structure and processes. Risks must first be identified, then aggregated and linked to understand their potential domino effect. While risk management is often functionally assigned to the audit committee, this is a full board responsibility that cannot be completely delegated.

During strategic planning processes, a SWOT (strengths, weaknesses, opportunities, and threats) analysis is often prepared by management and presented to the board. In today's business environment, the content of SWOT presentations should be updated quarterly and featured as a standing item on the board's agenda.

Directors should ask: What has changed since the last SWOT review? Has the company's competitive position improved, declined, or remained the same? Have threats and weaknesses been mitigated or are they growing? Have strengths and opportunities been amplified to gain benefits in the marketplace? What new risks have surfaced since the last analysis?

While the board's role is more strategic than tactical, and directors shouldn't get mired in operational minutiae, an appropriate level of detail is necessary to properly oversee the enterprise. With the recent demise of many well-known companies, directors must take a fresh look at the granularity of information they need to ensure the ongoing viability of the firm.

Allocate Time to Build an Effective Board

All companies share a common goal to assemble a team of highly effective, diverse, and competent directors. However, a first-class board of directors is not created by simply aggregating a group of professionals with impressive CVs. Like any successful team, a stand-out board requires a lot of work. The scarcity of time is perhaps the biggest challenge to effective boards and superior corporate governance. Similar to building a winning team in any sport, there must be enough time spent on the playing field (in board and committee meetings) *and* further time spent together when the game is over (board dinners, informal get-togethers, etc.).

Expecting a board to function effectively simply because a formal meeting schedule has been prescribed for the calendar year is unrealistic and naive. Boards should derive significant strength from the diversity of the directors' backgrounds and credentials, yet those same qualifications can create divisiveness if interpersonal board relationships are not actively managed. Board meeting agendas should foster spirited dialogue and debate, rather than one-way communication through end-

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less management presentations.

The board and committee chairs, as well as the CEO, have the responsibility to promote cooperation, mutual understanding, and appreciation of differing opinions. Informal opportunities should be created for board members to get to know one another better and promote tighter alliances in support of shareholders and the company's overall mission. The creation of ad hoc committees also offers an excellent opportunity for management and fellow board members to work closely together on important strategic topics.

From Today Forward

Corporate directors have significant responsibility and personal liability for their actions. The application of practical judgment, common sense, and a healthy attention to detail will insure that board decisions are made in a fully informed manner. Fostering a culture of mutual respect and open communication between directors, management, and shareholders will provide a cohesive and tightly aligned direction for the company. Establishing an environment of accountability, with well-defined performance scorecards, internal controls, and risk assessments, will prevent crippling surprises that jeopardize the ongoing viability of the firm.

Directors have the responsibility to lead and set the tone by asking tough questions, challenging strategies and tactics, digging deeper into critical issues, and building a solid team. Directors must be appropriately engaged to be highly effective. As today's turbulent business landscape has illustrated, there are no second chances to getting this right! ■

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