

A Board Member's Dilemma

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Many members of Boards of Directors of American companies—particularly outside, independent directors—are experiencing increasing frustration and pressure as they cope with a new set of challenges and expectations in the aftermath of the infamous corporate scandals of the last few years.

The Dilemma

On the one hand, the corporate scandals of recent years and the reaction that has followed from both the general public and lawmakers have imposed **New Expectations** and legal requirements on Boards; and Sarbanes-Oxley has given them both urgency and permanence. The Board role of protecting the interests of shareholders has been more clearly defined, and pressure has increased to invigorate that aspect of a Board's duties. This increasing pressure, though well-intentioned, has come with little constructive advice for the average Board member in terms of exactly what he or she is supposed to do to improve this oversight.

At the same time, there are forces at work creating pressure to minimize confrontation with both management and with other Board members. This further complicates efforts to exert effective oversight. While each situation is different, here are some typical examples of these **complications**:

- **Service Motivations:** People serve on Boards for a host of reasons. In addition to satisfying a genuine desire to protect the interests of shareholders, these can include
 - Compensation, although that is rarely a primary motivator;
 - The prestige of being on a Board;
 - Learning about other companies ; and
 - The opportunity to interact with peers in the industry is generally the most important motivator for most Board members. To be able to step out of an operating role at their own company, where it often is “lonely at the top”, and be able to exchange ideas and experiences with others who are similarly situated, is generally regarded as very beneficial and affirming—even therapeutic. This collegial interaction can be disrupted when board members are required to assume the “adversarial” roles that are often required for proper management oversight.

- **Structural Challenges:** At the structural level of the Board, there are more hurdles. For example:
 - Management often plays a significant role in bringing each individual on to the Board. To that extent, the Board members are conflicted in an oversight capacity, feeling a sense of loyalty to the managers responsible for attracting them to the board in the first place;
 - Most Board membership terms are staggered, which means each new member enters into a situation where the culture is typically established. This will cause the new member to first focus on fitting in, before fully engaging in the oversight process. In turn, this tends to perpetuate whatever culture already exists and can discourage objective reevaluation or doing things perceived as change;
 - The function of the Board and its individual members is rarely fully and clearly defined with respect to oversight. If a member feels a need to seriously question something, it will have to be done on his or her own initiative without the benefit of a process or procedure to engender that evaluation; and
 - In today's world, the prospect of a Board member's personal liability is no longer just a theoretical possibility and must be considered in determining each Board member's actions. While this increased liability risk could provide motivation to raise the hard questions, it can also provide pressure to go along with the group, with individual members taking comfort in numbers.
- **Inherent Limitations of Board Meetings:** Board meetings are not well designed to encourage or even accommodate the independent thought envisioned by the New Expectations. Quality boards are comprised of successful, busy people, so it is no surprise that most board meetings are very efficiently run, to avoid the waste of its members' valuable time. Board meetings simply cannot offer adequate time for the deep and careful thought required by the New Expectations with respect to management oversight. Some opportunities exist in various informal pre-meeting exchanges. But the challenges to real effectiveness in these informal venues are great and, practically, they offer little or no opportunity for the question of one Board member to trigger a constructive thought from another.

In summary, Boards face a fundamental friction between the realities of time and structure and the New Expectations regarding oversight that are now expected of them. The limitations to meeting the New Expectations, discussed above should not be seen to reflect badly on directors. Rather, they are intended to describe aspects of common Board cultures in which many Board

members operate that result in limitations to their response to the New Expectations, causing a growing sense of disquiet in the hearts of many Board members.

How to Respond?

How should an individual Board member facing this inherent friction today respond? Where can he or she turn for guidance? There is no easy solution. During this unsettled time, there is no clear path, and few qualified advisors have stepped up to offer counsel. No wonder Board members can feel uncertain of their roles and responsibilities!

Some steps are common sense administration, like putting together a clear, written definition of the Board's role, with emphasis and definition on the oversight function. This at least offers members a clear set of obligations as they ask the tough questions.

But beyond such basics, one is hard pressed to see much clarity in defining structural or other formal changes that pass the practicality test. In light of the efficiency of the actual meetings described above, it is the opinion of the Chesterfield Group that progress in clarifying board roles and responsibilities to address the New Expectations is most likely to come from (1) informal exchanges among Board members outside the meetings and (2) various exchanges between Board members and Management prior to or after the meetings. Painted with the broadest of brushes, there are at least the following three opportunities for Board members to actively participate in the process, outside of the time spent in the actual meetings:

- Business Model Oversight;
- Setting corporate strategy; and
- Preparation for and discussion of agenda items.

Business Model Oversight: Evaluation of a company's Business Model is one of the most valuable roles a Board can play, but it rarely happens. The outside perspective from different companies and industries offered by a diversified Board provides a tremendous resource to the company, if it can be harnessed to periodically review the underlying Business Model of the company. The whole concept of a Business Model is so abstract and fundamental that it typically receives inadequate focus by boards or management. It is constantly in need of reconsideration. Even if giving away razors to sell razor blades was a proven success yesterday, does it still make sense today? Is there a better way now? Even if a board is willing to take responsibility to review Management's Business Model, is that board well suited to do such an evaluation? For many companies the question is: How can they best harness the collective Business Model experience represented on the Board for the benefit of the company?

Setting Corporate Strategy: Both Management and Board members generally agree that Boards could and should be increasingly involved in setting corporate strategy. As with the Business Model, tremendous experience can be brought to bear from an experienced board. Why is it not happening more? In our experience, the reason generally boils down to time and priorities. A great deal of background work needs to be done to prepare a board member to fully participate in strategy development, and neither management nor board members has typically been willing to invest that time.

Preparation for Meetings: Members of the Board usually receive a formal agenda, with supporting information, in order to prepare for the meeting. They are expected to use this as background to consider the items set out and raise questions they may have directly with management *prior to* the meeting. In that way, the meeting itself can be as efficient, smooth and non-confrontational as possible. In fact, both sides will be embarrassed if a significant issue is raised for the first time at the meeting. As discussed previously, however, Board members are busy, and it is hard to go too deeply into proposals in the limited time provided either before or at the meeting.

Consider the example of an acquisition of another company. The agenda package will include information about the target company, the rationale for acquiring it and the justification for the price to be paid. However, typically little time will be taken to consider the possibility that the same rationale could be served in some way other than an outright acquisition—for example, a joint venture or licensing agreement. The statistical fact that the vast majority of acquisitions fail arguably increases the need for the Board to confirm that all reasonable alternatives to the acquisition have been explored.

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The principals of the CHESTERFIELD GROUP have spent considerable time thinking about ways to help boards deal with these issues. We believe we can add value in each instance, based on our actual experience and independent perspective, in the form of ideas, analysis and providing a buffer with management. An integral part of the CHESTERFIELD GROUP's own business model is to provide independent, third-party advice to Boards of Directors to help them sort through various aspects of this New Expectation dilemma and provide the "additional step" they need to more fully meet the New Expectations.

For more information, please refer to our web site at

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