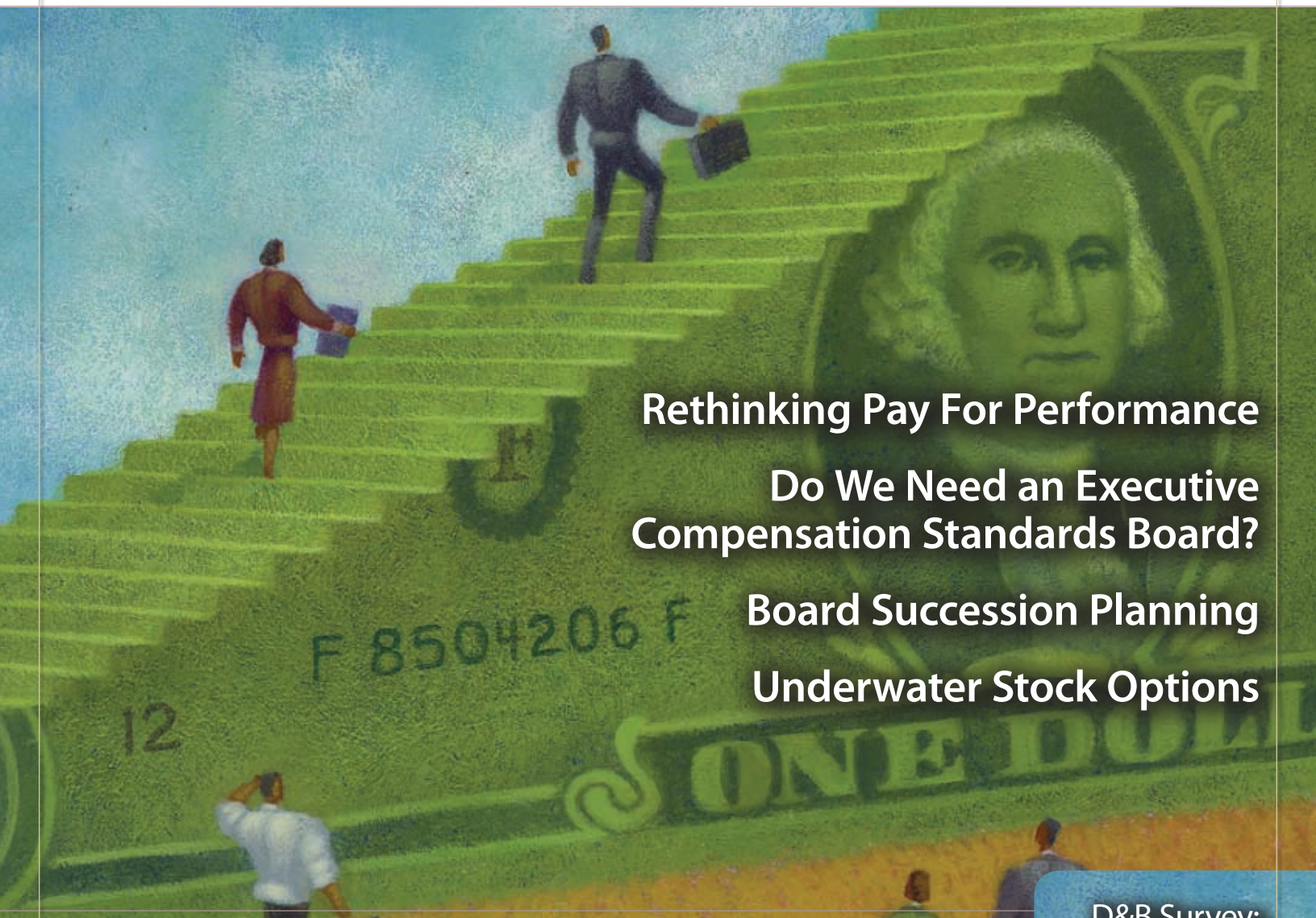


Boardroom Briefing

A publication of Directors & Boards magazine and GRID Media LLC

Executive Compensation and Succession 2009



Rethinking Pay For Performance

**Do We Need an Executive
Compensation Standards Board?**

Board Succession Planning

Underwater Stock Options

With the
support
of



The Delves Group



**D&B Survey:
CEO and
Executive
Compensation**



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No Parsley Permitted

By James Kristie

In compensation and succession oversight, the times require rising to a new level of everyday performance under extraordinary scrutiny.



James Kristie

decorative but useless.”

Why do I resurrect such an appalling statement? Because there are two issues that fundamentally determine how parsley-like board members are—compensation and succession.

For far too long—even during brief bursts of reformation—boards have been criticized for being more decorative than useful in the rigorous crafting and application of pay for performance policies and in having a firm hand in CEO succession planning.

Events of this past year have cast a particularly harsh spotlight on pay abuses. The country had a collective coronary over the bonuses paid at AIG, which seemed to be unjust reward for a company that almost sank the financial system.

If you want to know where the parsley will be meeting the road in the months ahead, look no further than the list of “10 of the Worst CEO Pay Practices” just issued in mid-April by the AFL-CIO’s Executive PayWatch monitoring website (www.paywatch.org):

Irving S. Olds, chairman of U.S. Steel from 1940-1952, once opened a speech by declaring, “Directors are like the parsley on fish—

- Pay for Failure
- Retention Bonuses
- Moving the Performance Goalposts
- Job Security for the CEO; Insecurity for Workers
- Golden Coffin Death Benefits
- Golden Parachute Severance Benefits
- ‘Super-Sized’ Stock Options (for CEOs whose investors have lost billions)
- Turbo-Charged Pension Plan (for CEOs whose workers’ pension plans have been pummeled)
- Lavish Perquisites
- Executive Physicals (yes, the economy may be driving us all into a state of physical and mental wreck, but if the CEO and top execs are receiving an annual physical paid for by the company, the firm better have a strong commitment to health care coverage of its workers).

Let’s call this list a parsley-studded minefield. Now, how to work your way through that? I’m reminded of five key questions that all boards and compensation committees should be asking themselves. They come from a past **Directors & Boards** article co-authored by Robin Ferracone, who collaborated with us on the survey that you’ll see reported on the following pages:

- 1) Are we just giving lip service to pay-for-performance?
- 2) Why are we targeting executive compensation above the market median?

3) Are we getting the most bang for our buck?

4) What “performance” are we really buying with our executive compensation dollars?

5) What does our consultant think? (i.e., since the “selective use of consultants can be manipulated to support the interests of different parties...set firm ground rules for how and when to use this counsel”).

Hard answers to these tough questions should keep you off the target list of the exec comp police.

In terms of succession, perhaps all that needs to be said, by me at least, can be summed up in two words—General Motors. When we see the government come in and take down the CEO, that sure looks suspiciously like more parsley on fish. Certain GM directors I have known in the past bear no resemblance to parsley. But who’s to say that the final verdict on the GM board, and many other boards (Citigroup et al., anyone?) that have not acquitted themselves well in this economic crisis will be—“decorative but useless.”

These are just a few pointers to set the stage for a fuller examination of compensation and succession best practices put forward by our *Boardroom Briefing* authors.

We know our readers do not think of themselves as decorative appendages.

(continued on page 53)

Opening Keynote: Rethinking Pay for Performance

By Debra Perry

What have we learned about pay for performance in the current financial crisis that can help us do a better job in the future?



Debra Perry

Our approach to executive compensation needs significant overhaul. At a time when several major financial institutions and industrial companies are on life support, shareholders have every right to question pay practices that have delivered outsized financial rewards to executives despite poor or *unsustainable* company performance. As the federal government has stepped in to backstop banks, auto manufacturers and our largest insurer, public outrage about executive pay has intensified.

The public acrimony over the AIG retention bonuses marks a new and alarming peak in anti-business sentiment that risks compromising the success of the measures being taken to repair the damage to our financial markets. It may also complicate our efforts to repair the economy. Private sector reliance on taxpayer-funded bailouts has also invited retaliatory legislative action on pay levels and pay policies. However, one-size-fits-all compensation rules crafted on Capital Hill are not likely to provide the right incentives to recruit and retain the skilled managers that we need to fix our companies and our economy. The recent executive compensation rules outlined in the stimulus package will further de-link pay from performance and over time, prompt an exodus of talented professionals from the very institutions

in greatest need of managerial talent. This is not a good outcome for public companies' stakeholders—not the taxpayers who are now sizeable creditors and not the shareholders either.

This disconnect between pay and performance has occurred despite the hard work of many board compensation committees and outside consultants. Both have worked to more effectively align management rewards with shareholder value. But high levels of dissatisfaction with their work in the current environment demands some careful analysis.

What have we learned about pay for performance in the current financial crisis that can help us do a better job in the future? I believe that there are several takeaways for boards and for compensation committees.

Performance goals that govern pay should be set within acceptable risk parameters

I believe that the compensation excesses of failed financial institutions are first and foremost a failure of risk oversight. Setting financial or operating performance objectives in the absence of clear and thoughtful risk parameters may be an invitation to bet the ranch. Companies make money by taking risk; the objective is not to eliminate risk but to take risks in ways that are quantifiable, manageable and in which the company has a competitive advantage. Strong financial performance in the short term may result from good operating

management and risk governance—or alternatively from excessive risk taking. Looking back only three or four years, there are many examples of companies that recorded seemingly robust financial results by taking risks they could not analyze or quantify—and in some cases by taking risks that were not even on management's radar screen. Many of those companies have failed, been forced into mergers, or are operating with taxpayer support.

Compensation design and metrics should be informed by explicit risk parameters that have been reviewed and approved by the board. Risk tolerance should be defined not only in financial terms but also in terms of operational, legal and reputation risks that over time can result in franchise damage and high financial costs.

Incentive compensation should be related to the time frame over which profits (or loss) emerge from the business

The financial crisis has delivered countless examples of managers who were highly compensated for strategic decisions and new business production that later generated enormous losses. Plan design needs to consider the time frame over which management performance can be accurately assessed. This can be a challenging issue.

In many industries, the performance horizon of a book of business or a product life cycle can be very long. In others, the performance horizon may appear to be short but in reality is the life of assets that were generated

for sale to others. A timely example is the mortgage banking business that relies on asset securitization as its primary funding source. The turmoil in the residential mortgage market reflects not only a pervasive failure of risk management but many failures of risk transference. Without a substantially longer perspective on performance horizons, compensation plans encourage maximization of short term compensation opportunities that may result in unsustainable—or worse, ultimately destructive, risk taking.

Very high senior executive pay levels and large pay differentials between CEOs and other officers may not be sustainable without high social costs

The enormous loss in stock market capitalization and home values and rising unemployment have delivered a deep sense of economic insecurity to many Americans, including those deemed to be ‘affluent.’ Social tensions in our society appear to be growing as the deepening recession and subsequent rescue measures affect people in different ways. Pay differentials between senior executives and lower level employees will generate more anger and more public scrutiny in this environment, not less, especially when public funds are required to keep many companies operating. Boards ought to reassess absolute levels of compensation and pay differentials in their companies and in American business as a whole. What is at stake is more than bad ‘optics’ around compensation payouts but more fundamentally, preserving a sense of fairness that is essential to democratic society.

Talent management and succession planning are as critical to ensuring strong and stable leadership as compensation strategy

The events of the past two years have provided distressing examples of



Boards ought to reassess absolute levels of compensation and pay differentials in their companies and in American business as a whole.

boards of major companies searching on the outside for CEOs and other c-suite executives in moments of crisis. The lack of well-developed internal succession plans results in paying top dollar for outside leadership with the risk that a newly hired outsider can get his/her arms around a complex and deteriorating situation in time to make a difference. There are few senior managers equipped to lead a company out of crisis, especially when they are unfamiliar with its people and operations. Boards need to focus on talent management and succession planning for key senior roles and should do so with a clear view of the company’s strategy and risk parameters.

It is time for boards to think deeply about compensation and leadership. We need a fundamental re-assessment of what pay for performance means—one that explicitly relates performance objectives to risk guidelines; that bases pay on meaningful performance horizons; and that addresses relative pay differentials and absolute compensation levels in a broader social context. Succession planning and talent management should be given

equal consideration to compensation plan design. Ultimately, our success in restoring trust and confidence in business and in preserving boards’ flexibility to reward operational excellence and entrepreneurial innovation will depend on getting pay for performance right.

Debra Perry is a corporate director who serves on the boards of Korn/Ferry International, a premier global provider of talent management solutions, and Conseco Inc., a life and health insurance company focused on the senior and middle markets. At Conseco, she chairs the board’s Human Resources & Compensation Committee and also serves on the Governance & Strategy Committee. She is a member of the Korn/Ferry International Audit Committee. In addition, Ms. Perry is a member of the advisory board of Bridge Associates LLC, a turnaround and crisis management firm. Since becoming a corporate director, Ms. Perry has been a frequent speaker on Audit Committee oversight and on crisis management on boards. She is a member of the National Association of Corporate Directors, the International Corporate Governance Network, The Economic Club of New York and Women Corporate Directors. Ms. Perry holds a BA (Phi Beta Kappa) from the University of Wisconsin-Madison and a graduate degree from Yale University where she completed all course work for a PhD in European history.

Underwater Stock Options: Timeless Issue for Tough Times

By Doug Friske and Paula Todd

The continuing stock market meltdown poses a difficult question that many companies confront in economic downturns: what to do about “underwater” stock options.



Doug Friske

Many of the issues companies face with regard to underwater options are timeless. On one hand, boards may feel they must take action to:



Paula Todd

- Restore the options’ ability to provide a meaningful performance and retention incentive to holders who view out-of-

the-money options quite negatively

- Promote fairness between holders of underwater options and new hires who receive at-the-money options with far lower exercise prices
- Limit the negative effect of underwater options when companies have low levels of share reserves available under shareholder-approved plans.

At the same time, companies understand that shareholders tend to view repricings of underwater options (in their various forms) as unfair to investors who suffer real losses. That perception isn’t new and isn’t likely to change.

Recent Towers Perrin research has found a growing number of companies wrestling with underwater options in the

As a general rule, option holders should not be enriched in an economic sense by a repricing transaction.

current environment, although relatively few have fully addressed the issue thus far. In our January 2009 survey of more than 500 U.S. companies, most reported that their shares have declined by more than 30% in recent months, while 28% reported share price declines of more than 50%. Just over a quarter of the companies surveyed either had already taken action to address their underwater options or were actively considering it at the time of our survey. If the market downturn is prolonged, we would expect to see more companies address the issue.

Unfortunately, there’s no answer to the question of whether or not to do something about underwater options that will work for every company. However, there are some guiding principles that can help companies reach the best decision for each unique situation.

For more than a decade, we have followed these guiding principles for evaluating how to address underwater options:

Decisions to reprice should be made with a very long-term perspective.

Repricings should not be used to “bail out” underwater options resulting from what is likely to be a temporary market decline. Repricings should not be viewed as a routine event.

Those most directly responsible for the stock price decline should not be

held harmless. Repricings and related actions are more appropriate for lower-level managers and other employees than for senior managers and directors who have the most direct obligation to shareholders.

There should be a “quid pro quo” connected with receiving repriced options, requiring recipients to give up something in return. As a general rule, option holders should not be enriched in an economic sense by a repricing transaction. Generally, this can be accomplished by replacing options on less than a share-for-share basis so that the Black-Scholes (or other) value of the replacement grant is equivalent. In many instances, the company may justifiably give less than equal value for the canceled options. For example, unvested options may be converted on less than a dollar-for-dollar basis.

A solution shouldn’t simply correct past problems. Unfortunately, it often takes a poorly performing stock price to identify structural flaws in a program, which should be corrected to steer clear of future problems.

Factors to Consider

In applying these principles, there are a number of specific issues companies should consider in deciding whether and how to deal with underwater options:

- The number of options that are underwater (and by how much), as well as the underlying expiration date(s) of the underwater options
- Reasons why the options are underwater
- Historical precedents (including any that a current repricing might set for the future)
- The extent of any accounting consequences
- The extent to which shareholders in particular are likely to react negatively to news of a repricing or a similar action and whether any commitments have been made not to reprice
- How employees who don't hold options may react, particularly if they have shares under ESOP, stock purchase or 401(k) plans
- What the company can do to prevent windfalls if the stock price rebounds to its former level soon after the repricing
- The risk of turnover among key executives or groups of employees
- Any 8-K and proxy disclosure requirements.

Beyond these issues, where new options are to replace existing underwater options, there are some design issues that must be considered:

- *Term*: Would the new options expire on the same date as the options they replace or would a new 10-year (or other) term be started?
- *Vesting*: Would the replacement options follow the original vesting schedule or would a new vesting schedule begin?
- *Replacement level*: What would be the relationship between the Black-Scholes

or other value of options given up and the value of replacement options?

Decisions on these and similar issues will affect whether proxy advisors will recommend a favorable vote for the repricing. These questions have to be answered with an understanding of exactly which option holders would be eligible for relief and the extent to which their overall compensation packages are changed.

Clearly, evaluating situations involving large numbers of underwater options and considering whether to reprice requires companies to weigh a variety of complex factors. The issues may play out in different ways depending on the approach, or strategy, that the organization is considering.

For example, a straightforward “do nothing” strategy may be appropriate if there is a long term remaining on the options in question and the stock price is expected to recover over time. Or, if the share reserve allows, a company might opt to leave its underwater options alone, but grant some additional at-the-money options or accelerate the next grant (either across the board or selectively) to promote retention and provide an ongoing incentive. At the other end of the spectrum, a repricing that cancels existing underwater options and replaces them with an equivalent value of at-the-money options, restricted stock or even cash may be appropriate for certain employees if the stock price is not expected to rebound, the company wants to minimize the amount of any additional accounting expense and a limited number of shares are available to make additional grants.

The Big Picture

It's also important for companies to address any fundamental flaws in their stock option programs that are likely to give rise to future incentive

and retention problems resulting from underwater options. A number of fundamental questions should be considered in this regard:

- Is the degree of risk inherent in stock options appropriate for all of the individuals currently eligible?
- Are other forms of compensation or a lessened role for stock options more appropriate, at least for some participants?
- Are there better ways to structure your stock option program? For example, would more frequent grants of fewer shares each time facilitate some dollar-cost averaging in exercise prices? Are there more appropriate vesting schedules and option terms that could be put in place?

With today's intense scrutiny of compensation decisions, it's critical for decisions about underwater options to carefully balance the unique perspectives of employees (including those who participate in the plan), shareholders who must approve the repricing and directors who may face difficult questions about the decision to reprice. In light of the volatility of today's markets, companies need a comprehensive approach to stock options, and to rewards in general, that prepares the organization for times of turbulence.

Douglas J. Friske is a managing principal in Towers Perrin's Chicago office and a leader of the firm's global Executive Compensation and Rewards practice. He advises clients on developing executive compensation programs that align management and owner interests, including incentive plan design, employment contracts, executive benefits and compensation for outside directors. Paula H. Todd is a managing principal in Towers Perrin's Stamford, CT, office and serves as a firmwide technical resource on issues including corporate governance, proxy disclosure, the design of stock-based incentives and executive employment arrangements. The authors can be contacted at doug.friske@towersperrin.com and paula.todd@towersperrin.com

The Case for an Executive Compensation Standards Board

By Donald P. Delves and Pastora San Juan Cafferty

If private industry does not act quickly to self regulate executive pay and set high standards, the government will try to do so, and as history has shown, it will not do it well.



Donald P. Delves

Contrary to popular perceptions, boards of American companies have made great strides in ensuring their independence from the CEO and management. Nominating, audit and compensation committees are composed solely of independent outside directors who are selected



Pastora San Juan Cafferty

by other independent outside directors. A significant and growing number of public companies have lead directors or non-executive chairmen who are also independent from management. The age of boards as old friends of the CEO is clearly over. This is a fundamental transformation in the nature of corporate governance.

Independent boards, in turn, have made positive strides in creating and overseeing executive compensation plans that pay for performance and reward the achievement of strategic goals. Several studies have shown a reasonably strong and increasing correlation between total executive pay and both financial and stock performance. Companies have moved away from a heavy use of stock options to plans that are much more reflective of long-term financial

performance. Perquisites, severance, and change-in-control benefits are gradually being pared down. These are marked improvements from past pay practices.

Despite these improvements, the public increasingly questions the independence of boards and the fairness of executive compensation. Regardless of the causes, there is a widely-held perception that CEOs and other executives of publicly traded corporations are overpaid, over-perked and over-protected: the general public is, at minimum, offended and suspicious. The result is an increasing distrust of public companies, cynicism about the American economy, and a rising call for regulation of executive pay.

Legitimate questions have been raised about the role executive incentives have played in creating the current economic crisis. Incentive plans that encouraged excessive risk taking and that provided tremendous upside rewards for success with limited downside penalties are likely culprits as are severance and parachute plans that protect executives from their own failure. Boards and their consultants did not effectively assess the risk they encouraged executives to take. In too many cases, compensation systems failed to align the interests of management with the long-term interests of investors, and—by extension—with the long term interests of the American economy. Some companies encouraged and rewarded excessive and inappropriate risk-taking and are now suffering the untoward consequences. An angry public is calling for punitive legislation to regulate executive pay.

The Treasury Department and Congress have already issued comprehensive rules governing executive compensation for the hundreds of banks accepting Federal assistance. Our new President has strongly criticized certain executive pay practices. This should serve as a wake up call for boards, executives and compensation professionals. If private industry does not act quickly to self regulate executive pay and set high standards, the government will try to do so, and as history has shown, it will not do it well.

Unintended Consequences

Given the populist tsunami sweeping the country, we can all look forward to more legislative action in spite of the fact that executive pay legislation does not work and has created the unintended consequences of increasing compensation. Golden parachute limits in the 1980s actually led to substantial increases in parachute payments. The government's upside limit was quickly adopted as the new floor for parachute payments and gross-ups were added to cover the cost of the additional golden parachute excise tax.

The million dollar pay cap in the 1990s, with its exception for stock options, engendered the biggest explosion in executive compensation ever. Option grants more than quadrupled in the years following the legislation. Trying to limit executive compensation with legislation is like trying to stop a raging river by throwing big rocks into the stream. The water will always find a way to flow around them. Better to

harness that power to positive ends with compensation plans that motivate executives to do the right things.

Executive compensation is a primary tool in shaping corporate behavior. Only those who understand the strategic goals, operations, and culture of the enterprise can design compensation that will create the proper incentives to meet short and long range goals without creating excessive risk. This should be the job of independent corporate directors representing the interests of shareholders.

Unfortunately, an increasing number of angry stakeholders and lawmakers believe that many corporate directors have failed in doing this all-important job. The answer is not to take away the responsibility of those in the board room, but to develop standards of excellence to which they can aspire and be held accountable: standards based on broad but meaningful principles that can be individually applied by independent directors.

Executive compensation is most effective when instituted and monitored by independent directors who best understand the goals and strategy of the enterprise as well as the core principles and assumptions on which compensation is based.

Reasonable and Independent

Such principles should be clear in their meaning, broad in their application and open-ended in their interpretation. Such principles are already practiced by many of the best companies. The exercise of reasonable judgment by independent directors mindful of principles of fairness and equity in creating executive pay packages have resulted in pay for performance systems that align the interest of executives with the long-term interest of shareholders and other stakeholders.

Management is held accountable for the performance of the company, rewarded for sustained superior value creation, and is not paid in spite of failure.

Hasty interventions and piecemeal legislation cannot address the complex and systemic set of issues which are different for each company. They will make matters much worse. Legislation and regulation intended to curb executive pay has succeeded primarily in generating more fees for lawyers and consultants. There have been a few exceptions, such as the accounting rule requiring an expense for stock options. Stock option accounting caused boards to assess the cost of options relative to other forms of long-term incentive pay, leading to far more effective incentives, tied much more closely to long-term corporate performance.

This accounting rule was implemented by the Financial Accounting Standards Board (FASB), an independent body sanctioned by the government and staffed by experts selected from industry, academia and the accounting profession. The improvements in board independence have also had a positive effect on executive pay. These improvements were a direct result of the Sarbanes Oxley legislation. The SEC's expanded compensation disclosure rules also seem to have had an impact in establishing clearer ties between pay and performance and causing some companies to reduce perquisites, severance and change-in-control benefits.

The creation of the Financial Accounting Standards Board (FASB) was the result of the accounting profession realizing in the 1960s that it lacked adequate principles and standards. Arthur Andersen Chairman Leonard Spacek led his profession in arguing for a centralized body to establish principles in accounting. As a result, The Financial Accounting Standards Board (FASB) was formed

to establish and define the accounting field's Generally Accepted Accounting Principles (GAAP). While the FASB and GAAP have not prevented notorious violations of established principles, they have successfully established accounting rules by which we can consistently judge the quality of a company's financial statements and take action when such rules are violated.

Unfortunately, there are no commonly agreed upon principles and standards defining what constitutes highly effective and fair executive compensation. Corporate boards have no consistent basis for evaluating the effectiveness of their compensation programs, nor are there standards of compensation excellence to which boards and management can aspire.

The Executive Compensation Standards Board

This argues for the formation of an Executive Compensation Standards Board—somewhat like the Financial Accounting Standards Board (FASB)—but with far greater flexibility and variation in accepted practice. This Board would be an independent body of corporate board members, executives, and experts from industry, academia, the investment community and the compensation consulting profession.

This Board would be charged with developing Generally Accepted Executive Compensation Principles and defining processes for assessing and evaluating the quality, integrity and effectiveness of a company's executive compensation programs. Unlike executive pay limitations and strictures established by shareholder groups, the Executive Compensation Standards Board would focus on promoting the highest levels of effectiveness and excellence in compensation. Awards and special ratings would be given to companies that achieve the highest

standards of pay-for-performance effectiveness, accountability, transparency, and fairness.

Such a body would be composed of knowledgeable individuals with experience and expertise in corporate governance, executive compensation, value-creation, purpose of corporations, human motivation and decision-making, and risk assessment and management. The body would conduct research, define principles, develop standards and best practices and design processes

for assessing the effectiveness and quality of compensation programs. The principles, standards and best practices would be used by directors and their independent advisors to evaluate compensation programs and provide guidance and direction to management. The ideal result would be compensation practices that create wealth for all stakeholders and contribute to a robust American economy.

Pastora San Juan Cafferty is professor emerita University of Chicago and has been serving on Fortune

200 boards since 1976. She currently serves on the board of directors of Waste Management, Inc., Integrys Energy Group and Harris Financial. She formerly served on the board of directors of Kimberly-Clark Corporation and Peoples Energy Corporation. She has served both as chair and as a member of the compensation committees of various companies for over 30 years. Donald Delves is the President of The Delves Group, an independent compensation consulting firm to boards of directors. He has advised over 100 board compensation committees over 23 years and attends 50-60 compensation committee meetings per year. He has published two books and many articles on how to improve executive compensation.

Executive Compensation Standards Board

Proposed Principles And Possible Definitions

The Oxford English Dictionary defines a principle as, “a comprehensive and fundamental law, doctrine or assumption; a rule or code of conduct; the laws or facts of nature underlying the working of an artificial device.”

As such, principles should be clear in their meaning, broad in their application, and open-ended in their interpretation. Presented below is an initial list of proposed principles for executive compensation and some possible definitions. Ideally, each principle should constitute an area of discussion, debate, research and development of best practices.

1. Alignment—Executive compensation starts with the purpose and mission of the organization and a clear articulation of whom the organization serves. Well-designed compensation programs align executive self interest with stakeholder interests and corporate purpose and mission.

2. Pay for Performance—This is the broadest and perhaps most important principle in executive compensation and includes several major areas, including:

- Systems of performance measures.

- Philosophy of value creation.
- Mix of financial, non-financial and stock performance.
- Basis for goal-setting: plan or budget; peer performance; consistent standards, etc.
- Amount of pay at risk.
- Degree of variability in at-risk pay.

3. Line of Sight—Incentives should be based on performance measures and goals over which the executive has a significant degree of influence. This argues against over reliance on stock performance as a primary indicator of success and source of compensation for all executives.

4. Accountability/ Responsibility—Senior executives are always accountable for the performance of the whole company, no matter what happens. There are no after-the-fact exceptions for “events beyond the control of management.”

5. Risk Assessment—Incentives are generally intended to induce people to take more risk than they otherwise would. So, the level of risk in the compensation plans should be carefully assessed relative to the level of desired risk the board wants managers to take.

6. Fairness/Equity—Companies should have standards for internal relationships between pay at different levels in the organization.

7. Ownership—Stock-based compensation should emphasize long term ownership, long term sustainable performance and long term value creation.

8. Reasonableness—A standard of reasonableness and common sense is applied to all elements of compensation, benefits, perquisites and severance policies. Avoid over-reliance on compensation survey data and blindly following common practice.

9. Symmetry—Compensation should move up and down with performance, in equal measure. (This is not meant to be literal. Bonuses, for example should not be negative if performance falls below a threshold. However, over-reliance on stock options and bonuses with accelerating upsides can cause excessive risk taking and short term decision making.)

10. Reverse Prioritization—In good times, executives have a greater upside than lower level employees. In bad times, executives have a bigger downside and take the biggest reductions in pay.

11. Flexibility/Adaptability
Boards should be able to make adjustments to performance goals, measures, formulas and payments as business conditions and strategies change. However, other principles should not be sacrificed in the process.

The Directors & Boards Survey: CEO and Executive Compensation 2009

By Robin Ferracone and Todd Gershkowitz

Co-sponsored and analyzed by Farient Advisors LLC



The 2009 **Directors & Boards** 2009 CEO and Executive Compensation Issues and Governance Survey, co-sponsored by Farient Advisors LLC and **Directors & Boards** Magazine, reveals that corporate directors, executives and shareholders believe that excessive executive compensation is a significant issue. However, not surprisingly, most of the survey respondents do not feel as though more government intervention is the answer. Instead, most view “self-help,” particularly in the areas of assessing the effect of the compensation system on risk-taking behavior, improving performance measurement, and strengthening the link between performance and pay as the right path forward.

The degree of change that the survey’s respondents are advocating with respect to executive compensation has begun to translate into changes to programs and practices, but so far, these actions have not matched the



Robin Ferracone



Todd Gershkowitz

Methodology and Demographics

This **Directors & Boards/Farient Advisors LLC** survey was conducted in March 2009 via the web, with an email invitation to participate. The invitation was emailed to the recipients of **Directors & Boards’** monthly e-Briefing. A total of 337 usable surveys were completed.

About the respondents

(Multiple responses allowed)

A director of a publicly held company	34.1%
A director of a privately held company	42.5%
A director of a non-profit entity	37.7%
A senior level executive (CEO, CFO, CxO) of a publicly held company	9.9%
A senior level executive (CEO, CFO, CxO) of a privately held company	23.7%
Shareholder	40.4%
Advisor (auditor, consultant, attorney or other board advisor)	33.5%
Academic	7.8%
Other	6.3%

Board service

(Average number of boards respondents serve)

Public	1.16
Private	1.49
Charitable	1.59

Compensation involvement

(Respondent’s role in determining or approving executive compensation)

Compensation Committee chair	13.7%
Compensation Committee member	24.6%
Board member, but not on the Compensation Committee	26.3%
CEO	9.8%
CFO	1.4%
Chief HR Officer	1.8%
Other senior executive	5.3%
Not involved in executive compensation decision-making	17.2%

Revenues

(For the primary company of the respondent)

Average revenues	\$2.2 billion
Less than \$1 billion	69.0%
\$1 billion to \$10 billion	20.7%
More than \$10 billion	10.3%

Total CEO compensation

(in \$US, including salary, bonuses, long-term compensation, benefits and perquisites, for fiscal year 2008)

Average	\$1.945 million
Less than \$250,000	20.5%
\$251,000 to \$500,000	23.5%
\$501,000 to \$999,000	13.0%
\$1 million to \$2.5 million	17.0%
\$2.6 million to \$5 million	10.5%
More than \$5 million	15.5%

level of rhetoric on the subject. Seventy-two percent of the organizations responding are not completely satisfied with the advice they are receiving from compensation consultants, which may account for some of the gap between intentions and actions.

Boards of Directors, Compensation Committees and management all are working to reconcile their current executive compensation programs with the views of their shareholders. In doing so, they often turn to outside advisors for strategic advice and data on external trends. Among survey respondents, the top selection criterion in choosing a compensation consultant is their objectivity.

For the purposes of this analysis, we've filtered out respondents who are not directly involved in executive compensation decision-making in public, private and non-profit organizations, most of which (69%) are members of a corporate board of directors. Of these remaining 289 respondents to the survey, nearly a third (29%) represent organizations with \$1 billion or more in annual revenues—referred to as “large organizations”—and just over two-thirds (71%) represent those with less than \$1 billion in annual revenues—referred to as “small/mid-sized organizations”. We have analyzed the difference in responses between large organizations and small/mid-sized organizations. (The full demographics of survey respondents and selected responses from the entire survey base can be found in the box on page 43.)

Survey Respondents by Annual Revenues and Role

Annual Revenues	%	% that are Members of a Board of Directors
More than \$1 billion	29%	80%
Less than \$1 billion	71%	64%
Total	100%	69%

Executive compensation is considered to be a serious issue, but the issue is “theirs,” not “ours”

With executive compensation in the news virtually every day and at the center of an ongoing public policy debate, more than half of the survey respondents (55%) agree that executive compensation is a significant issue. Approximately a third of the respondents (38%) think that executive compensation is an issue, but only in isolated cases. Only a small minority (7%) of respondents feel that executive compensation is an issue of little significance, fueled by the current financial crisis.

Significance of Executive Compensation as an Issue

(% of Respondents)	More than \$1 billion annual revenues	Less than \$1 billion annual revenues	Total
Significant issue	61%	53%	55%
Not a significant issue broadly, but in isolated cases	34%	40%	38%
Not a significant issue	5%	8%	7%

Notwithstanding their agreement that executive compensation is a legitimate business issue, approximately three-quarters (76%) of respondents indicate that the CEO pay levels in their organizations are “about right.” In particular, large organizations feel as though they would need to pay about the same to recruit a new CEO, while small/mid-sized organizations feel that they would be just as likely to have to pay more. Larger organizations showed more restraint than smaller organizations in 2008, perhaps driven by their larger total CEO pay levels. Larger organizations were more likely than smaller organizations to pay less in 2008 than 2007, and were more likely to withhold bonuses.

Respondent Organizations' CEO Pay Practices and Decisions

(% of Respondents)	More than \$1 billion annual revenues	Less than \$1 billion annual revenues	Total
Current CEO pay is about right	81%	73%	76%
Would need to pay significantly more to recruit a new CEO	31%	45%	33%
Would need to pay about the same to recruit a new CEO	58%	45%	49%
2008 CEO pay greater than 2007	37%	51%	46%
2008 CEO pay less than 2007	41%	20%	26%
Withheld CEO's 2008 bonus	46%	35%	39%

Increased government intervention is not the answer

Most of the survey's respondents feel as though government intervention is not the answer to address the issue of runaway executive pay. Moreover, they feel that, at best, government should establish more rules for those organizations receiving government assistance. Only 17% of large organizations and 30% of small/mid-sized organizations were in favor of establishing

more regulations, indicating that respondents from large organizations are more inclined to allow the free markets to determine how organizations should handle executive compensation, compared to their smaller counterparts.

Views on the Introduction of More Rules and Regulations Concerning Executive Compensation

(% of Respondents)	More than \$1 billion annual revenues	Less than \$1 billion annual revenues	Total
Establish more rules for all organizations	17%	30%	26%
Establish more rules, but only for organizations receiving government assistance	41%	40%	40%
Don't establish more rules	41%	30%	34%

Organizations should focus on increasing accountability for long-term performance

Notwithstanding the sentiment among most respondents that pay levels at their own organizations are about right, most respondents also agree that they can take concrete steps to improve the design and functioning of their existing pay programs and arrest runaway compensation

before it happens. These approaches emphasize increasing executives' accountability for the long-term implications of their decisions.

The top three approaches identified as "likely to be effective" include: eliminate pay-for-failure programs (e.g., rich severance packages, guaranteed bonuses and perquisites); demonstrate the potential impact of pay programs on risk-taking behavior (e.g., ensuring performance measures and goals are risk-adjusted, modeling the impact of different financial scenarios on incentive payouts); and limit the use of pay vehicles that promote excessive risk taking (e.g., stock options, highly leveraged incentive plans with limited or no downside exposure). Respondents also cite strengthening of shareholder oversight (e.g., better disclosures, voluntary adoption of a non-binding shareholder vote on executive pay) as a relatively effective way to address excessive executive compensation, although more small/mid-sized organizations (71%) are proponents of this mechanism compared to larger organizations (42%).

While most respondents feel that stock options should continue to play a role in the executive pay package, they also feel as though the design of stock option programs can be improved to better align stock option

Highest Rated Approaches for Addressing Excessive Executive Compensation

(% of Respondents Rating Approach as Effective)	More than \$1 billion annual revenues		Less than \$1 billion annual revenues		Total
	% Effective	Priority Ranking	% Effective	Priority Ranking	
Eliminate pay-for-failure programs	83%	1	85%	1	85%
Demonstrate the potential impact of pay programs on risk-taking behavior	70%	2	71%	2	70%
Introduce claw-backs to recapture compensation paid if future corporate performance problems can be linked to past executive decisions	70%	2	60%	Not in Top 3	63%
Strengthen shareholder oversight of executive pay	42%	Not in Top 3	71%	2	62%
Limit the use of pay vehicles that may promote excessive risk taking	63%	3	67%	3	66%

Highest Rated Approaches for Improving Stock Options as an Executive Compensation Program

(% of Respondents Rating Approach as Effective)	More than \$1 billion annual revenues		Less than \$1 billion annual revenues		Total
	% Effective	Priority Ranking	% Effective	Priority Ranking	
Vest stock options based on achieving stock price hurdles or other performance criteria	70%	1	77%	1	75%
Hold option gains in escrow subject to additional performance thresholds	66%	2	79%	2	72%
Limit stock option awards as a percent of total compensation	36%	3	50%	3	46%
Discontinue using stock options as a long-term incentive vehicle	16%		31%		26%

gains with long-term shareholder value creation. Stock option design changes supported by the majority of the respondents are to:

- add performance-based vesting provisions such as stock price hurdles,
- and hold option gains in escrow until additional performance thresholds are met.

Only 16% of respondents from large organizations and 31% from small/mid-sized organizations advocate eliminating stock options entirely as a compensation vehicle across all organizations.

Organizations need to improve the alignment between performance and pay

Decision-makers agree that they face vexing issues when it comes to establishing executive compensation programs and setting pay levels. Top challenges center on the performance measurement system and its link to pay. These challenges are consistent with respondents' views on what organizations in general should do to address excessive executive compensation. In particular, the top priority of both large and small/mid-sized organizations is to determine whether the right performance measures are in place. The second and third priorities are to: set relevant goals; and strengthen the relationship between pay and performance. Overall, 69% of survey respondents advocate taking specific steps to improve the degree of alignment between performance and pay.

Top 3 Highest Priority Compensation Challenges

	More than \$1 billion annual revenues		Less than \$1 billion annual revenues		Total
	% of Respondents	Priority Ranking	% of Respondents	Priority Ranking	
Determine whether the right performance measures are in place	31%	1	27%	1	29%
Set goals that are relevant to participants, as well as sensitive to shareholders	23%	2	15%	3	18%
Strengthen the relationship between pay and performance	14%	3	26%	2	22%
Total of Top 3 Highest Priority Challenges	69%		69%		69%

About a quarter of organizations are trying to maintain their overall approach to compensation strategy. **However, when changes are warranted, they are focusing on the performance measurement system and the use of long-term incentive vehicles.**

Top 3 Approaches Organizations are Implementing to Address Executive Compensation Issues

	More than \$1 billion annual revenues		Less than \$1 billion annual revenues	
	% of Respondents	Priority Ranking	% of Respondents	Priority Ranking
Change performance metrics	49%	1	36%	2
Change long-term incentive vehicles	43%	2	24%	Not in Top 3
Stay the course	40%	3	39%	1
Change compensation strategy	24%	Not in Top 3	27%	3

Compensation consultants play a key role

In terms of advice and counsel regarding the design and management of executive compensation programs, almost all (94%) large organizations and 40% of small/mid-sized organizations retain executive compensation consultants. Approximately half (54%) of large organizations and a third (32%) of small/mid-sized organizations retain separate consultants for the Compensation Committee and management. Large companies expect a high degree of engagement with their consultants.

Use of and Engagement with Compensation Consultants

(% of Respondents)	More than \$1 billion annual revenues	Less than \$1 billion annual revenues	Total
Formally engage a compensation consultant	94%	40%	57%
Retain separate consultants for the Board and management	54%	32%	43%
Expect high degree of engagement with consultant	67%	22%	45%

A third (33%) of large organizations and a quarter (23%) of small/mid-sized organizations are completely satisfied with their compensation advisors. There is room for improvement in that only just over half of the respondents (55%) are somewhat satisfied and 17% are not entirely satisfied with their compensation advisors.

Satisfaction with Current Compensation Consultant

(% of Respondents)	More than \$1 billion annual revenues	Less than \$1 billion annual revenues	Total
Completely satisfied	33%	23%	28%
Somewhat satisfied	58%	52%	55%
Not entirely satisfied	9%	25%	17%

However, relationships between organizations and their consulting advisors are slow to change in that approximately two thirds (66%) of all organizations have used the same compensation advisor for three or more years.

Tenure with Current Compensation Consultant

(% of Respondents)	More than \$1 billion annual revenues	Less than \$1 billion annual revenues	Total
More than 5 years	27%	30%	28%
3 to 5 years	39%	36%	38%
1 to 3 years	25%	24%	25%
Less than one year	9%	10%	9%

Regardless of their size, Compensation Committees rely heavily upon compensation consultants for data to inform the executive compensation design and decision-making processes. However, the Compensation Committees of large organizations are more inclined to use consultants as strategic advisors, partners and sounding boards than the Compensation Committees of small/mid-sized organizations. This may be a function of the cost of engaging a highly strategic advisor.

Role of Compensation Consultant (Highest Ranked)

(% of Respondents Rating Approach as Effective)	More than \$1 billion annual revenues		Less than \$1 billion annual revenues		Total
	% of Respondents	Priority Ranking	% of Respondents	Priority Ranking	
Data provider to Compensation Committee	81%	1	81%	1	81%
Strategic advisor and partner to Compensation Committee	63%	2	48%	2	56%
Sounding board, opportunistic advisor to Compensation Committee	61%	3	46%	3	54%

Conclusion

The results of this survey demonstrate that organizations are aware of the issues underlying the public debate and furor over excessive executive compensation and that Boards of Directors, Compensation Committees and management have identified a number of solutions (e.g., increasing accountability for long-term performance, improving the degree of alignment between pay and performance) that should be self-imposed, rather than government-mandated. It is incumbent on compensation consultants to help facilitate this process by offering objective, strategically-based guidance on how to best design and implement new approaches to executive compensation that increase executives' accountability for the long-term implications of their decisions and strengthen the relationship between executive performance and pay.

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New Deferred Compensation Statutes: Will It Ever End?

By Peter A. Furci, Jonathan F. Lewis, David H. Schnabel and Charles E. Wachsstock

Private equity fund sponsors need to watch out for Section 457A, a new rule in the Internal Revenue Code



Peter A. Furci

Hidden in the October 2008

bail-out bill was a new draconian rule that applies to traditional deferred compensation arrangements of partnerships and foreign corporations, and some performance and management fee arrangements of private equity and hedge funds. Deferred compensation that is subject to the new rule, §457A of the

Internal Revenue Code, must be included in income when the compensation is no longer subject to a so-called “substantial



Jonathan F. Lewis

risk of forfeiture” (meaning that the tax deferral will not be respected and the service provider may have phantom income). However, if the amount of the deferred compensation cannot be determined at that time because of future variable factors (such as the amount of future profits), the amount will continue to be deferred until the amount is determinable, at which time the service provider will include the

amount in income *and* be subject to a 20% penalty tax, plus interest.

Private equity fund sponsors should already be in the process of determining whether this new rule applies to them or any of their portfolio companies and, if it does, should be formulating their compliance strategies.

Who, Me?

Section 457A applies to deferred compensation arrangements of “non-qualified entities.” The first step in a private equity fund sponsor’s inquiry will be to determine whether there are any “non-qualified entities” in its universe. The term is potentially very broad: unless expressly excluded, a “non-qualified entity” includes any partnership, whether foreign or domestic, and any foreign corporation.

Unlike the other deferred compensation statute, §409A, both cash basis taxpayers and accrual basis taxpayers are covered by the statute. Under current IRS guidance, whether an entity is a non-qualified entity is determined on the last day of each year that vested deferred compensation is outstanding, and thus it is possible that an entity’s status could change over time. Helpfully, the IRS has limited non-qualified entity status to the “sponsor” or “sponsors” of the deferred compensation arrangement, which generally means the employer(s) for U.S. federal tax principles (i.e., those entities that would be eligible to deduct the compensation if it were paid rather than deferred in the relevant taxable year.).

In general, a partnership will be a non-qualified entity unless “substantially all” (which the IRS has indicated means at least 80%) of its income is allocated to partners that are subject to tax on that income. Taxable partners generally do not include (1) tax-exempt organizations and (2) foreign partners whose income is not subject to a “comprehensive foreign income tax.” For this purpose, a foreign partner will be subject to a comprehensive foreign income tax with respect to an item of income if the item, whether or not distributed to the partner, is subject to tax on a current basis in its home country and the partner is both eligible for the benefits of a tax treaty with the United States (other than Bermuda and Netherlands Antilles) and generally subject to tax under the applicable foreign tax regime with respect to that income.

A foreign corporation will generally be a non-qualified entity if its income is not effectively connected with a U.S. trade or business (also applying an 80% test) or is not subject to a comprehensive foreign income tax (determined in accordance with the rule above). Special rules may apply if the applicable foreign law excludes from tax a significant portion of the foreign corporation’s nonresident source income.

Private equity fund sponsors have for many years invested in portfolio companies organized in partnership form, including operating partnerships and limited liability companies. These entities will be “non-qualified

entities” unless substantially all of their income is allocable to taxable partners, which may not be the case where the partnership or LLC is owned by a fund with a substantial number of tax-exempt or “offshore” limited partners, or where a “blocker” company in place is in a tax haven jurisdiction. Similarly, foreign company portfolio investments may be “non-qualified entities.” The deferred compensation arrangements of these portfolio investments are subject to §457A.

In addition, many private equity funds will themselves be non-qualified entities if, for example, they have a substantial number of tax-exempt or “offshore” limited partners. The management and performance fee arrangements of such funds may be subject to §457A. However, in its recent guidance, the IRS has taken the position that, as under §409A, a partnership profits interest issued by a non-qualified entity is not subject to §457A.

What Arrangements Are at Risk?

Once the non-qualified entities are identified—be they portfolio investments, the fund manager, or the fund itself—the next task will be to identify whether they have any problematic deferred compensation arrangements. Under the statute and recent IRS guidance, the term “deferred compensation” is very broadly defined for this purpose to include any “legally binding right”—that is, any promise—to a service provider to receive compensation that is payable to the employee in a later year for services performed in an earlier year. Many private equity fund sponsors are familiar with the types of deferred compensation arrangements that are subject to §409A. Well, think of §457A as §409A on steroids—while the same types of deferred compensation arrangements are subject to §457A,

§457A also affects certain equity-based awards and performance-based compensation that are exempt from §409A’s reach.

The good news is that, under recent IRS guidance, §457A does not apply to (1) partnership profits interests (thus most private equity carried interests should not be subject to §457A) and (2) fair value stock options and stock-settled stock appreciation rights that are not covered under §409A. However, apart from these exceptions, §457A is broad enough to include,

- at the private equity fund and manager level, phantom carry arrangements and deferred management fee arrangements, including so-called “side pocket” fee arrangements, and
- at the portfolio company level, cash-settled stock appreciation rights and other performance-based compensation, severance agreements and other items of compensation not traditionally understood as deferred compensation.

What Are the “Outs”?

The main exception from §457A is compensation that is paid shortly after it ceases to be subject to a “substantial risk of forfeiture” (that is, it becomes vested). However, the only vesting restriction that works for this purpose is the performance of substantial services; vesting based on the achievement of performance conditions will *not* be a sufficient vesting condition to rely on this exception. Under this exception, payments made within 12 months after the end of the service recipient’s year during which vesting occurs are not treated as deferred compensation for purposes of §457A.

When Do the New Rules Apply?

Section 457A applies to deferred amounts which are attributable to

services performed after December 31, 2008. Deferred amounts which are attributable to services performed before January 1, 2009, will not be subject to §457A, *provided* that such amounts are included in income no later than (1) 2017 or (2) the taxable year in which the amount is no longer subject to a substantial risk of forfeiture. For this purpose, compensation is generally attributable to the period in which the related services are performed, except that, if the compensation is subject to a substantial risk of forfeiture, it is attributable ratably to the years in the vesting period. However, for plans that straddle 2008 and 2009, the recent IRS guidance allows employers to vest the unvested portion of the plan and thereby obtain the pre-2009 treatment described above for the entire plan; this transition relief expires on July 1, 2009. Note that §457A is not intended to replace the other draconian deferred compensation statute, §409A, and generally arrangements will need to be evaluated for compliance under both statutes.

What Should You Do Now?

The new rules and related IRS guidance leave many questions unanswered. The IRS is expected to provide more fulsome guidance on §457A and has asked for taxpayer feedback on a number of interpretive questions. If you are potentially subject to §457A, we encourage you to immediately take stock of your compensation arrangements and perhaps the structure of the relevant partnership or foreign corporation to consider any changes that may be warranted or desired to comply with the new rules.

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Board Succession Planning: Maintaining Board Strength

By George Davis

Most boards work harder than ever on identifying a successor for the CEO but rarely engage in a sustained, focused effort to plan succession for themselves.



George Davis

With the demand for skilled, independent directors higher than ever and supply shrinking, boards will increasingly

need to engage in the kind of farseeing approach to board succession that they have long applied to CEO succession.

On the demand side, shareholders increasingly want directors who take a more active role in oversight and provide strategic wisdom. They want directors who will address a growing board agenda that includes thorny issues like executive compensation and challenging imperatives like sustainability. And the longer the current recession lasts, the more they are likely to want directors who know how to navigate tough economic conditions and perhaps have experience with restructuring and turnarounds.

But while demand for such skilled directors is rising, the supply is being depressed by numerous pressures, including:

Economic uncertainty: Outside CEOs and other qualified individuals may feel compelled to concentrate exclusively on their own companies—and their boards may expect no less of them. Further, they may shy away from serving on boards of troubled or even potentially troubled companies and exposing themselves to being seen

as partly responsible should a company seriously falter.

Regulatory scrutiny: Ironically, Sarbanes-Oxley and the myriad other new rules, regulations, and codes of behavior that have increased the demand for demonstrably independent outside directors have also made many able board candidates unwilling to serve, driven away by the heightened sense of personal risk and accountability. With such scrutiny likely to increase, many outside director candidates who might once have been willing to serve will be even less inclined to do so in the future.

Sensitive issues: Unwelcome and sometimes unsavory corporate news appears with dismaying regularity: the back dating of stock options, the subprime disaster, outsize bonuses at failing companies. In the face of such news, many qualified board candidates, turned off by the idea that they might find themselves having to address such issues, elect not to take the chance.

Expanding responsibilities: The days of board service as an undemanding quarterly two-day interlude are long gone. Many board members, especially heads of key committees, now devote hundreds of hours annually to their duties. Committees undertake direct, detailed work. And the list of issues that directors must grasp grows longer—from new expectations in corporate governance to corporate social responsibility to new technology. As a result, many potential directors

conclude that they simply don't have the time to do the job properly.

These pressures make it more difficult than ever to find qualified director candidates who are willing to serve. As a result, finding the right candidate can take as long as a year or more, partly because it's necessary to look farther afield. Instead of restricting the search to the pool of proven, experienced candidates, boards must now consider less obvious candidates who can bring valuable skills and insights to the board's work. Assessing these less obvious alternatives takes time.

Additional factors further complicate the challenge of finding and attracting qualified board members. For example, boards today are expected to be more balanced in terms of race, gender, and national origin—not only because it's the right thing to do, but also because experience has shown that diversity in the board room ensures a much richer range of potentially valuable insight. The need for national diversity is particularly acute. Our firm's recent Global Board Index, a study of the composition of the boards of the S&P 500, found that while international revenues accounted for, on average, 31.6% of those companies' total revenues, only 6.6% of their board members are foreign nationals. With companies increasingly vying for such candidates, the demand rises but the supply remains constant. Boards must also be balanced in terms of the competencies required to address the board's many quite specific responsibilities across a range of committees. When a vacancy occurs,

opening gaps in specific duties, it must be filled with a degree of precision that can be accomplished only through careful advance planning.

As a result of such complicating factors and in the face of shrinking supply and increasing demand, boards could find themselves scrambling to fill vacancies and diluting their strength with members not precisely fitted to the company's current and future needs. But through careful board succession planning, boards can make sure that they remain strong, balanced, and ready to meet their lengthening list of responsibilities.

Getting Started

Just as with CEO succession planning, board succession planning should be a structured, proactive process, not an *ad hoc* event every time a vacancy looms. The nominating committee is the natural home for the process, but the full board should also take part. As with CEO succession planning, the process should begin three years before a likely vacancy. However, unlike CEO succession planning, which focuses on only one succession, the board process should encompass succession for several board seats at once.

After establishing committee and board accountability for institutionalizing the process, the board should assess its current competencies and areas of expertise, including strategic, operational, and functional expertise. Boards that employ annual self-appraisals can use them to help expedite this analysis. With an understanding of current board capabilities in hand, the board should then consider what capabilities will be required in two or three years as the company's strategy and the business environment evolves. What will be required to maintain the right blend of experience, expertise, skill sets,

When a board vacancy occurs, opening gaps in specific duties, it must be filled with a degree of precision that can be accomplished only through careful advance planning.



and diversity? How will anticipated vacancies, upcoming committee assignments, and committee chair nominations affect those needs? As these questions suggest, the analysis is necessarily multi-dimensional and complex, which is yet another compelling reason to institutionalize the process. At the end of the analysis, it is then possible to create profiles of the directors the board must identify and secure to meet future responsibilities.

Smart boards will go one step farther. Once they have established profiles for the needs they foresee, they will widen their focus to include requirements that go beyond those anticipated. They will then develop profiles of potential candidates that can meet those requirements should the unexpected happen. Further, the board can establish contact with these potential appointees. Then if the unexpected does occur, the board already has relationships with those candidates, allowing the board to adapt quickly to new circumstances.

A farseeing succession process also addresses the question of a potential appointee's fit with the board. As all board members know from personal experience, the effectiveness of a board in part depends on group dynamics, the degree of collegiality, and the

quality of personal interactions among members. A few formal meetings with candidates are inadequate for assessing candidates along this subtle—and critical—dimension. Advance planning, however, enables directors to get to know candidates better before committing to an appointment.

In an environment of constrained supply and increased demand for qualified directors, boards that have already reached consensus about their needs, identified potential candidates well in advance of the need, and begun to establish relationships with them will be far better positioned in the increasing competition for qualified board members. But there is another far less obvious but equally beneficial advantage. As boards go through succession planning, they become far more conscious of their collective capabilities, responsibilities, strengths, and what they require for success. In the process, they not only ensure that they will have the right colleagues in the future but they make themselves better boards in the present.

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Closing Keynote: Where Were the Boards?

By C. William Pollock

Directors were busy serving their Board to the best of their abilities—but did they get the help they needed?



C. William Pollock

In a recent article in *The Wall Street Journal* entitled “Where Were the Boards?” Bill George concludes that in response to the recent

round of financial failures by the likes of Lehman, AIG, Bear Stearns, Countrywide Financial, Wachovia, Washington Mutual, Fannie Mae and Freddie Mac, “the solution is not to diminish the responsibilities of directors, but rather to hold them accountable to fulfill their fiduciary duties and to enforce negative consequences when they fail to do so.”

Clearly, something went wrong—collectively, shareholder financial losses of the aforementioned companies are staggering. And, unfortunately, that is only a part of the total loss suffered as a result of the recent financial crisis. While I think Mr. George raises an interesting question in his article and I agree that Boards must be accountable, I suggest there is a real systemic flaw in corporate governance in this country that will continue to plague our public corporations and economy until appropriately addressed.

Directors are not being given the resources to do their jobs. And they have to worry about being subject to personal liability if something goes wrong. There have been at least 14 cases in the last 25 years where

directors had to write personal check—including the most recent one, Just for Feet, where directors wrote personal checks totaling \$41million. To make matters worse, most directors have to share their D&O insurance with the company and that coverage can be exhausted in the event of a securities lawsuit (why shouldn’t directors have their own coverage!).

Why would anyone with personal assets be willing to serve on a board today? This country desperately needs talented people to serve on its boards. The board has a huge job—it is supposed to set the strategy for the company and oversee management in the implementation of the strategy—not an easy job! Following the Enron and WorldCom meltdowns, new legislation, new SEC and NYSE regulations, and other regulations were enacted which in part are requiring boards to have more independence. Independence of directors is critical for improving corporate governance. But, in order to be independent, directors need greater resources to perform their jobs. They should ask for and demand the help—they are entitled to it. Otherwise, how can they possibly obtain the information they need on an “early warning basis.”

Will directors be held accountable for the recent round of financial failures? If so, how will they be held accountable? Legally, directors have three duties—the duty of loyalty, the duty of care and the duty of good faith. Simply stated, directors are required to act with loyalty and due care and the

honest belief that they are acting in the best interest of the corporation.

The Duty of Good Faith

A relatively new concept, the duty of good faith is emerging in the law as a new standard of conduct. Traditionally, the duty of good faith was more closely associated with the duty of loyalty. But, the duty of good faith is arguably becoming an additional duty along with the duty of loyalty and duty of care. The concepts of loyalty, care and good faith form the cornerstone of the business judgment rule, the presumption that business decisions made independently with due care and in good faith will not be overturned or even second guessed by the courts.

So, what about this duty of good faith. Ira Millstein, Senior Associate Dean for Corporate Governance and the Eugene F. Williams Jr. Visiting Professor in Competitive Enterprise and Strategy at the Yale School of Management and Paul MacAvoy, Williams Brothers Professor of Management Studies Yale University, in their book entitled “The Recurrent Crisis in Corporate Governance” (2003) predicted that directors would face an increase in litigation and that lawsuits would go beyond traditional claims based on concepts of loyalty and self-dealing. They opined that the new litigation would be based on failures by directors to embrace certain reform practices and/or the failure to ensure adequate access to information. I believe Millstein and MacAvoy were right—and unless directors take the recent

meltdowns seriously and pursue better corporate governance practices and get help, they will be subject to increased litigation and potentially personal liability.

It's hard not to agree with Bill George that directors should be held accountable in order for our corporate governance system to work properly.

The Right Equipment

However, we should equip directors with the tools to do their jobs and to protect themselves. What we are doing to directors is the equivalent of sending our military to battle without adequate weapons or training. The enemy will make sure they are held accountable. Unless we equip them to do battle, they are certain to be defeated.

Then, what do we need to do to equip our directors?

First, we should anticipate the trouble before the regulators and the plaintiffs get there; the plaintiff's bar's strategy will probably include:

- Further development of the lack of good faith argument
- Monitoring of corporate governance practices

Second, we should provide more and better information to directors, including access to outside experts and/or staff when needed (recommended by Millstein and MacAvoy in their book.)

Third, directors need better legal protection, including improved indemnification and improved D&O insurance coverage. Boards need to step up and embrace better corporate governance such as adherence to NACD's ten Key Agreed Principles to strengthen corporate governance for US publicly traded companies (recently published by the NACD and Business Roundtable.)

The Courts Will Decide

Ultimately, the courts will decide whether outside directors will be held accountable and if directors don't take measures to self regulate, we may see new legislation or new regulations or both regulating directors. Our system of governance is flawed— independent outside directors do not typically operate in such a way to adequately defend what the plaintiffs bar is bound to pursue—the duty of oversight based on a new lack of good faith requirement which includes the obligation by directors to know or be informed and follow new corporate governance practices. I think directors are in for a rough period as the various interested parties in the financial chaos sort out their losses and decide who to go after. It will be interesting to see what happens.

It's time for directors to check out their indemnification provisions and their D&O insurance and commit to a new level of corporate governance. They should do everything possible to educate themselves about the business, risks and financials of the

companies they are serving and use outside advisers wherever possible and certainly to a much greater extent than they are being used today. If they are intelligent about their protection (all aspects of it), they will survive the likely efforts of the plaintiffs bar to hold them accountable.

The challenges facing directors are monumental—they have tremendous volumes of material to review and little time to do it. Financial engineering, managed earnings and sophisticated and complex financial statements are putting greater pressure on directors and their duty of care. Directors need to get help. They should retain advisers who have expertise in the business of the company to help the board and give these advisers access to management. They should embrace new corporate governance ideas and policies and communicate them to the shareholders. It is time for directors to obtain help to satisfy their legal requirements regarding the duty of care, good faith, and adequate oversight. Until they do, their legal position will remain very precarious. This country cannot afford to have the best talent refusing to serve on our corporate boards. If we do not fix the system by adequately equipping and protecting our directors, it is only a matter of time before we experience another financial meltdown. This is one battle our country and its directors cannot afford to lose.

C. William Pollock is Chairman and Founder of National Insurance Partners, Inc.

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But we know that the times require rising to a new level of everyday performance under extraordinary scrutiny. As a board member serving on a compensation committee recently said to a *New York Times* reporter,

“We're all revisiting our practices and saying, ‘It's a new day, there are new practices, we are vulnerable, and is there anything we need to change?’ ”

Let this *Boardroom Briefing* help you better assess your vulnerability and

your current practices for any needed changes. And, remember, no parsley allowed.

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