

# Boardroom Briefing

A publication of Directors & Boards magazine and GRID Media LLC

## The Consultants Issue 2009



**A New Board Risk  
on the Horizon**

**What's in Store  
for Boards in 2010**

**Build a Board *Fast***

**Risk and Risk  
Management**



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## Boardroom Briefing

Vol. 6, No. 4

A publication of  
 Directors & Boards magazine  
 and GRID Media LLC

David Shaw  
 GRID Media LLC  
 Editor & Publisher

Scott Chase  
 GRID Media LLC  
 Advertising & Marketing Director

### Directors & Boards

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 Reprints/List Rentals

Robert H. Rock  
 President

### Art Direction

Lise Holliker Dykes  
 LHDesign

### Directors & Boards

1845 Walnut Street, Suite 900  
 Philadelphia, PA 19103  
 (215) 567-3200  
[www.directorsandboards.com](http://www.directorsandboards.com)

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# ROI—Return on Insight

By James Kristie

How about this as a metric of value delivered? It's one that CEOs and boards should evaluate when they call upon consultants for advice on 'what we should do now.'



James Kristie

**F**ittingly enough, I was introduced to the concept of ROI by a consultant. No, not return on investment. *Return on insight.*

Full credit goes to Anand Vengurlekar, managing director of Stoic A/S, a marketing and brand strategy consultancy ([www.stoic.dk](http://www.stoic.dk)), who shared this concept in October 2009 at the board meeting of the Wharton School's SEI Center for Advanced Studies in Management. I'm sure I was not the only one who was hearing for the first time this new usage of ROI as a metric of value delivered to the client by a consultant.

Indisputably, clients look to their consultants to deliver the kinds of "what we should do now" recommendations that yield a big return. Consultants, for their part, look to deliver to the client a perspective on the business and action steps that only an outsider is in position to provide. Nothing new there. But framing the result of the client-consultant engagement as a return on insight is, conceptually, an enlightened approach.

This return on insight metric is one that has lots of legs. It certainly applies to what we do here with **Directors & Boards** and the *Boardroom Briefings*. Each reading of the journal and the

*Boardroom Briefing* reports should yield insights for which there are impressive returns.

For example, I'm thinking back to one of the very first consultants I published in **Directors & Boards**, a fellow by the name of Peter Drucker. Already renowned in 1981 when he sat down with Warren Bennis for a Q&A for this journal, Drucker offered up the following comment when Prof. Bennis asked him to look ahead to the biggest management changes coming down the pike:

"Managements will realize that boards of directors can become effective and, therefore, had better be treated properly. They should be built to perform. Most managements still have the idea that the board is something the law forces you to have and they try to keep it in a cage like a nice pussycat. But it can become a tiger, and then you had better make sure it's your tiger."

That was vintage Drucker: a vanguard thinker and consultant teeing up a brilliant insight. Imagine the return on that insight by a **Directors & Boards** CEO reader who took that comment as a call to action—to rethink the role of his company's board and his relationship to his directors, and then to "build" a board that would add value to the company.

Let's jump ahead 10 years, to 1991, for another insight from the pages of this journal. It came from top IR consultant Michael Seely:

"Shareholders come first, other capital contributors thereafter, and other constituencies in the order that they contribute to the long-term profitability of the business. Public companies aren't in business to reward creditors, inspire the devotion of their employees, win the favor of the communities in which they operate, or have the best plants or products. These are all means to an end—making shareholders richer. Putting wealth creation first doesn't eliminate these concerns; it simply orders values in a way that eases corporate conduct."

Imagine the enormous return from that insight if it served to reorient management and the board's thinking on fiduciary duty, right on the eve of a decade of historic shareholder activism.

I am tempted to jump ahead another 10 years, and then again to this year, and pull out a passage from our pages that any CEO or board director could have banked for a big ROI. But, point made. That's why all of us—from editors to chief executives, managers, board members and, yes, to peer advisers—turn to consultants for guidance on the way forward.

And as much as we look to consultants for such guidance, let's not overlook the role that each of us plays in generating ROI. In fact, in the corporate governance realm, we should especially look to the board to generate a big ROI. Why not expect that bringing a group of

*(continued on page 47)*

# Opening Keynote: A New Board Risk on the Horizon

By Betsy Atkins

## “Green” issues have grown regulatory teeth—is your board ready?



Betsy Atkins

**A**s a frontline corporate director, I’ve seen how governance workload has increased in recent years. The time, effort

and resources demanded of board oversight often outstrip traditional board structures and membership, and we are forcing our governance systems to play catch up. But one coming governance change has upended this cause-and-effect evolution. Boards will soon need a formal risk management committee, or at least a formal risk management structure, in place... or be ready to explain why they don’t.

The demands for a formal board risk structure will force boards to look outside the sometimes-narrow fields of audit and pay, and examine other risk dangers that could be waiting on the doorstep. This covers many operational, strategic and legal concerns. But my work on the boards of energy and technology companies has alerted me to a very real, pending regulatory risk facing many major corporations. Worse, hardly any boards seem aware of it.

### The Risk of Green

In September 2009 the U.S. Environmental Protection Agency formally passed rules treating the emissions of greenhouse gases (GHG), such as carbon dioxide, as

“pollutants.” Beginning January 1, 2010, thousands of U.S. companies must now compile and disclose reports on the greenhouse gases they produce. At least 10,000 facilities will fall under the disclosure rules, accounting for 85% of all industrial GHG emissions in the US.

Despite the tight deadline, this sounds like a fairly technical item, impacting just the regulatory compliance staff at some utilities and smokestack industries, right? Well, *every* major corporation will feel the effect of this new rule, and every board needs to know the risks it will face. The EPA disclosure rules cover industries as diverse

as transportation, electronics manufacturing, agriculture, chemicals and food processing.

Facilities must meet the disclosure regimen if they emit over 25,000 metric tons of CO<sub>2</sub>-equivalent GHGs per year. That sounds like a huge amount, but the EPA proposal notes that this threshold is “roughly equivalent to the annual greenhouse gas emissions from just over 4,500 passenger vehicles.” Further, if you don’t scientifically calculate the greenhouse emissions from your facilities, how will you know for sure if each is above or below the threshold?

These disclosure rules definitely come under the purview of a board’s risk committee, not only for their reach, but for their potential liability exposure. Corporations that are out of compliance will face fines of up to \$37,500 *per day* for non-compliance.

Consider this scenario: At your next corporate annual meeting, you as a director face an angry shareholder demanding to know why your board ignored the new regulatory risk that left your company paying out \$37,500 daily in fines.

Further, the new EPA rules may only be the first shoe to drop on GHG regulation. In September, Senators John Kerry and Barbara Boxer

*Every major corporation will feel the effect of this new rule, and every board needs to know the risks it will face.*

introduced legislation to mandate a 20 percent cut in greenhouse emissions by 2020 (and up to 80 percent by 2050). The new EPA rules will make this huge scheme practical—before you can cut GHGs, you first need to count them.

### Green Grows Teeth

This shift in the environmental landscape is part of a new risk oversight trend that all responsible boards must consider. For the past decade or two, it’s been easy for some boards to accept vague, feel-good, “greenwashing” assurances from management on environmental

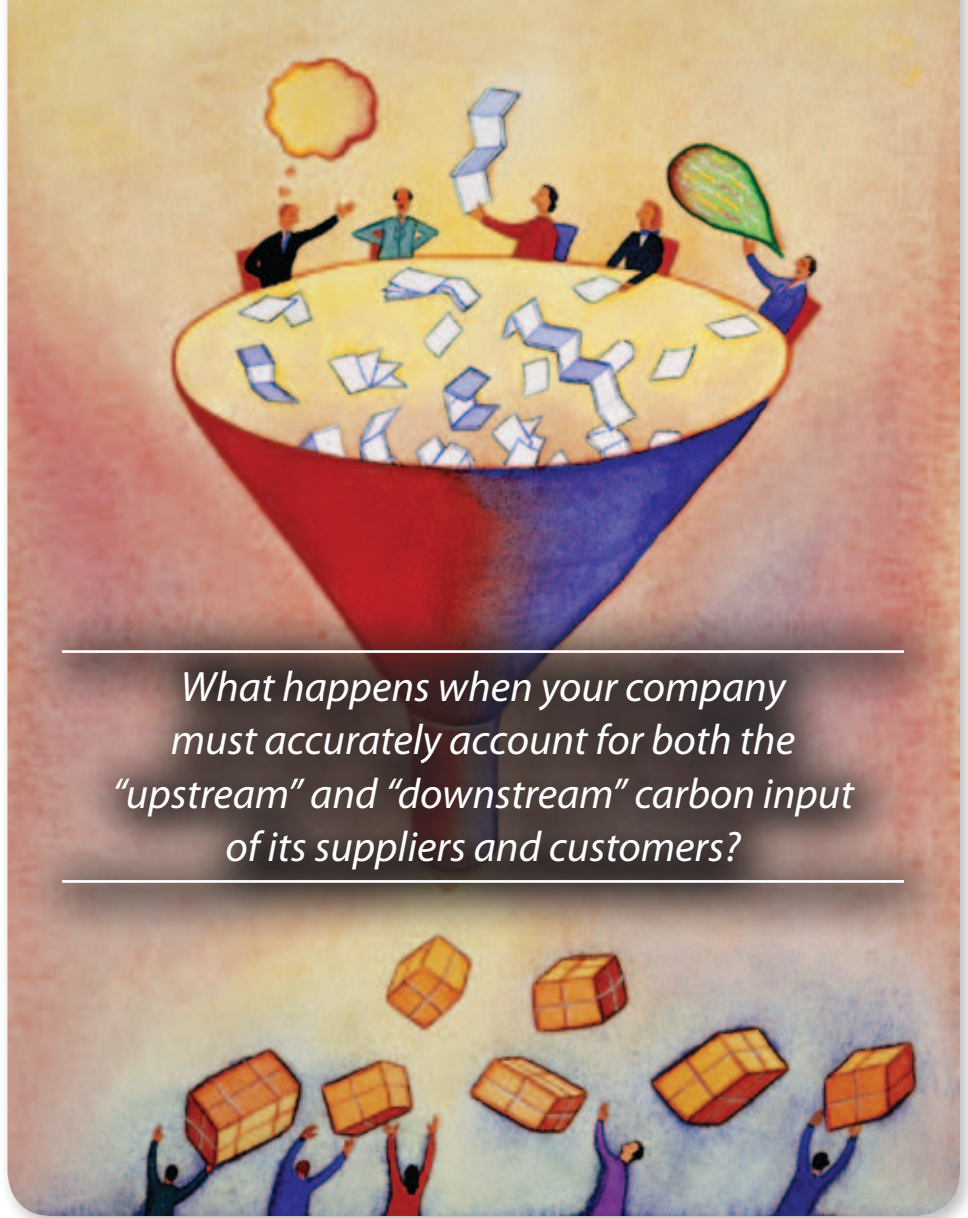
issues. No longer. Tough, enforceable legal disclosures are now the rule. Corporate leaders and boards of directors, who may have viewed most environmental concerns as public relations issues, must now disclose hard, objective, scientifically validated numbers from their legal and compliance staff. Green no longer means lovable images of wildlife and trees. Now, Green has grown teeth.

In July, the Social Investment Forum was joined by over 50 major movers in activist investing (including Ceres and Calvert Asset Management) in petitioning the SEC to require annual reports from all US public companies on environmental, social and governance (ESG) issues. Carbon footprint and sustainability would be among the measures required, with the legal accuracy and timeliness mandated for all SEC disclosures. Also last summer, a new international Climate Disclosure Standards Board (CDSB) was formed to develop solid standards on corporate climate-related disclosures.

The biggest risks your company may face in the years ahead, both in reputation and legal liability, will spring from disclosure that is inaccurate, partial or mishandled. Corporate “greenwashing” messages are no longer harmless. Soon, they will be as dangerous as CEO assurances that all is well the day before a major income restatement is announced.

In sum, your board now must not only weigh the risks presented by environmental issues. You must also weigh how well those issues are measured, disclosed, and reported to legal bodies and in the media.

But it’s not an easy task. Through my involvement with Clear Standards



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*What happens when your company must accurately account for both the “upstream” and “downstream” carbon input of its suppliers and customers?*

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(recently purchased by SAP and renamed SAP Carbon Impact), a software company that developed a solution to help corporations meet this “count every molecule” greenhouse gas mandate, I’ve seen first-hand the challenges companies face measuring and reporting GHG metrics. For example, currently, there are five different international carbon registry groups setting standards for calculating emissions—and all five differ (the formula SAP Carbon Impact uses is approved by all five). With stakeholders and regulators clamoring for increased visibility into the GHG emissions of businesses, a simple seat-of-the-pants, spreadsheet-driven tracking system is simply no longer tenable. Organizations need

a well-defined, well-implemented method of measuring and reporting these metrics.

What to measure and how can lead to confusion for even a seemingly simple task. The Sept. 18, 2009 issue of *The Wall Street Journal* notes how the UK’s Carbon Trust, a group formed to help calculate the greenhouse gas impact of retail products, is struggling just to measure the carbon “footprint” of a gallon of milk. But this is only the first hint of a wave of “carbon responsibility” that boards may have to factor into their future governance. The European Union is currently considering rules to mandate that most consumer products sold in

the EU include “carbon footprint” labeling (which might actually be preferable to every European country setting its own unique standard). And what happens when your company must accurately

must assure that the board is well informed. Brand impact and reputational risks are the biggest to consider. These long-term corporate resources are entrusted to the board’s safekeeping.

begin the costly reporting process, it will be difficult and time consuming to escape. Inaccurate calculation of carbon footprints will cost the company at either end of the scale.

*That means that management (and your board) will need to obsess over the technology used to assure accurate carbon counting.*

account for both the “upstream” and “downstream” carbon input of its suppliers and customers?

## What Boards Can Do

Sustainability mandates and reporting requirements present a real and present danger no board can ignore. But it is also proving to be an inconsistent, elusive risk, and tricky for a board to manage. How should directors cope?

- First, review your board and committee charters to see how you specifically address risk management and its oversight. Stating that overall risk monitoring is in the hands of the full board, with assignment to committees based on their expertise, is an important first step in proving your board takes its risk management role seriously. It shows thought and effort to craft an effective structure.
- Second, to deal with coming sustainability and carbon disclosure issues, seek ongoing reports to the board from the key staff involved in compliance. Environmental, legal and compliance staff will need to monitor regulatory developments and shape the company’s response structure. Most importantly, for governance purposes, companies

- Finally, note that the coming disclosure regimen doesn’t really seek to force companies to cut their greenhouse gas emissions or carbon footprint. Instead it focuses on full, accurate and timely data capture and disclosure—with penalties based around that goal. Pending legislation, such as the Kerry-Boxer bill, may indeed use the data collected to drive down emissions (any coming cap-and-trade system will need solid numbers). But for now it’s the data that counts. That means that management (and your board) will need to obsess over the technology used to assure accurate carbon counting.

Midsize corporations, for example, may be at the borderline of the 25,000 metric tons per year reporting threshold. The EPA rules place an affirmative duty on companies to know whether they are above or below this threshold. If a facility’s total emissions are just above the limit, and you’ve failed to accurately report it, those \$37,500 a day fines may be coming. But suppose you are unsure of a facility’s carbon footprint, start reporting it under the EPA plan, and later find the unit is below the reporting threshold? The new rules allow a facility to opt out, but this requires a multiyear process of measuring emissions to assure they are under the threshold. Once you

My experience with SAP Carbon Impact has made me aware of how vital accurate, scientifically valid measurement of a company’s greenhouse gases has become. However, I’ve also seen too many boards of directors who are still unaware of the looming risk and management challenge this burgeoning focus on sustainability presents to good governance.

Your board has very little time to prepare for this major risk-management challenge. Before your next board meeting, ask legal and compliance staff to prepare a board briefing on how the new EPA rules will hit your company. At your next board meeting, review your exposure and determine whether your board’s structure is up to the challenge of oversight. By considering this topic now, your board gains a head start on shaping the processes and systems needed to address the sustainability issues facing businesses today and in the near future.

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Betsy Atkins is the former CEO and Chairman of Clear Standards, Inc. Clear Standards provides on-demand enterprise carbon management sustainability software to help organizations measure, mitigate, and monetize carbon and other resources in their business operations. She currently serves on the boards of SunPower Corporation, Polycom, Inc., Chico’s FAS, and Reynolds American, Inc. She is an advisor to British Telecom and a board member of NASDAQ LLC. Betsy started her business career as an entrepreneur, co-founding several successful high tech companies including \$5.4 billion Ascend Communications. She has served as a CEO three times, and her venture capital firm, Baja LLC, made early stage investments in companies such as Yahoo and eBay.

# How to Survive an Uncertain D&O Insurance Market

By Thomas H. Bentz, Jr. and Shannon A. Graving

The threat of a looming hard market has created an uncertain D&O insurance market.



Thomas H. Bentz, Jr.

Since the beginning of the financial crisis there have been many factors that indicate that a hard D&O insurance market is “just around the corner.” More than a year later, however, pricing for D&O insurance remains relatively soft. This anomaly has made it difficult for



Shannon A. Graving

insureds and their brokers to plan ahead for their D&O insurance renewals. Although we cannot predict the future, we can offer the following tips for surviving the current “uncertain” D&O insurance market.

## Begin the Renewal Process Early

In an uncertain D&O insurance market, it is imperative that insureds start the renewal process early. Starting early will give insureds time to approach new insurers and create competition. Competition is key in an uncertain market because it allows an insured to test how the insurance market views its risk. Given the uncertainty in today’s market, this is the only way to know whether pricing is appropriate. Starting early also gives an insured ample time to

analyze the alternatives and negotiate terms and conditions with the current insurer and any competitors.

## The Most Important Factor is Coverage

Although saving on premium is certainly a worthy goal, far more important is making sure that a policy provides broad coverage and that the insurer will pay claims. Unlike many other types of insurance policies, there is no standard D&O insurance form. As a result, simply comparing

*Competition is key in an uncertain market because it allows an insured to test how the insurance market views its risk.*

the premium quotes of different D&O insurers is rarely informative. Instead, insureds must compare and contrast the terms and conditions of each D&O policy to ensure that it meets their risk transfer needs. Even the simplest of D&O policies has an intimidating number of detailed definitions, exclusions and conditions, with nuances of wording that can have very costly consequences. Narrow definitions and overly broad exclusions found in many “off-the-shelf” policies can mean the difference between a policy covering a multi-million dollar loss or one that leaves insureds to pay the tab. Thus,

before changing to a new insurer in order to reduce the premium, insureds should understand any differences in the coverage.

Insureds should also consider the claims-handling reputation of their potential insurer. Different insurers handle claims very differently. Saving a little money on the premium will be of little solace if the result is a denial of coverage for a significant claim.

## Pay Attention to the Excess Layers of Coverage

Most D&O insurance programs with more than \$10 million in limit will include one or more excess policies. Insureds often fail to spend the time necessary to analyze or negotiate these excess policies because the coverage is seen as “follow form.” Unfortunately, follow form policies nearly all add terms and conditions that restrict the coverage provided by the primary policy. Failure to review and negotiate the excess policies can result a loss of coverage for a claim that reaches the excess layer.

## Tread Carefully When Changing Insurers

Even if the terms offered by a competing insurer are identical to those of a company’s current insurer (which is highly unlikely), a switch can create a gap in coverage. For example, if a new insurer requires a warranty statement, either in response to a question in the application for insurance or in a stand-alone

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# What's in Store for Boards in 2010

By John B. Missing

Say-on-pay, proxy access, compensation and risk oversight will weigh heavily on the board agenda in 2010.



John B. Missing

The economic turmoil of 2008 and 2009 has already produced legislative and regulatory changes to the ways in which corporations govern

themselves. This process will continue in 2010, which is likely to usher in some of the most important changes in this regard, including efforts to limit executive compensation through say-on-pay provisions, enhanced shareholder proxy access and perhaps an increased emphasis on board oversight and management of enterprise risk.

There are other important changes whose effects will be felt in 2010, not the least of which is a dramatic restructuring of the SEC's Division of Enforcement designed to put more enforcement investigators on the front lines, and the prohibition on discretionary voting by brokers holding shares in street name in uncontested director elections. In this short piece, however, we will look at a few of the more prominent developments that more directly affect corporate governance.

## Say on Pay

Activist shareholders and members of Congress have continued to push for implementation of say-on-pay proposals. The House's Corporate and Financial Institution Compensation Fairness Act and the Senate's Shareholder

*While the SEC has made no formal move toward restricting executive compensation yet, the Commission is certainly not ignoring the issue.*

Bill of Rights Act and Excessive Pay Shareholder Approval Act all contain say-on-pay provisions. It is unclear at this point what shape this legislation will ultimately take or when it will be passed, although passage seems more likely now than ever before. Moreover, shareholder activists advanced more say-on-pay proposals in 2009 (about 100, of which 19 received a majority) than in 2008 (76 proposals advanced, of which 10 received a majority). Both the legislative proposals and the activist proposals have in common the key feature that shareholder votes are merely advisory and non-binding. Significantly, it appears that in every instance in 2008 and 2009 where shareholders had their "say," totaling about 20 companies, they voted to accept, on an advisory basis, the compensation proposed by the Board, in most instances by over 90 percent.

It was widely expected that say-on-pay proposals would get a powerful boost from the American Recovery and Reinvestment Act, which was signed into law by President Obama in February 2009, and which requires say-on-pay votes at about 400 companies receiving TARP funds. However, differing views on these proposals continue. The benefit of participatory shareholder democracy and the promise of reducing or eliminating "excessive" executive pay are plainly being weighed

against the concern that shareholders may not be well-equipped to make compensation decisions or that the proposals are simply too blunt an instrument. As a result, although the increase in support among shareholders for such proposals has been widely reported (46% in 2009, up from 41.5% in 2008), less widely reported are the facts that most large institutional shareholders continue to oppose such resolutions and that most resolutions continue to be rejected by shareholders.

In 2010, activist shareholders and advocacy groups are expected to continue to push for implementation of say on pay provisions, as well as the elimination of other compensation practices such as "golden coffin" death benefits and tax gross-up payments. Boards considering say-on-pay resolutions will need to consider, among other things, just what it is their shareholders are being called upon to approve (e.g., the company's compensation policies and procedures or the proposed compensation itself) and whether their compensation committees are sufficiently independent. Under the legislative proposals described above, compensation committee members would need to satisfy independence requirements similar to those that apply to audit committee members.

## Proxy Access

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Earlier this year, the SEC proposed rule changes that would allow shareholders to have their nominees included in proxy materials unless otherwise prohibited by state law or the company's charter or bylaws. The SEC received over 500 comment letters addressing the proposed changes. In support of the changes, many have cited the positive effect of opening this important aspect of decision-making to shareholders and the likely result of increasing director accountability. Others have expressed concerns regarding the impact the proposed rule would have on board composition, deliberations and decision-making ability. Senator Schumer's Shareholder's Bill of Rights Act would mandate annual elections for all directors by prohibiting staggered boards, and some are concerned that provisions of this kind are not likely to increase a board's focus on long-term growth.

It is now expected that the SEC's vote on this rule will take place in early 2010 and would be effective, if adopted, for the 2011 proxy season. In anticipation of the rule's passage, Delaware has added new sections to its General Corporation Law, which became effective on August 1, 2009, permitting shareholders to adopt bylaws that (a) require inclusion of one or more individuals nominated by a stockholder in proxy solicitation materials for director elections, and (b) require a company to reimburse expenses incurred by a shareholder in connection with the solicitation of proxies for the election of directors.

## Executive Compensation

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In late October of this year, Kenneth Feinberg, the Treasury Department's "pay czar," limited the compensation of over 90 percent of the highest-paid employees at a handful of TARP companies to \$500,000. While these

are the only pay limits to have been imposed as of this time, multiple "anti-executive-pay" bills have been introduced in both the House and the Senate during 2009 which target "excessive" executive compensation in publicly traded companies. One of these bills would prohibit compensation for a corporate employee from exceeding 100 times the average compensation of all employees. Another would deny employers a tax deduction when they pay an employee 100 times the average compensation paid to other employees. The fate of these bills is uncertain.

While the SEC has made no formal move toward restricting executive compensation yet, the Commission is certainly not ignoring the issue. On July 1 of this year, the SEC voted to propose rules that will require new disclosure in annual reports and proxy statements concerning the effect of a company's compensation policies in numerous areas, including risk, director qualifications, and potential conflicts of interest of compensation consultants. SEC action on the proposed rules is expected to occur prior to the 2010 proxy season. By focusing on disclosure only, the SEC's proposed rules do not raise the federalism concerns present in Congressionally mandated executive pay, and as a result, such rules may ultimately be less controversial than the corresponding legislation currently under consideration.

## Risk Oversight

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Both Congress and the SEC have made it clear that risk management is high on their agendas of corporate governance issues. Senator Schumer's Shareholder's Bill of Rights would mandate that all issuers create a special committee composed exclusively of independent directors responsible for establishing and evaluating the company's risk management practices. Similarly, the rules that the SEC will propose by next year require disclosure in a proxy

statement regarding the board's role in the company's risk management process, and the effect that this has on the manner in which the company has structured its leadership. Chairman Schapiro expects that such rules will provide investors and the market "with better insight into how each company and each board addresses" the vital tasks of managing risk, "both generally and in the context of setting compensation."

As a result, companies are putting renewed focus on Enterprise Risk Management initiatives, attempting to take a more comprehensive approach to identifying and understanding company-wide risks, and avoiding the 'silo' mentality. In connection with and to manage such initiatives, many companies—especially those in the financial services sector—have designated a Chief Risk Officer. The use of CROs seems likely to spread well beyond the financial sector in the event that legislation such as the Shareholder's Bill of Rights becomes law.

These measures address different areas of corporate governance, but the principles guiding these proposals are generally similar: increased shareholder participation and director accountability. Say on pay proposals and proxy access regulations would give shareholders new tools to influence company decisions, while directors could be shouldering additional risk management responsibility under the Shareholder's Bill of Rights.

If some of these proposals go into effect in the next year, then the economic turmoil of 2008 and 2009 will leave a lasting imprint on the boardroom.

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John B. Missing is a partner at Debevoise & Plimpton LLP whose practice focuses on securities and derivative litigation and the representation of companies, officers and directors in class actions. He has substantial experience representing companies and individuals in internal investigations and SEC enforcement matters.

# How to Reinvent Your Company Through Better Enterprise Risk Management

By Jack Bergstrand and John A. Wheeler

## Transcending “scientific management” in the Knowledge Age



Jack Bergstrand

**E**nterprise reinvention and enterprise risk management have been a challenge to implement in many large organizations. The key to unlocking the potential of both is to understand and overcome *why* the traditional implementation approach consistently struggles.



John A. Wheeler

While it can sound a little academic, the underlying problem is that companies have been built using “scientific management” principles from the early 1900s, but the nature and complexity of our companies have changed dramatically since then. As a result of technological advances, companies have automated their scientific management approaches—relying predominately on the results of historical data analysis. However, rigorous quantitative approaches and models—as witnessed on a grand scale in the recent global financial crisis—inevitably break down in rapidly changing, globally competitive environments.

A common example of this problem is often seen with large enterprise

*These enterprise programs, based on objective scientific management, have more often resulted in “over-engineered” organizations—with frozen decision-making processes and company routines.*

technology projects, which the Standish Group consistently finds struggling 70 percent of the time. These enterprise programs, based on objective scientific management, have not typically resulted in “reengineered” companies as promised. They have more often resulted in “over-engineered” organizations—with frozen decision-making processes and company routines.

It’s clear that companies must manage enterprise-wide initiatives differently. Consistent with the work of legendary management thinker Peter F. Drucker and more than 200 industry experts, enterprise reinvention needs to be managed more holistically.

### **Learning from Peter Drucker**

Drucker was the first to identify the need to transcend scientific management in the Knowledge Age. The implications for enterprise reinvention and enterprise risk management are significant. Where executives have historically been able to improve results through specialization, successful reinvention now requires a much greater emphasis on unification—

moving from the parts to the whole. This requires a different approach:

### **Start with your customer**

Every company’s enterprise view and strategy needs to start, as Drucker emphasized, with customers. Most agree with this tenet philosophically, but few enterprise restructuring and enterprise risk management programs follow this in practice—establishing and integrating *where* your company intends to go and *why*.

### **Be holistic and systematic**

Another principle to incorporate from Drucker is to be both holistic *and* systematic. To be holistic, it’s important to integrate people into the scientific side of the equation to better manage the enterprise risk management programs.

Without a shared enterprise view to guide companies in continually changing environments, companies often get stuck by focusing on the parts instead of the whole. When competitive and organizational situations change, executives get caught working on the wrong things—on areas that used to be important but are no longer bottlenecks.

## Don't forget your community

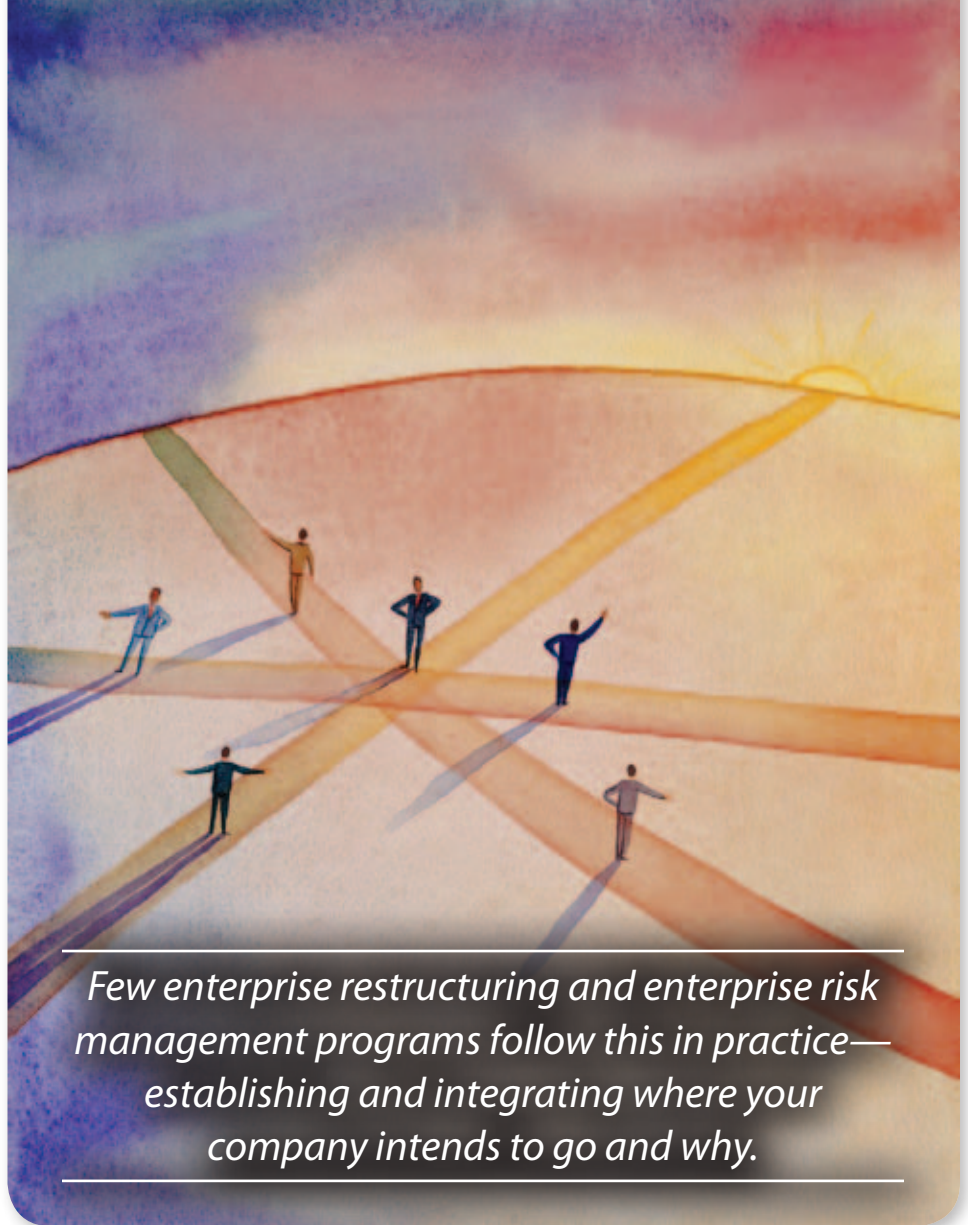
A third Drucker insight—important for sustainable enterprise reinvention and effective risk management—is to systematically manage social roles. Companies are the only true economic engines for society, and strong communities are the only source of sustainable profits. When companies don't formally integrate into their communities and view themselves as separate entities, enterprise risk profiles will inevitably increase.

## Integrating ERM into Sustainable Enterprise Reinvention

Enterprise risk management is an important tool for sustainable competitive advantage. Like the market and the enterprise itself, successful enterprise risk management programs require holistic and systematic processes supported by the following factors:

- **Envision:** Strategy linked to customer needs, with defined operational implications, and well-articulated enterprise guidelines for managing risks and opportunities.
- **Design:** Formal risk mitigation and opportunity sensitivity analysis/monitoring/reporting.
- **Build:** Enterprise-wide controls, processes and infrastructure.
- **Operate:** Well-established personal roles and motivations for people to act in the best interests of their companies through proper incentives.

For companies to reinvent themselves, they can't be viewed as the sum of their parts. The enterprise overall is the goose that lays the



*Few enterprise restructuring and enterprise risk management programs follow this in practice—establishing and integrating where your company intends to go and why.*

golden eggs. Similar to a brand, it needs to be holistic, integrated and relevant—and continuously adapt through successful and accelerated enterprise projects.

To improve your company, try taking your enterprise risk management program to the next level. Integrate Envision-Design-Build-Operate to achieve your objectives through a shared enterprise framework, integrated roles and responsibilities, and adaptive monitoring/sensitivity analyses. Then, holistically address risk gaps through independent program assessments to diagnose and correct identified weaknesses and take full advantage of new opportunities.

Driven by a rapidly changing environment, there has never been a better time to reinvent your enterprise and your enterprise risk management program.

Jack Bergstrand is author of *Reinvent Your Enterprise*, creator of the Strategic Profiling enterprise project acceleration instrument, and founder of Brand Velocity, Inc. Prior to founding Brand Velocity, he was chief information officer of The Coca-Cola Company and chief financial officer of Coca-Cola Beverages Ltd. John A. Wheeler is founder of Wheelhouse Advisors LLC and served as senior vice president and senior risk officer within the corporate risk management division of SunTrust Banks, Inc. He was recognized in 2005 as one of the "Top 40 Finance Executives under 40" and one of the "100 Most Influential People in Finance" by *Treasury & Risk Management Magazine*.

# New Boardroom Directives: Risk Oversight and Complex Valuation Challenges

By Noah Gottdiener

## A principles-based approach for corporate directors



Noah Gottdiener

Valuation reform has instigated an unusual and highly polarized debate in the otherwise civil world of accounting.

This is especially true as it relates to fair value accounting. Critics argue that the estimated \$1 trillion in write-downs exacerbated recent market turmoil, while proponents believe that the practice provides much-needed transparency to financial reporting. Some industry leaders, including Goldman Sachs' CEO Lloyd Blankfein, have even stated that *daily* marking of positions to current market prices can be a key indicator in reducing exposure to markets and instruments that are quickly losing value.

At the corporate board level, the valuation debate is being considered within the larger context of risk oversight. Boards have been increasingly pressured to embrace their oversight role and enhance their understanding of risk, liquidity needs and attendant valuation issues as a result of corporate scandals earlier this decade as well as the recent financial recession.

At the height of the financial crisis, the NACD launched the Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies. The NACD identified "oversight of risk" as one of the four areas that warranted more attention.

*How can boards take a complex accounting concept and make it relevant to complying with the best practices of the oversight function?*

The NACD report states: *Directors should continually monitor the financial health of the firm, ensuring accurate accounting and safekeeping of corporate assets. Appropriate attention must be given to detecting and deterring significant risks, particularly those that exceed the established tolerance levels of the company.*

For many corporate directors, this is a distressingly vague reference to valuation concerns and an uncertain regulatory environment. Similar efforts by FASB and IASB to refine fair value accounting have clouded the picture further.

### Multi-step Valuation

Based on this assessment, how can corporate directors carry out risk oversight responsibility with respect to valuation? As fiduciaries to shareholders, how can they take a complex accounting concept and make it relevant to complying with the best practices of the oversight function?

We propose that corporate directors take a multi-step approach to solving valuation challenges in the boardroom. This does not mean that board members need to *actively* manage day-to-day valuation issues or keep abreast of daily regulatory

developments that could impact specific valuation procedures. These responsibilities rest squarely within management's domain and should be carried out in conjunction with third party experts.

Boards should instead focus on four key valuation principles to establish policies and procedures that align with existing risk levels. This "principles-based" approach represents the essence of the oversight function, counterbalancing management's focus on the detailed application of rules and regulations.

The following tenets of fair value accounting will help to ensure that corporate interests are not compromised by a wholesale delegation or the outsourcing of valuation issues:

- Valuations need to be purpose-built and account for an asset's intended function, which has very real implications on an asset's value. For example, valuations for a merger vary greatly from those used to provide collateral for an overnight loan. How do current versus altered conditions over a period of time affect the market price of an asset? How does this vary if one shortens or lengthens the time horizon? How does it vary under different market

scenarios? Failure to answer these types of questions contributed to the massive write-downs over the past year.

- Valuations need to be as complex as their underlying assets. Highly technical and complex assessments of value must be repeated at each point in the business cycle as models, people and markets change. Actual performance should be compared to projected and financial models and refined quarterly.
- The need for independent and objective analysis is more pressing than ever. As financial instruments increase in complexity, it becomes harder to find someone who can provide an informed and independent valuation. Further

objectivity challenges arise when compensation is tagged to the values that analysts assign to firm assets. If the analysts performing the valuations and the managers who stand to gain monetarily are the only ones who understand the valuation process, directors have nowhere else to turn. It is therefore critical to create an independent class of valuation professionals who are capable of keeping up with innovations, while remaining free from conflicted compensation incentives.

- Transparency is vital to both the valuation process and the final numbers. Arcane instruments increase the need for transparent valuation so that investors can understand the methodology and make their own judgments.

The debate over fair value and the complex valuation of illiquid assets will continue as FASB and other regulatory agencies try to reach a consensus on what has become a contentious topic. Regardless of the outcome, it is imperative that corporate directors and board members embrace an informed, practical view of complex valuation for their own balance sheets. After all, a board must first appreciate the existing risk before it can employ a more rigorous risk oversight function.

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Noah Gottdiener is CEO of Duff & Phelps. Previously, he was the founding partner of Stone Ridge Partners LLC, a partner with Thomas Weisel Partners and Furman Selz LLC and a managing director at Lehman Brothers. He received his BA from Princeton University and MBA from Harvard Business School.

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director, you should demand that your company's reporting system allow for anonymity or confidentiality, where permissible by law. In addition, you should compel the organization to enforce a policy prohibiting retaliation against individuals who report issues in good faith.

Any compliance and ethics program worth its salt should be subject to separate audits by independent internal or external experts. The board of directors should require periodic evaluations of the program's effectiveness.

## 6. Incentives and Discipline

Your organization must enforce its compliance standards appropriately and consistently and should employ incentives to promote proper conduct and deter misconduct. Directors

should require effective incentive and disciplinary practices and procedures organization-wide.

## 7. Remedial Actions and Periodic Program Modifications

An effective compliance and ethics program requires reasonable, responsive, appropriate and well-designed reactions to criminal conduct. As a director, you should demand prompt, proper response to any and all criminal conduct at the organization, and the company must modify its compliance and ethics program accordingly.

## 8. Periodic Risk Assessments

In accordance with the Sentencing Guidelines, the board should require periodic and substantive assessments of compliance and ethics risk. Risk assessments must include thorough

analysis and appropriate remedial action. For instance, directors should oblige the company to reprioritize any identified risks and to alter the compliance and ethics program as appropriate.

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Andrea Falcione serves as senior director, Compliance & Ethics Consulting for Integrity Interactive Corporation. Prior to joining Integrity, she practiced law for nine years, most recently as senior counsel at FleetBoston Financial, then the 7th-largest financial services organization in the United States. She previously practiced corporate law at Day, Berry & Howard LLP (now Day Pitney LLP). Falcione is a Certified Compliance & Ethics Professional and is a member of the Society of Corporate Compliance and Ethics and the National Association of Women Lawyers. She can be reached at 781.398.3524 or [afalcione@i2c.com](mailto:afalcione@i2c.com). Kirsten Marcum is director of content and editorial services at Integrity Interactive Corporation. She can be reached at [kmarcum@i2c.com](mailto:kmarcum@i2c.com).

# Assessing Foreign Investment Risks

By Daniel Wagner

## Boards should use third parties to fill their knowledge vacuum



Daniel Wagner

**A**t a board meeting of a top 20 multinational corporation, the question of whether to invest \$50 million in a project

in a Middle Eastern country was discussed. The president of the company subsidiary seeking the board's approval insisted that the country was a safe place to invest because of its recent history of economic and political stability. Satisfied with the president's assurances and facts, the board approved the investment—a decision they now regret. As it turns out, the country in question was not as stable as portrayed and the company's investment is now tied up in costly legal limbo, which has had far-reaching and potentially damaging implications for the company's brand and reputation.

To make matters worse, the interests of some of the actors involved were not directly aligned with those of the company. The corporate underwriters were incentivized to promote the deal internally so they could meet their production targets. And while the underwriters sought the views of the country risk manager charged with vetting the transaction, a large portion of that analysis was deleted from the final version that went to the corporate risk manager for final approval

before being given to the president. Neither the corporate risk manager, the president, nor the board of

diligence before taking requesting a vote, rejected the request outright, or made the approval conditional

*Without data or insight of its own, the board was too reliant on the company's assessment to make an effective foreign investment decision.*

directors knew this had happened, and believed all necessary approvals had been obtained in the manner previously mandated by the board.

### The Dangers of Self-Reliance

As is illustrated by this real example, companies often rely exclusively on their own risk management processes, which they believe are bulletproof, but which may in fact be riddled with holes, inconsistencies, and contradictions. Clearly, the company's risk management function and the final version of the country risk analysis were faulty. Without data or insight of its own, the board was too reliant on the company's assessment to make an effective decision and fulfill its duty to protect the interests of the company and shareholders.

If the board had been better educated about the economic, social, media and political situation in that country, they may have been able to identify the errors in the assessment they received. They may have forced the company to conduct more thorough due

on receipt of the company's plans to mitigate and address the potential risks.

As company operations and holdings continue to expand into all corners of the globe, decision makers too often pay too little attention to specific country risks and other matters of crucial importance. Boards of directors are particularly vulnerable to this glaring oversight due mainly to a lack of direct insight into a particular country—which leads to an inability to discern fact from fiction—and not knowing the right questions to ask of corporate management.

### Mitigating Foreign Investment Risks

How can boards make better decisions with respect to country risks? One place to start is in the composition of the board itself. Too often, board members are selected from a small group of high-profile, well-connected and prestigious individuals who may not have relevant experience in foreign investments or operations, and who may not want to appear ignorant about a subject matter being



*It is difficult, if not impossible to find individuals who have direct and timely experience in every country that may be an investment target for a large corporation.*

discussed. Company management should emphasize experience and knowledge when selecting board members. That said, it is difficult, if not impossible to find individuals who have direct and timely experience in every country that may be an investment target for a large corporation.

Another solution is for boards of directors to press companies to regularly update their own risk management procedures and insist on instituting appropriate checks and balances. Given the competing interests that may influence an internal risk management team, a better solution is to look outside of the company's country risk management function and insist that either the company hire an independent third-party assessor or, ideally, do so themselves. A qualified third-party can conduct regular risk management audits that test and stress the system, provide insights into the target country that incorporate political, economic and social risk, and thus

can provide board members with unbiased information, empowering them to ask the right questions.

Unfortunately, even when a problem is identified, boards are sometimes reluctant to confront management. Candor often gets lost in the politeness of board proceedings, and too often boards are focused on building consensus, which inhibits due diligence and proper risk management. By remaining polite and silent, boards can do more than contribute to monetary losses; they may unwittingly cause reputational risk, often with long lasting and severe consequences. Therefore, board members must exercise their responsibilities with renewed vigor and with a solid base of knowledge and insight. If that had been the case with the company described above, the outcome would have been much different.

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Daniel Wagner is Managing Director of Country Risk Solutions, a political and economic risk consulting firm based in Connecticut ([www.countryrisksolutions.com](http://www.countryrisksolutions.com))

*Kristie, from page 35*  
incredibly bright and accomplished people together would yield insights that generate a great return for the management team and shareholders? If that's not happening, a case for change in the boardroom surely could be made.

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James Kristie is editor and associate publisher of **Directors & Boards**, and can be reached at [jkristie@directorsandboards.com](mailto:jkristie@directorsandboards.com).

*Bentz and Graving, from page 39*  
warranty letter, there is a potential for a gap in coverage. The new insurer will exclude any claim arising from any known facts or circumstances referenced in a warranty statement and the previous insurer will deny coverage for any claims made after the switch to the new insurer. Although there may be ways to minimize this risk, a company must tread carefully when changing an insurer.

## Conclusion

The threat of a looming hard market has created an uncertain D&O insurance market. That does not mean that insureds are at the market's mercy. By starting early, carefully considering the quotes that they receive (not just in terms of premium, but in terms of coverage), and evaluating the risks associated with any warranties required to make a desired change, insureds may not only survive but thrive in these uncertain times.

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Thomas H. Bentz, Jr. is a partner at Holland & Knight LLP where he leads the firm's D&O and Management Liability Insurance Team. Shannon A. Graving also practices insurance law with the firm where she focuses on D&O Insurance and Mergers and Acquisitions. Together, Tom and Shannon are among the nation's leading authorities on D&O and Management Liability Insurance.

# Sales of (Nearly) Distressed Companies

By Ryan D. Thomas

## Twelve considerations for directors



Ryan D. Thomas

For purposes of this article, a “distressed company” means a company that is not clearly insolvent, but is facing potential

debt covenant breaches or other significant liquidity challenges in the current economic environment.

### Consider All Options

At first blush, a fair acquisition offer may seem a panacea to the distressed company’s ailments, but is it really the time to sell? A transaction involving a distressed company will be under intense scrutiny from shareholders and creditors. A board should understand the sources and magnitude of the distress and how that impacts the company’s long-term operations and strategic options. It may be the core business is sound with potential long-term upside. In such event, a booster shot may be preferable over reconstructive surgery. There may be other solutions that could better maximize the long-term value of the company, if practicable, such as a sale of assets or securities or debt restructuring.

### Know Your Constituencies

Your fiduciary duties run to the enterprise generally, typically enforceable by your shareholders. For a solvent company, you should continue to focus primarily on the

best interests of the shareholders in considering a transaction or sale process. Outside of insolvency, creditors’ actions against the company will be limited to contractual claims and a commercial duty of good faith and fair dealing. However, in Delaware, upon (and only upon) insolvency the company’s creditors may bring derivative claims of breach of fiduciary duties as the primary beneficiaries of the residual value of the enterprise. Given the 20/20 hindsight analysis of insolvency in any post-transaction litigation, companies in or near the “zone of insolvency” should consider the impact of the transaction of the company’s creditors (as future potential litigants). Particularly if

the debt will not be repaid in full or a consent or tender offer at less than par is contemplated as part of the transaction. For companies of questionable solvency, consideration should be given to receiving a solvency opinion, or consulting with a financial advisor on the solvency analysis, prior to embarking on a sale process. This information could be instructive from a process standpoint—including as to the comfort in transacting outside of a court-supervised process.

### Consider a Role for Your Debt Holders

While a daunting debt load may initially seem an insurmountable hurdle to a transaction in the current environment, some debt holders have allowed at least a partial assumption and/or exchange of indebtedness in a sale context. Accordingly, consider a cooperative approach with your debt holders if your company has significant indebtedness that could be modified, exchanged and/or assumed in connection with the transaction. This could also enhance deal certainty relative to relying on the buyer or a new third party syndicate for the refinancing of this debt—which has contributed to

*For companies of questionable solvency, consideration should be given to receiving a solvency opinion, or consulting with a financial advisor on the solvency analysis, prior to embarking on a sale process.*

several failed deals. Also, consider providing your debt holders a place at the negotiating table sooner than later. Debt holders will not want to be “out of the market” for long to facilitate these confidential negotiations, but they will likely do so if it is in their best interests. Unduly delaying these negotiations could weigh down a time-sensitive process and debt holders will be more likely to consider modifications or an assumption if they are treated fairly and have adequate time to

review the proposed change in their investment.

## **Maximize Your Negotiating Leverage**

Seek to minimize any bleeding associated with the distressed situation. If defaults are imminent, consider seeking forbearances or covenant waivers or amendments from your lenders—ideally prior to negotiations with the buyer. Your lenders may not prefer to force you into bankruptcy and may be willing to negotiate. Also, insist on standstills with potential buyers, that include debt—do not let potential buyers purchase your debt opportunistically as a potential back-end way to seek control if the company ends up in default or bankruptcy. Maintaining confidentiality of the process is also critical, as prospective leaks to the market, employees, customers or other business relations could have adverse side effects that impair the process, increase the company’s distress or otherwise reduce your leverage.

## **Conduct (and Document) a Reasonable and Informed Process**

A plaintiff’s action challenging the transaction or related process is common for public company sale transactions, and even more likely for a distressed company. Under some circumstances, enhanced duties or scrutiny (in the event of a legal challenge to the sale process) may apply. Among others, these include *Revlon* duties—triggered upon a decision to embark on a change in control transaction (for cash)—or “entire fairness” review—applied to a transaction with a controlling shareholder or

where a majority of the board is not disinterested. The *Revlon* duty is to conduct a process to obtain the best value reasonably available for the shareholders, while “entire fairness” review considers the substantive and procedural fairness of the transaction.

Confirming the adequacy of the board’s decision making process will be the primary focus of the judicial *Revlon* review. In an “entire

fairness” transaction, the courts will look at whether both the process and consideration was substantively fair to your shareholders. Consider forming a special committee to oversee the process where “entire fairness” applies, as this may shift the burden of proof to the plaintiffs and otherwise provide favorable “optics.” In any case, maintaining an appropriate record of your decision making process will be critical to defending against any legal challenge. If solvency is questionable, structuring a process that considers the interests of the debt holders may be helpful in defending (or discouraging) litigation by your debt holders. The focus under such circumstances should be on designing a process to maximize the value of the enterprise for all of its residual beneficiaries.

## **Insist on Certainty of Closure**

For a distressed seller, there may not be a second chance if the first deal busts. Seek to minimize the “buyer outs” (and lender outs)—including

narrowing the “MAC out”—and obtain a specific performance remedy, if possible. The focus should be on ensuring certainty of closure, both contractually and practically. Understand the closing risks assumed by the company and the remedies in the merger agreement. You should also understand if there are any uncertainties around remedies or buyer’s termination rights. Conscious ambiguity should be avoided where possible. If buyer’s

*Consider a cooperative approach with your debt holders if your company has significant indebtedness that could be modified, exchanged and/or assumed in connection with the transaction.*

remorse sets in, an unclear contract may hamstring a seller’s leverage, limit recourse and drive a seller to the settlement table sooner than preferable.

## **Understand and Limit “Execution” Risks**

You don’t want to wake up to find out that the buyer’s financing source is the next massive Ponzi scheme. Diligence all third party financing or equity sources for “red flags.” Know the track record of the buyer and its financing sources and assess the practical execution risks. Prior actions may be a good indication of future actions if the going gets rough. With a strategic buyer, consider if the buyer can afford the company without the debt financing, and how that could affect a specific performance remedy. Consider if there are regulatory or antitrust risks, or “political” risks (i.e., Exxon-Florio) if the buyer is foreign controlled or owned. Additionally, if you are accepting an “option deal” as a distressed seller, understand the

trade-offs and weigh the walkaway risk relative to other offers or strategic options (and inquire about management’s “contingency” plans). As noted below, “timing” is another critical execution risk to factor. Consider these execution risks and “discount” for these risks as appropriate.

## Consider Potential Shareholder Reaction

Companies can have widely varying shareholder bases, with widely varying investment profiles or “activist” inclinations. Sale transactions are not immune from shareholder activism, from either existing or opportunistic shareholders. For a distressed company, selling when the stock price is low may draw additional skepticism and scrutiny. While you cannot predict activism from opportunistic shareholders, you can diligence your current shareholders and prepare to swiftly and appropriately respond to any public or private deal agitation. A strong and clear message supporting the board’s decision making, or (if applicable) the strategic benefit of a combined company, will go a long way to ensuring the support by the institutional shareholder base (and shareholder advisory groups such as RiskMetrics). This messaging should be conveyed as quickly as possible following the deal announcement, and clearly articulate the unified support of the board of directors.

## Timing is Everything

For a distressed company, time is of the essence—to avoid potential defaults on indebtedness, for employee and business retention and a myriad other reasons. Tender (or exchange) offers are frequently the fastest way to complete

a transaction, often avoiding protracted SEC review or excessive time for activist shareholders to mobilize against the transaction. Additionally, consider whether the identity of buyer may adversely affect the company’s business relationships, suppliers or customers or otherwise delay any requisite third party consents. Significant customer, supplier or partner defections could cause a buyer to get cold feet.

## Ensure Continuity of Management During Process

Employee “stress” has special emphasis in any distressed company, and key employees may

*In an “entire fairness” transaction, the courts will look at whether both the process and consideration was substantively fair to your shareholders.*

have been shopping their resumes even before the sale process. Confirm with management that appropriate change in control protection and/or stay arrangements are in place to help ensure key managers remain with company to facilitate the process and focus on business pending the deal, and to limit attrition if the deal falls apart. If management stock options will be washed out for little or no consideration, consider other means to incentivize management in connection with the transaction, if necessary. For example, while a board needs to be sensitive to the optics to its shareholders

or creditors, transaction bonus arrangements may be an appropriate exercise of fiduciary duties under certain circumstances.

## Review D&O Indemnification and Insurance Arrangements

Confirm the adequacy of the company’s D&O policies prior to executing a transaction agreement, as the cost and scope of any “tail” coverage is frequently part of the transaction negotiation. Such policies should also be scrutinized to understand coverages in the event of a bankruptcy—i.e., as a result of a failed sale. Additionally, push for customary post-deal contractual indemnification protection from the buyer in the merger agreement, with express acknowledgement that the directors are third-party beneficiaries of this agreement.

## Ask Questions, Then Ask Some More

Don’t be complacent or place undue reliance on your advisors or management. Question all “red flags.” Given the likely scrutiny of the transaction and decision making process, be vigilant in ensuring you are fully informed and exercising due care under the circumstances. You have a right and an obligation to be informed.

Ryan D. Thomas is a partner in the Corporate and Securities Practice Area at Bass, Berry & Sims PLC, and counsels boards and companies on corporate governance, shareholder activism, M&A and securities matters.

# Compliance and Ethics Programs

By Andrea Falcione and Kirsten Marcum

## Eight tips for proper board oversight



Andrea Falcione



Kirsten Marcum

**W**hat should boards and senior management look for in a compliance and ethics program? How can they adequately assess their companies' efforts?

The following eight tips will help you evaluate whether your company has the world-class

ethics and compliance program that it both needs and deserves and are based on 13 years of experience designing and deploying such programs.

All boards of directors should require their companies to establish and maintain compliance and ethics programs that, at a minimum, meet the criteria set forth in the U.S. Federal Sentencing Guidelines for Organizations (Sentencing Guidelines), as described in our tips below:

### 1. Compliance Standards and Procedures

Appropriate standards and procedures are the foundation of any compliance and ethics program. Your company must adopt standards and procedures to prevent and detect criminal conduct. The board should be sure that the organization's compliance- and ethics-

related policies and procedures have substance, have depth and are easily understood by the average employee.

### 2. Designated High-Level Compliance Personnel

The Sentencing Guidelines require that boards of directors exercise reasonable oversight of their companies' compliance and ethics programs. Directors should understand both the risks facing the organization and the compliance and ethics activities designed to address those risks. Boards should schedule regular and substantive compliance and ethics briefings by appropriate members of senior management.

In addition, the structure of your company's compliance and ethics department is crucial. A member of high-level personnel—such as a chief compliance or chief ethics officer—must be charged with overall responsibility for your organization's program. Your chief compliance officer must have access to both senior management and the board of directors for maximum efficiency and effectiveness.

As a director, you should insist upon adequate resources for the program. In the event of a catastrophic compliance or ethics failure, the government *will* assess whether the company's compliance efforts are genuine or whether they evidence merely a "paper program."

### 3. Personnel Screening Related to Program Goals

To meet the Sentencing Guidelines' standards, your company's general

hiring and promotion practices must incorporate compliance- and ethics-related candidate due diligence. That due diligence should include appropriate reference and background checks, within the scope of the law. The board of directors should require the company to promote both ethical conduct and a commitment to compliance with the law when making hiring and promotion decisions.

### 4. Training and Communication

Training and communication are two of the most critical aspects of an effective compliance and ethics program. Compliance and ethics education must be required organization-wide—from the board to employees to agents (as appropriate). As a director, you should ensure that compliance and ethics education and communications are ongoing, updated and appropriate to each group's roles and responsibilities at the company.

### 5. Monitoring and Auditing

All organizations—public and private, for-profit and non-profit—should establish auditing and monitoring systems to detect criminal conduct. Boards should insist that their companies institute and publicize a system for employees and agents to report or seek guidance about actual or potential criminal conduct.

A compliance hotline phone system and/or a web-based ethics helpline is an important foundation of any effective compliance and ethics program. As a

*(continued on page 45)*

# Three Keys to Building a Board Fast

By Bonnie W. Gwin

## When you need to get it done now: need, speed and heed



Bonnie W. Gwin

**U**nder ordinary circumstances, companies may be faced with filling a board seat only every few years and can do so at a

fast but deliberate pace. But under extraordinary circumstances—an IPO, a bankruptcy—filling out a board may feel like an attempt to get into the Guinness Book of World Records: *find 12 directors in 60 days*. That challenge appears daunting enough when you simply multiply by 12 the process of identifying several candidates for each seat, vetting them, and successfully recruiting the finalists. Compress the time-frame into a few months or weeks and the challenges grow exponentially.

The stakes are also unusually high. With an IPO or emergence from bankruptcy, a company is fundamentally being reborn. If the public offering is to succeed or the company just out of Chapter 11 is to survive, there is little room for error. Yet the company must create the right board as fast as possible.

Further, few mistakes are harder to undo than appointing an unsatisfactory board member. Executives can be fired. It is difficult to ‘fire’ a board member and most boards are reluctant to force out one of their members. They just do not want to be put in that position. When a board is being formed from scratch and against

the clock, the likelihood of poor ‘fits’, especially culturally—greatly increases. While a well-established board may be able to manage around the occasional ineffective or inattentive member, a company at a crucial moment in its history cannot afford the luxury of even one such member, much less several.

Decision-makers can avoid these pitfalls by adhering to three proven principles for building successful boards under extraordinary circumstances—principles that can be encapsulated in a simple, cut-to-the-chase mnemonic: *need, speed, and heed*.

- Identify the specific skill sets the board will need.
- Design the selection process for speed.
- Give candidate assessment its proper heed.

The first of these principles is generic, in that it applies to any board search. The remaining two are intended to resolve the inherent conflict between time pressure and due diligence. Together, these three principles and their practical application can ensure an efficient and effective process for reaching the ultimate goal: the creation of the best possible board to represent shareholders.

### Identifying the Need

Although identifying the skills the board will require to meet strategic

goals is critical in any director search, the sheer number of seats to be filled greatly complicates the challenge in building a new board or adding numerous members simultaneously. A stable company with one board vacancy has only to fit the skill set and style of a new board member into the already well-known skills and culture of the current board members. There is, in effect, only one variable. When the skill sets and styles of all of the board members must be identified and made to fit into a coherent whole, the equation entails multiple variables that must be worked out almost simultaneously.

The problem can be greatly simplified by having all interested parties together develop a strategic profile of the board-to-be. In an IPO, the parties would include the current management team and the existing board. In a bankruptcy, it could include bondholders, shareholders, a member of a bank workout group, a representative of a hedge fund or PE firm that has a major stake in the company, and others. In both cases, the strategic objectives are likelier to be more near-term—market traction for the IPO, survival for a post-Chapter 11 company—than long-term.

Nevertheless, in the case of bankruptcy, the objectives of the various constituencies will often conflict. But at the end of the day, after all of the intense and contentious discussions, everyone should be able to unite around

the principle of securing a board that can help management recoup as much value as possible. That means that in addition to having the right mix of expertise for the newly reorganized company and the specific capabilities required to cover all areas of board responsibility, such boards should have the right dynamics for tough decision-making.

Often in such cases, seats have been allocated to various interested parties, who may already have their candidates in mind. Even so, such unilateral decisions should be made in the context of the overall desired strategic and cultural profile of the board, not in terms of narrow interest.

## **Designing the Process for Speed**

Even under extraordinary time pressure, companies don't usually let the deadline slip for having their boards lined up. Instead, they sometimes do something much worse. They hastily fill the seats regardless of whether the appointees possess the right skills or the board will have the right dynamics to be effective. In the absence of a structured, well-timed process for selection, they find themselves at the eleventh hour forced to make rushed decisions, sometimes poor ones.

To avoid this pitfall, the key stakeholders should start with the end date in mind—when acceptance of offers of appointment should be finalized—and work backwards from that date to establish major milestones in the process:

5. Final decisions on candidates
4. Referencing of candidates
3. Candidate interviews and assessments

## 2. Identification of candidates/Initial referencing

### 1. Identification of needed skill sets

The real challenge of course is to adhere to the schedule. Because there are so many seats to be filled and so many potential decision-makers in an IPO, it is often a good idea to establish a neutral panel to conduct the process—to serve, in effect, as the nominating committee. In a bankruptcy, the composition of the panel will be determined by the interested parties. In both cases, a limited group increases the likelihood of achieving the discipline an efficient process requires.

Often, the biggest obstacle is finding appropriate candidates who are willing to serve in an IPO or following a bankruptcy, given that both situations require directors to devote a lot of time to their roles and entail more than usual personal risk. A search firm that has already identified a pool of candidates who have expressed interest in serving in such circumstances can greatly help streamline the process.

## **Taking the Proper Heed**

In the best of times, it is absolutely critical to take extreme care in selecting board members. In the worst of times, it is even more important. The same goes for an IPO. But with the clock ticking and so many seats to be filled, it is tempting to take what may appear to be a reasonable shortcut: appoint people who don't need to be assessed for the job. Simply recruit people who have an impeccable resume or bear a well-known name likely to excite stakeholders, the media or potential investors. These known quantities seem to solve at a stroke the dual challenges of speed

and heed.

Yet we have all had enough experiences with things that look good on paper to know that that is a poor criterion on which to base important decisions. Compromising on the assessments of candidates is risky. No matter how good candidates look on paper or in the press, they should be thoroughly referenced and interviewed face-to-face by the decision-makers in the selection process.

Here again, a search firm can assist with referencing, assessment tools and structured interviews. These tools can enable decision-makers to measure candidates against required skill sets, create the right mix of skills for the board overall, compare candidates, and ensure the right dynamics for the board. Having an extra set of professional eyes in the process can also help ferret out any problems early on and save the company from going down blind alleys or, worse, making poor decisions. Interviews are particularly important and needn't be inordinately time-consuming or grueling. For example, interview days on which numerous candidates are scheduled to meet with the decision-makers provide a means for interviewing candidates that is both efficient and thorough. There is simply no reason to let time pressure short-circuit what is, after all, the essence of any disciplined selection process: genuine assessment.

*Need, speed, and heed.* None of these three steps need be onerous, but neither should any of them be neglected. Time may not be on your side, but it doesn't have to be your enemy.

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Bonnie W. Gwin is managing partner, North America, Board of Directors Practice, Heidrick & Struggles.