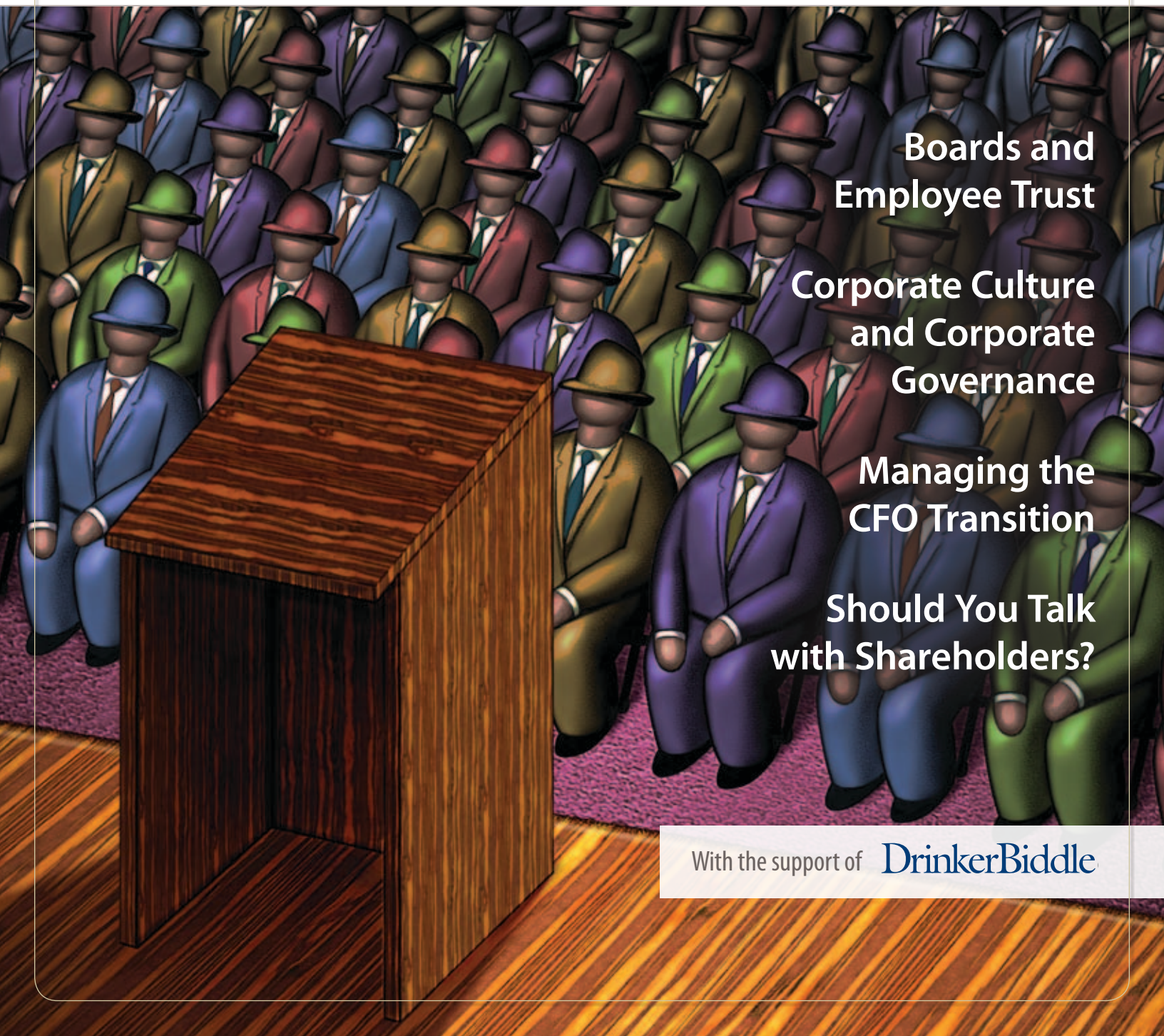


# Boardroom Briefing

A publication of Directors & Boards magazine and GRID Media LLC

## The Consultants Issue 2010



**Boards and  
Employee Trust**

**Corporate Culture  
and Corporate  
Governance**

**Managing the  
CFO Transition**

**Should You Talk  
with Shareholders?**

With the support of **DrinkerBiddle**



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# The Consultant Alchemy: Turning Risk into Reward

By James Kristie

A good adviser, if carefully selected and properly used, can be worth his or her weight in gold, says an authoritative source. We agree.



James Kristie

advice that keeps our Directors & Boards audience on the right path—in their business strategy, in their talent management, in their director recruitment, in their legal and financial affairs...in all aspects of leading and governing the enterprise.

Joseph Koletar has it right in his new book, *Rethinking Risk: How Companies Sabotage Themselves and What They Must Do Differently* (AMACON, August 2010):

*“If you deal with risk of any type, it is likely you have used or will use consultants at some point. There are perhaps almost as many consultant jokes as there are lawyer jokes, but a good consultant, if carefully selected and properly used, can be worth her weight in gold.*

*“Consultants are, by and large, subject-matter experts. Through education, training, and experience, they can bring to the table a range and depth of knowledge beyond that usually found within a given corporation. In addition, they have the advantage of being outsiders. They are not confined by the social relationships present within the corporation, not are they afraid (if they*

**T**his journal has a long and proud history of publishing the best minds in the consulting sector. We do this to provide the kind of

*are good) to challenge the prevailing conventional wisdom. They also bring a fresh set of eyes. They did not create or grow up with the issue now in question, so they can be dispassionate and objective when viewing it.”*

Koletar knows his way around risk and consulting—he spent 25 years with the FBI as a special agent and senior executive and then 12 years as director in the fraud and investigations practices of Ernst & Young and Deloitte & Touche.

*We can all benefit from the fresh set of eyes that an outsider brings to a challenge.*

Who doesn't deal with risk? We all do. Thus, we can all benefit from the fresh set of eyes that an outsider brings to a challenge.

You can see where I am going with this. Read again Koletar's characterization of consultants. Does it not sound like the qualities that an independent director brings to an organization?

Many authors over the years have been struck with the parallels of the consultant role and board director role. Frequently it is in the context of director compensation—as in, “What a bargain a board is...to get such talented players giving advice on your

key issues for the price of a director retainer...we could never afford such a body of experts if we had to pay them as consultants.”

You will find just such an observation in this Fourth Quarter edition's cover-story debate on “Are Boards Underpaid” when you read the analysis by Allan Grafman, a board advisor and director, which contains this keen observation: “When the board *as a group of five to 10 members* is paid less than a modest consulting assignment, they are underpaid” (emphasis his).

Another “value-add” dimension of this topic is the significant representation on boards of consultant-directors. In the third quarter of 2010—the period covered in the Directors Roster on pages 66-78—consultants comprised 7% of newly elected board members. For the year 2009, according to our Roster research, consultants comprised 5% of all new directors. At first blush that may not sound like a lot. But this representation is actually greater than the number of self-identified consultants we track. If we were able to pull back the veil on the huge cohort of retired executives named to boards—37% in the most recent quarter; 40% for year 2009—we would find many of those still keeping their hand in as consultants.

Such a board member, by some reckoning, might be seen as inherently bringing a double set of fresh eyes to an organization's risk issues—that of the consultant, and that of the

*(continued on page 58)*

# Today's Boards Have a Role to Play in Building Employee Trust

By Sharon Allen

Nearly two-thirds of the Fortune 1000 executives believe that employees' loss of trust in their employers will contribute to increased voluntary turnover in the coming months.



Sharon Allen

When boards provide independent management oversight and compelling strategic input, the positive impact on

business performance can be felt by consumers and investors. Today, in the midst of the most challenging economic environment in decades, the impact of board governance must register with another vital group—employees in general and, specifically, a growing percentage who simply do not trust their employers anymore.

If there is anyone who thinks that the loss of employee trust doesn't rank as a critical business issue, take just a moment to consider what we discovered from the Deloitte 2010 Ethics and Workplace Survey conducted earlier this year. In this fourth annual survey that I've commissioned since 2007, we interviewed 300 Fortune 1000 executives and more than 750 employees from outside our organization.

Among our key findings, 34 percent of employed Americans plan to look for a new employer when the economy gets better. During a time when unemployment is running at some of the highest levels since the end of World War II, one in three current jobholders say they will eventually seek work elsewhere.

Perhaps more troubling are the reasons these employees are considering a move.

*Trust is a vital aspect of the relationship between employers and their employees that cannot be held but certainly can be felt—and it does carry a bottom line impact.*

Nearly half—some 48 percent—cited a loss of trust in their employer as a major factor. Another 46 percent pointed to a lack of transparent communication from company leadership. Furthermore, nearly two-thirds of the Fortune 1000 executives we surveyed believe that employees' loss of trust in their employers will contribute to increased voluntary turnover in the coming months.

Trust is a vital aspect of the relationship between employers and their employees that cannot be held but certainly can be felt—and it does carry a bottom line impact. Several studies indicate that replacing employees can range between 25 to 250 percent of their annual salary, depending on industry and job type—costs that include attracting, recruiting, and training them—not to mention the “hidden costs” that come when productivity wanes, institutional knowledge is lost, and your talented employees are hired by a competitor. The cost of replacing a valued employee should be considered just as important as the cost of replacing a valued customer.

Clearly, the loss of employee trust is a situation that calls for decisive leadership—and not just from the C-suite. I believe that the influence of boards can have a positive impact on employee trust. In fact, 83 percent of executives

in our survey agreed that boards have a significant responsibility in this regard.

## **Boards Can and Must Get Involved**

While the directors of high performing boards exhibit trust in each other during their boardroom deliberations, seldom, if ever, is trust designated as an agenda topic for boardroom discussion. To help focus management on the importance of employee trust, boards can set the proper tone by sending an unmistakable message to management that building employee trust is an expectation that must be met.

Effective management communication is critical to building trust with employees. A survey conducted last year revealed that corporate leaders and employees shared little agreement when it came to understanding which key employees were leaving, why they wanted to leave, and what it would take to retain them. In this “tale of two mindsets,” employers focused on compensation increases and other financial incentives as important retention tools. However, employers did not appear to understand the significant non-financial priorities of their employees. “Besides effective communication, employees also expressed a desire for job security,

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# Curing the Economic Hangover

By Lord Mark Malloch-Brown, Chairman, Global Affairs, FTI Consulting

## Investing in the “second circle” countries.



Lord Mark Malloch-Brown

Developed countries are experiencing an economic hangover. Dismal financial conditions have cast a cloud over these countries,

limiting growth prospects while structural deficiencies hinder demand. Not surprisingly, to remedy the situation, companies are looking to emerging markets for growth opportunities, with the BRIC countries (Brazil, Russia, India and China) the target of the greatest interest from global investors. Yet, compared to underdeveloped nations, asset values remain high in BRIC countries, making it hard to find good deals while other emerging markets are

ignored by any global company. By 2050, Asia alone will account for over half of the world’s population while the U.S. and Europe will account for less than fifteen percent. The world economy is being transformed and those who do not change with it will be left behind.

There are attractive opportunities in the second circle with deal sizes being cheaper; however, each comes with unique requirements. Most are smaller deals than many investors are used to, yet they require a high degree of due diligence and board and management involvement. Over the past twenty years, we’ve seen the change from a buyer’s market to a seller’s market with companies in emerging economies such as Hungary and China no longer desperate for foreign cash infusions.

friends—not just footloose foreign money—and in order to capitalize on this opportunity, investors need to change. Striking the right balance between being viewed as a long-term partner with financial stability is a challenge many will face but is nevertheless imperative to remaining a major player within the global economy.

Investors and corporations once only had to focus on maximizing the underlying value of a business, but in the new post-recession economy, they must focus on buying “sleeping monopolies” that need cash, infrastructure and technology in a country that needs the same. For instance, financial nationalism is a continuing trend in Asia and something potential investors need to develop sensitivity to. Scarred from the 1997 financial crisis which was reinforced

*Emerging markets want lasting friends—not just footloose foreign money—and in order to capitalize on this opportunity, investors need to change.*

loosening restrictions and welcoming foreign investments. These nations, along with the BRICs, have emerged from the recession as the new frontier of investment with new opportunities, higher expectations and a deeper commitment from investors.

Many call these economies “second circle” nations, and they include countries like Indonesia, Malaysia, Thailand, Singapore, Egypt, South Africa, Nigeria, Colombia, Chile and Mexico. The scope of the “second circle” spans Asia, Africa, Latin America and the Middle East and includes markets that can’t be

In the new landscape, sellers have the opportunity to choose between multiple investors which have raised the stakes of the game; they are looking for a long-term partner rather than a short term influx in cash.

### Partners, Not Just Investors

Even more challenging, these companies are also looking for a partner willing to contribute to local society and overall national growth, spurring a focus on creating jobs, corporate social responsibility and tax revenue. Emerging markets want lasting

during the past few years, investors now need to be aware of unique local markets and suspicious leaders. This is mirrored in South Africa where many services are available locally but there is a strong resistance to importing services. Without this knowledge, foreign private equity investors dismally fail.

In addition to heightened sensitivity, potential investors need to shake up second circle business strategies to create globally competitive companies, capable of becoming acquirers themselves and thus, creating a multiplying growth

*(continued on page 58)*

# Corporate Culture in Corporate Governance

By Mark Rome

Directors must now take an active role in establishing and maintaining the appropriate culture and attitude for healthy and productive shareholder engagement.



Mark Rome

Within the past decade, Congress has empowered federal regulators with the Sarbanes-Oxley Act and now the Dodd-

Frank Wall Street Reform and Consumer Protection Act, with the latter paving the way for proxy access, additional executive compensation disclosures, and improved whistleblower protections.

In a number of recent webinars, the National Association of Corporate Directors (NACD) suggests that proxy access will be a game changer. The U.S. Chamber of Commerce claims that proxy access expands the role of the federal government, increases business uncertainty and costs, and stifles a company's ability to focus on long-term growth.

For long-term investors, proxy access is deemed necessary to ensure the company is on a long-term sustainable path; that directors are representing the interest of long-term shareholders; that mechanisms are in place to identify, contain, and adequately disclose risks; and that executive compensation is fair and equitable. The California Public Employees' Retirement System (CalPERS) has already engaged a firm to identify qualified director candidates in an effort to reshape the boards of underperforming companies.

If the Dodd-Frank Act has permanently altered the corporate-shareholder relationship, directors must now take

an active role in establishing and maintaining the appropriate culture and attitude for healthy and productive shareholder engagement. This includes working with management to not only ensure the right tone at the top for ethics and compliance, but also to achieve performance goals and objectives aligned with those of long-term shareholders.

## Culture and Character

In a 2007 study, Sean Griffith and Tom Baker examined how liability insurers transmit and transform the content of corporate and securities law. The findings suggest that what matters in corporate governance are deep governance variables such as culture and character, rather than the formal governance structures that are typically studied.

Corporate culture is a profound driver of any business—it determines the company's ability to execute its strategic vision and mission. Leadership and corporate culture excellence are essential to company performance and organizational well being. The "tone at the top" shapes corporate culture and drives the organizational behavior, which pervades internal and external relationships.

All the soft controls in an organization together constitute its corporate culture. The corporate culture will drive the success or failure of the corporation as the corporate culture is the most powerful control in any organization. It influences every employee's behavior.

Research conducted by the Institute of Internal Auditors suggests that a

company can assess the soft controls that define a company's corporate culture. Introducing a measure for corporate culture into the marketplace could improve board-shareholder communication and, ultimately, reduce the need for more federal regulation.

Evaluating the soft controls makes it possible for representatives from the legal, finance, and investor-relations departments to specifically quantify the various risks affecting the company, their potential impact, and whether that impact warrants disclosure.

Jonathan F. Foster, managing director of Current Capital, explains that while splitting the leadership of a company and its board generally improves governance, the quality of the people is the key factor for success. "The reality is that even the worthiest regulatory fixes and policy enhancements are not nearly as significant as the quality of the people involved."

Including a measure for corporate culture in proxy solicitation materials would give directors as well as shareholders a better understanding of risks specific to the company and its operations. Providing senior leadership and the board with a valid, independent source of risk intelligence could make it possible to identify leading indicators of economic performance, and allow directors to better understand what the company does well, and where they can do better.

Monitoring soft controls throughout the corporation could provide an early warning of problems and unintended

risks; extended visibility into the organization to correct problems and mitigate risks; and serve as a check and balance to ensure that the organization is optimized to drive business returns with integrity, transparency, accountability and comprehensive risk oversight.

Adopting a measure for corporate culture also addresses a number of shortcomings in the marketplace, including:

1) Ratings by credit rating agencies that evaluate a company's creditworthiness have proven to be unreliable and impossible to measure.

2) The outside auditors' audit report—which is the sole communication between auditors and investors on a particular company—explains the auditors' role and their limitations in finding fraud.

a. The disclosure of financial problems tends to come after the fact.

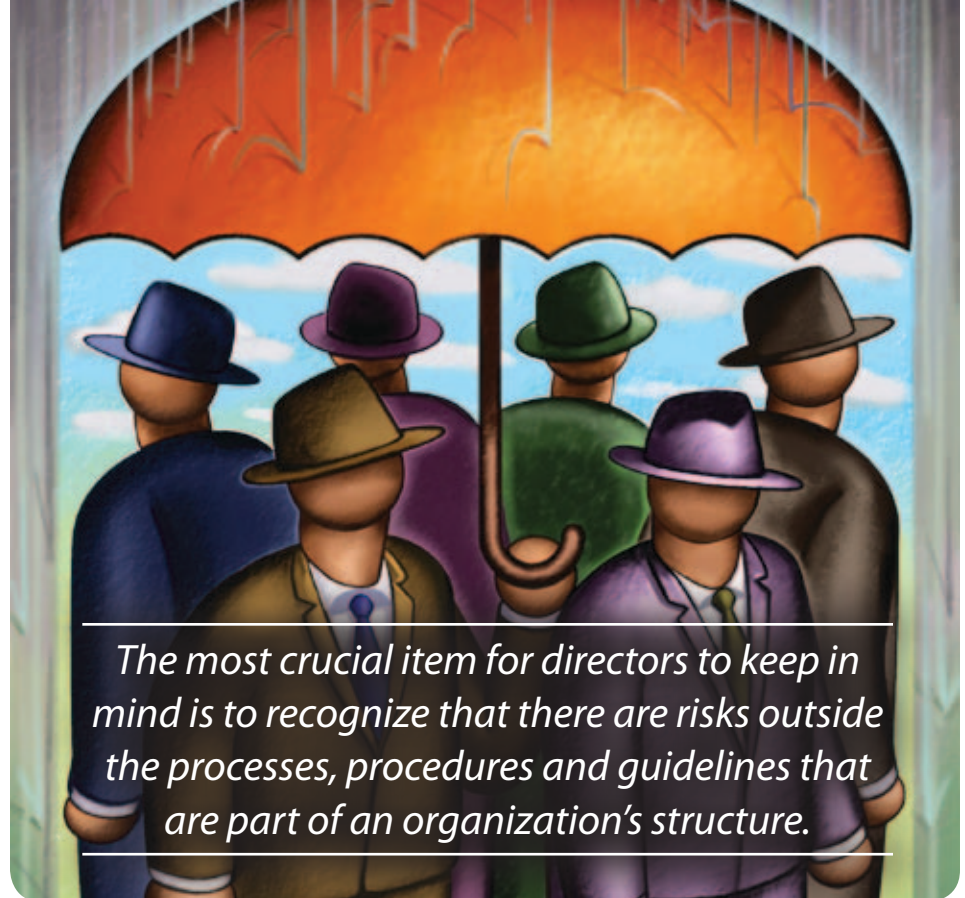
b. Auditors don't examine every transaction and event, so there is no guarantee that all material misstatements, whether caused by error or fraud, will be detected.

3) Securities analysts that assess the company's business prospects may not be independent, and their analysis has sometimes proved to be unreliable, biased and misleading.

4) According to SEC chairman Mary Schapiro, "Both companies and investors have raised concerns that proxy advisory firms may be subject to undisclosed conflicts of interest, may fail to conduct adequate research or may base recommendations on erroneous or incomplete facts."

## **Proxy Access as Opportunity**

Proxy access presents a unique opportunity for directors to increase their



*The most crucial item for directors to keep in mind is to recognize that there are risks outside the processes, procedures and guidelines that are part of an organization's structure.*

power and influence in the boardroom when there is an apparent disconnect between strategy and risk. Most of the key risk factors impacting a company relate to the company's strategy. Yet many directors seem not to fully understand the strategy, nor have they been engaged in strategy development and review in a way that would give them a good understanding of some of the risks that may emanate from that strategy. Notably, in the 2009 NACD public company governance study, strategic planning and oversight was rated the top issue of importance to board governance, yet less than 20% of respondents ranked their boards as highly effective in this area.

The most crucial item for directors to keep in mind is to recognize that there are risks outside the processes, procedures and guidelines that are part of an organization's structure, and it is incumbent upon the board to identify and manage those risks. Valid risk and operational intelligence must be acquired from the various silos within the organization and elevated to the appropriate board-management level in a timely manner to achieve the desired levels

of performance, properly oversee risk, and avoid costly mistakes.

The board has a responsibility to serve as "keeper" of the corporate culture—which is increasingly critical as a board duty—and it must ensure the right culture for its management and employees to operate in without fear of reprisal for reporting deviations from acceptable cultural norms. A lax culture permits employees to take myriad shortcuts and unacceptable risks. In practically any corporate scandal that allows a material risk to go undetected the question arises, "Where was the board?"

It is clear that the effectiveness of corporate boards will not be measured simply by a regulatory checklist, but by the ability of institutional investors to gain insight and assurance that cultural risks are considered as part of risk oversight responsibilities to maintain the corporation as a going concern and improve long-term business performance.

Mark Rome is the CEO and founder of zEthics, Inc. He can be reached at [mrome@zethics.com](mailto:mrome@zethics.com).

# Resist or Cooperate? The Enduring Dilemma for the Corporate Defendant

By Thomas C. Green

My experience suggests that resisting the investigation almost always leads to a better result for the company than had it surrendered at the outset.



Thomas C. Green

Almost every corporate official and board member will, at some point, have to confront the question of whether it is better to surrender and buy peace or better to resist and defend in court...or at least prepare to defend in court.

I understand that there are many, both in my profession and in the business community, who would argue that resistance is not an option. And, admittedly, they could point to myriad incentives to acknowledging wrongful conduct quickly and cooperating with the government, whatever the cost and whatever the outcome. Their view is that the risk of trial and conviction with substantial penalties, as well as debarment or exclusion under federal law, all accompanied by incessant adverse publicity, is too great to bear. Nevertheless, my experience suggests that resisting the investigation almost always leads to a better result for the company than had it surrendered at the outset.

The principal objective of resistance is the development of defenses and other legal obstacles to convince the government to agree to settlement terms better than those that would be achieved through instant cooperation. There is no secret to this process:

On any given day, countless corporations and their officials are under criminal investigation by federal and state prosecutors or agency officials.

the only tactic available is to make the government just as fearful of the eventual outcome of the investigation as you are. The more insecure the government becomes about its case, the better chance for a successfully negotiated outcome.

When a corporation rushes to disclose to the government the results of its own internal investigation, or signals a desire to resolve the government's allegations early, the wrong message is sent. The most that can be said for such an approach is that fear of the unknown is traded for certainty, but that certainty is both expensive and painful.

The Justice Department's internal guidance to prosecutors in deciding whether to charge corporate defendants embraces a strategy of seeking deferred prosecution agreements rather than convictions if the organization commits to a rehabilitative program and adopts corrective action. But cooperation is very expensive and includes resource-intensive review and production of enormous amounts of documents and access to all relevant (and some irrelevant) corporate employees. More important, the early cooperation strategy forces corporations under investigation to make critical decisions early—perhaps even before the corporate decision-makers themselves know the relevant facts. A decision to begin cooperating immediately also eliminates any chance the corporation would have of mounting an effective defense. In addition, the costs of settlement and structural reform can be immense. Under deferred prosecution or cooperation agreements,

the cooperating company will likely obligate itself to undertake extensive compliance or monitoring programs. These can last for years, sending costs skyward and spinning off new problems, issues and inquiries.

## The Risk of Losing

It is important to understand that government prosecutors are well aware of the risks associated with going to trial. The foremost risk is the risk of losing, and if their adversary is a successful trial lawyer, they are more fearful of losing. It is possible to rob government prosecutors of their confidence through a combination of tactics, including treating the prosecutors to ongoing presentations of well-reasoned and well-written arguments which expose legal and factual flaws in the government's theories; by pointing out mistakes and misconduct in their investigation and, if necessary, by winning challenges to an indictment or complaint or by winning other pre-trial motions based on evidentiary objections and theories of defense.

Because a corporation will always have easier and quicker access to its personnel and its documents than the investigating agents, it will have an unquestionable advantage and the ability not only to learn more than the government knows, but also to understand what the government is learning—and what it is missing. In addition, in many settings, the company's defense team will possess more experience, imagination and creativity than the government's lawyers. The result is that experienced and seasoned counsel can almost always

develop legal and factual theories of defense which prosecutors might not anticipate or be well prepared to meet.

Moreover, signaling that the company will not choose settlement and cooperation at all costs may cause prosecutors to rethink their own cost-benefit analysis. The government has limited resources, which it seeks to leverage by inducing cooperation. When a corporation refuses to cooperate, the investigation requires a substantially heavier investment of government time and money. Actually charging a defendant and trying the case drains even more resources. When faced with a non-cooperating defendant, a prudent prosecutor may be motivated to confront the weak links in his or her case and to offer improved settlement terms. The bottom line in almost all cases is that good prosecutors often are willing to listen and evaluate good defense arguments despite their bravado and their constant refrain that “the train has left the station.” The reason for that refrain is that time is hardly ever an ally of the government.

## At Trial

If a corporation is forced to trial, there are still options. Although there are certainly exceptions, many of the prosecutors who won't listen usually are overly optimistic, inexperienced or otherwise unable to see the flaws in their cases. Experience teaches that the government's evidence and legal theories almost never improve during a trial. Prosecutors frequently overcharge and over try their cases, trying to prove too many violations or crimes by calling too many witnesses and introducing too many documents, often causing exasperation on the part of the judge and jury. Contrary to popular belief, many prosecutors possess relatively little experience in complex trials. If they become overzealous, they are prone to make serious mistakes in

*The early cooperation strategy forces corporations under investigation to make critical decisions early—perhaps even before the corporate decision-makers themselves know the relevant facts.*

tactics and judgment. And a potential defendant should never underestimate how seriously jurors worry about fundamental fairness and dislike any notion of the government “piling on.” Finally, even if the corporation loses at trial, the fact remains that very often the jury's verdict on liability or the sentence of the court is far less severe than the government's settlement offer.

That leaves us with the risks of debarment or exclusion which are, in my view, overstated. Since the 1990s, only a handful of large contractors have been suspended, and many of them had engaged in egregious misconduct on a large scale—think of Worldcom and Enron. Many other large contractors have undergone suspension or debarment for only a brief period of time—GE for five days, and more recently IBM for a period of eight days in 2008. These companies are so big and so important that the government cannot live without them. Significant contractors have a high probability of obtaining a waiver of suspension or debarment if adequate, alternative supplies are unavailable or if no other contractor can provide the goods or services in a timely manner. For instance, during an unusually long 20-month suspension beginning in 2003, Boeing received multiple waivers for contracts totaling over \$100 million. Finally, suspension and debarment are to be imposed only to protect the government from contractors that are not presently responsible. Thus, while misconduct may result in criminal or civil liability, a corporation which is able to demonstrate that it has remedied wrongdoing should be eligible to compete for contracts going forward.

Perhaps the least quantifiable factor that drives companies to cooperate is the fear of adverse publicity that might accompany a trial or conviction. However, bad press, a depressed stock price and shareholder suits are equally likely to follow full cooperation with an investigation and eventual settlement. Efforts to minimize the risk of adverse publicity have to be realistic and measured against the prospects of achieving more attractive settlement terms and the chance for ultimate vindication at trial.

I understand that the risk-benefit analysis suggested herein is delicate, but corporations, boards, and executives under investigation should never fail to undertake a serious analysis of whether they could improve any outcome by resisting the government's charges.

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Thomas C. Green for many years managed Sidley's federal and state investigation and white collar defense practice group in Washington, D.C. Mr. Green is a nationally known and highly regarded trial lawyer who has tried countless complex criminal and civil cases. In June of 2009, Chambers and Partners selected Mr. Green for its USA Award for Excellence in the field of White Collar Criminal Defense and Government Investigations. In June of 2010, he was featured in the National Law Journal as one of 11 “Winning” litigators in the United States, and in October of 2010, Ethisphere Magazine named Mr. Green to its Hall of Fame honoring “Attorneys Who Matter” in the United States. In 2003, in a nationwide poll conducted by Corporate Crime Reporter, Mr. Green was selected as one of the top five white collar defense lawyers in the United States. He has been selected by his peers over 25 successive years for inclusion in the top tier of “Best Lawyers in America,” and was recently named Best Lawyers' 2011 Washington, D.C. White Collar Lawyer of the Year.

# Boardroom Activism: Talk with Shareholders?

By William Keiper

Board-shareholder communications could play an important role in improving company governance and performance.



William Keiper

Over the past few years companies across the globe have experienced an unprecedented upheaval and meltdown in financial markets, currency gyrations, political unrest and joblessness across all strata of the workforce. Boards today are working in an international environment where many variables once seemingly distant from the board governance process are now a part of the dialogue. Investors are faced with these same complex challenges, but with far more limited visibility into the thinking and management of even the so-called controllable (or at least ‘influence-able’) elements of the business.

Shareholder inputs (if heard at all by the board) are typically filtered in some fashion through the C-level officers of the company or investor relations. There

However, I believe there are at least three things wrong with this approach as the exclusive way for independent board members to receive shareholder input. First, it empowers the messaging intermediaries (who are clearly not disinterested). Second, it presents a ‘spin’ opportunity which could result in dilution or distortion of the message. Third, it reinforces the persistent isolation of independent board members from key shareholders. As opposed to direct board member-shareholder conversation, the actual practice is at best irrational and at worst dysfunctional.

## Direct Access to the Board

Although communication between these intertwined business constituents rarely occurs, it could play an important role in improving company governance and potentially company performance. I recently spoke with a senior analyst with a well-established investment management firm who said, “In my 10 years as an analyst, *I have never engaged with a non-executive director*

also on investors in an attempt to speak more actively with the board.”

For independent board members to act as effective and informed representatives of the shareholders, the viewpoints and opinions of institutional and individual shareholders should not only be delivered by management, but be accessed through more direct means. Dialogue between non-executive directors and shareholders that is unfiltered by management and others formally responsible for shareholder relations is a way to do this.

The conventional wisdom has been for the board to “speak with one voice” and the voice has typically (and properly) been that of the CEO. As the president and/or CEO of three public companies, I have had insightful and productive one-on-one dialogues with hundreds of hedge fund managers and other investors. In my role as CEO, I certainly would not have been happy with investor-board member conversations to which I was not a party. In my view at the time, it would represent just one more variable to look after.

There is, however, a strong case to be made that every board can be more effective by listening firsthand to shareholder perspectives on at least selected issues. Consider the value of non-executive directors understanding shareholder opinions about director recruitment, board assessment and performance, compensation structure and CEO succession. Even if the process is somewhat uncomfortable, objective

*(continued on page 58)*

*Due to public company regulatory and disclosure requirements, professional legal and financial advisors will almost without thinking urge non-executive directors to keep their distance from shareholders.*

are good and well-established reasons for this, including deep knowledge of the company at a level expected by professional investors and staying ‘on message’ as it relates to company positioning.

despite at times owning positions large enough to exercise significant influence...” He also said, “The burden (for such communication) should fall not only on the non-executive board members to engage with investors, but

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FORESEE RISKS  
> ADVISE ACCORDINGLY

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# Managing the Risk of a CFO Transition

By Dick Hissam

While much board attention is focused on the issue of CEO succession, there is another key role that directors should consider as part of risk management—the CFO.



Dick Hissam

In the past ten years, the CFO's role has continued to grow in breadth and complexity with the advent of SOX and other regulatory requirements, and turnover

has reached historical levels. Most CFOs are now making do with increasingly slim staffs, setting the stage for additional turnover.

What makes CFO turnover especially problematic is that companies, especially those in the middle market, typically lack someone on the finance team with the technical knowledge, political savvy and strategic perspective to step into the role, even for the short term. CFOs must

of risk. But there are steps you can take to mitigate those risks.

## Understand the Impact of a CFO Transition

The CFO serves as a company's financial steward and watchdog, providing business strategy support, horizon watching, insight and analysis into financial and operational performance. During a CFO transition, the Controller will most likely be able to maintain daily operations. However, financial leadership, strategy and direction may suffer, which can impact potential mergers and acquisitions, financing negotiations and the ability to respond to board requests and CEO priorities.

A CFO transition can also impact the organization's credibility with outside stakeholders, such as investors, lenders and private equity owners. During

During the economic downturn, most companies cut budgets and reduced staff sizes, adversely impacting the depth of financial talent on which the CFO could rely. However, the organization's needs have not lessened. In fact, CFOs are under pressure to accomplish more than before due to increased financial risk. Most have more objectives, priorities and initiatives than they can realistically deliver.

CFOs aren't the only ones suffering as the result of economic pressures, but they are often held accountable for poor results. The decision to terminate a CFO because of financial challenges is premature in many cases and misdirected in others, often addressing the symptom and not the underlying problems.

A costly termination and a lengthy, expensive search often exacerbate the problems instead of solving them. This is especially true if the new CFO inherits a situation identical to—or worse than—the one held by the predecessor. If the CFO role has turned over two or three times within one CEO's tenure, the issue may not be performance but rather an impossible position.

Every audit committee should consider an independent evaluation of the entire finance function (the office of the CFO) to ensure that the existing CFO has been given appropriate support around information systems and corporate governance, including the qualified resources to get the job done. A terrific

*With today's "lean" organizations, a CFO exit strains the finance team, the organization and the board.*

navigate complex market conditions, meet stringent regulations, mentor staff, support business lines, satisfy investors and provide day-to-day financial leadership. These tax the most talented financial officers, and with today's "lean" organizations, a CFO exit strains the finance team, the organization and the board.

If your company is experiencing a CFO transition, either planned or unplanned, there are predictable areas

a CFO vacancy, companies must assure stakeholders that risks will be mitigated.

## Think Again Before You Terminate

If your company is considering a change in CFO leadership, make sure you thoroughly understand the facts and reasoning behind this decision. Are you in need of a CFO transition, or are you just "shooting the messenger?"

CFO who lacks proper resources and support can put the company in jeopardy, and the audit committee should take action to mitigate this risk.

## Align the Role to the Organization's "Life Stage" Needs

The basic recruiting criteria for a public company CFO are relatively straightforward—background in finance/accounting; comfortable with public company financial reporting rules, internal controls, risk management, budgeting and operational analysis; strategic insight; able to provide expertise and insight to a broad range of stakeholders; and able to lead a finance operations team.

As the list grows, the combination of qualities becomes a more difficult blend to find. An effective CFO must demonstrate not only strong technical, analytical and business acumen, but also "soft skill" competencies—communication, problem solving, negotiation, conflict resolution, collaboration, relationship management and coaching and mentoring.

The odds of a successful "fit" are improved by looking for a CFO whose expertise matches that of your company's current "life stage," or the five-year goals your company is trying to achieve. For example, if your growth plan includes acquisitions, you need a financial leader who can negotiate deals and understand the complexities of valuations and post-merger integration. These needs are dramatically different from a business that needs to improve financial efficiency and achieve a turnaround. The track record of navigating a certain type of financial terrain outweighs factors like industry experience, and must be part of the recruiting criteria.

## Use Interim Leadership to Minimize Risk

During financially difficult times, there is temptation to leave the CFO seat empty during the three to six months that a search is likely to take and employ the company's Controller to keep the ship moving. However, this approach often overwhelms the finance team and removes a key strategic perspective from the boardroom.

Hiring an experienced interim CFO is a growing trend that can have long-term benefits. This option enables the company to tackle targeted management initiatives, such as an

acquisition or a restructuring, while the CFO search is underway. The interim leader can then help on-board the new CFO, potentially smoothing the transition at both ends of the search period. Similar to a relay team, an interim CFO can advance the company's immediate objectives and then pass the baton to a permanent CFO.

Sometimes, business conditions are too uncertain to warrant immediate rehiring. If a business unit is for sale or encountering difficulty, finding a permanent executive may be difficult. An interim CFO with experience in similar situations can help navigate the difficult waters absent the attendant distraction of longer-term career considerations.

## Address Core Issues to Avoid Future Turnover

When CFOs are highly dissatisfied or the finance function is impaired, there are often two key points of

weakness in the office of the CFO: the controllership function and information technology. A lack of competent functional managers, technical expertise below the level of the CFO, or IT systems will create a crack that grows over time into an extreme fissure in performance.

Many companies have reduced staff without enhancing the technology infrastructure required for accurate financial reporting or managing financial drivers like inventory. This creates a cycle of dependency on manual processes to derive management reports, which then breeds errors and burnout in key positions

*Are you in need of a CFO transition, or are you just "shooting the messenger?"*

within finance. Enhanced systems and processes—intelligently designed information flow—can ease regulatory reporting, audit committee concerns and peer requirements. Making a strong commitment to IT investments on the front-end will save time, money and heartache in the long run.

Like any executive change, the potential for risks during a CFO transition is significant without a plan for mitigation. Examining causes (not symptoms) behind a transition, making changes to better support the CFO and his or her staff, and employing flexible leadership for additional support when needed can help avoid a messy transition that negatively impacts your company's operations, morale and results.

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# Assessing the Implications of Healthcare Reform

By Randall K. Abbott

Healthcare reform's larger strategic considerations and the opportunities for officers and directors to rethink their organization's role in health care.



Randall K. Abbott

**H**ealthcare reform is a transformational moment in American history that will affect every American citizen and virtually every employer

starting in 2010. For employers, it is not just a health benefits consideration; it is a total business issue that will materially influence total compensation, the employee value proposition, workforce planning, long-range business plans and corporate finances.

The law calls for insurance reforms, broader access to health coverage and the creation of state-based insurance exchanges. It also introduces a substantive excise tax on so-called "Cadillac" benefit plans which is designed to deter overly rich benefit plans and create a tax revenue stream to help offset the expense of the law. Healthcare reform, as it affects employers, can be divided into four major tranches, by time frames: Immediate Compliance (2010-2011), Pre-Exchange (2010-2013), Post-Exchange (After 2014) and Introduction of the Excise Tax (2018).

## Immediate Compliance

Immediate compliance began with the law's passage on March 23, 2010, and affects most employers as of January 1, 2010, to some degree. The mandated changes include the popularly known provisions of covering adult children to age 26, eliminating lifetime benefit limits and phasing out annual benefit

limits. These provisions affect nearly all employers as of January 1, 2010. Other provisions, such as the liberalization of preventive care services and coverage of these benefits at 100%, become effective when a plan ceases to be "grandfathered" under the law. Grandfathering is determined by the employer's decision to operate the plan within very specific and limited parameters that proscribe its ability to change benefits or employee premium cost sharing. According to Towers Watson research, 55% of large employers expect to relinquish their grandfathered status as of January 1, 2010, while the remaining 45% have elected to operate within the prescribed limits to retain grandfathered status through 2011.

### Key questions for directors:

*Did our organization retain grandfathered status or not? If not, when do we expect to become non-grandfathered and what are the implications?*

## Pre-Exchange

The pre-Exchange period falls between now and 2014, during which employers will face a variety of additional compliance requirements. Moreover, because the introduction of the state insurance exchanges in 2014 will create the opportunity to exit employer-sponsored health coverage, employers will also have an unprecedented window to revisit the organization's position on providing health benefits. Exchanges will be available for active employees and especially for retirees. They will provide guaranteed coverage, a comprehensive range of coverage options and the

economies of aggregated purchasing. The decision to terminate coverage in favor of directing employees to the exchanges is not a simple one and should be considered carefully as soon as possible to properly analyze and assess the strategic implications for the business.

Exit would mean eliminating the health benefit obligation and its attendant costs. However, it also creates a compensation void that would need to be filled since the employer's exit would send the employee to the exchange without the means to purchase coverage that he or she had been receiving with a significant company subsidy on a tax-favored basis. It also creates a per employee penalty that is levied as the employer elects not to "play" and decides to "pay" the penalty to exit. For some organizations, exit may be appropriate with a shift in compensation strategy and restatement of the employee value proposition. For other organizations, exit will not be feasible and will require an aggressive rethinking of health care benefit design and delivery to manage costs in an environment of 8-9% annual cost growth and a looming excise tax in 2018. Cost trend mitigation will be critical during this time period (and beyond) using the best practices demonstrated by top-performing organizations that have been able to bring annual cost growth rates well under 5%.

### Key questions for directors:

*Have we begun analyzing our "play or pay" options to determine financial and other implications? In the meantime what are we doing to bring down our cost trends? What strategies are we pursuing?*



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## What is our strategy to avoid the excise tax ceiling in 2018?

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Employers need not wait until 2014 to address the potential opportunity to “monetize” or exit retiree health care obligations. Use of accounts to monetize the value of the retiree health financial commitment by converting it to a defined contribution by the employer has become a popular technique that eliminates volatility. The advent of retiree purchasing groups or collaboratives as well as more robust individual product offerings has enabled a growing number of employers to define the obligation, monetize it and exit direct plan sponsorship. This opportunity exists today and will only be enhanced by exchange-based coverage in 2014.

### Key questions for directors:

*Have we examined opportunities to monetize our retiree health obligations?  
Have we explored purchasing collaboratives and individual product solutions to potentially exit plan sponsorship?*

### Post-Exchange

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The post-Exchange period is defined by the opportunity to continually revisit exiting coverage for active and retirees. In all likelihood employers will not jump to exit in the first year of exchange availability. Instead most

will wait to test the effectiveness of the new options and public perception of them. But, regardless of the decision whether to offer—or not offer—health benefits, all employers will face a continuing need to provide tools, resources and support to maintain or improve the health and productivity of the workforce. Healthcare reform addresses protection against illness or injury when it occurs but provides only minimal support in health improvement, wellness, chronic condition management or returning employees to work quickly after an illness or injury. With this in mind, a Towers Watson 2010 survey found that 86% of large employers plan to maintain or enhance their efforts to improve the health of their employees. Employee health is critical to optimal productivity and engagement.

### Key questions for directors:

*What is our workforce health improvement strategy? Are we pursuing a culture of health to boost productivity, reduce lost time and increase employee engagement?*

### Excise Tax

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The introduction of the Excise Tax on high-value health plans emerges in

2018 with a 40% non-deductible excise tax being levied on plans that exceed \$10,200 for individuals or \$27,500 for a family. Towers Watson estimates that over 60% of large employers will hit this threshold in 2018 with others soon to follow. Given this scenario, the need to begin managing cost growth now is paramount to avoid the excise tax ceiling and the effects of the penalties.

### Key questions for directors:

*What is our strategy to avoid the excise tax ceiling in 2018? What are we doing now and what is our plan over the next few years?*

Despite the rhetoric, repeal of healthcare reform is highly unlikely. Healthcare reform constitutes a business issue that must be addressed and analyzed like any other business risk. The phasing of the law gives prudent companies a lengthy glide path to adapt and anticipate its impact. Inaction is not an option.

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# The Best Kind of Succession Planning

By Douglas Wilson, Ph.D. and Michael Kelly

The number one priority for the board is to insure that there is a companywide plan for the succession and the cultivation of leadership talent.



Douglas Wilson, Ph.D.

Tolstoy opens *Anna Karenina* by observing that happy families are all basically the same, while unhappy families are unhappy in their own particular ways.



Michael Kelly

The same observation might be reasonably applied to companies that have recently experienced a management succession or

transition: Those that feel satisfied about the results they have achieved in a smooth succession are generally happy.

The challenge for students of corporate governance is to isolate those common elements that lead to a successful outcome, regardless of industry, sector, size or nature of company. Understanding the common elements that these “happy families” share will permit a codification of policies and procedures that differentiates sound from unsound governance.

It is generally agreed that the top priority for a board of directors is to hire or fire the CEO. We suggest that the number one priority is to insure that there is a companywide plan for the succession and the cultivation of leadership talent, starting first with the

CEO and moving then throughout the company.

Picking the next CEO is only the start. Larry Higby, the former CEO of Apria Health Care, who now serves on three public boards and five non-profit boards, says that only focusing on CEO succession is a huge mistake made by boards. He says, “Succession is a company-wide issue. The board needs exposure to multiple players in management, not just the CEO.” In other words, the board needs to insure that talent development is a dedicated business process. The framework must include regular assessment of leadership, skills and talent gaps in the organization, along with a program and budget to close these gaps either through professional development or external executive coaches and recruitment of outside talent.

## Talent Development Committee

The board must also possess the political will to enforce the planning process when the sitting CEO is reluctant. It strikes us as odd that the most important committees of the board are generally deemed to be the Audit, Nominating, and Compensation committees. These functions of the board are critically important to good governance practices; so is creating a process for identifying, grooming and preparing future CEO leadership. Wouldn't it make sense for every corporate board to create a new committee called the Talent Development Committee?

Over the past five years we interviewed executives at a number of companies

that demonstrated the ability to mount a successful CEO succession campaign. Our focus was on public and private companies that had strong boards, had hired professional managers, and that had a serious commitment to making succession of the CEO a priority.

First and foremost, a commitment by the board to a positive, future succession is an absolute requirement. Research suggests that about 80% of new CEOs come from within the company, so it is not unusual for the board to stress with an incoming CEO that the cultivation of internal talent is a priority.

## Best Practices

Based on the research we have conducted, we offer up other elements below as a list of best practices for CEO succession and talent development:

1. The CEO is accountable to the board for an annual review of succession throughout the company. The board chair, at least once a year, places on the board's agenda a report by the CEO about what he or she is doing to plan for a successor. Initially, the CEO may simply report on possible internal candidates. For those companies interviewed for this article, the CEO usually went down three levels. Each individual identified was evaluated on strengths of character, leadership, and technical competence. The company's future needs were also considered and they were overlaid on each individual's personal strengths, were matched to the company's future, and were evaluated. A full report should be presented to the board for their review and discussion.

Human Resources should play a role in these candidate assessments, but not be the driver. Often, when the board is within two years of a transition, they will ask a search firm to conduct a detailed, comprehensive review of one or two top internal candidates. The HR officer is a resource, but an external consultant brings a degree of objectivity as well as an ability to benchmark internal candidates in light of potential external candidates. A good consulting group can also bring a set of analytic tools that evaluate candidates' strategic intelligence, ability to partner with outsiders, emotional intelligence, and modes of resolving conflict. Such tools enable the board to compare the style of leadership needed for the future CEO with the leadership style of the candidates at hand. One board developed a list of 16 traits required as givens for their next CEO. They also added a list of five traits they desired as unique to the new CEO. Each internal candidate was evaluated against this list by the sitting CEO, the HR director, the outside consultant, and one member of the board committee. The results were presented and discussed at the larger board meeting in the form of a dashboard on CEO competencies for each candidate.

2. To ensure that the board secures good exposure to future internal leaders, the executives in question are asked to make reports to the board. The board is also paired up to meet with the candidate executives outside the board room. It is important for the board to get to know senior leadership and have a feel for their leadership capabilities. Keeping management away from the board is a bad idea and limits the board's ability to really understand internal talent. Good boards insist on meeting up-and-coming managers who are not yet officers of the company.

3. As the time approaches for actual succession—usually about two years out—the board becomes more heavily involved. At this point, a special succession committee is formed or the

responsibility is lodged with the executive committee of the board to insure the process and responsibility of replacing the CEO is owned by the entire board.

4. Since the board has made it clear to the CEO that internal development of future leaders is a priority, the CEO will then establish a process for recruiting and nurturing top talent. When the CEO hires new candidates for top positions, he or she always asks, "Could this person succeed me?" If the answer is "No", the person may not be right for the company. There are naturally some exceptions. If, for instance, the company finds an IT executive with great skills, the CEO might hire the person into that role with no expectations that they will advance. In general, however, the CEO is very

*Wouldn't it make sense for every corporate board to create a new committee called the Talent Development Committee?*

rigorous in demanding a future "runway" for the new hires at senior level positions.

5. The CEO involves Human Resources and outside consultants in the future development of senior leaders. Coaching is quick and to the point. Where problems exist, they are, whenever possible, aired in a constructive way. For example, a new and brilliant hire in an Asian subsidiary was being cultivated to replace an existing General Manager but he was known for talking too much and at the wrong times. He manifested a desire to be seen as the smartest person in the room. Both the CEO and the General Manager made it clear that less talking and more listening were required for future advancement. At the same time, they made it clear they believed the individual

was on track for great things, but that good listening skills were necessary for success. Change soon followed.

Regardless of the quality of internal candidates, the board's responsibility to the shareholders is to select the best candidate for the CEO position. If and when the CEO is going to be replaced, some companies benchmark several candidates in the marketplace to compare to internal candidates. This is a process, commonly and most competently performed by an outside search firm. In other words, there is no official search, but the firm is surveying the marketplace to look at possible replacements for the sitting CEO. The board can avoid a conflict of interest with the search firm they choose by letting the search firm know that if and when they do decide to do an outside search, there is a good chance they will not pick the search firm that did the benchmarking.

Why not research the industry and come up with five potential candidates for each position in the C-suite? It is not a search but rather a useful research project. The potential candidates may or not be available, but the board will obtain detailed backgrounds on promising individuals and be able to connect with them at industry events and monitor their success. In such an exercise, internal candidates may or may not need to know about this research project since it is not a formal search.

Peace of mind for shareholders, the board, and management is critical to the success of any company's future. The board showing great leadership on succession planning and execution is one of the most important steps to accomplish this outcome.

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*Kristie, from page 43*

director. Which would then make them—presuming they don't go on the company payroll for a sidebar consulting gig—even more underpaid!

Whether they are serving *on* the board or in an official capacity *servicing* the board, consultants are bringing something to the organization that is not within the organization. That something is, ideally, an expert view that addresses the risk(s) in whatever course of action is being contemplated—and by so doing, minimizes the risks, and turns risk into reward.

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strong leadership, and career advancement opportunities.” With these non-financial priorities shrouded in doubt, employees begin to look elsewhere.

That trend was confirmed by the findings of our 2010 Ethics & Workplace Survey. Trust and transparent communications—both vital aspects of strong leadership—emerged as non-financial priorities that employees felt have been lacking during the recession. Boards can help make management aware of these vital needs so that retention efforts can be aligned accordingly.

Another nonfinancial consideration for boards to assess is the quality of their

own transparency and trust. The model for management transparency can begin in the boardroom. When the attitudes, behavior, and candor that mark healthy debate are firmly in place—what I call the “ABCs of boardroom governance”—chairmen and directors can provide an example of openness that management can foster with employees.

The value of employee trust is priceless.

Through high governance standards, how they conduct themselves, and the expectations they set, every board can help build the employee trust that will be absolutely vital to economic recovery—and their organization's future.

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*Malloch-Brown, from page 45*

effect. Younger, yet highly trained, management teams within the second circle companies tend to lack long-term aspirations for their companies, causing cracks in the process and possibly even perpetuating the obvious risk when investing in the second circle: a solid exit strategy.

In the second circle, exit strategies are not clear-cut but are complicated, convoluted and sometimes dangerous. The continual lack of transparency and reporting perpetuates investors' risk. In a number of countries, there is not a liquid local stock exchange and return on investment can be stretched due to the complex nature of the disclosures and significant restructuring needed. For companies planning to invest in the second circle, it is important to enter negotiations with a clear understanding of the local market, traditions and business practices.

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inputs are crucial to functional and professional shareholder representation. It may even be that institutional and professional investors will value the company more highly than its competitors because of the greater visibility to those responsible for governance.

## Ground Rules

Due to public company regulatory and disclosure requirements, professional legal and financial advisors will almost without thinking urge non-executive directors to keep their distance from shareholders. Board members obviously must be carefully guided in how to participate in such communication without creating potential liability for the company. Rational investors will completely understand that specific ground rules for this kind of constructive engagement with board member-insiders must be established in advance, and adhered to during discussions. One such ground rule might be that the board member's role will be

simply to listen and not to present plans or solutions on behalf of the company.

A *starting point* for changing the current non-executive board member-shareholder dynamic is proactive, unfiltered communication with key investors. Shareholder conversation with seasoned, independent, professional board members not only serves the interest of high performance governance but also the mutual interest of company value creation. I believe this represents investor relations at its best. The company's market valuation over time may positively benefit from the improved accessibility and communication.

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William Keiper has served as a non-executive director of five US public companies and also as president or CEO of three. In addition, he has served as an officer and director of numerous private companies both domestic and international. He is founder and managing partner of FirstGlobal Partners LLC, dedicated to helping boards and investors in their efforts to create company value through continuous improvement. The author can be contacted at [will@firstglobalpartners.com](mailto:will@firstglobalpartners.com).