

Rules for rock-solid governance

'Sutton's Laws' won't solve all the problems that boards face, but they can filter the bad boards from the good and help directors sleep better. **BY GARY SUTTON**

SHOOT ME if I join another public board. “Sarbanes-Oxymoron” adds cost and little else to having or being on a board. Anybody who’s eager to join a public board is inherently unqualified. Anybody who’s very eager is very unqualified. That’s because there’s huge downside and little upside, so candidates who lobby and lust for these “opportunities” are clueless and ought to be denied any further responsibilities.

I’m on 12 boards (11 of them private), and would chew fewer Tums if I could gracefully leave the sole public board I sit on. Yeah, I know, that’s too many boards. But I’m retired, and most of these companies are startups with five employees and a company dog, with minimum risk and plenty of upside, so cut me some slack. Those that fail, I mourn, but those that succeed go public and, while celebrating, I immediately look for the nearest exit.

Out of this irony, I’ve figured out how those of you being recruited can filter the bad boards from the good. Call them Sutton’s Laws. They make sense, bewilder Congress, yet give you rock-solid defenses in the courtroom and your own heart.

Let’s first agree that boards have three jobs:

1. A board hires and compensates the CEO fairly.
2. The board fires and replaces CEOs fairly.
3. The board approves any financial restructurings that affect the balance sheet — be they mergers, annual budgets, dividends, or acquisitions.

That’s it. If you go beyond, to a point at which the board is managing the business, then there is no CEO. And if you’ve traveled, seeing many statues in many parks, you know that there’s not one yet erected to a committee. One thing makes it easy to confuse a board with a committee: They are identical.

Gary Sutton has served as a chief executive and board member of a number of public and private companies in his career as a specialist in business startups and turnarounds. He ran aerospace manufacturing, retail advertising, online data storage, printing, garbage, software, and satellite communications businesses, as well as a college. He is the author of *The Six-Month Fix: Adventures in Rescuing Failing Companies*, published in 2002 by John Wiley & Sons.

The trick is this: A board cannot intelligently handle these three tasks, when they arise, unless each director understands the business. To do this, board members must contact a few customers, auditors, employees, and vendors every year. Yet this intrusion must be casual, graceful, and low-key to avoid undercutting the leadership. These customer and vendor calls should be made with an employee. The employee contacts should be one-on-one.

Now, here are Sutton’s Laws:

1. Voting directors should be all outsiders with one insider. Anybody who has been on the board for more than five years has become an insider. Period. Restrict terms to five years. Rational perspective is lost with time. History is less relevant in a fast-changing world. Outside directors are best but not infallible: Using Calpers’s guidelines on outsiders vs. insiders, we’d all invest in Enron but dump Dell.

2. Meet quarterly. This lets the board review financials without getting buried by monthly detail. Those who argue against quarterly reporting, claiming that it hurts long-term thinking, seem to have never studied long-term success. Profits over time are made up of a consecutive series of short-term gains. It’s a habit ... momentum. Can you name a business that lumbered along for years and suddenly skyrocketed into success? Fat chance. If so, was it planned or an accident? Right.

At least 75% of the directors must attend each board meeting — *physically*. You see stuff in the hallways and parking lots that doesn’t show over a phone line. The information packet should arrive one week in advance and contain 20 to 40 pages of data, with minimal verbiage. The meeting is for the talking. An ideal meeting is formally presented, with a third of the time left open for discussion. Too much open time leads to chaos; not enough means it was a presentation, not a meeting. Managers should present their department results during part of the meeting. The current trend toward dinners the night before a board meeting is bad. That lets management pre-empt the proposals. A dinner after the meeting is better. That lets directors dig into points that came up during the day.

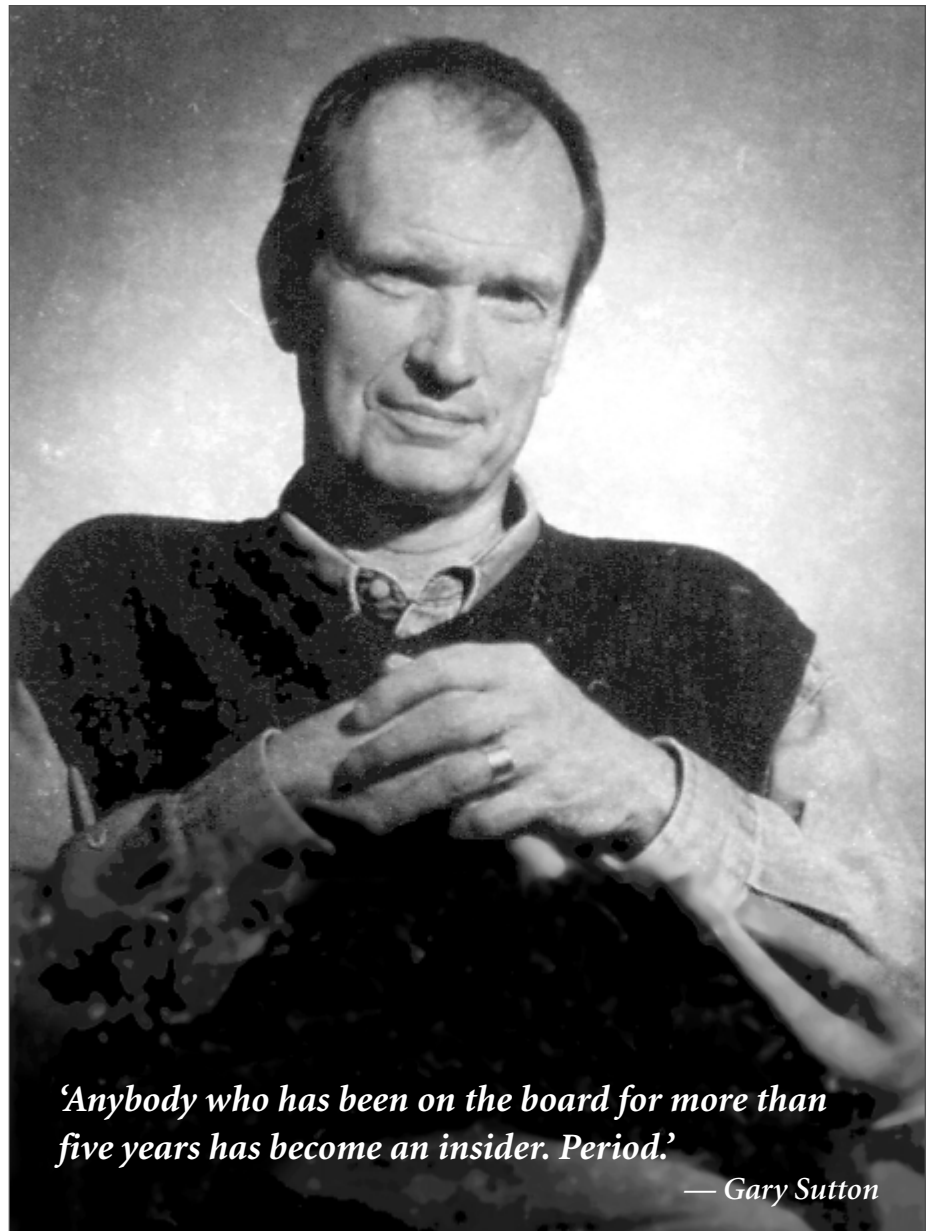
Board members should not be friends outside or directors together on other businesses, and ought to have begun their careers in different disciplines.

3. Five or seven board members work best. Six leads to tie votes. More is worse, since it diffuses responsibility. Look at Leonardo Da Vinci's *Last Supper*, with 12 distracted disciples, conducting separate conversations. If you think bigger is better, consider Congress. Remember those park statues.

4. Have no lawyers, minorities, or professors on the board, unless they've been CEOs somewhere, anywhere, for a decade or more. Then they get it. Avoid the VPs from AT&T, IBM, and American Express. Those types succeed on politics, presentations, and selling bigger budget requests. They have yet to experience the fact that costs should be below revenues. Worse than not understanding the basics, these articulate types feel the need to speak more often.

An exception should be made for companies that depend on the government for business. Then the Henry Kissingers and Sam Nunn of the world can pocket big fees without understanding much. This is because they know where and how the bodies are buried within government spending. In those cases, paying outrageous fees to open doors is often in the shareholders' interest. (Nunn sat on seven public boards after leaving the Senate, every last one of which also did business with his firm; and Kissinger probably did even better.) Taxpayers' interest? Hey, that's not the topic here.

5. The minutes should show split votes sometimes. If every vote is unanimous, there's no governance or discussion going on. It's okay and healthy if a director resigns every couple of



'Anybody who has been on the board for more than five years has become an insider. Period.'

— Gary Sutton

years. When several quit, that's nervous time. If nobody ever leaves, the job's too cushy and there's not enough jousting.

6. Directors' compensation should match the chairman or CEO's, roughly, on an estimated hourly basis. Directors are peers, each with one vote, and pay should reflect that. (We'll touch the explosive issue of CEO comp as law 10.)

7. Perhaps the silliest Sarbanes-Oxymoron rule is that the audit committee needs a finance or accounting expert. That's way insufficient. Everybody on the board must be fluent in the language of business, which is accounting. Absent that, they're as effective as the Portuguese-speaking directors of a Lithuanian business. (I remember a director in one board meeting wailing over the loss of all that goodwill from our balance sheet. If that joke requires explanation, stay far away from any board.)

8. Audit, compensation, and governance committees must meet quarterly without insiders attending. Comp committees should look at expense totals incurred by all officers. The auditors must assure the committee that there are no travel or entertainment expenses allocated elsewhere.

9. Directors should average 10 years older than the officers. Running a business requires energy. Spotting problems requires pattern recognition. Over-the-hill CEOs like me have lost the energy to manage effectively but have some “been there” advice that’s occasionally worth hearing. Best of all for stability, these geezers try to help when things get rough. If they fire the CEO, it won’t be because they want the job themselves.

10. CEO compensation for base salary should be in the bottom half of a survey for both similar-sized companies and

for companies in the same industry. Period. This is the biggest governance issue in business today — so significant that it threatens the concept of public ownership. How can you attract talent with low base salaries? Simple. Give those CEOs generous bonuses based on performance:

— Half should be stock that vests over five years, priced at market, aligning the CEO perfectly with shareholders. It even puts the CEO above shareholders, since the average institutional holding time has dropped to a year.

— The other half should be a bonus based on operating cash flow, the ultimate builder of value. When stock markets go soft, the CEO still gets rewarded for strengthening the business with improved cash. When the stock markets spike, the CEO profits only if the upswing holds.

Set those incentives so the CEO gets rich only when the shareholders get rich. Sleep nights. Let the CEO get rich no matter how the business does, and best you get a lawyer now.

Board management in a turnaround

Boards need coddling in normal times. If you don’t, the company wobbles. That’s the way it is. They’re ill-prepared to manage, only to advise.

Boards are only there for the big moments. You guide them and they know they’re being guided. When things go awry, they’ll make the big moves and change the CEO.

You must remove schizoid and underemployed directors. The smaller their world, the more time they have to disrupt in turbulent times.

You must work the directors individually outside of board meetings, so that any votes are predetermined. If they’re busy, and pray that they are, they appreciate advance preparation. They’re big boys (and girls) and understand exactly what you’re doing and can cope with that just fine.

But, you see, this is board management in normal times. And what they are used to.

In a turnaround, you simply don’t have time to handhold directors. They won’t want involvement until the business starts to revive anyway, when you’ll see several of them volunteering to pile on.

What you must do in a turnaround is diagnose the business first. Then you’ll know if you even want to take it on, and have a generalized idea of how you’ll try to fix it. This is key. The best heart surgeons know how to pick patients, and their percentages just keep getting better.

But it’s also critical for the directors. Your

diagnosis gives them your roadmap. They must have that before you start. They were there when things went wrong, so they’re not quite heroes, but since you’re invited to look, they are doing the heroic thing now, and hopefully in time.

If it helps, hand a copy of this expert advice to the directors as part of your reasoning for requiring abnormally strong independence during the turnaround. Your replacement will bring back the normal interaction with the board, once cash flow is restored.

Sign a contract that allows for a weekly meeting of an hour or two for the first month — casual, no preparation, no more contact than that. Go to monthly meetings of two hours for months two through six. If the board is comfortable, ask them to assign a single point of contact. Make your contract specific on those terms.

Don’t change the board. They’re responsible and a few will leave out of fear. But they do have some history, and you certainly don’t understand enough yet to explain the business to a gaggle of new directors. And anybody who would join now is not likely to have an IQ stretching much above room temperature.

From The Six-Month Fix: Adventures in Rescuing Failing Companies, by Gary Sutton. Copyright 2002 by Gary Sutton. Published by John Wiley & Sons Inc. Reprinted with permission.

11. All reports should emphasize operating cash flow first, GAAP diluted net earnings second, and *pro forma* only to show results without expensing stock options. *Pro forma* is Latin for “in your dreams.” Operating earnings pretend that the least manageable cost — interest expense — is immaterial. Any other invented terms are suspect. Showing *pro forma* earnings to factor out stock option expense is acceptable, since that cost is an extremely subjective entry, with formulas that feign science while abusing objectivity.

12. There should be no related transactions. Where acquired with another business, unwind them within a year. This includes relatives on the payroll, leased properties owned by shareholders, loans, and private use of company assets. Language that says “believed to be at fair market rates” when describing related-party transactions invites fraud at worst, suspicions at best. If they are truly “believed to be at fair market rates,” then unwinding the deal causes nobody any harm.

I’ve not always followed Sutton’s Laws. These are goals. When I was a CEO during the ’80s and ’90s, my board duties were simple. All I did was to keep those directors who thought me stupid from talking much with those who hadn’t decided yet. Those days are gone. Good thing. ■