PETER BROWNING AND WILLIAM SPARKS

# THE DIRECTOR'S MANUAL

## A FRAMEWORK FOR BOARD GOVERNANCE

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## A Framework for Board Governance

Peter C. Browning
William L. Sparks

Wiley

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# PREFACE

Each corporate board has its own unique culture, created by the mix of directors, the personality and style of the CEO, and the culture of the company. Boards operate within this context to fulfill their fiduciary duties to shareholders while at the same time satisfying growing regulatory reporting requirements and regulations. It's a balancing act that is difficult at best.

*The Director's Manual* provides a proven, flexible framework to help boards of directors meet these challenging requirements while allowing each board to do so in the context of its own unique culture and business demands. The framework offered in this book provides guidance that is well suited for both established and new boards as they convene members and establish themselves within an organization.

Help is provided with regard to all aspects of board governance, including the role of the board, board schedules, dealing with a disruptive director, member selection, advice on management of group dynamics, and the creation of high-performing boards. Further guidance is contained in a comprehensive set of board and director assessments and a proprietary assessment (Board Culture Profile) that measures the most important determinant of board performance: group culture.[1]

## WHY WE WROTE THIS BOOK

The impetus for writing the book was rooted in both our interest in, and our experience with, board governance, and the increasing scrutiny of shareholders and shareholder activists in board structure and performance. We believe this book will be an essential educational and practical resource for both current and aspiring directors, since it blends leadership and research findings on organizational

dynamics with practical, straightforward advice for corporate directors, along with a solid set of how-to best practices.

Corporate boards are influenced by the prevailing corporate governance climate outside the boardroom. If the economy is booming, unemployment is low, and the country's confidence is high, then a board's set of priorities and options are likely to be very different from those in times of economic and social uncertainty.

Although this may seem to be an obvious connection, most resources concerned with board governance don't fully explore the impact of this symbiotic relationship between the world inside the corporate boardroom and the realities of the world outside the boardroom. And, even when the impact of this board and real-world relationship is covered in these resources, little practical advice and useful tools are offered.

*The Director's Manual* directly addresses this information shortfall by providing governance guidelines that are not only clear and concise but also immediately applicable to every board type and environment.

## Chapter 1

# THE CHANGING WORLD OF BOARD GOVERNANCE

## *How We Got Here*

**What's in This Chapter?**

- How and Why Boards Have Changed
- A Barometer for CEO Compensation
- Why Pay Ratios Have Changed Radically
- A Board Governance Tipping Point
- Impact of the 2008 Financial Meltdown
- Chapter Summary and What's Next

One of the principle tenets of our consulting work is that every board is operationally and culturally unique. It is this simple fact that makes constructing a single, all-inclusive set of board governance best practices an impossible task. Therefore, the guidance in this book is not positioned as a set of "hard and fast" rules or universally applied "must have" characteristics. Rather, the guidance is based on a flexible framework approach that allows boards to meet their fiduciary and governance duties while remaining

responsive to the real cultural dynamics that directly influence the quality and consistency of decision making.

A framework approach also has a second advantage: it allows boards to respond appropriately to an ever-changing external socio-economic and political landscape. This is an important point, since society's swiftly moving cultural currents, along with the ebb and flow of an economy's strength, has a profound impact on the performance expectations of corporate boards. Of course, this is no grand revelation to anyone reading this book, but we believe these concepts are important to keep in mind as context for the board governance recommendations made in the pages that follow.

## HOW AND WHY BOARDS HAVE CHANGED

If you were asked to make a list of the most important game-changing events or trends that have profoundly impacted the U.S. economy and culture in the last sixty-five years, the list that you would make would likely include at least the following:

- A move away from a manufacturing economy to a service economy following decades of dominance in the post–Second World War global economy.
- Improvements in automation and the manufacturing process of the 1970s and 1980s. It was a trend that further undermined the manufacturing sector over the years as computer-driven machinery and tools (robotics, CAD-CAM design tools, etc.) replaced individual workers. Global competition also slowly eroded the U.S. manufacturing base as more and more manufacturing jobs moved to countries outside U.S. borders with lower labor costs.
- The diminishing influence and power of organized labor's ability to guarantee members a lifetime of a steady, living wage and a fully funded, secure pension upon retirement.
- The "creative destruction" of industries in the 1980s brought about by the world of leveraged buyouts and a ruthless cadre of "corporate raiders" who broke up many marquee old-line companies and sold off the divisions to score huge profits for themselves.

- The dot-com bubble that began its rise in the early 1990s and continued throughout the decade until it popped, to a devastating effect, in 2001. Investment strategy at the time was a race toward unrealistic valuation. Investors were willing to fund nearly any technological start-up venture even if it lacked a viable business plan. It is interesting to note that this investment setback did little to cloud the financial community's continued unrealistic economic outlook. In fact, this unsound enthusiasm in the marketplace was encouraged in large part by favorable economic policies of the federal government, supported by a period of low inflation due largely to lower cost of goods from China and a continuing worldwide technological revolution.
- The impact of blatant corporate malfeasance in 2001, exemplified by three highly visible corporations at the time: WorldCom, Enron, and Tyco. It was a revelation that rocked both the investment community and individual stockholders. Again, high-flying investors and shareholders lost millions of dollars when these companies declared bankruptcy (Enron Corporation declared bankruptcy in December of 2001), a singular action that further exposed an underbelly of lies and deceit that had pervaded these organizations at the very top and eventually put thousands of ordinary workers out on the street without jobs or their life savings.
- Finally, the 2008 huge financial meltdown and the economic panic that followed. It was a time of fear and shock as we watched once powerful brokerage houses as well as large banks and old-line industrial giants teeter on the brink of declaring bankruptcy. It took massive, last-minute, stopgap federal cash infusions to save the world's economy and to shore up institutions that were deemed "too big to fail."

## WHY THESE EVENTS ARE IMPORTANT

The reason for noting these historical and societal events is twofold. First, it demonstrates how past events impact the current expectations placed on corporate boards; and second, it establishes the contextual "waters" for the operational strategies, policies, and

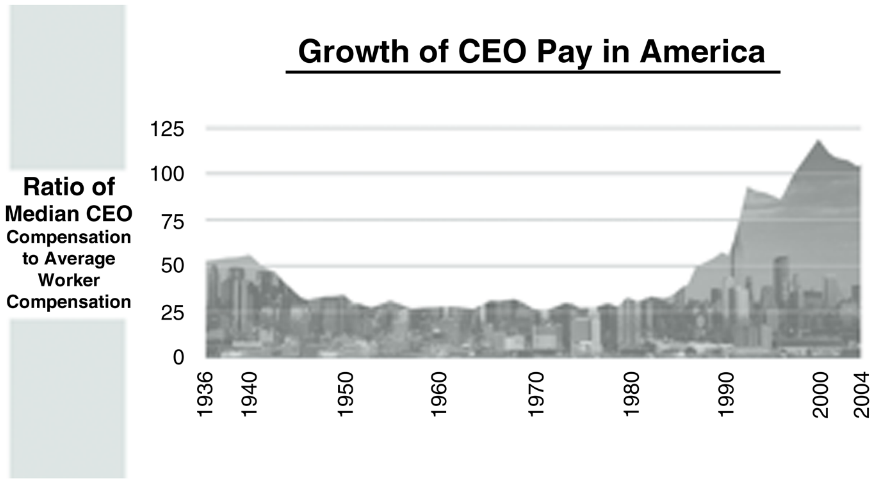


**Figure 1.1** History of CEO Pay

*Source:* Peter Browning Partners

procedures that most boards follow today. This chapter will focus on two specific trends that grew out of these economic and social gyrations:

- Ever-increasing chief executive officer (CEO) compensation (see Figure 1.1).
- The impact of a 2002 change to the New York Stock Exchange (NYSE) Listed Company Manual that required "non-management directors to meet at regularly scheduled executive sessions without management." While this change to the NYSE Listed Company Manual (303A.03) occurred during the same time period as the passage of the 2002 Sarbanes-Oxley Act (Congress's response to public outrage over Enron's corporate malfeasance and greed), the fact that the two actions occurred at the same time is a coincidence of timing. The fact is, as important as the Sarbanes-Oxley legislation has been to curbing illegal corporate activities, we would argue that the NYSE Listed Company Manual change has ultimately produced the most far-reaching impact on board governance, performance, and effectiveness.

## A BAROMETER FOR CEO COMPENSATION

According to Carola Frydman and Raven E. Saks, authors of "Historical Trends in Executive Compensation 1936–2003," CEO compensation experienced three distinct phases over the last seventy-five years: World War II, the mid-1940s to the 1970s, and the 1980s through the 1990s.[1]

Prior to World War II, the median executive compensation was about fifty-six times higher than average wages, although CEO compensation did decline sharply during World War II. After the war the U.S. economy experienced a period of unfettered growth and development. This expansion created a rapidly growing middle class that was confident about lifelong careers with the same company, steadily rising wages, and opportunities for career advancement. All of this confidence brought with it a predictable stream of disposable cash to buy American products.

Interestingly, executive salaries during this period of expansion remained relatively low and, in fact, slowly fell until 1970, when they reached a low point of twenty-five times average wages. During this period organizations promoted their most senior and capable executives to the CEO spot and then compensated them with a salary, cash bonuses, and limited stock options. As a rule, these groomed CEOs kept their jobs until retirement.

### Global Competition Brings Change

Global competition in the 1970s imposed new economic pressures on corporate America. Nations previously ravaged by war, especially Japan, took full advantage of industrial redevelopment support from the United States. Soon these countries began to compete directly with their benefactor, especially in the car and consumer electronics markets. This competition resulted in the closing of many U.S. manufacturing plants, and once thriving towns, cities, and communities, and even whole regions, were economically decimated. All of this upheaval and uncertainty in the manufacturing sector from mid-1970 to the end of the 1980s resulted in a 2,000 percent increase in merger and acquisition activity (as compared to previous years) as companies struggled to

keep control of their organizations and to avoid the ravages of a hostile corporate takeover (Gladwell, 2009).[2]

## The Impact of Strategic Planning

Beginning in the early 1980s, CEO compensation policy began to radically change as U.S. corporations switched their focus to long-term strategic planning models and away from more traditional, short-term business planning approaches. This was a change in thinking that directly impacted corporate board management and its priorities.

A key proponent of this long-term strategic planning approach was Bruce Doolin Henderson, who in 1963 founded the Boston Consulting Group. Corporate leaders, including General Electric's CEO Jack Welch, became disciples of the approach in the early 1980s, as did many university business schools and scores of consultants who were eager for the business opportunity created by Henderson's ideas.

In his 2010 book, *The Lords of Strategy: The Secret Intellectual History of the New Corporate World*, which is about Henderson's influence on business practices worldwide, author Walter Kiechel notes that Henderson literally "changed the world." "Few people," Kiechel says, "have had as much impact on international business in the second half of the twentieth century." (A complete account of this industry-changing consulting group can be found in *The Lords of Strategy: The Secret Intellectual History of the New Corporate World*.)[3]

## The Impact of Long-Term Incentives

The shift to corporate strategic-planning practices not only created a multibillion-dollar consulting industry but also set the groundwork for a new way to compensate CEOs and other top corporate executives. Now, instead of traditional compensation packages (i.e., salary, cash bonuses, and limited stock options), corporate boards had a range of pay strategies that mirrored these emerging long-term business planning strategies. CEO pay packages soon included long-term incentives (LTI) that tied a CEO's overall pay to the long-term performance of the company (typically, three years).

These changes to the traditional rubric used to calculate CEO compensation occurred just as investors and other financial community movers and shakers began to demand that companies produce higher profits within ever-shorter time lines. The pressure behind these short-term profit demands resulted in great measure from the dissolution of traditional pension plans and the significant expansion of mutual funds. These various funds competed with one another for shorter-term performance increases.

According to a recent article in *Foreign Affairs* magazine by Jerry Z. Muller, a history professor at The Catholic University of America, the hypercompetitive 1980s resulted in "companies (as well as various public-sector organizations) attempt[ing] to shift the risk by putting their pension funds into the hands of professional money managers, who were expected to generate significant profits." The result of this strategy, according to Muller, was that "retirement income for employees [was] now depend[ent] . . . on the fate of [the employee's] pension funds. "The change had the practical result of putting even more "pressure on corporate executives to produce short-term performance results."[4]

The shorter time line to increase profits also had an unfortunate downside: it created a temptation among fund managers, corporate CEOs, and others at the corporate top to boost immediate profits at the expense of longer-term investments, such as research and development or improving workforce skills.

## Phase Three—The Results of Uncertainty

The final phase of Frydman and Saks's executive compensation development framework extended through the 1990s. It was a time when many CEOs lost their jobs because the company's promised performance failed to square with the company's earnings reality or because of increased merger and acquisition activity. The employment uncertainty led boards to offer highly sought after CEOs and their teams a "change of control agreement" (also known as a "golden parachute") in their employment contracts. This practice grew to such a degree that the Internal Revenue Service (IRS) responded in 1984 with new rules that capped these payments at