

# MERCER DELTA

Organizational Consulting

May 1, 2004

## From the Outside In The Association of General Counsel

David J. Nygren, Ph.D.



Marsh & McLennan Companies

# Hot Topics in U.S. Boardrooms Today



- Board and Individual Director Evaluation
  - Board evaluation now an NYSE requirement
  - Governance Committees responsible for director re-nomination
- Chair/CEO Split
  - Lead Directors (30% of U.S. Boards now have Lead Directors)
  - Separation of Chair/CEO Roles at Disney and NYSE
- CEO Succession
  - Rated #1 Board Issue by NACD survey released Dec. 2003



# Board and Individual Director Evaluation

# Governance Assessments

- Board Structure, Process, Composition, and Independence
- Committee Structure, Charters, and Operations
- Roles and Responsibilities
- Director Competence
- Director Accountability
- Board Information Systems/Agendas
- Ethics, Code of Conduct, and Organizational Compliance
- Constituencies and Corporate Communication
- Proxy Review/Assessment
- Risk Assessment



# Does Assessment Lead to Effective Boards?

- The key to developing an effective Board lies in an appropriate assessment of how the Board functions
- Appropriate Board assessment raises the bar, helps spot vulnerabilities, and limits costly risks to the company
- Board evaluation is the best alternative to further regulation
- Assessment must be beyond compliance
- Combined Board, Chair/CEO, Director Peer, and Committee Assessment hold highest promise
- Process must be fair, impartial, scientific, and transparent to participants
- Board must be willing to act on results
- Assessment provides the conditions for the possibility of integrity



# Moving the Board Forward

- There is a convergence of concern and controls: SEC, Congress, investors, underwriters, etc.
- Good news: If you are well governed, you will have little problem but changes will still be required
- Likely a massive change out of directors with fewer available
- Expect both scrutiny on CEO pay and demands for increased pay by directors
- Portfolio of Board competencies will be re-aligned: Strategic, financial/analytical, contextual, interpersonal, political, and educational
- Boards are now “rated” online
- Evaluation of Boards required and tougher standards applied to CEOs
- Institutional investors are rating governance and looking for evaluation

# Types of Assessment

- Board as a whole
- Chair/Lead Director
- Committee/Committee Chairs
- Individual Director (Peer)



# Board Assessment

## Sample Questionnaire

Board Assessment Questionnaire

**Board Composition and Structure**

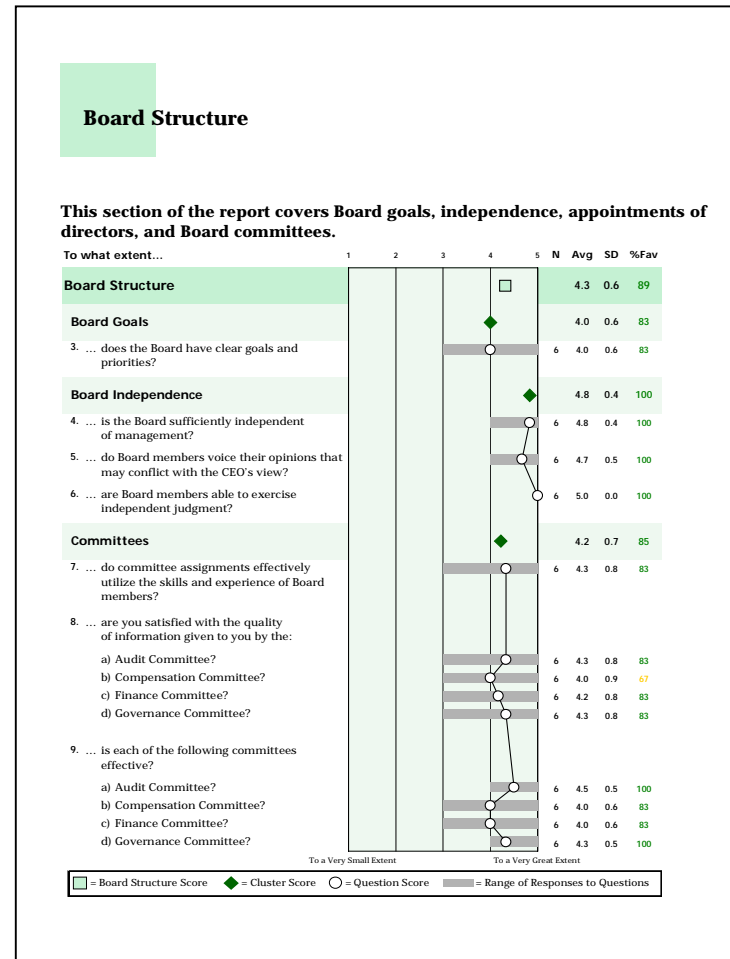
Please read each statement carefully and circle the number that best describes your opinion.

	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	Not Applicable/ Does Not Apply
<b>Board Composition</b>						
21. The Board has the appropriate mix of skills and experience to be effective .....	1	2	3	4	5	?
22. I am satisfied with the process for nominating new directors.....	1	2	3	4	5	?
23. When selecting new directors, we seek out skills and experience that complement the Board's composition .....	1	2	3	4	5	?
24. The Board has the right mix of inside and outside directors.....	1	2	3	4	5	?
25. The Board has clear <i>policies</i> for nominating new directors.....	1	2	3	4	5	?
26. The Board has clear <i>criteria</i> for nominating new directors .....	1	2	3	4	5	?
<b>Board Structure</b>						
27. The Board is organized into the appropriate committees.....	1	2	3	4	5	?
28. The number of committees is sufficient for the Board to be effective .....	1	2	3	4	5	?
29. The current committee structure enables the correct work to be accomplished .....	1	2	3	4	5	?
30. Committee assignments reflect the interests, experience, and skills of Board members.....	1	2	3	4	5	?
31. The Board uses task forces for specific projects, rather than static committee structures .....	1	2	3	4	5	?
32. Committee assignments offer adequate opportunities for leadership and leadership development .....	1	2	3	4	5	?
33. The Board is organized well to oversee the company's strategy .....	1	2	3	4	5	?
34. How many Board directors are required to function most effectively?.....						Directors
35. How many Board meetings per year are required to function most effectively?.....						Meetings per year

MERCER DELTA

1

## Sample Report





# Director Peer Assessment

## Sample Questionnaire

Peer Assessment Questionnaire

**Peer Assessment Questionnaire**

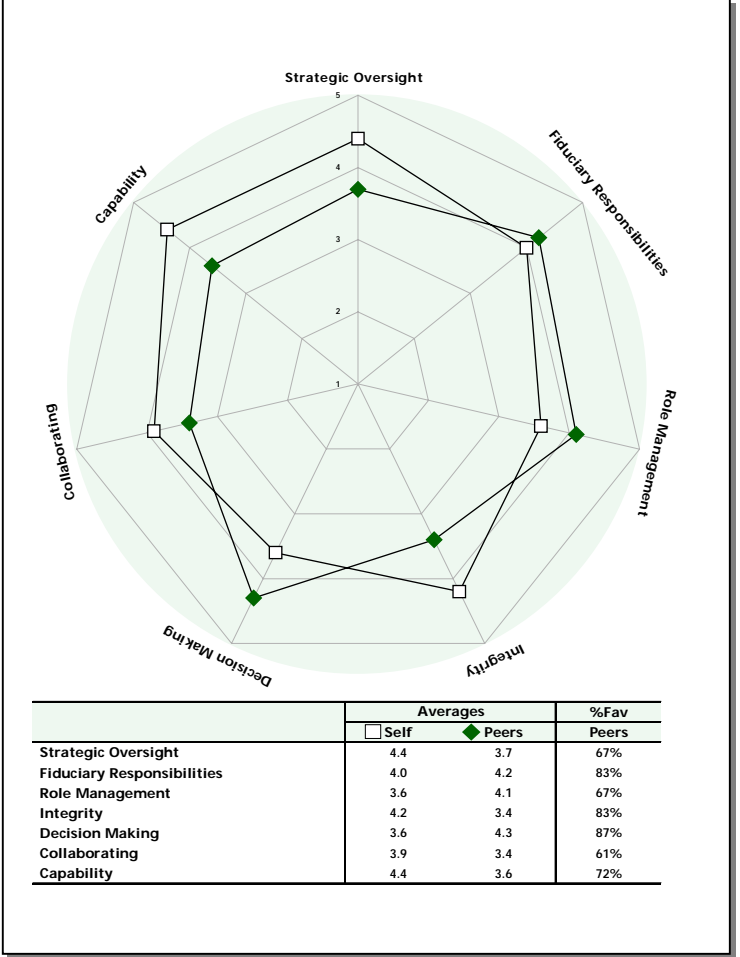
Please read each statement carefully and write a number for each director, using the scale provided, that best describes your point of view. If you are unable to evaluate a person on an item, please indicate a "?" for "Don't Know."

**Scale for Response**  
 1 = To a Very Small Extent  
 2 = To a Small Extent  
 3 = To Some Extent  
 4 = To a Great Extent  
 5 = To a Very Great Extent  
 ? = Don't Know

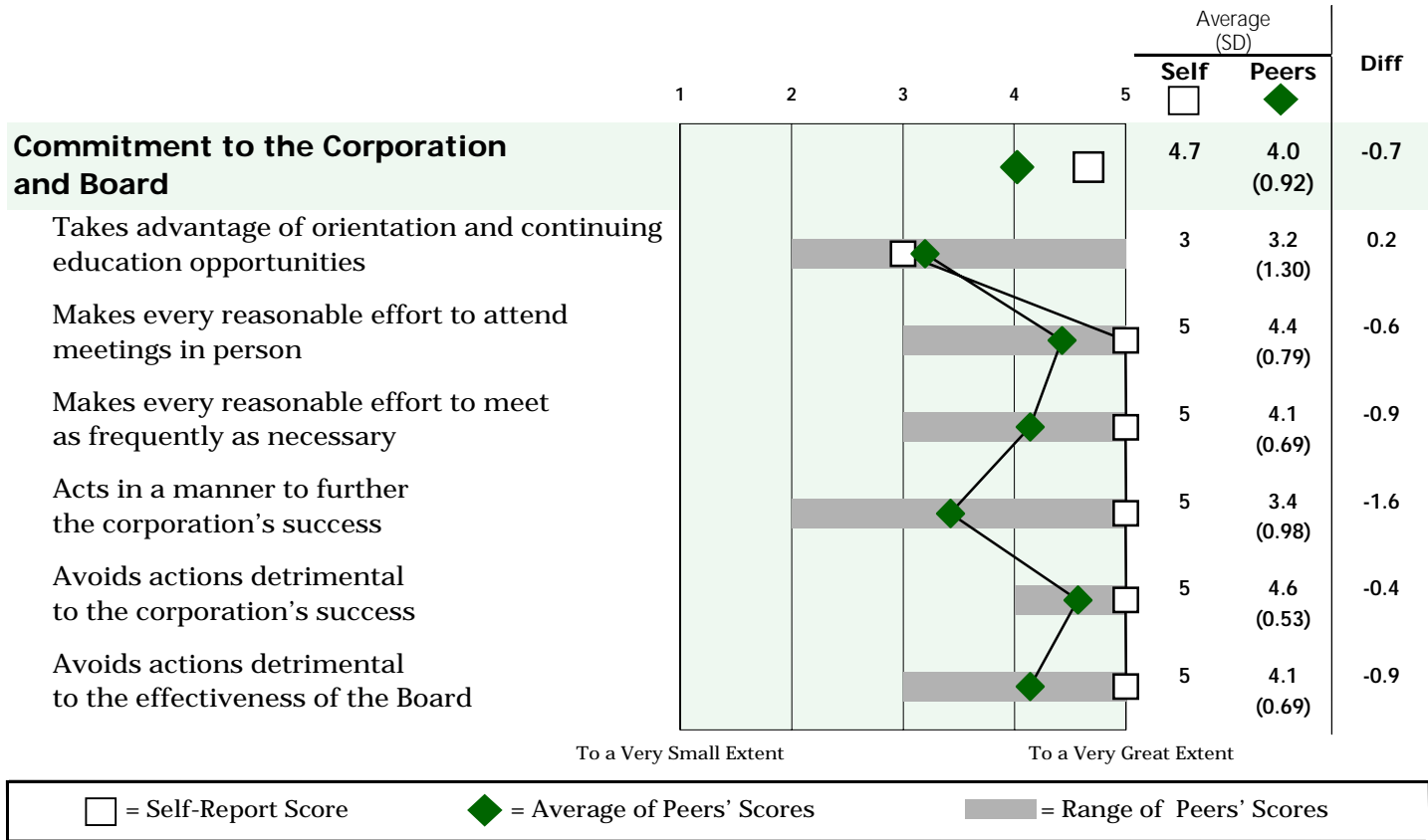
	Director 1	Director 2	Director 3	Director 4	Director 5	Director 6	Director 7	Director 8	Director 9	Director 10	Director 11
<b>Strategic Oversight</b>											
1. Understands the company's strategic direction.....											
2. Focuses comments and questions in the Board to advance the strategic direction.....											
3. Understands the company's business priorities.....											
4. Speaks knowledgeably about the company's standard of quality.....											
5. Actively directs comments toward policy development.....											
<b>Fiduciary Responsibilities</b>											
6. Demonstrates a strong understanding of fiduciary responsibility and stewardship of organizational resources.....											
7. Effectively contributes to reviewing the company's financial performance.....											
8. Demonstrates an ability to identify the costs, benefits, and consequences of Board decisions.....											
9. Advances all shareholder interests rather than those of a particular organization.....											
10. Monitors organizational performance by understanding financial analysis that impact the company's performance.....											

MERCER DELTA 1

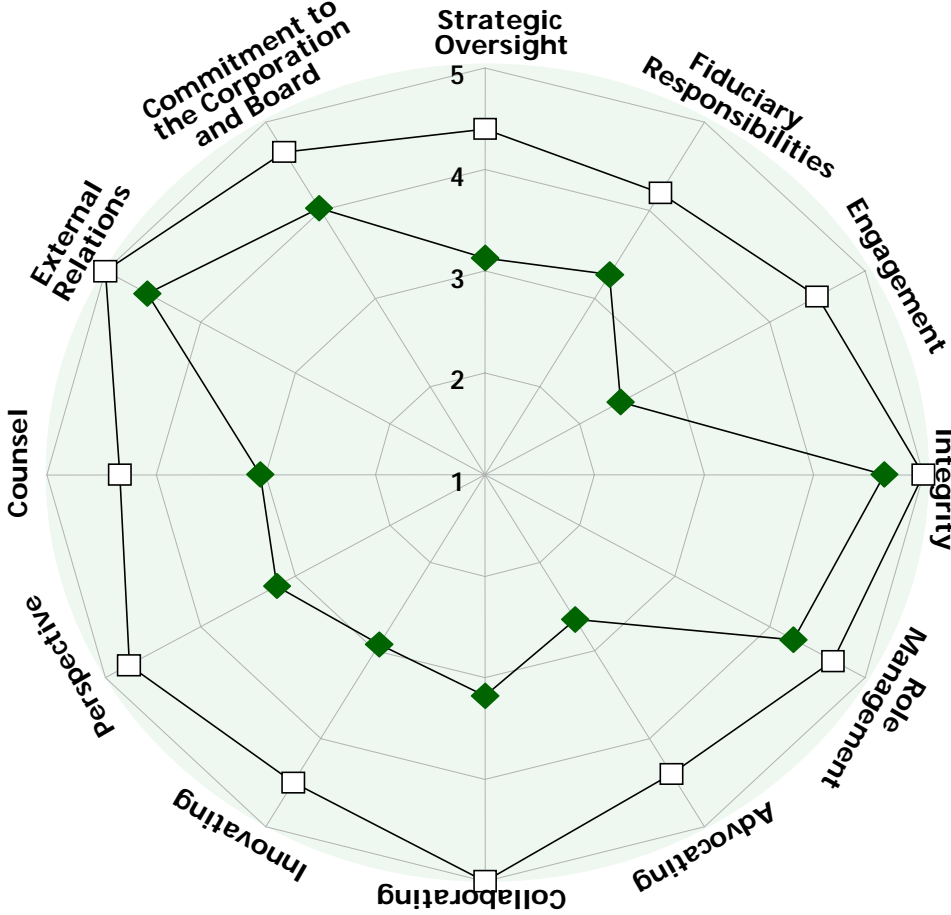
## Sample Report



# Director Renomination Assessment Questionnaire



# Director Renomination Assessment Results



Recommend to Withhold Nomination	Recommend Nomination With Reservation	Recommend Nomination
5	2	

# Board Engagement

## Sample Questionnaire

Board Engagement Questionnaire

**Board Engagement**

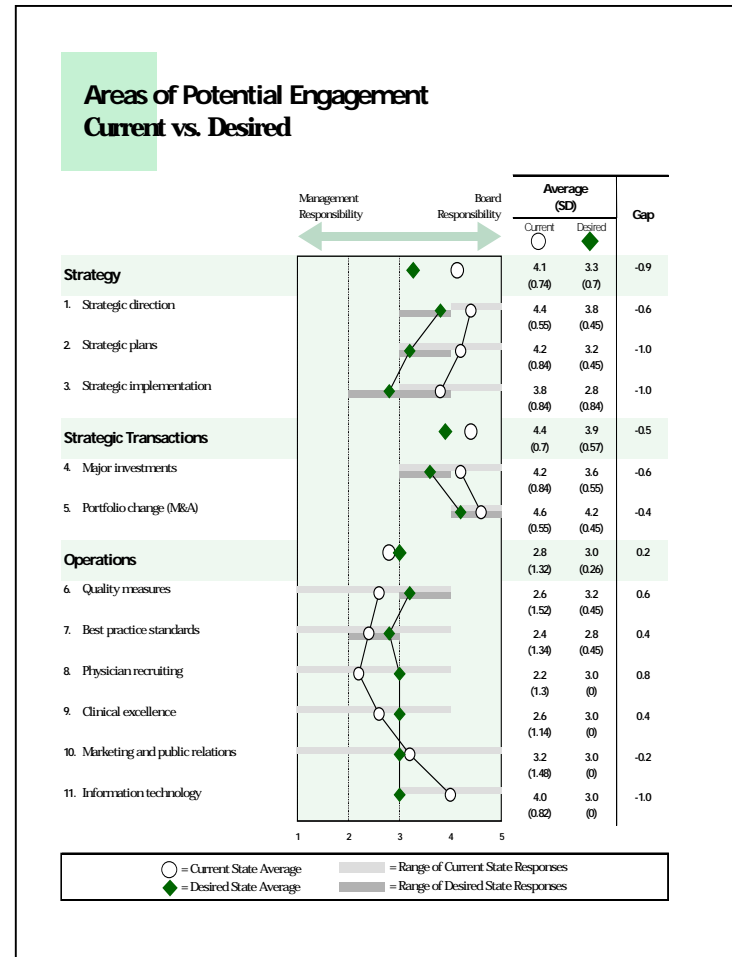
Please circle the response that best corresponds to the level of Board engagement in the following areas.

**Area of Potential Board Engagement**

	The Current State					The Desired State							
	No Engagement	Low Engagement	Moderate Engagement	High Engagement	Exclusive Engagement Not Applicable/ Don't Know	No Engagement	Low Engagement	Moderate Engagement	High Engagement	Exclusive Engagement Not Applicable/ Don't Know			
<b>Strategy</b>													
1. Strategic direction.....	1	2	3	4	5	?	...	1	2	3	4	5	?
2. Strategic plans.....	1	2	3	4	5	?	...	1	2	3	4	5	?
3. Strategic implementation.....	1	2	3	4	5	?	...	1	2	3	4	5	?
<b>Strategic Transactions</b>													
4. Major investments.....	1	2	3	4	5	?	...	1	2	3	4	5	?
5. Portfolio change (M&A).....	1	2	3	4	5	?	...	1	2	3	4	5	?
<b>Operations</b>													
6. Research and development.....	1	2	3	4	5	?	...	1	2	3	4	5	?
7. Manufacturing.....	1	2	3	4	5	?	...	1	2	3	4	5	?
8. Marketing and sales.....	1	2	3	4	5	?	...	1	2	3	4	5	?
9. Information technology.....	1	2	3	4	5	?	...	1	2	3	4	5	?
<b>Human Resources and Organization</b>													
10. Leadership development.....	1	2	3	4	5	?	...	1	2	3	4	5	?
11. Non-CEO executive compensation.....	1	2	3	4	5	?	...	1	2	3	4	5	?
12. Human capital.....	1	2	3	4	5	?	...	1	2	3	4	5	?
13. Organization.....	1	2	3	4	5	?	...	1	2	3	4	5	?
14. Corporate culture.....	1	2	3	4	5	?	...	1	2	3	4	5	?

1

## Sample Report





Panel Conversation:  
Separating the Role of Chair and CEO

# Prevalence in the U.S. Verses U.K./Canada



- Gradual trend in the U.S.
  - Between Feb. 2003 and Mar. 2004, S&P 500 shows drop from 391 to 376 having shared roles
    - However, about 1/5th of all public companies report having independent lead directors in 2003, up from 3% in 2002
    - 40% of directors and 69% of investors favor split
  - 47 shareholder proposals to split roles on the slate for 2004
  - Recent defeats for independent chair at Boeing, Tyco, and GE
- In 2003, The Conference Board commission strongly recommended splitting roles and name outside Lead Director to run meetings without management present
- In the U.K., approximately 95% of FTSE 350 split the roles and approximately 80% in Canada

# Some Recent Splits (Since 1997)

- Bank of Montreal, Dell, Walt Disney, Intel, JDS Uniphase, Lafarge, Microsoft, Nationwide Financial Services, Nextel Communications, Omnicom Group, Oracle
- In this group of sample companies, only 5 out of 11 have outperformed the S&P 500
- As a group, they did 11% better than the market (based on Forbes 4/12/04)



# Pros and Cons for Non-Executive Chairs

## Pros

- Providing oversight requires independence
- Appears to work well in U.K./Canada
- Helps spread the workload
- Two heads are better than one
- Shareholders are demanding it
- Becoming an explicit criterion for investors
  - Basis for Moody's bond ratings
  - Fitch ratings
  - S&P "creditworthiness" consideration

## Cons

- Sharing of power is unrealistic and often unacceptable
- Creates ambiguity as to accountability
- Creates a job that may be hard to fill
- Administratively more complex
- May create "over ambitious" Boards
- Hard to attract some CEOs without the dual role
- How many Non-Executive Chairs are really independent?
  - Often past employee/CEO
  - Highly compensated



# Considerations

- This type of person is often hard to find
- May require as much as (or more than) 50% commitment of time
- High salary requirements will raise questions of independence
- If past employee, may be perceived as not being truly independent
- Sometimes it is easy and makes sense given the players, situation, timing
- Probably not right for all situations
- Clear role definitions do not yet exist distinguishing Chairman, Lead Director, Presiding Director, Non-Executive Chairman from the role of the CEO
- Questions of appropriateness are best raised at time of succession

# Alternatives to Board Independence

- Appoint Lead/Presiding Director
  - Chair of Governance Committee
  - NYSE requires Presiding Director
- Focus on the values and ethics of the Board and CEO
  - Correctly done, will protect shareholders more than any artificial role definition
  - Use in selecting and evaluating Chair and CEO
- Ensure intellectual diversity on the Board
- Use systematic, comprehensive Board and CEO evaluation
- Ensure strong two-way communication/access between the Board and Senior Management so that CEO cannot be a filter





# Panel Conversation: CEO Succession

# Current Perspectives

- Recent studies show an alarming increase in CEO turnover
  - CEOs appointed after 1985 are three times more likely to be fired than CEOs appointed before that date
  - In the past seven years alone, more than two-thirds of all major companies, worldwide, have replaced their CEOs
  - Once in the job, CEOs are there for a shorter tenure. Since 1996, the career of the average U.S. CEO has decreased from 9.5 to 7.3 years
- A study of over a dozen cases of CEO failure discovered that two significant contributing factors to involuntary CEO turnover are:
  - Flawed formal succession processes
  - The destructive, although often unintended, actions of the outgoing CEO



# Common Pitfalls in CEO Succession Planning

- Insufficient Planning
  - Many large U.S. corporations do not have succession plans in place (33% according to one survey)
- Static Plans
  - May have a set of requirements and list of candidate names that are discussed periodically but not systematically revised as the needs of the organization and candidate status evolve
- Role Confusion
  - There is a disagreement over roles and authority, making responsibilities difficult to be aligned
- Mismanaged Communications.
  - Prematurely “leaked” information can create undue anxiety, politicized behavior, and a loss of control over the process



# Consequences of Failure to Plan

- An effective succession process can create a smooth transition from one CEO to the next, however, a poorly run succession process can have dire consequences:
  - Lowering the company's stock price by threatening investor and analyst confidence
  - Creating dissension within the Board
  - Initiating destructive political behavior among candidates
  - Disrupting the continuity of strategic efforts
- In a recent survey of Fortune 1000 corporate directors, less than half thought their company's succession processes were effective
- Less than one-fourth thought the Board was effectively involved in developing internal candidates

# Creating a Culture of Succession and Leadership Development

- Numerous companies are recognized and respected for their best-in-class approach to not just CEO succession, but their broader investment in creating a culture of succession and leadership development.
- Examples of the most widely recognized exemplars include: General Electric, Dell Computer, Colgate-Palmolive, Eli Lilly, and Honeywell

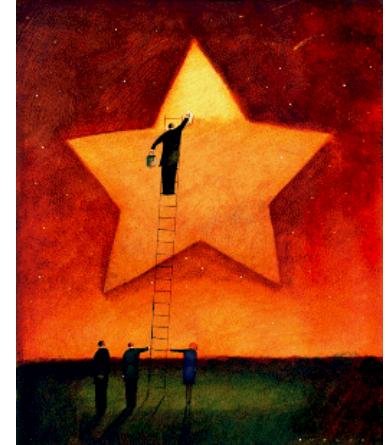


General Electric Company



# Critical Practices of CEO Succession Planning

- Identify competencies required to take the company to the next level of growth
- Identify potential successors from within the company based upon the specific criteria
- Establish a process and timeframe for preparing internal candidates or looking outside the company for successor
- Determine how best to maintain the CEO's contribution after his/her transition from the role of CEO





# Leadership Succession Model Strengths and Weaknesses

	CHAIR CEO	CHAIR CEO	NON-EXECUTIVE CHAIR CEO	CHAIR CEO
	Internal Candidates	Transition Model	Security	External Candidates
<b>P O S I T I V E</b>	<ul style="list-style-type: none"> <li>+ Knows the business</li> <li>+ Demonstrates ability</li> <li>+ Understands strategy</li> </ul>	<ul style="list-style-type: none"> <li>+ Builds public trust</li> <li>+ Allows smooth transition</li> </ul>	<ul style="list-style-type: none"> <li>+ Post-Enron Security response</li> <li>+ Widely used outside the U.S.</li> <li>+ Gives sense of control</li> <li>+ Helpful in some industries</li> </ul>	<ul style="list-style-type: none"> <li>+ Signals change</li> <li>+ Good solution to no internal candidate</li> <li>+ Presumes a strong board</li> </ul>
<b>N E G A T I V E</b>	<ul style="list-style-type: none"> <li>- Diminished confidence</li> <li>- Potential loss of competition</li> </ul>	<ul style="list-style-type: none"> <li>- May signal low trust</li> <li>- May cause alarm in candidates</li> </ul>	<ul style="list-style-type: none"> <li>- Not easily reversed</li> <li>- Only 20% U.S. Companies use</li> <li>- May not have available talent</li> <li>- Limits CEO power</li> </ul>	<ul style="list-style-type: none"> <li>- May not easily fit the culture</li> <li>- May lose key talent</li> </ul>



Panel Conversation:  
The Intangibles of Governance

# The Intangibles of Governance Character and Competence

- Authenticity
  - Intellectually honest and straightforward
- Intention
  - To add value
- Integrity
  - To do the right thing
- Worthy of trust
  - Seeking the right end free of conflicts
- Mature self-awareness

