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THE JOURNAL REPORT: CORPORATE GOVERNANCE

Move Over, CEO: Here Come the Directors

Board members are becoming more plugged in to the companies they serve. It makes for better oversight -- and potentially strained relations with management.

By **KAJA WHITEHOUSE**
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The boardroom walls are coming down.

By tradition, outside corporate directors long stayed away from the nuts and bolts of the companies they served. Almost everything they knew about the business came from management, and they rarely went into the trenches to talk to investors or employees. Many were passive in the face of strong CEOs -- who saw the board as a rubber stamp.

THE JOURNAL REPORT


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As [more boards meet without management present](#)², it makes for franker talk -- and anxious CEOs.

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Now the old way of doing business is beginning to crumble. Directors are mingling with employees to get the lowdown on simmering problems. They're opening channels of communication with investors to hear their complaints. They're hiring their own advisers to double-check management's decisions. And they're even taking over responsibilities that once belonged to the CEO -- such as nominating new board members.

"Directors are a lot closer to internal controls than they've ever been," says Paul Lapidés, co-founder and director of Kennesaw State University's Corporate Governance Center in Kennesaw, Ga. "A good number of directors are waking up to the fact that asking tough questions" about a company is difficult if management filters all the information.

DIRECTORS' PAY


PODCAST:⁵ While excessive executive pay has been attacked for years as a sign of poor corporate governance, directors' compensation has received relatively little attention. But that may be starting to change. WSJ's Joann Lublin, the Journal's management news editor and contributing editor for this report, talks about recent trends in directors' pay, different kinds of compensation and the pitfalls they may involve.

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To some extent, boards have little choice in becoming more aggressive. New rules and regulations guiding director duties are forcing major changes. The Sarbanes-Oxley Act of 2002, for instance, requires corporate boards to establish nominating committees made up entirely of independent directors.

But directors also seem to be embracing the new level of responsibility. Today's higher standards are allowing

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some directors to enforce practices they've long supported but had little power to implement.

Most governance experts applaud these developments as a way to create more-effective checks and balances. But they warn that boards shouldn't overstep their bounds and try to make company policy themselves.

"A board's responsibility is oversight, not management," says Allan J. Reich, a corporate lawyer with the law firm Seyfarth Shaw in Chicago and a board member of mutual-fund company Oakmark Funds. "Today, what you see is boards coming right up to the line" between management and oversight. This is good, "as long as they don't cross the line," he adds.

GOING THEIR OWN WAY



The percentage of surveyed directors saying their board has these practices

- **75%** An independent director who provides leadership to the board (e.g., lead director, presiding director)
- **61%** Separate staff or consultants for the board
- **51%** A requirement that outside directors visit company operations during the year
- **30%** A nonexecutive chairman or chairwoman who is not a present or former employee of the company

Sources: *Center for Effective Organizations, Marshall School of Business, University of Southern California; Heidrick & Struggles*

Here's a look at some of the ways directors are moving beyond the boardroom -- and the impact that's having on their relationship with management.

TALKING TO SHAREHOLDERS

In the past, directors had minimal contact with shareholders, even big ones. Management was the official voice of the company, and rarely gave investors a way to contact board members other than through the chairman and CEO. Warren L. Batts, an adjunct professor of management at the University of Chicago, recalls serving on the board of one public company where shareholders resorted to getting in touch with directors by looking up their home numbers in the phone book.

Yet hearing views outside of management is an integral part of being a good director, says Charles Elson, head of the University of Delaware business school's John L. Weinberg Center for Corporate Governance. He also serves on three public-company boards.

"What if politicians said, 'I don't talk to the voters'?" Mr. Elson asks. Among other things, lack of contact means directors are insulated from outside complaints -- and investors have no access to the only people who can challenge management's decisions and hold executives accountable.

Now, the situation is beginning to change. In 2003, the New York Stock Exchange began requiring listed companies to tell "interested parties" how they can reach nonmanagement directors. Mostly, this amounts to simple measures such as posting contact information for a corporate secretary in public filings and on Web sites. The corporate secretary monitors the letters received and decides what should be forwarded to the directors.

Even at this stage, though, there are some significant signs of progress. If correspondents make enough noise, or represent a big enough block of shares, some directors will accommodate them. The AFL-CIO, for example, recently secured a meeting with **Home Depot** Inc. director Bonnie Hill, who heads the board's compensation committee, to discuss a controversy over stock-option grants to company executives. Funds affiliated with the union hold more than 6.4 million shares of Home Depot stock.

After some correspondence between the AFL-CIO and Home Depot's corporate secretary, Ms.

Hill agreed to meet with the union in early September. Daniel Pedrotty, a counsel with the union, won't disclose the outcome of the meeting, but says it was productive.

Still, he says, union officials would have preferred to meet Ms. Hill without management representatives in the room. These kinds of discussions would probably be a lot franker -- between both parties -- without management listening in, Mr. Pedrotty says.



William Duke

But many directors, including Ms. Hill, feel it's necessary to have management representation during these meetings so that their comments aren't misconstrued by shareholders. Moreover, says Mr. Elson, the last thing a director wants is to be seen as sharing information with select investors; a corporate secretary or general counsel can make sure the director doesn't disclose any critical information inadvertently.

Besides, Ms. Hill says she didn't feel inhibited by the presence of management. "Anyone who knows me knows that that is just not the case," she says. "I say precisely what I think and what I believe."

LISTENING TO EMPLOYEES

It isn't just investors who are getting more access to directors. Employees are, too. Increasingly, directors are trying to get a closer look at the companies they serve by talking to rank-and-file workers. The board might make site visits to a company's plants or stores, for example, or meet with teams of workers one-on-one, without any hand-holding from the CEO or another top executive.

These days, directors won't join a board if they don't have open access to employees, especially those who work directly for top management, says Steve Mader, a vice chairman of executive-search firm Christian & Timbers in Boston. "They want to know they can pick up the phone and call anybody they want to without interference and objection," he says.

This helps directors not only get a better grasp of the company's operations but also pick up on any problems in the company. Mr. Mader recalls a situation where the board of an \$8 billion electronics company he counseled discovered a big behind-the-scenes conflict by talking to employees.

The board had put a new CEO in place a few months earlier, and thought it wise for the exiting CEO to remain as chairman. But as the directors spent time with the executive-team members, they learned something troubling: The former CEO and sitting CEO were engaged in a power struggle.

Some of the new CEO's staff sided with the former CEO. The directors learned of the staff's distrust for the new boss's leadership and vision during talks about regular business matters. Directors ended up removing both executives, Mr. Mader says. Without regular and unfiltered access to employees, he adds, the problem may have taken a lot longer to discover.

NO MORE RUBBER STAMP

In the old days, directors might approve a business plan within hours of hearing it. They saw

themselves as sounding boards, not overseers -- which often amounted to rubber-stamping management's proposals after a few routine questions.

Now directors are becoming more-aggressive watchdogs. They're being more forward about questioning management's proposals, and following up on those plans to see how they're progressing.

One of Mr. Reich's corporate clients recently presented a significant business proposal to the board. Once the directors finally approved the project, they didn't just let it drop. Instead, they took steps to keep on top of it. The first move: The nonexecutive chairman made plans to attend a meeting of the project team so he could see how the initiative was developing. "Five years ago, it's unlikely you would find a member of the board attending a meeting of this nature," says Mr. Reich.

Boards are even bringing in outside consultants to help them digest complex business plans -- and, in some cases, amend them. Janet M. Clarke, a director of some well-known companies, including computer maker Gateway Inc., says directors have little choice, given the increased liability they face if they neglect their fiduciary duty.

"At the end of the day, the buck is stopping with the board," says Ms. Clarke, who says she has brought in outside experts to review management's plans.

Still, it's an area of some sensitivity, say directors and corporate lawyers. Unless the board is very careful, managers will think that they're being second-guessed or even that the board doesn't trust them.

Gordon S. Kaiser Jr., a corporate lawyer with Squire Sanders & Dempsey in Cleveland, has seen the tensions this new practice can cause. In one instance, top management of a company he advises went to the board with a proposal for executive bonuses. The directors sent it back and hired their own pay consultants to help them restructure it, says Mr. Kaiser. Among other things, the board wasn't sure the incentives in the plan were rewarding the right kind of performance.

The result: "There was some sense that the board was overstepping its lines," says Mr. Kaiser. "Management often feels, 'If they really trust us, they shouldn't have to do that.' "

Indeed, board members have to be careful not to abuse their access and step into management's shoes. With more board members taking an active role, the line between governance and management can seem fuzzier, consultants and some directors say. Mr. Reich recalls a situation where a board member, who had a lot of accounting knowledge, began questioning the CFO's decisions with the CFO's staff and openly criticizing the CFO's decisions. "The individual was using his knowledge or beliefs to supplant the authority of the CFO," says Mr. Reich.

This can undermine the executives' credibility and disrupt their ability to perform their job, says Mr. Batts. "Having been CEO of four companies, I'll tell you, that's a hard job. You don't need someone guiding your hand," he says.

There's also a cost issue if outside consultants get involved. "When management has already gone through that [checking] process, they see it as an unnecessary intrusion and an unnecessary expense for the board to spend money to go through the same process," says Mr. Kaiser.

TAKING BACK THE BOARD

Directors are asserting their independence in another crucial way: taking control of the operations of the board itself.

In the past, directors were generally hand-picked by the CEO, creating cozy relationships and potential conflicts of interest. And CEOs, who often also were board chairmen, generally dominated the board's proceedings -- from scheduling meetings to showing up at every gathering, which hindered independent directors from talking freely.

Today, regulators are forcing big changes in these areas. Sarbanes-Oxley calls for independent nominating committees for directors. And the Big Board now requires listed companies to hold regular meetings without management, known as executive sessions.

There's a distinct link between the way a board is structured and its ability to operate effectively, says Warren Neel, an experienced director and executive director of the University of Tennessee's Corporate Governance Center in Knoxville. When a CEO "controls the boardroom, it's his attempt to control the organization," he says.

Mr. Neel experienced this kind of power struggle many years ago as a director. The CEO of the company refused to let the board set the meeting agenda. "He wanted all the committees to meet when he could meet," says Mr. Neel. If the board said it wanted to hold an executive session, "he would either say no, or he would arrange it such that you couldn't. You would be forced to meet in front of him."

If the board pressed the issue, the CEO would act offended at the notion that the board wanted to meet without him. "It was a very pronounced struggle," says Mr. Neel.

With the new rules, "we have repositioned the fulcrum of power," he says. "The board can't simply give away its responsibility."

--Ms. Whitehouse is a reporter for Dow Jones Newswires in Jersey City, N.J.

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