

**“The Board’s Balancing Act:  
Managing Risk and Setting Strategy for Long Term Value”**

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**I. SHAREHOLDERS’ PRIMARY EXPECTATION: BOARDS TAKE CORPORATE INTEGRITY AS THEIR NO. 1 RESPONSIBILITY.**

1. What shareholders need most from Boards of Directors and senior management is assurance of an organization’s integrity – including an assurance that the corporation’s values and culture support that integrity.

Specifically:

- That the Board of Directors is uncompromising in the selection, evaluation and retention of directors of high integrity and skill.
- That the Board of Directors is uncompromising in the selection, evaluation and retention of executive management of high integrity and skill.
- That the Board and senior management recognize their joint roles in assuring that the organization has, and practices, values that support a culture of integrity, fairness, trust, and high performance.

A key element in leadership is trust. Boards and senior executives must be extremely sensitive to the signals they send to the stakeholders and employees of the organizations they lead. Signals to shareholders include responsiveness to shareholder director nominees, proxy proposals, governance standards, views on executive compensation, etc. Signals to employees include who is selected for Board service, who is hired/promoted to serve as a senior executive, what behaviors are endorsed or permitted at the Board, management and staff levels, how people are rewarded, and how employees, suppliers, customers, shareholders and other stakeholders are treated.

- ❑ That the public disclosures and comments of senior management and the Board have integrity and are reflective of the true state of the company's affairs.
- ❑ That senior management would above all responsibilities see that the company's business was conducted in a manner which would serve rather than detract from its integrity; and would enhance rather than reduce the value of its good will.
- ❑ Consider companies' market values, and the percentage comprised of tangible assets versus goodwill. For many companies, particularly technology companies, but also companies like Starbucks, Goldman Sachs, Best Buy, the goodwill on their balance sheets far outweighs their tangible assets.
- ❑ That a corporation's advisors and consultants, including lawyers and accountants, will act to protect the organization's integrity, and take important issues to senior management and the Board of Directors to assure that they are acted on appropriately.
- ❑ That the compensation and benefits paid to Board members and senior management, which directors alone approve, will not in actuality or perception co-opt their judgment, compromise their independence, detract from the corporation's integrity, or have a corrosive effect on the company's culture.

This subject is and will continue to be a critical shareholder issue which will be used to advocate for governance reform until Boards and their compensation committees assert more oversight and controls. The stock option backdating, spring-loading and bullet-dodging is a subset of shareholders' executive compensation discontent. The continued publication of reports and disclosures, and consequent loss of market value for many of the companies involved, further shareholders' distrust of management and current Boards' oversight capabilities. Many large shareholders see their only remedy as gaining more control over Board composition.

- ❑ That directors and management will avoid actual or perceived conflicts of interest which would detract from the integrity of the company and its governance.
  - ❑ That management has in place compliance systems and procedures that will give it early warnings of activities that would threaten the integrity of the company.
  - ❑ That the corporation's financial statements have integrity – in other words that they can be clearly understood and relied on by those responsible for assessing the financial condition of the company for purposes of investing in it and doing business with it.
2. The bottom line of governance is that the ultimate authority for the governed entity (the “governing authority” in the language of the Revised U.S. Federal Sentencing Guidelines) is responsible for the entity's integrity. In many of the current corporate scandals Boards “failed” because they did not take responsibility for the

organizations' integrity. The directors did not see the organizations' integrity as an extension of their own integrity – and ultimately that is the critical point.

## **II. SHAREHOLDER CONCERNS ABOUT BOARD/DIRECTOR PERFORMANCE FUEL THE DRIVE FOR GREATER PARTICIPATION IN BOARD COMPOSITION, DIRECTOR ELECTIONS, AND EFFECTIVE MEANS OF HOLDING BOARDS/DIRECTORS MORE ACCOUNTABLE.**

Common causes of Board failures:

1. In analyzing and approving strategy, many Boards don't thoroughly assess organization, business, financial, legal and personnel risks, and balance those risks against opportunities for improving performance and growth.
2. Many directors don't understand what it means to be a fiduciary.
3. Directors often don't truly understand their oversight roles.
4. Non-management directors are sometimes intimidated by management, uncritically reliant on the views of management and advisors, or passive. This has had serious consequences for U.S. companies in the first decade of the 21<sup>st</sup> Century (e.g., Enron, Worldcom, Tyco, Citigroup, Lehman Bros., AIG).
5. Failure to understand/monitor the corporate culture.
  - ❑ Failure to appreciate the signals Boards send about the values and ethics of the organization.
6. Failure to appreciate and use the oversight tools at their disposal. Will we see increased use of second opinions by Boards?
7. Failure to observe good governance practices.
8. Committee failures.
  - ❑ governance: re Board composition and director independence; Board and committee evaluation; CEO and director succession.
  - ❑ compensation: excessive CEO and senior management compensation (including bonuses, perks, benefits, and retirement and severance payments and benefits); stock option issues; poor CEO evaluation and senior management oversight.
  - ❑ audit: financial statements (these are the company's statements, not the auditors); compliance; stock option issues.
9. Insensitivity to conflicts of interest.
10. Failure to understand and perform legal duties.

11. Failure of management to understand its role in Board effectiveness, particularly with respect to strategy and risk.
12. Failure to embrace Board/director education.

### **III. SOME THOUGHTS ON HOW BOARDS MIGHT IMPROVE GOVERNANCE AND OVERSIGHT TO ADDRESS SHAREHOLDER CONCERNS AND IMPROVE SHAREHOLDER RELATIONS AND SOME HELPFUL TOOLS:**

1. Understand that governance is a discipline different from management. It's about proactive, vigorous oversight. Who populates Boards? Often it's people who have excelled at management. The challenge is developing excellence at governance.
2. Recognize that integrity is everything. It is the root of stakeholder and public confidence in a company. Organizational integrity starts at the top, i.e., the Board of Directors and senior management.
3. Boards must strive to understand risks, pay attention to warnings and confront problems promptly and forthrightly. Policies and procedures for assessing and monitoring risks are essential, and directors must assure that they are in place and functioning well. Warnings need to be heeded and promptly investigated. Investigation means a thorough effort to obtain all relevant information, using independent resources where necessary to assure objectivity. History provides ample lessons of the disastrous consequences of cover-ups.
4. Board composition must receive more attention. In addition to management, a variety of voices and skills are needed on today's Boards; *e.g.*, analyst, risk assessment, human resources, stakeholder relations, government relations, institutional investor, internal audit, regulatory, compliance, legal, accounting/finance.
  - In today's political environment, Boards must, more than ever, pay attention to political risk and its impact on corporate strategy. Boards need directors and access to resources capable of assessing the impact of political risk on corporate strategy and performance.
5. Recognize Board oversight of the corporate culture is critical. Boards must understand and take responsibility for the corporate culture.
  - Boards must also work with management to create an appropriate Board/management culture. This culture clearly impacts Board effectiveness on matters of strategy and risk.
6. Boards must take more responsibility for compensation, perks and incentives, retirement and severance pay. This subject continues to inflame shareholders, politicians and regulators. This subject clearly impacts strategy and risk.

- ❑ Boards must be more aware of the corrosive effect on the corporate culture, particularly trust, which can result from poor compensation practices at the Board and management levels.
  - ❑ Boards must realize that excessive director and executive compensation reflects poorly on their independence, integrity and judgment.
  - ❑ The bottom line is that Boards must assure that management establishes the compensation and incentives for any group in the context of an overall compensation philosophy for the organization which is in fact, and perception, fair, rewarding excellent performance and addressing poor performance.
7. Boards must carefully assess actual and perceived conflicts of interest. Like the compensation issues, unresolved or poorly resolved conflicts of interest reflect badly on Boards' independence, integrity and judgment, and can have a corrosive effect on the corporation's culture.
  8. Boards must pay more attention to the organization's human capital. Boards have always accepted responsibility for the organization's financial capital. They must devote equal attention to the organization's human capital.
  9. Boards should participate with management in developing and maintaining key shareholder interaction policies and practices. Boards must improve shareowner communications, seek an understanding of shareowner concerns and views on a variety governance issues, including input into the director nomination process and company performance issues, and demonstrate a willingness to engage with shareowners and their representatives on these matters. Avoidance is no longer workable.
  10. Directors must pay close attention to their core duties: care, loyalty, good faith, compliance and oversight.
  11. Boards must use the tools at their disposal to effectively execute their oversight responsibilities.
    - ❑ Selection of capable directors, known to be ethical and screened for past legal and ethical issues, knowledgeable about governance and oversight, who have the time, energy, knowledge, judgment, leadership and courage to effectively discharge their responsibilities.
    - ❑ Selection of a CEO, known to be ethical and screened for past legal and ethical issues, who is experienced and committed to building a corporate culture that is ethical and compliant, and holding the CEO accountable for the development of that culture.
    - ❑ Selection of independent Board leadership with the knowledge and skills to assist the Board in meeting its responsibilities.

- ❑ Periodic independent assessments of the company’s culture, ethics, values and compliance, and the effectiveness of training programs designed to instill appropriate corporate values, familiarize employees with the company’s ethics and compliance expectations and assure those expectations are met.
- ❑ Insistence that management have in place processes and procedures for preventing and detecting violations of laws, regulations, company governing documents and company codes of ethical conduct; followed up with oversight over, and periodic assessment of, the efficacy of those processes and procedures.
- ❑ Oversight over the evaluation, hiring, firing and compensation of employees who are key to assessing and shaping the corporation’s financial reporting, human resources, risk assessment, ethical and legal compliance environment, e.g., the CFO, controller, internal auditor, risk manager, investor relations officer, internal counsel, head of information technology. Periodic one-on-one interviews with these individuals are an essential check.
- ❑ Independent contact with key corporate advisors: outside counsel, independent auditors, various consultants.
- ❑ Engagement of the independent auditors and compensation consultants; oversight over management’s engagement of outside legal counsel and other key advisors to assure that the loyalty of these advisors is to the company and not the personnel at the company who engaged them.
- ❑ Engagement of independent counsel and consultants to advise the Board, or Board committees, on matters with respect to which the Board requires a “second opinion” or advice from a service provider who is not regularly engaged to serve the company under management’s direction.
- ❑ Use of various tools to assist with monitoring:
  - Business intelligence and balanced scorecard software.
  - Culture assessment.
  - Awareness of sustainability and corporate social responsibility.
- The 7 Principles of the Caux Roundtable:
  - i. The Responsibilities of Businesses: Beyond Shareholders Towards Stakeholders.
  - ii. The Economic and Social Impact of Business: Toward Innovation, Sustainability, Justice and World Community.
  - iii. Business Behavior: Beyond the Letter of Law Toward a Spirit of Trust.

- iv. Respect for Rules.
  - v. Support for Multilateral Trade.
  - vi. Respect for the Environment.
  - vii. Avoidance of Illicit Operations.
- Caux's Arcturus Matrix for corporate assessment. The Center for Ethical Business Cultures and its tools for assessing culture.
  - Use of corporate and outside investigatory and research resources to scan backgrounds of key people and organizations.
  - Use of search firms to assist with the identification and screening of director and CEO candidates.
12. Transparency is good; obscuring reality is bad.
  13. Targets are good; quarterly earnings obsessions are bad.
  14. Monitor corporate disclosures. Boards must be aware of the many ways in which the corporation provides information, e.g., public comments by management, management conduct, media interviews, press releases, websites, broadcast or directed email, regulatory agency filings and a multitude of forms and applications for other third parties.
  15. Monitor external information sources such as analyst reports, positions taken by proxy advisors, competitors' public disclosures and advertising, blogs, websites, chat rooms, etc.
  16. Boards should monitor the governance views of business, shareholders, institutional investors, proxy advisors, legislators, regulators, governance commentators, and contrast those views with the corporation's governance policies and practices.
  17. Boards must be extremely conscious of the signals they send to the organizations they govern. Signals which come from their own conduct, who they nominate as directors, who they hire as the CEO, what conduct they endorse, what values they espouse directly and indirectly, how they deal with behavior which is antithetical to those values, and situations which test those values – it's about the culture of the organizations for which they are ultimately responsible.
  18. Boards and management should be very selective in opposing corporate reforms and governance practices advocated by responsible stakeholders.
  19. Directors need to be schizophrenic. Vigilant overseers of management on the one hand, and effective, constructive collaborators with management on the other.

20. Boards must focus on protecting the reputational value of their organizations. Reputations take years to build and moments to lose. For most organizations their reputations and goodwill are among their most valuable assets. Boards must be alert to individual and organizational conduct which may compromise a company's reputation for integrity and trustworthiness with its various stakeholders.
21. Embrace good governance practices. Good governance in actuality, not just in appearance. Good governance is about organization, process, education and **EXECUTION**. And finally **EVALUATION** -- evaluation of management, principally the CEO, evaluation of the Board, and evaluation of directors.

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