

Lead Director Network ViewPoints

Issue 12 December 12, 2011



Challenges in board leadership

Introduction

On November 1, 2011, the Lead Director Network (LDN) gathered in New York City for its 11th meeting, at which members discussed challenges they face in their role as lead directors.¹ This issue of *ViewPoints* synthesizes discussions with members concerning this topic. For further information about *ViewPoints*, see “About this document,” on page 9. For a full list of contributing members, see the Appendix, on page 10.

Executive summary

Every director has a responsibility to help resolve challenging board issues. But by virtue of their role as first among equals, their temperament, and their experiences, lead directors frequently guide the board through critical situations. Members focused their discussion on four challenges:

- **Handling individual director performance issues (Page 2)**

Some directors may not meet the high performance standards set by their boards. When a director is underperforming, the lead director works with other board leaders to identify the deficiency and tailor the board’s response. Performance issues sometimes require requesting the individual to resign from the board immediately or declining to renominate the director for another term. Such requests and the timing around them may be complicated by the director’s past contributions, relationships with key stakeholders, and external pressure, and require the lead director to carefully consider what response is best for the board and company.

- **Responding to an underperforming CEO (Page 4)**

When a director is dissatisfied with the CEO, that individual should discuss the issue with the chief executive. When the board, as a whole, is dissatisfied, it must determine whether to develop or remove the CEO. If the CEO is “teachable,” then the board should seek to address the deficiency; if not, it should look elsewhere. Regardless of the response, members believe that boards have a tendency to wait too long to address performance concerns. Certain factors make CEO transitions particularly difficult, including when many of the board members were involved in hiring the CEO or approved the strategy that has proven ineffective.

- **Bringing new directors on board (Page 6)**

Across industries and geography, boards are competing for similar individuals – leaders with substantial experience and desirable skills – at the same time that companies are more likely to restrict the number of boards on which their executives and non-executives can serve. Skills matrices are evolving, with increasingly detailed prioritization of desired director attributes. Prospective director evaluations are even more thorough, involving deeper background research and the involvement of more directors and

¹ The network operates under a modified version of the Chatham House Rule, whereby member names and company affiliations are a matter of record, but their comments are unattributed. Members’ comments appear in italics in *ViewPoints*.

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executives. Members said that the best boards never stop recruiting, are willing to expand the board when opportunities arise, and invest in new director orientation.

- **Preparing for lead director succession** (*Page 7*)

Lead directors should serve a term of more than one year, members said, but the right tenure for a particular board and lead director is situation specific. Lead director transitions can be complicated by plans for CEO succession and major corporate transactions, absence of a suitable successor, and fellow directors' reluctance to change something that is working. Identifying a successor takes time and care and should be handled discreetly.

Handling individual director performance issues

Directors want their board colleagues to have a deep understanding of the company's business and strategy, carefully review and probe materials prior to board and committee meetings, offer candid and constructive thoughts succinctly during those meetings, maintain cordial relations with fellow directors and senior management, and exhibit unimpeachable ethical standards. While many directors meet this high threshold, it is inevitable that some will not.

The lead director plays a key role in dealing with underperforming directors. Members discussed how to identify and evaluate director performance issues:

- **Strengthen the director evaluation process.** Members said that their annual director evaluation processes could be more robust and effective. One member noted, *"We made a decision to ask a director to step down because of the evaluation process, but really that just picked up on years of poor performance that became difficult to ignore."* Several lead directors suggested that making the evaluation process more confidential would make it more candid, robust, and useful. One tactic suggested was to have outside counsel conduct the evaluation, potentially shielding sensitive statements with attorney-client privilege protection.
- **Provide regular, year-round assessment in addition to the annual review.** Members broadly agreed that boards often take too long to react to signs of underperformance. Overreliance on the annual evaluation may be a contributing factor – and one that lead directors can avoid by regularly soliciting feedback: *"In one of the frequent conversations with other board members, the lead director can ask if there's anyone on the board who is not pulling his or her weight. Being named once does not mean much, but being named three times is very significant."* Regular feedback outside of the evaluation process can help identify and rectify performance issues more quickly. One member saw this as a fairness issue: *"Every director deserves thoughtful real-time feedback from the CEO and other directors."*
- **Discuss performance issues with other board leaders.** One member said, *"Although our board has a policy that no director is more important than any other, it and the other boards on which I serve have thought leaders: the CEO, committee chairmen, and other influential voices. These are the people who should be consulted on any emerging performance concerns."* Members said that if it can be avoided, director performance issues should not be raised to the full board because they can cause personal animosity and distract from board duties.

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Members noted that the suggestions outlined above make it possible to address director underperformance while remaining sensitive to each board's unique circumstances. This is important to members, who stressed that *“one size does not fit all when responding to performance concerns.”*

Members agreed that when a director's service falls short of expectations, *“boards have a responsibility to act.”* However, several factors can complicate the response:

- The underperforming director has made exceptional contributions to the company's success in the past.
- Personal problems, such as health issues or family trouble, are affecting the director's performance.
- The underperforming director has strong relationships with other board members or executives.
- There is significant external pressure – for example, from shareholders or the government – for director removal.
- The board's size is not ideal – perhaps too small due to unexpected vacancies, or too large due to a recent merger.

While boards cannot brook underperformance, members said it was important to separate performance concerns from personality conflicts: *“Some directors are a little difficult; they may be hard to please, more critical of management or other directors, or conduct themselves in a different way than the rest of the board. It may be frustrating, but it's not grounds for removal.”* Indeed, maverick directors can add value to the board's deliberations and help avoid groupthink. Members have previously stated that it is the lead director's responsibility to protect such directors.²

However, when there is underperformance, members were clear: *“Board seats are not an entitlement.”* If a board member has not abided by the board's code of conduct, for example, *“they need to leave.”* Even when they have followed the rules, it may be time for a transition: *“Regardless of how great the person is or their past success, if they aren't right for the board, if they aren't adding value now, they have to go.”* Determining when, and how, requires a full understanding of the facts at issue and careful deliberation. In some cases, the board may have to request the underperforming director's immediate resignation; in others, the board may simply decline to renominate the director for another term. One member remarked, *“You have to make a judgment on what is best for the organization. Sometimes that will be swifter action; other times it will be best for all parties if the issue does not come to a head.”*

Several members noted that offering outgoing directors a way to save face can make the process easier for everyone involved: *“Little things – issue a congratulatory press release, letting them announce the reason for retirement – can make all the difference.”*

Benefits of taking action against underperformance go beyond the particular director in question: *“It surprised me how much the other directors took notice of our response to a performance issue. Something happened – everyone started to move more quickly and seriously. The board was good before, but it got even better.”*

² See Lead Director Network, [“The lead director's role in major transactions.”](#) *ViewPoints*, March 29, 2010, 5.

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Dealing with the Director Who Refuses (or is Slow) to Leave

The power to remove sitting directors generally lies with the shareholders. The board cannot remove a director even in many situations where that director has acted inappropriately, such as disparaging the company or its management team. This highlights the importance of the nomination process; re-nominations should never be “automatic.” To give teeth to the re-nomination process, King & Spalding suggests that directors consider the following:

- Evaluations of individual directors, rather than only the board and its committees, will give board leaders visibility to performance issues or problems with “chemistry.”
- Refreshing the board’s skills matrix prior to the nomination process may suggest that a director is not positioned to contribute well to the board.
- When a director is re-nominated, despite some reservations about performance or personal issues, the lead director should make the director aware of expectations for the coming year.
- Committee assignments should reflect a director’s performance and a director who is not contributing well may be relieved of committee assignments.

Responding to an underperforming CEO

Members said that they spend substantial time working with their boards to identify any issues that need to be raised with the CEO and deciding how to proceed, determining whether they should seek to change the CEO’s approach or the person who fills the role.

When a company and CEO are both performing well, the lead director’s job is, as one member said, “*not very difficult – some might even say easy.*” Unfortunately, members said, sometimes the company and CEO are not performing well.

Communicating dissatisfaction

On many boards, the lead director is tasked with having tough conversations with the CEO.³ But the lead director should not be the only person speaking candidly with the CEO, members said. One member was dissatisfied with fellow directors who refused to express concerns to the CEO, instead venting at executive sessions and “*turning to me and saying, ‘OK, now go and tell the CEO all of that.’*” This member criticized this approach, saying it prevents the CEO from “*getting the flavor of how the whole board and its members see an issue.*” Another member explained why this dynamic is frustrating: “*Sometimes the CEO can sense dissatisfaction, but not always. If the CEO doesn’t understand or appreciate the minority view, conversations [between the CEO and board] are like two ships passing in the night. That is a difficult dialogue for the lead director and CEO.*”

³ See Lead Director Network, “[The relationship between the lead director and CEO.](#)” *ViewPoints*, March 24, 2011.

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When the board as a whole loses confidence in the CEO's leadership, it is time for a conversation between the CEO and lead director. For these conversations, the method of communication should befit the message. One member explained how he handled the situation: *"We were very dissatisfied with our CEO. To do our comments justice, we put together a pretty robust package of materials – a detailed assessment, views from other executives and board members – and delivered a written packet and talked through it in person. It was a big investment, but the CEO certainly received the message."*

Develop or remove?

"We've frequently said it's our job to support the CEO until we can't. CEO transitions are complicated, resource intensive, and risky, but sometimes necessary," one member said. *"Determining when they are and when they aren't is very challenging."*

If there is widespread dissatisfaction with the CEO's performance, the full board must decide whether to develop or remove the CEO. One member commented, *"The only question is whether the CEO is still teachable."* Some members agreed that both in and outside of the boardroom, leaders do not always respond to performance problems decisively: *"When someone is underperforming for me, whether it's when I'm a director or an executive, I think I have stayed with those people a little too long."*

If the board waits too long to address the problem, developing the CEO may no longer be a possibility, which some members felt was regrettable: *"It is always worth a shot to try and help the CEO get better. Forced successions may be necessary, but not taken hastily."*

And while there are instances where a board vainly tries to develop a CEO, there are also success stories: *"We were dissatisfied with our CEO and decided to take big action. We called him in and told him it was not working out, but that we weren't going to write him off. If he was willing, we'd invest heavily in him. After some work, he has really become an outstanding CEO, in part because of the board's work to develop him."*

Complicated removals

Members noted that when a board has decided it would be better off with a new chief executive, several factors can complicate the transition:

- A history of positive CEO performance reviews
- Large severance obligations
- Personal ties between the CEO and the board or certain board members
- Lack of an identified, agreed-upon successor
- The presence of directors who were involved in hiring the CEO
- Earlier board approval of the CEO's failed strategy

None of those factors should prevent a board from acting decisively and in the company's best interest, members said, but they should be considered. If many of the directors championed the CEO's

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appointment or approved the CEO's inadequate strategy, *“that raises the question of whether some board members should join the CEO on the way out.”*

Bringing new directors on board

“Boards and companies are placing restrictions on how many boards their directors and executives can serve on, limiting the pool. And many boards are looking for people with similar types of experience and expertise. It’s harder and harder to find the right people, and quickly, when a vacancy occurs,” one member said. Members agreed that recruiting is becoming more difficult and important, and they offered suggestions to improve the process of identifying and evaluating board candidates.

Directors want tailored recruiting services, but often receive off-the-rack advice

Most members use executive search firms to help identify candidates for membership. In general, the services are helpful but underwhelming. One member complained, *“Listen to our needs. Once, two of my boards were searching for a new director at the same time. The profile was very different at each company, but a search firm sent both boards the same list of candidates!”* Members said that they generally have better success with new board members who were first identified by other independent directors on the board.

Boards need to prioritize desired skills, not just list them

“Our biggest problem isn’t finding people; it’s figuring out what we want most.” As board recruitment matrices⁴ grow, it becomes impossible to find candidates that have all the desired traits, members said. Many members said that their boards are forced to make difficult decisions about which attributes are most important: *“Do we want a sitting executive more than we want someone with intellectual property experience? Do we want someone with experience in Asia more than we want a financial expert? We struggle.”* A few members suggested that there is a growing pushback against more robust matrices: *“Our position is that we want really smart people with good judgment, period.”* Another member agreed, saying, *“Companies need a lot of skills to thrive. But they don’t all need to come from the board – you have management, outside advisers, and other thought leaders as well.”*

Candidate evaluations are more comprehensive than ever

Members agreed that *“you can’t delegate due diligence. If you do, you get in trouble. You need to speak with their references, with your own contacts, really dig into their history.”* One member’s board pays for a full background investigation of all serious candidates. Additionally, many boards are requiring more independent director involvement in the recruitment process than ever before. One member reported, *“[My board] requires everyone to meet with the candidate before we can nominate them to the board. This is a major change from the old days.”* Another added, *“When you interview someone, it’s not a presumptive ‘yes’ that is confirmed with a nice conversation over dinner. We really probe their experiences and try to get a sense of how they think.”*

⁴ For more on director skills matrices, see Julie Hembrook Daum and Thomas J. Neff, *Cornerstone of the Board: Lessons on Creating or Rebuilding a Board* (Chicago: Spencer Stuart, 2010). For more on network member thoughts on those matrices, see Lead Director Network, *“Enhancing board performance.” ViewPoints*, December 1, 2010, 4.

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Lead directors have identified emerging best practices for director recruitment

Members discussed practices that lead directors can use to ensure the boards find, recruit, and train the right independent directors, and the right number of directors:

- **Never stop recruiting.** Board membership is frequently stable, but unforeseen board departures can create havoc, particularly for small boards. *“Things were working really well on my board, and we were small, and for a variety of reasons, we decided not to recruit. Then we had a totally unplanned departure, and things changed quickly,”* one member reported. If a board is too small, the burden on directors and executives grows, which can create pressure on the board to lower its recruiting standards. *“You have to keep people in the director [recruitment] pipeline, even if you are at capacity,”* one member said.
- **Expand the board if an opportunity emerges.** Some members said that because it is becoming harder to find and recruit outstanding new directors, their boards are expanding beyond their identified target size if particularly compelling candidates becomes available: *“You’ve got to be flexible. If we see the right person, but we’re at capacity, we’ll [still] bring on an extra director or two.”*
- **Invest in orientation.** Efficiently providing background information on company and board operations saves significant time for management and board colleagues. Clearly identifying legal and ethical requirements may help avoid the infrequent, and unpleasant, director removal situations discussed earlier. One member suggested that having outside counsel, rather than the general counsel or another insider, conduct the orientation *“helps everyone take it more seriously.”* Orientations are particularly important for first-time directors, members said. *“These are really smart, accomplished people, but they might not yet be comfortable in the difference between oversight and management. You need to sit them down and explain the rules of engagement before they get too far into the trenches.”*

Preparing for lead director succession

“I can’t – and don’t want to be – lead director forever,” one member said. Members discussed how long they should serve as lead director, factors that complicate or prevent a transition, and how to select and train their successor.

The appropriate term for a lead director is board and situation specific

Members agree that there is no ideal tenure for lead directors. *“It’s very specific to the situation at hand. In some places it might be four years, others eight, others more.”* However, members believe that rotations of one year or less are too short for the lead director to become comfortable and successful in the role. One member reflected on the benefit of experience: *“Now, I’m more experienced in the role than I was during the first year. Just as importantly, management regards me differently – they treat me more like a chairman than the first year I was doing this.”*⁵

⁵ See Lead Director Network, [“The lead director’s role in major transactions,”](#) *ViewPoints*, March 29, 2010, 5.

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Certain situations make it difficult for a lead director to step down

There are many reasons not to transition out of the role, according to members. One said, *“I know one lead director who has been trying to step down for four years, [but he is prevented by] events inside the company that pop up every time he wants to go.”*

Members identified several factors that may alter the lead director’s succession plans:

- **Current or scheduled CEO transitions.** *“The board may need stable leadership when onboarding a new CEO. If there is a planned CEO transition, the lead director may need to sit tight.”*
- **Absence of a suitable successor.** If others on the board are not interested in or suited for the role, some lead directors believe they have a duty to continue their service.
- **Reluctance to “fix something that isn’t broken.”** The CEO or other directors may be reluctant to make a change when things are operating at a high level. *“Some of the other directors want old ghosts like me to stick around,”* one member said. *“Our CEO called me and said, ‘I can’t think of a day when you are not lead director here anymore.’ Well, you have to.”*
- **Mergers and acquisitions.** When contemplating or completing a major corporate transaction, stepping down may be unwise, members said. Choosing which person from the two relevant boards should serve as lead director *“is a real challenge, and incredibly political,”* one member said.

Choosing the right successor takes time, judgment, and care

Ideally, all members of the board would be well suited to serve as lead director. *“You need to fill the board with the kind of people who could be great lead directors,”* one member said. But several other members said while that should be a goal of board composition, it is not always possible. Further, even if everyone is qualified to be the lead director, boards should still choose carefully. *“Succession into the role should not be a reward for longevity or anything else; you have to find the best person, the right person,”* one member said.

Although the lead director role is commonly viewed in mechanical terms – chairing meetings, setting agendas, interacting with the CEO – as described throughout this document, lead directors are often called upon to exhibit true leadership on a wide variety of challenging problems; not everyone has the temperament or experience to do the job well. This led several members to state that identifying and training their successor was essential. *“You have to have the right approach and temperament. It’s a delicate job,”* one member said.

Identifying candidates for the lead director role requires informal dialogue

The lead director’s successor is generally identified through informal conversations, outside of formal board meetings, well before any votes occur. Members suggested that the lead director or nominating and governance committee chairman should take the lead in polling board members for insight on who should be the next lead director: *“If you’re thinking about the next lead director, anyone who is or seems like they might campaign for the job is probably not the right kind of person.”*

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The CEO should have a role in the selection of the lead director. *“The CEO shouldn’t make the decision, but should have input,”* one member said. *“We’ve noted the importance of a good relationship between the lead director and CEO, so if the candidate can’t work with the CEO, that should be noted.”* This may be a complicating factor in deciding when to step down as well. *“My CEO will retire before I will, but not long before. Do I ask him for input on my successor? Do I ask the leading internal candidates for the job for their input? I’m not sure,”* said one member.

There is no consensus on how to train a successor

Members were divided on how to train their successors, if at all. One member said, *“I don’t think you should prepare the next lead director for two reasons: [first,] people who are good enough for the role don’t need that type of training, and second – and more importantly – you can disturb the dynamic between the board, lead director, and CEO.”* But a few members suggested some training was appropriate. One member recalled his first days as a lead director and said, *“It’s not realistic to think a lead director can show up on day one and understand and own the role without some guidance.”* Informal mentoring of the identified candidate by the current lead director may be enough, but some boards are also considering more formal programs, including electing vice-chairmen or vice lead directors.

About this document

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the issues confronting lead directors. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* is encouraged to share it with those in their own companies and their colleagues at other companies. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

The Lead Director Network (“LDN”) is sponsored by King & Spalding and convened by Tapestry Networks. The LDN is a group of lead independent directors, presiding directors, and non-executive chairmen drawn from America’s leading corporations who are committed to improving the performance of their companies and to earning the trust of their shareholders through more effective board leadership. The views expressed in this document do not constitute the advice of network members, their companies, King & Spalding, or Tapestry Networks.

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Appendix: Contributing members

The following members attended the November 1 LDN meeting:

- Frank Blount – lead director, KBR
- Dan Carp – non-executive chairman, Delta Air Lines
- Gene Fife – presiding director, Caterpillar
- Ray Gilmartin – presiding director, General Mills
- Dick Goldstein – presiding director, Interpublic Group
- Bonnie Hill – lead director, The Home Depot
- Karen Horn – lead director, Eli Lilly
- Phil Humann – presiding director, Coca-Cola Enterprises and Equifax; non-executive chairman, Haverty Furniture Companies
- Bob Kidder – lead director, Morgan Stanley
- Linda Fayne Levinson – lead director, NCR
- Jack O'Brien – lead director, TJX; non-executive chairman, Cabot

The following King & Spalding attorneys participated in all or some of the meeting:

- Hon. Bob Ehrlich – senior counsel, Government Advocacy and Public Policy Practice Group
- Laura Hewett – counsel, Corporate Finance Practice Group
- J. Kelley – partner, Corporate Practice Group
- Michael Smith – partner, Business Litigation Practice Group
- Tom Spulak – chairman, Government Advocacy and Public Policy Practice Group
- Jeff Stein – partner, Corporate Practice Group

The following members were unable to attend the meeting but provided their thoughts in pre- or post-meeting discussions:

- Peter Browning – lead director, Nucor
- Dan Feehan – non-executive chairman, RadioShack
- Ed Kangas – non-executive chairman, Tenet Healthcare
- Bob Lawless – lead director, Constellation Energy Group
- Jim Robinson – presiding director, The Coca-Cola Company
- Wes von Schack – lead director, Bank of New York Mellon; lead director, Edwards Lifesciences