

# Lead Director Network ViewPoints

Issue 2 November 24, 2008



## The board's role in corporate strategy

### Introduction

The second meeting of the Lead Director Network (LDN) was held in New York City on November 3, 2008. Members began the meeting with an overview of the issues confronting U.S. companies, their boards, and lead directors in today's turbulent economy. The discussion then turned to the role of the board and the lead director in corporate strategy.

The LDN brings together a select group of lead directors, presiding directors, and non-executive chairs<sup>1</sup> drawn from Fortune 500 companies for private discussions about how to improve the performance of their corporations and earn the trust of their shareholders through more effective board leadership.

*ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before, during, and after meetings are not attributed to individuals or their companies. Members' comments are shown in italics. For further information, see "About this document," on page 10.

The lead directors who participated in the meeting included:

- Frank Blount, presiding director at Caterpillar and lead director at KBR
- Peter Browning, lead director at Nucor and The Phoenix Companies
- Ray Gilmartin, lead director at Microsoft and presiding director at General Mills
- Dick Goldstein, presiding director at Interpublic Group
- Karen Horn, presiding director at Eli Lilly
- Bob Kidder, lead director at Morgan Stanley
- Dick Notebaert, presiding director at Cardinal Health
- Jim Robinson, presiding director at The Coca-Cola Company
- Stephanie Shern, presiding director at GameStop

King & Spalding partners participating in the meeting were:

- J. Kelley, Partner, Chair Corporate Practice Group
- Chris Wray, Partner, Chair Special Matters and Government Investigations Group

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<sup>1</sup> For the purposes of this network, the term *lead director* is used as shorthand to refer to all three titles – lead director, presiding director, and non-executive chairman – except where otherwise stated.

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### Executive summary

LDN members believe a shift has occurred that is leading the boards of U.S. public companies to play a greater role in the development and oversight of corporate strategy. They expect this transformation to accelerate with the financial downturn and anticipated changes in corporate governance. At the meeting, members focused on the topics summarized below (and described in detail on the pages noted):

- **Impact of the financial crisis** (page 2)

Members painted a sobering picture of the depth and likely duration of the financial downturn and its consequences for American corporations. All agreed that their companies' strategic decisions have been fundamentally affected by the crisis. They identified a number of factors that are impacting corporate strategy, including liquidity, commodity prices, executive compensation, and, on the positive side, investment opportunities.

- **Board's engagement in strategy** (page 4)

In recent years, boards have shifted their focus from execution of the corporation's business model to strategy. LDN members support the board's intensified focus on strategy and believe the board should play an ongoing, iterative role in strategy instead of reviewing strategy intermittently. Members find that traditional off-site meetings alone are an inadequate forum for discussing oversight of corporate strategy; they provide additional input into strategy through discussions of particular aspects of strategy during regular executive sessions and board meetings.

- **Lead director's role in corporate strategy** (page 6)

Although the development of corporate strategy is primarily management's responsibility, lead directors play a crucial role in ensuring that the board provides appropriate oversight of strategy. Members articulated five actions lead directors can take to keep the board working collaboratively and efficiently on corporate strategy: (1) improve the quality of board discussions about corporate strategy; challenge management as appropriate; (2) ensure that the board receives adequate information; (3) use executive sessions for discussions of corporate strategy; (4) provide guidance and feedback to the CEO; and (5) ensure that the board's composition facilitates effective contributions to strategy.

### Impact of the financial crisis

Members attending the second meeting of the LDN sit on the boards of 27 leading public companies in industry sectors that include financial services, industrial manufacturing, consumer products, retail, biotechnology, and pharmaceuticals. Bringing these diverse perspectives to bear on the current financial crisis, members agreed on the depth of the financial downturn and its impact on all American companies. One member said, *"I would emphasize that this will be a long recovery ... The de-leveraging alone has substantially impacted the system. Home equity values are down, consumer buying is down, 401(k) pension plans are down – and they're not coming back. You could have a long period of very difficult growth, if any growth at all."*

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Several members talked about the immediate consequences of the financial turmoil for their company's strategy. Said one, *"You can have a well-thought-out strategy, [but] when you have a seminal event in the economy, as we've just experienced, it throws any strategy that's been discussed up in the air ... Anything that was decided before August 2008 has been thrown up in the air."* Another commented that strategic oversight by the board has become more dynamic, with more board meetings and teleconferences to review what's happening to the business: *"We have copied the financial industry ... We have added non-mandatory board [briefings] in between our regularly scheduled board meetings, and even though they're not mandatory, everybody attends."*

LDN members outlined a number of factors that will impact their companies' strategic decisions:

- **Loss of liquidity.** One member summed up the prevailing view: *"Liquidity is a big issue. If you're thinking about an acquisition, you raise questions at the bank ... The banks aren't lending. They're using every opportunity to rebuild their capital."*
- **Volatile commodity prices.** A number of members expressed concerns about the volatile nature of commodity prices and how that might affect companies' long-term strategy: *"Commodity prices were up, and now they've collapsed. And we are asking, 'Are we dealing with a year or two years of a deflationary effect? How are we going to weather this?'"*
- **Executive compensation.** One member stated, *"When the economy has a dramatic downturn, the problem we have is rewarding our people in the form of equity in long-term grants. The compensation issue is going to affect us all."* Another lead director said, *"We're going to have to reevaluate our compensation program with stock. All the metrics are now totally different."*
- **The U.S. presidential election.** One member commented that *"the election is a big deal, and considering how it might impact every one of our companies is a big deal."* Echoing this sentiment, another said, *"We're concerned about the government and what [it's] going to do."*
- **Consumer behavior.** Many members expressed concern that consumer spending will be weak in the upcoming holiday season, which will lead to further problems for the U.S. economy. Said one, *"We are concerned that people are simply going to stop buying our products. Although our liquidity looks good, we are nervous about how long this crisis will take [to work itself out] and how long people could delay their investment in our product."*
- **Layoffs and hiring freezes.** One member suggested that because fewer people are choosing to retire (a function of smaller retirement accounts), companies will have to revise their strategic plans to include some layoffs: *"Most good companies plan on a good turnover rate. Now companies are going to lay more people off. Companies can't use the same number of resources they were using a few years ago."* Another member commented, *"In the last two weeks, [senior management] put out edicts on hiring freezes. Now the regional manager must sign off on any hiring."*
- **Share buybacks and dividends.** With concerns about liquidity to fund debt maturities and other capital requirements, many companies are reviewing their dividend payments and share repurchase programs. One member said, *"It is ironic because this is the perfect time to be buying back shares [because the price is depressed], but we're not doing that."* In a discussion of the impact of the

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financial crisis on dividend programs, one member noted, *“I think that the strategy for the blue-chip companies is to cut their dividend back so that they have the cash to take advantage of the opportunities as they present themselves. But my question is, how do you do that and avoid being perceived as weak?”*

- **Capital expenditure programs.** A number of board members have recommended that management undertake a detailed review of their company’s capital expenditure programs with an eye toward reining in capital-intensive spending programs. Other members affirmed this more conservative approach to capex and recognized the potential impact this reduction might have on companies and their suppliers.
- **Earnings guidance.** With so many types of risks and uncertainties threatening their businesses, some LDN members’ companies are beginning to consider whether or not to publish earnings guidance: *“We’ve been thinking about not giving earnings guidance anymore.”* Participants at a recent meeting of audit committee chairs also discussed the issue of earnings guidance: *“The budgeting process used to be fairly simple, but that has changed now. How do you define it for the Street? What kind of guidance can you give in such an unknown environment?”*<sup>2</sup>
- **Investment opportunities.** One lead director summarized members’ belief that there is reason for both optimism and caution in today’s economy: *“There are going to be a lot of investment opportunities in this time ... and I’m asking my directors, ‘What makes sense for us right now?’”*

### Board’s engagement in strategy

According to the National Association of Corporate Directors, formulating strategy entails “establishing an overall destination, and making provision for frequent mid-course correction. It involves perpetual redefinition – internally for strengths and weaknesses, and externally for opportunities and threats, focusing intently on competition.”<sup>3</sup>

LDN members agree that management is ultimately responsible for the development of corporate strategy. But members believe that lead directors also play a critical role in corporate strategy by ensuring that the board takes an appropriate role with respect to management’s strategic decisions.

### Evolution of the board’s involvement in strategy

LDN members noted that the board’s increased involvement in corporate strategy is a trend that began well before the current financial crisis. One member suggested that *“in the 1980s, boards started to get more engaged with management and in the execution [of strategy] ... Now boards are coming to recognize that strategy is a huge determinant of shareholder value. Strategy seemed to have gone out of fashion for a while, and execution seemed to be most important. Now the pendulum has swung the other way.”*

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<sup>2</sup> Pacific Southwest Audit Committee Network, “Enterprise risk and the financial crisis,” *VantagePoint*, November 11, 2008, 3. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_PSWACN\\_Vantage-Nov08.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_PSWACN_Vantage-Nov08.pdf).

<sup>3</sup> National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on the Role of the Board in Corporate Strategy* (Washington, DC: National Association of Corporate Directors, 2006), 6.

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Other members date boards' increased involvement to the aftermath of accounting scandals earlier in the present decade. Noted one member, *"Only six years ago, my board was not engaged in strategic discussions at all. And then there was a transition – and it was as though we started all over, and the directors began to ask, 'When are we going to have our strategic reviews?' and 'Do our deep dives include looking at our markets?' Now, we have a strategic discussion at every single board meeting. It's not only execution; it's about rethinking the strategy. We don't do strategic retreats; it's continuous."*

One possible catalyst for the board's increased involvement in strategy is the rise of the activist investor. Said one member, *"The emergence of the activist investor has put more pressure on boards to be engaged in strategy. If you look back 30 years, you wouldn't have seen the same thing."* Another member tied the board's increased involvement in strategy to directors' growing awareness of their fiduciary responsibility to shareholders: *"Damage to shareholders is too great if the board is not involved [in corporate strategy]. The board must be involved in some kind of constructive way."*

Even before the current financial crisis, board surveys showed that directors wanted to spend more of their meeting time focusing on corporate strategy. In light of recent events, one LDN member predicted the trend toward increased board involvement in strategy will continue to accelerate: *"I think boards have continued to evolve and will continue to, especially now ... Strategy is the next frontier, and we will continue to question how boards can become more involved in strategy."*

### **Model for the board's engagement in strategy**

In pre-meeting discussions in early September, members characterized their boards' engagement in strategy along a continuum, from regular, ongoing involvement to episodic review. At that time, most members believed the continuous model was more effective, but some did argue for episodic review. At the meeting in November, however, LDN members unanimously agreed that board members should be involved in corporate strategy in a continuous way. Said one, *"[Directors] don't depend only on the CEO for strategy anymore; it is a collaborative effort."* Another member pointed out the power – and consequent responsibility – actively involved directors can have in strategy oversight: *"The board can destroy the company ... by authorizing a major acquisition which is either poorly timed or a bad investment, choosing the wrong CEO, or allowing a dysfunctional board to persist."*

Directors must identify an appropriate process and venue for increasing their involvement in strategy. A 2007 article in *Strategy & Leadership* summarized this dilemma: "Strategy work is an iterative process, not a big bang event. Yet, often we treat it as though it were a one-time event by scheduling the board's strategy meeting or making strategy the key agenda item at the annual board retreat. Absent a rich context, directors are hard pressed to contribute effectively."<sup>4</sup>

### **Off-site strategy meetings**

Although nearly all LDN members attend off-site strategy meetings for their boards, they believe these sessions are inadequate as the sole forum for advancing corporate strategy. One corporate governance expert described the limitations of the one-sided discussions that often take place in off-site strategy

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<sup>4</sup> Donley Townsend, "Engaging the Board of Directors on Strategy," *Strategy & Leadership* 35, no. 5 (2007), 24.

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meetings: “These mind-numbing presentations [by management] have to go. They need to be replaced by animated, relevant, focused, easy-to-comprehend presentations that zero in on the issues that the directors need to know to perform their oversight function effectively and assist management in achieving the objectives and strategies jointly established by the board and management.”<sup>5</sup>

One member company altered the off-site meeting’s format to encourage robust dialogue between management and the board: *“We don’t do many slide presentations anymore. [Board members] get the deck [before the off-site meeting], and then we get a white paper with it. The off-site meetings are for interaction and [discussing] where we, the company, are going. It has to be a constant discussion.”*

Members supplement the discussions at off-site meetings by adding strategic items to the agenda at board meetings and executive sessions. One member stated, *“All the boards I’ve been on are at the point where they have strategic discussions at board meetings [and not just off-site strategy meetings]. That is a given.”*

### Strategy formulation during a corporate crisis

LDN members underscored the importance of the board’s assuming a more active role in strategic decisions during periods of crisis. One member said, *“Time appears to speed up very quickly during a crisis. So instead of weeks or months, you have a matter of hours to make very important strategic decisions.”* Another pointed out the dramatic increase in time spent on his lead director responsibilities during a crisis: *“I assumed the lead director role, and I thought it would take 15% of my time ... And then we had some serious problems, and it became 60% of [my] time.”*

### Lead director’s role in corporate strategy

In describing the positive effect a lead director can have on a company’s strategic decisions, one member related that before the New York Stock Exchange amended its listing requirements,<sup>6</sup> the company had not named a lead director: *“I remember one occasion when the CEO talked the board into making an opportunistic acquisition that was against the strategy, and it took several years before we realized what a mistake that was. My evaluation of that situation was that we got talked into the acquisition, even though it didn’t fit into our strategy, because we didn’t have a lead director. I believe if we’d had a lead director, several of us would have expressed our point of view more forcefully to the lead director and the CEO.”*

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<sup>5</sup> Paul P. Broutas, *Boardroom Excellence: A Common Sense Perspective on Corporate Governance* (San Francisco: Jossey-Bass, 2004), 74.

<sup>6</sup> The NYSE requires only that non-management directors meet at regularly scheduled executive sessions, that there be mechanisms for selecting a non-management director to preside at such sessions, and that companies provide a way to communicate with the presiding director (or the non-management directors as a group). See NYSE Euronext, *Listed Company Manual* (New York: NYSE Euronext, 2008), section 303A.03.

Available at

[http://www.nyse.com/Frameset.html?nyserref=http%3A//www.nyse.com/regulation/listed/1101074746736.html&displayPage=/lcm/lcm\\_subsection.html](http://www.nyse.com/Frameset.html?nyserref=http%3A//www.nyse.com/regulation/listed/1101074746736.html&displayPage=/lcm/lcm_subsection.html)

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### **LDN members described several actions lead directors can take to have a positive impact on corporate strategy:**

- Improve the quality of board discussions about corporate strategy; challenge management as appropriate
- Ensure that the board receives adequate information
- Use executive sessions for discussions of corporate strategy
- Provide guidance and feedback to the CEO
- Ensure that the board's composition facilitates effective contributions to strategy

### **Improve the quality of board discussions about corporate strategy; challenge management as appropriate**

Lead directors must make sure that the decision-making process at their companies is structured to allow the board to be appropriately and effectively involved in strategy. One member saw this as an important shift for the lead director: *“Historically, it is the chairman’s role to think about the governance process. It strikes me that we’re talking about going to another level of responsibility for the lead director to step back and critically examine the governance process.”*

One way to ensure that the board’s participation is effective is to keep directors’ discussions of strategy at an appropriate level – neither too tactical nor too high level. For one member, the difficulty is in identifying a good balance: *“I know we’ve talked about directors staying at the 30,000-foot level ... but I’m interested in defining what exactly a 30,000-foot level is.”* Once identified, a good balance may be difficult to maintain: *“We have to guard ... against getting too tactical. I have to go to other directors and say, ‘No, we’re high level, and management is responsible for the tactical things.’”* Another member agreed: *“As lead director, you have to understand when a particular issue goes from a micro level to a macro level.”*

Keeping board discussions focused and well paced is also essential. Several members talked about the difficulty of reining in board members who dwell too long on the same strategic issue or derail the discussion by bringing up tangential scenarios. Said one, *“We have some board members with a single-minded focus on one issue, which may not have anything to do with what’s on the table for discussion. I deal with those directors offline. I think it’s appropriate to give coaching shortly after the meeting or executive session.”*

The lead director can only be as successful at stimulating direct communication between the board and management as board members allow. Some directors are reluctant to openly challenge management’s strategy: *“My biggest frustration is ... sometimes directors won’t speak up in a meeting when you want them to talk. And then I go to them after the meeting and say, ‘Why didn’t you speak up? That was your chance.’”*

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### **Ensure that the board receives adequate information**

For boards' input into corporate strategy to be effective, they must thoroughly understand the assumptions and analyses upon which the strategy is based.<sup>7</sup> Providing directors with the information that has led management to recommend a particular strategy can be difficult. *"I have to ensure that the right flow of information is getting to the board to help directors understand why management is taking a particular course,"* a member said. *"I only have one vote as a director, but I can orchestrate things to ensure we see the same facts and have a complete discussion about the issues."*

Another member commented, *"The lead director's role is being sure that in the strategic discussions, risk is an important part of the discussion."* One member said, *"My question is, how do you do proper deep dives on the risk of a strategy without getting into micromanagement?"* Members also said their boards want to understand the complete range of strategic options: *"I need the board to be able to ask, 'What is the option you are presenting? And what were the alternative options you eliminated?'"*

### **Use executive sessions for discussions of corporate strategy**

The executive session, which brings together independent directors to discuss a range of issues, is an important tool for lead directors seeking to influence strategy discussions: *"If you're a lead director, the first task is chairing the executive sessions."* In these sessions, lead directors can see to it that important strategic topics are discussed: *"[By] guiding the executive session discussions and making the agenda and discussing the agenda setting with management, the lead director can have some influence on the strategic issues [the board addresses]."*

One member stated, *"The role of the lead director is to make sure that the board's issues, whatever they are, don't lie fallow for a year or two. We have to make sure that the board's issues are collected and [that] management understands when the board has not quite reached a consensus yet."*

If the board has not reached consensus on a particular issue, it will have difficulty helping to shape management's thinking about the issue. Said one member, *"The lead director is crucial in bringing together more uniform thinking and broader consensus for action."* The same holds for agreement with management. Another member stated, *"The lead director must ensure that the dialogue continues until you reach an agreement. You have to make it clear to management that they haven't made their case yet, and they need to come back to the board with a better business case."*

### **Provide guidance and feedback to the CEO**

At the network's first meeting in July, members agreed that building a productive relationship with the CEO "is one of the least clearly defined yet most important aspects of a lead director's responsibilities."<sup>8</sup> In thinking about the lead director's role relating to corporate strategy, members said that a core responsibility of a lead director is to *"fill the CEO in after the executive sessions and to get feedback."*

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<sup>7</sup> National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on the Role of the Board in Corporate Strategy*, 5.

<sup>8</sup> Lead Director Network, "The Role and Value of the Lead Director," *ViewPoints*, July 30, 2008, 6. Available at [http://www.tapestrynetworks.com/documents/Tapestry\\_KS\\_LDN\\_July08\\_View1.pdf](http://www.tapestrynetworks.com/documents/Tapestry_KS_LDN_July08_View1.pdf).

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One member stated, *“In the executive sessions that we have, I need to make sure there is prompt communication with the CEO. As lead director, I do my best to regurgitate what was said.”*

The CEO’s experience should inform the way in which lead directors offer feedback: *“If you have an inexperienced CEO who’s getting more help than he wants from directors, that is where the lead director has a role. I have the responsibility in working with the CEO to determine what is working for him and what is not.”* The CEO’s personality also affects how a lead director guides the executive in interactions with the board: *“There is a role for the lead director in helping the CEO to understand how [his or her] own personality might suppress or challenge [the] directors.”*

One member discussed guiding the CEO in thinking about strategy: *“It took quite a while for the CEO to understand that the financial crisis throws our strategy into question. I said, ‘You have to look at the deep dive on our strategy again.’”* Another member described helping the CEO prepare for directors’ questions: *“I take a lot of the directors’ concerns to the CEO before the meeting and say, ‘You’re probably going to get this question.’ It’s a constructive way of [introducing opposing] points of view.”* Another member advises the CEO when and where to bring up different strategic issues: *“As lead director, I suggest to the CEO in what forums certain strategic issues can be addressed. Some can be addressed one-on-one with directors, and some issues can be addressed to the full board with management.”*

Members also discussed the link between the CEO, strategy, and CEO succession: *“The single most important issue is who your CEO is going to be ... Do you match your internal strategy to your CEO, or do you find a CEO with a new strategy?”* CEO succession also demands that directors agree on the strengths and weaknesses of a company’s strategy: *“A good starting point for CEO succession is to ensure that everybody is on the same wavelength with strategy. This is an opportunity for the lead director to forge agreement on ... strategy.”*

According to a recent survey, CEOs ranked board participation in strategic planning as the second-highest priority for their boards, but the surveyed CEOs gave their directors only the eleventh-highest score in rating their effectiveness in this endeavor.<sup>9</sup> One member commented on this statistic: *“As a former CEO, I was struck by the fact that CEOs ranked boards’ value at eleven. Why would CEOs rank boards so low in terms of their engagement to strategy?”* One member offered a potential explanation: *“As a CEO, you have some board members who could get you focused on a question. You can also have other board members who don’t add as much value. Sometimes a few board members color how you [the CEO] view the whole board.”*

### **Ensure that the board’s composition facilitates effective contributions to strategy**

Members agree that board composition is a critical factor in having a well-functioning board, and that composition is especially important when the board considers matters of corporate strategy. One member said, *“I’m not sure that boards are as conscious as they should be about the types of people [who should serve]. I think there’s an opportunity to determine how to be more strategic about your board. There’s an opportunity in board composition.”* Another member suggested it’s critical to consider every

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<sup>9</sup> David A. Nadler, “What’s the Board’s Role in Strategy Development? Engaging the Board in Corporate Strategy,” *Strategy & Leadership* 32, no. 5 (2004), 25.

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candidate thoroughly before asking an individual to join the board: *“There are a lot of great résumés and a lot of ineffective board members. You have to recruit and vet the best you can.”*

There was less consensus, however, on the skills and expertise directors must bring to strategy discussions. Although a number of members believe *“strategic-thinking ability”* is critical, one member said, *“Having a [diversity] of experiences on the board is important. Not everybody needs to be a strategic thinker. If you do the right job and have management do the right job, then everybody can contribute. I wouldn’t put on my criteria for every director to be a strategic thinker.”* Another member said that the experience level of most directors would allow them to contribute to corporate strategy: *“You can expect that with the quality of people we get on our boards, we ought to be able to all talk at a strategic level.”* And another member emphasized the importance of striking a balance between directors who focus on a strategy’s execution and directors who are strategic thinkers, who tend to look more at the big picture.

### Conclusion

Members agreed that prior to the current financial crisis, the board’s traditional level of involvement in corporate strategy had increased from the remote, episodic review of the 1980s to a more continuous model of engagement. Some members predicted that the financial crisis will accelerate this trend and that board members will become even more involved in their company’s strategic direction. As public pressure mounts and scrutiny of American boardrooms increases, some members suggest board members and executives will work even more closely in developing corporate strategy.

### 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 with their colleagues at other companies. The more board members, 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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