Cover Story

Isn't it ironic that the one group with the power to decide the fate of an organization—the board—is the one group in an organization that is often randomly selected, casually engaged, rarely evaluated, and almost never held accountable? What better examples exist than Enron, WorldCom, HealthSouth, Adelphia, Tyco, and even the New York Stock Exchange?

I have been working with boards of directors for many years, and I have found 10 common mistakes companies make in creating and using their boards. So, I have developed a continuum for board excellence based on those mistakes. My premise is simple: BETTER BOARDS MEAN BETTER COMPANIES.

Developing Strategic Boards of Directors

Here are 10 common mistakes to avoid when choosing board members.

By Susan F. Shultz

Too often recruitment has to do with relationships—like golf buddies—or celebrity appeal—rather than capacity.

The untold stories are the thousands of companies that have avoided crises because of their hard-working boards that have high integrity, add value, and prevent the fatal mistakes. As financial experts, you have a *rare opportunity* to make a difference. You have a rare opportunity to restore consumer confidence and inject *integrity* back into the system. You have a rare opportunity to infuse governance with best practices—to make boards the solution instead of the problem. In addition to the work you are now doing to strengthen boards, if you are not already doing so, I encourage you to serve as a director.

Think about these 10 mistakes, and figure out where your board fits on the continuum of excellence. At the same time, consider where the Enron board went wrong.

Mistake 1: Failure to Recruit Strategically

If a board is to add value, its members must be recruited strategically. Too often recruitment has to do with relationships—like golf buddies—or celebrity appeal—like O. J. Simpson on the audit committee of Infinity Broadcasting, a subsidiary of Viacom—*rather* than capacity.

To avoid this mistake, proactively recruit directors to your future—to your strategic plan. In other words, devote the same energy to recruiting your board members as you do your key officers, your CFO. See the seven-step process outlined in the sidebar, "How to Recruit Board Members."

What's the hardest thing to do? The most popular article in *Directors and Boards* is how to fire a director. No one wants to confront a poor director and ask him/her to leave the board. Why not invest in the process instead of a failure?

Strategic boards are a value add for all companies, large and small. In a Boardroom Consultants' study of 360 early-stage companies, success moved from 20% to 70% when independent boards were in place.

So the first and most important step is to recruit strategically. How did Enron measure up? Not well. Directors were recruited by management for management. Enron = 0

Mistake 2: Too Many Insiders

The best number of insiders is one. *Why?*

An insider's allegiance is likely to be to his/her boss. It's too difficult for an inside director to function as the subordinate of the CEO *every day* and then, at a board meeting, become, in effect, his/her superior. Further, a CEO may be reluctant to discuss certain issues in front of employees, such as succession and compensation.

You already *know* what the insiders think. And you have the benefit of their expertise and commitment. Why not get the benefit of outside knowledge, experience, access, and wisdom?

Enron had only two employees on their board, so was within accepted standards. Enron = 1

Mistake 3: Too Many Paid Consultants

This includes anyone who stands to have his or her income compromised. A survey by Christian & Timbers found that 74% of board seats are filled by individuals who have some previous association with the company on whose board they sit, so this is a critical issue.

If a conflict does exist, it is most likely to surface during the very crises the director is there to help resolve.

Many of the Enron directors were conflicted. Board member Lord Wakeham had a consulting contract with Enron. The chair of the Enron board's finance committee, Herbert Winokur, voted for the off-balance-sheet transactions that were the trigger for Enron's undoing. He

How to Recruit Board Members

Now that you know what to avoid, take a look at these seven ways to recruit good board members.

1. Create a board charter (corporate governance guidelines). Know what you want your board to accomplish and how it will be structured and measured.

Your charter can range from a carefully restricted advisory board of directors who work for the founder or the CEO to a statutory board of directors who work for the shareholders.

2. Create a needs matrix. Prioritize your strategic issues—the critical "must haves" that keep you awake at night. What expertise—what attributes and skills—will get you there? Given the requirement that audit committee members be financially literate and that at least one be a financial expert, these criteria will be a part of every needs matrix.

Then define your current board members in context of the needs matrix. Where is your bench strength? Where can you add value?

3. Develop a measurable profile for each director slot. Specify what you expect from each board member. What are the criteria? Perhaps IPO experience, public company and M&A experience, regulatory expertise, human resources, and particular industry knowledge would be valuable at the board level. Remember that every director votes on every issue, so avoid the temptation to recruit a specialist who isn't strategic. How will the director be measured? What will constitute success?

Circulate the profile within your organization to gain consensus and additional input. Then use the profile as your platform for recruiting, and circulate it to potential candidates and referral sources.

4. Recruit proactively to each profile. Throw a broad net. CEOs repeatedly are astounded at the level of individual willing to serve if the directors are asked in the right way. Reach beyond your network. Conduct original research into synergistic companies with outstanding reputations. Avoid the trap of recycled directors. This is an extraordinary opportunity to gain valuable expertise not otherwise available—or affordable—as an employee or consultant. At FFCA, which finances fast food companies, we recruited the outgoing EVP and general counsel of the largest fast food company, the only one the company did not yet do business with. Think of the difference that one director made.

5. Interview potential directors in the context of your board. Pose your toughest questions, describe real situational issues, and take advantage of the opportunity to learn from and strategize with the prospective directors.

- Explore time availability and commitment. It takes 12 to 25 days a year for each board. Remember, nonprofits count as well. There are required meetings, and the fiduciary obligations and liabilities are equally compelling. For an employed individual, two outside boards are the limit. Otherwise, three or four board memberships are appropriate.
- Remember that every person you recruit is a reason for others to stay or stay away.
- The only person who won't serve is the one you don't ask.
- Look for people who will elevate the caliber of the board—every time.

6. Reference intensely. Has the prospective director made a difference as a board member? How does she deal with risk? Does he drive change? Is she visionary? What kind of people does he hire? What mistakes does he make? Does she grandstand? What record of hiring does she have? Would the reference hire/serve with that person again? How does she compare with other board members?

7. Finally, recruit in a continuum. Keep your matrix in mind, and maintain a list of prospects tied to your future. If an unexpected opening does occur, you have a process and options in place.

was also the managing partner of National Tank, which sold $370,000 of product to Enron in the year before Enron's bankruptcy. In addition, Winokur chaired the board of Azurix Water Company. Enron invested $1 billion in Azurix. Azurix went public, and then Enron bought the shares back for more than double the market price. Winokur made $184,000 through that deal. Ironically, Winokur was one of three people who sat on the Special Investigating Committee that looked into the Enron abuses. Enron = 0

Mistake 4: Too Many Friends and Colleagues

A board built of friends and associates is likely to breed an environment that generates special favors and compromises objectivity.

Interlocking directorships are especially treacherous. Directors sitting on one another's boards are likely to have allegiance to one another rather than to shareholders. They don't want to embarrass a colleague by asking tough questions, such as challenging each other's compensation. In fact, chief executive officers get paid 17% more on interlocking boards than those with truly independent boards.

All the Azurix Water Company directors also sat on Enron's board, an extreme interlock situation. Remember that Enron invested $1 billion in Azurix. Enron = 0

Mistake 5: Too Much Family

There are unique issues superimposed on independent directors of family-owned enterprises. Too often, family-owned businesses are run for the personal benefit of the family, who use the income for things like private airplanes and exotic vacations instead of the long-term good of the organizations. Employees, clients, customers, and the financial community need an independent governing body to validate and balance their interests. Enron isn't a family-owned company, so this doesn't apply.

Mistake 6: Getting the Money Wrong

The money, from the perspective of the board, has to do with directors' pay, management's compensation, and the company's finances.

Directors are the best bargain in the corporate world. But too many boards reward mediocrity and failure instead of achievement—with such devices as repriced options, inappropriate and undeserved exit packages, and compensation guarantees.

Further, too many directors give management a blank check. The trend today is for the board to hire compensation consultants directly instead of relying on consultants who have been hired by the management whose pay they prescribe. Zero-based compensation is another tool to break the cycle of incremental increase spawned by comparatives. Instead of ratcheting up pay by comparing one CEO to another, evaluate pay according to the key metrics by which the CEO is evaluated within the company.

The overwhelming majority of financial officers and advisors have impeccable ethics and diligence in managing the financial health of their organizations. Unfortunately, the exceptions are those that have undercut consumer confidence.

Enron was rife with financial abuse. "No officer or employee should make an investment or perform services for his or her own related interest in any (Enron) enterprise under any circumstances." So read the Enron policy. Yet the board authorized CFO Andrew Fastow to sit on both sides of the off-balance-sheet partnerships and earn an extra $30 million as a result. The board proactively waived the conflict-of-interest rules three times. Further, Enron paid no income taxes in four of its last five years. And, of course, Enron ultimately slashed shareholder equity by some $14 billion. Enron = 0

Mistake 7: Fear of Diversity

CEOs who have 10 people just like them sitting around the board table may as well be talking to themselves.

Diversity means that you have access to the best. It goes beyond gender and ethnicity to age, culture, background, geography, expertise, training, function, and industry. Diversity drives the synergy of different ideas that generate from varied backgrounds and intellects. Of course, with the new regulations around audit, the most desirable director today is the financially literate individual with operating experience. Here is your opportunity.

Enron had a somewhat diverse board. Enron = 1

Mistake 8: Information Block

Excellent boards have the trust and cooperation of management who share good and bad information freely and

trust the directors to do the right thing. Too often, however, management filters and parcels out information to the board, giving only the good news, acting protective and defensive, thus sacrificing the opportunity to gain the advice of the directors who are there to help them succeed.

At Black & Decker, the board book was given to directors as they entered the boardroom—and taken back as they left. At Inprise, directors were required to get written permission from the CEO before talking to other employees outside the boardroom or receiving information not formally distributed.

Enron management contrived to withhold key information from the board members. Enron = 0

Mistake 9: Passive Boards

Boards that exist solely to stamp their approval on management's decisions are failed boards. Directors have a proactive duty of oversight and must ensure the right management is in place and working with integrity in the long-term interests of the shareholders.

One symptom of passive boards is entrenched directors. At Enron, the audit committee chair was there for three decades.

Enron is a classic case of a passive board that failed to ask the difficult questions and take responsibility for the welfare of the company. Every step along the way the board had the opportunity to say "no" to the partnerships and uphold the ethics code. The board could have refused to suspend the ethics code. They could have denied the outrageous pay packages for failing executives, including $1 million for an administrative assistant. The board could have asked why gross revenues increased from $40 billion in 1999 to $100 billion in 2000.

What would have happened if this board had fulfilled its fiduciary responsibility? What if the directors had asked the hard questions? Would the company and the jobs of tens of thousands been saved? Enron = 0

Mistake 10: Failed Leadership

"The responsibility of our board—a responsibility which I expect them to fulfill—is to ensure legal and ethical conduct by the company and by everyone in the company…." Thus proclaimed Enron CEO Ken Lay in April 1999.

It's the CEO who imprints the board, empowers it, and shapes its culture. A CEO must want—and model—a strong, strategic, ethical board.

If you can set aside the ethics policy, then you have no ethics policy. Enron= 0

What's the Rating?

- A board scoring 8 or more indicates a strategic board poised to add value.
- A board scoring 5 to 7 warrants investigation.
- A board with 3 to 5 points is in the danger zone.
- And a board scoring 2 or below is a failed board.

So where does Enron rank on the strategic board continuum? Enron scored 2 points—a failed board. Where does your board rank?

According to a study of the Investor Responsibility Research Center, 70% of the S&P 500 and 55% of NYSE firms will have to make changes to their boards just to meet pending requirements for director independence. This is your opportunity as financial professionals to make a difference—to make boards the solution instead of the problem.

It is a myth that there is a shortage of qualified directors. In my company's experience, the opposite is true. We have recently recruited audit chairs, board chairs, CTOs of large enterprises, and diversity. In every case, our challenge was choosing among targeted excellence. We have seen a significant increase in the number of qualified directors willing to serve. The shortage does exist among recycled and celebrity directors who are often on the board for the wrong reasons.

Take advantage of this rare opportunity to make a difference by becoming more engaged with governance, by serving as a director, and by carrying best practices into the boardroom. Better boards *do* mean better companies. ■

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