

Lead Director Network ViewPoints

June 15, 2016



Leading the board toward superior performance

On May 17, 2016, members of the Lead Director Network (LDN) met in New York City to discuss board leadership challenges, especially those involving CEO and director performance. This issue of *ViewPoints* synthesizes the key points that emerged from that discussion and conversations in advance of the meeting. It also briefly summarizes an update by King & Spalding partners on the current antitrust environment.¹ For further information about the LDN, see page 11. For a list of participants, see Appendix 1, on page 12.

Executive summary

LDN members addressed three key board leadership tasks:

- **Managing CEO performance** (*page 2*)

Monitoring the performance of the CEO and communicating feedback effectively was a topic of much interest. Warning signs that might signal a CEO performance issue, such as employee turnover, restricted access to the leadership team, lack of delegation, lower quality of board materials, and contentious executive sessions were discussed at length. LDN members advocated frequent and regular communication with the CEO and other senior leaders, including conversations before and after board meetings. Members also said that openness, tact, and empathy are important for maintaining the trust that is critical to the relationship between the board and CEO.

- **Managing director performance** (*page 4*)

The performance of individual directors was also discussed. Members discussed the value of peer evaluation for monitoring and improving director performance, noting that such evaluations can identify problems early and even strengthen relationships among board members over the long term. Members also touched on approaches to recruiting new directors and the attributes they look for, including specific skills and expertise and also intangible qualities such as judgment and collegiality.

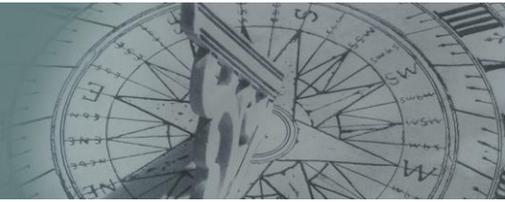
- **Managing leadership transitions** (*page 7*)

LDN members further discussed the challenges that arise in leadership succession, including transitioning to a new CEO or lead director. They focused on a frequently used approach to CEO transitions, which is to have the outgoing CEO serve as executive chair of the board for a set period of time. Members noted that this requires clear agreement on the respective roles of the new and former CEOs, and members were generally wary of extending this arrangement for too long. Like CEO transitions, members also agreed that lead director transitions are best planned in advance, and term limits or annual reappointments to leadership positions can help promote regular turnover, before succession becomes an issue.

¹ *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 are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

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Managing CEO performance

A primary role of a public company board is to ensure strong performance from the CEO. LDN members discussed how they monitor and communicate with their CEOs in order to assess and improve performance while also maintaining trust, collegiality and a results-based environment.

Monitoring CEO performance

How does a board know when a CEO might be falling short? In some cases, underperformance is easy to diagnose because it is obviously linked to a change in company circumstances, such as when a company outgrows its entrepreneurial foundation and a new type of leadership is required. In other cases, a board may not be certain that the problem lies with the CEO. As one member noted, it is easy to know when a CEO is performing very well or very poorly, but tougher to discern and respond in the zone between these extremes.

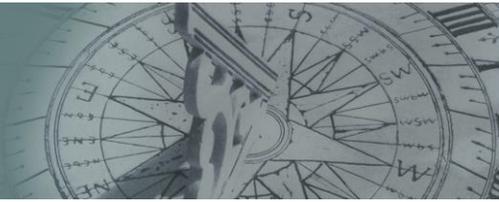
Members mentioned a number of signals that might indicate that a CEO is underperforming:

- **Employee turnover.** A member said, *“One obvious canary in the coal mine is a number of seemingly unrelated departures of critical employees.”*
- **Restricted access to the leadership team.** The CEO should not limit board members’ access to other executives. As a member noted, *“A good CEO should want you to have these relationships.”*
- **Lack of delegation.** Another member noted that concern can arise when *“the CEO micromanages much more, rather than delegating, even when he or she is told to delegate.”*
- **Unproductive executive sessions.** While there should be an active and sometimes pointed debate of ideas in an executive session, it is problematic if the sessions focus on complaints about the CEO – and even more troublesome when a CEO refuses to acknowledge legitimate feedback. *“You can tell there is a problem if the directors spend the session complaining and the CEO gets angry and does not respond.”*
- **Restricted information.** A member said, *“If your company utilizes employee satisfaction surveys, is the CEO keeping those away from you?”* More generally, another member added, *“Is there a reticence to share bad news?”*
- **Lower quality of Board materials.** A subtle deterioration in deliverables to the board is worrisome: *“You get into a rhythm of timing and depth of materials. And then, things fall out of that rhythm. It seems silly, but it may indicate that something is awry – when timing and quality are fraying a bit.”*

One member added that an additional concern is when *“the quality of the explanation of underperformance seems a little shallow.”* While the CEO and the executive team are key sources of information for assessing performance, members mentioned supplementary sources among the personnel below the C-suite. One member said, *“The controller is a great resource. If management starts pressuring*

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them, CFOs might cover for them, but controllers will be transparent.” Another member added, “One of the best resources is the corporate secretary. You sit down with the person and talk. You get real clarity.”

Maintaining trust and communication

Efforts to monitor and improve the performance of a CEO can jeopardize trust if they are not executed carefully. One member said, *“If you want to be trusted, you need to be trustworthy. Board members have different perspectives, but you need to be able to receive information and not overreact or try to micromanage.”* Another member added, *“Be very clear with the new CEO about what your expectations are. If you don’t want the previous CEO to serve as a role model, then say so. Having a very open discussion at the beginning is important.”*

Members agreed that it is important for the board and especially the lead director to build a relationship with the CEO, and this relationship has to be built on a shared understanding of their respective roles. A member said, *“One new CEO wasn’t sure what our relationship was supposed to be. I said, ‘I am not your boss – I am a counselor and a sounding board.’”*

Several members mentioned techniques for communicating regularly and effectively:

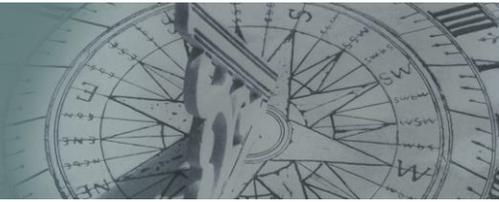
- **CEO/lead director meetings.** *“The CEO and I meet between board meetings. We discuss a whole range of topics, which are typically generated by him.”*
- **CEO/board dinners.** The use of a board dinner with the CEO the night before the meeting, providing a chance to air problems in a more relaxed setting, was noted to be highly beneficial.
- **Post-meeting debriefings.** *“It’s most helpful, immediately after the end of our independent executive session, to meet with the CEO, while the executive session is fresh and current.”*
- **CEO/committee chair meetings.** Several members mentioned the importance of communication between the CEO and the chairs of key committees, including audit, compensation, and nomination and governance. One member said, *“I also bring in the audit chair to debrief the CEO. I do the majority of the debrief, but I turn to her for color and additional context.”* An additional benefit of group meetings is that they ensure that no one director’s views predominate, as a member explained: *“I wanted to make sure that my views weren’t drowning out everyone else’s, and that I’m reporting the board’s collective view and not my own.”*

Members noted that the level of interaction between boards and CEOs has increased significantly over the past few decades. One member explained, *“It was such a different environment [20 years ago]. There was the mushroom theory of directors – you put them in a dark place, piled on the manure, and hoped they didn’t make noise. Today, the world of the imperial CEO is gone.”*

The increased demands on CEOs have also required a shift in how boards interact with them, as one member described: *“The pressures are incredible – it’s a very lonely job. Boards are not good at telling CEOs what they’re good at. [However,] you can do that without losing independence, and you gain*

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credibility for tougher messages. Tell them about their wins. It gives a real indication of the openness of the culture.”

Members said that *“the role of the lead director has really changed.”* As a lead director conveys the board’s views to the CEO, he or she has to be open and candid while also protecting the confidentiality of the board’s discussions. This may be difficult, as a member noted: *“I find it hard to avoid talking about individual board members. I try not to, but the CEO can often tell whom you are talking about. You might be testing the trust.”* Another member said, *“You have to be artful. You have to create relationships, but also you have to be an independent director.”*

Managing director performance

Another challenge for lead directors is handling an underperforming director. While director performance problems are often less visible to the public than those associated with a CEO, the performance of the board as a whole and the performance of individual directors is still critically important.

Peer evaluations

Several members underscored the value of regular peer evaluations in maintaining the performance of individual directors. A member explained, *“You go through the feedback [from the evaluation] with each director. Especially with newer directors, there are things that can help bring them along. We had an academic who had never previously served on a board. That person needed some coaching initially but ultimately became a great director. You develop a relationship with people. Sitting with them one-on-one, you learn a lot.”* Another member added, *“I have a conversation on an annual basis. Then we divide the board up and do deep dives every three years. You get a good sense of where the issues really arise, and you can correct them with tweaks. When you don’t have a process, it’s easier to drop into a complacent mode.”*

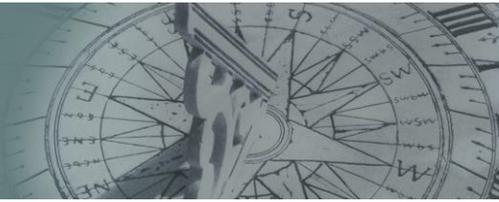
One member dismissed concerns that such evaluations may ruffle feathers or fail to yield honest opinions: *“If you keep it private, it doesn’t create problems. You don’t have to rank the directors or do the evaluations in writing. I get real candor.”* Another member noted that investors have increasingly emphasized high performance from individual directors: *“Shareholders don’t want a sleepy, clubby board.”* As a result, Spencer Stuart reports that 38% of S&P 500 boards annually evaluate individual directors as well as the full board.²

What happens when a director appears to be falling short of expectations? In pre-meeting conversations, members suggested that while it is important to establish clarity before taking action, problems should not be allowed to fester. One member declared, *“The last thing to do is to ignore the problem.”* Another pointed to the consequences of failing to act: *“It’s important to have courage. Every director matters – one dysfunctional director can affect the whole board. You need to be proactive.”*

² Spencer Stuart, *2015 Spencer Stuart Board Index* (Spencer Stuart, 2015), 29.

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Board refreshment

LDN members discussed various approaches to board refreshment, an aspect of director performance that shareholders are also increasingly focused on. Several members noted that recruiting capable board members is becoming more difficult, and some types of capabilities are particularly challenging to find:

“The hardest person to replace is a good audit committee chair.”

Members described longer-term approaches to recruiting, in which both current and future needs of the board are assessed. In a pre-meeting conversation, one member explained, *“It needs to be very explicit, involving the creation of a skills matrix. What are the skill sets the board will need in the next three to five years? Let’s look at the current board and see what’s missing ... Sometimes it’s not until you look at the matrix that you see the whole.”*

One member linked this analysis to the evolving strategy of her company: *“Part of our job is to create a resilient board. We go out as far as we can, looking through the lens of strategy. Every company is affected by digital, for example.”* The member noted that a long-term approach – leveraging the normal pace of retirements – can also make for less jarring shifts in board composition: *“You have to take advantage of the opportunities you have to refresh the board. What can destabilize the board is too much turnover.”*

A long-term approach allows candidates to be cultivated well in advance of actually joining the board. One director said, *“We’ve started reaching further down into organizations that we admire and recruiting candidates who may not necessarily be a CEO yet. We know that we’re taking the risk that an executive may have setbacks and fall off the fast track. However, we believe it’s a risk worth taking.”* Another member added, *“We identified a great candidate and over 24 months we worked on him.”*

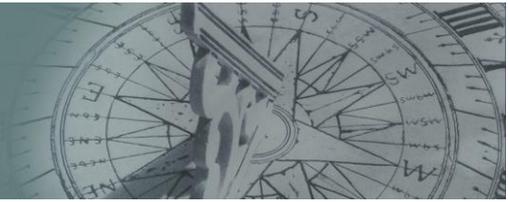
While the use of recruiting firms is a common way to find candidates, a member noted in a pre-meeting conversation that some boards prefer to do the legwork themselves: *“We’re doing more and more on our own instead of using search firms. Their lists tend to remain the same from one board to the next.”* The member acknowledged that cultivating candidates takes time but saw benefits in the process: *“It may take a number of approaches – a reasonable period of time – but you get a good cultural fit, and they get to know us. They will meet four to five directors before coming on to the board.”*

Selection criteria

What qualities should boards seek when recruiting new directors? LDN members acknowledged the need for certain types of specialized expertise. As one member put it, *“Almost every board has an ex-CFO. Most have a digital marketing person. Third is now cyber. The damage to the brand from cyberattacks could be huge. We are all over this issue.”* However, members also underscored the importance of more general skills and qualities. One said, *“On digital technology, we saw that the need is broader than just for an expert. They have to be a great director. Otherwise, the leverage is diminished.”* Members mentioned a range of more general criteria:

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- **Judgment.** *“How have they been operating in their environment? Do they have the big picture? Have they been courageous? Do they see the patterns and where the leverage is?”*
- **Collegiality.** *“Do they operate with mutual respect? The cost of one disruptive director can be huge.”*
- **Motivation.** *“Power, prestige, money – those motivations should disqualify someone. You need people who want to build businesses in service of something other than themselves.”*
- **Performance focus.** One director shared a conversation with an institutional investor: *“They said, ‘We’re not interested in your adding directors with expertise in social responsibility. We want you to bring on the best performance athletes you can find.’”* Some directors disagreed with this emphasis, noting that social responsibility can be very important to long-term performance.

Members noted that the promise of a potential director sometimes can be evident immediately. One member said, *“They are really prepared and we have a great discussion, as opposed to question, answer, question, answer.”* Another added, *“If you didn’t get anything out of the conversation, the board won’t either.”*

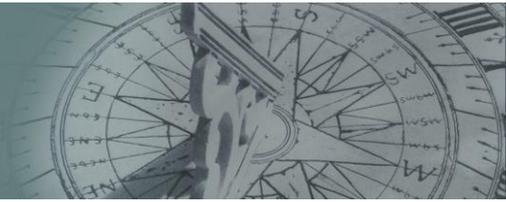
Bringing new directors up to speed

In pre-meeting conversations, LDN members mentioned a number of elements, formal and informal, that might be included in the process of onboarding directors:

- **Learning from fellow board members.** A member said, *“There’s got to be strong engagement between new board members and as many different board members as possible, particularly committee chairs.”*
- **Learning from management.** Members also mentioned interactions with management: *“In one board, they have extended sessions with the heads of major businesses.”*
- **Committee service.** A specific committee of the board may provide a particularly good view into the company. One member said, *“We have a practice that all new directors go on to the audit committee, even if they are without financial experience. That’s the best way to learn about a company.”*
- **Outside programs.** Members mentioned courses and conferences but noted that these must be selected carefully.

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Bringing new directors up to speed *contd*

Members raised the issue of directors who are serving on a board for the first time and may not fully understand all of the processes and activities involved. One member said, *“If they are less experienced, we’re attentive to aspects of governance they may not know. We don’t want them feeling awkward.”* Another added, *“For people joining for the first time, they might be a little naïve, particularly with respect to the time commitment. So we make sure they are aware of all the other things. The last thing you want is for them to be blindsided because they think it’s just six meetings.”*

Members brought up several other considerations that come into play when selecting new directors:

- **Diversity.** *“The data is so clear about high-performance teams being diverse,”* one member said. Another suggested that improving diversity may be easier than some believe: *“Don’t miss people because the gatekeepers did not cast a wide enough net.”*
- **Sitting CEOs.** Some members saw significant advantages in having current CEOs on the board, especially in certain circumstances: *“I think it’s good to have a sitting CEO located in the same city as your CEO. It gives great insight, community, networking.”* But others noted that the time constraints faced by sitting CEOs can be a problem.
- **Board experience.** Previous experience on a board is obviously helpful, but is it necessary? One member said, *“Over the years, lack of board experience has been a barrier, but I’m not sure that it should be disqualifying if you have extraordinary talent in a senior person.”*

Managing leadership transitions

During an important leadership transition, an incumbent must transfer knowledge and responsibilities to his or her successor; this is often a stressful time for CEOs and boards. In pre-meeting conversations and at the meeting, LDN members discussed management of CEO and lead director transitions.

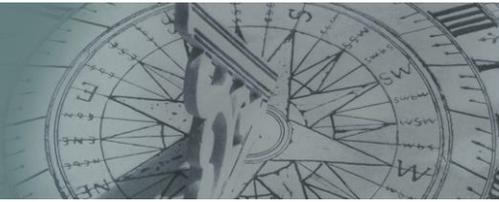
CEO transitions

A key focus of the discussion on transitions was the role that an outgoing CEO should play at his or her company. More specifically, should an outgoing CEO stay on as chair of the board? According to a Conference Board study of CEO succession at S&P 500 companies, 35% of departing CEOs in 2014 stayed on as chair for a transition period.³ LDN members had mixed views about this approach.

³ Matteo Tonello, *“New Statistics and Cases of CEO Succession in the S&P 500,” Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), April 23, 2015.

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One member described a difficult situation: *“An incumbent CEO with an impeccable record decides to retire. The board accepts that and has a candidate. But then the retiring CEO says, ‘I intend to stay on as executive chair for five to seven years. I’ll handle strategy.’ And we can’t believe we’re hearing this – that’s what the [CEO’s] job is!”* The situation was resolved only after considerable turmoil, marring *“what should have been a giant celebration.”*

Other members had faced similar situations and were generally wary of long transition periods with an outgoing CEO as chair. However, some members noted that with careful planning, a short transition period with the outgoing CEO serving as executive chair could work well. One director said, *“We worked on it for three years. The new CEO has to totally agree with it.”* Another said, *“We decided, since there were some big projects going on, that the outgoing CEO could stay focused on these for a year. A year is about as much as you want to go.”*

In a pre-meeting conversation, a member said, *“A lot of time and effort goes into defining the role so they don’t get in each other’s way.”* Another member, who had himself made the transition when he stepped down as CEO, commented, *“It’s about recognizing that you’re no longer number one – you’re one voice among many. You have to accept that you can provide input, but your successor has to make the call and live with it.”*

In pre-meeting conversations, members also brought up the challenges posed by an unanticipated CEO departure. Having a plan of action prepared in advance can be valuable. One member described a plan in which three likely successors had been identified; when the CEO died unexpectedly, *“there was no equivocation on what to do.”* A plan for an abrupt departure can be part of a broader succession plan that includes anticipated departures such as retirements. According to the *2015 Spencer Stuart Board Index*, which draws on the proxy statements of 486 S&P 500 companies, 73% of boards had succession plans for both emergency transitions and long-term planned successions.⁴

A long-term plan may involve cultivating executives in tiers below the CEO, but that strategy presents its own challenges. As one member explained, *“When you create expectations, it’s hard to say to an aspiring CEO, you have to wait five years. It has to be within two years, and you have to keep it confidential.”* Members also noted that when multiple executives are groomed for the top position, the runners-up may not want to stay at the company. One member said it was important to explore these dynamics with the internal candidates but added that these are delicate conversations: *“You’re dealing with a very imperfect world as you try to project how someone might behave.”*

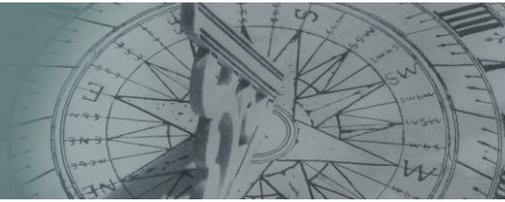
Lead director transitions

Lead director transitions also require planning, as a member noted: *“You have to have a plan. I know when I will retire, and I worked with the CEO on candidates.”* Other members elaborated on the process. One said, *“I’ve identified a sitting CEO who is retiring and is in the area. You have to work very closely with the CEO. We’ve nurtured the relationship between the candidate and the CEO.”*

⁴ Spencer Stuart, *2015 Spencer Stuart Board Index*, 19.

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You really have to plan for it to make it smooth.” Another added, “We’ve involved an advisory firm. I sent out a questionnaire to every director. We’ll review the results with the entire board. I have a vote, but I don’t want to dictate the process.”

Members also touched on different approaches to lead director rotation. Some mentioned fairly lengthy terms for the lead director, such as five to seven years, or even indefinite tenures: *“More recently, like the chair of the board, the lead director is in the role until there’s a reason to change.”* But one member raised an issue he was currently facing at a board where he is not the lead director: *“What if the board says the lead director has become tone deaf, and there’s no term limit? And the CEO says, ‘It’s not my problem.’”* One member responded, *“I’m elected and assessed every year – it’s an early-warning system.”*

Members remarked on the human aspects of lead director succession. In a pre-meeting conversation, a member said, *“I’ve been there for a while, but it’s hard to change. You have a personal relationship with the board and the CEO and chair. It becomes difficult when these relationships are involved.”* The importance of such relationships drives the strategy for achieving a smooth transition, as another member explained: *“It’s important to establish the right relationship with the CEO right off the bat. I had a series of dinners to establish expectations. A cadence of communications back and forth is indispensable. Once a week, we have a telephone conversation. That is the baseline, but there are other interactions too.”*

Selection criteria

In pre-meeting conversations, members mentioned a number of attributes that they believe lead directors should have:

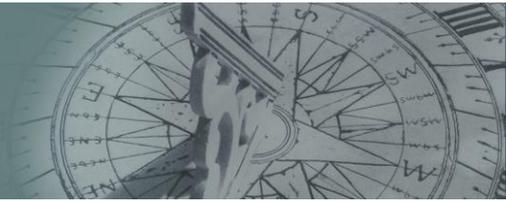
- A historical understanding of the company and its governance issues
- The respect and trust of the independent directors and management
- The ability to communicate around sensitive issues
- A broad perspective on business rather than the narrower perspective of a specialist
- Experience as a CEO or chair elsewhere

Conclusion

Issues such as CEO performance, individual director performance, and leadership transitions can test the board in many ways, forcing board leaders to think strategically about company needs, interpersonal dynamics, and individual preferences and motivations. These imperatives make it more important than ever to select the right person to serve in the lead director role. Reflecting on some of these, one member said, *“These are tough issues. You’re going to earn your pay.”*

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Insights on the current antitrust environment

During the meeting, LDN members received an update on the current antitrust environment from Norm Armstrong, a partner in King & Spalding’s global antitrust practice, and Jeff Spigel, partner and head of the practice. The Justice Department recently forced Halliburton and Baker Hughes to call off a \$35 billion merger, and a federal judge blocked a proposed Staples–Office Depot merger. Government opposition also led to the demise of high-profile deals between AT&T and T-Mobile, Comcast and Time Warner, and Sysco and US Foods. The *New York Times* described this antitrust crackdown as having “sent chills down the spines of many potential dealmakers and heightened caution in corporate boardrooms.”⁵

Mr. Armstrong and Mr. Spigel confirmed that strong antitrust enforcement is a priority for the current administration, but they noted that both the Federal Trade Commission and the Justice Department believe that the deals coming before them are more problematic than they used to be. Mr. Armstrong and Mr. Spigel recommended that companies think through their merger proposals carefully before they file them with the agencies, asking the following questions:

- What is the real rationale for the proposal?
- What do company documents – including internal e-mails – say about the merger?
- What do the documents of the target company say?
- How will customers react?
- What protections – such as breakup fees – will be included in the deal?
- What remedies – such as divestitures – is the company prepared to accept?

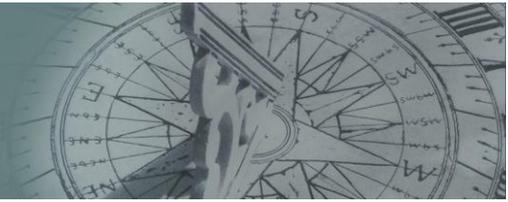
Mr. Armstrong and Mr. Spigel advised that companies remember that sensitive issues may have been discussed in internal company documents and that these discussions could surface when the agencies assess the proposal.

Mr. Armstrong and Mr. Spigel saw strong enforcement continuing under a Clinton administration, but viewed the impact of a Trump presidency as a wild card. However, they noted that the Federal Trade Commission is an independent agency, making it less susceptible to shifts in approach when an administration changes. They further noted that antitrust enforcement is also influenced by the sentiment of Congress, which has shown a strong interest in key sectors such as energy and healthcare.

⁵ Michael J. de la Merced and Rachel Abrams, “Office Depot and Staples Call Off Merger After Judge Blocks It,” *DealBook* (blog), *New York Times*, May 10, 2016.

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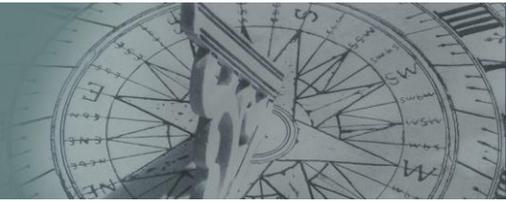


The Lead Director Network (LDN) is sponsored by King & Spalding and convened by Tapestry Networks. The LDN is a group of lead independent directors, presiding directors, and non-executive chairmen drawn from America's leading corporations who are committed to improving the performance of their companies 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 1: Participants

The following network members participated in the meeting:

- Dick Auchinleck, Lead Director, ConocoPhillips; Non-Executive Chair, TELUS
- Loren Carroll, Non-Executive Chair, KBR
- Sandy Cloud, Lead Trustee, Eversource Energy
- Dave Dorman, Non-Executive Chair, CVS Health
- Ann Hackett, Lead Director, Capital One Financial Corporation
- Ed Kangas, Non-Executive Chair, United Technologies and Tenet Healthcare
- Ellen Marram, Lead Director, Eli Lilly, and Presiding Director, Ford Motor Company
- Mike McCarthy, Lead Director, Cabela's and Union Pacific
- Jack O'Brien, Lead Director, TJX; Non-Executive Chair, Cabot
- Pam Reeve, Lead Director, American Tower; Non-Executive Chair, Frontier Communications
- Ed Rust, Lead Director, Caterpillar
- Doug Steenland, Non-Executive Chair, AIG
- Tom Wajnert, Non-Executive Chair, Reynolds American

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

- Norm Armstrong, Partner, King & Spalding
- Jeff Spigel, Partner, King & Spalding
- Cal Smith, Partner, King & Spalding
- Chris Wray, Partner, King & Spalding