Navigating Complexity: A Corporate Director's Path

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The U.S. historically has had the most robust capital markets in the world in large part because of the structure of our corporate governance system. I'm firmly convinced that we have the best system of governance that exists anywhere.

But it's undeniable that our capital markets are under attack right now. As more and more disclosures have come to light about businesses that have not behaved ethically and responsibly, confidence in our capital markets has been undermined. Restoring the credibility of these markets should be an essential mission for all of us—one that is especially important for anyone serving, or contemplating serving, as a director on the board of a publicly traded company.

Do corporate directors share responsibility for the magnitude of problems that are facing us today? Absolutely. Directors have failed in a number of situations that have been both painful and well publicized. Have they failed through inattention? Unlikely. Did they fail through deliberate malfeasance? This is less likely still, although, of course, it may well have happened. What I believe is that, on most occasions, corporate directors have failed because they have not had the tools to do the job properly. Perhaps more significantly, they have not fully understood what the job is.

In this article, I will address both of these complex issues, drawing upon my own experiences while serving on the boards of nearly a dozen publicly traded corporations and non-profit organizations, as well as some vital lessons I've learned from a number of gifted experts in this field, among them, attorneys, financial advisors, corporate leaders, and veterans of the board room.

My objective is to enable current and prospective directors to understand more fully not only the broad strokes but the subtleties of what they will—and won't—be responsible for as board members; to help them identify and therefore minimize the risks that may prevent them from fulfilling their responsibilities; and to motivate them to contribute their skills, integrity, and personal energy, at the highest level possible, to this essential mission of restoring worldwide confidence in our corporate governance system and our capital markets.

THE ROLE

How does one best characterize a corporate director's job?

We all know the classic definition: In a solvent corporate situation, the director is obliged to perform fiduciary duties, as guardian of the corporation, on behalf of the company's shareholders. Those duties, generally speaking, take the form of promoting the best, longer-term interests of the corporation itself, rather than the interests of management, any internal or external constituent, or the director himself. In situations of corporate difficulty, the director's responsibilities shift and evolve depending upon the extent of the company's

problems. There likely are responsibilities to creditors that will supplement or perhaps replace those due to shareholders. There are also less clear, but nonetheless real, responsibilities to employees, vendors, customers, and perhaps others.

No matter what's happening, a director cannot act on her own individual needs and desires. I often imagine that one is putting one's self aside and acting as if the parent of a small person, which in this case is the corporation. Among other things, this requires a director to deal with the business issues at hand with an impartial mindset. One needs to be capable of taking the emotions out of a business situation. There may be all kinds of pressures to focus on short-term matters and immediate rewards, but directors must concentrate on longer-term issues as they relate to the corporation. It's a challenge.

What is the ultimate responsibility of a corporate director? It's not to be infallible, not matter how much we might like to be. Our corporate governance system does not expect this of us, but focuses instead on a "prudent man's" rule of conduct that expects us to act in good faith with the same care and attention that an ordinarily prudent person would display in a similar position and set of circumstances. The recent Sarbanes-Oxley Act is an attempt to underline appropriate activities and practices for corporate directors and officers and it provides criminal penalties to make certain that people take these rules seriously. But I actually don't believe that the legislation changes the standards that responsible directors have been trying to meet all along.

I first served on a board of directors about a dozen years ago. It wasn't something that I intended—it just happened. After working in the mortgage-backed securities division of Drexel Burnham Lambert, I was on the verge of leaving to start up my own asset management firm. When Drexel filed for bankruptcy, I decided to undertake a grass-roots effort to organize the company's shareholders, who were mainly rank-and-file employees, into an equity committee. Having achieved recognition as an official committee in the proceedings, we quickly established ourselves as the lone voice pressing for two important changes: 1) a replacement of the management-controlled board of directors by an independent board and 2) a post-crisis strategy aimed at reorganizing rather than liquidating the firm. Both were successful.

It became my responsibility to try to attract people of the highest skills and integrity to Drexel's board. Many people expected me to fail at this task but, fortunately, I did not. Among others, I recruited Fletcher Byrom, the former chief executive of Koppers Company, who had retired in 1982, and Fred Zuckerman, then Treasurer of Chrysler. I was asked to join the board as well.

It would be an overstatement to say that I had very little experience to serve on Drexel's board. I had *no* experience. None. But I was a born fiduciary. I very quickly came to see that the "child mind"—the person who is able to come into a situation like this and fearlessly ask questions, without worrying about looking idiotic or unprepared, to keep probing until he or she truly understands what's in the company's best interest—can be very valuable for a corporate director. That's the role that I played then and, in one way or another, it's the role I continually have tried to play whenever I have served on a board.

There's a fascinating tension, when you're serving on a board, between complexity and simplicity. One often is confronted by incredibly complicated business situations. Drexel was certainly like that. I lost count after I attended 150 meetings of the board and its committees just in the first year after taking my seat on July 18, 1990. But somehow one needs to make sense of all of this complexity. After all, directors must act, but they also need to understand *why* they act as they do.

So I evolved a standard to which I'm still committed: I needed to be able to explain what I did in terms my children could understand. What were the basic issues? What were the risks? What did I think would be best for the company and why was it best? If I could not keep it simple, I probably didn't understand it as well as I should have. And that meant I needed to work harder to figure things out. I needed to ask more questions and to keep answering them.

I'm proud of what we were able to accomplish on the Drexel board. We resolved more than $30 billion worth of claims and emerged from bankruptcy in a little more than two years—record time for such a complex case. We established a number of important legal precedents and achieved equity as well as the creditor groups received excellent recoveries. To my mind, we proved the value of an independent board of directors in the most contentious and complicated of corporate situations.

In the 10-plus years that have followed my involvement in Drexel's board, I've served on a number of different boards and these experiences have reinforced my commitment to the "child mind" that asks questions. It may be that this is the best, simplest, truest way to define a director's job—that, in fact, everything else falls into place if one is actively engaged in the process of asking questions, probing below the surface, challenging the

status quo until it all makes sense to oneself . . . or to one's children.

This all *sounds* so simple. But being a director actually is difficult for many, many reasons. People are scared and intimidated by the situation. Directors don't want to seem foolish or unprepared. They're worried that they will raise doubts about the value they're bringing to a board, so they are reluctant to ask questions. Also, they don't want to be seen as threatening management. This is understandable. But it stops them, as well, from asking questions and that's a situation that we all must work to combat. It's hard for a director to be gentle and supportive yet at the same time persistent and challenging in the best sense of these words.

But this should be a goal for all of us. A healthy tension between a company's CEO and its board is a good thing, not bad. It creates a system of checks and balances that provides a positive and constructive—*not* an obstructive or hostile—environment in which to pursue the company's long-term objectives. As someone who has served as a CEO, I know that is a lonely job. One benefits from having directors who are committed to actively providing ideas and feedback, rather than just passive support. The result, I'm convinced, is better management and, even more important, a stronger corporation.

THE RISKS

If one's role as a corporate director is, therefore, to be actively engaged in this process of seeking information and continuously and constructively challenging management, then it follows that the greatest risks one faces as a director are, quite simply, those that may prevent him or her from behaving this way. And I believe this to be the case.

What are those risks and how can they be minimized or eliminated? I've already addressed one common problem: an unwillingness to ask questions that arises from many directors' failure to grasp the fundamental nature of their role and responsibilities. When people understand that "squeaky wheels" really do help drive companies to their desired destinations, this reluctance tends to disappear.

But I have seen another big danger inherent in corporate board life—that a director, basically, will fall asleep on the job. This does not result from a lack of good intentions. But it's very, very difficult to remain vigilant. One finds oneself thinking, "If something important happens within the company, I'm going to be told about it." And I'm convinced that this is the most dangerous form of thinking that a director can lapse into. It's the opposite mindset from that of a director who is actively engaged in asking questions.

No one is immune. I found myself thinking this way while I was serving on the board of a high-tech company not too long ago. I began to recognize signs of passivity in myself, which included a general complacency that I'd be alerted to any significant developments within the company. But directors can't rely upon assumptions like these. When one is doing one's job properly, one should be continuously probing to find out about significant developments, even the ones management isn't worried about. And, as recent corporate experiences have shown us, when a director doesn't know enough to do this kind of probing, it may be time to bring in an independent expert who can. The one thing a director shouldn't do is just sit back and assume the best.

In this particular instance, I told myself that I needed to figure out a way to insure that I would be getting all the right information and asking the right questions. I wasn't a specialist in this industry. So I decided that the way to accomplish my objective would be to adopt the mindset of a customer and try to ask all the kinds of questions a savvy customer might ask. It was remarkably effective. By asking a different set of questions and approaching the company's business from a different vantage point from my typical position as a director, I succeeded in making management more accountable for a flow of essential information. I really made sure that I understood the company's mission and the way that management was working to achieve it.

As corporate directors, we all need to work to combat what may be our inevitable tendency toward what one person might term "passivity" and another "excessive confidence in the status quo." We need to keep asking questions. How we achieve this goal is a matter of individual preference and even may entail some trial and error when it comes to discovering which methods work best for each of us.

But on a corporate governance level, there is one practice that I believe has a tremendous impact in keeping boards active and alert: to appoint only non-executive directors as chairmen of the board. The National Association of Corporate Directors strongly recommended this practice in its recent Blue Ribbon Commission on "Risk Oversight." I support this so strongly that, in my own life as a director, I will not serve on a board in which the chairman and the CEO are the same person.

I hate to see judgments replaced by rules, so I'm

not arguing that we should legislate this practice into law. But I would like to see it acknowledged as a best practice, perhaps even as a listing requirement for the New York Stock Exchange. There are many reasons why tension between a non-executive chairman and a company's management is healthy. But for the purposes of this article, I'll remain focused on this one issue: the challenge of creating and maintaining a board environment in which directors can remain actively engaged as questioners or seekers of information.

Along these lines, I believe that the chairman of the board should be responsible for establishing the agenda for board meetings in conjunction *with* management but not *replaced by* management. Most of the work that goes into creating an effective board meeting should be done before the meeting itself. An independent chairman plays an essential role in making this happen.

Ideally, the pre-meeting work should include a fair amount of questioning and probing by the chairman personally to determine what type of information is appropriate for the board to see, which kinds of issues should be discussed, and how the material should be distilled in the most meaningful and useful way for the board. A lot of benefit comes from this give-and-take, which ultimately leads to the better management of the company. And that, after all, is what everybody wants to achieve: the board, the shareholders, management, customers, suppliers, the community and other stakeholders. When well done, this is an extremely constructive process.

These days, some people believe that recent corporate problems in the United States represent a failure of boards of directors or even of our corporate governance system itself. But I would argue that during the 1980s and 1990s, our financial technology outstripped our knowledge of how to set up systems and procedures to protect the corporation from misuse of new financial instruments and techniques. That, in the grand scheme of things, is not an unpredictable set of developments; it's the way of free capital markets. One development leapfrogs another, which in turn leapfrogs still another. With the series of bad news and misadventures that we've had in the past couple of years, the correction mechanisms will swing in. In other words, ultimately the market will speak.

One last thought, however: In the wake of recent corporate scandals, I believe that there's actually a new risk facing corporate directors, one that is not as readily apparent as others may be. It's the risk of focusing so much on risk-avoidance—trying to protect ourselves against the disasters of yesterday, a list that is now much larger than it ever was—that we fall prey to the kind of backward thinking that will wind up weakening directors rather than strengthening them.

I think it's very important to find ways to educate the broader community about the proper roles and responsibilities of the shareholder, the lender, management, and the board. I don't think there's a lot of understanding of these in the outside world. It's easy to point to the boards of the recently fallen, former high-flying companies and say they were asleep at the switch. The result is new rules and recommendations that include a lot of checklists, which should be received as guides to show boards where the light switches are located. Their purpose is to wake boards up. Lists can be helpful in promoting proper behavior, but they can also be reductionist and ultimately wind up promoting passive behavior. If people follow the lists and the letter of the law, but don't push themselves beyond that, they might tell themselves they've been doing good jobs as directors, but that wouldn't be true.

Good directors, after all, should be able to do more than simply identify and address corporate problems and, when it occurs, management malfeasance. They should be helping management think strategically and constructively about how to build the best possible future for the company. If we allow ourselves to behave passively or in a limited fashion simply to avoid yesterday's risks, we will fail to foster the kind of active debate in the boardroom that really helps manage a company so as to thrive in tomorrow's environment. That's a real risk we must strive to avoid.

THE REWARDS

In an environment like this one, many people might ask: Why serve as a director? Public misperceptions and criticisms abound. The job is hard—much harder than many people can imagine. The pressures that directors face, as a matter of course, are often nothing short of extraordinary.

Let me share one last story from my own life as a director, which illustrates just how painful these pressures can be. I served, several years ago, on the board of a company that was coming out of bankruptcy. Its corporate governance structure had been developed by the bankruptcy court: There were five board members, including two nominated by the company's former creditors, who were now its major shareholders, and two nominated by management. There was a lot of tension inherent in the situation, in part because the former lenders/current share-

holders lacked confidence in management, while the long-time, asset-based lender supported the CEO. In this somewhat thankless environment, I agreed to serve as chairman of the company's board. The company was nominally public, but there was an agreement that its shares would not trade for two years after the company emerged from bankruptcy.

Less than a year after the restructuring plan was confirmed, there was an unexpected windfall: Thanks to President Bush's first round of tax-cuts, the company received an $18 million refund from the IRS. Since it was completely unanticipated, there was no provision for it in the company's reorganization plan approved by the court.

The company's shareholders were still thinking like lenders; that meant they wanted the money themselves. My view as chairman, which was supported by the company's counsel, was that the most important objective was to make certain that the company would survive and hopefully thrive, since this would ultimately benefit all its shareholders. If I had allowed this dominant group of shareholders to insist that the money be distributed, at a time when the company's industry was still in the lowest part of its business cycle and company operations were not yet stable and reliably profitable, I would have been irresponsible; I would in my own mind have breached my duty to the corporation, through which my duty to corporate owners flows.

Did I trust management? Not particularly. But did I think I was doing the right thing for the company? Absolutely. And I remained steadfast, despite the fact that the former creditors made all kinds of threats, claiming that I was breaching my fiduciary responsibilities. I was wildly uncomfortable on a personal level. My decision even may have even been costly to me personally in terms of sacrificed business opportunities sometime down the road. But I did what I believed to be the right thing. And I fulfilled my responsibility as a director.

It's a tough job. But to me, serving on a board is like being involved in our political system or serving on a jury. I regard it as a calling and an honor, a public service kind of position that is critically important to the functioning of our system. It's essential for people to commit to this work and to know how to do it well.

The confidence that the world places in our capital markets is our country's most important asset. In order to rebuild our markets' credibility—and to restore the confidence that most of our managements and corporations fully deserve—we need corporate directors who will fulfill their responsibilities with the highest levels of skill, dedication, and integrity.

I'm a child of many generations of missionaries. It seems to me that it's exactly when the times are the worst and the chips are down that the willingness to serve is most critical. At times like these, when the system appears to be broken, it is possible for one individual to make an enormous difference. That's the challenge facing all of us.