A JUDICIAL DIGESTIVO: SOME TIPS ON AVOIDING HAVING STOCKHOLDERS, THE BUSINESS PRESS, AND JUDGES LIKE ME WRITE STOMACH-CHURNING, HEAD-SEARING THINGS ABOUT YOU!

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Please indulge me today while I speak to you for a few minutes about some factors I have found to be danger signals for directors. When one or more of these indicators exists, a director has set herself up for potential embarrassment and, most important, made it more likely that she will have failed to live up to her duties to the stockholders. I arrange them in no particular order, although two common themes emerge: the need to sweat over the job of being a director and the need to understand what the duties of that job – and it is a job! – entail. Here goes.

Not Knowing The Business: Many public corporations are quite complex. They have diverse operations. If you don't understand those operations, the risks they involve, and the rewards they are supposed to promise, you cannot hope to act as an effective director. To understand the business, you must cut through accounting bullspeak and think like you do when you are in your day job or managing your own finances. There is one key question you must always be able to answer: How does this company make money? It sounds deceptively simple but one suspects that many directors, and even top managers, of some of our leading financial firms did not really know the answer to that question. By focusing on how actual cash flow is generated, you surface whether you are making money in a sound, old-fashioned way (e.g., by selling iPads) or in a risky, edgier, gimmicky way (e.g., gambling that a real estate zeppelin will grow even huger, booking the paper profits up front, and pushing risk into the future).

Getting to this answer may take persistence and it may annoy the managers, but you must get there. Otherwise, you shouldn't serve.

Not Thinking Like A Business Person: Second, apply that insight throughout your board service, and think like a business person. Do not turn into a dulled signer of checklist items presorted by management. Too many directors act differently as directors than they do in running their own businesses and affairs. When farming their own land, they know everything about the risks and rewards, can separate the real from the phony, and have a locked-in focus on generating sustainable cash flows. When serving as an advisor (i.e., a director for someone else's firm), directors too often leave their business acumen, savvy, and perhaps most important, skepticism, back at the horse farm. Instead of actively pressing management for answers and really learning the business, directors are more like well-mannered season ticketholders to a stylized interactive theatre, in which performing managers shepherd the audience through ritualized plays, mostly involving listening to the managers give set piece reports, asking a few brief questions so as not to disrupt the actors' timing, and completing a series of management-driven acts, often written not in the blunt, earthy style of an Arthur Miller, but in the obscurantist, high-falutin style of a jejune drama student in a master of Fine Arts program. "At the end of the day," after you have "drilled down" on all the "drivers" and other trite phrases of management speak, you may well find you have spent a day and a half and know very little more than you did when you arrived. But you have been very busy indeed.

Failing To Be The Boss Of The CEO: Third, and again related, is failing to understand that the board is the boss of the CEO, and not vice versa. Nor are you his therapist. You don't offer much of that to your employees in their health plan, nor do you offer them solace and comfort, and assure them that they will make more than anyone in the industry.

If the agenda of your board is largely determined by the CEO, if you don't engage in meaningful planning as a board on how to employ your scarce time as directors, you will be managed by the CEO and his team, rather than be capable of monitoring that team and helping it succeed.

How much time as a board do you want to spend on strategy, implementation, and identifying and addressing key risks? Do you set priorities to drive the use of board time, or does the CEO do that?

As a subset of this key topic, here are a few other warning signals:

1) Lack Of A Succession Plan: If a CEO has been in place for four years and has not identified capable successors, he has confessed to managerial failure. Succession planning is uncomfortable for the CEO, but valuable to the board precisely because that is true. It is also necessary. Stuff happens, see HP.

2) Lack Of Access To Other Top Managers: Related to succession planning is whether you have access to other top managers. If you only really interact with the CEO and perhaps his right hand dude, the CFO, that is a scary narrow window into the company. On a regular basis, directors should interact with, build relationships and trust with, and form judgments about, other key managers. This not only gives you a real insight into their capabilities, but also gives you a much more thorough information base about the company. Although these managers will be loyal to the CEO, when you have relationships with them, you will pick up concerns, themes, and hints about problems and

challenges much earlier. Critically, if these managers are stilted and intimidated in dealing with you because the CEO has put them in lock-down mode, you will get real insight into how much integrity and confidence your CEO has as a leader.

Functionally, too, it is important that key managers view themselves as accountable to the board. For example, however busy a board is, it must make sure that all key players in risk management, and not just the CFO, have regular time with the key board risk committees, which too often is just a singular committee, and the board itself. The General Counsel, the head of internal audit, and other key compliance officers (think environmental in the case of say, BP) cannot be shunted aside simply because the CFO has a huge checklist to get through.

Setting up regular opportunities for other key managers to spend with the board eases this process and helps in succession planning.

Watch out for CEOs who limit your access to their subordinates and who make themselves your only window into the company. In that regard, let me tell a tale out of school. When I was on the faculty of another Directors' College — not nearly as good as NYU's of course — a very prominent CEO of a very, very large financial institution spoke at a dinner. He said when he became CEO, he wanted good governance. Traditionally, the board was comprised of 8 or 9 independent directors, the CEO, and the next two top executives. He wanted to make the board more independent, so he got the board to have him as the only non-independent director. Likewise, when the board came into town, it had been traditional for the directors to have dinner with the CEO and five or so of the top managers. The CEO, as he put it, wanted to make sure that the board had better access to him. So he changed the dinners to just include the CEO and the directors, plus their spouses from time to time. The other managers were excluded so the board could speak freely to the CEO. And, because he wanted a strong board, the CEO suggested, and the board agreed, that the lead director position would rotate at each meeting.

This speech lulled some. My reaction to the CEO was rather more skeptical. Come again? You mean the board now sees the company essentially only through your eyes? And the board has no leader of its own, just a rotating tour near the head of the table and perhaps a chance to have his rental town car driver park in the lead director of the month spot! Although I have no doubt this CEO cared deeply about his company, that company's board later, at his instance, took rather huge risks on short notice, and got stung badly. The CEO departed in ignominy.

3) <u>Insufficient Notice And Information</u>: That brings us to another CEO-related issue: the bullrush. If a CEO is asking you regularly to act on short notice, you are putting the company and yourself at grave risk. There is no excuse for being asked to act on an emergency basis on non-emergency business. If you are getting materials late on a regular basis, deal with that. Refuse to act until you have adequate time. Make sure that deficient performance in this respect factors negatively in the CEO's evaluation and therefore compensation.

4) <u>Addressing Conflicts In An Unplanned Naïve, Unprofessional Manner</u>: The dangers of acting on short notice and inadequate information are especially acute in conflict situations, to which I now turn.

The traditional area where directors get sued is for approving conflict transactions. The areas that are most sensitive now involve going private transactions, both those involving controlling stockholders and those involving CEOs and private equity sponsors. There is NO EXCUSE, I repeat NO EXCUSE, for a board to be bullrushed into either of these proposals. But it regularly happens. As directors, I am sure that each of you has been schooled to say "we are not for sale" and to refer any interested party to the CEO if an approach occurs.

But in recent years CEOs have confronted their own boards seeking to have them rapidly approve a fully-baked proposal whereby the CEO gave out confidential information to a private equity firm and financing partners, including too often with the help of the company's own bankers (and outrageously even lawyers!), and enlisted other top managers to support the bid, sign up voting agreements to vote for the deal, and pledge not to work for any other buyer. The CEO then asks the board to sign up quickly because it's a 20% premium!

Rather than recognize this as a firing offense, several boards just got weak advisors and signed up; relying on a short go-shop to cure the problem, a go-shop that was likely to be ineffective because other P/E shops were unlikely to bid if the managers had made their deal and were happy.

That is flat out outrageous behavior on so many levels. Aside from the obvious conflict the managers have because they want to buy at a low price, the CEO has betrayed the board by usurping its authority to determine whether and when to sell. Why has the CEO not told the board a sale could be in the stockholders' best interests? Why hasn't he suggested they seek out other buyers, such as strategic competitors? Is it because they won't keep him or pay him as much? How could the CEO tamper with company employees by getting them to refuse to work for any other buyer? Who authorized him to give out company information for his own self-interest? Was there a confidentiality stipulation? Who gave him the right to use company advisors for his own selfish purposes?

The best way to prevent these situations is to have in place protocols that require the board to hear first if the CEO thinks a sale might be advisable. These protocols should prevent the CEO from entering into any arrangements or understandings with buyers, providing them with any confidential information, or involving other employees without the prior approval of the board. All company outside advisors should be on notice that they cannot work for the CEO personally absent written authorization from the board. If and when a decision to explore a sale is made, it should be made by the board.

<u>Strong Advisors For Managers; Weak Advisors For The Board</u>: The selection and use of outside advisors is another key topic. In conflict situations, advisors are critical. Management knows more than anyone else about the business. They are your usual source of information. In a conflict transaction, that channel is distorted, especially if a CEO has gone so far as to sign up his subordinates in the buy-out group. The M&A game is complicated. Many directors have little M&A experience and don't know the dark arts of the game. But instead of addressing this problem by getting the very best advisors, they often get second- or third-tier financial and legal advisors, while

management (armed already with its deep knowledge of the company) arms itself with the very best.

This is a DANGER SIGNAL, akin to the one at Niagara about the approaching falls. You don't guard Dwight Howard with Nate Robinson — however much you enjoyed their teamwork in the slam dunk contest a few years ago. If you get weak advisors, you will screw up. You will not do the right thing by the stockholders, you will get sued, and you may well lose and at the very least, get publicly embarrassed.

If the CEO, as a controlling stockholder, wants to buy the company for cash, that is not the time to economize. It is time to get the best. And if the CEO or controlling stockholder has taken the company advisors, act as a board to disqualify and bar them from doing so. That will set the CEO or controller back on his heels. Remember this, too: a good advisor will make you understand who has the real leverage in all these situations, and particularly in conflict situations — you do, as an independent director, not the managers or controller. The law gives you great power. If you refuse to endorse a tainted process, the conflicted party will have to face withering legal scrutiny if he attempts to cram down a deal. The easiest party to say no to ought to be your own CEO or controlling stockholder. If you are afraid of doing so, get another job.

Another key area where good advisors are critical to success is executive compensation. If you want to do it right, have a real negotiator with management-side labor experience. Bargain hard. Reliance on so-called "compensation consultants" is just an admission that you are planning to treat top executive comp different from how you treat other labor. Use common sense metrics, too. If the rest of your workforce has suffered job cuts, pay freezes, and benefit costs increases, why are you giving the CEO a big raise? If you think the CEO pay package is complex, ask why? If he wants a raise, ask him who has been seeking to hire him? And remember that succession planning will aid in helping the CEO think rationally about compensation.

There are many other danger signals. But I will finish with two.

<u>Feeling The Tug Of Loyalty To The CEO Or Controller:</u> The penultimate point is admittedly redundant, but so important it deserves to be said again. When you feel a tug of friendship or beholdedness influencing your approach as an independent director, you are in danger land. This can be especially true when you have served on a board for many years with the same CEO or when you had social ties to the CEO or controller before coming to the board.

Although it is critical that you have a good working relationship with the CEO and his management team, you must recognize that you are his boss and approach it with that mindset. A good boss does not let his employees take advantage of the business and a good boss has to discipline and be ready to fire his employees. It can be lonely being a boss because the reality is that the boss can never be a (insert term for rear end) buddy of his employees. As in any superior-subordinate relationship, the board-CEO relationship must have at its core a level of required distance and adversarialness. Too often, board members do not act as good bosses. Reluctant to upset the CEO, they do not act early on warning signals or correctives. Rather, they only act when it is crisis time, requiring a highly public removal and an exercise in crisis management.

So, think and act like a good boss. If you can’t, then leave the board.

Not Putting In The Sweat: Finally, I turn to the last danger signal: which is that you can't put in the sweat. If you are skimming the surface of materials, pretending to read them on the plane on an iPad when googling yourself, rather than reading and marking up hard copies with highlighters, stickies and writing down questions to ask; voting on proposals you don't understand; failing to ask questions because you think it will reveal your lack of preparation or because your plane leaves in 90 minutes and it takes 20 minutes to get to the airport, you need to give thought to whether you can get rid of other duties or need to resign. The law rightly provides you with a lot of protection if you make a good faith effort to carry out your duties. But it also holds you accountable if you don't try.

If you can't pass this single question mirror test, you are likely not living up to your duties: Am I doing justice to this responsibility? Related to this question is one to ask about your colleagues on the board, which is: Does everyone else seem to be doing justice to the job? If the answer is no, you are in the danger zone. It is challenging enough for a board to perform well when all its members are trying. If they are not, it is impossible. The premise of a board is that there will be collaboration and deliberation, where the various perspectives and professional backgrounds of the directors are put to use in making judgments. If board members are not carrying their weight, the risk of making mistakes or missing key issues is heightened. If you know that there are slackers, you have a duty to deal with that matter.

Admittedly, all these danger signals are interrelated. If you do not organize your time well as a board, you are more likely to fail the justice test. If you don't think like a business person, the time you put in will be less effective. If you are unwilling to or too timid to challenge management, you will find your time diverted to being managed by the CEO and you will be unable to be an effective monitor. If you tolerate the continued service of non-performing director colleagues, you put the company and yourself at risk. By contrast, if you approach the job of a director seriously and with the right mindset, it is one of the safest that exists in the world. The liability risk is low, the intellectual rewards are high, the pay is pretty darn good, and the principal danger is that you will gain weight from eating too many good cookies and brownies.