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Directorship

IN ITS THIRTY FIRST YEAR AS THE AUTHORITATIVE BOARD RESOURCE

The Independent Director: James Harris

As an independent director for El Paso Electric and Peregrine Systems, Seneca Financial CEO James Harris has faced troubles at nuclear facilities and tough technology turnarounds, but the emerging challenge from a more aggressive plaintiffs' bar that is now incentivized to go after the net worth of board directors is another matter. Another consequence of the rapidly changing environment is the change in relationship between the board and CEO. "If I were a CEO today I'd be a little uncomfortable", he says. The line between management and the board is being redrawn, which he believes is "not all bad." P. 8

In This Issue

The New DNA of Corporate Governance

Ultimately, governance is about wealth creation, not compliance. Here's a framework for directors to help them keep their eye on the real prize: fulfilling the strategic duty to long-term shareholders.

By Mark Van Clieaf and Janet Langford Kelly

Enron's rapid descent into bankruptcy, followed by numerous corporate accounting scandals (WorldCom most notable among them) caused a flurry of legislative, regulatory — and ultimately commercial — activity designed to ensure against corporate chicanery. As a result, corporate governance has come to be confused with compliance activity — with directors charged with ensuring that the corporation they serve and its management are in compliance with a dizzying array of rules designed to create board independence and management accountability. The recent WorldCom and Enron settlements, in which directors agreed to pay $31 million dollars *personally* to shareholders, sent further shock waves through the corporate world. In the aftermath of these settlement agreements, many law firms issued client

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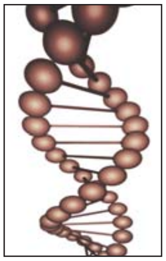
The New DNA of Corporate Governance *(continued from front cover)*



memos focused on ensuring that directors have fully met their compliance and oversight duties in order to merit the protection of the business judgment rule. Fully four years after the demise of Enron, "compliance governance" remains the focus of most governance discussions.

The problem with this emphasis on "compliance governance" is that compliance and oversight constitute only a portion of a director's duty to ensure that the business and affairs of a corporation are managed "by or under the direction of" the board. The ultimate goal of corporations is to continue to create wealth as a viable and growing entity for the long term; directors have a *proactive* responsibility to ensure that the corporation they serve has those processes and metrics in place — including strategic and financial plans — that they believe will accomplish this end. In other words, they have a "strategic duty," not just a compliance duty. To fulfill his or her "strategic duty," a director must ensure that the corporation he or she serves has three key interdependent processes that, when designed effectively, integrate into a holistic organizational and leadership framework for the corporation's future and sustainability:

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"Boards and CEOs also need to be careful not to allow CEO tenure to distort executive accountability."

- Board review/approval of three-year-plus business plans and strategies and setting of appropriate metrics to evaluate longer-term management performance;
- Succession planning and talent management processes; and
- Appropriately structured pay for longer-term performance.

Given the magnitude of the work involved in ensuring such processes are in place and appropriately integrated, we estimate that boards should spend at least 60 percent of their time on their strategic duty.

Although this strategic duty is rarely discussed in corporate governance conversations, both the Delaware judiciary and long-term stockholders assume that boards have a strategic duty of longer-term planning and strategic goal-setting. For example, in a 2004 speech to the Tulane Corporate Law Institute, former Delaware Chief Justice Norman Veasey reassured the audience that the business judgment rule remained available to protect the strategic review and strategic goal setting he assumed boards engage in:

> *Although the law of fiduciary duty recognizes the evolving expectations of the standards of directors and officers, we must keep in mind that the business judgment rule continues unabated to protect directors' decisions made in good faith, enabling them to **set strategic goals for the corporation** and to be relatively free to engage in prudent risk-taking. (Emphasis added)*

Similarly, the Council of Institutional Investors, which represents 130 pension funds with $3 trillion in invested assets, recently issued a policy statement on executive compensation assuming boards have engaged in long-term goal-setting and performance measurement to which executive compensation is linked:

> *The Council endorses reasonable, appropriately structured pay-for-performance programs that reward executives for **sustainable, superior performance** over the "long term," consistent with a company's investment horizon and generally **considered to be five or more years for mature companies and at least three years for other companies.*** (Emphasis added)

Unfortunately, most boards do not appear to have approved three-year-plus business plans and corresponding metrics to evaluate management performance and then tied executive compensation to the achievement of three-year-plus goals emanating from these longer-term strategic plans (beyond a one- to two-year focus on current operations). Paul Hodgson of The Corporate Library recently analyzed the 2004 proxy statements of the top 2000 US companies. He concluded that 85 percent of these companies had not disclosed multi-year metrics to evaluate management performance. The 2001 proxy statements analysis by MVC Associates reached a similar conclusion: Only eleven percent of the S&P 500 had set strategic goals for management beyond three years.

Not surprisingly in the absence of such plans and goals, most corporations are not creating long-term sustainable growth and intrinsic value. A financial analysis of the top 2,100 companies in the Russell 3000 just completed by MVC Associates revealed that 56 percent of these companies have failed to return a profit greater than their cost of capital over the five years ending in 2003. This should raise a bright red flag for investors and the boards that the business model/strategy of these companies needs to be transformed.

If capitalism, and fiduciary capitalism in particular, is to live up to the expectations of the millions of people whose future financial security depends on long-term corporate growth and positive return on invested capital (ROIC), it is critical that directors and officers spend substantially more time and energy fulfilling their higher-order strategic duty than on their lower-order compliance and oversight duties. So how is a board to fulfill its strategic duty, its duty of sustainable governance?

Five Levels of Management Work and Capability

To fulfill its duty of sustainable governance, a board must ensure that the corporation it oversees has three integrated components:

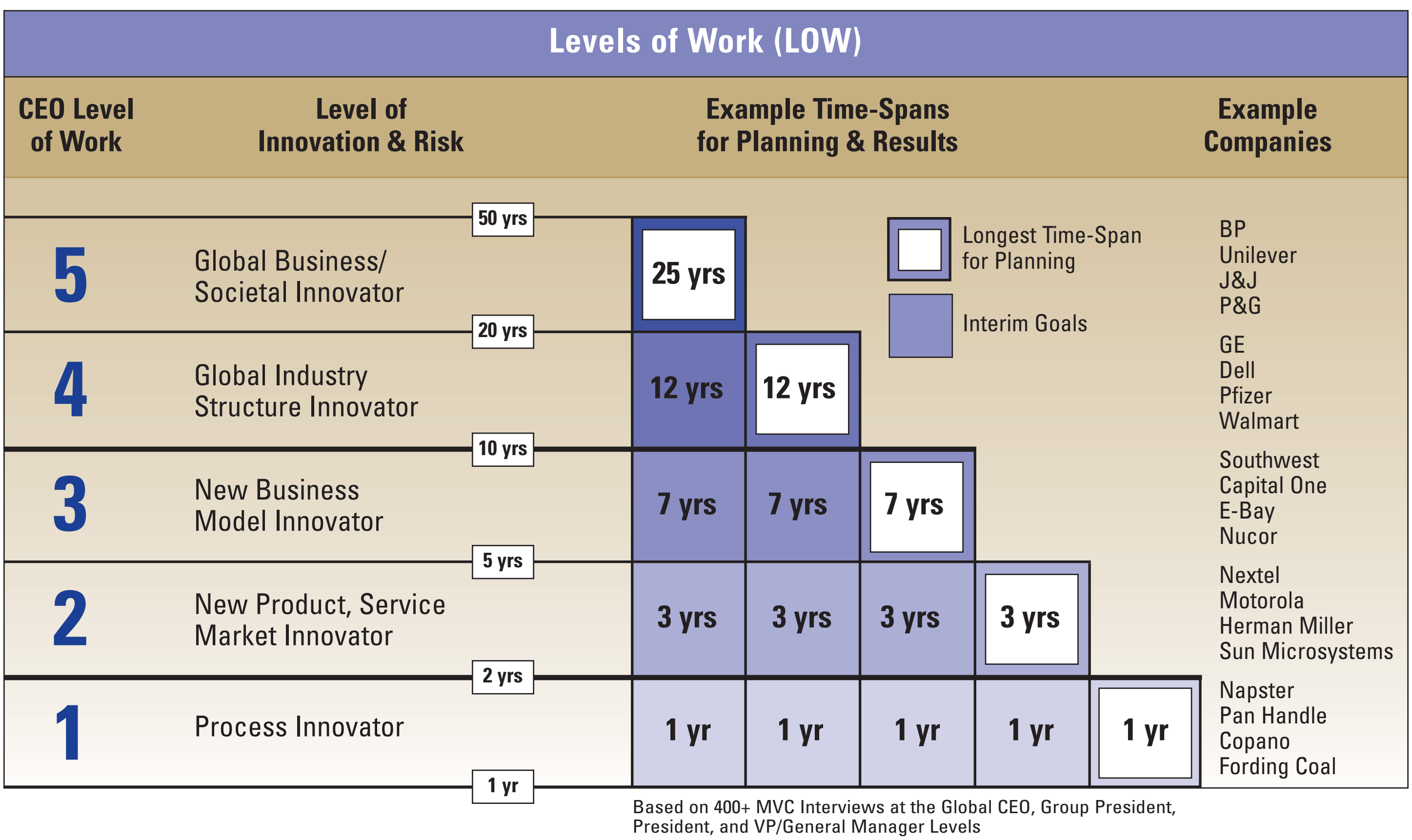
1. A three- to five-year or longer strategic and organizational plan, with clear and measurable goals, and accountabilities (what, by when, with what resources), and decision authorities for achieving the plan that directors and management believe in (not just an aspirational plan with no clear accountabilities);
2. A leadership team capable of performing at the level of complexity required by that plan (now and in 3 to 7 years from now); and
3. Measurement tools and pay-for-performance compensation design that both enable the board to assess the execution of the plan over time and appropriately incentivize management to create long-term value while equitably sharing that value created between employees and shareholders (labor and capital).

In over 10 years of research, MVC Associates has developed a framework called Levels of Work (LOW) and Levels of Executive Capability (LOC) to help directors and officers in their governance efforts. The Five Levels of Work provides an empirically proven set of tools, processes and principles to define work complexity, accountability and decision-making authority and ensures that value is being added at each Level of Work for customers, shareholders and global society. These levels are based on principles of complexity and how they relate to value creation, not the size of the company. This framework builds on two streams of over 30 years of earlier management research worldwide known as Requisite Organization (RO) and the Viable Systems Model (VSM). We see these as building blocks for the "new DNA" of corporate governance that provides real substance to board and management processes.

The first principle is that there are five levels of CEO work and five levels of corporate governance: at any given time a corporation's strategic needs will be at one of these five levels. The Level of Work (LOW) framework uses six factors to determine which of five levels of work and innovation is required by an organization to sustain itself as a viable system. Four of these factors are the level of innovation complexity; the planning horizon; the level of complexity of assets/capital managed; and the level of complexity of stakeholder groups to be managed given the number of different businesses and countries in which the enterprise may operate. See Figure 1.

There are five corresponding levels of CEO accountability and capability. The Level of Capability (LOC) identifies the level-specific conceptual and planning skills and other competencies that match to each requisite Level of Work. Each jump in level is a discontinuous jump both in work complexity and conceptual and strategic thinking.

When a board has identified the level of work required by an enterprise, it has also identified the Organization Value Added — OVA™ — that management



> *"Our analysis of the 2001 proxy statements revealed that only eleven percent of the S&P 500 had set strategic goals for management beyond three years."*

should add at each level. This framework establishes an equitable basis for compensating the CEO role versus compensation for other CEOs, as well as internal pay equity relative to direct reports and other levels in the managerial hierarchy, based on "felt fair" pay research.

It also reveals the shortcoming of current comparative practices, which determine suggested CEO compensation based on medians and percentiles for peer groups: CEO roles within peer groups may be operating at significantly different Levels of Work complexity and so traditional peer group comparisons result in overpayment of the less complex CEO roles and underpayment for more complex CEO roles.

To illustrate this, let's compare an oil and gas income trust to a global business like BP, both which are in the energy sector. An income trust (e.g., real estate or oil and gas such as Copano Energy, Panhandle Royalty, Fording Coal) focuses on maximizing quarterly dividend payouts and cash flow from the existing asset base. This enterprise, if truly an income trust, really has no strategic needs; there is no expectation for investing new capital for innovation in new products, new services and new businesses. The focus is on operational leadership, and the decision-making authority granted by the board is for short-term core business process efficiencies to maximize return on invested capital. Given that the Level of Work is at Level 1, this enterprise only requires a process innovator, Level 1 CEO (Figure 1). Because the CEO role is in the operational leadership domain, it should be paid commensurate with this level of complexity, innovation and decision-making authority over assets delegated by the board.

Contrast this income trust with a global business/societal innovator, Level 5 CEO role (e.g., BP, Unilever, P&G, Nestle, Alcan) accountable for a global entity, operating in at least three industry sectors, with 30 or more business units presidents who are accountable for investing in new products and new business models in 40 or more countries.

This corporation has dramatically more complex strategic needs and requires a CEO role accountable for, in addition to the ongoing operational needs:

- Growing profit and return on risk-adjusted capital over the next two to 10 years from investments in new products, new services, new markets and new businesses;
- Envisioning and making 10-year-plus investment decisions in R&D to create future industries (e.g., hydrogen energy, genomics, food from plant protein to feed the world) and manufacturing plant location decisions that will drive sustainable returns of the enterprise for shareholders;
- Defining a set of values and a purpose for business and its contribution to worldwide society today and 10 – 20 (or more) years into the future in enhancing peace, prosperity and the equitable distribution of wealth globally, in so far as its business operations affect these.

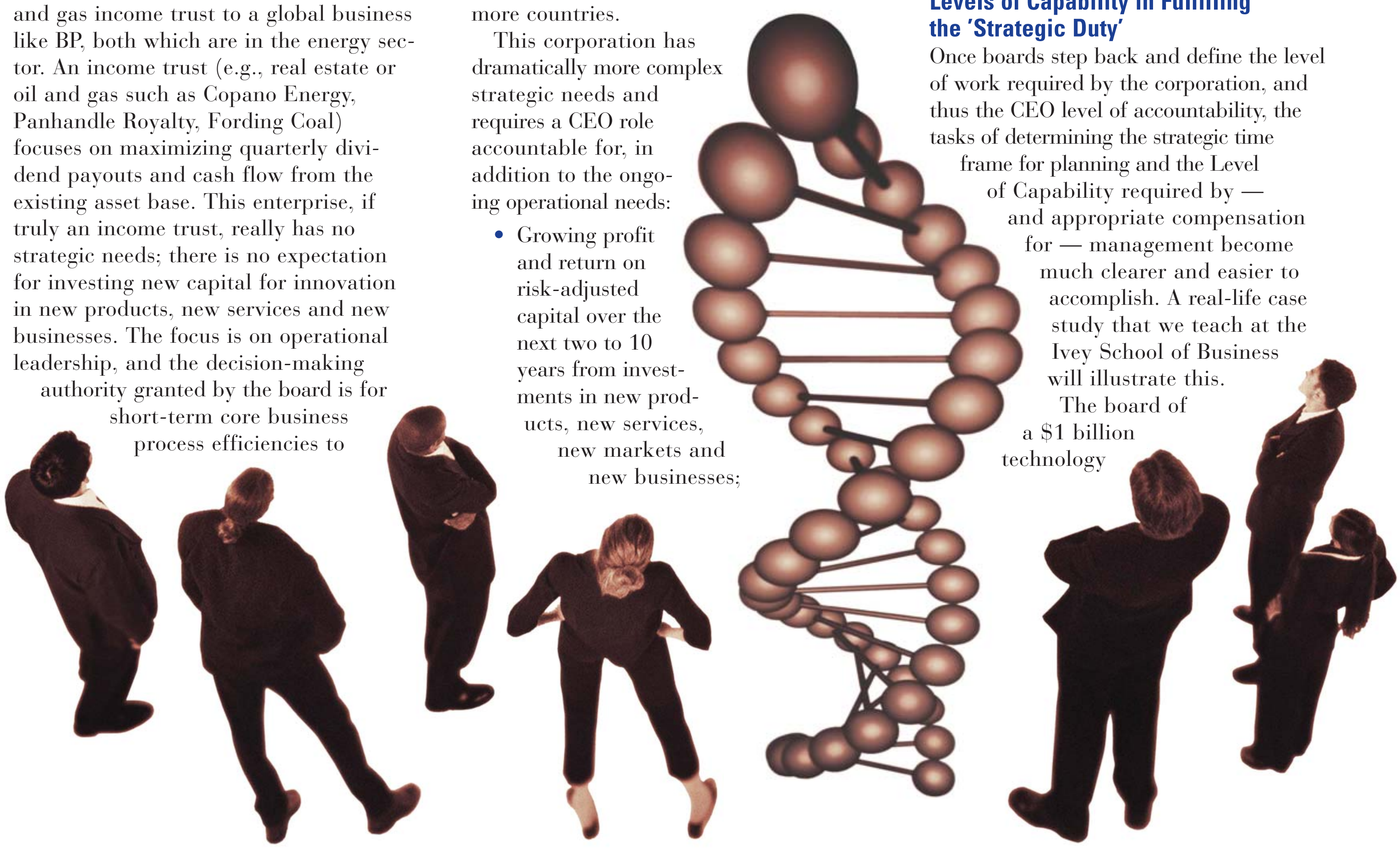
A CEO role operating at this level of work complexity and long-term value creation should be compensated at a multiple of 16 to 32 times more than the CEO of the income trust. See www.mvcinternational.com for specific articles related to research about excessive compensation, "felt fair" pay and the internal executive pay equity multiplier.

Thus, in different corporations different levels of value can be added by the CEO role, each of which requires different levels of executive capability and merit different levels of defensible CEO compensation.

Applying Levels of Work and Levels of Capability in Fulfilling the 'Strategic Duty'

Once boards step back and define the level of work required by the corporation, and thus the CEO level of accountability, the tasks of determining the strategic time frame for planning and the Level of Capability required by — and appropriate compensation for — management become much clearer and easier to accomplish. A real-life case study that we teach at the Ivey School of Business will illustrate this.

The board of a $1 billion technology



company with poor financial results, responding to pressure from institutional shareholders, removed the CEO and replaced him with the best candidate from the current executive team. Within a year, the newly promoted CEO requested the board to more than triple his compensation based on the industry peer group compensation levels.

MVC Associates facilitated a discussion of independent board members using its Level of Work (LOW) framework. The independent board members agreed that the company needed a CEO role held accountable at CEO level 3 — Business Model Innovator — because the enterprise required a new business model given changing technologies, aggressive new competitors, emerging new markets and the fact the company had not returned a profit greater than its cost of capital in five years. The leadership capabilities required for the CEO 3 — Business Model Innovator role included:

- Conceptualizing and implementing a new business strategy and economic model enabling the company to create a positive return on invested capital;
- Planning out three, five and seven years and setting accountable milestones for the company transformation as the industry changes with new technologies and emerging new markets; and
- Continuing to meet short-term revenue and profit growth targets while managing a change process that requires transformation of the company's structure, technologies, processes and profit drivers.

The independent directors then assessed the current CEO's Level of Capability, (we call this the Leadership Value Added — LVA™), relative to the skills/capabilities required for the newly defined CEO Level of Work. Each independent director completed a rating and assessment tool designed by MVC Associates, rating the current CEO on 12 key skill dimensions based on the agreed CEO 3 Level of Work and other strategic competencies we helped the board identify. After analyzing the rating results, it was apparent that the board believed that the current CEO was a great operator — CEO Level 1-capable (LOC) — but not capable of performing effectively at the CEO Level 3 – Business Model Innovator level.

Finally, the board discussed the $10 million total direct compensation level requested by the current CEO compared to the current $1.6 million approved total compensation package. The $10 million targeted compensation level was based on a peer group the current CEO suggested in the same industry. After analyzing the peer group companies and the level of complexity of their CEO roles (not their size, revenue or market cap), we concluded that four of the five peer companies selected were CEO Level 4 — Industry Innovator roles, operating across multiple business models and multiple countries. In other words, the roles weren't truly comparable, and the more complex CEO roles merited significantly higher levels of executive compensation than either the "as is" CEO role actually being performed at the client company or the "should be" CEO role based on the strategic needs of the enterprise.

We mapped out all the diagnostic results on flip charts for the board to illustrate the inter-dependencies and degrees of alignment (See chart below):

- Level of Work — CEO Level 3 — Business Model Innovator
- Level of Executive Capability — CEO Level 1 — Process Innovator

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Calibrating CEO Pay with Level of Work – Ivey Case Study

This illustrates the degree of misalignment in the case study between what the CEO role should be accountable for and the current level of CEO capability. The level of work required — CEO Level 3 (blue) — was not consistent with the executive's capability — CEO Level 1 (yellow) — or with the level of requested pay — CEO Level 4 (red) — validating why the board nixed the 6X+ pay increase.

CEO Level of Work	Level of Innovation & Risk		Leadership Value Added	Compensation Multiple
5	Global Business/ Societal Innovator	Universal Values & Purposes	32X	Wasteful Compensation
4	Global Industry Structure Innovator	Meta-Level Transformation	16X	4
3	New Business Model Innovator	Extrapolation & Transformation	8X	3
2	New Product, Service Market Innovator	Integration & Synthesis	4X	2
1	Process Innovator	Analysis & Deduction	2X X	1 Equitable Compensation

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- Level of Requested Pay — CEO Level 4 — Industry Innovator

Once this analysis was complete, the board was surprised to see the degree of misalignment:

- There was a gap of 3 Levels of Work between the Level of Executive Capability (LOC) of the current CEO and the Level of Work (LOW) of most of the benchmarked peer group CEO roles.
- Even more, there was a gap of 2 Levels of Work between the Level of Executive Capability of the current CEO and the Level of Work required by the company

Stated differently, if the board determined the CEO's appropriate compensation by the traditional approaches of benchmarking the competition, they would have agreed to pay the current CEO 4 to 8 times more than the level of compensation merited given his personal level of leadership capability.

Mostly importantly the board not only could not justify the compensation demands, it needed a CEO role that would be held accountable at a higher *Level of Work* (*LOW*) than currently, and a new CEO capable of operating at the equivalent *Level of Executive Capability* (*LOC*). Based on this organizational and leadership analysis, the board determined that it needed a new CEO — despite the fact that the current CEO had performed admirably in doing the necessary operational work to get the corporation to its current point and had produced improved short-term financial results.

The board started a nine-month search for a new CEO, as there was no internal candidate with the requisite level of executive capability required.

Boards and CEOs also need to be careful not to allow CEO tenure to distort executive accountability. Just because a CEO may be two years away from retirement does not mean the CEO role should only be held accountable for one to two year operational work. Doing so risks the longer-term sustainability of the enterprise and continues to create the problem of excessive compensation for CEO accountabilities at too low a Level of Work.

In the current high-profile CEO leadership change at HP with Carly Fiorina's departure, some have suggested HP needs a real operator CEO. If the HP board went through a similar process and analysis to the above case study, they might determine that this is not the case. Our preliminary analysis suggests what they really require is at least a CEO Level 4 — Global Industry Innovator role. This then has implications for the leadership competency profile the board should be using to assess potential candidates with a track record of performance/potential at the matching CEO 4 — Level of Capability.

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The DNA of Strategic Governance

The Level of Work and Level of Capability framework provides the processes, diagnostics and substance to facilitate "sustainable governance" decision-making and organizational design. We term this the "DNA" of strategic governance because it is the intertwined double helix of Levels of Work and Levels of Capability that makes this framework so effective. Those directors and officers wishing to discharge their strategic duty may find the logic and research outlined appealing.

We believe that Level of Work/Level of Executive Capability can make corporate governance work much easier and clearer in providing both disciplined processes and real substance. Regardless of whether these integrated principles, processes and tools we have outlined are used, however, a board that can demonstrate such organizational and leadership planning processes which were undertaken in "good faith," and with appropriate external expertise as the judiciary has already outlined, will have met its fiduciary duties, regardless of the ultimate results of the chosen business strategy. A board that has not ensured that the corporation it oversees has such organizational and leadership planning processes may find itself outside the protection of Delaware's director exculpation provisions regardless of the amount of compliance governance it has pursued. As former Chief Justice Veasey wrote in the Disney case:

> *Where a director consciously ignores his or her duties to the corporation, thereby causing economic injury to the stockholders, the director's actions are either "not in good faith" or "involve intentional misconduct." Thus plaintiff's allegations support claims that fall outside the liability waiver provided under Disney's certificate of incorporation.* ■

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