The Softer Side of Governance

BY NANCY DROZDOW
Special to the Legal, PLW

Governance has tipped in the direction of the Sarbanes-Oxley Act and compliance — not just for public companies, but also for organizations across the spectrum, including professional services firms. No doubt the pendulum has remained stuck on compliance issues for a good reason. Still, many boards are not harvesting the intellectual capital around the table.

Framing governance in a way that allows little real attention to the organizational and strategic issues (e.g., the internal dynamics of law firm mergers, the challenges of leading professionals, the globalization of services) undoubtedly leads to missed opportunities that can be more damaging to the long-term health of a firm than the technical and analytic elements of board functioning. This article lifts up some of the critical, "softer side" issues, some subtle and some not so, that paradoxically may contain at least as much risk as compliance.

For those of us not dealing explicitly with the legal issues around what boards do or don't do, it's important to know what we mean when we throw around "governance." Here is a guiding definition, courtesy of Sir Adrian Cadbury in *Global Corporate Governance Forum*:

"Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society."

NANCY DROZDOW *is a founder of CFAR (Center For Applied Research), a management consulting firm specializing in strategy and organizational development that spun off from the University of Pennsylvania's Wharton School in 1987. She has directed the firm's work with owner-led businesses, both public and private, for more than 20 years.*

Boards of directors are made up of human beings. Any human gathering with more than two people introduces difference: political, social, ethnic, familial and interpersonal, to name a fraught few. Boards, composed of insiders and outsiders, academics, and executives, with expertise in finance and distribution and manufacturing and global sourcing, strategy, operations, and leadership, along with high expectations about their voice and view being heard, are a crucible for underperformance or least common denominator deliberations.

In professional services, for example, providing oversight and guidance regarding the right balance between motivating individual professional passions (which all knowledge workers bring to their work, at least at the beginning), and following good business principles (profitability, productivity, selling, managing) is only one of the many serious challenges with which board members wrestle. This guidance is made even more challenging in professional settings because board members are also typically owner/employees themselves, often with a large ownership stake.

Let's take a couple of cases that illustrate the strategic and organizational issues that a board might face:

- A merger of like-sized, professional-services firms — basically, eliminating competition by joining forces — to deepen expertise in a particular area of focus and expand their global reach.
- A firm's underperformance against budget across multiple quarters.

MERGING FIRMS

Two law firms merge. Each firm's board brings its own theory of the case for merging: one may believe that they are establishing a "colony" from which a pool of resources (e.g., associates) can be extracted at a lower cost; while the other believes that their mode of "growing talent" in each office will expand their delivery of services and therefore their margins. Both have clear economic and organizational implications for the joined firm: how many and what kind of professionals are hired, how people are deployed, where supervision takes place, how fees are established.

The issue is how to bring these two boards to a meeting of the minds. Investment and expectations about returns, the shareholders', clients' and professional employees' views and interests will need to be assessed because they affect firm results. However, what skills will a newly formed board of this merged firm have with which to unpack the differing assumptions about the merger's economics?

Such boards need a process by which to manage the undercurrent of power and influence that is natural to any board's "groupness" so that decisions get made thoughtfully and inclusively rather than back channel and "imperially" — not because back channel is bad, but because it often leads to poor firm outcomes.

AN UNDERPERFORMING FIRM

A large private firm's board faces six quarters of underperformance against plan. The CEO has been in the job for five years, and he owns 20 percent of the firm. The rest of the board is a thoughtfully assembled group of nine varied experts, some of them CEOs themselves, others with expertise in some aspect of the firm's products or customers.

Some of the questions for the board include the following:

- Is the CEO's leadership adequate to run the firm?
- Is the firm's strategy obsolete?
- Was the firm's leadership delusional about the plan?
- Does the firm have the horsepower to execute against the plan?
- Is the level of investment recommended to right the problem worth it?
- Can the board trust the firm's leadership since it has not presented a successful solution given the continued poor performance?
- Can the board have a meaningful conversation about any of these issues with the CEO in the room and setting the board's agenda?

As with most boards, this one's talented members suffer from the following other handicaps:

- The limited time they have together, coupled with their overloaded and unrelated schedules between meetings, making adequate preparation for board meetings difficult.
- The varied familiarity with the "right" level of detail about the company's operations, so they can use their time effectively.
- The regulatory and legal environment that dictates much of what must happen under their aegis.

Again, this board needs a process with which to tackle these issues. Sarbanes-Oxley is about controls, disclosure and reporting — not process. Boards need a way to deliberate in which they multiply rather than divide the expertise of members.

PROCESS SUGGESTIONS

These suggestions take some work. Managing group dynamics around high-stakes issues is not for the meek, impatient or weary. Still, the results of putting in place some of these suggestions can increase a board's value as thinking partners for a firm's leaders, and make for better oversight on behalf of shareholders.

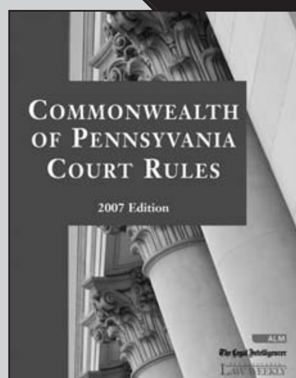
- Beyond standing committees: Ad hoc opportunities to work on an issue outside board meetings can make a big difference in members coming to know each other. While firms will have a strategy committee and an audit committee, an ad hoc committee that digs into a specific dimension of strategy can be tremendously illuminating not just for them but for the whole board. This committee could provide a high-level assessment of the firm's cost structure against a couple of competitors, for example, with a cross-cutting, small group of someone from the strategy committee, someone from audit and someone from inside.
- An agenda that isn't really just a checklist: Some boards follow a standard Robert's Rules agenda with executives reporting on the business. The board meeting becomes something just to get through. Setting up on a rotating basis a habit of one member checking in with a couple others in advance of the agenda going out, where members get to candidly disclose concerns or opportunities that could be topics of board discussion, is another way to break the rote rhythm of board work.
- Crafting a theme that crosses meetings: For boards that meet monthly, include a theme that runs through a full quarter, for example, succession planning. For boards that meet quarterly, devise a theme that might run for a full year. What we often find is that board members scatter after meetings and the thread of their work gets lost once the meeting concludes. This is a real productivity sink — just as the group gets going, the meeting is over

Softer Side continues on **CG7**

AVAILABLE NOW!

Know the Rules ...

WIN THE CASE!



For many years legal professionals have relied on our Court Rules Book Series to keep them up-to-date on recent changes for the Commonwealth of Pennsylvania and 12 counties in the greater Philadelphia and Pittsburgh areas. Published annually, every edition includes the most thorough and comprehensive coverage of newly adopted, amended and rescinded rules to provide you with accurate information needed to help you win cases!

The 2007 Commonwealth of Pennsylvania Court Rules includes:
- Editor's notes alerting rule changes and their impact
- Official comments to rules from the court
- Master table of contents listing each rule and the page on which it can be found
- Key contact information for each county's common pleas court judges, court officer listings and courthouse information
- Sections highlighting recent and historical administrative orders
- Writable forms on CD-ROM to make your practice more efficient

To receive your copies, complete the order form below and return with your payment in the postage paid envelope provided. For faster service call us at 800-999-1916 or order online at www.lawcatalog.com.

When you order the 2007 Commonwealth of Pennsylvania Court Rules you have 30 days to review and return it. If you are not completely satisfied, just return the book along with your invoice marked "cancelled" and we will refund your money (excluding S/H), no questions asked.

❏ **Yes!** I want to order the ***2007 Commonwealth of Pennsylvania Court Rules***.

Method of Payment:
❏ Payment Enclosed ❏ VISA ❏ MC ❏ Amex ❏ Bill Me Later
Account #:____ Exp. date:____
Signature:____
Name:____
Company/Firm:____
Address:____
City, State, Zip:____
Phone:____ Fax:____
Email:____
(Includes a standing order for future volumes)

	QTY	PRICE	AMOUNT
		$77.80	
Add $7.25 s&h per copy			
Subtotal			
PA residents add $6.02 sales tax per copy			
TOTAL			

2009 20189

For faster service please call us at 800-999-1916 or go to www.lawatog.com

(If you are tax exempt, mail or fax a copy of your tax exemption certificate with your order.)

A publication of
The Legal Intelligencer
1617 JFK Blvd. • Suite 1750 • Philadelphia, PA 19103 • 800-999-1916
ALM

Update

continued from CG2

exercise price (i.e., bullet-dodging or spring loading).

Once the material nonpublic information has been publicly disclosed, a reasonable time should elapse for the purpose of permitting public dissemination and evaluation of the information before the options may be granted. Generally, an "open window" is a period of approximately two weeks beginning two business days after the public dissemination of the information and lasts until the end of the company's fiscal quarter. The compensation committee should develop a policy for granting options during the company's "open window" periods, provided that during such periods, the compensation committee is not otherwise aware of material nonpublic information to avoid allegations of spring loading or bullet-dodging.

Under the new SEC compensation rules, public companies, excluding small business issuers, will be required to include a new table in their SEC filings disclosing, among other items, the following:

- The grant date for option awards as determined under Financial Accounting Standards Statement No. 123R, which is generally the date on which the decision to award an option is made, provided such decision is promptly communicated to the recipient of the award;
- The date on which the compensation committee (or another committee performing the function of the compensation committee or the full board of directors) takes action to grant options if such date is different from the date of the grant;
- The per-share exercise price of the options granted; and
- The closing market price of the security underlying the option on the date of grant if the exercise price of the option is less than the closing market price of the underlying security on the date of grant.

The "Compensation Discussion and Analysis" required under new SEC compensation rules should include the disclosure of:

- Whether the company has any program to time option grants to its executives in coordination with the release of material nonpublic information;
- How such program to time option grants to executives fits in the context of the company's program with regard to option grants to other employees;
- The role of the compensation committee in approving and administering such a program; and
- Whether the company has timed, or plans to time, its release of material nonpublic information for the purpose of affecting the value of executive compensation.

In order to provide this detailed analysis in SEC filings, the compensation committee has to carefully and accurately document the policies and procedures applicable to option grants and review prior grants for compliance with these policies.

The compensation committee should keep abreast of all new developments in the executive compensation area, including changes to the laws, rules and regulations imposing new requirements related to option grants. This can be accomplished through the committee "expert," or by hiring compensation professionals and attorneys familiar with the accounting, tax, SEC and exchange rules related to option grants.

THE BEST DEFENSE

A properly documented grant is the best defense to option backdating or other allegations. Generally, backdating option grants is not illegal as long as the backdating is properly disclosed and accounted for. Therefore, if a company is permitted under the terms of its option plan to grant options at the exercise price that is not the same as the market price on the date of the grant, there should be no backdating issue, provided the information is properly disclosed in the company's SEC filings and the appropriate tax and accounting treatment is utilized. Problems arise when the company either intentionally does not properly disclose and account for the backdated option grants or does so due to poor record-keeping and general informality of taking corporate actions.

The corporate secretary or other designated member of the compensation committee should be in charge of properly documenting all actions taken at meetings in the minutes, which then should be filed in the company's record book. Minutes should be reviewed by corporate counsel familiar with the option granting rules and other requirements to ensure all appropriate steps are taken and correctly documented.

Usually, under the state corporate law and the company's governing documents, a committee of the board of directors, as well as the board of directors, is permitted to take actions by written consent in lieu of the meeting. If some directors abstain from voting due to a disqualifying interest in the matter (for example, options are being granted to that particular director), then the action can not be taken by unanimous consent. Moreover, under most state corporate laws, the action by written consent is effective when the last signature to that consent is received, even if the consent is dated as of a prior date. Therefore, the date of the option grant may turn out to be later than anticipated by the company, which would result in a backdating issue. Avoid this problem by using telephonic or in-person meetings to make option grants.

CONCLUSION

Board oversight over the process of option granting is critical. Even if the authority to grant options is delegated to the compensation committee, the board of directors must oversee the option granting process, as the board is the "gate keeper" of all corporate actions. The written minutes of the meetings of the compensation committee should be submitted to the board, and the committee should make reports at board meetings at least once every quarter or upon each particular grant of options or other compensation. •

Good Faith

continued from CG3

ensure that corporate good practices are in place and being enforced.

The *Disney* decision has particular significance for Delaware corporations, because under that state's law a corporation may indemnify its directors for a breach of due care only if the director acted in good faith. Corporate officers who are found to have violated the duty of good faith, therefore, can be held personally liable for their misconduct.

It is possible that Pennsylvania's courts will apply the same duty of good faith to directors of Pennsylvania corporations. In fact, Pennsylvania's Business Corporation Law already requires that a director perform his duties in good faith. Like Delaware law before the *Disney* decision, however, Pennsylvania law never has clearly elucidated what the duty of good faith requires. Rather, Pennsylvania's courts have often conflated the duty of good faith with the well-recognized duties of loyalty and due care, holding that good faith requires that directors not usurp corporate opportunities, or that directors act with reasonable care in their decisions on corporate matters.

Clarification of Pennsylvania's duty of good faith, in accordance with the *Disney* court's explication of that duty, would be consistent with the Business Corporation Law. While Pennsylvania's courts have not clearly explained the duty of good faith, the *Disney* court's interpretation of good faith is not contrary to any previous interpretation of Pennsylvania's statutory duty. Further, the Pennsylvania Legislature has set forth the duty of good faith as separate from directors' duties of due care and loyalty.

Recognizing that good faith has a distinct meaning from those previously recognized duties would reflect the legislative intent underlying that language. Recognition of good faith as a distinct duty, along with an explanation of its requirements, would also provide additional guidance to courts interpreting the standards for corporate governance in Pennsylvania. The *Disney* decision, in fact, provided its guidelines at least in part as the result of consistent academic advocacy for a distinct duty of good faith under Delaware law.

In conclusion, the decision of the Delaware Supreme Court in *Disney* offers some level of comfort to directors who approve executive compensation plans, even if shareholders or the public might view the levels of compensation as shockingly excessive. So long as the compensation amounts are supported by rational business purposes, there is no breach of fiduciary duty. The *Disney* decision, however, also clarified the "triad" of fiduciary duties that directors owe to their companies. The court made clear that directors have a duty of good faith to actively monitor and control corporate conduct, which will leave directors facing clearer liability if they fail to act despite knowledge of corporate problems or wrongdoing. •

Softer Side

continued from CG4

and that's that. Charging a board member with "keeping the theme" across meetings, in conjunction with the CEO and chairman and their agenda-setting jobs, is a way to re-enter a conversation that may not need an immediate outcome but which would benefit from periodic revisiting. Board minutes just can't do this job. The texture of the discussion needs to be thoughtfully brought forward.

No one said good governance is easy. In fact most of what we hear is that poor governance is the norm. Along with attending to the legal, not to mention the technical, business skills — people and group skills (the soft side of governance) matter. •

SOX

continued from CG5

significant valuation premium for companies that can meet the requirements of U.S. listings."

Niemeier says that New York Stock Exchange estimates peg the valuation premium at 30 percent. Similarly, a December 2005 Wharton study found that companies from countries with more extensive disclosure requirements, stronger securities regulation, and stricter enforcement mechanisms, have a significantly lower cost of capital.

Christianna Wood, senior investment officer at the California Public Employees' Retirement System, told Reuters that the cost of capital for companies listing in the U.S. is 7 percent less than abroad, and valuations are at a 13 percent premium. As a result, "the U.S. share of worldwide IPOs actually has increased since 2001," SEC Commissioner Annette L. Nazareth told *Newsweek*, adding, "SarbOx has not harmed our ability to compete but rather is viewed by other countries as providing valuable investor protections."

While the short-term view may seem like a swinging pendulum of public policy, investor confidence and corporate initiative, the transparency and reliability of U.S. corporate governance systems, accounting and financial reporting standards, and related requirements for internal control structures, over time, lead to the kind of growth in value that is desired by long-term investors, who depend on clear and reliable financial reporting. That transparency and reliability is precisely what has enabled the United States to enjoy its long term economic leadership in the global markets. A philosophy of transparency through reasonably accurate disclosure — which is embedded in the federal securities laws and in Sarbanes-Oxley — is the key driver towards ensuring that U.S. capital markets continue that leadership for years to come. •

"This article is reprinted with permission from the November 20, 2006, issue of The Legal Intelligencer.
Copyright 2006 ALM Properties Inc. Further duplication without permission is prohbited. All rights reserved."