The wave of new governance reforms will bring a major shakeup in board composition. Who stays on your board, who is retired, who is selected, how they are recruited—and whether or not they say yes—will now be very different from what they were even a year ago.

If you sit on the nominating, governance, or audit committees of the board of a public company, you may want to consider curtailing your social life. New federal legislation, regulations of the stock exchanges and public outrage over corporate scandals have combined to create enormous pressure on public companies. They are expected to fill their boards with people who have little or no prior connections to the company or its executives.

This is an unfortunate overreaction that may have its own, unintended negative consequences. The fact that the CEO already knows someone who joins his/her board does not necessarily invalidate the prospect’s judgment or independence. Indeed, a degree of “chemistry” and ease of social interaction is a prerequisite for an effective board of directors. A look at how we got here may prove helpful.

The corporate scandals of the past year at companies like Enron, Global Crossing, and Tyco exceeded anything we had witnessed before and deserve our strongest possible condemnation. No doubt much of the blame for these crimes lies at the feet of corporate boards who either looked the other way or never bothered to ask the hard questions that would have uncovered the problems.

In some cases, these directors did indeed get their positions because of their personal relationships with the CEOs or other top executives, rather than as a result of particular skills or experience which would have benefited the company. Further, deeper personal and/or business relationships develop over time. These tend to erode the exercise of truly independent judgment on the part of directors who get too cozy with the CEO.

In the wake of these scandals, it was perhaps inevitable that steps would be taken at numerous levels to prevent a recurrence. Thus, we now have the Public Accounting Reform and Investor Protection Act, or the Sarbanes-Oxley law.

What does the new act actually mean? Sarbanes-Oxley puts an extra “really” in “this time we really, really mean it about these rules,” almost all of which were already on the books, though admittedly not codified in a single act of Congress. In order to understand how developing a corporate board has changed so significantly as a result of this law, it is important to understand at least in basic terms, how the law effects board recruitment.

For too long, the question asked when recruiting directors was “Who do I know?” Rather, boards should be asking “What does the company need?”

Whom to recruit? Because of the requirements of the Sarbanes-Oxley Act, as well as the other newly enacted regulations, companies are already taking a different view of how they fill seats on their board. For too long, the question that most corporate executives asked themselves when composing their boards was “Who do I know?” In fact, CEOs and chairmen should always have been asking themselves “What does the company need?”

The most productive boards have been those composed of leaders with specific skills or experiences directly relevant to the challenges facing the corporation that they were elected to serve. This more rigorous “gap analysis” will continue to lead nominating and governance committees to increasingly seek executives with strong operating experience.

Thus, in addition to recruiting board members with significant financial expertise (as required by

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Should You Join That Board?
Nine Pitfalls To Watch For

For the potential director, accepting a position on a board is no longer an easy decision. Here are nine issues to consider before signing up:

☐ Financial accountability. Are there robust financial controls and procedures in place? Consider the use of an independent consultant to determine this, beyond the report of the company or its current auditors. The money that this costs you will be well worth it if it saves you from financial or reputational liability down the road.

☐ Regulatory compliance. Do the other directors meet the new standards of independence and financial expertise required by Sarbanes-Oxley, the NYSE, CalPERS, etc.? Your due diligence should include inquiries about the background of all board members, including their professional achievements as well as personal relationships to the CEO and other senior executives. Most current members of audit committees do not meet the new standards relating to financial expertise. If the company is serious about complying with Sarbanes-Oxley, you should be seeing the election of new, financial experts to the board.

☐ Personal financial liability. What D&O insurance is in place? Though it is rare that a public company would not carry adequate D&O insurance, do not simply assume that this is the case. Look carefully at the coverage limits as well as any exceptions. You may also want to do a little due diligence on the strength of the company issuing the policy.

☐ Time commitment. What is the true time commitment likely to be? Find out the schedule of full board and committee meetings. After Sarbanes-Oxley is fully implemented, expect at least a ten hour per month commitment—more if you are on the audit committee. If you currently work in a senior executive position at another company, clear the commitment with your own board.

☐ Legal liability. Is there any outstanding litigation against the company? What is pending or likely? Are there contingent liabilities that are lurking? You should demand the same type of disclosure schedule that is provided to parties in an acquisition.

☐ Try to predict surprises. What are the potential financial or operational surprises, the not-so-obvious risks, or “bear traps”? You certainly do not want to find yourself in the position of approving a restatement of earnings at your first board meeting.

☐ Watch out for structural conflict. Does the board have a unified agenda? Are there factions or cliques? This could become a major issue as boards add new members in order to comply with Sarbanes-Oxley. In addition, you may want to inquire about what kind of training the company is providing for current board members, to bring them up to speed on the new governance requirements.

☐ Interpersonal issues can hamper board effectiveness. How does the board truly interact? Do they have regular meetings independent of company management? Why are they really adding a new member? How much does the CEO look to the board for help and of what sort? Does the CEO listen? Why have others left the board? Seek out departed board members to interview personally—find out the facts for yourself. Also, find out what the company does to aid in the orientation of new directors.

☐ What gets measured, gets done. Does the board engage in an annual review of its overall performance? Does it review the performance of individual members? This is not something that most boards historically have welcomed, but it is fast becoming the gold standard of corporate governance. Be prepared to demand it, to support it and to accept the results of your own personal review.

Sarbanes-Oxley), corporations should be looking for people whose own businesses have faced similar challenges such as expanding into new markets, developing new products, reconfiguring a company to grow to its next stage.

For this reason, former CEOs and COOs are now, and will continue to be, in high demand as board members. In addition, it is extremely valuable to have people on the board who have relationships with potential strategic partners for the company. We are now seeing a trend toward bidding wars between large, high-profile boards to win powerful, high-profile directors. It is a matter of supply and demand.

☐ Whom not to recruit. There are essentially two categories of people who are no longer in high demand as corporate board members. The first category, not surprisingly, is the group of people that the CEO or other top executives know socially. Playing golf together or belonging to the same social club used to be one of the primary criteria by which board members were identified—but no longer.

While in the not-too-recent past many would have
argued that a board should be composed of accomplished people who had a strong mutual affinity with the CEO, today we may be seeing an overreaction against this view. More importantly, CEOs of large corporations generally have wide networks of contacts that include similarly situated people who may be able to offer extremely valuable insights to the company. Thus it is too extreme a measure to eliminate from consideration everyone with whom the CEO has spent any time. Yet this is exactly what some people think we should be doing.

The second category of people who may not be as desirable now as board members is academics. While there is certainly still a place for academics on corporate boards, I sense a growing feeling that they lack the real-life, hands-on experience that the market demands. Professors of economics and business at top-tier institutions once brought cachet and name recognition to corporate boards. Today, given the challenges of a difficult economy in addition to the added regulatory requirements, these qualifications alone fall short of what is required.

Dealing with board turnover. Average board turnover for public companies has been about 12,000 directors per year. This is attributable to normal changes such as retirement. However, we saw a huge increase in demand for board searches during 2002—a trend that is widely expected to continue for the foreseeable future.

Some directors are resigning from boards due to liability concerns, though this is not as large a problem as some assume. Reputation risk, however, is another matter.

Aside from the legal and regulatory changes, other factors are creating board member flight now. Some executives are resigning directorships because they fear exposure to personal liability. This is not as large a problem as some people assume, however. Virtually every company has good directors and officers insurance coverage to mitigate directors’ personal liability (though clearly premiums are rising).

Reputational risk, however, is another matter, and clearly a growing concern among board members. Our surveys show that the vast majority of directors do not sit on boards for compensation reasons. Rather, they do it because they want to make a genuine contribution and to stay at the forefront of business issues that interest them. What they do not want, however, is to have their personal reputations sullied by sitting on the board of the next Enron or Tyco. No one wants to be surprised at their first board meeting to learn that the company is restating the last three quarters of earnings.

Probably the most important reason that directors are leaving boards in greater numbers than ever, however, is time. After the full implementation of Sarbanes-Oxley, service on a corporate board will require a significantly greater time commitment.

Even prior to the new act, the National Association of Corporate Directors estimated that sitting on a board could easily require ten hours per month. Directors who also sit on the audit committee should now plan to tack on an additional five to eight hours per month, and in some cases more. This quickly adds up to real time. As a result, we see more corporations asking their CEOs who serve on four or five boards to scale back their obligations.

There is incredible variance in board pay. Over time, directors’ compensation will inevitably tend to rise and equalize.

The result of the increased demands required for board service is that director pay is likewise increasing significantly. For the vast majority of directors, the cash compensation that they receive is not enough to change their lifestyle. Nonetheless, if directors spend more time, and exercise more serious oversight roles, it is only natural that their fees will go up.

Today, there is an incredible variance in board fees. For a board of a Fortune 100 company, typical fees often exceed $125,000 per year. Yet there are cases where a $4 billion company might pay their directors little more than one-tenth that amount. Over time, directors’ compensation will inevitably tend to rise and to equalize.
How the board search process can help. Because it is so much harder to fill board seats today, it is also important that companies avail themselves of the most comprehensive tools available to identify and recruit new board members. Board search is really no different now than executive search.

The challenges facing corporations today are huge and increasingly complex. Having a board member who has faced and successfully met similar challenges in his or her own company can be extremely valuable. Finding such a person who is also willing to serve and meets the increasingly stringent guidelines, however, is easier said than done. It requires the application of the same methodical processes that companies use to identify their next CEO or other senior management executives.

Board member search, post-Enron, however, is much more difficult than it used to be. During 2002, some 60 percent of qualified board candidates we approached turned down offers to serve on boards. In 2001 and prior years, only 25 percent rejected board positions. The process of identifying someone as qualified for a board position is also more difficult. Because of the new demands of independence, as well as the need for skills and experience, we are now contacting at least 100 senior executives and/or thought leaders for a board search to find just two qualified candidates to whom our clients can even extend offers.

We have found that the most common reasons candidates decline joining a board include:

- **Geographic location.** Board members’ complex schedules and geographic logistics make it difficult to travel long distances for meetings.

- **Over commitment.** Top candidates are in high demand and can generally only commit to serving on a maximum of two or three boards.

- **Conflict of interest.** Candidates may perceive a conflict of interest, in which case it is critical that the selection committee discuss and resolve potential issues.

- **Personal liability.** Director candidates have more at stake today than ever before, and some may find that there is too much personal risk.

- **Size and scale of the company.** There may be a lack of interest in the company based on size and/or industry.

- **Incompatibility with current board member.** The importance of director-to-director compatibility should not be underestimated. Some director considerations are the composition, characteristics and personalities of current board members.

All is not all bad news, however. We have also found that what compels a director candidate to join a new board include:

- **The opportunity to make a clear contribution.** This applies both in a business sense, and often to help restore confidence in the transparency and structural integrity of the U.S. brand of free market capitalism.

- **Being a part of the success of the company and building something meaningful.**

- **Learning new technologies and markets that will broaden their perspectives and assist them in their current or future role.**

- **Expanding their personal network among top leaders.**

- **Working with other smart and experienced board members.**

- **Creating shareholder and personal wealth.**

- **Enthusiasm and belief in the company.**

Even if executives turn down a position on your board, the company will often gain valuable exposure through the search to high-profile people who could help the corporation down the road.

Many people have criticized the new regulatory environment as a case of “closing the barn door after the horse has fled.” I believe, however, that the renewed rigor and care in the board selection process it has caused are fundamentally positive.

Directors’ increased independence and advocacy for the interests of the shareholders can only benefit the system in the long run, even at some potential cost in the ease and affability of boards’ social interaction. It is certain that in the near term, however, there will be some pain in implementing these changes, not the least of which will come in the recruitment and selection of disinterested, qualified, and engaged directors.