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How To Be An Effective Director As Standards Change

By Harvey L. Pitt, Compliance Week Columnist—October 26, 2004

Being an effective director is a learned, not innate, skill. Nor is it a static proposition. Standards for directors change over time, especially as we consider more about what directors should do, and as we learn what happens when there are important things they don't do. To ensure and improve their effectiveness, directors must continually evaluate how best to meet their fiduciary, legal, ethical and corporate governance responsibilities. To help in this undertaking, this is the first of an occasional series of "how to" columns on directing.

For at least a century, the role of non-management corporate directors was often treated as one of passivity, not activism. Power to manage a corporation's affairs was believed to reside exclusively in the hands of its senior officers, with the proper role of outside directors being generically and non-intrusively to oversee, and approve—when asked to do so—significant managerial decisions. This misperception of an outside director's proper role was fostered by several factors:

- Selecting outside directors was seen as a CEO perk;
- Good corporate officers were perceived as focused and effective, and also absolute monarchs;
- Outside directors lacked effective resources to obtain their own guidance and assistance;
- No clear consensus existed on how outside directors should perform their roles; and
- Many corporate advisors were fixated with elevating form over substance.

Corporate scandals bred in the '90s exposed this weak leadership, which at times had permitted practices that were clearly illegal to occur and thrive nonetheless. The passage of Sarbanes-Oxley re-emphasized the role of directors as elected representatives of the shareholders and the stewards of company assets. Changes in corporate governance standards and expectations have been coming at Corporate America at a fast and furious pace, and with them a plethora of training courses. Far too often, however, the training or guidance available to directors is legally or accounting-oriented; answering, for example, questions like, "What does SOX require?" Or, "What must be done to satisfy the new internal controls requirements?"

Instead, this series aims to assist directors in understanding how they can be effective. The guidance is pragmatic, and is intended to assist directors in finding the correct balance between two unacceptable extremes—either complete abdication to management, or an adversarial relationship.

General Guidelines

It is axiomatic that directors must act in good faith, in the best interests of the corporation, and with appropriate diligence and care. While SOX did not formally change the responsibilities of directors, it has federalized those responsibilities and given regulators and prosecutors new weapons in enforcing them. SOX has also placed added emphasis on the policies, procedures and methodologies with which directors fulfill their responsibilities. The performance of these functions now assumes even more critical importance to the success and well-being of Corporate America.

The role of corporate directors is extremely important to the prosperity of our market-based economy. Corporate directors represent the shareholders of public companies—who put their faith in directors. As shareholder representatives, directors are responsible for ensuring that their company governs its affairs to maximize shareholder value. Directors do not manage the company; that authority is delegated to management. Rather, directors oversee management or direct, a word derived from the Latin word meaning to "set straight." Without honest, wise, and experienced directors, public investors would not trust their funds to managers.

Here are some general guidelines for all directors to consider:

1. **Understand your responsibilities.** Directors are elected by and serve their companies' shareholders. As such, they're required to be leaders in identifying and then protecting shareholder interests. Those interests must be the driving force behind everything they do. At the same time, the outcry following the recent spate of corporate debacles underscores the necessity of being attentive to other corporate constituencies as well, such as the public interest, employees, and customers.

2. **Monitor and assess corporate policies and procedures.** Among other things, directors should monitor and ascertain whether: the company operates in compliance with its charter and by-laws; company-instituted procedures and controls are reasonable and are being followed; disclosure is reasonable and accurate; and significant risks are appropriately identified, disclosed and reasonably controlled.

3. **Understand the requirements and obligations associated with being a director.** Directors also need a clear understanding of the requirements and obligations of their positions, including restrictions on buying and selling stock, new and ongoing director education, required attendance at annual meetings, site visits, conflicts of interest, additional board memberships, mandatory retirement and reasons for leaving the board.

4. **Assure the existence of effective delegation of oversight responsibilities.** There is only so much an individual director can do by himself or herself. Companies need an effective governance structure, with competent committees exploring different facets of each company's intricate operations.

5. **Avoid constituency dictates.** As more and more companies seek to find outside directors who can add credibility and integrity to their boards, directors must bear in mind that they do not represent any constituency external to the companies on whose boards they sit. Thus, for example, bringing in someone who has a position with a university or pension

fund, does not mean that such a director represents his or her university or pension fund while sitting on the board.

6. **Learn the business of the corporation.** Directors must be knowledgeable about the corporation's operations. They should be conversant about the company's lines of business, locations of operations, and principal products and services. Directors should have a clear understanding of how the company earns revenues and generates cash. They must be familiar with the company's financial condition, liquidity and capital resources, critical accounting policies and results of operations. They also must stay attuned to trends, events, demands, commitments and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance.

7. **Know where the company and its competitors stand.** Directors should regularly receive an analysis of the companies on whose boards they sit as contrasted with their companies' significant competitors. Focus should be placed on areas of under- or over-performance. Where there are disparities, directors should explore the explanations given and the steps being taken to address problem areas or to preserve competitive advantages.

8. **Make compliance and ethics programs a priority.** Directors must be knowledgeable about their companies' compliance and ethics programs. This means the board must play an active and continuing role in developing these programs, monitoring them, assessing their effectiveness and revising them, all on a regular, periodic, basis.

   Directors should oversee the adoption and implementation of rigorous policies for dealing with employee complaints.

9. **Assess risk and fortify internal controls.** Directors should understand significant risks facing the company and satisfy themselves that appropriate and adequate internal controls are in place to control and monitor them.

   Directors also should ensure risks are appropriately disclosed and explained in company documents.

10. **Be prepared.** Just like investors, directors need to do their homework. They need to be prepared for board meetings and committee meetings. They need to insist on quality information from management, and this includes access to key managers, auditors and consultants. Doing homework also means keeping up with, and being responsive to, current issues.

11. **Ask questions.** Directors should ask questions that reasonable shareholders would ask of management if given the opportunity, and raise and discuss issues with management reasonable shareholders would discuss over the life of the business.

12. **Understand alternatives.** For every decision that is made, it is axiomatic that a number of alternatives have been considered along the way. Directors need to focus on choices and judgments management makes in presenting a recommendation, and the reasons for their recommendations.

13. **Be committed.** Being a director requires vigilance, dedication and significant amounts of time. Directors must prepare for and participate in board meetings and committee meetings. Recent surveys estimate that outside directors spend almost 200 hours a year attending or preparing for meetings.

    Directors need to earn their pay, and demonstrate that they are both committed and not over-committed. Working a demanding full-time job and serving on too many boards is a disservice to investors, and a ticket to problems.

14. **Be direct.** "Be even and direct with me" demands Hamlet of Rosenkrantz and Guildenstern, and the same must be demanded of directors. In this context, direct means "straightforward; not of crooked ways, or swerving from truth and openness." Directors cannot become complacent or set in their ways. They must remain on guard and continue to probe, and ask difficult questions.

    That being said, they should not assume an adversarial posture in the boardroom, making it difficult for companies to function effectively and efficiently.

15. **Keep up.** As with any other skill, a time-tested strategy for staying fresh is continuing education. There are more and more institutes providing continuing education for directors and directors should avail themselves of these resources. Policy conferences, newsletters, executive education courses and related programs all help directors to improve their skills as overseers, as well as provide an opportunity to exchange ideas, experiences and information. Directors must be flexible enough to recognize that doing things the way they've always been done isn't always good enough.

16. **Ensure that you have adequate resources at your disposal.** It is critical for directors to have adequate expert resources available to ensure that they are not only doing what is expected of them, but proactively seeking to identify problem areas before problems actually arise.

17. **It's important not only to do the right thing, but to be able to prove that you did the right thing.** Diligence, integrity, thoughtfulness are all critical attributes of a director. But, in the face of a crisis, it's important to be able to re-create the process by which the board tackled a specific problem.

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