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WHAT IT TAKES TO BE A LEAD DIRECTOR

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COVER STORY

What It Takes to Be a Lead

You'll need diplomacy, judgment, and the ability to work as a team player. There'll be plenty of awkward moments and gut-wrenching decisions, but the payoff can be well worth it.

Perhaps the real issue is, would you ever want to wear the lead director's shoes? The role is constantly evolving, so you're always feeling your way between doing too little and doing too much. You're the man or woman in the middle, the conduit between the board and the chief executive, and you carry water for both. Your fellow independent directors have made you the point person for a number of unpleasant tasks, like canning the CEO, whose children you watched grow up along with yours. And only an elephant would be enticed by the pay, which is comparative peanuts.

Yet many board members love the work. Otis Winters became lead director of Dynegy Inc. after a failed bid for foundering Enron in 2001 nearly destroyed the company. He ticks off the difficulties the Dynegy board faced: "We had directors resign, there were lawsuits when the stock price plunged, there were layoffs, cash was running out the door, we were investigated by the U.S. attorney and the Securities and Exchange Commission, and we had to find a new CEO." Winters, 73, the chairman of Oriole Oil Co., retired from the Dynegy board in 2003 with most of these problems solved. And looking back, he remembers the experience as rewarding. "It's very satisfying to help the board work together to save something," he says. Adds Kevin Sheehan, 60, a managing director at the Indianapolis venture capital firm CID Equity Partners and the former lead director (now chairman) of Flowserve, an Irving, Texas, maker of pumps, seals, and valves: "This is a job for people who like to be part of the answer. But I don't think anybody would consider it a favor to be made lead director."

Not a favor, perhaps, but an extraordinary compliment. The independent directors elect the

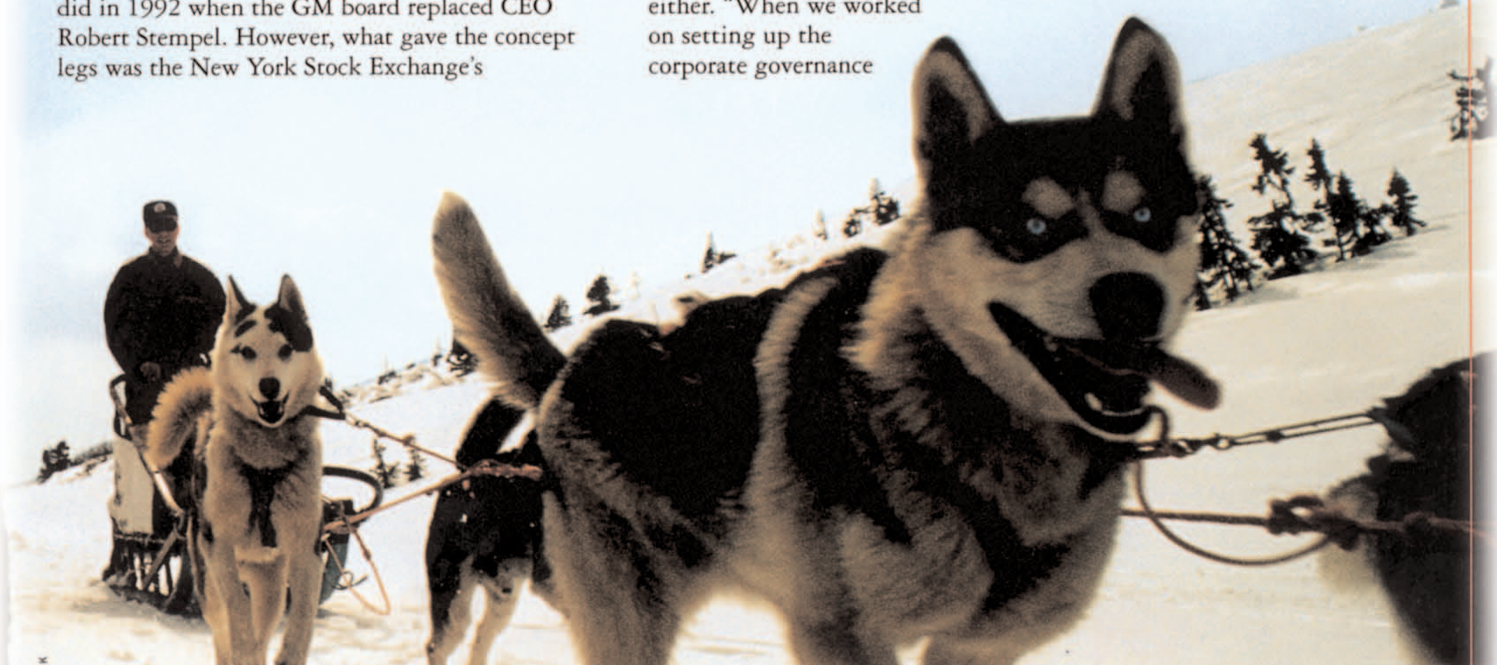
Director

by Julie Connelly

lead director, "and I think everyone acknowledges that the person who becomes lead director is the best-qualified person to do it in terms of personality and trustworthiness," says Raymond Troubh, 79, the former independent chairman of Enron, who in a 30-year career as a professional board member has seen his share of lead directors. "Do they trust this person with confidences? Trust his intelligence and trust his ability to convey a serious message to someone who is sometimes perceived as the enemy or untouchable or unwooable?"

The idea of a lead director is not new. During crises, strong-willed and highly respected individuals have frequently emerged as leaders of the board, much the way General Motors director John Smale did in 1992 when the GM board replaced CEO Robert Stempel. However, what gave the concept legs was the New York Stock Exchange's requirement in 2002 that the independent board members of each of its listed companies meet at least once a year in executive session without management present.

Bold as it may seem, that ruling was something of a compromise. After the corporate scandals early in the decade, institutional shareholders began agitating to divide the jobs of CEO and chairman, as U.K. companies usually do. The goal: to make the board a more effective counterweight to the King Kong in the corner office. But it's a rare person who voluntarily cedes power. Few CEOs of American companies who also held the role of chairman embraced the idea, and it wasn't that popular among directors or even some reformers either. "When we worked on setting up the corporate governance



PER ERIKSSON/IMAGEBANK

rules at the NYSE in 2002, we considered carefully whether there should be a separate chair, and we decided against it," says governance expert Martin Lipton of the Wachtell Lipton Rosen & Katz law firm, who has long argued that boards should have lead directors. "We decided that the best way to structure governance was to have a majority of independent directors who would meet in executive session led by a lead director or a presiding director on a rotating basis." Today, according to the Spencer Stuart Board Index, 94% of all Standard & Poor's 500 companies have a lead director, up from 36% in 2003.

Because the exchange rules specified only that there should be someone to lead the executive sessions, the job is not well defined. Says Richard Koppes, a director at Valeant Pharmaceuticals and Apria Healthcare: "The NYSE, to its credit, gave a vague standard. Now the boards are taking it on." Over the last three years, companies have struggled to delineate the responsibilities of their lead or presiding directors, aided by guidelines from organizations like the National Association of Corporate Directors. The duties vary from company to company. "I've been in board meetings where the job of the lead director rotates and all he does is preside over the meetings of the independent directors. That's one end of the spectrum," says E. William Barnett, 72, formerly managing partner at the Baker Botts law firm in Houston and now the lead director at Reliant Energy. "But as you move across it, he or she needs to be able to deal effectively with the independent directors and with the CEO." Barnett was voted the NACD's Director of the Year in 2005.

Everyone seems to be clear, however, on what the lead director's role is not. He is not the CEO, nor is he the straw boss of the other directors. "There are horror stories about lead directors who thought they'd been crowned king and made demands for offices and such," says Kevin Sheehan. "You can have someone screw this up." Case in point: A couple of years ago, the board of an NYSE-listed company forced out its president and CEO for financial improprieties and gave both titles to a board member with considerable experience in the company's industry—or at least that's what the directors thought they'd done. The lead director, however, supported an internal

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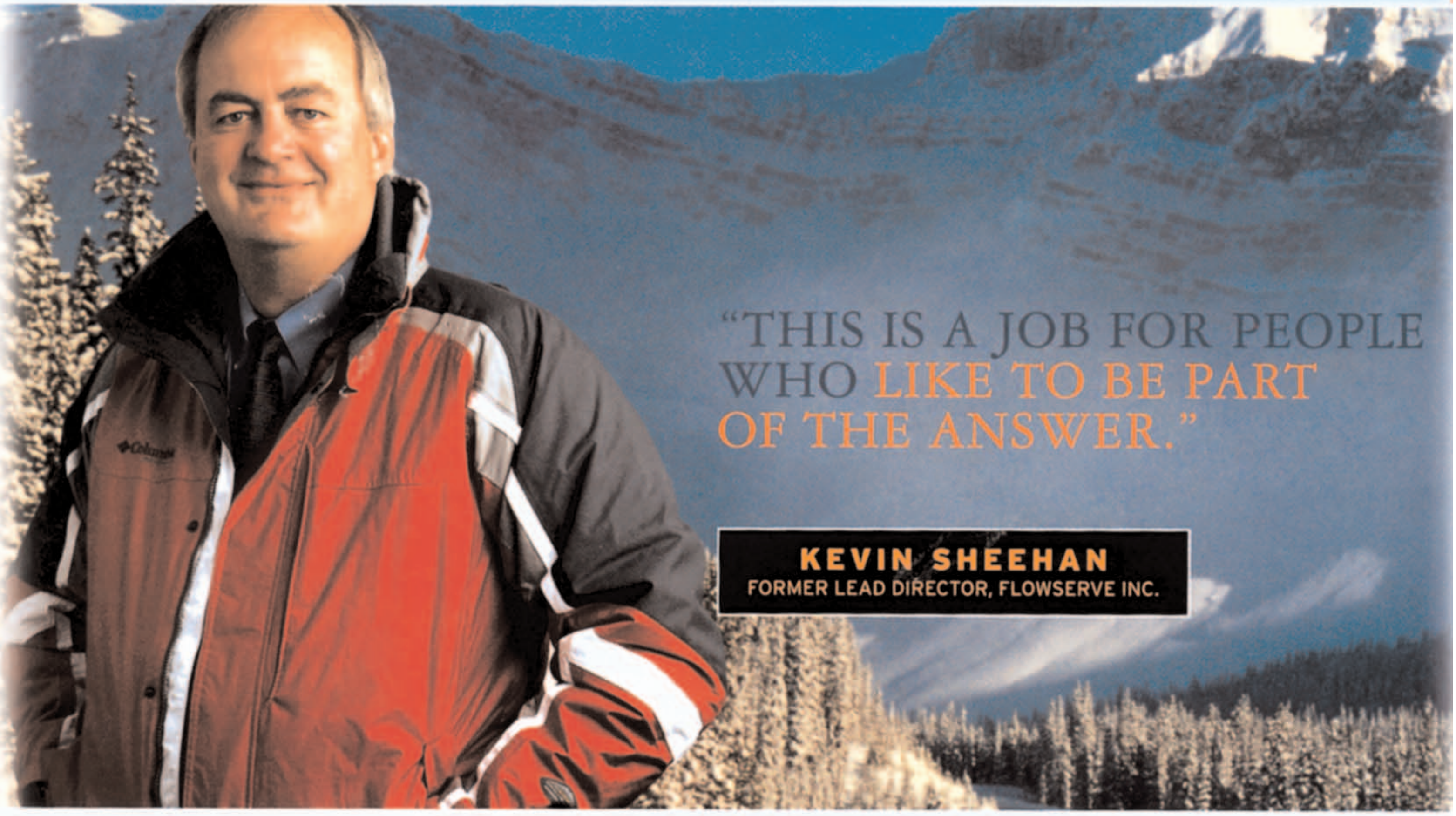


JOHN BRAGG/PHOTO BACKGROUND ADDED

candidate who had never stopped campaigning for a top job. So at the annual meeting, the lead director announced to the shareholders that the company had a new CEO—the board member the other board members all liked. But then the lead director sprang his surprise and presented the company's new president—the insider he liked.

"This was the first any of the other directors had heard of this, and we were dumbfounded," says one board member, who asked not to be identified. "I kept wondering, when was this decision made? Was I in the bathroom or something?" Because there had been so much public turmoil over the dismissal of the former CEO, the directors realized that they had to accept this fait accompli lest the board look inept. The lead director, however, is now on notice. "We'll get rid of him at some point," says the board member grimly.

In 2004 the NACD's blue-ribbon commission on board leadership issued recommendations about the responsibilities of the lead director, and many boards follow this template. In addition to presiding at the executive sessions, the commission thought the lead director should act as an intermediary between the CEO, the chairman, and the board, with the authority to call meetings of the independent directors and set the agendas for those meetings. This director should also be able to suggest to the chairman and CEO when it's appropriate to call a full board meeting and collaborate with him on setting the board agenda after soliciting the views of the other independent directors. The commission added that the lead director is to facilitate discussion among the independent directors and pass along their views to the CEO. In other words, this role calls for the soft skills, diplomacy and judgment, plus the courage to raise tough issues.

All aspects of the lead director's talents come together in the responsibility for the executive sessions, where he must first listen to what the other directors are telling him and then convey it accurately to the CEO. The board members need to

BAH HUMBUG TO LEAD DIRECTORS

"Lead directors and non-executive chairmen interfere with good governance." So says Frank V. Cahouet, 73, the retired chairman and CEO of Mellon Financial Corp. Cahouet makes an exception for companies where either of the positions is temporary. That's the case at the two companies he serves as a board member—recruiter Korn/Ferry International and Teledyne Technologies, which makes products for broadband communications—whose boards both have rotating lead directors. Cahouet expanded on his contrarian view in an interview with *Corporate Board Member*'s Julie Connelly. Excerpts:

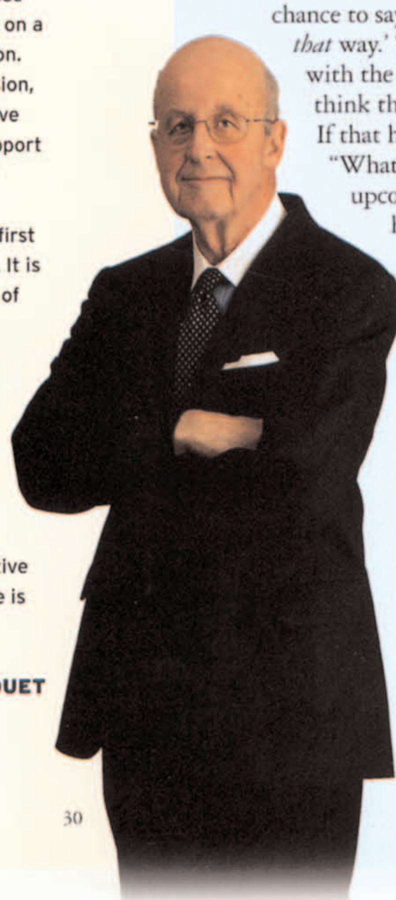
What have you got against lead directors and non-executive chairmen?
As a board member, one of my principal responsibilities is to evaluate the CEO. Among other things, I'm interested in seeing how the CEO relates to his board and to his key managers, as well as his ability to articulate the corporate strategy and perform against this strategy.

One issue that can arise with a non-executive chairman is that the chairman normally runs the board meetings and the CEO would tend to play a secondary role. This lack of leadership of the CEO can be a serious issue for the company if it's struggling, because it is particularly important for all the directors to have a thorough understanding of how the CEO performs when faced with very difficult issues.

But what about lead directors?
The issues with permanent lead directors who develop a special relationship with the CEO are somewhat similar. However, I don't visualize a problem with what is commonly called a rotating lead director. These are directors who chair the executive session of the board meetings on a rotating basis and are responsible for helping to structure the session. Normally they report to the CEO on the issues discussed at the session, and this process seems to work well. In the same way, a non-executive chairman who serves for a limited period of time, for instance to support a new CEO, can be equally constructive without interfering with the governance of the other directors.

However, there are two issues for everyone to keep in mind. The first is that all directors have an equal responsibility to the shareholders. It is up to the directors to feel totally comfortable with the performance of the management team. Second, and equally important, we must be careful not to create a governance structure that is so risk-averse that management avoids taking appropriate risks and thereby fails to make the necessary investments for the long-term benefit of the shareholder.

You serve as a rotating lead director at Korn/Ferry and Teledyne Technologies. How well does the process work?
I've felt it worked well as a way to provide a structure for the executive session. And since the lead director serves on a rotating basis, there is no sense that any one director is senior to the other directors.



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have confidence that their message will be delivered as intended, and the CEO needs to feel that the lead director is an honest communicator who is not sharpening his own ax. As a result, lead directors spend much of their time teasing out the opinions of the other directors in the session and using periodic side conversations to stay abreast of what's going on in the various committees. "Boards function best when they don't operate in silos," says Stuart Levine, 58, chairman and CEO of his own management consulting firm in Jericho, New York, and the lead director of Gentiva Health Services.

Every director has equal access to the CEO, of course, and could eliminate the middleman. But, asks a lead director, "you want to drive the CEO crazy?" Just let seven or eight board members start phoning him to give him their views on what happened in the executive session. If the lead director is doing his job, the board will arrive at a collective judgment that he can convey with one voice to the CEO. But that's where the element of trust comes in. The other directors must be convinced that he won't filter their message or subsume it into his own agenda.

"I'm a facilitator at the executive sessions to get everyone to weigh in," says Karen Horn, 62, a partner at Brock Capital Group in New York City who is Eli Lilly's lead director. "After everyone has spoken, I go back over what was raised subject by subject and say, 'This is what I think I heard and what I'll communicate to the CEO.' This gives a director a chance to say, 'Well, maybe I wouldn't put it *that* way.' Then I have a one-on-one meeting with the CEO where he is free to say, 'I think the directors have it all wrong.'" If that happens, her prompt response is, "What can we do with the agenda of an upcoming board meeting to be sure we have it all right?" Horn thinks the most important part of her job is making sure "the interactions between management and the outside directors are as productive as they can be."

But when there's a clear split on a matter, the lead director isn't there to cast the deciding vote so he can later tell the CEO that the board agrees they should commit to the billion-dollar joint venture in China. Says James Ukropina, who has observed lead directors as a member of several public boards: "The vote might be 5 to 3 in favor, but the three who aren't in favor may feel strongly about it. Then the lead director might tell the CEO that there is a consensus, but it's a weak one. What he is really saying is, 'Listen to the dissent here.'"

The best way to be a bad lead director is to be reluctant to let the CEO know there is dissent. A board member at one industrial company repeatedly told the lead director at meetings limited to outside directors that he wanted to discuss a compensation matter relating to a former CEO. The lead director routinely swatted him down. "So now," says the board member, "I keep sending e-mails to everyone on the board, saying, 'Let's put this on the record, that we met and had these discussions, so at least there's a paper trail.'"

THE LEAD DIRECTOR'S BIGGEST ASSET IN CONTENTIOUS SESSONS IS THE ABILITY TO LISTEN, ENCOURAGE EVERYBODY TO TALK, AND THEN SYNTHESIZE DIFFERING VIEWS.

The lead director's biggest asset in contentious sessions is the ability to listen, encourage everybody to talk, and then synthesize differing views. "I take a clean white pad into the room, and I listen, record, and transmit to the CEO," says Stuart Levine. But sitting through discussions without imposing your own ideas is not easy. Investment banker William Mayer, 65, of Park Avenue Equity Partners in New York City, is the lead director of Lee Enterprises, a newspaper chain that acquired the Pulitzer papers last year. "Every once in a while I develop a very strong point of view about what the company should do," he says. "But I'm very, very careful not to influence the decision on the board just because of my own feeling. Sometimes it's very difficult to sit there and just keep quiet and let the board discuss something when I know what I think we should do."

By their nature, executive sessions are critical of the way the CEO is running the company. If they weren't, why would they have to be held without him? "In a board meeting, if you thought someone would be hurt by your saying something, you might not say it," says Karen Horn. "In executive session, people speak up. Someone will say something like, 'I really don't think Fred has thought out this idea of his too well.' And then a second person might say, 'I'm glad you brought that up.' And there's piling on." By the end of the session, the independent directors have agreed: It's time to pull the plug on that line extension, or the candidate the CEO desperately wants to succeed him isn't up to it. This is what the lead director must convey to the chief executive.

"Central to the role of lead director is the relationship with the CEO," says Harvard Business School professor Constance Bagley. Without the right chemistry between them, the chief executive is likely to view the lead director's comments as harsh and destructive and be tempted to shoot the messenger. "If the lead director tells him there's a problem, the CEO has got to feel that yes, there's a problem," says Dan Dalton, director of the Institute for Corporate Governance at Indiana University. "But this trust has to be built, and it is the responsibility of the lead director to build that linkage between him and the CEO."

The lead director should begin the relationship with the presumption that the CEO may view him with suspicion. "The CEO worries about any other power center in the company," says Robert Felton, a former leader of McKinsey & Co.'s board governance practice. Moreover, CEOs know their tenures at the top are shrinking, and they are nervous about executive sessions—what are they saying about *me?*

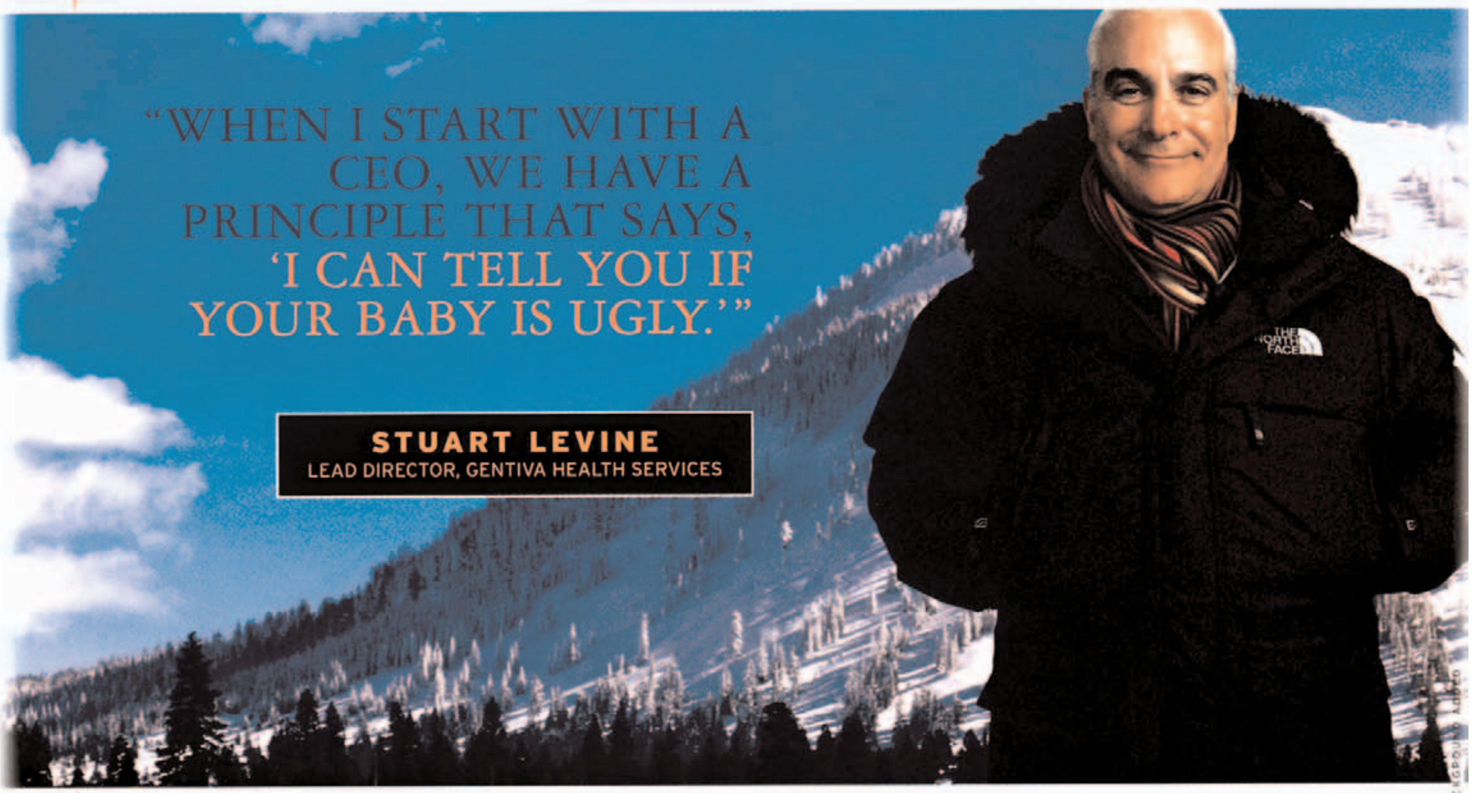
To top things off, the lead director is usually the one to break any bad news to the CEO. "When I start with a CEO, we have a principle that says, 'I can tell you if your baby is ugly,'" says Stuart Levine. So those corner-office conversations after the executive session have to be approached with sensitivity, intelligence, and clarity. The lead director should be focusing the CEO's attention on two or three serious problems, not on a laundry list of complaints. Those can wait for another day.

Many CEOs are more comfortable when the lead director is or has been a CEO. "If you've run something yourself, I think it's always easier to relate to a chief executive when you're the lead director, because you know what it's like to do it—to make budgets, miss budgets, and have strategies that work and maybe some that don't work as well as you would like," says William Mayer, who's a former CEO of the investment bank First Boston Corp.

If the relationship is successful, the CEO will understand that the board wants him to be operating at peak capacity, and he will gradually start to trust the lead director as an adviser, sounding board, and sometimes confessor. He'll also recognize that there's something in the relationship for him. Mary Junck, CEO of Lee Enterprises, notes: "I'm also chairman and president here, so if I want to bounce ideas or get advice, having a lead director provides me with someone to talk to. It makes my life simpler. I get a sense of the board without having to talk to eight people."

Moreover, a lead director can run interference for the CEO. On one board, the chair of the audit committee was bringing in five or six consultants to speak at every board meeting, and the meetings were dragging on for several extra hours. All the other directors were increasingly exasperated, but the chairman and CEO didn't want to deal with it. "Look," he told his lead director, "I have enough problems with this board. I'm not taking on the chairman of the audit committee. You do it." The lead director spoke to the audit committee chairman, the consultants disappeared, and board meetings returned to a more manageable length.

There is always the risk, however, that the relationship between the lead director and the CEO can get too close; they can become permanent allies against a board that just doesn't understand. This



seems to have been a problem during the management uprising at Morgan Stanley last spring. Charles Knight, the chairman of the compensation committee, who rotated lead-director duties with the audit and nominating committee chairmen, appeared sufficiently blinkered by his relationship with CEO Philip Purcell to quash dissent on the board. Even after Purcell finally resigned, Knight still carried a torch and blundered irredeemably by publicly refusing to consider John Mack, whom Purcell had forced out of Morgan Stanley in 2001, as a candidate for the vacant post. A few weeks later, the signs sprouted at Morgan Stanley: "Mack Is Back." Knight left the board.

Personal friendships do develop—in fact, lead directors are sometimes chosen by the other directors in the belief that a friend might communicate with the CEO better than someone he doesn't know. But given the pressure on boards to demand the CEO's head when things are not going well, lead directors can pay a heavy price for friendship. Says one: "I don't really socialize with the CEOs of any of my companies except at and around board meetings, because I'm not sure that's a good idea." Ray Troubh notes, "I think it takes enormous guts to put a friend down. It's very difficult to do that."

As Dynegy's troubles mounted in 2002, the board decided chairman and CEO Chuck Watson would have to go. Otis Winters, the lead director, with a few other board members, had to communicate that message to Watson. "Chuck built this company. He was its first employee. It was terribly traumatic, terribly painful. I was the closest to him personally; I knew him best," Winters says. "Chuck is probably pretty upset with all of us—and especially me, for which I am very sorry."

Similarly, Frank Zarb, 71, former head of NASDAQ and the lead director of AIG, exploded a three-decade friendship last March when he organized the directors to demand the resignation of the insurance group's chairman and CEO, Hank Greenberg. Greenberg felt so betrayed that although he was still a director, he refused to attend the company's May board meeting because it would put him in the same room as Zarb.

Neither wimps nor fists need apply for the job of lead director. And the pay is certainly no draw. In a recent study of lead and presiding directors, Spencer Stuart estimated that 40% of lead directors spend 11 hours or more a month either attending meetings or preparing for them, and another 40% spend at least six to 10 hours a month. But only 46% of S&P 500 lead directors receive additional retainers, ranging from $5,000 to $30,000 a year. Executive recruiter Roger Kenny of Boardroom Consultants sums it up: "They get stipends, not fees."

LEAD DIRECTORS ARE SOMETIMES CHOSEN IN THE BELIEF THAT A FRIEND MIGHT COMMUNICATE BETTER WITH A CEO. BUT THIS CAN END THE FRIENDSHIP.

Though the job calls for a cross between Oprah Winfrey and Norman Schwarzkopf, having a lead director appears to be working for many boards. Says Roger Raber, the NACD's chief executive: "As executive sessions go on, they seem to be getting better. The communications seem to be getting better." Board processes, at least in relation to communications with the CEO, are more efficient. But all directors "need to raise the question regularly of how well this is working," says Harvard's Constance Bagley. That means evaluating the lead director at periodic sessions where the CEO and the other directors get to talk privately...about you.