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# Proceedings of the Inaugural IJDG Conference

## Recruitment, training and assessment (and removal) of directors post SOX

**Sox's Fifth Birthday: A Candid, No Holds Barred Debate on the Good, the Bad and the Unresolved, Rutgers Business School, Newark, New Jersey, 21st September, 2007**

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*Richard W. Leblanc is a qualitative researcher in corporate governance, who is migrating towards mixed methods research, using the results of his qualitative inquiry (interviews and board observation) towards quantitative inquiry (surveys to assess the effectiveness of boards, committees and individual directors). Dr Leblanc has served as an expert witness for under-performing boards, advised regulators and securities commissions on the assessment of individual directors, and has been an external advisor to boards that have won national awards and peer endorsement from institutional shareholders for their governance practices. Prof. Leblanc has also assessed the effectiveness of audit, compensation and nominating committees, as well as board and committee chairs, CEOs and other directors.*

Good afternoon. It is a pleasure to be with you here today.

I am a professor and I study boards of directors. That said, let me be clear. This is not an address on academic theory but business and governance reality. I advise and study some of the best boards in a variety of industry sectors. My applied research involves having interviewed hundreds of directors and studied dozens of boards.

Second, I am a qualitative researcher. This means I study my subject matter directly, through interviews and direct observation, rather than using archival data. I have had the unique opportunity to examine, and witness, decision-making failure and success in boardrooms and dialogue with and study directors and chairs who are at the top of their game.

What I would like to speak to you about today is the recruitment, education and assessment, and in certain instances, the removal, of individual directors. My remarks in many respects go beyond the formal requirements of SOX and the NYSE rules.

Academics can be terribly independent and critical, as their job is to be, and in some instances, conduct unpopular research, and go where others may not. Investigating the competency and behaviours of boards, and directors in particular, is within this realm. The task of the academic is to present his or her work, with a rigorous method and recommendations, in as proactive and positive a manner possible.

The data for this speech come from my book, *Inside the Boardroom*, as well as board research and assessments conducted by me and interviews since then, and expert witness reports I have been asked to provide, for companies whose corporate governance practices were thought to be inadequate. I am drawing in particular from best practice originating from a report that came out a week ago, providing recognition to top-governed companies. I am or have assessed the boards of the three of the four top companies recognised and draw on much of the recommendations in my remarks here with you today.

I am also drawing on advice I have given to our Securities Commission on the recruitment and assessment of individual directors, which has been incorporated into our national corporate governance guidelines for TSX-listed companies.

I have organised my remarks into a 'top 10 list'.

### **GO BEYOND BOARD STRUCTURE IN RECRUITING, EDUCATING AND ASSESSING DIRECTORS**

When you look at the academic literature, there is a limited, at best, causal relationship between the formal independence of directors, the separation of Chair and CEO, the independence of committees, share ownership, director tenure in years, the number of boards on which directors serve, their age, etc, and whether the board is effective, the individual directors are effective, and, ultimately, performance for shareholders is enhanced, by virtue of the board's contribution.

But when you think about it, experientially, if we accept the proposition that (i) much of corporate performance comes down to the quality of the CEO and the management team, and (ii) the most important job of the board is to hire and fire the CEO, then (iii) how can a board of directors not have an effect on corporate performance? The fact that academics cannot prove a causal effect does not mean the effect does not exist. In fact, of all my inter-

views I have conducted over the last ten years, there was only one director who did not believe that better boards lead to better performance for shareholders.

The problem is that the study (and rating) of boards is largely confined to what is readily measurable, given the confidentiality of board proceedings. In corporate governance terms, what is readily measurable may matter significantly less than what is not readily measurable. It is like studying a sports team without having entered the locker room, the arena, or interviewed the best and worst players.

What is not readily measurable, in corporate governance, includes factors like the leadership effectiveness of the chair of the board, not only whether the chair is non-executive or not; the effectiveness of the individual Directors, including their competencies and skills, not just their formal independence; and other more qualitative factors like the quality of management and assurance provider reporting, board chemistry, board — management relations, committee work and reporting, decision-making processes and information flow. These processes are not readily measurable, at present, and perhaps even discernable or accessible to many researchers, but matter greatly as to whether the board adequately fulfills its oversight function.

For example, strategically, what is not measurable may include when the board says 'no' to the CEO. How do you measure this?

In short, in the arena of corporate governance, what is readily measurable may matter far less than what is not. This, of course, is reiterated during interviews with practicing directors and observation of boards in action, where the emphasis on what I term the '3 C's' of governance is emphasised: namely Chair, Chemistry (of the board) and Competency (of directors). I have had the unique opportunity to observe decision-making failure and success within boardrooms and my data support the notion that these softer, subjective factors matter more than compliance with structural-based, formal governance guidelines.

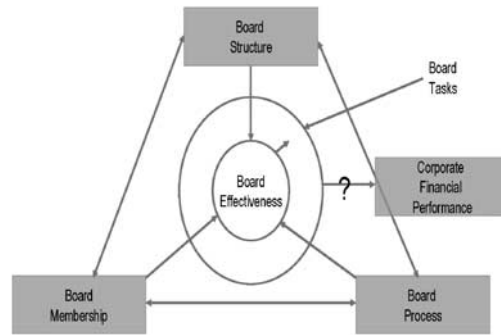


Figure 1: A model of board effectiveness

In fact, best governed boards see structural governance guidelines as minimal requirements, necessary conditions, but not sufficient to ensure that the board is effective and adds value to management. In the boards that have used my work, board structure comprises a small portion of my model of board effectiveness (Figure 1).

### ENGAGE IN PROPER DIRECTOR RECRUITMENT

The problem with director recruitment is that it is not subject to adequate prescriptive criteria and disclosure requirements. Recruitment becomes some sort of ‘black box’, whereby shareholders — and in some cases directors themselves — do not know the basis for director selection and the recruitment practices of the nominating committee.

This is unfortunate because the nominating committee is charged with recommending to the board and ultimately shareholders, the directors of the corporation. You can have an audit committee and a compensation committee, structurally independent, but without the right directors, you will not be as effective as you can be. The nominating committee has not received the attention it has deserved.

Whether you have the ‘right’ directors should be a rigorous and defensible process, not *ad hoc*, informal or ‘fluff’ in nature.

However, drilling down into a director’s competencies and skills is not particularly pleasant. Directors are not used to doing this,

but it must be done, in the most constructive manner possible, by nominating committees and director search firms, if one is retained.

Canada has unique legislation, which I participated in recommending. The nominating committee should select directors based on their competencies and skills, and do a gap analysis prior to recommending new or next directors, similar to chapter 10 within my book. The board should also pay attention to personality, or behaviour, as this may impact the board dynamic. Let me actually read from the legislation itself. This should be what best practice Nominating Committees should do:

Prior to nominating or appointing individuals as directors, the board should adopt the following two-step process: *Step One*. Consider what competencies and skills the board, as a whole, should possess. In doing so, the board should recognise that the particular competencies and skills required for one issuer may not be the same as those required for another. *Step Two*. Assess what competencies and skills each existing director possesses. It is unlikely that any one director will have all the competencies and skills required by the board. Instead, the board should be considered as a group, with each individual making his or her own contribution. Attention should also be paid to the personality and other qualities of each director, as these may ultimately determine the boardroom dynamic. The board should also consider the appropriate size of the board, with a view to facilitating effective decision-making. In carrying out each of these functions, the board should consider the advice and input of the nominating committee.

Nominating committees should devise and maintain a rigorous and transparent competency and skills matrix that should drive the selection of incoming Directors. ‘Evergreen lists’ should also be used. Competencies and

**Table 1: Director competency and skills matrix**

Competency	D1	D2	D3	D4	D5	D6	D7	D8	D9	D10
Fin Lit/Exp.										
Regulatory										
Executive										
Technology										
Strategic										
International										
Governance										
Legal/Compliance										
E-commerce										
Human resources										
Compensation										
Marketing										
Special										
Total										

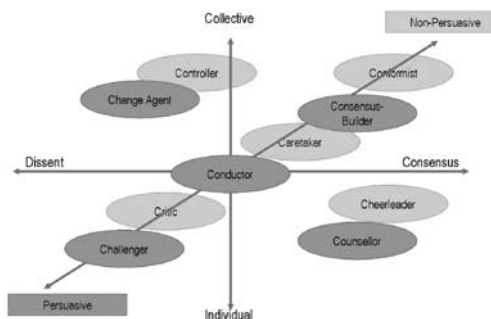
skills should be calibrated to avoid misunderstanding.

This year, for the first time to my knowledge, a Canadian company, one of the boards I advise, disclosed its competency and skills matrix to shareholders, together with the number of directors possessing skilled or expert application, on a four-point expertise scale. This company was recognised as innovative in the disclosure of its skills matrix used in the director selection process.

I believe more and more companies will follow suit. Eventually, shareholders will (or should) require/ask to see the competencies and skills upon which directors are recommended and nominated to the Board. This disclosure request would compel companies to exercise diligence and rigour in selecting and recommending directors (Table 1).

**ASSESS BEHAVIOUR AND COMPETENCE, NO MATTER HOW DIFFICULT IT IS TO DO**

I have developed a series of director behaviours in my book, ten in total, that boards have used, or a variant thereof. It does not matter what you use, only that you assess the behaviour of individual directors. If a director is independent and competent, but does not behave in a certain



*Figure 2: Director behavioural types*

way, in the eyes of his colleagues, that director will not be effective as he or she can be.

Often a rigorous peer review, which I will talk about shortly, is the first step towards director self-enlightenment. The peer data should be shared with the chair of the board, for developmental and mentoring purposes, and not retained only with the individual director whose competency, skills and behaviour is being assessed (Figure 2, Table 2).

**ASSESS BOARD AND COMMITTEE CHAIR LEADERSHIP**

The leadership of the board is incredibly crucial. With a weak or ineffective chair, the board will

**Table 2: Director behavioural matrix**

<i>Behaviour</i>	<i>D1</i>	<i>D2</i>	<i>D3</i>	<i>D4</i>	<i>D5</i>	<i>D6</i>	<i>D7</i>	<i>D8</i>	<i>D9</i>
Conductor									
Change Agent									
Challenger									
Counsellor									
Consensus-Builder			✓						
Caretaker	✓								
Controller		✓							
Critic					✓	✓			
Cheerleader								✓	✓
Conformist				✓			✓		

not be effective. With a strong chair, the board will be effective. It is that simple. So it is not only the separation of Chair and CEO that matters, but the selection of Chair, and the competencies and skills of that Chair.

I had recommended to the securities commission that there be formal position descriptions for the Chair of the Board, the Chair of the Audit Committee, the Chair of the Compensation Committee and the Chair of the Nominations Committee. This is now the law in Canada and is unique so far as I know, in having position descriptions recommended for all board leaders.

Further, these position descriptions should be a basis for assessing whether or not the person occupying such positions are doing so adequately or not, in the eyes of their colleagues, and in certain instances management, as 360-degree reviews are increasing. One of the boards I advise was recognised last year for this innovation, that is incorporating management's views on the effectiveness of the board. Management, including direct reports to the CEO, in working directly with and being accountable to board committees, have informed insight as to the Committee's effectiveness and that of the Chair and its Members. Assurance providers may also as well.

And to determine whether a Chair is effective, the Chair must be assessed by his or her

colleagues. To do this effectively, you need a position description for the Chair of the Board and the Chair of all the Committees.

I would venture to say that many American Corporations do not disclose, on their websites, a rigorous, explicit, comprehensive position description for the Chair of the Board and each of its Committees, and indicate how these Chairs are assessed (and selected).

### **CONDUCT INDIVIDUAL DIRECTOR SELF AND PEER REVIEWS**

Not many professional service firms are in this space as they do not want to offend their clients, delivering negative advice, and have liability concerns.

A peer review occurs when directors assess each other's performance. Boards have not reached the stage yet where such data is shared among all Directors, but I believe this will come.

My sense is that many American Boards may not be at this stage yet, that is a peer review of directors, given that it is not a public requirement to assess individual directors. This is the case, as companies such as Disney, Hewlett-Packard, Boeing, Pfizer and Home Depot have neither individual nor peer assessments according to an article by an American academic this month.

However, Canadian boards have reached this stage. I had recommended that the assessment

of individual directors be based on their position description and the competencies and behaviours that directors bring to the board. I will read from the legislation:

The board, its committees and each individual director should be regularly assessed regarding his, her or its effectiveness and contribution. An assessment should consider (a) in the case of the board or a board committee, its mandate or charter, and (b) in the case of an individual director, the applicable position description(s), as well as the competencies and skills each individual director is expected to bring to the board.

Tools and best practices are beginning to emerge in this area. The peer review is vitally important as it holds individual directors collectively accountable.

The weak area at present, based on a study I conducted for a government shareholder, is acting on the peer review data.

### **ENGAGE IN BEST PRACTICE DIRECTOR EDUCATION**

Here are best practices — those at the leading edge — for director education: Director education activities and professional development opportunities available to directors should be disclosed to shareholders. This means disclosing the individual sessions and which directors attended.

Director education should be tailored to the needs and requirements of the board, committees and directors, in the view of directors, not just management. Continuing education should be mandated for all directors and occur through different channels. Technology should be used. On site visits should occur and should not be staged or managed by Management.

Director education should not be controlled by management. This means that director education should be funded by the company, including a stipend provided to individual directors as appropriate. Director education

should be incorporated into Board and Committee meetings. If warranted, director education should occur during executive sessions, between the independent directors and the external expert.

The Board should have the complete freedom to engage in all of these activities.

### **DEAL WITH LEGAL RESISTANCE IN THESE AREAS**

Lawyers properly advise their clients that less disclosure is better than more, generally. Lawyers have questioned me as to why I advance this notion of individual director assessment and disclosure to this degree. I have had my reviews and assessments, for particular boards, condensed, in one instance, into bullet points for the board to consider, in general (superficial) oral discussions.

As a lawyer I completely understand the need to protect one's client, but as an academic here is my response to lawyers, and to client boards, who are deciding the degree and rigour to which they self-assess their performance, as well as that of their colleagues:

If you assess, recruit and develop your directors and do so in a non-rigorous and structural manner, and something goes wrong, the media and plaintiff's lawyers will quite correctly come down on you, your company, yourself and your reputation, and say, 'You knew or ought to have known of these best practices, and chose not to do so.' Witness the Disney case where the court in fact wrote 'This Court strongly encourages directors and officers to employ best practices, as those practices are understood at the time a corporate decision is made.'<sup>1</sup> I believe it is a risk not to assess or to do so in a non-rigorous manner.

### **DISCLOSE BOARD RECRUITMENT AND ASSESSMENT PRACTICES**

This is an area ripe for review, and shareholder expectations. Much disclosure in the area of nomination, education and assessment of individual directors is boiler-plate and 'fluff' in nature.

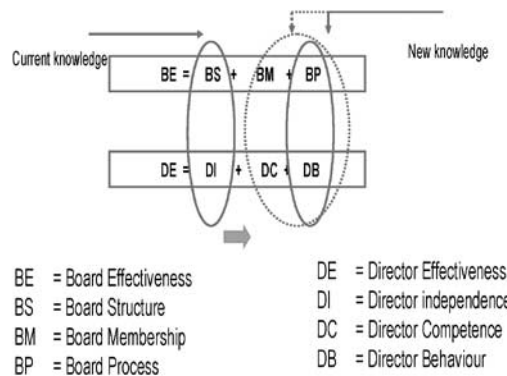


Figure 3: Moving the governance field forward

The movement at the leading edge is disclosure of practices and policies to assure shareholders that transparent, rigorous and robust assessment, developmental and succession planning practices are in place.

For the first time, one of the boards I advise began disclosing some assessment data and how the Board follows up on the data produced by the assessment. I believe more and more of this type of disclosure will occur. Shareholders will demand it (Figure 3).

### RETAIN THIRD-PARTY EXPERTISE IN THE GOVERNANCE OR NOMINATING COMMITTEE'S DISCRETION

For governance assessments and recruiting of Directors, similar to the Audit and Compensation Committee having freedom to retain experts, so should the Nominating and/or Governance Committees.

At the Governance Committee level, if this Committee does the assessment, supported by management, particularly the peer review, candour may be reduced. Directors may not be sufficiently candid if they are not assured that their identity is being protected.

A third-party expert brings objectivity and independence to the assessment process. The retention and remuneration of this Advisor

should not be constrained in any manner by management. The expert should be accountable to the Committee.

Executive Sessions should also occur following each assessment, at the Board, Committee and individual Director level, including one-on-one sit downs with the Chair of the Board following an individual Director peer review.

### REMOVE NON-PERFORMING DIRECTORS AND CHAIRS

Lastly, this is an unpleasant topic but must be addressed, when addressing assessment of directors. The non- or under-performing director is a liability for a board. It is very difficult to remove such a director without an objective, independent means of assessing the effectiveness of directors. Otherwise, the Director will 'wiggle' and claim the Board is targeting him or the board is wrong and he or she is right.

Boards need to link the re-nomination of the director with the results of the peer review. That way, you do not have to rely solely on artificial tenure policies, such as retirement age, tenure in years, number of boards, professional occupation, geographical representation, or otherwise, many of which lack predictive validity with regard to individual director effectiveness.

Best practice boards are moving towards what I term 'external limiters and internal robustness', which is a hybrid of retirement age, etc, and whether the director is actually effective or not in the eyes of his colleagues.

Eventually, artificial tenure policies may be replaced by director performance reviews. You remain on the Board so long as you continue to perform, in the view of your colleagues.

### REFERENCE

- 1 In re Walt Disney Co. Derivative Litig., Cons. C.A. No15452, 2005 Del Ch LEXIS 113 (Del Ch. Aug. 9, 2005).