THE CORPORATE BOARD

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THE LEADING JOURNAL OF CORPORATE GOVERNANCE

SEPTEMBER/OCTOBER 2022
VOL. XLIII NO. 256

THE CORPORATE BOARD

THE LEADING JOURNAL OF CORPORATE GOVERNANCE

EDITORIAL OFFICE

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Subscriptions: *Available to corporations at an annual cost of $3,200. This provides delivery of six bimonthly issues to each board member, senior executive officers, and the corporate secretary. Periodicals postage rates have been paid at Okemos, MI and at additional mailing offices.*

POSTMASTER: *Send changes and all subscription correspondence with the mailing label to:* Customer Service
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2807 Jolly Rd Suite 360
Okemos, MI 48864

SEPTEMBER/OCTOBER 2022 Vol. XLIII No. 256

Printed on Recycled Paper

Making The Grade In ESG Ratings

By Vic Svec and Stephanie Weiler

Your board has gotten the message: Environmental, social and governance (ESG) issues matter to shareholders, lenders and customers. Now, how do you proceed to corral the many ESG ratings services and make sure external ratings reflect the *true* ESG performance and discosures of your company for maximum value?

□ A fund manager in Boston is ready to buy 300,000 shares of a gas pipeline company with a growing carbon capture business. The fund's ESG team rejects the purchase based on the poor environmental quality scores from ISS.

□ A prominent parts distributor loses $120 million in contracts after failing to achieve a minimum threshold in ESG ratings from EcoVadis.

□ A professional services firm issues $1 billion in debt with a unique provision—a 25-basis point reduction in the interest rate if the firm receives a passing grade from CDP for its climate performance.

Welcome to the world of ESG ratings, where not just reputations but hundreds of millions of dollars of market value, debt and even revenues can be pegged to a company's environmental, social and governance results. Here is the rub: Performance is often demonstrated by precarious ratings from far-away firms with little or no interaction with the company.

Because of the enormous sway of ESG ratings, directors are right to be sensitive to their implications. Yet boards must also play an important role in prioritizing timeliness, accuracy and improvement, often with management teams unaccustomed to managing ESG performance, disclosures and the very public scorecards that accompany them.

Why do ESG ratings matter? There are four powerful ESG currents which combine to form a tsunami of change companies are only beginning to comprehend and address.

□ *Factor 1.* The global financial community has undergone a dramatic shift, with ESG factors moving from a niche area of focus for particular investors to a near-universal emphasis for most fund managers and lenders.

□ *Factor 2.* There is a massive drive to decarbonization, as companies grapple with decades-long journeys to reduce or eliminate greenhouse gas emissions.

□ *Factor 3.* Customers in both B2B and B2C sectors are applying pressure for responsible sourcing, with particular focus on the environmental sustainability and human rights attributes of their supply chains and consumer products.

□ *Factor 4.* A new generation of workers is pushing for diversity, inclusion, equity, accessibility and a sense of belonging, which is changing the landscape of employers around the world.

Each of these forces adds to a macro trend with substantial implications for corporate boards and management teams. The combination of these within the rubric of environmental, social and governance trends explains why ESG is a major and growing priority. A February 2022 survey of CEOs by a major accounting firm revealed that building ESG capabilities was the number two priority for global companies pursuing merger and acquisition activity in 2022, behind only improving operating capabilities. In the U.S., ESG ranked first in the priority list.

ESG ratings today are given to companies from over 796 ratings sources, rating nearly 50,000 companies in 150 countries.

It is tempting to apply the analogy of credit ratings firms to ESG ratings, but there are major differences. ESG ratings today are given to companies from multiple sources including business media franchises such as Bloomberg, proxy voting firms such as Institutional Shareholder Services (ISS), credit ratings firms such

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as S&P, equity index organizers such as MSCI, and firms such as Sustainalytics, Refinitiv and EcoVadis.

In fact, ESG ratings aggregator CSRHub cites no fewer than 796 ratings sources, rating nearly 50,000 companies in 150 countries. CSRHub CEO Cynthia Figge said of ratings: "ESG has had a dramatic increase in importance in just the past several years, becoming a mainstream concern for companies and investors. The growth in total ESG assets under management is projected to exceed $50 trillion by 2025. Companies are recognizing the need to improve their ESG performance, reporting and external ratings."

Such an overwhelming sea of third-party scorecards may leave directors tempted to throw up their hands, but that would be a mistake.

Prominent third-party ratings services are heavily relied upon by the financial community.

The 2020 Edelman Trust Barometer survey of U.S. institutional investors found that 80 percent of investors will not invest in companies with a lack of sufficient information on ESG performance. More than 90 percent of investors believe that a company with strong ESG performance deserves a premium valuation to its share price.

Here is the challenge. Investors have very little time to decide if a company is part of the solution or part of the problem from an ESG perspective. A stunning 98 percent of institutional investors use ESG ratings to inform their investment decisions. According to a survey of pension funds and institutional investors by SigTech, more than two-thirds of investors expect to increase their use of third-party ratings.

The global fund manager of a $2 billion sustainability portfolio said: "A company's ESG ratings are incredibly important. They're like credit ratings. We can all complain about how inaccurate they may be, but the pressure I get if I want to invest in a Triple C versus a Triple A company can be intense." This extends beyond sustainability funds into prominent "long only" institutions.

Index funds have been among the most vocal in ESG matters, and for good reason. Combined, they control the ownership of an estimated 20 to 30 percent of most public companies of any size. Index funds cannot "vote with their wallets" by selling their shares, but instead must own shares in all companies that comprise the indices. They also hold their shares for years, meaning that longer-term ESG risk metrics are more likely to come about on their watch than for a hedge fund manager "renting" the stock for mere months.

Even as boards might ignore ESG ratings, activist investors are very much drawn to ESG as they scout opportunities to identify vulnerabilities for potential targets. The Center for Board Matters reports that more than half of all shareholder resolutions since 2018 have been ESG-related.

The financial community is far more diverse than just these institutions. Consider university endowments, state pension funds, bank lenders, public bondholders, insurers and sureties. For a time, private equity was viewed as a haven from ESG pressures, but today more than 500 private equity firms have signed onto the "Principles for Responsible Investment".

Retail investors also fan the flames by seeking investments that can accomplish more than financial returns. Observers often cite Millennials and Gen Z investors as being among the most socially conscious, combined with Boomers who look beyond their wealth to legacy impacts.

ESG ratings are increasingly essential for customers.

Second only to financial community ESG pressures are those needs being placed upon companies by customers. Five years ago, ESG evaluations would have been concentrated among the largest corporations. Today, many of those companies are taking steps to ensure that their supply chain, with perhaps hundreds of vendors, are also responsible.

Typically, this process includes surveys, scorecards or other bespoke evaluations that a customer can send to suppliers, sometimes with a request for payment as well, with responses then rolling back up to the company. This dynamic, in turn, has led to the rise of large firms such as EcoVadis and ISN which work to streamline the process and expand supplier qualification beyond traditional metrics.

EcoVadis *(www.ecovadis.com)* rates more than 90,000 companies in 160-plus nations. Many customers now require that vendors complete an ESG assessment through the EcoVadis platform, evaluating how well ESG is integrated into their products and services. While simple completion of the survey may be a minimum requirement to continue to do business with certain customers, some companies are beginning to focus on results, and require minimum acceptable ratings to retain suppliers.

ISN *(www.isnetworld.com)* can work the same way. One global distributor recently cited $1 billion of revenue associated with maintaining an accident rate of 2.0 or better per 100 employees annually as reported into the ISNetWorld system.

Consumers, too, increasingly prioritize sustainability. According to work from the Brand Experience Group, more than four out of every five U.S. consumers have some degree of concern about the sustainability of the brands they buy.

Employees rely on ESG ratings to evaluate where to work—and for how long.

Employer review site Glassdoor reports that 86 percent of employees and job seekers research company reviews and ratings to decide where to apply for a job. This makes sense as branding activities are by nature subjective, and word-of-mouth recommendations are powerful, but anecdotal.

Social responsibility plays an enormous role in employment. A Cone Communications study on Millennial Employee Engagement notes that 76 percent of millennials consider a company's ESG commitments when deciding where to work, and 64 percent will not take a job if a potential employer fails to have strong responsibility practices. It is likely these factors are even more prominent today, as the study was done before Covid, the outburst of flexible work options and newfound tightness in hiring markets brought about by The Great Resignation.

Company ESG scores can differ significantly between ratings providers. This is a concern.

A lack of consistency between rating provider's scores has been cited by critics as a shortfall of ESG ratings, with a company's score often differing significantly between providers. Part of this is the subjectivity of the firms and their analysts. Part is the lack of comparability. How important are disclosures versus performance? How important is a carbon footprint versus diversity or cybersecurity? Part is a lack of quality control on the part of ratings services.

Some ratings providers will admit they are stretched thin, with often-junior staffers analyzing hundreds of companies, and updates sometimes take a year or two following a company's revisions. Finally, part is weighting. Major issues such as carbon can be treated with very different degrees of importance by, say, CDP versus Bloomberg.

That latter point is demonstrated by a critique from the MIT Sloan School of Management with the biting title, "The Aggregate Confusion Project." This points out that, while the major credit rating firms have a 0.92 correlation on their ratings of companies' debt instruments, the correlation among prominent agencies' ratings for ESG averaged just 0.61.

The issues with ratings have caught the attention of global standards bodies and regulators. The Securities and Exchange Board of India issued a consultation paper in January 2022 announcing plans to regulate ESG ratings by requiring providers to obtain accreditation. The United Kingdom is considering whether to regulate ratings services under the European Securities and Markets Authority. The International Organization of Securities Commissions also has provided recommendations for ESG raters and are urging regulatory focus on ratings.

As a society, multiple entities are established to drive out distortions. Savvy investors and traders often use small arbitrage opportunities to create substantial value. Political campaigns scour speeches for opportunities to fact check opponents, and play "gotcha" with inconsistencies. Regulators and auditors carefully review financial statements for errors in process and reporting.

How do companies manage ESG ratings? The wild-west nature of ESG ratings can be tamed.

It is surprising that widespread inaccuracies are found among ratings due to incorrect, outdated or misunderstood ESG-related data. Such neglect is rarely the case with credit ratings, where treasury teams carefully review reports, company analysts crunch the calculations, and CFOs conduct pilgrimages to New York to plead their cases.

The wild-west nature of ESG ratings can be tamed. In fact, managing ratings well provides not only effective risk management hygiene, but a powerful point of differentiation from competitors.

This is particularly true since nearly all companies, even mature ones, are not operating at optimum levels by harmonizing their external disclosures with internal policies, and their ratings with their disclosures. Some companies, frankly, do not appear to be trying. Consider the bottom of the S&P 500. These are companies that clearly have the size to devote resources to ESG and sustainability, yet 19 have overall ESG scores by Refinitiv lower than 30, on a 100-best basis.

Directors should know that there are multiple reasons why ratings are not being managed well. Whereas other pressures can occur from within an organization, ESG needs are often first evident at the C-suite and board level, coming from investors and customers. In addition, ISS Quality Scores may be sitting in the email box of a paralegal who left the company two years ago (seriously).

Management may also not know where to find ratings. Small public company managers may only be aware of their MSCI rating when they sleuth in a Fidelity investment account, or happen to see a stray Sustainalytics score on Yahoo Finance.

Other challenges include making clear who within the company has responsibility for reviewing and engaging with ratings services. ESG is often set up as a multi-disciplinary project as opposed to a line-oriented function—but when everyone is in charge, no one may be. This is where clear assignment of the task to a manager or advisor can pay dividends.

Boards are well-positioned to help their companies focus, connect the dots and capitalize on dramatic "infomatrage," if you will, between three dimensions:

- A company's internal policies and practices that may be both meaningful and powerful.
- External disclosures that may be incomplete or difficult to access.
- Third-party ratings that reflect analyses that are often stale, misclassified or mistaken.

Call to action: The board plays a critical role in ESG oversight, including performance, disclosure and ratings.

Consider these seven steps that board members can take to help companies manage the process.

☐ ***Focus on all aspects of ESG.*** Directors should spend substantial resources focusing on the essential matters of sustainability substance, strategy and policies. It is not "studying to the test" to make sure you are completing the circuit of ESG disclosures. Within ESG circles, another fifth-grade math axiom applies: You do not get credit for it if you fail to show your work. Disclosures and ratings matter. A well-placed question during a committee meeting can go a long way in determining how attentive management is to all aspects.

☐ ***Identify the target state of the company across the many aspects of ESG.*** Where on the maturity model, from reactive to integrated, does a company want to reside in safety, diversity, cybersecurity, compliance, emissions? The answer may be different for each board and each component.

☐ ***Understand the differences between the prominent ratings firms.*** Some ratings firms apply a far greater weighting to *disclosure* than *performance*. Others have a heavy emphasis on climate change and are less focused on the "S" or "G." Recognize the inconsistencies,and what is most important to the company's stakeholders.

☐ ***Request regular reporting on ratings from management.*** Make sure that, in addition to being apprised on ESG-related key performance indicators, directors also receive updates on the ratings services. When a company makes a substantive change such as strengthening a governance practice or tying ESG to executive pay, nudge management to rapidly disclose the information broadly, and also communicate with ratings services. Companies can see changes in an ISS quality score, for instance, within days of making the firm aware of improvements in disclosures. This timing can be particularly important prior to proxy voting and the annual meeting.

☐ ***BYOA—Be Your Own Activist.*** Ask your management team to switch hats and look at the company through the lens of an activist investor. Increasingly, activist defense activities do just that, and come up with blistering attacks based on public information, much of which can be supplied through third-party ESG ratings. Further, do the same through a customer or employee lens at reviews and online ratings.

☐ ***Consider opportunity as well as risk.*** Done properly, ESG management, including ratings oversight, can add major valuation benefit, enormous company differentiation, and far more accurate stakeholder assessment, along with an opportunity to polish the windows on your corporate identity.

If *Institutional Investor* names the management team best-in-class for the sector in ESG, or a firm receives "Top 100 Companies to Work For" recognition, these become their own ESG-related proof points. The opposite, of course, applies when it comes to avoiding needless controversies and conflicts.

☐ ***Be authentically you.*** Ultimately, a company's ESG exists not in disembodied metrics and ratings, but as a demonstration of achievement against the values and goals of the enterprise, and the value created for all stakeholders. That includes the company's composite value of its products and services for society.

On that last point, perhaps no one has come up with the perfect rating to capture the full benefit. That leaves a blank canvas that is a company's for the painting. ■

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Expanded Role For The Compensation Committee

By Ani Huang and Richard R. Floersch

The role of the modern board's compensation committee has expanded far beyond simply setting the top management team's pay. There is far more disclosure (and tough questioning) on compensation levels, goals and fairness. There is also greater attention to talent management and planning, investor relations, and stakeholder issues.

The scope of the compensation committee continues to expand, especially in the areas of human capital management, talent strategy, and diversity, equity and inclusion (DEI). A Center On Executive Compensation survey found that almost two-thirds of member companies have formally expanded the role of the compensation committee by either expanding the charter or both the charter and committee name.

As an experienced compensation committee chair put it, "I suspect that within one to two years, companies without an expanded compensation committee charter will be outliers." As the remit of the compensation committee grows, committee chairs and chief human resource officers (CHROs) are faced with the challenge of managing this growth with the full board, committee, independent compensation consultants and management.

This discussion is based on 24 interviews conducted by the Center On Executive Compensation with compensation committee chairs, CHROs, and compensation consultants of large companies across multiple sectors regarding their experiences, learnings and advice on expanding the charter of the committees.

As we learned during the interview process, each company is unique in how it approaches the evolving compensation committee remit. Following are the prevailing practices based on our interviews, plus a number of trend-forward or "best practices" that may not have hit the mainstream, but that work well for the companies using them.

Boards understand that the SEC is considering mandated, prescriptive human capital disclosures for all public companies.

Throughout our interviews, we heard the recurring theme of "the perfect storm" of factors driving a rapid expansion of the committee's charter beyond the traditional roles. Primary factors mentioned include:

☐ ***Investors.*** Almost without exception, companies noted an increased focus by institutional investors on talent, ESG and diversity and inclusion as a primary factor. "I remember a time," said one committee chair, "when Investor Day questions were 100 percent financial. Now they relate to whether you have the skills to execute on the strategy that the CEO just outlined. How are you remaining competitive? How are you keeping your workforce safe? What is your people strategy for executing not only your long-term strategy but how you will deliver product tomorrow?"

Another chair noted, "It took us a long time to realize the SEC mandate isn't the limiting factor of what the committee can do. We can examine compensation in the broader context of talent, the same way we do with retention."

☐ ***Rise of stakeholder capitalism.*** Employee voice is increasingly heard in the boardroom, as employees encourage their employers to focus on human capital issues that matter to them. Meanwhile, companies are expected to solve societal problems previously considered solely within the purview of governments, bringing a broad focus on a range of stakeholders.

As one chair and former CEO put it, "In Europe today, your job is to maximize the company for stakeholders, not just shareholders. And that is moving across to America."

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☐ ***Regulatory pressure.*** Boards understand that the SEC is considering mandated, prescriptive human capital disclosures for all public companies. They are planning now for a committee to monitor the company's performance on human capital metrics.

☐ ***External events.*** The social justice movement pushed issues of diversity, equity and inclusion to the forefront of board discussions. Meanwhile, the COVID crisis pointed out the importance of people and empathetic leadership, driving the need to ensure there is board oversight of the company's human capital risks, talent strategy and pipeline.

Cross-committee planning is becoming more common, with companies reporting that they are experiencing greater coordination and alignment across committees.

The companies we interviewed reported changes in almost every aspect of committee work. The most common changes reported were to the committee agenda, with a slew of new topics being discussed throughout the year.

One committee chair suggested that "committee chairs, the CEO and the lead director should meet annually as a group to identify key issues for the board over the next year, and determine if each one is best covered at the committee or board level, which committee should be involved, and timing."

We heard in interviews that ESG topics generally fall to the nominating and governance committee, and climate specifically often lands within audit. However, most companies place human capital issues within the compensation committee. Cross-committee planning is becoming more common, with companies reporting that "we're experiencing coordination and alignment across committees that we didn't have before."

A compensation consultant pointed out, in his view, many of these topics are not in fact outside the realm of executive pay since the compensation committee's duty has always been to evaluate CEO performance.

"I don't consider them to be outside executive compensation—they are deeply related. It's all wrapped up in the committee's role to evaluate CEO performance, which has increasingly become important on ESG issues. So it's not really expanding the scope, it's just doing a deeper dive."

The most common "new" topics we heard for the compensation committee included:

☐ ***Talent management and succession planning for key leadership positions below the C-suite.***

Best practice. One company developed a two-page talent scorecard for the committee. One page was devoted to the entire company's workforce while the other focused on top talent. Both showed statistics around hiring, retention, promotions and diversity.

Best practice: Consider the use of an "HR Dashboard" including items such as diversity and inclusion progress against goals, results of pulse surveys on engagement, success in hiring with key populations, wellness scores and employee hotline statistics.

Best practice: The committee should consider the changing requirements of critical roles and how that changes their view of the talent pipeline. What will the workforce look like five to seven years from now? Does the company have sufficient plans to meet such needs as:

- Diversity, equity and inclusion
- Culture and employee engagement
- Human capital metrics
- Pay equity
- Reskilling
- Safety and wellbeing
- Retention strategies

☐ ***New faces.*** Expansion of the compensation committee remit has also changed the makeup of participants in meetings. Core members of management participating in meetings continue to be the CEO, CHRO, head of rewards or executive compensation, and corporate secretary. However, we have seen others participate as well. Invited guests now often include the chief diversity officer and head of talent, and occasionally the head of corporate social responsibility.

Best practice: Committees are more interested in meeting top talent throughout the organization. We heard a number of interesting and useful suggestions for how to accomplish this:

Compensation Committee Year
Sample Committee Calendar

NOVEMBER
- ☐ External compensation trends review
- ☐ Annual total rewards strategy
- ☐ Risk assessment
- ☐ Quarterly equity update
- ☐ Compensation consultant approval
- ☐ Compliance summary report
- ☐ Quarterly DEI program review

FEBRUARY
- ☐ Approve incentive compensation payments (certify performance results for prior fiscal year)
- ☐ CEO compensation review and recommendations to board for approval
- ☐ Certify performance of performance-based restricted shares
- ☐ Executive and senior officer compensation review and approval
- ☐ Committee self-evaluation
- ☐ Preliminary CD&A review
- ☐ Quarterly equity update
- ☐ Stock ownership review
- ☐ Compliance summary report
- ☐ Quarterly DEI program review

MARCH (Conference call)
- ☐ Officer compensation summary
- ☐ Proxy review and approval
- ☐ Annual equity grant summary
- ☐ Set performance goals for management incentive program, restricted stock and performance shares

MAY
- ☐ Talent review / succession planning
- ☐ Annual equity grant summary and quarterly equity update
- ☐ Directors' annual compensation award
- ☐ Compliance summary report
- ☐ Quarterly DEI program review

AUGUST
- ☐ Directors' compensation program review
- ☐ Incentive plan update
- ☐ Committee charter and calendar review
- ☐ Quarterly equity update
- ☐ Annual legal update
- ☐ Quarterly DEI program review
- ☐ Annual benefits review
- ☐ Pay equity analysis
- ☐ EEO compliance summary report

▫ Invite a business or function head and his or her HR business partner to a committee meeting to discuss talent in that business or function.

▫ Assign projects to top talent and have them come back and present results to the committee.

▫ Invite diverse talents who have been through leadership training to present to the committee about the development received.

▫ Have management dive deeply into the organization and pick one or two employees "they'd bet on" to engage with the committee. That way, the company (as overseen by the committee) can "focus, measure, and stretch them" and ensure the bench gets stronger faster.

▫ Have members of the CHRO's team run breakouts during committee meetings on different aspects of human capital initiatives, such as the war for talent, "speak up" culture, total rewards, diversity and inclusion, and wellness.

"If you send really good material out ahead of time, there shouldn't be a need to go through all of it."

☐ ***Meeting duration and agenda.*** Almost all companies we spoke to had increased to at least five compensation committee meetings per year, with a mix of in-person and virtual. The average duration of these meetings was approximately 90 minutes, reflecting the increased time necessary to cover the additional slate of topics. Several companies mentioned further unscheduled meetings as well to cover topics such as COVID-related pay changes. As one chair put it, "compensation committee is the new audit!"

Several companies reported that they spend 20 to 30 minutes of every meeting on talent, with one or more sessions totally dedicated to the subject.

Best practice: Consider the meaty human capital management (HCM) topics for the summer months, outside of the heavy executive compensation timing (for calendar-based fiscal years).

Best practice: Make committee meetings more efficient by using a consent agenda for routine items, moving informational items to the appendix and sending out thorough materials so directors can get right to the discussion. One chair noted, "if you send really good material out ahead of time, there shouldn't be a need to go through all of it—we should come prepared to ask questions. As a chair I'm ruthless about cutting agenda items so we get to what's important."

☐ ***Role of the compensation consultant.*** Those interviewed commented on where the compensation consultant can add value on human capital topics, such as reporting on trends, and how to consider linking rewards to ESG measures. A surprise finding was how few companies utilize outside advisors on issues such as talent, diversity and culture.

As one CHRO put it, "you bring advisors in to help make decisions, and the board isn't making many decisions on these topics. Talent strategy helps enable corporate strategy—there is no formal remit for the board around talent strategy." Neither the board's independent compensation consultant nor a second outside consultant seems to be advising the board directly on human capital issues.

Best practice: Have management present the results of an outside firm's work on human capital issues, and reference the findings in the committee meeting.

Best practice: Consider bringing in an outside expert on ESG to advise the board, especially after SEC rules on climate and human capital metrics are finalized.

☐ ***New expectations for directors.*** The changes in remit, time commitment and agenda have caused boards to think differently about education on new topics as well as the backgrounds of those who sit on the compensation committee. We heard about a sharpened focus on more diverse boards, as well as diversity of skills to include expertise in human capital, leading to an increase in sitting or former CHROs on boards.

Best practice: Give directors an "education allowance" that encourages them to attend external training on their own.

☐ ***What stays with the full board.*** Almost without exception, all those interviewed stated that CEO succession must remain with the full board. In general, companies with an expanded compensation committee charter follow an "and, not or" philosophy when it comes to the board agenda. In other words, topics can be discussed at both the board and committee level—the difference is the depth to which issues are discussed.

Best practice: Take the issue of where the topics are discussed off the table by using a clear committee calendar and charter with report outs to the full board. For example, the board might receive an annual review of diversity, equity and inclusion and culture, while the committee does a deeper dive at one or more meetings and delves into the numbers behind the summary.

Best practice: Another way to keep the board informed is to make all committee materials available to the entire board. This way, any curiosity about issues being delved into at the committee level can be satisfied without having to do a deep dive on each issue with the full board every time. ■

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Modernizing The Board's Oversight Of Joint Ventures

By Neetin Gulati, James Bamford, and Geoff Walker

Monitoring the management, operations and risks of your company is difficult enough for any board. What happens when those oversight duties are shared with another company? Joint ventures are an increasingly popular tool that allows corporations to share synergies and risks with an outside partner in a separate entity. Yet these benefits must be balanced with joint venture governance that protects both sides.

If you serve on a corporate board, chances are your company is actively considering entry into a new joint venture (JV). JVs and non-equity partnerships have exploded in the last few years, and that trend is not abating. Your company may also have existing JVs that could be underperforming or exposing the company to risks.

Increasingly, companies use JVs to address critical environmental and societal challenges, as well as stay competitive in the face of disruptive innovation. Some sustainability JVs have, for example, included partnerships between General Motors and LG Energy Solutions to manufacture battery cells for electric vehicles; Unilever and food-tech company Enough to bring plant-based meat products to market; and ExxonMobil and Agilyx to develop ways to process waste plastic to prepare it for recycling.

This trend is not surprising. JVs allow companies to access capabilities, enter new markets, share risk, and achieve both revenue and cost synergies. While some JVs have been extremely successful and performance has been improving over the last decade, they are also prone to underperformance and dysfunction. Our research on joint venture performance found that half still fail to meet their shareholders' strategic and financial expectations. In addition, we have found that most corporate directors are unable to answer the most basic questions about their company's joint venture portfolio.

Considering the stakes, boards can play a valuable role in helping executive teams pursue, negotiate, govern, and manage JVs in ways that create more value. Two such opportunities are forming new JVs and governing existing ones.

A JV should be pursued only if it is a better structure than other strategic options. JVs consume significant management time and expense in its launch and ongoing governance.

☐ ***1. Forming new joint ventures.*** While the executive team is responsible for driving a new JV transaction to close and launch, boards have an important role to play in oversight and guidance at the onset. Three areas corporate directors should focus on are: deal rationale; voting and control rights; and evolution and exit.

▫ ***A. Deal rationale.*** *Is a JV the right structure, and what are the strategic and financial objectives?*

An obvious but tricky question is whether this JV is the right deal. This is really a two-part question. Is this the right choice compared to other transaction structures, and how will this JV help the company achieve its strategic and financial goals? If done well, directors can bring a valuable perspective informed by their experiences and separated from the pressures on management to do a deal, while at the same time challenging optimistic assumptions, risk analyses, and the business environment.

On the first point, a JV should only be pursued if it is a better structure than other strategic options, or is

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the only viable way to pursue an attractive business opportunity. Directors should push on whether a simpler contractual arrangement (such as a licensing, marketing, or supply agreement) could accomplish similar strategic objectives with similar results. A JV will consume a significant amount of management time and expense in its launch and ongoing governance. Similarly, an acquisition should be preferred when possible, and the synergies are large enough to cover the expected control premium.

As for the second point, the strategic and financial rationale for a JV should be clear and crisp. For example, Ultium Cells, the battery cells joint venture of General Motors and LG, aims to create a battery that will cost less than $100/kWh, as well as provide 60 percent more capacity, and reduce the cobalt content by 70 percent compared to other EV batteries. GlaxoSmithKline and Pfizer's consumer healthcare JV aimed for annual cost synergies of $650 million, and eventual separation and public listing of the JV.

For both JVs, clearly defined success metrics provide quantifiable measures that the board can look to for evaluating how effectively the venture is achieving its objectives. Directors should also be well equipped to analyze and question the JV's feasibility, and the financial projections of management.

It is important to monitor due diligence to ensure it appropriately covers ESG risks. The poor ESG reputation of a JV partner can infect both the venture and its owners.

As part of its strategic assessment, the board should also assess how the JV fits with the company's mission, vision, and values, as well as the increasing importance of environmental, social, and governance (ESG) factors. As long-term stewards of the company, directors have an important role to play in both areas.

Because the company will not be in complete control of the JV, it is important to monitor the due diligence process to ensure it appropriately covers ESG risks. The poor ESG reputation of a JV partner can infect both the venture and its owners. Separated from the pressures of doing a deal, directors should ask tough questions about how deeply management has investigated potential environmental and human rights issues, and make sure the company is willing to walk away based on what they find.

□ ***B. Voting and control.*** *Has a workable decision-making and oversight structure been included in the JV agreement?*

A second topic the board should examine is whether the company's interests are properly safeguarded through the JV's governance structure. This is important particularly for non-controlled JVs, with a non-controlling partner's leverage greatest at the time of entry.

The great challenge of JVs—control—comes in many more gradations than "I control," "you control," or "we share control." For starters, control need not flow directly from ownership percentage. Many JVs have been formed over the years (including MillerCoors and the Solae JV between DuPont and Bunge) with unequal ownership, but are still governed as 50/50 ventures.

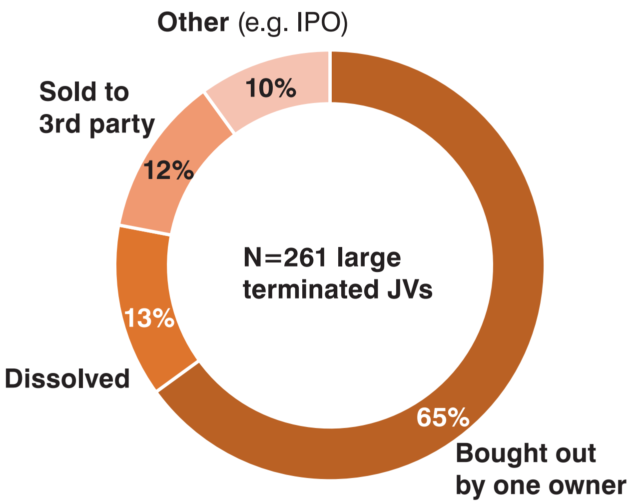
Ankura's analysis revealed that most minority partners in JVs have more negotiating leverage than they realize, and that a firm's ownership stake does not dictate, nor even correlate with, its voting rights. What voting and control rights a company secures is a function of its negotiating prowess and leverage—not its contributions or ownership interest. With distance from deal negotiations, directors are well-positioned to examine the governance terms included in the agreement.

The standard voting- and control-related terms in a JV agreement usually do a good job spelling out where the most fundamental decisions will be made (shareholders vs. JV board), and defining the voting thresholds needed to carry a decision (unanimous, supermajority, simple majority). Typically, these relate to topics like liquidating the company, changing the capital structure, amending the legal agreements, and appointing the top officers.

We have found that there is another level of operational decisions that are rarely defined in the JV agreement, but such decisions are critical for the venture to function. Board oversight of a JV agreement should include ensuring that defining and agreeing on these

What Is The End Game?

Most Common Joint Venture Outcomes



Source: Ankura JV and Partnership Database.

next-level decisions (including authority delegated to the JV CEO and management, and whether board and non-board committees will have any approval or vetting rights) are not punted to another day. These decisions are essential to ensuring strategic alignment and getting the JV off to a good start.

□ ***C. Evolution and exit.*** *Will the JV be adaptable to changing market conditions and parent company needs? What are the strategic considerations affecting exit?*

The future is impossible to predict, and even the best-laid plans sometimes go awry. Virtually every JV gets "stuck" at critical inflection points, unable to evolve or respond when necessary. When entering into a JV, it is important to build the capacity and flexibility to evolve when these inflection points arise.

Boards have a duty to look out for the company's long-term interests, and should ensure a new JV has built-in flexibility to evolve as market conditions and the company's ambitions change. This flexibility could include, for example, "opt-out" provisions that allow one partner to proceed with investments if the other cannot contribute additional capital, provisions for adjusting service and offtake agreements, and so on.

More importantly, the board should assess a new JV facing the reality that all JVs eventually come to an end. The median lifespan of a joint venture is 10 years, a figure which has remained largely unchanged for decades. Some 65 percent of JVs end with the venture being bought out by one partner. The other 35 percent end in other ways (such as being unwound, dissolved, sold to a third party, or taken public).

What is the desired end game of the venture? Is the JV intended as a long-term partnership, or a staged exit? Are you the "natural" buyer or sell of the JV?

There are questions the board should discuss with management prior to entering into a new JV. First, what is the desired end game of the venture? Is the JV intended as a long-term partnership, a staged exit, or a stepping-stone to a bring in additional partners, or to an IPO? For example, when Pfizer and GlaxoSmithKline formed a consumer healthcare JV in 2018, the parties announced that they intended to separate the JV as an independent company. They included provisions on which party could trigger the separation process.

A second and related question is whether you are the "natural" buyer or seller of the JV. In our experience, one partner is likely to be better positioned to buy out the venture from its partner, for instance, because the venture is co-located on its site, is more core to its business, or receives critical technology or services from that partner. There may also be legal or regulatory reasons, such as rules on majority local ownership, that prevent one partner from taking over the JV.

Once the most likely eventual exit is established, the board should confirm that these considerations are reflected in specific contractual terms. Most JV agreements contain four to eight exit triggers, which are the events that allow a partner to exit the JV. The majority of JV agreements also include at "at-will" exit clause.

Consider whether such a clause should be paired with a "lockup" provision, during which time no partner can exit, to allow the JV time to get off the ground. Each exit trigger may have one or more exit mechanisms, such as a "put" or "call" right to force a buyout of one or more partners, or an IPO trigger. Finally, the board should ensure that the agreement addresses the post-exit relationship between the JV and the exiting partner to ensure a smooth withdrawal or wind-down.

Corporate directors may have first-hand experience in how tricky JV exits can be, and how it can distract from business operations. With that perspective, directors should be well-positioned to provide oversight and test the exit triggers and mechanisms so the exit process is smoother for all sides.

Few corporate boards have an adequate understanding of their company's joint venture portfolio or its performance.

☐ ***2. Governing existing joint ventures.*** Corporate boards should also ensure they have visibility into and oversight of current JVs that are material to their company. The materiality and importance of a company's joint venture portfolio will depend on both company size and industry. Within the natural resources industry, JVs are very common and material to core business operations. For example, major oil companies like Shell, ExxonMobil, and TotalEnergies have ownership stakes in hundreds of JVs, while in the mining industry, BHP, Rio Tinto, and other mining companies are invested in dozens.

JVs are increasingly common in other industries as well. GM's operations in China and Korea, as well as its electric vehicle battery manufacturing operations, are carried out by joint ventures. Such operations are material to GM's bottom line and future as a company.

For companies where JVs are materially important to business operations, they are also important to shareholders and boards. Unfortunately, few corporate boards have an adequate understanding of their company's joint venture portfolio or its performance.

While directors do not have the time nor the responsibility to understand and review each JV in a company's portfolio, they still have a duty to provide oversight and strategic guidance. To start, directors should understand JV financial and operational performance and fit with the company's strategy; how JVs impact risk management and ESG performance: and how JV directors are selected and trained.

▫ ***A. JV performance and strategy.*** *How effective is the financial and operational performance of our JVs? Do they continue to fit into our corporate strategy? Are there JVs that need to evolve, restructured, or be exited?*

JVs are often outside of senior management's day-to-day supervision, and their financial and operational performance is aggregated with wholly owned assets within a business unit. This can make it difficult for boards to have visibility into the how they are performing. As part of the board's oversight responsibilities, it should have access to and review the financial and operational performance. An annual performance and strategic review that summarizes the financial and operational performance of the company's JVs by key characteristics (such as business unit, geography, and level of control), as well as how JVs fit into the company's overall strategy can provide useful insights for the board.

By calling attention to joint ventures, directors can prompt management to pay greater attention to the company's JV assets. For JVs that are not meeting their strategic and financial rationales, this should lead management to consider what changes need be made, or if the JV should be exited.

Our research suggests that JVs that evolve their scope, structure, and governance are more than twice as successful as those that do not. Such changes should not be made reactively. There are also times a JV reaches an inflection point or deadlock, and the best move may be for a partner to exit or the JV to unwind.

As with any divestiture, your board should assess whether it is the opportune time to exit the JV or buy out the other partners in light of market factors, the company's long-term strategic plans, and the best interests of shareholders.

▫ ***B. Risk management and ESG.*** *How do we manage risks associated with our JVs, and do we* *have sufficient information to adequately assess such risks? How will ESG considerations from our JVs impact our corporate ESG scores or disclosure, as well as possible future financial performance?*

An important responsibility of a company's board is to ensure that the company's risk management and controls are appropriate and robust. This responsibility needs to extend to the company's JVs, including those not controlled or operated by the company.

For example, at a leading chemical company, the audit committee annually reviews corporate policies, controls, and performance across the company's joint venture portfolio. This review can reveal areas where JV policies, controls, or performance are not up to company standards, or where there are gaps in the information received from JVs.

Most public companies publish codes of conduct and corporate policies that define their operating principles. In many cases, the published policies also cover the company's JVs, and require the company's suppliers and business partners to abide by similar standards and policies. As part of their oversight responsibilities, directors should ask management how they are engaging with their JVs and partners to ensure sustainable and responsible practices on the environment, human rights, health and safety, and community impact.

Boards should understand how JV ESG performance flows up and impacts the company's ESG performance and ratings.

Institutional investors, asset managers, financial institutions, and other stakeholders increasingly look at non-financial data on ESG performance. This data may be included in security filings and public disclosures, as well as gathered and aggregated by independent ESG rating agencies.

In the next couple of years, the amount of non-financial ESG data that needs to flow up from JVs to their parent companies will only increase. For example, both U.S. and European regulators are on track to requiring greenhouse gas emissions data disclosure in financial reports. Material value chain emissions (also known as Scope 3 emissions) from a JV will likely need to be disclosed. Directors should take action to understand how this increased disclosure will impact the company and the anticipated reaction from shareholders and stakeholders.

□ ***C. JV director selection and training.*** *What policy guides the selection of executives serving as JV directors? Is training provided, and expectations communicated? Are JV directors adequate for the demands and responsibilities of the role?*

To start, corporate directors should be more involved in establishing the policies and guidelines used when selecting JV directors. In most companies, identifying executives to serve as JV directors is less thoughtful than it should be. The process itself is typically reactive, a fire drill triggered by a looming vacancy on the JV board.

Too often, the job of finding a new director lands on the desk of a senior company executive, or human resources or legal as an added task in their busy schedules. Rather than a structured process, the easiest and quickest path is to replace a departing JV director with the executive filling the internal role being vacated. In many cases, director selection is a process that the corporate board has no role in and, most likely, no insight into.

Directors are well positioned to challenge the biases that can impact job assignments and promotions. The leadership and professional development opportunities provided by serving as a JV director should feed into a company's broader strategic talent development plan.

A diverse set of JV directors will lead to a diverse pool of potential future senior executives of the company.

JV directors often come from finance and operating backgrounds, leading to underrepresentation of executives with other functional backgrounds, like external affairs and sustainability. Women are also significantly underrepresented—in one specific example, only six percent of all directors on mining industry JVs are women.

A diverse set of JV directors will lead to a diverse pool of potential future senior executives of the company. Prioritizing this is consistent with the board's responsibility for guiding the long-term vision of the company, and nurturing future talent and leaders.

While selecting actual JV directors may encroach on the line that separates governance from management, boards should advocate for a director selection policy that defines the expertise, competencies, attributes, and other factors that would be valuable on a JV board. In addition, such a policy would ensure that the selection of JV directors is consistent across business units and geographies.

Finally, transition and onboarding policies should lay out how to transfer responsibilities and knowledge from the outgoing JV director to the incoming director, as well as the required training. This includes conflicts of interest and how to effectively represent the company's interests.

In conclusion, as companies increasingly incorporate JVs into their long-term business strategy, corporate directors need to ensure that their oversight and governance do not gloss over the opportunities and risks that a portfolio of JVs can provide. Many directors, wary of crossing the line between governance and management, do not ask necessary questions on how the company's JV portfolio is performing.

We think those fears are overblown. Board members should recognize that they are well-positioned to take a long-term view on how a well-run portfolio of JVs can complement and round out the company's strategy, values, and risk tolerance. ■

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Shaping Governance For Startup Boards

By Brad Feld, Matt Blumberg and Mahendra Ramsinghani

While Fortune 500 level corporations attract the world's governance discussion and research, most of these giants began as small venture investments. Today's startup ventures face many challenges—including shaping the early board and governance structures that can help build them into tomorrow's giants.

The first time I, Matt Blumberg, saw the inside of a boardroom, I was the most junior executive at MovieFone, an interactive telephone/media company at the dawn of the commercial internet. The board consisted of the founders, the chairman/majority shareholder (the CEO's father), one of the chair's business associates, and one independent director.

I presented to the MovieFone board several times. Each session was uncomfortable, but I got a lot out of each one. I constantly confronted one question, "Why is your group losing so much money?" I responded each time with an unsatisfying combination of mumbled apologies, while pointing out that other internet businesses were losing much more money.

Even though that was not a winning answer with the MovieFone board of directors, it was a formative experience in my career. By the time I started my first company, Return Path, I felt like at least I had a running start on how to form, lead, and report to my board.

I have learned how to build and run an effective startup board of directors, and realized the immense power of a strong board.

I was CEO of Return Path and chaired its board for two decades. We scaled the business through multiple pivots, acquisitions, financings, divestitures, growth spurts, layoffs, two recessions, 9/11, and the dot-com bust. When Validity acquired Return Path in 2019, we were a vibrant, $100 million revenue, profitable industry leader.

Our board started with two independent directors and me. It grew to a highly functioning board, including three great venture capitalists and two outstanding independent directors. Over two decades, we have had over 15 directors serve on the board. I learned how to build and run an effective board of directors from each of them.

I realized the immense power of a strong board many times, but the most memorable was a board meeting when we were wrestling with several tough decisions since the business was going sideways. These decisions included whether to sell off two business units to focus on our most promising line, even though that meant shrinking the company by over 50 percent. We were also considering whether to expand internationally, and whether we should build an indirect sales channel.

In a long and boisterous board meeting, we charted a bold new course for the business that set us on a path we ended up following to a successful exit a dozen years later. A less functional board could have taken a more conservative approach. The business likely would not have thrived, and might not even have survived.

Today, my new company, Bolster, helps startups, scaleups, and public companies find and recruit talented executive leaders, mentors, and coaches. We help CEOs build their boards and have helped dozens of CEOs think strategically about bringing in independent directors. We help CEOs determine the kind of executives they want to add to their boards.

I took a different approach to building Bolster's

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board. This board has two white men, one black man, and three women, one of whom is Asian-American, one of whom is black, and one of whom is Latina. Four are first-time directors. Three of our investors, who are white men, chose to be board observers rather than take a board seat so we could fill board seats with diverse directors.

I already feel that our board is more powerful and effective than the one we had at Return Path, especially at this stage. This approach is a new way to scale up a board—leveraging excellence through the *observer* roles, while expanding the boardroom's diversity of experience and demographics.

The key question is: How large should your board be, and who should be on it? The size of your board is directly related to the stage and complexity of the company. If you are pre-Series A (Startup), then a board of three is plenty. Once you have raised Series A or Series B (Revenue) funding, a five-person board should be adequate until you raise a later-stage round (Growth), or start thinking about going public. At that point, your board will often expand to seven or nine people. Recognize that these are general guidelines, not specific rules.

Except for founders, boards should only include one management team member—the CEO.

The performance of the board is independent of size. We have been on unruly and ineffective three-person boards and high-octane nine-person boards. Ultimately, the composition and management of the board are more important than the number of people.

While it is not a requirement, most boards have an odd number of directors, which helps address the situation where you have a tie vote on an issue. However, during the 20 years as CEO of Return Path, the company had long stretches with four or six directors, and it was never a problem. The view was that if something came down to a tie vote, they had more significant issues.

Your board will have three different types of directors:

- *Management:* Founders, the CEO, or a management team member who works at the company.
- *Investors:* Institutional investors such as venture capitalists (VCs). These can also be angel investors or a formal or informal angel group.
- *Independents:* People who are neither company management nor representatives of institutional investors, even if they own some stock options or made a small angel investment.

☐ ***Management.*** Except for founders, boards should only include one management team member, the CEO. Since boards hire and fire CEOs, having a management member on the board creates a challenging dynamic. If you are the CEO and Mary reports to you as your VP of revenue, and is also on the board, then Mary reports to you, but you also effectively report to her.

As a CEO, you have a limited number of board seats to fill. Your board members add outside perspective, strategic advice, and a broad network. In contrast, management team members are 100 percent focused on your company, so you already have their daily perspective and advice. Adding a second team member to your board takes away an opportunity to add another outside director who can bring diverse talent and brainpower.

There are several exceptions to this guideline. The first is a co-founder who is still at the company and reporting to you. In the early stages, there may be several founders on the board. As you raise more financing rounds, the board configuration often shifts to a founder seat, and a CEO seat, so if you are a founder/CEO, you may still have another founder on the board.

The other exception occurs later when the founder remains CEO but hires an operating president or COO. Occasionally, this person will get a board seat, especially if they run a large part of the company.

☐ ***Investors.*** Board seats held by investors can be challenging to manage because many VCs believe an essential part of their investment is having a board seat. As you get to later rounds of funding, you often find new investors asking for a board seat, while the earlier investors insist on keeping their existing board seat. As you negotiate this dynamic, you can often persuade investors to have the right to assign an independent director. Alternatively, many later-stage investors will be willing to accept an observer seat. While this may help, the independent director, in this case, is still linked to the VC firm, and an observer still takes up space in the boardroom.

Seth Levine (Foundry, partner) wrote a post citing a study done by Correlation Ventures showing that there are limits to how many VCs you should have on the board:

> "There's value to having VCs on your board. In fact, there's value (or at least a correlation with success) to having multiple VCs on your board. But this value diminishes—and does so rapidly—as you add too many."

"The true role of a board director is governance and holding the CEO accountable, not being a consultant to them."

☐ ***Independents.*** The independent director provides the perspective of a business operator, functional executive, or customer. Brenda Freeman (founder and CEO of Joyeux Advisors) has been a founder, C-level executive, and independent director on early-stage and global, established companies. She provides seasoned advice about her experience.

> "You can be incredibly helpful to a board as an independent director, but your effectiveness depends in part on the stage of the company you're working with and your own skills. When I'm serving on the board of an early-stage company, I'm providing advice based on my functional expertise, but the role requires me to stay at about 10,000 feet. Even though I can provide operational advice, doing so is crossing a line, and the true role of a board director is governance and holding the CEO accountable, not being a consultant to them."

Unless you are focused on controlling the board, try to create a balanced board. Building a balanced board can be challenging since you are simultaneously trying to get the right balance of the three types of directors while also getting a mix of skills and experience relative to your stage as a company.

Over the years, I came up with a simple approach, called the "Rule of 1s," that allows you to be intentional about building and managing your board.

- Build your board purposefully and with independence from Day 1.
- Have 1 member of the management team on your board (the CEO).
- For every 1 investor director, appoint 1 independent director.

While you do not need to follow the "Rule of 1s", and might not be able to if you have a co-founder on your board, it is a great heuristic to manage the development of your board, especially in the later stages of your company when independent directors become even more critical.

Smart founders understand that building a great company is all about the people, and board members are just as important as the early employees.

Not all venture capital board members understand their unique role. Some believe that their job is to provide "adult supervision" to entrepreneurs. We find this language to be pejorative and insulting to entrepreneurs. Some VCs feel the need to manage the CEO and the entrepreneurs. Others cannot help but get involved in minutiae, try to solve emerging problems, and stir up conflict. This type of VC board member gets in the way, confuses the management team, and, in the worst case, damages the startup.

If you seek capital from VCs for your startup, it comes with strings attached, including at least one VC board member. Be prepared to deal with various mindsets and personalities, as VCs are not a singular archetype.

Once you raise the first round of capital, a new set of challenges arises. Investors are looking for substantial financial returns. They want you to make demonstrable progress and achieve certain milestones. They may also be looking for new rounds of financing at higher prices or even quick exits—both of which increase the value of their investment. While some

A Board That Evolves With The Company

The Role Of Board Members At Different Stages

	Startup	Revenue	Growth
Role of Board Member/ Company Needs	**Working/Active**	**Shaping/Nurturing**	**Governing/Monitoring**
Strategy	High	High	High
Recruiting	High	High	High
Customer discovery and market development	High	Moderate	Low
Product development	High	Moderate	Low
Sales and marketing	High	High	Medium
Finance and operational controls	Moderate	Moderate	High
Human resources	Low	Moderate	High

investors may be patient, taking a decade or longer view to helping build the company, others are more anxious to see quick progress.

Often, these investors view the company as partly their own, which is true now that they are investors. Some of these investors are happy to support the entrepreneur. Others have their own view of what the entrepreneur should be doing.

When a term sheet is on the horizon, many founders are ecstatic that the process of raising financing is almost over. At this point, some founders ignore the type of board members that come with the money. Smart founders understand that building a great company is all about the people, and the board members are just as important as the early employees.

"If I was prepping my younger brother on a startup journey, I would tell him to raise money only from those investors who can strategically add value and emotionally connect with you to help you be better," says Jason Mendelson, Foundry partner emeritus.

Choose your VCs wisely. While founders and investors often fret over control issues, Fred Wilson, Union Square Ventures partner points out, "Boards should not be controlled by the founder, the CEO, or the largest shareholder. For a board to do its job, it must represent all stakeholders' interests, not just one stakeholder's interest."

VCs typically conduct a significant amount of due diligence on the founders, the CEO, and the management team before investing in a company. Entrepreneurs should do the same with prospective investors and board members. In assessing fit, entrepreneurs should look at individual attributes while also considering group dynamics. The composition of the board and the interplay between different board members are the first steps in assessing prospective board members.

As you evaluate VCs, pay attention to the following three areas as you explore their firm.

☐ ***Capital.*** Can the VC firm invest across multiple rounds of your company? If unclear, ask the VC you are dealing with how their firm approaches future financings, how they reserve capital for follow-on financings, and whether they require a new investor to lead subsequent rounds. Ask how much capital they have available in their fund for future investments. If VCs are tight regarding capital, that can constrain your ability to grow quickly, and lead to desperate measures by VCs who focus only on their short-term returns and ignore all other shareholders.

☐ ***Firm stability and individual tenure.*** How long have the partners in the firm worked together? Is the partner you are talking to new to the firm? Has there been turnover or changes in the partners at the firm? Instead of relying on articles in the tech press, ask other entrepreneurs for their perception of the firm.

While some of the best VCs are relatively new to the business or junior in their firms, an entire board filled with VCs just learning the business can be a problem, especially in difficult or complex situations. If you find yourself working with a junior partner at a firm, you should insist on having a personal relationship with one of the senior partners and touch base with them a few times a year.

☐ ***Strong portfolio with demonstrated exits.*** A VC firm's future depends on its ability to generate returns. If it lacks a strong portfolio or meaningful exits, it may not be on solid ground. If the firm is struggling, the partners may focus on issues separate or divergent from yours, such as the survival of their firm, interpersonal conflicts between partners, or short-term exits.

The VC firm's financial strength, stability, stature, and individual attributes of the partners all impact your startup. Many CEOs get caught up in the flamboyance of a resume or the historical reputation of a particular partner or the firm. Jaclyn Hester, a partner at Foundry, points out the mistake entrepreneurs make when they seek a famous, superstar board member:

> "You should find the most prestigious and pedigreed board member you can find. But there's so much more to what makes a great board member for you and your company. Some questions to consider include: Do I like and trust this individual? How will this person show up in the boardroom? Does this person bring a relevant perspective? Will this person be responsive, available, and supportive? Will this person tell me the truth?" ■

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A New Strategy Playbook For Boards

By Claudio Garcia

For too long, company strategy has been a topic boards think about, often discuss, but then implement in a half-hearted way. A new, more effective approach is for the board to intelligently discuss its involvement in shaping corporate strategy, its role versus that of management, and how to shape a company strategy adaptable to an era of rapid change.

It is unbelievable that, in an unpredictable and erratic world, many corporations still rely on a regular three to five-year strategic planning cycle as their primary source of interaction with the board about the future. It was almost 30 years ago that Henry Mintzberg's remarkable book *The Rise and Fall of Strategic Planning* questioned companies' focus on strategic planning. Instead, they should pay more attention to the emerging nature of strategy.

This, wrote Mintzberg, is driven by "serendipitous events and recognition of unexpected patterns" that happen as business faces new evolving contexts, technologies, competitors, and consumer habits, if we can mention just a few. Amazon started as an online bookstore and became a large retailer, but currently most of its profit comes from its technology services. This does not look like a planned project.

According to Mintzberg, strategy is "an immensely complex process, which involves the most sophisticated, subtle and, at times, subconscious elements of human thinking." It should "encourage informal learning that produces new perspectives and new combinations."

The last few years have been a significant lesson for corporations in this sense. New disruptive technologies, a global pandemic, supply chain disruptions, inflation, and the "great resignation" are all driving decisive conversations in the boardrooms. These have a substantial impact on the company's direction—not counting how these discussions need to accommodate other relevant priorities for boards, such as ESG agendas, cybersecurity and many others.

Even for companies with a clear, unnegotiable vision, business strategy is becoming closer to a dynamic ride than a deliberate decision. This will significantly affect capital and resource allocations, corporate focus, and value creation (or destruction).

Boards are noticing the shift. In 2020 research by the NACD, directors placed oversight of strategy development and execution among the three key priorities to be improved on for their boards.

But there are still many questions about boards constanly having a hand in strategy, mainly from board members and management teams that want to be active players in a winning organization. What is the board's exact role? What should they be looking at? With what frequency? Where should strategy be housed? Should they have a dedicated board committee?

As there is no one-size-fits-all model, many points should be addressed by boards and management teams about the strategy-setting task. These start by addressing two key dilemmas, followed by structural recommendations critical to giving strategy a suitable place in their agendas.

Even small decisions at the board level can have broad and deep implications on the current strategies in the minds of a management team. Limiting board involvement would make misalignment more prevalent.

☐ ***Boards should augment strategy thinking.*** Boards already have a considerable influence on the strategy of the corporation. This is not because boards are approving strategic plans. Rather, even small decisions at the board level can have broad and deep implications on the current strategies in the minds of a management team. From capital allocation to

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governance policies, strategies can be constrained, diverted, or even eliminated. Conversely, limiting board involvement in the strategy would only make misalignment more prevalent.

This means directors should be at the core of strategy thinking, which can benefit the quality of the decisions and how boards influence the company.

The critical challenge is how to create an environment that supports a continuous, consistent, and aligned interaction around the company's strategy. A fast-paced and changing world will not forgive too much energy lost on the wrong endeavors. Boards can be valuable for strategy, but that would require breaking two common misunderstandings about the role of a board and its interaction with management.

Boards should include directors with relevant experience and knowledge. Ignoring this available wisdom for discussion on strategic possibilities is utterly senseless.

□ *Convincing vs. conversation.* The management team exhaustively and carefully prepares presentations to convince the board on its plans. Sometimes, rounds of rehearsals and reviews are necessary. A perfect meeting is the one in which management delivers a presentation and has all the answers to get board members' consent. For strategic plans, this reality is even harsher.

Boards and management usually get stuck in this dynamic which rarely creates the required trust to jointly navigate through real-world complexity and possibilities.

In a strategic sense, this ritual is actually a large trap. A modern strategy is dynamic, a constantly moving piece, emerging and adjusting itself through possibilities and calculated bets. Strategy-setting requires many different perspectives and points of view to help understand the complexity involved.

Boards are supposed to be composed of directors with relevant experience and knowledge for the company they serve. Ignoring this available wisdom for discussion on strategic possibilities is utterly senseless.

In a "conversation mode," presentations are still required—but they should support the discussion, enlighten blind spots, help understand eventual risks, and nurture new approaches.

Boards still need to feel convinced on the strategy, not by a group "on the other side of the table," but as strategic-thinking partners of management teams on the best prospects to take the company to a subsequent stage.

□ *Oversight vs. learning.* The board activity of monitoring management, and eventual conflict with shareholders is unquestionable. Waves of corporate scandals and regulations have better defined and increased the relevance of this board role.

Some topics challenge the oversight role of boards to avoid unnecessary risks. No industry is static and invulnerable to a fast-changing world. This means that effective adaptability risk should be in the board's best interest.

Many situations companies deal with today are unprecedented. We face a complex mesh of variables with few references from the past. Boards cannot control what they do not know. The board's focus should be on the assumptions that support strategic decisions.

Many areas of board oversight are in regulated or visible control functions. For example, audit committees can identify a lack of compliance with regulation or financial or auditing reporting. Financial committees can identify eventual cash flow vulnerabilities, and boards as a whole can check capital allocation inconsistencies based on agreed decisions.

Still, many of the risks corporations face today come from unprecedented business and social transformation. The pace of technological innovation, for example, has ignited a wave of transformations in business models, products, customers habits, and society. This is compelling companies to consider all these trends at the core of their strategy.

This path is tricky. A successful bet can move the company to the top of the world, but evidence suggests that a large majority fall short. Instead of focusing on the potential results of investments in new areas, the strategic focus should move to oversight of the assumptions that support any major plan, especially when those are in uncharted territories.

Instead of only tracking how much revenue or profit can be generated, boards should focus with management on the essentials of the idea itself. Is there a market-product fit? How much are customers willing to pay for it? How difficult is it to attract and develop the new required skills? What will the adoption curve look like?

With the proper framework, boards can approach strategy decisions with a learning mindset. When they are right (or when mistakes happen), this allows the board to adjust the course.

The recent digital transformation at GE is an effective example. The organization created a whole strategy to become "digital-first" in its industrial business. In this direction, acquisitions were made, talent was intensively hired, and digital and R&D received serious investments.

However, as implementation proceeded, many decisions were made focused on a traditional quarterly profit and loss performance, usually centered on revenue and costs. Only at a later stage in the process did GE conclude that clients were not that comfortable adopting their services. This was a problem that should have been checked in earlier stages of venturing into new paths. Many analysts credit this failure as one of the factors that drove the company's downfall.

With the proper framework, boards can approach decisions with a learning mindset. This strategic approach supports better resource allocation, driven by smartly designed investments that test key assumptions and learn from the experience. When they are right (or, much more common, when mistakes happen), this allows the board to adjust the course before allocating more capital.

The leading strategic mindset should be how to optimize oversight over the cost of learning to evolve the business without risky exposures.

□ ***The setup of a strategic board.*** Many dilemmas associated with a clear separation of board and management roles include strategy. It is not uncommon to see boards defining the boundaries of strategies for the management team. In a few cases they even mandate it, as is the case of some boards with activist investors, or when the company is in crisis mode.

Boards need to be part of the strategy conversation, and not limit themselves to an approval/veto role. Two areas deserve special attention to allow this to happen.

Directors must remain independently able to change their minds and challenge management depending on strategic outcomes.

□ *Strategy ownership.* Boards should not own company strategy. Management, or preferably, the whole organization, should be in charge of it.

There are two reasons. First, ownership is essential to those who will execute the strategy for motivational and accountability reasons.

Likewise, management is closer to the implementation process that results from decisions made through the strategic conversation. Management will have the proper infrastructure and resources to monitor and report on the environment, competitors, and business evolution.

As such, they are better positioned to make quick decisions and adequately conduct dialogue with the board. They can report relevant data on evolution, assumptions, and results, as well as key dilemmas, learnings and competitive movements. On the other side, directors should feel responsible for the right environment to allow that to happen.

Despite its relevance, strategic ownership can lead to protective behavior and resistance to change, which brings us to the second point. Directors must remain independently able to change their minds and challenge management depending on the evolution of the outcomes, when they face relevant new information, or when there are meaningful changes in the company.

□ *Is a strategy committee needed?* One of the main criticisms of traditional strategic planning is that managers do not like to be "ordered" to execute something. They want to be part of the thinking. Strategy planning, as a separate, exclusive process, "reduces managers' power over strategy making," says Mintzberg.

The same reasoning applies to strategic committees. Committees are often used to meet the increasing tactical demands on boards. A *strategy committee* fits well in circumstances that require a high level of attention to a current strategic path facing, for example, imminent business disruption or contextual changes (such as a significant change in regulations). Sometimes boards can assign a few directors with better knowledge in targeted business areas to strategy committees to discuss relevant strategic decisions.

However, if not framed well, strategy committees always carry the risk of demotivation and accountability issues. Leaders in an organization may accept the challenge of executing a given strategy, but that can backfire as they may find inconsistencies when running it, and have little political margin or board availability to quickly shift if required.

Committees can also miss the diversity of points of view that should exist in a well-composed board of directors. Strategy is not a specific problem-solving task. It requires an integrated perspective of the organization. Strategy has evolved into a constant and emerging conversation. It should be one of the most critical points on the regular agenda of boards.

Boards and management are responsible for maintaining companies useful for clients and society in a constantly changing environment. At the core of that challenging endeavor is how the company manages strategy, which should be as dynamic and fluid as the context where it acts.

Boards and management need to frame an approach to strategy that considers its emerging and unexpected nature. They also should outline their relationship to provide for a strategic conversation that leverages the diversity each side possesses, rather than constraining it. This requires a rethink of how each side's responsibility is framed, and setting up the right processes and culture to make it happen.

All these points are challenging in themselves. Unfortunately, the world will not pause or slow down to allow companies to adapt. Fortunately, if done weil, they can increase the odds of a fruitful strategic journey. ■

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In Review

Recent Notes & Events

Audit

FASB standard clarifies fair value guidance for equity securities.

The Financial Accounting Standards Board (FASB) in June 2022 issued an Accounting Standards Update (ASU) that improves comparability of financial information across reporting entities that have investments in equity securities measured at fair value that are subject to contractual restrictions preventing the sale of those securities.

Topic 820, "Fair Value Measurement," states that when measuring the fair value of an asset or a liability, a reporting entity should consider its characteristics, including restrictions on its sale, and if a market participant would take those characteristics into account. Key to that determination is the unit of account for the asset or liability being measured at fair value.

Some stakeholders noted that Topic 820 currently contains conflicting guidance on what the unit of account is when measuring the fair value of an equity security. This has resulted in diversity in practice on whether the effects of a contractual restriction that prohibits its sale should be considered in measuring the equity security's fair value.

To address this, the amendments in the ASU clarify that a contractual restriction on the sale of an equity security is not considered part of the unit of account and, therefore, is not considered in measuring fair value. The ASU introduces new disclosure requirements to provide investors with information about the restriction, including the nature and remaining duration of the restriction.

Boardroom Practice

Boards are experimenting with more independent chairs, more committees, and more meetings.

A report from The Conference Board reveals that boards are increasingly electing independent board chairs. In the S&P 500, the share of independent board chairs increased from 30 percent in 2018 to 37 percent as of June 2022, while the share of companies combining the chair and CEO roles decreased from 49 percent to 44 percent. These changes are not being driven by an overriding wave of shareholder sentiment, but rather by internal governance and business reasons, including an increase in the level and scope of responsibilities of U.S. corporate boards.

Additionally, boards at larger companies in particular are holding more meetings than before the pandemic—a trend likely to continue. Whereas S&P 500 companies held 7.8 meetings on average in 2019, the average rose to 8.3 in 2021. Companies are also experimenting with committee structures to address expanding ESG risks and growing workloads. While public companies with under $5 billion in annual revenue typically have just three committees, larger companies tend to have four or five standing committees. This reflects that larger companies have moved beyond simply satisfying the stock exchange listing standards and other regulatory requirements.

The report also reveals that smaller companies are seeing a decrease in independent chairs with business strategy experience. In the Russell 3000, the share with such experience decreased from 79 percent in 2018 to 76 percent in 2022, and is poised to further decline in the years ahead.

"A likely driver of the rise in board chair independence is the increased workload of boards and management. Both are contending with multiple crises, fundamental transitions in business models, and growing demands for companies to address ESG issues and the needs of stakeholders," said a Conference Board spokesman. "Against the backdrop of increased workloads, CEO succession events—which have recently seen an increase and may remain elevated in the coming years—are often an opportune juncture for the board to reconsider its leadership structure and separate the two positions."

At larger companies, independent chairs with business strategy experience increase. But smaller companies see a decrease, a worrisome trend that may accelerate.

"Having strategic experience is critical for an independent chair in collaborating with the CEO, setting the board agenda, managing board conversations, and serving as a liaison between the board and management," said The Conference Board spokesman. "Even more importantly, that kind of experience is essential in helping to identify from board discussions key opportunities and risks that should be addressed by management and at future board meetings."

The average number of board meetings has decreased since COVID's first year, but levels remain elevated, especially at larger companies. From 2017 to 2019, in the years prior to the pandemic, boards at companies of all sizes met approximately eight times annually on average.

"Expect to see an increased average number of board meetings going forward," said a spokesman for the John L. Weinberg Center for Corporate Governance. "Factors behind the increase include the multiple crises that are unfolding globally (including the ongoing pandemic and war in Ukraine), business challenges ranging from talent management to digital transformation, and increasing regulatory and disclosure burdens in areas such as cybersecurity, climate change, and human capital management."

While larger companies are most likely to have four or five board committees, smaller companies tend to have three or fewer.

In addition to the traditional audit, compensation, and nominating/governance committees, the most common standing committee is the executive committee.

Compensation & Recruitment

Equity compensation plans are a legal contract, says Delaware Chancery.

A May 2022 Delaware Chancery court

opinion serves as a reminder to companies and their boards that shareholder-approved equity compensation plans are contracts, and failing to follow the terms of such contract could result in costly shareholder litigation.

In *Garfield v. Allen,* a shareholder brought claims against the compensation committee of ODP Corporation for breach of contract and breach of fiduciary duty because the committee approved an equity award that violated the terms of the shareholder-approved equity pay plan. Specifically, ODP's equity pay plan included "individual award limits" that restricted the number of shares of common stock that could be subject to awards granted during a fiscal year of the company.

In March 2020, the compensation committee approved performance share awards to the company's CEO which, if earned above the target level, would have exceeded the individual award limits in the plan by approximately 1.2 million shares. A shareholder sent a demand letter to ODP asking it to modify the awards to comply with the limit, and to investigate whether there were additional violations of the company's equity plans. The company responded with a letter telling the shareholder that it would not amend the awards because it interpreted the individual award limits as applying to the target number of shares granted under an award, rather than the maximum number that could be earned if performance exceeded target.

The shareholder subsequently filed a claim against the committee and the board asserting, among other claims, breach of contract since the awards as issued were not in compliance with the terms of the equity plan and breach of fiduciary duties for approving awards in excess of the individual award limits. The defendants moved to dismiss the complaint, and the court denied the motion.

With respect to the breach of contract claim, the defendants contended that the equity plan was not a contract. To the contrary, the court noted that it has previously "held that a stockholder-approved equity compensation plan is a contract between the board of directors and its stockholders." The defendants also contended that a provision in the plan permitted the compensation committee (as the administrator of the plan) to "interpret, construe, and administer" the plan. However, the court found that the defendants could not rely on such language to escape the plain meaning of the individual award limit.

With respect to the breach of fiduciary duty claims, the court declined to dismiss under the business judgment rule, noting that the rule only applies to discretionary decisions that are within the board's authority, but does not extend to decisions that exceed that authority. The court also found fault with the defendants' inaction after receiving the plaintiff's demand letter, noting that "a conscious decision to leave a violative award in place supports [an] inference that the decision-maker acted disloyally and in bad faith."

This case is a reminder to companies (particularly public companies) that shareholder-approved equity plans are considered contracts with the company's shareholders. Failing to follow the plan terms can result in claims against the board for breach of contract and breach of fiduciary duty. Blanket statements in an equity plan giving the administrator the ability to interpret the plan cannot be used to "rewrite" unambiguous terms. As a result, it is important to take the time to read through plans and award agreements in full, to assure that management and the board understand all plan terms to avoid violation, and to respond appropriately to any allegations.

Corporate Responsibility

Financial firms see climate risks as a priority, but are uncertain on analyzing them.

Firms are focused on the financial impacts of climate change, but most are still in the early-stages of effectively modeling and monitoring this risk, according to a survey by Bloomberg. The survey polled over 100 senior executives from financial services firms and corporations around the globe.

The results indicate that firms are aligned on the goal of incorporating climate risk into their broader risk management frameworks for much more than regulatory compliance, but lack consensus on how to effectively manage and report on these risks.

The majority of respondents (85 percent) indicated that their firms have started assessing climate risk, but of that group, 37 percent are in the early stages of planning how to incorporate climate risk into models and governance, and 43 percent are in the mid-stage of incorporating climate into risk management and governance analysis based on measures like carbon emissions. Only five percent of respondents are in the advanced stage of having comprehensive data and multi-scenario analysis based on climate variables like carbon emissions, geolocation data, and extreme weather events.

Regulators are increasingly focused on better understanding the financial risks arising from climate change, and 21 percent of respondents said regulators are the intended top audience for their climate risk analysis. However, a larger number of participants listed senior management as their top audience (27 percent), followed by investors (20 percent), portfolio managers (18 percent), and traders (13 percent). This indicates that climate risk is not just a compliance exercise, but instead a priority for proper risk management frameworks.

When asked about what is driving firms' climate risk considerations in their investment process, regulation and disclosure requirements came in first with 25 percent of respondents. However, the remaining reasons primarily span senior management priorities, including risk management (18 percent), performance (15 percent), reputational risk (14 percent), sensitivity and stress testing (12 percent), and client pressure (9 percent). This further evidences that firms have a variety of reasons for considering climate risk, with regulations being only one piece of the puzzle.

However, there is still a ways to go with embedding climate into risk management frameworks. Respondents were quite varied in what they are seeking from a climate stress test, with 16 percent not knowing what they want. The remaining responses ranged across priorities including climate value at risk (22 percent), valuation impact at different timelines (20 percent), climate adjusted default probability (15 percent), and climate risk scores (15 percent), indicating a significant lack of consensus on how to evaluate and report on climate risk.

When asked about priorities for credit risk management, incorporating climate risk outright is currently the lowest priority (six percent). Instead, the top priorities for credit risk management were listed as generating early warning signals (30 percent), identifying credit risk developments as they may affect counterparties (28 percent), scenario analysis and stress tests (18 percent), and firm alignment on managing credit risks (17 percent). This indicates that firms continue to prioritize other factors over climate in their credit risk frameworks.

"Most firms are at the early stages of implementing their climate risk frameworks, and even those who say they have a robust model will be making significant changes over the next few years as our understanding and consensus around climate risk grows. More and better data will go a long way toward improving firms' ability to manage climate risk," said a Bloomberg spokesman.

Liability & Litigation

Delaware Chancery Court questions independence of some activist directors.

A May Delaware Court of Chancery decision may signal increased scrutiny of the independence of directors repeatedly placed on boards by activist investors, according to a Sidley, Austin client memo.

On May 26, 2022, Vice Chancellor Laster issued the first installment of a two-part decision denying the motions to dismiss filed in *Goldstein v. Denner.* The litigation is grounded in the decision made by the board of directors of Bioverativ, Inc. to merge with Sanofi S.A. In May 2017, Sanofi expressed interest in a transaction to two company directors. These included defendant Alexander J. Denner, an activist investor responsible for placing a number of directors on the company's board. Denner did not disclose the offer to the company's board of directors, but allegedly directed hedge fund entities he controlled (collectively, "Sarissa") to purchase over one million shares of the company's stock, in violation of its insider trading policy.

Plaintiffs alleged that in order to circumvent Section 16(b) of the Securities Exchange Act of 1934, (which requires an insider to disgorge short-swing profits from any sale that occurs within six months of purchase), Denner rejected Sanofi's attempts to purchase the company until the six month short-swing period expired in November 2017. Soon thereafter, the board agreed to the acquisition, allegedly at a price almost one-third below the its standalone long-term planning model.

A stockholder plaintiff subsequently filed suit, alleging breaches of fiduciary duties by failing to make requisite disclosures; approving, falsifying, and omitting material information from key documents related to the transaction; and failing to secure the highest value for stockholders in favor of the board members' own self-interest. The complaint further charges that Denner engaged in insider trading, and that Sarissa aided and abetted this breach of fiduciary duty.

Although Part I of the Vice Chancellor's motion to dismiss discusses numerous issues, of particular note is the focus on whether directors acted independently of Denner in authorizing the transaction. The court explained that the receipt of past directorships and access to a steady flow of future board opportunities (such as those from activist investors) may be sufficient to compromise a director's independence.

Plaintiff alleges that four board members were beholden to Denner, and, as such, were not independent from him. The court rejected the claim for two board members, but other independence allegations presented a "close call." One director had previously supported and financially benefited from a similar transaction Denner had orchestrated. Less than two weeks later, Denner appointed that same director to a position on Bioverativ's board. The court held that, when viewed in tandem with Denner's "practice of rewarding directors with other lucrative directorships on other Sarissa-affiliated boards" and the sale terms, the allegations were sufficient to support a reasonable inference that the director was not acting independently of Denner.

Similarly, the court ruled that a board member who was unemployed prior to Denner's securing him a seat on the Bioverativ board, and who was also placed on an additional board by Denner which resulted in a $3 million gain, was not independent. Thus, the court ultimately found that at least half of the six-person board, including Denner, was either potentially interested in the transaction or lacked independence.

The court held that these facts allowed plaintiff's claims to survive the pleading stage. Still, the opinion emphasized that:

"Outside of a Rule 12(b)(6) motion in a case governed by enhanced scrutiny, it is unlikely that a similar constellation of facts would be sufficient to overcome the presumption of good faith or to call a director's independence into question… Nor is it clear that the same constellation of facts would render [the board member] non-independent for purposes of rebutting the business judgment rule and causing entire fairness to apply."

The top cybersecurity challenge is weak risk identification.

Skybox Security has released findings from a cybersecurity benchmarking study of global executives. The research reveals that traditional security approaches that rely on reactive, detect-and-respond measures and tedious manual processes cannot keep pace with the volume, variety, and velocity of current threats. As a result, 27 percent of all executives and 40 percent of chief security officers (CSOs) say their organizations are not well prepared for today's rapidly shifting threat landscape.

On average, companies experienced 15 percent more cybersecurity incidents in 2021 than in 2020. In addition, "material breaches"—defined as "those generating a large loss, compromising many records, or having a significant impact on business operations"—jumped 24.5 percent.

The top four causes of the most significant breaches reported were:

☐ Human error.
☐ Misconfigurations.
☐ Poor maintenance/lack of cyber hygiene.
☐ Unknown assets.

"What's notable about this list is that all of these conditions result from mistakes or manual processes inside organizations—which means they are all in principle avoidable," said a Skybox spokesman. "With the right practices and tools—including automation to maximize efficiency and get the most out of limited staff—breaches can be prevented."

Though organizations, on average, saw a significant uptick in incidents and material breaches in the past two years, a distinct subset had few or no breaches at all. The researchers found that firms with fewer breaches were different from the rest in two fundamental respects:

☐ Companies that prevented breaches ranked higher in cybersecurity progress as measured by the NIST framework. The framework, developed by the National Institute of Standards and Technology, provides guidelines that help companies evaluate and improve their cybersecurity maturity in activities such as detecting and responding to incidents.

☐ Beyond the NIST framework, those with no breaches took what the researchers call "a risk-based approach" to cybersecurity. Forty-eight percent with no breaches in 2021 had implemented risk-based cybersecurity management strategies.

Looking more closely at the ingredients of a risk-based approach and the specific practices that distinguish risk-oriented firms from their less proficient peers, the benchmark study found that risk-based leaders excelled in key areas beyond the NIST framework, including:

☐ Attack surface visibility and context.
☐ Attack simulation.
☐ Exposure analysis.
☐ Risk scoring.
☐ Vulnerability assessments.
☐ Research (threat intelligence).
☐ Technology assessments and consolidation.

The business impact of successful risk-based security management—versus the old *status quo,* detect-and-respond approach—is measured in this research. By preventing or mitigating breaches, risk-based methods could have saved companies millions of dollars annually and prevent untold damage to reputation, customer trust, company morale, and market standing.

Said a Skybox spokesman, "at the board level, leaders want to understand their risk profile rather than how many vulnerabilities were patched each month. CISOs need to validate and report on how they're taking measurable, active steps to reduce risk systematically and reduce the financial impact a breach could have on their company."

Strategy & Finance

Corporate ESG strategies will demand long-term commitments.

Companies around the globe have made earnest, often specific, commitments to environmental, social and governance (ESG) goals, but are struggling to meet them.

Among the barriers they face are divisions within the leadership team over how to balance short-term business and financial priorities with long-term ESG objectives, lack of processes and capabilities to build ESG programs, disconnects in strategy, product and service portfolios and supply chains, and internal cultures that are out of alignment.

Aligning incentives and creating executive pay programs to support ESG is another significant challenge. Designing and executing effective ESG programs will require major rethinking of all these barriers and issues, in particular, greater internal consensus on the tradeoffs ESG and sustainability objectives require.

Those are among the findings of the *Global Corporate Sustainability Survey 2022,* a major survey of 400 C-suite executives in the U.S., Europe and Asia and report by global strategy consultancy L.E.K. Consulting, in conjunction with Longitude.

"Companies are willing, for very sound business and societal reasons, to become more sustainable, but they're not fully ready, and far from able at a senior executive and board level, to deliver against those ambitions," said an L.E.K. spokesman.

Sustainability and ESG have significant momentum in the private sector. More than 700 of the largest 2,000 publicly traded companies have claimed net-zero commitments; 60 percent of the FTSE 100 have committed to net zero by 2050, and two-thirds of the S&P 500 have emission reduction targets.

Most companies with ESG commitments see them as far more than just ways to be compliant and reduce certain risks. According to the survey, 51 percent of organizations are approaching ESG as a growth driver, and a further 20 percent focus on it in the context of innovation.

In fact, 51 percent of executives agree that their company should address ESG issues—even if doing so reduces short-term financial performance with 54 percent of executives from publicly-listed companies confirming this position.

Yet a fundamental challenge companies must overcome before meeting ESG goals is achieving internal consensus on handling the tension between short-term priorities and investments for sustainable growth. Indeed, 58 percent of executives said there are "significant differences of opinion within the leadership team" on balancing short-term priorities with long-term ESG goals. "Analyzing financial and non-financial benefits of the strategic choices to achieve ESG goals is a tall order. It means quantifying non-financial benefits in a way that allows for careful strategic choices to engage fully in ESG," the spokesman said.

Aligning is also difficult because of the range and complexity of the risks associated with ESG and sustainability. These include:

☐ *The cost of energy transition,* supply chain sustainability commitments and regulatory compliance.

☐ *Finance-related areas,* including stranded assets with lowered value, ESG ratings, which are yet not standardized nor consistent, and pressure from activist investors.

☐ *Reputation-related,* which includes consumers' increasing sophistication, "cancel culture" targeting corporations and talent and retention issues related to perceptions of about a company's ESG stature.

Part of the challenge is the lack of metrics or key performance indicators (KPIs) to track progress toward ESG goals. Only a quarter (27 percent) of companies have any enterprise wide ESG KPIs in place, and fewer still have a full set in place (just 3 percent), according to the survey. Without such metrics, companies will continue to struggle to align executive pay with ESG targets.

The survey asked executives to select those challenges that may be affecting their ability to achieve their sustainability goal. Thirty-four percent selected "lack of strategic alignment across key stakeholders;" 33 percent selected "leadership team unaligned on what ESG ambition should be;" 33 percent selected "lack of relevant capabilities/skills for clear decision-making and accountability," and 33 percent selected "lack of the right culture/mindset."

When asked about areas where their organization is least prepared to deliver on ESG goals, 43 percent cited "reward and incentives frameworks" and 40 percent selected "the right culture, including tone and engagement from the top." Among other findings:

☐ 79 percent of executives said the company has more to do to put the required skills and capabilities in place to deliver sustainability goals.

☐ 59 percent said their company has not made substantial progress in understanding the financial risk and financial opportunity posed by climate.

☐ 54 percent said their company has not made significant strides in integrating ESG factors into the way the company allocates capital.

☐ 48 percent said they do not think their company's current product and service portfolio meets the needs of a more sustainable future.

Retrospectives

Twenty years ago in The Corporate Board. We cannot count on changes in corporate governance to substitute for needed reforms of the accounting and auditing disciplines. After all, most boards of directors are (and should be) collegial bodies closely attuned to, and sympathetic with, the chief executive officer. They are necessarily havily dependent on mangement for information. Their independence and experience is invaluable, particularly on strategic issues and organizational questions. However, their attitudes and talents are not those of a skeptical auditor, acting at arm's length in the interest of the investment community.

—Paul Volcker,
Finally, A Time For Audit Reform,
September/October 2002

Ten years ago in The Corporate Board. Many boards are too large to operate effectively as decision-making groups. Boards often lack the requisite industry experience. Finally, few directors devote the time and effort necessary to truly understand the company's complex activities and monitor new developments.

—Robert C. Pozen,
Toward A New Culture For
Corporate Boards,
September/October 2012

Books Received

The Virtual Leader: How to Manage a Remote Workplace. By Takako Hirata. BenBella Books. $21.99. By 2025, up to 70 percent of the global workforce will put in at least some remote work time. Here are the rules managers are learning on leading, motivating and team building when staff are out of the office.

The Man Who Broke Capitalism: How Jack Welch Gutted the Heartland and Crushed the Soul of Corporate America—and How to Undo His Legacy. by David Gelles. Simon & Schuster. $22.99. GE's Jack Welch was a management icon of the 1980s, but the author tasks Welch's tactics of focusing on stock price, downsizing and "financialization" with long-term harm both to GE and the American economy.

Spoken & Written

Articles & Speeches

When I joined a large bank board, I was used to being an expert in my field, oftentimes one of the smartest people in the room. But when I went to my first board meeting at the bank, I had no idea what they were talking about. I did not understand any of the acronyms. It was like being dropped into a foreign country, and it had been a very long time since I had felt like the dumbest person in the room. It took me a while, and I worked hard. I met with people outside the boardroom to learn and find a way to add value based on my experience.

—Linda Hudson,
The Cardea Group

Breaking up [conglomerates] is happening because a generation of top executives is less wedded to the idea of a conglomerate and suffers from FOMO (fear of missing out)--the observation that the conglomerate is missing out on investors' tendency to drive up the prices of more focused companies to much higher levels.

Conglomerates were very late to do something about their conglomerate discount. I am sure they were aware of the arguments in favor of breaking up, but they resisted doing anything about it. There are many possible reasons top executives delayed. They convinced themselves that the divisions were more valuable together than broken up; they feared a low sale price for the divisions they would jettison; or that overseeing a smaller portfolio would make them feel less important.

—Peter Cohan,
Babson College

It's our day job just to study the company. And then, when you join a board, you bring new information to the room. So we come into the room with our own information, we learn from them, they learn from us, and then working together, we get it right.

Because you also have these biases. You're like, "That business is the bad business. It needs to be spun out." Then you get in the room and the business you thought should be spun out needs more investment rather than less investment. It is a two-way street.

-—Jeffrey W. Ubben,
ValueAct Capital

I have yet to be in a venture-backed board meeting that hasn't felt hostile. And hostile doesn't necessarily mean it's wrong. It means that people have a fiduciary responsibility to provide a return for the capital.

—Dan Rossignol,
JKURV

Our activism is a way to really get to know our companies well, and doesn't an investor want to know what's underneath the hood or inside that battery pack? Whatever the metaphor is that we're using these days, I do see that change does happen one conversation at a time. When they're not listening or responding as quickly as we need, we do use shareholder activism.

—Kristin Hull,
Nia Impact Capital

When we think about how we can address our carbon footprint, a lot of it's through nature-based solutions. It's beyond just the greenhouse-gas measurement, it's around the availability of water, it could be the soil profile, how you approach land use in terms of rotation of crops, that type of thing. I think the underlying principle is that this should be ultimately an integrated disclosure, because there's a very strong interconnectivity and dependency between nature and climate.

—Alison Bewick,
Nestlé SA

AI is sometimes able to infer sensitive information from public or seemingly innocuous data. Which means that privacy laws that rely upon dichotomies such as public vs. private, ordinary vs. sensitive, or personal vs. nonpersonal are becoming outdated.

—Ryan Calo,
University of Washington

The coordinated [ESG} effort to depress oil and gas production is potentially a violation of American antitrust law. This combination of bad policy and legal risk will likely prove too much for profit-minded ESG supporters, and the movement will lose much of its support.

—Sean Fieler,
Equinox Partners

When Americans discuss our shared past freely, coming independently to moral conclusions, we open the door to real and lasting progress. Young people in the next generation must learn that they are agents of their own uplift and that they do not need to wait for an external force to rescue them. If our children lack models of excellence and inspiring stories to which they can connect, then we have lost what education should be about.

—Robert L. Woodson, Sr.,
Woodson Center

[In negotiating], one thing I like to do is instead of asking people where are you most flexible, ask them, where are they least flexible? And that will tell you what it is they can't do. And it also tells you all the other things that you can ask for. I like to say to people: Try "yes, if," rather than "no, unless."

—Barry Nalebuff,
Yale School of Management

Workers of a certain age and attitude will have to reckon with the coming recession. Rising inflation and a market downturn guarantee layoffs. The days of expecting employers to be grateful for your application will be gone soon. People who started work in the past dozen years are about to experience their first tough job market.

—Daniel E. Greenleaf,
Modivcare Inc.

Directors' Register

Recent Board Elections

Academy Sports and Outdoors, Inc. has elected to its board ***Theresa E. Palermo,*** senior vice president, connected commerce and marketing at Signet Jewelers Limited.

Acuity Brands, Inc. has elected to its board ***Marcia J. Avedon, Ph.D.,*** former executive vice president, chief human resources, marketing and communications officer for Trane Technologies PLC.

Alphabet Inc. has elected to its board ***R. Martin Chávez,*** former partner and vice chairman of Sixth Street Partners.

American Electric Power Company, Inc. has elected to its board ***Donna A. James,*** managing director and founder of Lardon & Associates, LLC.

Amgen Inc. has elected to its board ***Michael V. Drake, M.D.,*** president of the University of California.

Archer-Daniels-Midland Company has elected to its board ***Jim Collins,*** former chief executive officer of Corteva.

Campbell Soup Company has elected to its board ***Bennett Dorrance, Jr.,*** managing director for the DFE Trust Company and co-founder of the Kohala Institute in Hawaii.

The Coca-Cola Company has elected to its board ***Carolyn Everson,*** former former president of Instacart and former vice president, global business group, at Facebook.

Conagra Brands, Inc. has elected to its board ***Denise A. Paulonis,*** president and chief executive officer of Sally Beauty Holdings, Inc.

Danaher Corporation has elected to its board ***Feroz Dewan,*** chief executive officer of Arena Holdings Management.

Dollar General Corporation has elected to its board ***Ana Chadwick,*** executive vice president and chief financial officer of Pitney Bowes Inc.

Dominion Energy, Inc. has elected to its board ***Kristin G. Lovejoy,*** global security and resilience practice leader for Kyndryl Inc.

Eastman Chemical Company has elected to its board ***Eric L. Butler,*** former executive vice president and chief administrative officer of Union Pacific Corporation.

General Mills, Inc. has elected to its board ***C. Kim Goodwin,*** former managing director and head of equities at Credit Suisse's asset management division.

The Hanover Insurance Group, Inc. has elected to its board ***Elizabeth A. Ward,*** chief financial officer of Massachusetts Mutual Life Insurance Company.

Intel Corporation has elected to its board ***Lip-Bu Tan,*** executive chairman of Cadence Design Systems Inc.

JPMorgan Chase & Co. has elected to its board ***Alex Gorsky,*** executive chairman of Johnson & Johnson.

L3Harris Technologies, Inc. has elected to its board ***Christina L. Zamarro,*** vice president, finance and treasurer at The Goodyear Tire & Rubber Company.

Lowe's Companies, Inc. has elected to its board ***Scott H. Baxter,*** president and chief executive officer of Kontoor Brands, Inc.

NorthWestern Energy has elected to its board ***Kent T. Larson,*** former executive vice president and group president with Xcel Energy.

Nucor Corporation has elected to its board ***Michael W. Lamach,*** former executive chair of Trane Technologies plc.

Phillips 66 has elected to its board ***Gregory J. Hayes,*** chairman and chief executive officer of Raytheon Technologies Corporation.

Regions Financial Corp. has elected to its board ***Mark Crosswhite,*** chairman, president and chief executive officer of Alabama Power Company, ***Noopur Davis,*** corporate executive vice president and chief information security and product privacy officer for Comcast, and ***Tom Hill,*** chairman, president and chief executive officer of Vulcan Materials.

Stanley Black & Decker, Inc. has elected to its board ***Robert J. Manning,*** former chairman and chief executive officer of MFS Investment Management.

Target Corporation has elected to its board ***Grace Puma,*** former executive vice president and chief operations officer at PepsiCo.

Tractor Supply Company has elected to its board ***Andre Hawaux,*** former executive vice president, chief financial officer and chief operating officer of Dick's Sporting Goods.

Wabtec Corporation has elected to its board ***Beverley Babcock,*** former chief financial officer of Imperial Oil Limited.

Westrock Company has elected to its board ***Dmitri L. Stockton,*** former chairman, president and chief executive officer of GE Asset Management.

Xerox Holdings Corporation has elected to its board ***Philip Giordano,*** founder and chief investment officer of Livello Capital Management.

Zoetis Inc. has elected to its board ***Vanessa Broadhurst,*** executive vice president, global corporate affairs at Johnson & Johnson.

Conversations

Christine Spadafor: Boards In A New Era

For two and a half years, corporate boards worldwide have faced crisis after crisis. This includes demands that they improve their oversight of environmental issues, racial equity and diversity, all while dealing with the turmoil of Covid. After putting out a seemingly endless series of fires, how are boards coping with this newly diverse, demanding and uncertain corporate world?

Christine Spadafor has a few answers based. CEO of SpadaforClay Group management consultants, she counsels boards and managers on governance and strategy issues. She also brings current boardroom knowledge as an independent director with Boyd Gaming, Intus Care, and Kindred at Home.

The Corporate Board: How have boardroom topics evolved since 2020?

Christine Spadafor: The agenda of meetings has definitely changed, especially around ESG topics. For one of my boards, it's a standing agenda item, with reporting through the nominating and governance committee, which I chair.

Diversity, equity and inclusion [DEI] are also high on the agenda. We need to understand that D doesn't always equal E or I. Boards can focus on the numbers, X percent women, X percent people of color, but not question how that translates into I—inclusion. Diversity is like being invited to the dance, but inclusion is being asked to dance. DEI goes far beyond the numbers. Some organizations may think that numbers are sufficient, but company culture dictates how deeply employees get into the inclusion aspect, and boards have a responsibility to look at that.

TCB: How does the board monitor DEI and ESG on a functional basis?

Spadafor: On one of my boards, at every meeting we have an ESG report with metrics. For oversight, we monitor against those metrics. If you assure the right metrics are in place, then it becomes easier to advance progress on those metrics. You also need the person who's ultimately responsible for monitoring to come in and report to the board at every meeting. We see the percentage of women, of underrepresented groups, what percentage are in the C-suite and in management, and so on. It's also important to have a pay equity analysis done.

TCB: How well is diversity advancing in the boardroom?

Spadafor: We monitor our boards the same way we monitor our workforce—gender, ethnicity, race, diversity of thought, and maybe geography, depending on company distribution. In recruiting, those need to be part of our analysis. In addition, cultural fit is important on the board. You want someone who is a good team player, who won't try to take up the whole room, and is career minded. They need the ability to think strategically, and look at differing, sometimes complex, points of view.

TCB: What about recruiting board members to meet new needs?

Spadafor: There are some best practices I've seen across my companies. At one, we have a process in place to assure the CEO isn't just picking friends.

The chair of our audit committee was retiring, so we needed a replacement. We started by updating our board capability matrix. The CEO and independent board members talked about the board talents the company would need going forward. Then we reached out, both within the board and outside for talent. We assembled a list of 28 people, and shared their resumes with the nominating/governance committee. We reviewed them all, and selected six finalists.

At that point we had a conversation with the CEO and board chair. The CEO wanted to include another of the 28 candidates with audit background. Following interviews with the finalists, our committee deliberated and ranked them, anonymously, on a rating sheet. It was pretty unanimous who our number one and number two candidates were. We added the top prospect to the board, and it's worked out great.

TCB: What about orienting new board members?

Spadafor: One thing that's overlooked is having structured onboarding for new members. An existing board member should be a mentor to help the new director get acclimated. Also, the new board member should have a structured set of conversations with the CEO, executives and other members to learn about the organization.

A board orientation book is also helpful, including a map of all company locations, all committee charters, minutes for the past 12 months, corporate governance guidelines, conflict of interest guides, etc.

TCB: How have remote board meetings worked for your boards?

Spadafor: My boards have all worked fine remotely, though we missed being together, of course. I find it's important for the board to have dinner together, and share social time. That doesn't happen when you're out of the boardroom. While we missed being together, that hasn't made us any less effective—everyone adapted. I didn't find our committee work or duties derailed either. We continued work without interruption.

TCB: Any other changes you've seen the past few years for boards?

Spadafor: I find that supply chain issues are now a conversation topic in boardrooms, and also the new war for talent. Trying to recruit and retain is quite different than it was a few years ago. People were in the office working 9 to 5, and then suddenly they weren't, and some CEOs and managers are having problems with that.

I work with a CEO who really wanted everyone in the company in the office and in their seats. Then Covid hit, and he had to adjust. Now, no one is more surprised than he is how well it has worked out—some people working at home, some hybrid, and some in the office depending on role. That shows flexibility and open-mindedness,. That's something employees are now demanding. ■

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There is enough light for those who only desire to see, and enough obscurity for those who have a contrary disposition.

— Blaise Pascal