What to do about the 'opportunity-cost' director

The termination of marginal directors will be one of the most important governance issues in the years ahead. **BY DENNIS C. CAREY AND THOMAS J. NEFF**

SHAREHOLDER RIGHTS groups are likely to make the termination of nonperforming directors their cause célèbre of the new millennium. The "CIAO test" is becoming the new buzzword in corporate governance, referring to shareholder demands for director commitment, independence, attendance and ownership. But, unlike some other initiatives by shareholders in recent years, one of their allies might be CEOs themselves (albeit perhaps for different reasons than the CIAO test) — i.e., those CEOs who often feel like they lack the tools to force poor directors off the board.

The termination of directors "for cause" raises thorny corporate governance issues. Most boards in the U.S. are not culturally disposed to deal with director termination. Further, our governance system is structured so that directors are there to protect shareholder interests: If their view of what is best differs with the CEO's, thereby undermining a productive relationship, can't action against directors be potentially damaging to shareholder interests as well?

Other questions beg for clear answers. Who initiates the termination process? Should it be the CEO as chairman of the board? Should it be the chairman of the corporate governance or nominating committee? Should be it be a lead director? What criteria should be used to

There are no elegant solutions to dealing with a nonperforming director.

— Dennis Carey

determine the adequacy of a director assuming he or she meets all the requirements of the CIAO test but is simply disruptive, non-value adding, or out of sync skill-wise with the future direction of the company? And, who holds the "score card" on what in most cases is a judgment call?

Inheritance problem

Complicating the issue further is the fact that every new CEO inherits the board from his predecessor. Unlike a new President who, when taking office, can name his own Cabinet, a CEO must work with a group selected by someone else. And, in cases where a new CEO has been recruited from the outside to take the company in a new direction, the skill set around the board table may better fit a past strategy than a new one.

Case-study tales of director termination are few and far between, but there are a few examples to learn from or be humored by.

• A former CEO of a Fortune 10 company told us recently that one of the most difficult things he had to do as chairman of the board was to remove a director. (Serving simultaneously as CEO, he notes, is not at all helpful in this initiative). He related the story of one of his worst directors who appeared to be suffering from severe memory loss. Although the director attended every meeting, he was indeed Alzheimer-prone. The CEO's strategy was simple and effective: He hosted a surprise retirement party for the director and thanked him for his service.

• In 1995, Al Dunlap used a different method when appointed as CEO of Scott Paper Co. He simply interviewed all of his directors and summarily dismissed three of them who he believed didn't fit and replaced them with three of his choosing.

• A Nasdaq-listed company last year fired an underperforming director after the director urged the board to consider a date and location change for its annual retreat...and then failed to show after the board acquiesced to his wishes.

Dennis C. Carey is vice chairman, and **Thomas J. Neff** is chairman, of Spencer Stuart U.S. Both specialize in board of director and CEO-level recruitment.

The excuse for the no-show was deemed insufficient.

• A NYSE company last year performed a self-evaluation of directors. After the evaluation, a director submitted his resignation when he deemed himself inadequate.

The reality, though, is that director termination is as rare as a snowfall in downtown Phoenix. Many CEOs we talk with have at least one nonperforming, underperforming, or "opportunity-cost" director on the board. Some directors, they say, are simply relics from days gone by when the company was very different. Others simply are not compatible with the CEO for reasons unrelated to business objectives and strategy.

Systems lacking

What is a CEO to do? How can a CEO face the challenge of firing a boss? Given U.S. business culture, which tends to blend the responsibilities of chairman and CEO, the buck on this one usually rests with the CEO.

Boards across the country have adopted a variety of practices and governance policies to address the issue of director performance. However, very few have implemented systems to tackle the issue of termination, and, unfortunately, most of the attempts to do so are superficial and ineffective.

The assumption of lifetime tenure for directors is almost implicit in the way the system is set up. Once a director is selected by the CEO (and, undeniably, that is who selects), a director is normally cycled again and again through continuous renewable terms. Unless challenged by vocal shareholders to be "de-elected," which is rare, almost every director placed in nomination and/or put up for re-election is approved. CEOs and directors are for the most part simply passive observers to this ritual.

Litmus tests

In the 1980s, many boards began to address CIAO test-related issues, inaugurating litmus tests for board attendance and share ownership. Our data from the Spencer Stuart Board Index (SSBI) annual survey reveals that approximately 15% of boards in 1980 had attendance requirements. This rose to 37% by 1995.

In 1980, virtually no boards in the Fortune 100 had set stock ownership requirements. This rose to 13% by 1995. Some boards have even begun to require significant thresholds for ownership as a condition for acceptance to the board. *(Editor's Note: See separate story on page 55.)*

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Pressure is also mounting to ensure director commitment by limiting the number of boards on which directors serve. Although impossible to link number of boards to definable levels of commitment, most of our clients are excluding board candidates who already serve on two or three boards in addition to their own. In fact, by 1995, 15% of the Fortune 100 had placed limits of two to three boards in their governance policies.

The independence element in the CIAO test is being partially addressed by boards by changing the mix of director pay from cash and benefits programs, which often resemble employee-based systems, to shareholder-responsive systems. The elimination of retirement benefits, consulting fee arrangements, and other benefit programs is rapidly accelerating: 14% of the Fortune 100 dropped such plans in 1995, and the trend continues.

Beyond the CIAO test, more boards are adopting: (1) mandatory retirement age limits (SSBI data show 85% have now adopted such limits); (2) change-of-status requirements (28% have adopted requirements for directors to submit their resignation if their employee status changes); and (3) governance guidelines which define director responsibilities and expectations. Such initiatives have provided useful tools for CEOs and boards to force the issue of rotation and director "relevance."

The big issue

However, none of these steps necessarily addresses the question of terminating a director "for cause." Ridding a board of members who no longer add value, are disruptive, or are viewed as less valuable to the enterprise than other available alternatives is for most CEOs the real issue going forward — and the toughest to tackle.

A significant movement to evaluate the performance of boards has emerged to address some of these concerns. Our SSBI survey reports that approximately 80% of boards are now implementing some form of evaluation. However, closer scrutiny reveals that few of these boards use such systems to evaluate the performance of individual directors. Until this practice is institutionalized, CEOs will continue to have a difficult time building a case with the board to terminate a poorly performing director. And, unless the CEO has a preponderance of effective directors already, the standards for performance are skewed in the wrong direction.

Even if a board has an effective performance evaluation system, which importantly includes core competencies for directors, CEOs still face the dilemma of how to act on the data should it be negative. What to do if a director is "simply okay but not great"? (And what happens if the CEO and board disagree on the