

Board Effectiveness Insights

Chapter 9 / Version 1.0

October 2007

Board Effectiveness Insights

We publish *Board Effectiveness Insights* periodically to encourage dialogue on strengthening director and board effectiveness.

Our readers are encouraged to pass this *Insights* chapter along to others, or to contact us for additional copies in printed or electronic form.

Previous chapters:

Chapter 1 – A Roadmap:
Strengthening Corporate Governance

Chapter 2 – A Methodology:
Strengthening Board Effectiveness

Chapter 3 – Identifying and
Mitigating Corporate Risk

Chapter 4 – Strengthening Healthy
Boards

Chapter 5 – Director Compensation

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Chapter 7 – The Lead Director . . .
A Controversial and Evolving Asset

Chapter 8 – Role of the Board in New
CEO Success

DIRECTOR INTEGRITY

“*We never believed that something like that would happen on our board,*” is a sentence we have heard too many times from directors caught in a media and shareholder firestorm over lapses in director integrity.

“*We had complete trust in our director colleague, and even spent a great deal of time together developing our code of conduct,*” is another sentiment we have heard, delivered in disbelief over a breach of confidentiality or during a conflict-of-interest controversy.

Solutions are frequently hampered by semantics. What is meant by “*independence,*” “*conflict of interest,*” “*in the best interest of all shareholders,*” and even “*integrity*”? The words themselves launch fervent debates. In addition, a code of conduct, laws, and regulations have little impact on someone who lacks a common frame of reference for honest and ethical behavior. Detection and enforcement are clearly challenges.

One director commented: “*If a director does not agree with company strategy, and feels that his only avenue to influence change is to take a confidential issue outside to the media and embarrass corporate leaders, the board has a much bigger problem than a code of conduct is designed to address.*”

Too often, organizations’ executives and directors find themselves doing damage control after failing to proactively implement effective processes to address director focus and integrity. This chapter of *Insights* outlines Board Effectiveness Partners’ (BEP’s) recommendations for managing the risks more effectively and implementing proactive measures.

Following board effectiveness disasters in 2006 involving high-profile companies, we reflected on our management consulting experience improving director and board effectiveness. We also conducted interviews with more than a dozen seasoned directors and governance thought leaders, some of whom are listed on pages 6-7. Collectively, BEP was able to consider the successes and disappointments with director integrity, focus, and conflict of interest at over 50 large and small corporations.

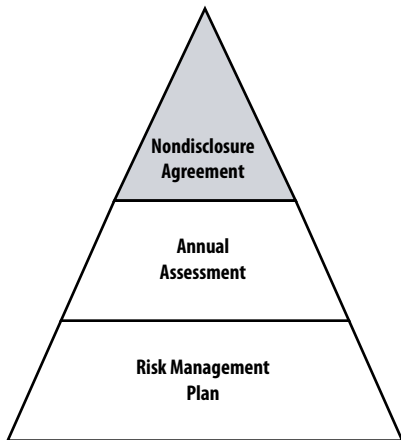
Our recommendations for immediate board action encompass three areas:

1. **Annually, directors should re-sign a nondisclosure agreement to attest in writing that they do not have conflicts of interest.**
2. **Annually, director and board effectiveness assessments should include a confidential review of directors’ concerns about focus, competence, integrity, and possible conflicts – their own and those of colleague directors.**
3. **Proactively and reactively, prepare to address breaches in the same way organizations deal with other risk management challenges.**

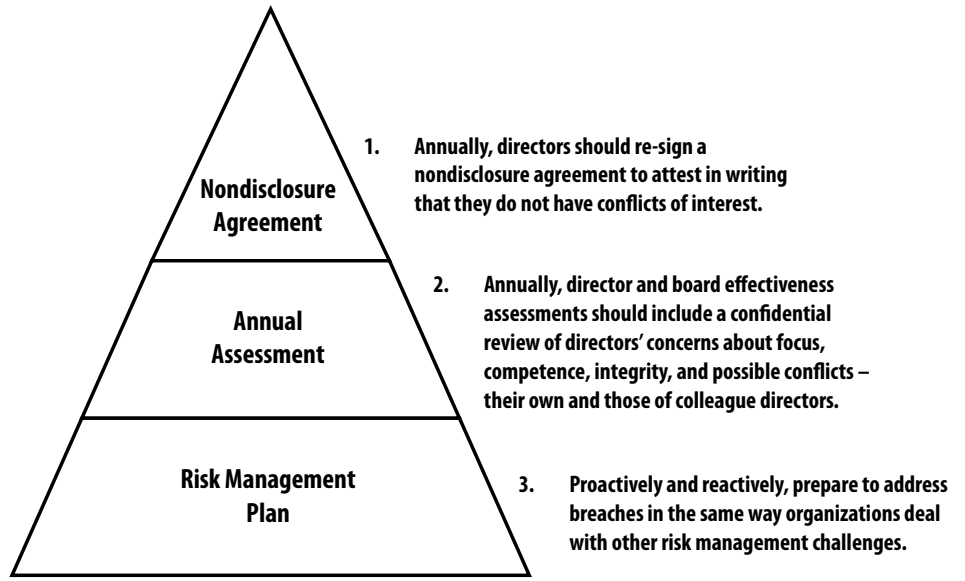
October 2007
Director Integrity

In addition to the original group of experienced board leaders interviewed for this chapter, we sent an early draft to an expanded group of 30 peer reviewers.

A selection of peer-review comments has been included in the following pages.



Recommendations for Immediate Board Action



1. Annually, directors should re-sign a nondisclosure agreement to attest in writing that they do not have conflicts of interest.

Insist that directors attest annually, in writing, that neither they nor members of their family in any way have, or could, personally gain from decisions they make as directors.

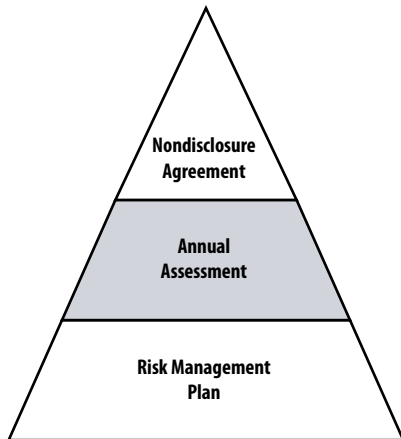
Additionally, directors should attest annually, in writing, that they have not shared confidential company information with anyone other than their fellow directors.

As part of this process, directors should affirm their agreement to resign immediately as an independent director if they have a conflict of interest or if they inappropriately share confidential company information.

This process does not guarantee that unscrupulous individuals, or directors not wishing to incriminate themselves, will not lie on their forms. However, this process can provide a level of damage control for other directors and management should the actions of one director come into question.

There are a host of circumstances that could pose a potential conflict of interest or provide opportunities for personal or family financial gain from board service. Therefore, the board orientation program and an annual training session for directors should include thoroughly exploring circumstances that could constitute conflicts of interest or compromise integrity.

The annual training session for directors should include a discussion of responsibilities to shareholders, "horror stories" that occurred at other companies, and the impact on insurance coverage of director breaches of conduct or confidentiality.



In terms of context, BEP believes one pillar of board effectiveness is centered on director respect for their fellow directors' integrity and focus on the sustainable health of the enterprise – in the best interest of all shareholders.

Clearly, there are countless situations where directors are focused on protecting the priorities of special interest groups. In these instances, that director's focus is recognized and respected. But the special-focus director should then be identified as nonindependent, with limited involvement in board committees and some board deliberations.

2. *Annually, director and board effectiveness assessments should include a confidential review of directors' concerns about focus, competence, integrity, and possible conflicts – their own and those of colleague directors.*

Annual board and director effectiveness assessments should include a candid and thorough examination of each director's concerns about the apparent focus, competence, integrity, and possible conflicts – or appearance of conflicts – for every director.

The director assessment should clearly define the process for self-reporting changes in circumstances, suspected ethics violations, investigations, and resignation if necessary. The process for reporting suspected violations by other directors, executives, or stakeholders should also be defined.

Assessments can be done through self-evaluation forms and by confidential evaluations of other directors. Examples of questions to include: Do you believe that you may have done something inconsistent with the nondisclosure agreement or conflict-of-interest policy? Do you have any reason to believe that any member of the board may have compromised the nondisclosure agreement or conflict-of-interest policy?

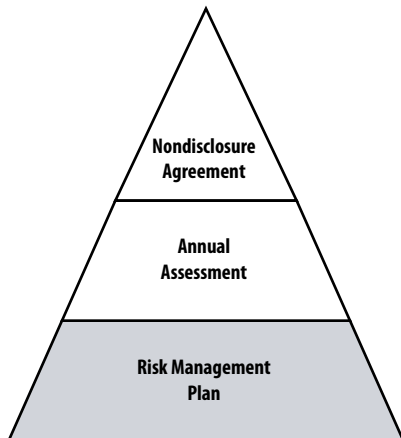
When the annual assessment surfaces concern about a director's focus, competence, or integrity, this concern should be shared immediately with, as appropriate, the board chairman, or the chairman of the Governance Committee for investigation.

There may be instances involving public companies when the concern should be referred to the enforcement division of the SEC. For other organizations, referral to the Internal Revenue Service may be necessary.

During our peer review process for this chapter of *Insights*, we received the following additional comments we believe readers should consider:

"I think you need to emphasize the added costs in both cash and distractions in dealing with the issues on a reactive basis as opposed to preventative measures. Remember the old Fram oil filter advertisement – pay me now or pay me later."
Tom Thomsen, director, EFJ, Inc.

"I think it can get dicey when directors are asked to express concerns about focus, competence, integrity, etc., as relates to their peer directors. Any board that undertakes this level of assessment had better be sure it has a discreet, thoughtful process to deal with the results." Robert Lyons, president and CEO, The Bilco Company



“The concepts of conflict of interest and other related issues are sort of the Supreme Court’s definition of obscenity – “you know it when you see it” – plus the old adage about the “eyes of the beholder.” Even carefully considered codes of conduct have the potential for an individual board to decide (or more likely avoid the issue) to do what (s)he thinks is best. The translation from the theoretical-general to the specific-practical is a long, tortuous journey. That gap might be diminished by holding an annual exercise of reviewing a few hypothetical case studies – giving the board members short fact statements, ask them to think about them before the meeting and discuss them when all are present.”
Sandy Murdock, attorney and former SVP of administration and general counsel, National Business Aviation Association

3. Proactively and reactively, prepare to address breaches in the same way organizations deal with other risk management challenges.

Be agile, objective, thorough, decisive, shareholder-focused, and uncompromising in defending and enhancing corporate vision and values.

Have a risk prevention and mitigation plan, and the talent and other resources on standby in the event it becomes necessary to implement the plan. Persistently search for the symptoms of small and emerging risks before they become overwhelming.

In BEP’s post-incident analysis involving a widely publicized board integrity situation, we confirmed our hypothesis that discovering a single, apparently insignificant lapse in a director’s judgment is often the “tip of an integrity iceberg.” We urge that directors leave no stone unturned when their experience and judgment tells them director integrity may be a problem.

Act decisively to neutralize the risk – at the root cause. Be prepared to over-communicate to all stakeholders with the need to know. Said another way . . . “tell them before they tell you.”

During our peer review process we received the following additional comments for readers to consider:

“Embellish this section with examples so it is clearer from an action perspective. This has the potential to be the heart of the article, and the reason why you feel this is one of your new insights.” Haluk Ariturk, chairman, president and CEO, Acacia Life Insurance Company

“One very small suggestion. You refer to a risk mitigation plan. I wonder if it might not be worthwhile to spell out just what you mean by a risk mitigation plan. What is involved in setting it up? What is included in such a plan?” Pete Peterson, senior chairman and cofounder, The Blackstone Group

“While I concur with the three opening paragraphs outlining the issue, I am concerned that more bureaucracy (“process” would be a less emotional word) is not the answer. Values, tone at the top, and annual reminders of potential conflict issues are important. Signing an annual statement in connection with the proxy incorporating conflicts of interest is clear. Annual director evaluations can encompass these issues, but the process definition you outline seems a bit much. Also, given the priorities of boards’ duties, I would not put having a risk mitigation plan and the talent and resources on standby anywhere near the top of the list (or even on it). Good directors will, hopefully, react well.” Art Weinbach, chairman of the board, Automatic Data Processing, Inc.

To leverage the comments we received from our peer reviewers, we would like to offer the following additional suggestions.

We broadly addressed the challenges of risk management and risk management plans in BEP's November 2003, in chapter 3 of *Board Effectiveness Insights*, "Identifying and Mitigating Corporate Risk." Chapter 3 can be downloaded from our Web site, www.bepartners.com.

Although chapter 3 did not specifically address a plan for dealing with director integrity risks, we can briefly suggest the following:

- To quote from our earlier chapter, "Risk assessment and mitigation is not a science or a matter of checklists. The process requires time, attention, and customization, particularly in establishing a baseline and during periods of change."
- In terms of director integrity, be proactive in ensuring that everyone understands the semantics and that there is a process in place for annual review and discussion, as suggested in the sections above.
- Understand the real exposures in advance of a breach of director integrity, in terms of D&O insurance coverage and directors' personal liabilities.
- Understand the real exposures, in advance of a breach of director integrity, in terms of how all stakeholder groups may be impacted by public disclosures. Research the lessons learned by other companies that have had to address director integrity breaches.
- Have in place a communications plan, with messages targeted to stakeholder groups that may be impacted. Identify the full range of communication channels to be employed, including leveraging Internet-based tools. Ensure that the communications plan emphasizes listening as well as speaking.
- Identify, in advance, the senior company executives who will manage the mitigation response. These executives should be experienced in dealing with the media and have credibility with the stakeholder groups involved, including the news media.

We look forward to sharing our lessons learned in more detail, and we welcome your suggestions, thoughts, agreement, or disagreement.

Please contact Sharon Carrigan,
Insights Editor and Vice President,
Communications, at
203.801.5002 or
sec@bepartners.com.

Thought Leaders

It is important to BEP to acknowledge the many hours others have invested with us to develop this chapter of *Insights*. We have honored requests for anonymity from some of the participating clients and alliance partners. Although some of the following thought leaders listed below might not agree with all ideas presented in this chapter, we appreciate their collaboration and contributions.

Haluk Ariturk, currently chairman, president, and CEO of Acacia Life Insurance Company, and EVP and member of the board of UNIFI Mutual Holding Company. Formerly: leadership positions at American Express Financial Services and American General Corporation.

Joe Bartlett, currently of counsel at the law firm of Fish & Richardson LP, founder and chairman of the board at VC Experts, and a courtesy professor at the Johnson School of Business at Cornell University. Formerly: Undersecretary of Commerce, law clerk to Chief Justice Earl Warren, president of the Boston Bar Association, acting professor of law at Stanford University, adjunct professor at New York University, instructor at Boston University Law School. Former director of Advanced Telecommunications Corp., Shawmut Corp., GMIS Inc., Harbor National Bank, National Realty Investors (non-executive chairman), and Northeast Federal Savings and Loan Association.

Hal Burlingame, currently director of UniSource Energy Corporation, the Tallberg Foundation, board member of Heldrich Center for Workforce Development of Rutgers University, chairman of ORC Worldwide, and chairman of Board of Trustees of Muskingum College. Formerly: EVP of human resources of AT&T and member of the AT&T Foundation; past chairman of the Personnel Round Table, and the National Academy of Human Resources.

Kevin English, currently a consultant in private practice, and a co-founder and managing partner of Board Effectiveness Partners. Formerly: chairman, CEO, and president of Covisint; managing director and CEO e-commerce of Credit Suisse First Boston; chairman and CEO of TheStreet.com; VP and general manager of NEXIS Enterprise Group; board of directors special assignment for Reed Elsevier plc; and VP of sales and marketing for LEXIS-NEXIS.

Irv Hockaday, currently director, Aquila Inc., Crown Media Holdings, Dow Jones & Company, Estee Lauder Companies, Ford Motor Company, and Sprint Nextel Corporation. Formerly: president and CEO of Hallmark Cards, Inc., president and CEO of Kansas City Southern Industries, board chair of Kansas City Area Life Sciences Institute and Civic Council of Greater Kansas City, trustee of Midwest Research Institute, chairman of the board of the University of Missouri-Kansas City Bloch Endowment, chair of the Federal Reserve Bank of Kansas City, and trustee of the Aspen Institute.

Ed Kangas, currently non-executive chairman of Tenet Healthcare Corporation, and director of EDS, Eclypsys Corporation, Hovnanian Enterprises, and Oncology Therapeutics Networks. Formerly: global chairman and CEO of Deloitte, and managing partner of Deloitte USA; immediate past chairman of the National Multiple Sclerosis Society.

Greg Lau, currently executive director, Global Compensation and Corporate Governance, General Motors Corporation, director of GMAC Insurance Holdings, Inc., member of The Conference Board's Councils on Executive Compensation and Global Human Resources Management, and member of The Wharton School's executive education advisory board. Greg's career at GM includes positions as secretary of the executive compensation committee of the board and director of executive compensation and bonus distribution. Formerly: director of General International Limited, World at Work, and special assignment to The Conference Board's Congressional Assistant Program.

Robert Lyons, currently president and CEO of The Bilco Company; board member of NewAlliance Bank, Connecticut Hospital Association, and the United Way of Greater New Haven, and chairman of the board of Habitat for Humanity of Greater New Haven. Formerly: chairman of the board of Gaylord Hospital.

Sandy Murdock, formerly SVP administration and general counsel of National Business Aviation Association; partner at Shaw, Pittman; partner at Baker, Worthington; partner at Heron, Burchette, Ruckert and Rothwell; chief counsel and acting deputy administrator of the Federal Aviation Administration; and general attorney for United Airlines.

Kevin O'Connell, currently director, Innovative Analytics and Training. Formerly: VP, Intelligence Community Programs, Defense Group, Inc., and director, Center for Intelligence Research and Analysis; director, Intelligence Policy Center, RAND; senior staff officer, Office of the Director of Central Intelligence; special assistant to the vice president of the United States for national security affairs; senior analyst, White House Situation Room; and intelligence analyst, US Department of Defense.

Pete Peterson, currently senior chairman and co-founder of The Blackstone Group, chairman of the Council on Foreign Relations, founding president of The Concord Coalition, and founding chairman of the Peterson Institute for International Economics. Formerly: chairman of the Federal Reserve Bank of New York; chairman and CEO of Lehman Brothers and successor company Lehman Brothers, Kuhn, Loeb Inc.; chairman and CEO of Bell and Howell; U.S. Secretary of Commerce; and director of numerous boards, including Sony, Minnesota Mining and Manufacturing, Federated Department Stores, Black & Decker, General Foods, RCA, The Continental Group, and Cities Service. In addition, he is the author of several books on economics and social policy.

Steve Sherwin, M.D., currently chairman of the board and CEO of Cell Genesys, chairman of the board of Ceregene, director for Neurocrine Biosciences, director of Rigel Pharmaceuticals, and director of Biotechnology Industry Organization. Formerly: vice president of clinical research at Genentech, and staff member of the National Cancer Institute

Joe Toce, founding member and director of Wealth and Tax Advisory Services, frequent speaker on individual tax issues, and author of *The Tax Economics of Charitable Giving*. Serves on the board of trustees of St. Joseph's College, and provides pro bono services in fund raising for several major universities. Serves on Georgetown University's Wall Street Alliance Board of Advisors.

Allan Topol, currently partner in the law firm Covington & Burling, specializing in international environmental law. Writes a weekly column for the on-line newspaper *Military.com*, is a speaker on public policy issues, and author of several bestselling novels.

Tom Thomsen, currently director of EFJ, Inc., director of PECO II, and a member of the executive committee of the University of Nebraska Technology Park. Formerly: chairman and CEO of Lithium Technology, retired president of AT&T Technologies, and served as director for Sandia Labs, Western Electric (Lucent Technologies), AT&T Credit Corp., and Olivetti.

Art Weinbach, currently chairman of the board of Automatic Data Processing, Inc. and Broadridge Financial Solutions, director of Schering-Plough Corporation, and trustee of New Jersey SEEDS. Formerly: chairman and CEO of Automatic Data Processing, Inc.

John White, currently managing partner of Global Technology Partners, a member of the faculty of Harvard University's Center for Business and Government, and a director of L3 Communications. Formerly: director of Harvard University's Center for Business, Deputy Secretary of the US Department of Defense, VP of Kodak, SVP for national security research programs and member of the board of trustees of The RAND Corporation.

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Director Integrity

FOCUS

BEP analyzes board structure, membership, processes, and procedures, and recommends changes to enhance effectiveness. BEP also evaluates CEO succession plans and candidates, and analyzes company performance against strategic goals.

INSIGHTS

Please visit www.bepartners.com for other chapters of *Board Effectiveness Insights*, as well as the sites for our sister firms: www.implementstrategy.com and www.ciogroup.net.

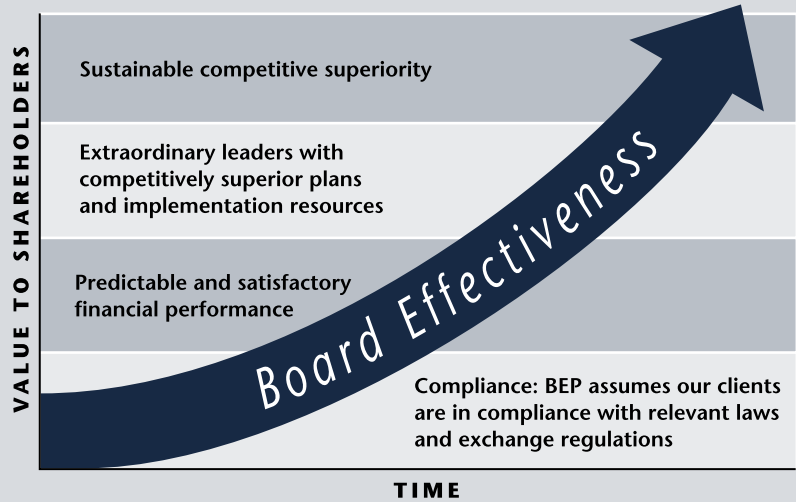
**BOARD
EFFECTIVENESS
PARTNERS**

BOARD EFFECTIVENESS PARTNERS, LLC
Research & Operations Center
36 Grove Street
New Canaan, CT 06840

Tel: 203.801.5010
Fax: 203.801.5013
E-mail: roc@bepartners.com
Web: www.bepartners.com

Our Firm

Board Effectiveness Partners (BEP) collaborates with directors and CEOs to objectively analyze and improve the effectiveness of directors and their boards.



Managing Partners

Each of BEP’s managing partners has over 20 years of experience as a CEO, a board or corporate leader, or a consultant. With career credentials that range from manufacturing to financial services, and skills ranging from strategy design to change implementation, BEP’s managing partners provide the breadth and depth of professional experience essential to strengthening director and board effectiveness.

KEVIN ENGLISH has devoted his career to leading business units, companies, and boards, and has improved corporate performance as a CEO and board chairman.

JOHN MCCREIGHT has dedicated over 35 years to consulting and partnering with CEOs, senior leaders, and directors, and investors defining and implementing large-scale strategic change.

MARK SCHNEIDERMAN is a senior-level human resources professional who has held corporate leadership roles and has partnered with senior leadership and boards as a consultant, to facilitate strategy implementation and change management.

Alliance Partners

BEP nurtures relationships with over 200 alliance partners worldwide. They exemplify preeminence in their fields and complement our core competencies. Our alliance partners strengthen our capacity to improve director and board effectiveness.

As an example, BEP’s understanding of developments in Europe and the United Kingdom and our ability to partner with clients worldwide are enhanced by our relationship with London-based colleagues Patrick Haighton, Andrew Leung, and Leslie Dighton, the founder of the Chairman’s Club and CRA, a global consultancy.

Research & Operations Center (ROC)

Our Connecticut-based ROC professionals are linked globally to our clients, alliance partners, industry experts, and the academic community. We focus daily on monitoring director and board effectiveness facts, opinions, successes, disappointments, lessons learned, and emerging best practices.