



Counsel for
BOARD AND EXECUTIVES

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Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives. Acredula is available to clients and friends of the firm. It is not to be construed as legal advice or opinion.

What Boards Should Do as a Result of the Financial Crisis

What governing boards should do as a result of the financial crisis that began in 2008 depends upon whether the crisis, which is still ongoing, is the confluence of unlikely events or a failure in corporate leadership. Although arguments can be made in favor of either, the media as well as the President Obama's administration have stated that it is a failure in leadership. The purpose of this article is to explore, in short bullet-point discussion, the media's and Obama administration's conclusion that it is a failure in corporate leadership and, accordingly, what boards should do as a result.

Media Headlines

The following headlines from various media since the last quarter of 2008 provide both a chronological summary of events at the culmination of the crisis, as well as evidence of the media's assumption that the crisis is man-made:

- "418 Got AIG Bonuses; Outcry Grows in Capital," by Jackie Calmes and Louise Story, New York Times, March 18, 2009
- "U.S. Seeks Expanded Power in Seizing Firms," by Edmund Andrews and Eric Dash, New York Times, March 24, 2009
- "Fed to Start Purchasing Treasuries to Unfreeze Credit," by Scott Lanman, Bloomberg Press, March 25, 2009
- "Government Forces Out GM CEO Wagoner," by Tom Krisher and Dan Strumpf, AP Associated Press, March 30, 2009
- "U.S. Plans Key Role In Naming GM Board – Government's Sway Over Firms It Aids Is Topic of Debate," by Peter Whoriskey and Kendra Marr, Washington Post, April 1, 2009
- "Chrysler Board to be Named by Fiat and U.S. Government if Deal Goes Through," by Soyoung Kim and Dave Baile, Reuters, April 17, 2009
- "GM Hires Search Firm for New Board," by Joann S. Lublin and John D. Stoll, Wall Street Journal, May 11, 2009
- "BofA Urged by Regulators to Revamp Board," by Dan Fitzpatrick and Damian Paletta, Wall Street Journal, May 15, 2009
- "BofA Gets New Blood for Board," by Dan Fitzpatrick and Joann Lubin, Wall Street Journal, June 6, 2009
- "Most responsible are the boards - Lack of care led to the financial collapse," by Nell Minow, CNN Commentary, September 18, 2008
- "Entitlement permeates Wall Street – Over-the-top pay, perks appear ingrained in most execs' DNA," by Madlen Read, Associated Press, January 25, 2009
- "Consumer Confidence Collapses – And home values plunge to historic lows," by Bob Willis and Timothy R. Homan, Bloomberg Press, February 24, 2009
- "Independent boards, but ineffective directors," by Gordon R. Caplan and Andrew A. Markus, The Corporate Board March/April 2009

“Fundamental causes” Cited by Geithner for the Crises

An authoritative and also credible view of the “fundamental causes” of the credit crisis is set forth in Treasury Secretary Timothy Geithner’s on March 26, 2009, before the Committee on Financial Services of the U.S. House of Representatives:

- Large flow of capital into the United States in the 1990s resulted in “pushing down long-term interest rates and pushing up asset price,”
- Demand for higher returns resulted in “institutions and investors . . . taking on greater exposure to the risk of infrequent but severe losses”
- “Home price appreciation encouraged borrowers, lenders and investors to make choices that could only succeed if home prices continued to appreciate,”
- Mortgage brokers, investment banks, large insurance companies, finance companies and the GSEs encouraged consumers as well as businesses on Main Street “to take unwise risks on complicated products, with ruinous results for them and for our financial system”
- “New financial products were created to meet demand from investors, and the complexity outmatched the risk-management capabilities of even the most sophisticated financial institutions,”
- A “large share of loans made by banks and other lenders were being originated for distribution to investors through securitizations,” spreading the risk, and the eventual losses, throughout the world economy,
- Demand for higher returns led to “Ponzi schemes and other flagrant abuses that should have been detected and eliminated [but for the rush to invest],”
- Decline in asset values, including home values and equities, eroded savings which eroded confidence, investment and available capital.

Governance Failures Cited by Commentators as Contributing to the Crisis

Commentators have cited failures in governance that contributed to the crisis, including the following failures to:

- Focus on long-term fundamentals, including the long-term effect of business strategies on net worth, capital and surplus
- Identify, monitor and, where appropriate, avoid or mitigate financial and legal risks to the organization
- Align compensation incentives with a long-term focus on the correct fundamentals, including managing financial and legal risks
- Have strategies for avoiding pressure from hedge funds, special interest investors and other bargain hunters seeking a short-term return in the form dividends or other distributions from divestitures, changes in control or liquidations
- Avoid entrenchment of senior management, especially in times of crisis, by not limiting entitlements such as severance, change-in-control premiums and golden parachutes and by not having strategies in place for succession
- Understand the clout of, and fiduciary duties owed to, creditors in the time of insolvency and the government when expending emergency funds
- Require oversight and, where appropriate, disclosure of material adverse changes and correction of previous public statements
- Be able and willing to oversee and participate in the scheduling and call of meetings, preparation of the agenda and dissemination of necessary information
- Balance (i) guidance versus direction of strategy and (ii) review versus oversight of risks
- Consider and avoid or mitigate risks to the reputation of the organization

Strategies for a Board to Have in Place as a Result of the Crisis

In light of the forgoing, what should boards do in the current environment? Boards should consider overseeing that their organizations have strategies in place providing assurance that:

- Focus from the top downward is on the correct fundamentals. The view should be long term and include the effect on net worth, surplus and capital of the organization. It should include being compliant with legal and ethical standards and continuous improvement of the organization’s operations and practices.

- There is authority and accountability for assessing and managing risks. Boards should consider authorizing some officer or group of officers to identify, assess and advise management and the board of risks. The officer may be a standalone chief risk officer or a combination of existing officers, such as general counsel and the chief financial officer. Management should be required to consider risks in making decisions, and their consideration of such risks should be reported to the board for any decision requiring board approval or authorization. Finally, without authorization of the board, management should by policy avoid or mitigate known material risks.
- Compensation and other incentives are aligned with the fundamentals and with managing risks. Boards should assure that pay is consistent with pay-for-performance standards with performance periods of two or more years for a longer term focus and with performance measures that include desired changes in net worth, surplus and capital. There should be no incentives encouraging management to take large risks not authorized by the board. Any excessive severance, change-in-control premiums and golden parachutes that could result in management entrenchment should be reduced or eliminated.
- Appropriate expertise is present on, or otherwise available to, the board. Boards should evaluate and inventory the individual skills, experience and other expertise of each of its members; determine the expertise needed in the foreseeable future; and then determine whether to fill any gaps in such expertise through:
 - Recruitment of new or additional directors
 - Education of directors to enhance expertise
 - Availability of advice of advisers to provide missing expertise
- Board members are committed in terms of time and freedom of conflicts. Boards should review the willingness and ability of individual directors to take the time, free of conflicts, for the best interests of the organization. This includes periodic evaluations of each director's outside interests, including other directorships, conflicts with a director's time or the director's duty to act in the organization's best interests.
- The board is prepared to lead in a crisis. Boards should avoid or limit entrenchment of management through entitlements such as excessive severance, change-in-control premiums and golden parachutes. At least one outside director, such as a lead outside director, should regularly participate in preparing the agenda for meetings and approving information being provided to directors. Outside directors should assure their ability under applicable governing documents to call and preside at meetings, including executive sessions where appropriate. Boards should have strategies for providing succession.
- The board and management are reasonably protected against liability. Boards should assure that members of the board and management are periodically reminded of what precautions to take to reduce risks of liability, including what to do upon becoming aware of any claim or potential claim. Indemnification provisions should be reviewed periodically with the extent that indemnification is currently permitted by law. D&O coverage should be reviewed for its adequacy in the event of insolvency, bankruptcy and government funding as well as to the solvency of the D&O insurers.
- The organization's other resources, including reputation, are adequately protected. Boards should consider adoption of strategies to prevent bargain hunters taking advantage of low evaluations or under-performance to force divestures, distributions, or liquidation or changes in control. Boards should also consider adoption of strategies to reduce the risk of competition or head hunters in soliciting employees, customers, suppliers and other resources. Finally, boards and management should consider business decisions in light of damages to reputation if the decision results in a headline in the news or financial media.
- Necessary or required information is being provided and is accurate and complete. Boards should ensure that there are periodic evaluations of whether all necessary information is being provided to the board and management and whether it is accurate and complete; and whether all required information is being provided to other stakeholders and whether it is accurate and complete; and whether there are safeguards to provide corrected information when information provided becomes materially misleading, whether because of adverse events or otherwise.

- Operations and practices are continuously reviewed for compliance and improvement. Boards should ensure that strategies are in place for continuous review of operation practices for legal and ethical compliance and in comparison with peer or better practices for improvement.

Conclusion

Whether the financial crisis of the last 18 months is confluence of unlikely events or a failure in

leadership, focusing on the correct fundamentals, managing risks, aligning pay with those fundamentals, making expertise present on or available to the board and the other strategies discussed will strengthen corporate America.

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First Step in Any Board Succession Plan – Board Evaluation

The days of relying on traditional approaches to board succession planning are over. Boards, and their composition, are under scrutiny of shareholders, media, regulators and even the government. As a result, boards need to move past reliance on term limits and mandatory retirement ages as the foundation of succession plans and structure succession plans that focus on the strategic goals of the organization.

To adapt to the ever-changing environment in which they must operate today, corporations, both for profit and nonprofit, need to remain flexible – this includes flexibility in an organization's strategy, its market, its workforce and even its board. This ability to be flexible is one key indicator of a high performing board and makes succession planning more important than ever.

One of a board's more important duties is to plan for its own succession. However, most boards fail to take the time to appropriately structure a plan that will allow it to easily adapt as the corporation changes.

Boards need to remember one theme while developing a board succession plan: structure follows strategy.

The composition of an organization's board must be built to meet the organization's strategic goals. The first element of board succession planning is evaluating every seat on the board and recognizing that each represents an opportunity to increase an organization's expertise. The final element is evaluating the skills and expertise of every indi-

vidual chosen to fill one of those seats and providing each with the information, resources, training and support needed to succeed as individual board members and as a collective board. In between these two steps is the strategic planning process of the organizations where the board considers the following:

- What are the organization's growth plans?
- Will it expand into new markets?
- Will the organization develop new products, programs and/or services?
- Will it be an acquirer? Or is it a target?
- Will pending/proposed changes in the law/regulatory environment affect the organization?
- Will the competitive landscape force the organization to act?

Boards should strive to move from a random collection of individuals to a board of "experts." Composed of persons each having particular skills or expertise, the board should collectively have to achieve its future objectives.

An "expertise" board requires the organization to assess the core competencies present among its current management team and board, prioritize the additional competencies necessary for future operations, and recruit only those persons having the needed competencies for the board. Further, an "expertise" board allows the organization to create job descriptions of requisite expertise or skills for future directors.

Before a board can create a job description based on the expertise needed to help the organization

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reach its goals, the board must know what skills and expertise are present amongst the current board members.

There is a tool to effectuate this process — a Board Evaluation. Board evaluations can take many shapes and forms each with a specific purpose

or goal to help the board improve efficiency, effectiveness and fulfill its legal obligations to provide direction and oversight to the organization. The three most common evaluations are the full board evaluation, the self-evaluation and the peer-to-peer evaluation.

Prior to beginning the process of developing a board evaluation, it is important that all directors understand the need to conduct and participate in the evaluation and that the directors buy-in to the process. Without buy-in from the entire board, the evaluation will not succeed. Therefore, it is important the initial steps are taken carefully.

For the purposes of succession planning, the key evaluation is the self evaluation. Self evaluations will allow the organization to take an inventory of skills and expertise present amongst the current

board members. This skills inventory will provide a guide in assessing what expertise is lacking amongst the current board that is needed to ensure the board has the breadth and depth of competencies it needs to support corporate strategy in the upcoming years.

With this knowledge in hand, the board can memorialize in writing the expertise the board needs going forward and allow the board the opportunity to begin recruiting potential directors to fill that need. Such a plan also will provide the board with time and a larger pool of candidates to find the right director, not just any director, to fill an immediate unplanned opening on the board.

It cannot be overlooked that a board evaluation process without buy-in from the entire board is doomed to fail. Thus, before undertaking the process to develop a plan, boards should seek guidance on the appropriate steps to take that will provide the best chance of success.

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