

# Weil Briefing: Corporate Governance

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## Six Priorities for Boards in 2006

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As the flurry to institute the governance reforms of recent years settles down, boards of directors have an opportunity to refocus their attention on their fundamental mandate, which is to “direct the affairs of the company.” The first and fundamental responsibility for a board in “directing” is to determine and prioritize just what it is the board should focus its attention and efforts on, given the unique circumstances of the particular company. With the strong caveat that the details will vary for each company -- and generic compliance checklists won't provide significant guidance -- we nonetheless suggest that in 2006 boards consider the following priority issues, which we believe are of importance to most companies:

1. *Taking charge of the board's own focus, agenda and information flow.* Boards need to develop their own sense of business priorities and their own view of the matters that are most important to the success of the enterprise. Doing so enables a board to provide management with meaningful guidance and support. It also helps the board focus its attention appropriately, determine its own agenda and obtain the information it needs to make objective judgments. Obviously, the board needs to dig down and really get to know the business of the company and the competitive environment in which it operates, in collaboration with -- but not unduly dependent on -- management. Even the best managers will have potential conflicts or blind spots about performance, strategy and/or risks. (This is why boards matter in the first place.)
2. *Ensuring that management not only performs, but performs with integrity.* Selecting, monitoring and compensating management and, when necessary, replacing management, continue to lie at the heart of board activity. Directors should assess management's integrity not only at the outset in their hiring decisions, but also continuously thereafter when:
  - Considering matters proposed and presented by management;
  - Assessing management performance;
  - Determining management compensation; and
  - Planning for succession and management development.

Management integrity is the first defense to director liability. Equally if not more important, management integrity is key to building relationships of trust with customers, suppliers, employees, regulators and investors. Integrity and trust can be difficult to assess, and are not subjects conducive to “box-ticking.” But directors can assess whether the CEO and her team: invest real effort (not lip service) in setting the tone at the top (see item 3, below); are attentive or reactive (as well as aggressive or conservative) in areas of legal compliance, accounting and disclosure; embrace or resist efforts to adopt and adapt best practices in various disciplines (including but not limited to corporate governance); and exhibit basic decency in their treatment of others. Directors can take a close look at how senior executives approach issues in which they have a considerable personal interest, such as compensation, potential related-party transactions, perquisites, etc. (Remember that by its very nature the board is designed to attend to areas where senior management may have a blind spot or a potential conflict.) Directors can also assess whether management is “straight” with the board – forthcoming in helping to identify key issues and provide unbiased information about important matters. This is the foundation for the board's trust in management and the basis for effective board oversight.

3. *Setting expectations about the tone and culture of the company.* Related to its ongoing assessment of management integrity, the board has an important role to play in assuring that management is promoting an appropriate ethical culture within the company. Only the board is positioned to assess whether senior management is setting the appropriate tone and culture, both in the messages management sends throughout the company and as exhibited in management behavior. The standards of ethics and business conduct that are followed -- or not followed -- throughout a company impact the bottom line in many ways. "Tone at the top" should be a priority throughout the company and not viewed simply as a compliance matter.
4. *Formulating corporate strategy with management.* Once the board has hired the best and most trustworthy management team available, it should challenge the team to propose and continually fine-tune the corporate strategy. Directors should apply a healthy skepticism in questioning assumptions behind the strategy. After agreeing to a strategic course with management through an iterative process, the board should determine the benchmarks that will evidence success or failure in achieving strategic objectives and then regularly monitor performance against those objectives. *As boards look beyond reform implementation, the key challenge is to get down to business, focusing not only on corporate strategy and its execution but, in particular, on understanding the key risks to the drivers of corporate performance, and how management is controlling for such risks. This all requires significant understanding and information about the company, its industry and competitive conditions, and it requires active control by the board of the board's agenda and the information available to it. It also requires the development of a clear understanding between the board and the senior management team of just what issues are board-worthy and in what time frame and under what circumstances the board expects to be informed of a critical emerging issue.*
5. *Ensuring that the corporate culture, the agreed strategy, management incentive compensation and the company's approach to audit and accounting, internal controls and disclosure are consistent and aligned.* Active engagement in strategic oversight and knowledge of the key drivers of corporate performance and the corporate culture position the board to ensure that the company's approach to compensation, financial disclosure, internal controls, risk and compliance all complement one another. True and fair should be the goal with respect to all of these issues. Boards should consider whether incentive compensation truly rewards performance in line with the agreed strategy. Consider whether incentives, coupled with pressures to provide the market with guidance, may put undue pressure on management to go beyond legitimate earnings management. A concerted focus on the future by the board, together with efforts to align compensation policies with strategic objectives, and board sensitivity to the complexities and pressures surrounding the provision of earnings guidance may all help to lessen undue emphasis by management on quarterly results.
6. *Helping management understand the expectations of shareholders and regulators.* Boards add significant value when they help management cope with the complex context in which the company operates, and when they support management in focusing on the long-term interests of the company and its shareholders. Managers tend to work in the here and now and often don't have the time or inclination to fully learn how the world at large views the company. Boards can help put the company's corporate governance ratings and securities analyst reports in perspective, encouraging credible ratings and reports to be attended to -- particularly credible analyst reports -- because they may provide insights about how the company is viewed, while at the same time, recognizing that ratings and reports don't define what effective governance or performance is. Slavish adherence to recommendations derived from box-ticking is just as bad as ignoring credible analysis in the first place. Boards can also help management recognize that shareholders have a legitimate interest in more meaningful input into the board selection process, in terms of both nominating procedures and voting methods. Similarly, boards can help management recognize and address the concerns that excessive compensation raises among shareholders, regulators, rating agencies and others.

And this takes us right back to integrity.

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