Can You Help Board Member Teresa Hughes with her Gray Director Problem?

Excerpted from Ch. 3 of *Giving Voice to Values in the Boardroom*

To many, the primary role of a board lies in the effectiveness of its ability to protect shareholder interests by hiring the right managers, compensating them properly, and overseeing managerial decisions. In fact, most academic research, popular press accounts, and government regulation all echo the deeply held belief that boards should be able to actively monitor management.

One of two approaches is generally offered as the way to achieve this effective monitoring:

1) The first and primary assumption rests on the idea that independent directors can effectively monitor executives.[1] This assumption is so prevalent that, for some, it defines the very meaning of good governance.[2] Independence as a director attribute has largely proliferated because of regulation. Boards of firms listed on a U.S. exchange are required to have independent directors on the audit committee and a majority overall. The 2002 Sarbanes Oxley Act also increased the monitoring role of boards. And, as of 2016, most member states of the European Union and virtually all major Asian jurisdictions have rules for appointing at least some independent directors to their companies' boards.[3]

2) Second, some believe effective governance can be achieved by hiring board members with the right qualifications – those who bring human and social capital – because they provide these much-needed resources and thus they will use them to monitor management. In this way, the

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[1] Westphal, J. D., & Fredrickson, J. W. (2001). Who directs strategic change? Director experience, the selection of new CEOs, and change in corporate strategy. Strategic Management Journal, 22(12), 1113-1137.
[2] Coombes, P., & Watson, M. (2000). Three surveys on corporate governance. The McKinsey Quarterly, 74.
[3] Harvard Law School Forum on Corporate Governance. Available at: https://corpgov.law.harvard.edu/2016/08/23/the-rise-of-the-independent-director-a-historical-and-comparative-perspective/

> board serves as a provider of resources (e.g. expertise, status, advice and counsel), which are then used to evaluate management.[4]

Bringing an independent director (sometimes referred to as a non-executive director or outside director) to the board is one of the most common value challenges in the field of corporate governance. But, why?

While it may be obvious that independence is necessary for effective monitoring, it is far more complex than that. One of the primary tensions all boards in all countries face is the dual nature of the board's tasks; one the one hand, a board must monitor upper management, on the other, it must provide support for them.

In assessing a director's independence, the nominating and corporate governance committee (i.e. Nom/Gov) needs to take into account certain facts and circumstances. First, it must determine if a director is indeed independent. A director is considered independent when he or she is free from any "material" relationships with either the listed company or with senior management (e.g. commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships) during the past three years. Second, even if a director satisfies each listed requirement, the board still needs to determine whether the director could exercise independent judgment given the director's specific situation. The NYSE, as well as the Nasdaq, require the board of any listed company to make an affirmative determination of each director's independence, which must be disclosed publicly.

In contrast, ownership of a significant amount of stock, or affiliation with a major shareholder, in and of itself, does not necessarily preclude a board from determining that an individual is independent.[5] But, even if a director satisfies each listed requirement, the board must still decide whether the director's independence has been compromised in some way.[6] These examples illustrate some of the board's challenges in classifying independence and whether or not a specific personal relationship is material.

Another problem is rather obvious - if a director is truly independent then s/he typically has few other sources of information internal to the company other

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[4] Hillman, A. J., & Dalziel, T. (2003). Boards of directors and firm performance: Integrating agency and resource dependence perspectives. Academy of Management Review, 28(3), 383-396.

[5] Commentary to NYSE Listed Company Manual, Rule 303A.02; Nasdaq Listing Rule IM-5605.

[6] For more information, see ICGN Governance Principles: http://icgn.flpbks.com/icgn_global_governance_principles/#p=14

than the CEO or the other board members. And, in order to monitor management, a director must have information about the inner workings of the company. Certain barriers can exist that ultimately inhibit directors from providing effective oversight on an ongoing basis. Chief among these barriers is the board member's ability to obtain, process and act on information from management on a timely basis. At the same time, boards have a duty to "ask the right questions" of management and may not escape liability even if management does not inform the board, as noted above.

Board Challenge #1: Independence and the Gray Director

Prized Possessions Inc. is a mid-cap clothing company listed on the NYSE, primarily targeting women, with a close-knit culture among its executives and top management talent.[7] Its off-beat bohemian style is very popular among women of all age groups and its financial performance has typically been strong since its start in the 1990s. However, at the last board meeting in July the discussion centered around its declining revenue and what might be the cause(s). PPI's board as a whole has an average tenure of 13 years and is comprised of a total of 9 members, 4 of whom are insiders who work at PPI.

Teresa Hughes, an independent board member for the past 5 years and the new Chair of the Nom/Gov committee, has observed a troubling trend at PPI – the graying of its directors. *Gray directors* are those who lack perceived independence for one or more reasons but are nonetheless independent for regulatory purposes. Some of these reasons include a director who: serves on a 2nd or 3rd board with another director or the CEO, is a former employee or consultant, receives above market director fees, has social relationships with management or other directors, has an office at the headquarters and uses its administrative staff, or has excessive tenure on one board.

Over time, two of PPI's five original independent directors have begun to exhibit what Teresa thinks of as lacking "independence of mind". They do not speak up or question the CEO and founder Dirk Smith, as they once did, and they rely heavily on management briefings to tell them what is going on inside the firm. These two board members have the longest tenure on the board – over 10 years each – one (Will Arquette) attended college with the CEO in the mid-1980s and the other (Steve Manning) frequents the same country club as the CEO.

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[7] PPI is not a real company, but the board challenge is based on a compilation of actual events.

Teresa is not the only one concerned. A large investor group is urging shareholders to vote against the re-election of these two directors, saying the board's "extreme clubbiness" has contributed to its recent weak performance. At PPI's next board meeting, in October, a senior vice president for retail sales is coming to give a management briefing to the board's audit committee about the weak performance.

After thinking about it for a few days, Teresa decided to raise her concerns with the board about the lack of independence and the information barriers at the firm. There is some time before the October board meeting to prepare her approach and work on gaining allies and do some additional data gathering if needed. How does Teresa act on what she knows is the right thing to do?

In your group, please answer the following questions:

- What's at *stake* for the key parties, including those who might disagree with Teresa addressing the lack of independence and the information barriers? How can she find *allies* among those who may agree with her? (Inside the board? Outside the board?)

- What are the main arguments she is trying to counter? That is, what are the *rationalizations* need to be addressed?

    - *See URL in Zoom chat for four common rationalizations.*

- What is Teresa's *most powerful and persuasive response* to the rationalizations needing to be addressed? To whom should the argument be made? When and in what context?

- How would you recommend Teresa proceed?