

Board of Hard Knocks

Activist shareholders, tougher rules, and anger over CEO pay have put directors on the hot seat

Just five years ago, the Directors' College run by the Stanford Law School was a pretty tiny affair. If the three-and-a-half-day training program drew even 100 people, that was big. But in the wake of the corporate scandals, board members realized they needed to bone up on everything from financial accounting to governance, and applications exploded. Stanford has since enlarged the program to some 250 slots. This year, it also added a twice-yearly session in conjunction with its Graduate School of Business that will take in an additional 100 attendees. Yet even with this expansion, last June's session sold out months in advance. And this year's openings are filling up even faster. "The pressures on boards are already great, and they are only going to grow," says Joseph A. Grundfest, co-director of the university's Rock Center for Corporate Governance.

A new era for directors dawned with the passage of the Sarbanes-Oxley Act of 2002. Then board members were hit with the frightening prospect of real financial liability in a smattering of lawsuits that followed the corporate crime wave. Now the heat on directors is growing more intense. Their reputations are increasingly at risk when the companies they watch over are tainted by scandal. Their judgment is being questioned by activist shareholders outraged by sky-high pay packages. And investors and regulators are subjecting their actions to higher scrutiny. Long gone are the days when a director could get away with a quick rubber-stamp of a CEO's plans.

The new dynamic has played out in recent board dramas involving Home Depot, Hewlett-Packard, and Morgan Stanley, among others. If Home Depot's directors had any hope that the spotlight on them would fade in the wake of departure of ex-CEO Robert L. Nardelli on Jan. 3, they now know better. Unhappy investors are continuing to agitate for new blood in the company's boardroom. "The culpability is not on the CEO for asking [for high pay] but the directors" for approving it, says Richard Ferlauto, director of pensions and benefits policy for the American Federation of State, County & Municipal Employees, one of the more vocal investment funds putting pressure on Home Depot's board. "Compensation is a symptom. It flags for us a board that is unwilling to challenge a CEO."

And that just won't do. The old rules of civility that discouraged directors from asking managers tough or embarrassing questions are eroding. At the same time, board members are being forced to devote more time and energy to many of their most important duties: setting CEO compensation, overseeing the auditing of financial statements, and, when needed, investigating crises. That's the good news. The bad news is they are so busy delving into the minutiae of compliance that they don't have nearly as much time to advise corporate chieftains on strategy. Many board candidates no longer find the job attractive. "If someone has accumulated a lot of wealth, they just don't think it's worth the risk," says retired General Hugh Shelton, the former chairman of the Joint Chiefs of Staff who now heads the compensation committee at Red Hat Inc.

The latest luminary to sound off about the situation is Jim Clark, who resigned from the board of photography Web site Shutterfly Inc. ([SFLY](#)) on Jan. 8. "I basically kept that company alive. I hired the CEO and have been involved in every step," said Clark in an interview two days later.

Because he owns 30% of the company, however, new rules on director independence limit his role on important board committees. "Being on the board of directors of a public company has already got all this risk. And I have all these constraints and essentially no power."

The hottest issue for boards this year is shaping up to be executive compensation. For the first time ever, companies are required to disclose a complete tally of everything they have promised to pay their executives, including such until now hidden or difficult-to-find items as severance, deferred pay, accumulated pension benefits, and perks worth more than \$10,000. They will also have to provide an explanation of how and why they've chosen to pay executives as they do. The numbers are likely to be eye-popping. Michael S. Melbinger, a top compensation lawyer in Chicago, thinks that when all the proxies are filed, there could be 50 companies or more with CEO pay packages worth \$150 million-plus.

And this is, believe it or not, coming as just as big a surprise to many directors as it will be to investors. Up to now, most directors have never seen a tally for the total pay they've promised to executives. "Pay was all compartmentalized: Boards would approve a salary, a certain amount for a bonus, or a certain amount if he got fired, but no one ever added it all up," says Fred Whittlesey, the head of pay consultants Compensation Venture Group.

With proxy season approaching, boards are finding themselves digging deep into compensation consultant reports and questioning the logic of these packages--and even sometimes, in awkward meetings, asking CEOs and other highly paid officers for givebacks. Compensation lawyer Melbinger tells the story of a meeting several months ago in which he sat down with a board and their CEO and outlined his perks. The CEO had a provision in his contract that not only required the company to reimburse him for his medical coverage, deductibles, and co-pays but it also had to give him a "tax gross-up" for the payments. One of the stunned board members said: "Now let me get this straight--not only do you not have to pay the amounts for your medical coverage that every other employee of this company has to pay, we pay your taxes on it, too?" The CEO turned bright red, Melbinger says, recognizing how badly that was going to look on the disclosure forms. He quickly agreed to give up the perk.

Elsewhere, too, such goodies are disappearing--but not without a price. In a December filing with the Securities & Exchange Commission, the board of Lockheed Martin Corp. ([LMT](#)) said it would eliminate certain executive perks--including fees for country clubs, a car and driver, and tickets to sports events--in return for onetime salary adjustments. Lockheed's directors had no comment. But getting executives to actually notch down their pay isn't so easy. On the really big-ticket items directors have little leverage to alter the terms of employment contracts.

It's not just compensation committee members who find the world changing. Audit committees used to meet only twice a year: once when it was time to take the audit in and once more to ratify it. Dick Swanson, chair of the audit committees of two NASDAQ-traded companies, says he now holds 8 to 12 meetings a year for each committee. In addition, he spends many more hours keeping up on what all the other board committees are doing, especially focusing on any risk--financial, operational, or otherwise--that the company may run. "It's not like the old days when you could join a board for the twice-a-year dinners," says Swanson.

Some argue that as a result of the heightened pressure, boards are getting better. "One of the reasons bad stuff went on so much in the past," says Warren L. Batts, former chairman and CEO of Tupperware Brands Corp. and now a director of Methode Electronics Inc., "was the board wasn't organized to deal with them. People would look around at each other and say, 'Who's going to be the first to say something here? I don't think I want to.'" Now, better-educated and maybe a little scared, more directors are speaking up.