

Is It Time For The Non-Executive Chairman?

by Madeleine B. Condit and Edward D. Hess

Common in Europe but rare in the U.S., a permanent board chair separate from the CEO is drawing renewed attention as we seek to reform corporate governance. Can the concept of a non-executive chairman finally take root in America? If so, how do we structure the role, and make it effective?

Financial and accounting scandals have again raised serious questions about the effectiveness of boards of directors in exercising their fiduciary duties. Did the directors of those companies properly oversee management and ensure management's actions were in the best interests of the shareholders?

Further questions have been raised about the independence of board members, how directors are selected, who controls their pay, and how effective can they be if the CEO controls the agenda, content, and debate as chairman of the board. Good governance requires that the board be a check and balance on the CEO. Now many are asking whether the roles of CEO and chairman of the board should be separated.

Interest in the non-executive chairman solution is fueled in large part because of its use in the United Kingdom, Canada and parts of Europe. However, the extent of its use, as well as its effectiveness, is open to debate. The concept of a non-executive chairman as a check and balance on a CEO may have some appeal, particularly when we ask questions like: How can a CEO manage the business and be his own overseer? How can a CEO fulfill these two duties diligently?

Arguably, the CEO should spend his or her time managing the business and the chairman of the board should spend his or her time managing the board and its corporate oversight functions. The CEO and the chairman should be part of a leadership team representing the best interests of the shareholders in maximizing value.

Should major corporations, NYSE or NASDAQ listed, preclude a CEO from also serving as chairman of the board? We will address the issue from several vantage points, and discuss some of the practical implications which will help boards determine whether good or bad governance would result from a non-executive chairman.

Some boards are considering the appointment of a lead director in a manner similar to a non-executive chairman. Almost all of the issues discussed herein are equally applicable to the issue of whether to create a lead director position.

The non-executive chair could create a new power base in the corporation which could lead to competition and turf battles. Without care, good intentions could create bad results.

First, there is no universal correct answer. Whether precluding a CEO from serving as board chairman would result in more effective governance will depend on the facts and circumstances of each case. The experience, emotional maturity, and personality of the CEO are factors, along with the experience, emotional maturity, and personality of the non-executive chairman. Policies and procedures adopted by the board, for selecting, staffing, paying and implementing the non-executive chairman process and function will also matter.

The creation of a non-executive chairman would signify a new power base in a corporation which theoretically could create competition and turf battles between a CEO and a chairman. To mitigate this

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risk, detailed operating procedures must be developed first. What the chairman will do and how he or she will do it is the essence of the matter. It is imperative that these issues be resolved and memorialized upfront to lessen the risk of good intentions producing bad results.

Some opponents of the non-executive chairman idea call it too much oversight, too much government regulation, or an overreaction to a few bad apples. We believe those ideas are equally as wrong as the belief that merely creating a non-executive chairman position will result in good governance.

Whether or not separate CEO and chairman positions lead to better governance or not depends on the qualifications, emotional maturity, and values of the two key participants (CEO and non-executive chairman). Other factors are the policies and processes put into place beforehand to manage tension and conflicts which will arise under a check and balance oversight system, and the underlying reasons for the change.

What issue or problem would a non-executive chairman solve for your company? Will there be problems with power or perceptions?

The issue of whether a non-executive chairman will lead to better governance has to be evaluated in the context of other changes occurring in the makeup and work ethic of boards in general. Boards are becoming more independent, working harder and longer, and exercising more detailed oversight. Should this preclude the CEO from serving as its chairman? That depends upon the answers to the following questions:

- Why does your company need a non-executive chairman? What is wrong with the current governance practices?
- What circumstances create a case for a non-executive chairman?
- What are the qualifications for a non-executive chairman?
- What “firewalls” need to be created to mitigate against power plays and competition between a

CEO and a non-executive chairman?

- What firewalls are needed to keep the CEO and non-executive chairman from developing an alliance which negates the effectiveness of the separation of the roles?

- How would the process be structured to implement the non-executive chairman oversight role in the corporation?

- *Why is a non-executive chairman necessary?* What issue or problem needs to be solved, and will a non-executive chairman solve it? Is it a process issue? Is it a balance of power issue? Is it a controlling CEO issue? Does the CEO have his or her hands full with business issues? Has the CEO been resistant to good governance best practices? Has the CEO micromanaged the board, its agenda, content and access to people and information?

If the board is concerned about perception issues and inherent conflict of the chairman overseeing himself or herself as CEO, then the positions should be split. If perception is not the dominant issue, then the independent directors should assess the effectiveness of their service as compared to good governance best practices (in a legal framework). Determine whether this oversight and advisory fiduciary duty requires the appointment of a separate chair.

Other options include expanding the board’s oversight policies and procedures, changing the makeup of certain board committees, changing the nominating procedures for directors, adding independent members, or appointing a lead director. The real issue may be the board itself. Creating a non-executive chairman will not necessarily solve that issue.

- *What circumstances create a case for a non-executive chairman?* Certain facts and circumstances create a more compelling case for a non-executive chairman. For example:

- A new CEO is brought into a major corporation from the outside. It will be enough of a challenge for him or her to learn and manage the business. The responsibility of also managing the board only adds to an already full agenda.

- A “young” CEO is promoted from within the company. Again, the responsibilities of managing the company will consume most of his or her time

and energies, and a non-executive chairman could be extremely beneficial. This allows the CEO to focus on the primary duty of operations without the burden of managing the board.

□ The current CEO/chairman built the company and the CEO's family controls a meaningful block of stock. In order to mitigate the "family corporation" mentality, a non-executive chairman as a check and balance may be beneficial.

□ A corporation is in a turnaround situation and a turnaround CEO is required, or the corporation may be a serious takeover target, or it could be involved in a major acquisition. All of these heighten the potential real and perceptual conflicts of interests between the CEO and chairman functions. The financial self-interests of a CEO may diverge from shareholder interests, and a non-executive chairman could be beneficial.

□ A CEO who has resisted good governance practices and the appointment of effective independent directors may need a strong counterbalance in the form of a strategic thinking non-executive chairman who can organize and lead the board's oversight function.

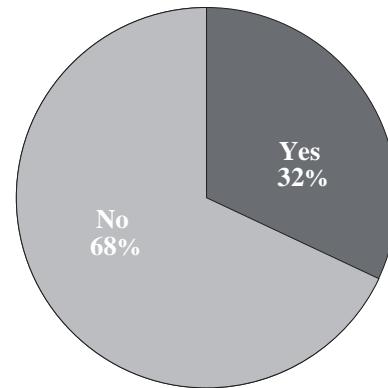
An effective non-executive chair should invest something like 1000 hours yearly into the role, and be paid accordingly.

□ *What should the qualifications be for a non-executive chairman?* The non-executive chair should be a person of the highest integrity, accomplishment, and emotional maturity. A successful non-executive chairman has satisfied his ego/ambition needs, and is looking for significance not success. A non-executive chairman must have strong leadership capabilities, to spur the board's oversight and advisory roles, and gain the respect of senior management and employees. The non-executive chairman could be a current board member, or someone may have to be brought in from the outside.

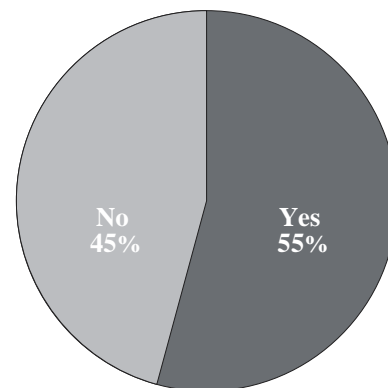
Not only should a non-executive chairman have superb personal qualities, but it would be very helpful for him to have knowledge of the company's

Split Or Not To Split? Boards Are Of Two Different Minds

If your chairman is also the CEO, do you have an elected or appointed lead director?



Should a board that has an inside director as chairman elect or appoint an outside director as the lead director?



Source: Korn/Ferry 29th Annual Board Of Directors Survey

industry and the company itself. If the non-executive chairman lacks company experience, upon taking the job he must strive to learn the business, the people, and its issues from the bottom up.

Lastly, a person serving as a non-executive chairman should have the time available to properly discharge the duties involved. The amount of time will vary in each situation, but in the case of a large complex company, somewhere on the order of 1000 hours a year would seem reasonable. To attract the right person, significant compensation may be required.

□ *“Firewalls” needed to prevent power plays.* The non-executive chairman has two main functions relating to the CEO: overseer and advisor. Central to the effectiveness of this relationship is the ability of both to build a trusting relationship while implementing the checks and balance system.

By definition, there will be two leaders, two strong individuals. The CEO has ultimate responsibility for managing the business. The board has the ultimate responsibility for managing the managers. If you choose the wrong person as non-executive chairman, the potential for personality conflicts, turf wars and political battles between the CEO and non-executive chairman will be significant and could cause serious problems. Likewise, the position should be structured to lessen the ability of the CEO and non-executive chairman to form an alliance which may frustrate the purpose of the separation. What can be done to mitigate these outcomes, assuming a well-qualified non-executive chairman has been chosen?

By contract and policies, a non-executive chairman should be precluded from serving as CEO of the corporation or as CEO of a competitor.

To prevent the creation of opposing teams, neither the CEO nor the non-executive chairman should serve on the nominating committee of the board.

To prevent pay conflicts, neither the CEO nor the non-executive chairman should serve on the compensation committee of the board.

The non-executive chairman should have a contractual term and should only be removed by a vote of the independent directors. In the case of a non-casual removal, a super majority of independent directors should be required.

The board should promulgate the non-executive chairman’s duties and responsibilities. The CEO and all senior officers should contractually acknowledge those duties and agree to use their best efforts to ensure effective governance and shareholder oversight through the board’s activities.

The non-executive chairman’s performance should be evaluated annually by the other independent directors to insure that the purposes of separation are being met.

□ *Implementation process and policies.* What are the rules of engagement? How will a non-executive chair and the board execute their oversight duties? A key factor here is the creation of a new power base whereby another major player, the non-executive chairman, is added to the corporate mix. What kind of access to information, company personnel, customers, suppliers, etc., would the non-executive chairman have? What kind of staff, travel budget and advisors would the non-executive chairman need? This should be thought through and set forth in written policies.

The goal should be unlimited access to information and people consistent with the board’s fiduciary duties. The positive benefits should be communicated to all employees, avoiding any possible connotations of conflict or challenge to the CEO. A joint communiqué disseminated throughout the company by the CEO and non-executive chairman should set forth the fiduciary requirements and the positive impact of this new working relationship. Within the limits of their respective roles, a team mentality is required. Employees need to be educated about the role of the board and the fact that the CEO reports to the board who oversees the management for the owners—the shareholders.

The question of whether the creation of a non-executive chair would lead to better governance depends upon the two people involved, and on how the details of implementation are worked out. The inclination is to split the roles because of the inherent conflict of the manager (CEO) overseeing himself or herself. However, it is possible for strong, active, independent boards to fulfill the oversight functions without a non-executive chairman.

Additionally, the wrong non-executive chairman or the wrong process implementing a non-executive chairman system will not improve governance. The “devil is in the details.” It is both a people issue and a process issue as to whether good or bad governance will result from severing the CEO/chairman roles. Can you have good governance without a non-executive chairman? Yes. Can you have bad governance with a non-executive chairman? Yes. ■