Creating the board your company deserves

The art – and science – to choosing directors

Many issues compete for a place at the top of a company's list of governance priorities, including the potential expansion of shareholder rights, regulatory demands for enhanced disclosure, and the oversight of risk management. However, we would argue there is no higher governance priority than ensuring you have the right people on the board. Without that prerequisite, the ever-growing requirements will be more difficult to meet in a way the company and its stakeholders deserve.

So how does a company approach board composition? Where does the process begin and does it ever end? This paper is written for chairs of governance and nominating committees, board chairs, and other senior-level decision makers who have input on the board selection process — in short, the people responsible for making sure your company gets the board its stakeholders deserve. It discusses a strategic way of thinking about and approaching board composition that is fair but realistic, timely but timeless, and, with the help of a few resources, just may set your board on a journey to a place of enhanced governance.

Enhancing relationships, rebuilding trust

We bring this approach to light now, because most companies, whether large or small, start-up or mature, face an unusual confluence of exacting demands that have to be constantly juggled: optimizing operations in a recovering economy; identifying and managing unrewarded risk while maximizing innovation and growth; and meeting both short- and long-term capital and financing needs in a competitive market, to name a few. These challenges must be addressed in a way that enhances, rather than hinders, the interaction between management and the board. Furthermore, companies must achieve all of this in a way that restores trust between company leadership and stakeholders.

Much of the learnings behind this whitepaper are based on Deloitte's collective experiences related to regulatory findings, governance failures, or other "triggers." ("What Drives Change" sidebar provides common drivers of board composition review and change). Despite the varying reasons for action, we are seeing a meaningful trend, specifically, a growing numbers of senior executives recognize a need to be proactive in helping the company's board self-assess and improve. They are learning that while, in most cases, ineffective boards don't inevitably result in complete company failures, they do often result in slower decision-making, frustration, and distraction.

Given these circumstances, the compelling questions raised are:

- Does your company have the board it deserves?
- Does the board have the rich mix of skills, experiences, and values that can take the enterprise where it needs and wants to go?
- How well does the board see and evolve with changes from within and from the outside?
- Is the dynamic between the board and management one that encourages active oversight while minimizing unnecessary and costly delay?

At the end of the day, one of leadership's top priorities must be to ensure that the right people are onboard and properly engaged at the highest level.

What drives change?

Following are some common drivers of board composition review and change. As noted, while these often spur change, it is not necessary — or even recommended — to wait for them to occur before acting. In fact, proactive steps can actually offset, or minimize, the occurrence of, or challenges caused by these events.

- Breakdown in board effectiveness
- Board-member turnover (unexpected departures and planned succession)
- New regulation
- Enforcement actions
- Significant growth (organic or acquisition based)
- Post-merger integration
- Initial public offering
- Shareholder activism

How to develop the board that your company deserves: Introspection & assessment

Is your company considering a major transaction, such as a merger, for example, or exploring entry to new or emerging markets? Is its strategic plan dependent on "going global"? Is management looking to start up a new product line or brand extension?

These are big changes which could create significant opportunity. An effective assessment approach would focus on the future of the company instead of rehashing the past. It is critical to ask: Do we have the right board for this company to be able to execute upon the desired future objectives? A forward- looking approach can also take some of the "ego" out of the process. It isn't about criticizing the skills and experiences of any individual director. It is about poising the company for the future. A well-thought out process is more likely to be sustainable, at the ready when it is time to fill board seats as vacancies naturally open up due to director retirement or resignation.

Before embarking on a proactive assessment process, a board must acknowledge that it is committing to a continuous course of voluntary self- or peer-examination. Once development needs are identified, a board must embrace the process for improvement or potentially risk leaving itself exposed should something go wrong. In fact, this is probably the most difficult part of the process — understanding and accepting that it is better to know and address fractures in board composition. That is why an approach that focuses on the *desired future state* of the board — in the context of its strategic plans — is effective.

Alpha Natural Resources case study: Bringing board composition strategy to life

In the spring of 2009, Alpha Natural Resources, Inc., one of America's largest coal producers, announced it would acquire Foundation Coal Holdings, Inc. The transaction would combine their respective geographical focal points — Alpha and Foundation's operations in Central and Northern Appalachia and Foundation's facilities in the Powder River Basin of Wyoming. In tapping these two disparate sources, the combination also would enhance product diversity at a time of market volatility, bringing together Alpha's strength in metallurgical coal (used in steel making) with Foundation's steam coal capabilities (used in generating electricity).

As the deal neared completion, the company recognized the importance of establishing a strong and integrated board, one capable of fulfilling the strategic vision of the company. Rather than simply combining the two capable boards, they engaged in a process to streamline the combined boards to 10 directors who would serve on the new body.

With Deloitte's assistance, Alpha's management and board leadership engaged in a self-assessment and board rationalization process designed to consider four vital and overarching objectives:

- Minimize any negative impact of the process on relationships with members of the former Alpha and Foundation boards
- Present the most qualified candidates from the old boards, given the company's go-forward strategy and business objectives
- Make the actual changes as smoothly and seamlessly as possible, so as not to distract the new management team, new combined employee population, and all other key stakeholders (investors, suppliers, customers, etc.)
- Create a new board that could provide the leadership, skills, and cultural influence to successfully oversee integration of the two companies and ongoing operations of the new, combined enterprise

Alpha Natural Resources case study, continued

Two years after the business combination was first announced, the current Alpha board and senior management team say they are very pleased with the proactive approach they took to design the board Alpha deserved and with their progress in getting "the right people on the board" as a result of their board rationalization initiative. Moreover, this was accomplished with the understanding and support of former Alpha board members. "We followed a process that helped us identify the right director attributes, refine our board structure, and enhance how we communicate and engage as a board," says Kevin Crutchfield, Chief Executive Officer of Alpha Natural Resources. "In addition, it is a sustainable process that will help us on an ongoing basis move Alpha toward the brightest possible future for our industry."

In order to sustain successful engagement between and among the board, management, and stakeholders, leadership implemented improvements in three key areas:

1. Quality of information provided to the board and assessment of board effectiveness
2. Discussion of critical strategic governance topics, e.g., company strategy, risk management and governance, and succession planning
3. Design of a multiday off-site planning session to focus the new board on hot topics — particularly the company's future direction

"We realized this was a special moment in time as the deal was coming together. With this in mind, we leveraged the momentum of a new board coming into the completion of the merger, and the new board's desire to support the vision and strategy behind the combination. That momentum continued to build as we focused on the process improvements Deloitte helped us implement in the early months following the merger," says Crutchfield.

Alpha's acquisition of Foundation was one of the first of a number of consolidations among coal companies in recent years as producers addressed the industry-related challenges of a weak economic environment. In fact, with continuing depression of valuations through 2009 and into 2010, Alpha has since proceeded with plans to merge with Massey Energy Company.

They tell us that the processes they put in place nearly two years ago continue to yield important business vitality and outcomes that benefit the company's governance, strategy, and operations. The new board believes it has the understanding and tools needed to sustain effective board performance whatever challenges marketplace changes may drive.

Crutchfield summarized the process this way: "Governance considerations became a driver in helping the board focus on both its immediate goals of successfully integrating the companies as well as aggressively acting upon our long-term strategic initiatives."

Assessment: How do you know what you need?

Experience tells us that doing a comprehensive assessment of where the board currently stands is an effective way to get started. When the following three key elements of board effectiveness are optimized, it can turbo-charge all of the board's activities, yielding greater efficiency and effectiveness and putting in place repeatable, sustainable processes.

1. Director attributes, composition, and competencies
2. Structure, policies and practices
3. Information, communications, and engagement

The first objective is to explore the key director attributes required (e.g., technical and professional skills and experiences, and leadership qualities, such as governance expertise, personality traits, diversity of thought and background — see accompanying sidebar on "What constitutes the optimal mix?"), and then consider current composition in light of the organization's future goals. The next steps are to consider the way the board works – its structure and policies. Last, but in no way least important, the quality of the boards' interactions and information is considered. All three elements of the assessment drive the creation of a comprehensive development plan for individual directors and the full board, as well as a short- and long-term succession plan.

Board development — Not all competency gaps can — or should — be recruited "away."

- Individual board member development — One-on-one coaching and mentoring designed to focus on individual directors' areas of needed development, such as leadership skills, communication, and meeting participation, is an often-overlooked element of the process. When led by a trusted board member and/or independent advisor, it can reap huge benefits.
- Full-board development — Focused, in-the-boardroom development that incorporates deep-dive group sessions is an effective way to enhance the collective board's competencies in key areas such as strategy, risk, and the company's business.

Succession planning — The challenge is to have a plan that is adaptable to the dynamic, ongoing assessment process to be conducted going forward, as well as the shifting demands of the company's operations and future direction. The succession plan can focus on the tactical: identifying candidates from various sources (e.g., from other director references, a search firm, list of retired executives from other companies that might add needed dimensions) and the orientation, mentoring, and training of new members.

Use of advisors and specialized resources

When undertaking this process, a board will need a number of resources, including:

- A set of relevant leadership, technical, and professional attributes;
- Board, committee and individual director assessment tools, such as surveys, and interview guides
- Templates for individual and board development plans
- Short- and long-term succession planning models that reflect individual directors' current thinking about retirement and the impact on board composition

While there are a number of tools and templates available — including a number published by Deloitte — it is critical that a board tailor these to fit the specific facts and circumstances of the company. This process is an art and a science. Avoid pitfalls by tailoring tools for board assessment and succession planning.

In many cases, an outside perspective is critical to the change management aspects of this process. In fact, many boards have a pretty strong sense of their strengths and development needs on the front-end of the process. An advisor can help to bring those issues to the fore in a way that an insider cannot. In addition, an advisor can help the board to tailor the available resources to provide the most value, can project manage the process, and can ensure a comprehensive set of tactics for improvement. Again, each of these can be challenging for an insider.

What constitutes "The optimal mix"?

The ultimate objective of any board assessment is to achieve effective board oversight and strategic advice in an increasingly complex business environment so that the enterprise succeeds and thrives; but how do you know you've considered the characteristics that achieve the optimal mix of experiences and perspectives for your organization's business strategy, future direction, and risk profile? Careful review of the desired characteristics according to director, company, and performance requirements will help:

Characteristics of the members

An effective "composition balance" certainly will need to track with the essential skills, personal competencies, and experiential attributes needed to fulfill the board's mission for a particular company and this will vary by both industry and individual organization. These might include qualifications as specific as technical and industry knowledge or a professional skill set, such as business operations or law or it might be well defined but less prescriptive, such as possession of global and local market experience, appreciation for customer focus, or a history of association with innovative ideas. There is also the growing importance of gender and ethnic diversity, which helps ensure not only variety of perspectives but which also should better relate company decisions to customer or stakeholder experiences and attitudes.

Characteristics of the company

The composition of the board should be in part a function of the company's size, stage of growth, and other specific characteristics. Annually, the nominating and governance committees should take the opportunity to reexamine the needs of the board in the context of the company's current and future direction at that point in time.

Characteristics of board effectiveness linked to performance

Board composition should reflect in-depth "understanding" of the company, including its strategies, operations, financial condition, and compliance requirements. After all, assembling the best team of people in the world that possesses the best intentions in the world is useless if that group doesn't have visibility into the company's goals and inner workings and/or if that group isn't capable of processing and acting on its responsibility to maximize performance in concert with those criteria.

Conclusion

In an increasingly complex and unpredictable business world, the board must be strategic about board structure and composition. In the same way that corporate leadership would never consider entering into a merger or acquisition without thorough due diligence, so, too, should assessing board composition (and how well your board meets your expectations) be treated as a significant strategic activity for the company, bearing long-term implications for strategic, financial, operational, and compliance decision-making.

As an organic entity, the board has an evolving story punctuated by departures, role transitions, and successions. Building a qualified, effective board is a continuous process — a journey, not a once-and-done proposition. Invest in a sustainable framework that can be used now and into the future. Draw on outside experience and objectivity to help you drive a disciplined process, to think originally, and to build credibility with all the stakeholders of the process.

For a company that is focused on market agility, innovation, and growth, management should be proactive in providing resources and support to the process. Board and company leadership should think carefully about the future — will this particular group of directors be a good fit from a strategic and experiential standpoint?

The leading approach is to take a proactive, constructive stance about who's minding the store. Go after the best people you can find based on your "white space" or "gap" analysis and make it clear that continued service on the board will be based on a demonstrated commitment to active, informed, and engaged oversight. Stay in tune with the ebb and flow of board member skills and experiences as they relate to the company's ever-changing environment and circumstances and you are well on your way to fulfilling the fundamental sustainability of your board's effectiveness.

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