Doomsday signals for directors

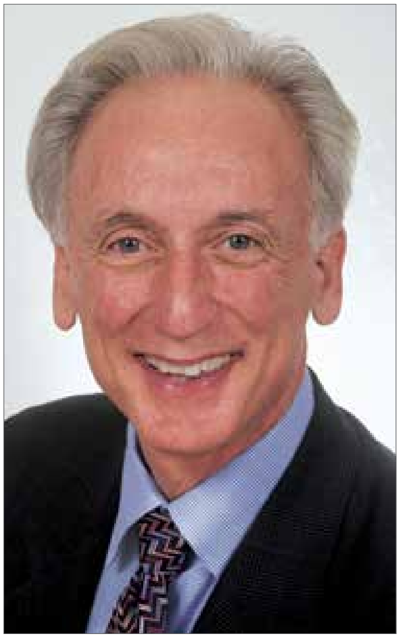
These indicators of board and management concern should be on your radar — potential dire consequences may lie ahead.

By Allan Grafman and Andrew De Camara

Board service is necessarily a 'team' sport. We spend significant time with people we respect, often developing social and business relationships. Over a span of years, bonds of friendship develop. These bonds of friendship and respect can be the glue that keeps a board and company moving forward.

Conversely, these bonds can lead to a mentality that overpowers a director's own good judgment, inhibiting direct action. The result: a director avoiding awkward conversations that need to take place.

When do numerous smaller concerns tip the scale toward initiating a conversation not warmly welcomed by esteemed colleagues? Ask yourself that question as you consider how many of the following "doomsday signals" your company is sending to you. While no single indicator is predictive or conclusive, the presence of many of these signals — our focus is on board governance and director-level issues — is indicative of problems ahead.



Signals frequently encountered (but often left unaddressed)

Put a check by the ones that are on your radar:

☐ *Culture, ethics and integrity concerns* that you would address more directly if you were CEO of the company, but do not because this is a CEO's responsibility.

☐ *Directors who have side consulting deals* with the company or with large shareholders. Conflicts are apparent, as it becomes unclear where their priority or loyalty resides.

☐ *Family members as employees and consultants.* Would a truly independent director just arriving

Allan Grafman (at left) is president of All Media Ventures, which monetizes brands and content for investors and corporate owners (www.allmediaventures.com). He is an operating executive and board director in turnaround, growth, VC and PE portfolio companies. **Andrew De Camara** is senior managing director of Sherwood Partners Inc., which provides consulting services in crisis management, corporate restructuring, business development, and strategic and financial planning (www.shrwood.com).

on the board find this relationship overwhelmingly beneficial to the company, or questionable?

☐ *Committee chairs have not rotated*, leading to ossified and entrenched positions, approaches and opinions. The same concern arises when boards have not embraced new members in a long time, or lack diversity in viewpoints and relevant experience. [*Ed. Note:* Additional guidance on avoiding board entrenchment can be found in Allan Grafman's article, "The Board's 'Seven Year Itch': It Would Benefit All To Have Directors Take a One-Year Sabbatical," Directors & Boards, Fourth Quarter 2014.]

☐ *No successor is in place for the CEO*, or even an agreed-upon succession plan process.

☐ *Combined CEO/chairman roles.* It is challenging for every individual to put their role as an executive ahead of their personal interests. Allowing a CEO to occupy both roles increases that challenge, and makes it harder and less likely for a director to challenge a sitting CEO/chairman. No surprise that the bank with a combined CEO/chairman tops the banking industry leaderboard with $35 billion in fines and penalties.

☐ *Directors authorize bonuses as the company loses money*, and fail to address spiraling costs that grew during the good years.

☐ *Investments in 'outlier' sectors* that have little or no relationship to current operations or talent roster.

☐ *Repeated security 'glitches'* that have been left unattended. Directors have been found liable for just such inaction over a period of time.

☐ *Evergreen employment contracts that 'auto renew.'* Do these allow the board to 'get by' with less robust performance reviews and considerations of new leadership?

When times are good, directors may accept or ignore the above warning signs. Directors who are seeing many of the above indicators should be prepared for their company and board to enter the world of *distressed.*

Directors in distress

In a distressed situation, directors and management are required to execute with greater precision while resources become increasingly constrained. These constraints include less time, dwindling cash, loss of institutional knowledge from the employee base, less patience from stakeholder constituencies, and increased public scrutiny.

Directors need to be focused on the following signs of dysfunction among the board or they are likely to face an inability or unwillingness of management to effectuate proper change, with unfortunate consequences. Key examples of more urgent doomsday signals:

WHAT HAT IS A DIRECTOR WEARING WHEN THEY SPEAK OR VOTE IN A MEETING?

☐ *Management continually misses performance targets* and demonstrates no ability to accurately project future performance — most damaging when related to revenue projections and cash availability. Management compounds this issue by not being intellectually honest enough to explain the poor performance.

☐ *Management develops a counterproductive relationship with the company's lenders* through its inability or unwillingness to provide data analysis that will help demonstrate to the lender that their interests are being considered in the decision-making process.

☐ *In board meetings, the CEO and/or CFO are unable to answer basic and critical financial questions* regarding cash position, receivables, deferred revenues, head count, contingent liabilities, and alternative courses of action.

☐ *The CEO blocks* or attempts to control the ability of directors to interact separately and independently with the CFO and other key executives.

☐ *The CEO "springs" important issues or decisions on the board* at meetings without placement on an agenda, limiting the ability to assess alternatives or appropriately analyze an issue.

☐ *A "cult of the CEO" arises* whereby the CEO hires or trains the other key executives to mimic his talking points, which dissuades honest discussion of alternatives.

☐ *Directors wearing multiple hats.* In a venture or private equity-backed company, what hat is a director wearing when they speak or vote in a meeting: 1) board member with fiduciary obligations; 2) debt holder with senior secured or subordinated secured debt; 3) shareholder trying to maximize their individual holding. Certain directors are indemnified by their funds so they may be willing to engage in a more aggressive approach by the company, in contradistinction to the independent directors who are protected only by a company's D&O insurance policy.

Would a truly independent director just arriving on the board find certain relationships questionable?

☐ *Resistance of management to support hiring of outside, independent legal or business professionals* with expertise in specific areas. This typically demonstrates a desire to avoid third-party scrutiny which could be at odds with management's viewpoint.

☐ *Excessive abstentions* by a particular board member on difficult votes, or a board member always asking to vote last or always voting with the majority or with the CEO.

☐ *Board members and executives heading for the doors* as company performance deteriorates.

Your takeaway

Directors represent shareholders, the company, their board, and themselves. They are in this position due to their acumen, and their experience guides them. The above list of doomsday signals is one tool that will allow a concerned director to initiate a conversation with colleagues on difficult issues before dire consequences take hold. If you found yourself checking off several of the above indicators you may wish to use this article to overcome the awkwardness and approach your colleagues today. ■

The authors can be contacted at allangrafman@allmediaventures.com and ad@sherwoodpartners.com.

The Reg Jones list of danger signals

When he was chairman and CEO of General Electric Co., Reginald Jones was named the best CEO in the country in a poll taken by *Fortune* magazine. After he retired (and was succeeded by Jack Welch), he served on a number of corporate boards and made several appearances in *Directors & Boards* offering his guidance on enlightened governance practices. The following list comes from his article, "Things You Can't Live With As a Board Member" [Spring 1994]. He died in 2003.

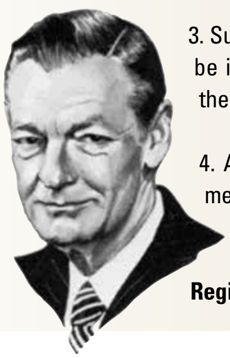
Things You Can't Live With As a Board Member

1. A predominantly inside board.

2. An overly dominant CEO who rejects a participating board.

3. Surprises — the board should be informed before reading in the papers.

4. A closed agenda for board meetings. Failure to include topics suggested by the board.



Reginald Jones

5. Inadequate number of board meetings.

6. Actions taken and announced by the CEO that are within the province of the board, but have not yet been discussed with and approved by the board.

7. A compensation committee that includes insiders.

8. Personnel appointments by the CEO that are within the province of the board but have not yet been approved by the board.

9. Compensation plans announced without board approval.

10. Failure to review with the board the performance appraisals of key executives and their participation in incentive compensation arrangements.

11. Inadequate involvement of the board in succession planning.

12. Failure to review with the board significant union negotiations.

13. Appointment of outside auditors without the approval of the board.

14. Interference with the board's independent discussions with outside auditors.

15. Inadequate management responses to outside auditor criticisms.

16. Adoption of operating and capital budgets without board approval.

17. Inadequate involvement of the board in development and approval of strategic plans.

18. Inadequate indemnification and liability insurance coverage for directors.

Things You Can't Live Without As a Board Member

1. Reverse of items above!

2. A relationship among the directors that is friendly, open, mutually respectful of differing opinions and positions, and yet supportive of the CEO and devoted to the interests of the shareowners.