Sign Your Own John Hancock

Why directors should write an annual letter to shareholders.

By Allan Grafman

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We can all agree that the CEO is responsible for the company's day-to-day operations and results. In the United States' system of corporate governance, the board of directors represents the interests of the company owners. Board directors are *collectively* and *individually* responsible for the long-term progress and success of the company.

Further, public companies must provide their shareholders with an annual report on the company's results, operations and policies. Thus, the annual report may contain both:

1. Operating results that are primarily the CEO's domain, and
2. Topics that only a board can address, as they are properly outside the control of the CEO.

Shareholders will be best served and boards will be most effective when all directors write an annual letter to shareholders. (We assume the CEO is on the board.) This board letter may be in addition to the CEO letter, which addresses operational results and activities. Alternatively, the board letter may incorporate the CEO report on operational results. The board letter should draw upon but not replace the voluminous material now found in the committee reports. Every company will determine which alternative is best for its specific circumstances. Finally and importantly, each director should sign the annual board letter.

The Specific Topics

There are several reasons why the board is best suited to properly communicate a complete and comprehensive annual letter to shareholders. Certain topics regularly come before the board for consideration, discussion, review and modification, followed by board approval or rejection. The CEO participates and contributes, and often may initiate these discussions, but the final decision rests with the full board.

Every company will find its own approach and balance in addressing these topics, as Allstate and Prudential have done in their director letters. There are many topics beyond the scope of a CEO to speak exclusively about in an annual letter. Shareholders deserve to hear the details of these issues from the directors charged with their resolution. The board needs to lead the conversation with its owners on these topics.

■ **Strategic direction and implementation:** All significant questions of strategy and implementation come to the board. This is generally viewed as a primary responsibility of every board. Many recent corporate failures and bankruptcies can be placed at the feet of boards that failed this supervisory task. Is it possible that boards engaged in writing a report to their owners will increase their knowledge of the company's operations?

■ **Management evaluation, compensation and succession:** This is another universal task of every board. Certainly management is not empowered to write to the owners regarding their own evaluation, compensation and succession. Yet owners need to have some outline as to how these issues are being addressed. Say on pay is now forcing many boards into a dialogue on this topic. It is possible that boards will soon be asked to address the gap between CEO and median employee compensation. The board is better equipped than management to address why the company CEO is paid 10 times (100 times?) the median pay of its employees.

■ **Risk and crisis management:** Almost always a crisis is caused by actions taken, or not taken, by management. Often, the board is entrusted to take the lead in sorting out what has happened and the best course forward. This approach leaves management free to continue to run the business and the board to run the important fact-finding process.

■ **Company performance:** Management provides a comprehensive report on performance. It is up to the board to provide an informed and independent evaluation as to how the performance compares to budgets, expectations, opportunities, challenges and the road ahead.

■ **Investor communications:** Recent events have led to increased director involvement in investor communications. This trend is driven by investors' desires to be heard directly, sometimes about management issues, and sometimes by a desire to gather input directly, rather than indirectly. For selected directors to be available on a reasonable basis to the owners of the company is a growing practice. Addressing concerns in a director-written annual letter could reduce the need for ad hoc meetings and be an effective time-management practice for some larger companies.

The Soft Reasons

Perhaps the numerous spate of board failures attributed to "We did not know" could have been reduced if every board director fully engaged and signed the annual letter addressing at a minimum these two topics:

■ **Corporate culture and ethics:** Effective boards monitor issues of culture and ethics throughout the year. Management may establish corporate culture, with effective boards monitoring that culture in order to reduce the likelihood of serious ethical breaches and the shareholder losses that result. Directors convey real engagement and topic importance to internal and external stakeholders when it is addressed in the annual letter.

■ **Board transparency and unity:** The task of uniting all the board members around the issues to be communicated in an annual letter is likely to require commitment, engagement and resolution. This process will bring to the fore any lurking divisions in the thinking among the directors. While unity is not always within reach, surely a board is more effective when its members are unified, or at least have clarity on where the divisions are.

Why Not?

What is preventing directors from writing an annual letter to shareholders? The obstacles fall into two broad categories: legacy and legal.

■ **Legacy:** Past practices have historically left the annual letter in the hands of the CEO. Even worse, the still-extant combined chairman-CEO structure, writing as one party on behalf of the entire board, is a legacy remnant of the receding "Imperial CEO" era. Board-CEO relations are transitioning to an era of greater board control and clarity. Transitions require leadership to generate action and forward momentum. Some CEOs may resist this change. Wiser ones will accommodate or welcome it. In every case, the decision to write an annual letter rests with the directors.

■ **Legal:** As an annual letter signed by directors is a new practice to some companies, there will be some concern about legal exposure. The reader will recognize the aphorism "Anything we say can and will be used against us." As this already applies to all actions taken or not taken by a board, no serious director will find this a credible obstacle. Diligence and care are always required.

Why a Signature Matters

So how is John Hancock's signature relevant to the governance role entrusted to directors?

According to legend, John Hancock signed the Declaration of Independence with his clear and bold signature so that the King of England could see exactly who had signed the treasonous document. Initially only Hancock, as president of the Continental Congress, signed the document.

Hancock's example inspired his 56 fellow delegates to subsequently sign the Declaration. Fully aware of the potential consequences, the delegates signed their names to what would become their death sentence should the British prevail. These "board directors" did not delegate or hide behind a single "CEO" signatory when reporting to the country the results of their efforts. The "director delegates" took responsibility and courageously put their names to the Declaration of Independence.

While of lesser impact and historical dimensions, directors should be sufficiently engaged to put their name on the annual letter to shareholders. Directors might even consider it their own Declaration of Independence. D

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