

# The Case for Lead Directors

THAT GIANT CRACKING SOUND you hear is the splintering alignment among many of the world’s largest joint ventures. The global economic crisis is putting severe strains on partnerships as their corporate shareholders face intense pressures and often have very different views on how to respond. As the CEO of one multi-billion dollar joint venture told us:

“It’s been extremely tense. One set of Board members believed starting in September that there was going to be a 30% drop in demand coupled with extreme pressure on our ability to raise funds – and believed that the venture should reduce its capital plan from \$450M to zero, and dramatically move to reduce not just variable costs but cut fixed costs by 25-30%. The rest of my shareholders thought that was a seriously dramatic over-reaction. My Board members were close to throwing lamps across the room.”

What can be done? A simple governance practice – the creation of **Lead Directors** – is a vital tool for maintaining shareholder alignment. Lead Directors can also be instrumental in driving other performance improvements (e.g., taking out costs, making changes to the capital structure, and mitigating risks) essential in the current economic environment. We are starting to see a pattern of 7-10% operating performance improvements associated with the creation of Lead Directors.

The purpose of this memo is to make the case for appointing a Lead Director, and to outline the profile, roles and responsibilities associated with the position.

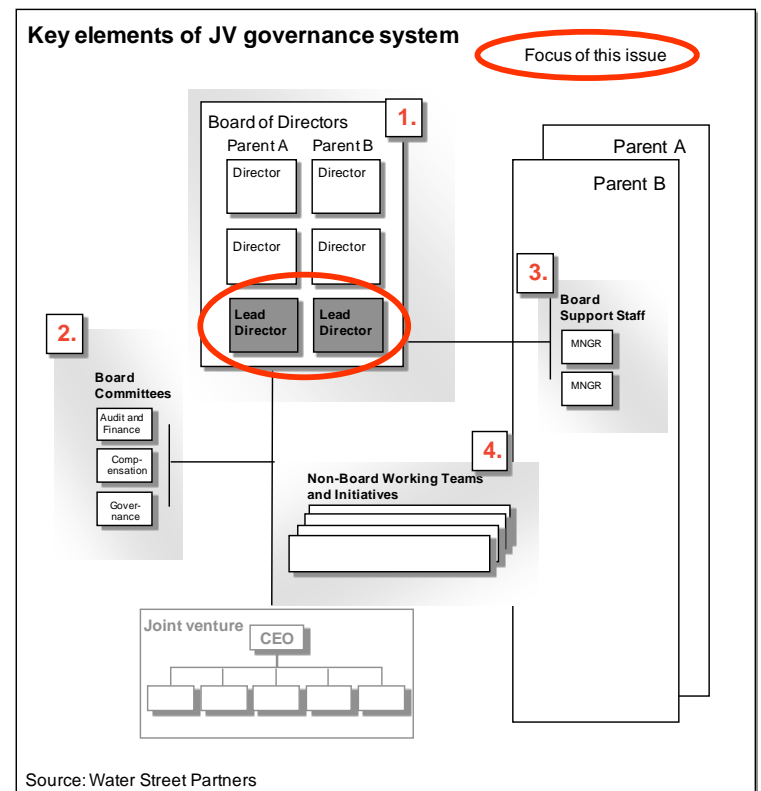
## THE LEAD DIRECTOR DEFINED

We believe that each joint venture shareholder should formally designate one of its board members as its Lead Director (Exhibit 1). At its core, the role of the Lead Director is to maintain the integrity and controls of the joint venture governance system, represent the shareholder’s interests between board meetings, and support and manage the performance of the JV CEO.

To be clear, a Lead Director is not an informal label assigned to the company’s most senior board member; rather, it is a formal role that: (a) comes with specific obligations, and that (b) must be performed by a particular type of director. All too often, companies end up with something that resembles a Lead Director position - but that falls far short of the mark (Exhibit 2).

The case for getting this right is compelling: our benchmarking database of some 40 large JVs shows that the presence of true Lead Directors is the governance practice which exhibits the strongest correlation with JV financial and operational outcome performance. Some 71% of JVs with

Exhibit 1: Lead Directors in Context



Source: Water Street Partners

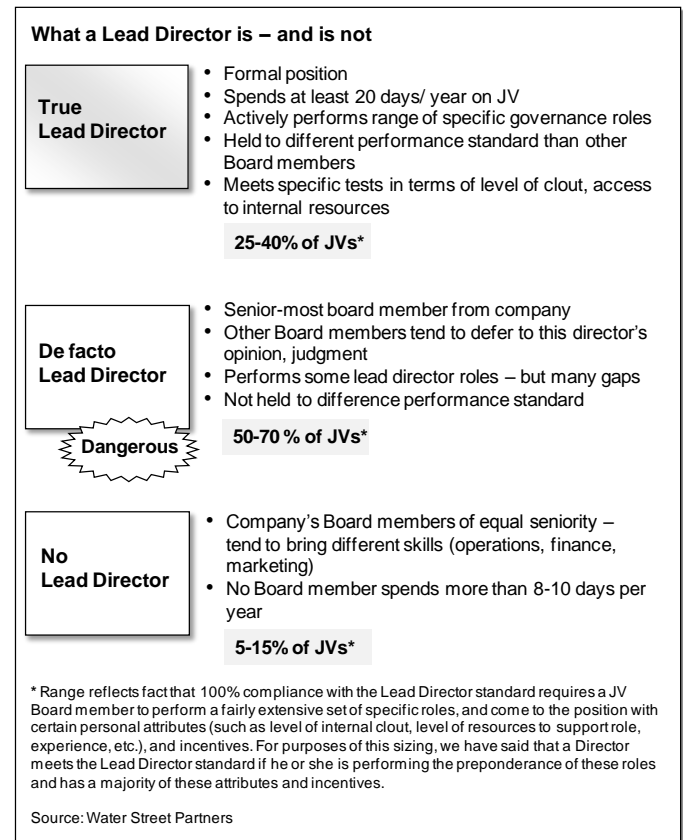
at least one Lead Director meet or exceed key outcome performance targets, while only 50% of JVs without any Lead Directors performed as well<sup>1</sup>. The presence of Lead Directors also correlates with high alignment scores based on self-assessments of JV Board members, thus underlining the key role that Lead Directors play in resolving shareholder tensions and disputes. And yet, Lead Directors are not common in joint ventures, at least when compared to public companies: less than 40% of JV Boards have Lead Directors, whereas, thanks to new exchange listing requirements and increased investor activism, 96% of publicly-listed US companies do<sup>2</sup>.

Why are Lead Directors so important in joint ventures? Given the complexity of governance and the challenges of running a large joint venture (see Memo to a New JV CEO, JVX, December 2008), Lead Directors can alleviate some of the intense burden on the JV CEO – for instance, by streamlining the messages that the CEO is receiving from the shareholders, helping the CEO manage “up” to parents by syndicating decisions prior to Board meetings, and enabling the CEO access resources inside each parent company. Likewise, given the longstanding tendency for JVs to have weak performance management disciplines, a Lead Director is instrumental in ensuring the venture faces a “challenge process” of equal intensity to a parent company business. Lead Directors can also be a mentor to other Board members, and the standard bearer for other directors to model.

**The Role of the Lead Director.** Our client work, research and correlation data on joint venture governance indicate a set of very specific responsibilities and obligations associated with being a Lead Director<sup>3</sup>, including:

- ¶ Spend at least 20 days per year in an active non-executive capacity overseeing and supporting the venture<sup>4</sup>.
- ¶ Perform the following roles:
  - Promote the success of the venture by: (i) working with the JV CEO between Board meetings to resolve issues that do not require full Board approval; (ii) accessing resources (skills, data, capital, people, privileged relationships, etc.) from inside the parent company in support of the JV;

## Exhibit 2: Lead Directors Defined



<sup>1</sup> According to research from McKinsey Benchmarking of JV Governance authored by James Bamford, David Ernst and Lois D'Costa and presented to the ASAP in February 2008, which tested for the correlations between a number of governance practices and JV performance

<sup>2</sup> According to research from Spencer Stuart, 96% of S&P 500 companies surveyed had a Lead or Presiding Director in 2006

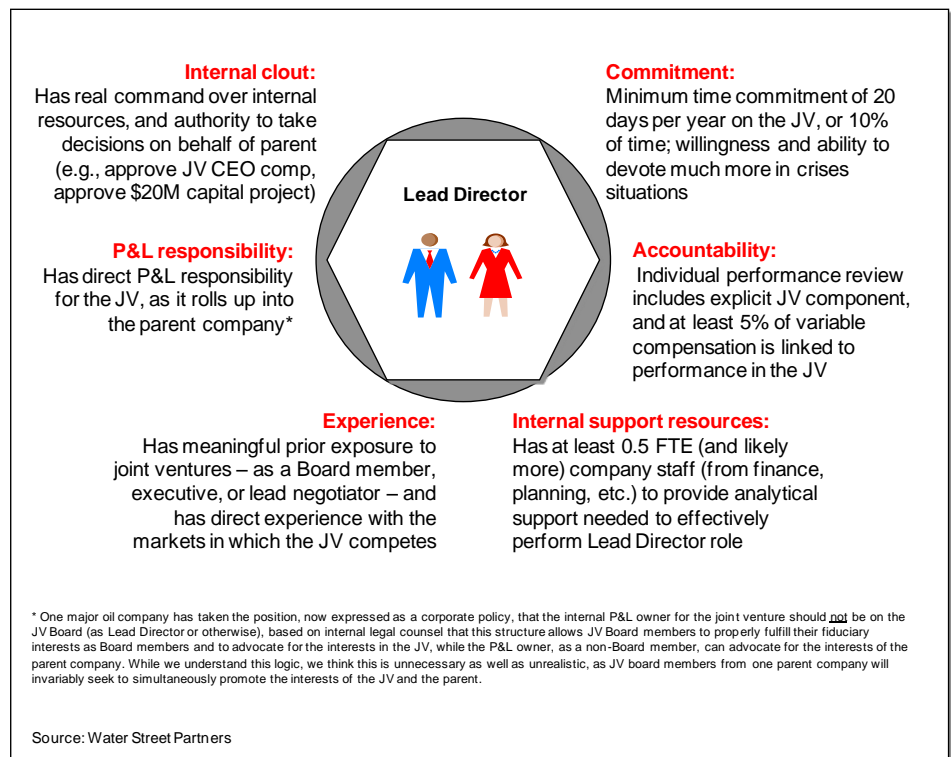
<sup>3</sup> Note: This discussion focuses on two- and three-owner joint ventures. The role of a Lead Director plays out somewhat differently in JVs with 5-10 or more owners, such as with financial service shared utilities, purchasing networks, global airline alliances, and other marketing network JVs such as have been seen in telecoms, real estate, professional services, and hotels. In these cases, the size of the owner pool prevents more than one director from each owner, thus precluding the need for board members from the same company to be coordinated and for some lead director functions. However, such ventures typically create the same effect as a Lead Director by creating a Chair (and sometimes Vice Chair) position and these 1-2 board members drive the remaining core functions of Lead Directors, as outlined in this memo.

<sup>4</sup> The rationale for 20 days minimum is as follows: 6-10 days travelling to, preparing for, and attending Board and Committee meetings (a Lead Director will typically sit on the Compensation and Human Resource Committee of the Board, given its central role in defining targets and managing the JV CEO performance contract and conversation); minimum of 1 day per month (12 days per year) to stay in touch with JV CEO and make meaningful contributions to the role described below. Our research indicates that such 20-days-per-year commitment is in the upper quartile of large joint ventures today; however, we do not believe that this represents exceptional or unrealistic commitment. For comparison purposes, in Corporate Boards, directors spend an average of 24 days (190 hours) per year preparing for and attending Company Board and Board Committee meetings. [Source: Jeremy Bacon, Corporate Boards and Corporate Governance, 22-24 (New York, The Conference Board, 1993).]

(iii) coordinating with other Directors from his or her parent company to ensure opinions are heard, and a consistent “voice” is presented to JV and partner; and (iv) shielding the JV from excessive parent company information requests and bureaucracy (e.g., duplicative reporting requirements, slow capex approval processes).

- Protect the corporate parent’s interests by: (i) ensuring that the venture is meeting corporate oversight and financial control minimums; (ii) incorporating the JV into the parent company’s strategic planning and portfolio review discussions (all too often, JVs wind up at the bottom of the agenda in such corporate-level reviews – and either never make it into the discussion, or are treated as an anomaly, subject to lower standards or inconsistent approaches); and (iii) exposing the JV to appropriately rigorous corporate-level financial controls, risk management and compliance processes<sup>5</sup>.

### Exhibit 3: Characteristics of an Effective Lead Director



- Own, with the other parent’s Lead Director(s), the performance and annual evolution of the Board, Committees, and governance processes.
- Trigger restructuring and independent outside assessment of the JV’s strategy, operations and governance as needed.
- If the Lead Director is also designated as the Chair of the venture, then he or she is also responsible for: (i) managing the overall Board agenda (including syndication prior to Board meetings of key issues and decisions); (ii) overseeing the quality, quantity and timeliness of the flow of information to the Board from venture management; and, (iii) ensuring the integrity of the governance system, including being responsible for an annual assessment and discussion about governance performance (e.g., underlying health, and potential changes to the governance, scope or structure venture to improve its performance).

**Characteristics of a Successful Lead Director.** A Lead Director must have certain skills, experiences and incentives to effectively perform or enable the role (Exhibit 3). Such “characteristics” relate to the Lead Director’s level of internal clout, personal

<sup>5</sup> While the nature of these controls will vary across companies and depend on the extent of the company’s interest in the specific JV, we’ve found that JVs, as an asset class, consistently receive significantly less attention from a performance and financial controls standpoint than wholly-owned operating units. As one CFO told us: “Our joint ventures were not being ‘put on the spot’ to explain their performance in a consistent way – nothing like what was happening for a wholly-owned business. Everything was happening through the context of the JV Board members, who have a lot of other things going on, tend to not do much digging beyond asking some questions within Board meetings, and had a very hard time explaining the performance drivers. Joint ventures were a complete afterthought.”

accountability for the venture, experience in other ventures, level of internal support resources to monitor the venture, etc.

Specific tests can be applied to assess whether these each of the required characteristics is in place. For instance, “clout” might be assessed by whether that director has the proven authority to, among other things: (i) sign-off on the JV’s annual budget and operating plan, within limits consistent with the parent company strategy, budget, and operating plan; (ii) approve the JV CEO’s annual performance contract and, when needed, the selection of a new CEO of the joint venture.

Likewise, an assessment of the Lead Director’s “level of personal accountability” for the venture might include a discussion on how much of the individual’s annual performance review and short-term variable compensation is tied directly to the performance of the joint venture (we recommend at least 5%, and prefer to see at 10%). Similar tests can be applied to evaluate the presence of other key Lead Director characteristics.

### THE LEAD DIRECTOR IN PRACTICE

Now that we’ve defined the role, what do Lead Directors look like in practice? Exhibit 4 outlines how a half-dozen Lead Directors stack-up on certain tests. To further understand how this comes to life, let’s look at three successful Lead Directors – their background, how they conceive of the role, and how, in the last year, they have made a difference – in terms of increasing alignment, driving performance improvement, and/or putting in place better financial controls and risk management processes.

Exhibit 4: Lead Director: Basic Tests and Impact on JV

Lead Director position in parent	Basic tests							Positive impact on JV performance Weighted average score of 2 key indicators: alignment and resource efficiency Highest possible score = 100%*
	P&L responsibility	Clout: Ability to command internal resources	Commitment: Time spent on JV – minimum 20 days per year	Internal support resources	Experience: Prior exposure to JVs	Accountability: Is JV performance ...		
						Explicit part of review	Linked to incentive comp	
BU President	✓	✓	✓ 25%	1 senior engineer and 2 project managers – 40% dedicated	✓ Sits on Board of 2 other JVs	✓	✗	75%
Senior technology officer	✗	✗	✓ 33%	2 managers – 75% dedicated to executing parent strategy in technology licensed to JV	✗ None	✓	✓	60%
SVP – Strategy and Business Development	✗	✗	✓ 15%	Shareholder representative director - 100% dedicated. 4 senior 100% dedicated support staff – organization parallels JV operating structure	✓ Ex-CEO of another JV	✗	✗	55%
President of region which consolidates JV	✓	✓	✓ 12-15%	Country manager – 40-50% dedicated to JV. Attends JV working group meetings	✓ Early in tenure was officer in JV. Board member of another JV	✓	✗	70%
Head of International Operations	✓	✓	✓ 10%	5 person fulltime team overseeing service level agreements and “contract compliance”	✓ Helped establish a JV – senior sponsor but not on Board	✓	✗	70%
Independent – retired industry executive (also non-executive Chairman of JV Board)	✗	✗	✓ 100%	4 FTEs part of “Board Support Office”. One key role is tracking internal controls and regulatory compliance	✓ Ex-Board member of another shared utility	✓	✓	80%

\*Areas of alignment assessed include alignment among parents, and between parents and JV management on JV strategy, operating model, organization, commercial arrangements, governance and performance. Indicators of resource efficiency include “tax burden” on JV management team’s time from handling different requests for information, participating in multiple reviews, duplicating feasibility studies and other additional work that wouldn’t exist if the business were wholly owned; JV Board meeting time not well spent – e.g., revisiting decisions already taken, working at tactical issues inappropriate for the Board

Source: Water Street Partners

¶ *Lead Director 1: Upstream oil joint venture*

**Background:** Regional VP for international oil company, and Lead Director for major exploration and production JV in resource-rich North African country. (JV is a top 5 global asset for his company). Former BU President of gas business. Direct experience as lead negotiator or board member of 5 other joint ventures.

- **Concept of the Role:** “To actively manage the shareholder-to-shareholder relationship and bring governance professionalism to a complex venture,” which has multiple ownership entities and where the other equity partners include the national oil company and a small, venture-backed exploration firm which discovered the reserve. Also sees his role as “an orchestrator of internal company resources” to ensure that the parent company is giving the venture sufficient attention, despite non-operator status.
- **What the Lead Director did in the last 12 months:**
  - Got shareholders more aligned around long-term management of reservoir (concerned that one partner was taking too many decisions to accelerate short-term production levels).
  - Secured skilled accounting staff on loan to partner/ operator to ensure venture meeting basic financial management and reporting disciplines. (“We could have had those people sitting on the outside, pushing and prodding the operator – but we decided to send them in as extra help and elevate our partner’s capabilities.”).
  - Re-set the shareholder operating structure for the asset, creating a set of short-term functional committees (drilling, sub-surface, finance, HSE, etc.) to jointly define operating processes. He has since started to manage a “phasing out” of these committees as processes become fully defined and agreed by partner companies.
  - Built project team of 50-plus high-caliber people inside his parent company to support the venture.
  - Led discussions with other shareholders about future structures for venture – e.g., consolidation of the partners’ equity positions in several adjacent fields into one larger entity, discussions about whether to create joint venture company (rather than run as a project-based joint venture).

¶ *Lead Director 2: Specialty Chemical consolidation JV*

- **Background:** Business Unit President, European chemical company; portfolio includes 4 large joint ventures.
- **Concept of the Role:** “First and foremost, to ensure the JV is truly tethered to the [parent] company’s strategy and direction; and second and more tactically, to ensure that the JV is meeting the [parent] company’s compliance/ risk management standards.”

- **What the Lead Director did in the last 12 months:**
  - Presented JV strategy and annual plan to the parent company executive team as part of corporate business review process (including calibration of JV performance and potential relative to other business units) – and deeply engaged other senior execs on potential synergies with other parent businesses.
  - Secured invitations for JV CEO and CFO (non-secondees) to key parent company strategy meetings to create additional exposure and linkages.
  - Championed initial roll-out of added compliance mechanisms – e.g., review of vendor selection policies and practices, and compliance with fiscal delegations across JV company, while also protecting JV from what Lead Director viewed as excessive reporting demands from parent.
  - Put an end to “special reports” (with up-to-date data) that each shareholder’s finance and technical staffs were regularly requesting.

¶ *Lead Director 3: High-tech cross border JV*

- **Background:** EVP-Strategy & Corporate Development. Board member (non-lead) on another major JV, and has participated in or led numerous structuring/ re-structuring of JVs over previous 15 years.
- **Concept of the Role:** “Improvement Initiative Champion” – i.e., originator and sponsor of a 1-3 initiatives each year to improve how the parent companies interact with the venture. “Usually not radical restructuring, just important incremental changes to governance and operational links in the spirit of continuous improvement.”
- **What the Lead Director did in the last 12 months:**
  - Drove clarification of IP protocols – including development of: (i) guidelines for filing patents (what the JV/ Partner can file patents on, and how they do it); (ii) protocols for how to communicate and share information with the JV’s capital-equipment vendors; and (iii) who conducts and controls patent enforcement (JV vs. parent companies).
  - Increased compensation transparency of the JV management team composed almost entirely of partner company secondees. The Lead Director believed that historically, his company “simply did not understand the partner’s compensation philosophy or practices – it was an annual fiasco calculating bonuses each year as our partner did not want to share any information.” The Lead Director drove a frank discussion between senior HR executives at the partner company that resulted in a new sense of understanding and trust between the companies. The plan is to repeat this process every six months.

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Lead Directors are the yin to the JV CEO’s yang – preventing shareholder alignment from splintering, while positively – and significantly – influencing JV performance. We rest our case. ☯

## THE JOINT VENTURE EXCHANGE

*The Joint Venture Exchange* is a forum that connects senior joint venture practitioners, including Joint Venture Board members and CEOs, through the sharing of ideas, practices and experiences unique to joint ventures. It was conceptualized and is managed by Water Street Partners, a boutique consulting, research and information services company focused exclusively on joint ventures and partnerships, founded by the former co-leaders of the Joint Venture and Alliance Practice at McKinsey & Company.

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