Lessons from the 2008 Meltdown:

Know Your Business Intimately & Prepare for the Unexpected

Governance Whitepaper Series
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Dear Colleague:

Annually, we conduct governance research on a topic “germane to the moment.” Driving this research are interviews with Chairmen/Lead Directors across a variety of industry sectors. This issue’s topic focuses on what we should learn, relative to corporate governance, from the corporate meltdowns of 2008.

We look forward to your feedback.

Best regards,

William J. Ferguson
Chairman and CEO
Ferguson Partners Ltd.
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**Leigh J. Abrams**, Chairman of the Board at Drew Industries Incorporated (NYSE: DW) since January 2009 and for almost 30 years prior thereto he was President and Chief Executive Officer of Drew Industries. Mr. Abrams is also the Lead Independent Director at Impac Mortgage Holdings Inc. (NYSE: IMH), and from 1994 until the sale of its operations and its subsequent liquidation, he was President and CEO and a Director of Leslie Building Products Inc. (OTC: LBP).

**Charles L. Atwood**, Lead Director, Equity Residential (NYSE: EQR), and former Vice Chairman of the Board of Harrah’s Entertainment Inc. (now known as Caesars Entertainment Corporation), and had been a member of the Board of Directors from 2005 to its privatization. Mr. Atwood is currently the Director of Gala Coral, a private United Kingdom gaming industry company.

**Stephen R. Blank**, Senior Resident Fellow, Finance of Urban Land Institute. He was former Managing Director, Real Estate Investment Banking, Oppenheimer & Co., and is a member of the Board of Directors and Chair, Audit Committee, of MFA Financial, Inc. (NYSE: MFA), member of the Board of Directors and Chair of the Audit Committee of Home Properties, Inc. (NYSE: HME), and Nonexecutive Chairman of the Board of Trustees and Chair of the Governance Committee of Ramco-Gershenson Properties Trust (NYSE: RPT).

**Stephen F. Bollenbach**, Non-Executive Chairman of the Board of KB Home (NYSE: KBH). He was Co-Chairman and Chief Executive Officer of Hilton Corporation. Mr. Bollenbach serves as a Director of Time Warner Inc. (NYSE: TWX) and Macy’s, Inc (NYSE: M). He previously served as a Director of the American International Group Inc. (NYSE: AIG), Harrah’s Entertainment, Inc., Caesars Entertainment, Inc. and Catellus Development Corporation.

**John K. Castle**, Chairman and CEO of Castle Harlan. Immediately prior to forming Castle Harlan, he was President and Chief Executive Officer of Donaldson, Lufkin & Jenrette, Inc. Mr. Castle has been a board member of Morton’s Restaurant Group, Ames True Temper, Inc., Sealed Air Corporation, and various private equity companies. He also served as a Director of the Equitable Life Assurance Society of the U.S.

**Thomas J. Corcoran, Jr.**, Chairman of the Board of FelCor Lodging Trust. He co-founded FelCor, Inc. (NYSE: FCH) in 1991. Mr. Corcoran served as President and Chief Executive Officer of FelCor from its formation until 2006. His long history of management in the lodging and foodservice industries began with Brock Hotel Corporation as President and Chief Executive Officer and a member of the Board of Directors for Chuck E. Cheese Entertainment, Inc.
Bruce W. Duncan, President and CEO of First Industrial Realty Trust Inc. (NYSE: FR). He presently serves as Chairman of the Board of Starwood Hotels & Resorts Worldwide, Inc. (NYSE: HOT). From April to September 2007, he served as Chief Executive Officer of Starwood on an interim basis. Mr. Duncan was President and CEO of Equity Residential (NYSE: EQR), the largest publicly traded apartment company in the United States.

Lewis A. Levey is a Principal of Colliers International Saint Louis, LLC, which formerly operated as EVS Realty Advisors, Inc. Levey was a Founder and Managing Director of Paragon Group, Inc., a national owner/developer which became a publicly-owned REIT (NYSE) prior to its merger in 1997 with Camden Property Trust (NYSE: CPT), where he currently serves as Lead Independent Director. He is also a Director of Enterprise Financial Services Corporation (NASDAQ: EFSC) and has served on or Chaired various Committees including Audit, Compensation, Executive and Nominating/Governance.

Irving F. Lyons, III, Principal of Lyons Asset Management. From 2001 to 2006, he served as a Vice Chairman of ProLogis (NYSE: PLD). He is currently the Chairman of the Board at BRE Properties Inc. (NYSE: BRE). Mr. Lyons also serves as the Lead Independent Director at ProLogis and Director at Equinix, Inc. (NASDAQ: EQIX)

Rick Magnuson, Executive Managing Director of GI Partners. He founded GI Partners in 2001. Mr. Magnuson currently serves on the boards of SoftLayer, ViaWest, Duckhorn Wine Company, and is the Chairman of Digital Realty Trust (NYSE: DLR). He also previously served on the Board at Glenborough Realty Trust, Inc. (NYSE: GLB) until its sale in 2006.

Michael McKee, Chief Executive Officer of Bentall Kennedy US. He was Chief Executive Officer and Vice Chairman of the Board at The Irvine Company. Mr. McKee currently serves as the Lead Director at HCP, Inc. (NYSE: HCP) and is Chairman of Realty Income Corporation (NYSE: O). He is a past Director of Mandalay Bay Resorts, Irvine Apartment Communities and Oasis Residential.

Douglas M. Pasquale, Former Chairman, President and Chief Executive Officer of Nationwide Health Properties, Inc. (formerly NYSE: NHP) from 2004 to 2011 until NHP was acquired by Ventas, Inc. (NYSE: VTR) in 2011. Mr. Pasquale currently serves as a Director of Ventas, Inc. He also is currently the Director of Sunstone Hotel Investors, Inc. (NYSE: SHO), a lodging REIT, Alexander & Baldwin, Inc. (NYSE: ALEX), a Honolulu-headquartered ocean transportation, real estate and agribusiness company, Matson Navigation Company, Inc. (a subsidiary of Alexander & Baldwin, Inc.) and serves as Lead Director at Terreno Realty Corporation (NYSE: TRNO), an industrial REIT with a strategic focus in six coastal US markets.
Executive Summary

“It’s what I’d call a ‘shake-up call.’ That’s a wake-up call to the tenth power.”

The causes and effects of the financial crisis and economic recession of 2008-2009 will be discussed and debated for years to come. Among the lingering questions, particularly in the post-mortem analysis of companies that failed, is whether boards of directors exhibited the appropriate stewardship to protect shareholders’ interest and collectively served as advisors to management.

In the midst of the crisis, the effects of which continue to be felt far and wide across all industries, in both the private and public sectors, the epicenter was single family, and then commercial real estate. High property valuations, aggressive and lax lending practices, irresponsible debt levels, and the securitization of mortgages and other debt instruments all played a direct role in the crisis. Where there has been heavy damage and loss, however, there are powerful lessons to be learned, which should help us to understand the past, navigate the present, and prepare for the future.

To that end, we sat down with chairmen and lead directors of well-respected organizations in real estate, mortgage finance, and related sectors (homebuilding, restaurants, hospitality, and health care). Although their expertise is industry-specific, their experiences are instructive to boards and management throughout the broader economy, particularly with regard to risk management and the importance of a proactive board comprised of informed directors who have in-depth firsthand experience with relevant issues.

Candid, one-on-one discussions with these leaders centered on three questions to explore the lessons around the meltdown, and what board members should take away from the crisis of 2008-2009 in order to improve oversight and leadership going forward:

1. Given the challenges in the world today, what are your priorities in providing leadership to the board? Where are you pushing the board to focus its time and efforts?
2. What should we learn from the great meltdown of 2008? What mistakes did boards make then that we need to safeguard against repeating in the future?
3. What are the corrective measures that should be in place in response to the recession as we continue to manage through adversity?
Based on an array of thoughtful responses to these questions, the role of board leadership can be summarized by two straightforward, yet extremely important, responsibilities. The first is to make sure that a company strategy is set, with full knowledge and understanding of current opportunities and appropriate risk parameters. The second is to make sure that this strategy is communicated to and understood by the entire management team and C-suite, as well as by all board members and top management and subsequently by all key employees. Concurrent with these responsibilities are issues and concerns such as protecting shareholder interests, overseeing the balance sheet and capital preservation, and talent development and CEO succession.

Overall, the importance of an empowered and independent-thinking board emerged as the lead takeaway from the crisis. Directors must hold management accountable, even as the board is held accountable for how an organization executes its strategy, manages risk, and preserves capital. Beyond “checking the boxes” for compliance, board members will be relied upon more than ever, to be forward thinking, to participate in strategy setting, to evaluate risk and to contribute at a higher level.
Setting Strategy, Managing Risks

“We spend hours discussing operations—not only existing operations, but what’s going to happen in the future. We bring strategy into operations discussions because that’s where it belongs. We don’t worry that much about checking the boxes.”

It goes without saying that it is not the job of the board of directors to manage the company. Rather, it is the responsibility of directors to direct, to ensure that safeguards are in place and that management is appropriately accountable to stakeholders and compliant with regulations. For board members today, and chairmen/lead directors in particular, that means having the courage to ask the tough questions and if need be to ask the question again and again until a satisfactory answer is received, to go beyond “checking the boxes” on risk management and to have in-depth knowledge of the business in order to provide guidance, wisdom, and stewardship.

If the crisis of 2008 yielded but one lesson on strategy and risk, it is the importance of having a conservative “fortress-like” balance sheet, with a priority placed on preserving capital and reducing leverage. The crisis taught the importance of dealing with “the right side of the balance sheet,” making sure that risks taken do not become excessive if another downturn occurs. One director illustrated the risk management approach to constructing a matrix—on one side ranking the probability of specific occurrences, from highly likely to very remote, and on the other, the impact on the organization. But even those occurrences that are thought to be remote—the so-called “black swan events”—cannot be dismissed. As the worst downturn since the Great Depression illustrated, events that were previously unforeseen can, indeed, come to pass: volatility is part of the “new normal.”
The biggest fear for directors is the unforeseen event and its impact on the decisions that the company has made, particularly with regard to enterprise risk. As one director noted, “Companies usually don’t go broke by executing extremely well. They go broke executing extremely poorly, but usually that is because they start with a bad plan.” Risk is generally viewed through two lenses. One is financial, guarding against taking on too much debt or retaining sufficient capital and liquidity. The other is operational—in other words, delegating too much authority without the proper checks and balances. Risk management by the board and top executives involves greater diligence to identify potential risks, determine how the company could be impacted, and putting early warning signals, “speed bumps,” and safeguards in place. Specifically, boards are looking at major transactions more carefully, with increased focus on the downside. Although the upside potential remains important, boards are more diligent than ever in considering what can go wrong, particularly when leverage is involved. In addition, every strategy comes with execution risk, and when an acquisition is made there is always integration risk.

Risk management cannot be relegated to reports presented by management or “fancy books” that are given directors and end up on a shelf. Risk management is an ongoing discipline that involves every facet of a company’s strategy and execution. Robust discussions about the appropriate amount of risk to be taken in the current environment are the result of a good working relationship between management and the board.
A perennial top priority for the board of directors over the past 40 or 50 years or longer has been succession planning. Beyond finding a good CEO candidate to run the company, succession planning today includes ensuring that internal talent is being evaluated and developed, and that outside recruits are also identified. In the aftermath of the crisis, it is more important than ever to ensure that highly qualified people are in place in the top five or six positions in the company—one or two of which may distinguish themselves as potential candidates to become CEO.

Every company should have an emergency plan that identifies people who, in a crisis, could immediately step in to become the chairman, CEO, or president, even on an interim basis. Whether for emergency planning or succession, having a deep bench of talent is critical, although this is usually easier in larger companies than in smaller organizations.

Board members acknowledged the importance of developing internal talent who know the company and whose strengths and weaknesses are likely to be apparent. When grooming internal candidates, it is possible to be more deliberate about addressing weaknesses and ensuring that developmental experiences result in people becoming well-rounded.

Nonetheless, directors also saw value in recruiting from the outside as a means of gaining new ideas and fresh approaches. Getting “new blood” can help to revitalize a company and/or bring it to a new level. However, directors cautioned that bringing in a top executive who is “expensive” could create dissension among the ranks of very talented people who “get the wrong signal” and leave the company.

“Succession Planning

“The priority is having the right CEO in place for that phase of the company’s evolution, whether it’s in a growth or turnaround mode.”
Whether focused on an internal candidate or external recruit, the succession process is driven by the ideal qualifications—integrity, leadership, listening, and intelligence. “Every board has a heightened awareness now of the importance of succession,” one director observed. “I prefer to call it leadership or talent development—and not just for the CEO position.”

Although many companies talk the talk, succession is an area in which few do well. Often, it is a superficial endeavor that does not drill deeply into talent development. One reason is that succession planning may not be a comfortable subject for the current CEO and the senior management team to embrace. Therefore, succession needs to be viewed by both senior management and board members as more than a pro forma exercise. For one board chairman and former CEO, succession was a centerpiece of his legacy to the company. “I prepared a successor and that person worked out fine,” he said.

Succession addresses having the right CEO in place for that phase of the company’s evolution, whether in a growth and expansion mode or in the midst of a turnaround. In addition, it helps to ensure that the company continues to evolve, with the right talent in place to take it to the next level.
The Importance of Industry Experience

“As a board member, you have to know how to ask the tough questions, how to read between the lines, and how to look at the analyses of other companies in the industry. Learning the industry is not often a luxury a Board member can afford to enjoy.”

There has been a debate over the past several years over the advisability of having retired industry CEOs as board members. Furthermore, some sitting CEOs were less than welcoming of retired top executives from their industry who might conceivably second-guess what they were doing. Instead, it became preferable to recruit directors who were current top executives from non-related industries, who brought expertise in other areas or who also expanded the board’s diversity, such as gender or ethnicity.

Now, in the wake of the financial crisis, many lead directors are voicing a strong preference for experienced executives, including retired CEOs and chairpersons who bring with them in-depth understanding of the industry and the unique risks of the business. Industry knowledge and experience is more highly valued today because of the need for board members to contribute immediately, to become involved in important issues, such as execution, risk management, and growth.

The “old boy” network among directors who are handpicked by the CEO has given way to emphasis on board members who can carry their weight and truly earn a seat on the board by virtue of their contribution. Given these demands on board members today, retired executives are generally seen as “gold mines,” particularly for the maturity and experience they bring. A recently retired CEO may also have both the inclination and the time to serve as a board member, now that he/she is no longer running a company.

In contrast, when a board member is brought on for a skill that is unrelated to the core business, there is the concern that he/she may not have the necessary in-depth understanding of the current issues facing the industry. “You don’t see many [companies in the real estate business] recruiting someone with manufacturing experience, for example,” a director observed. “I haven’t heard a CEO give a really cogent argument as to why having that person would be helpful.”

The value of industry experience for board members becomes heightened during crises when companies typically focus on their core competencies—one board member described it as “hunkering down”—rather than expanding into new areas. “During tough times, such as the recent crisis, industry experience becomes even more valuable,” one board member stated. “Years of industry experience will heighten your awareness of what could go wrong when you don’t stick to your knitting.”
Board Compensation and Composition

“I’m concerned about the independence of directors today, because of compensation.”

A corollary to the discussion on board member experience is the issue of director compensation. Two schools of thought emerge: one that favors only nominal payment so that directors do not become “fee-dependent” and potentially more inclined to side with management; and another that believes directors should be highly paid in order to take their roles more seriously and invest the appropriate time.

On the side of nominal payment for board service, one lead director gave the example of the boards on which he serves that are composed largely of independently-wealthy directors. “I don’t worry about any of them voting their fees versus voting what’s right for the company,” he said.

On the other hand, another director made the point that without sufficient compensation, it may be difficult to engage board members who must invest a significant amount of time, effort, and diligence, both during regular board meetings and in between with committee assignments and/or special calls as issues arise. “How can you expect someone to really engage in the company and get paid that little, unless that person has nothing else to do but fly fish and go to board meetings?”

Although no clear-cut recommendation emerged from the discussion, an examination of both sides is enlightening as the issues surrounding director compensation continue to be debated. The “gravitational pull” is that lead directors should be much more highly compensated than fellow board members. Also compensation for all board members should be increasingly focused on equity ownership, not cash.

In addition, there is a preference emerging for smaller boards of directors. Specific estimates of board sizes ranged from seven to nine. Beyond the number of directors, what is most important is cohesion. Although board members will be at odds with each other at times particularly as difficult or complex issues are discussed and debated, when a decision is made they must have the necessary camaraderie to work “shoulder-to-shoulder.”
Conclusion: Final Lessons

“The activity level that board members internalize about their companies is much stronger than it was ten years ago. The fact that we went through the meltdown that scared almost everybody had a lot to do with that.”

If there is one singular takeaway for boards of directors from the financial crisis and economic downturn, it is accountability. Just as company management is ultimately responsible for what happens on its watch, so board members also hold culpability for negative fallout.

Going forward, boards will be held to a higher level of accountability due, in part, to the fact that the unthinkable—a meltdown of near-catastrophic proportions—has already occurred. At the same time, it must be acknowledged that boards have neither the ability to, nor the responsibility for, predicting turns in the market. Therefore, the best approach is to ensure that the company is following a solid strategy, one that is well understood by management and the board, as well as by shareholders. This requires the CEO to be an effective communicator who can explain to the board the current situation, the complexities and risks involved, and what he/she sees as the direction for the company given the circumstances, whether economic contraction or expansion.

For board members, the lessons from the recession raise the stakes for serving as a director. The position carries with it even more responsibility for being informed and involved. Board members need to be able to dive deeply into issues, ask the tough questions of management, and apply their expertise and experience in meaningful discussion. As one board chairman noted, “My job is to make sure the directors understand that they need to step up their game. Or, if it’s not there, then it’s time for them to go.”

At the same time, more importance is being placed on forward-thinking board members with industry expertise, who are able to contribute to and evaluate the strategies for expanding the business, broadening the product line, and increasing shareholder value over time, while also being vigilant around risk management and the health of the balance sheet.

Having weathered the crisis, board members know they cannot become complacent, expecting that a cataclysm will not occur again. Rather, having gone through such a violent storm, they have hopefully gained a much deeper appreciation of what it takes to be prepared, to increase the company’s chances to survive even the most severe downturns, and emerge ready to take advantage of future opportunities.
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FPL is comprised of two primary operating companies that work together to serve a common client base. **Ferguson Partners** provides executive, director, and professional search services. **FPL Associates** provides a range of specialized compensation and management consulting services. Through our complementary practice areas, we work with our clients to develop the right talent, leadership, structures, and strategies for success in today’s intensely competitive marketplace.

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