Meeting Challenges and Exceeding Expectations in Farm Mutual Insurance Company Governance

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This white paper was authorized and sponsored by the Farm Mutual Conference of the National Association of Mutual Insurance Companies (NAMIC). The paper discusses corporate governance issues, concepts, and principles of good corporate governance, and their specific application to farm mutual insurance companies. It is an educational tool and reference work intended for the exclusive use of NAMIC member companies. It does not represent best practices that should be adopted by every farm mutual insurer nor does it represent NAMIC's public policy position on the subject.

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Preface

It hardly seems necessary to create another paper on the subject of corporate governance. The list of current works on the subject is large and impressive and includes efforts in both academic and business literature. Organizations such as The Business Roundtable and the National Association of Corporate Directors (NACD)[1] have dedicated themselves to the subject, providing substantial information and direction on governance issues and practices. As a result, there are notable corporate governance activities taking place in Canada, the United Kingdom and Europe, as well as in America.

Governance practices are, however, impacted dramatically by the differences that exist not only between countries, but also between industries and between companies within industries. Some of the most significant of these differences are the financial, geographic, and regulatory structures of any industry and the ownership and organization of individual companies within these industries. Many of these differences distinguish the property/casualty insurance industry from other industries. And within the insurance industry itself there are substantial differences between companies organized as stock companies and those organized as mutuals. Many farm mutual insurance company boards are interested in how all of these differences impact corporate governance practices.

Before moving forward to review governance practices for farm mutual insurance companies, two observations seem appropriate. First, much of the best business literature dealing with corporate governance has identified a recurring and important theme: *One size does not fit all.* While a consensus can exist regarding governance *principles*, specific governance *practices* generally should not be mandated. Instead, practices should generally be allowed to conform to the specific needs of an industry or company. According to a noted governance expert, *"In considering…(governance) measures, one should keep in mind the variety within the universe of … companies in the United States. We should be careful that any norms that are established are flexible enough to accommodate this diversity."*[2] NAMIC believes there is a very real danger of misapplying the lessons to be learned from prominent governance 'failures.'

> *There are more than 20 million businesses in America, and virtually all of them are as unlike Enron as an owl is unlike an ostrich. Almost all of the 20 million companies in America are smaller than Enron. Furthermore, the majority deal in more tangible commodities than energy supply contacts and "special purpose entities". Most importantly, all but a few thousand are private companies, and that's precisely where it becomes risky to try to learn too much about boards from the Enron debacle.*[3]

Farm mutual companies are organized in a fundamentally different fashion than other organizations, especially publicly traded stock companies. Mutual companies do not have an *investor-owner* constituency that expects and is entitled to appropriate care from their boards of directors regarding their *investment-ownership* interest. Mutual companies have *policyholder-member/owners* with different, but no less significant, expectations and entitlements. NAMIC believes, along with organizations such as the NACD, that any demand for a "best practice" that applies to all companies regardless of how they are organized should be cautiously examined.

> *… we are fully aware of the variety – often uniqueness – of individual corporations, stakeholders, and circumstances. … [and] recognizes that considerable flexibility is needed in applying general recommendations to specific companies and boards. At the same time, we do not see diversity and flexibility as incompatible with sound principles and approaches in dealing with the important issues addressed here. The following pages offer guidelines for crafting a tailored strategy, rather than prescribed steps for implementing a single, universally applicable, all-purpose plan.*[4]

A second observation concerns the importance of business ethics to good corporate governance. Polls tell us that more than half of Americans " … believe that the vast majority of corporate executives are dishonest" and "that executive white-collar crime occurs on a regular basis?"[5] In today's business environment it is not difficult to identify circumstances or pressures that can often lead to questionable business practices,

> *Demands on the chief executive have multiplied. A broad spectrum of societal issues has become an important matter of everyday business concern (the environment, diversity of workforce, etc.) At the same time,*

competition has intensified and become global, increasing pressure on management for financial results, raising the stakes on decisions, and narrowing the tolerance for mistakes.[6]

If a lack of commitment to business ethics is the root cause of corporate misconduct, something more than new procedures and rules will be required for better governance to occur. It will take moral leadership.

If we are to prevent these incidents from happening again, the real issue we should be examining is personal and organizational integrity. Upholding the rules in an organization requires a strong ethical compass from both leaders and employees. [7]

… ultimately, the ethics of American business depend on the conscience of America's business leaders. We need men and women of character, who know the difference between ambition and destructive greed, between justified risk and irresponsibility, between enterprise and fraud. [8]

Introduction

Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers … and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.[1]

The most important subject matter in corporate governance today concerns the board of directors – its role, function, makeup and operation. This is not surprising. The modern day success of the corporate business enterprise is testimony to the effectiveness of the board/executive management model of corporate governance. Even leading advocates of corporate governance reform recognize that it is essentially "board reform" that is called for, not the abandonment or replacement of the board/management model itself.[2]

All boards are, however, facing challenges for which past performance does not guarantee future success. Within the insurance industry, dramatic changes in business and markets are taking place, and in the words of one observer "…the opportunities are enormous, as are the challenges and the potential rewards. But there is a real risk of getting it wrong … "[3]

Demography: A major shift is taking place in the ratio of working adults to retirees as the general population ages.

Personal responsibility: As the government withdraws from more of the activities that it took on in the days of the welfare state, so the individual will be forced to take on more responsibility for his or her personal financial affairs.

Technology: The increasing demands that the individual will place on the financial system are already being met by massive technological changes that will radically alter the way he or she handles the business of money.

Globalization: Technology is breaking down geographic boundaries in all sectors, but most especially in the almost completely de-materialized world of financial services.

Boards themselves are undergoing change in response to the challenges identified above and the demands for effectiveness and efficiency. Some of these changes include:

- Boards will shrink in size and grow in independence.
- The non-CEO chairman will become more widespread.
- Boards will support the emergence of a "lead" director.

- Directors will serve on fewer boards.
- More non-CEO directors will serve.
- Fewer non-business directors will be selected.
- Formality will increase in the boardroom.
- The evaluation process will grow in importance and structure.
- Directors will be terminated.
- Fixed board terms will become increasingly common.[4]

Are farm mutual organizations prepared for the challenges of the new financial services industry? What role can the board play in getting its company ready? Are boards a resource that can contribute even more significantly to the development of strategies for success in such an environment? What areas of board practice will be themselves be challenged – size of board, qualifications of directors, types and role of committees, board leadership roles? How will boards stay current in all the areas that require board attention? Clearly, boards of directors have some challenges ahead.

Executive Overview

Corporate governance is an important and timely subject, and not just because of recent corporate scandals. The organization and operation of companies impacts our society and culture, for better or worse, and influences the lives of many – not just employees or customers. As noted, farm mutual insurance companies, like all business organizations, are being challenged as never before. These challenges will tax the creative energy and abilities of all employees and their leaders. Board members are in a position to do great service to the variety of stakeholders within a business organization in addressing change.

To provide a quick overview of all of the components of governance that are addressed in this paper is an almost impossible task, but the following very basic encouragements should suffice:

First, boards that want to be effective are serious about understanding their role and function within an organization. That seriousness is best demonstrated when a board clearly defines and implements their specific understanding. Key areas in which boards can make an impact include: participation in strategic planning; the number, kind and quality of board policies; the quality and impact of CEO evaluation; succession planning (to name a few). Perhaps the most important initial decision for any board in the area of corporate governance is simply to decide how active it intends to be in carrying out its responsibilities.

Second, effective boards are serious about the details of their efforts – in other words, "how" a board works and functions. This includes establishing expectations in a number of board operational areas, including: board leadership; the number and length of board meetings; the qualifications of directors; the formation and membership of committees; etc.

This paper is organized along these two rather basic approaches to board activity – what boards do and how they do it. Within this framework, many farm mutual companies will find opportunities for better corporate governance.

Section I:
Board Responsibilities: The Role of the Board of Directors

The fundamental oversight responsibility of the board of directors in the modern corporation is already well established. The Model Business Corporation Act succinctly states, "All corporate powers shall be exercised by or under authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors." [1]

> *The board is the focal point of our corporate governance system. Pursuant to state statutes (and corporate charters or articles), it is elected … and is charged generally with directing the affairs of the corporation. The board fulfills its role by delegating managerial authority to the managers, which it hires, monitors incentives (compensates), and replaces when necessary. The board also is charged with oversight of the company's financial reporting and legal compliance. To do all this, it can – and must – reasonable rely on advice from professionals … The board is not positioned to (and hence does not) manage, audit, practice law, or render advice on the short- and long-term reactions of the market. Rather it delegates to management, and then monitors the management and performance of the company …* [2]

A board's basic responsibilities consist of:

- Approving a corporate philosophy and mission.
- Selecting, monitoring, evaluating, compensating, and – if necessary – replacing the CEO and other senior executives, and ensuring management succession.
- Reviewing and approving management's strategic and business plans, including developing a depth of knowledge of the business being served, understanding and questioning the assumptions upon which such plans are based, and reaching an independent judgment as to the probability that the plans can be realized.
- Advising management on significant issues facing the corporation.
- Reviewing and approving the corporation's financial objectives, plans, and actions, including significant capital allocations and expenditures.
- Reviewing and approving material transactions not in the ordinary course of business.
- Monitoring corporate performance against the strategic and business plans, including overseeing the operating results on a regular basis to evaluate whether the business is being properly managed.
- Ensuring ethical behavior and compliance with laws and regulations, auditing and accounting principles, and the corporation's own governing documents.
- Nominating directors and committee members and overseeing effective corporate governance.
- Focusing on the integrity and clarity of the corporation's financial statements and financial reporting, engaging outside auditors and considering auditor independence issues.
- Performing such other functions as are prescribed by law, or assigned to the board in the corporation's governing documents.[3]

As they perform these responsibilities, however, boards can tend to exhibit specific styles of behavior or roles. These roles are rather distinct and are often influenced by company size, business circumstances, culture, or the subject matter under consideration by the board. Board roles can be grouped as follows:

> **Legitimizing role:** Generally passive and simply fulfills the legal requirements for the corporate charter. This role, especially 0if it is the only one the board plays, is the one so heavily criticized these days.

Auditing Role: Tries to ensure the accuracy of information going to the public and to the government and the adequacy of financial reporting systems. This responsibility has been brought on and emphasized by the increasing pressures on and potential liabilities of directors. The audit committee … is especially important in this kind of environment.

Directing Role: Becomes more important as the board gets involved in focusing on the company's future goals and derivation of the strategies by which they will be reached.[4]

Often, the *directing* role of the board is identified with making the board a *strategic asset* or a *competitive advantage* for the company. One of the principal objectives of this role is to *maximize the performance of the company through a more resourceful board*. Boards that embrace this kind of role get involved in matters such as setting high, but realistic standards of performance; attracting, motivating and retaining a top executive management team; and contributing to corporate decision-making on strategic and major operational issues.

It is important for all boards however, to avoid the unhealthy extremes and consequences of the *directing role*, which can basically be described as "getting in management's way." Boards will want to avoid the worst consequences of the *legitimizing role* as well – namely, failing to timely intervene in performance problems.

There are indications that many boards are moving to a more active *directing* role:

… again because of the rapidly changing environment – boards must be proactive to add necessary value. Board members must lean toward more timely involvement than less… the right board members bring critically needed expertise, experience, and judgment to bear on issues determining the company's success or failure. Managements need all the help they can get, and there's often no better place than the board to find the skills and company-based knowledge to make a positive difference.[5]

It can be a very useful exercise for a farm mutual board to review and discuss these and other descriptions of the functions and roles of a board of directors. These discussions help a board come to a consensus regarding their current board responsibilities and desired future role.

Strategic Planning

Strategic planning, done properly, is an activity that involves the allocation and commitment of company resources for the long term. As a result, it should command the attention and involvement of any board. The degree to which a board is involved in the strategic planning process will reflect a board's governance philosophy perhaps more than any other board activity or decision. Interestingly, many boards rate their involvement in strategic planning as a significant concern.[1]

Several factors often influence a board's involvement in strategic planning – the size of the organization, the ongoing challenges within the industry, and the relative capabilities and styles of the board and CEO. For mutual insurance companies, other issues that may influence board involvement in this area include: the intense competitive environment facing the many company, concerns over company profitability, and the opportunities for mergers or combinations with other mutual companies.

Board involvement in strategic planning runs from an acknowledged *micro-management* of the process to a hands-off *non-involvement*.[2]

Micro-management: The board or a committee dominates the planning effort, which may be necessary during periods of transition, start-up or turnarounds, but is otherwise not considered a normal or advisable practice.

Participative: The board or a committee is very active and engaged in the process, contributing expertise or experience in key areas, providing advice or perspective throughout the process.

Review and approve: There is no designated committee or special board activity related to the development of the strategy and the review and approval process is a part of a normal board meeting.

Non-involvement: The board does not require or does not approve a formal plan (manages simply by numbers).

The recent trend in thinking and attitude is for the board to become more *participative* on strategic matters. This is generally consistent with the trend for boards to become more *directing* in their role or style. Such participation in planning generally means that a board becomes more involved in one or more of the following: reviewing, evaluating and challenging strategic options; ensuring and insisting on a solid and productive planning process; examining and approving plans for implementation (although this may be too operational or tactical for some boards or some issues); monitoring implementation by reviewing agreed upon measures of success; and advising and guiding management throughout the planning effort.[3]

Boards that participate in strategic planning regard it as an issue for the full board. To facilitate the process however, some companies have established strategic planning committees.[4] Boards that want to develop their involvement in strategic planning should consider looking for new directors with experience and ability in this area. To obtain temporary or initial assistance, boards may consider hiring outside expertise to assist them in becoming more involved in strategic planning. Boards will also want to consider measurement tools that will effectively monitor and oversee strategic performance.

> *Monitoring company performance must be done right and continuously. Done well, it allows a board to really know to what extent management is successfully implementing the approved strategy and operating plans. But to do so properly, the board needs to move well beyond reviewing traditional financial reports. Industries, markets, and competitors have become too complicated and dynamic for these measures alone. And financial measures are largely after-the-fact yardsticks. Effective directors are skilled in identifying and using predictors of future performance, not merely evaluating what has already happened*.[5]

Board Charter

All boards and their management allocate decision making authority between themselves. This allocation can often be established and/or changed over time. Issues, personalities and circumstances can all play a role in this allocation process.

Often, the only documents that provide any specific guidelines on this issue are the bylaws of the company and the CEO’s job description. If something more specific is sought, it can be helpful to have a separate document that contains the “position description” of the board.[1] Such a document can anticipate and reduce uncertainty or confusion regarding issues of board or management decision-making. It can also be a useful tool in director recruitment and orientation.

Drafting a board charter should be approached with a proper perspective. Board and executive management decision-making should be thought of as complementary not competitive activities.[2] Potential topics for a board charter include the following:

Board Responsibilities
(major areas of responsibilities that distinguish between management and the board)

Board Composition
(size, terms, retirement age, etc.)

Director Selection
(selection criteria and process)

Board Leadership
(identification of positions and roles)

Board Meeting Procedures
(frequency, length, attendance expectations, agenda setting, participation expectations, executive sessions practice, etc.)

Board Performance
(evaluation expectations, conflicts of interest policy, mutual principles)

Committees
(brief descriptions of committees, tasks and functions, membership, meetings, agendas)

Relationships
(communication guidelines for contact with the CEO or other management; media contact; etc.)[3]

Anything that is intended to provide general guidance to board decision-making should be clearly identified and explained in a charter document. Farm mutual companies may want to include statements of relevant mutual company purposes or ideals (e.g., the mutual purpose of the company, the policyholder's interest, etc.). These expressions serve to remind existing directors of the company's distinct organizing principle and help to orient new directors.

Board Policies

Board policies vary significantly from company to company, with many companies setting formal board policy on a number of issues and others setting formal policy in only a few areas. Every board however, sets policy for the organization and these policies help the organization by providing clear expectations and guidance for individual and corporate behavior.

Some board policies relate directly to corporate governance. These policies help establish guidelines for board action; set behavior expectations or limits for board members; provide clarity or consistency on board or company matters; keep boards from reinventing the wheel or relying on institutional memory for recurring issues; and help orient new directors and remind current directors of established practice.

In NAMIC's 2002 survey of corporate governance practices, farm mutual companies identified a number of areas where boards had set governance policy. Nearly 33 percent of the respondents had established formal board policy on corporate investments. Forty percent of companies had a formal policy on conflicts of interests. Slightly more than 17 percent of responding companies had an ethics policy or code of conduct, while nearly 13 percent of companies responded that they had established a policy on director orientation.

Some of the most common corporate governance policies address the following subjects:

Conflict of Interests: NAMIC farm mutual member companies recently surveyed adopted a conflicts policy more frequently than an investment policy. This suggests that mutual boards are keenly aware of their responsibilities to insure the ethical soundness and operational integrity of their organizations. Conflicts of interest generally arise in one or more of the following categories:

Conducting business with the company itself: Contracts with the company to buy or sell products or to receive a personal benefit.

Competing with the company: Operating a similar yet independent business.

Business opportunities: Taking personal advantage of a business opportunity that could be pursued by the company.

Gifts and gratuities: Receiving something of value from an interested party that gives the appearance of being influenced.

In an atmosphere of increasing public scrutiny, a conflicts policy helps boards assure others that objective and good faith decision-making is taking place. Alternatively, failure to disclose conflicts and take appropriate precautions in board decision-making can make board decisions suspect to a number of important stakeholders: policyholders, company staff, and business partners. Such decisions, if challenged, may also be subject to increased scrutiny by a court of law. As a result, many companies have adopted conflicts policies that require the board members (and often all staff members) to verify on an annual basis that they understand and agree to abide by the conflicts policy and to disclose all known conflicts.

Conduct/Ethics: A conduct/ethics policy addresses standards for business behavior or conduct in the workplace and industry. These policies go beyond conflicts policies to address areas that are important to a company's reputation and legal compliance efforts. Conduct/ethics policies can include a number of topic:

Employee and customer privacy	Global business practices
Workplace safety and violence	Fair competition/antitrust
Environmental protection	Sexual harassment
Dealing with the media	Vendor relationships
Agent/customer relationships	Political contributions/activity
Protecting company assets	Advertising and marketing practices
Intellectual property and trade secrets	Confidential information
Computer data and security	Protecting company funds
Equal employment opportunity	Policyholder communications[1]

Farm mutual boards may want to determine which of these policies are important or significant enough to require board action or approval. Several can be quite important to the image and perception of the company in the marketplace or involve significant corporate property interests. Some may legally justify or require explicit board involvement (such as equal employment, privacy or other compliance matters, etc.).

Conduct/ethics policies may also express company commitment to issues that are very important to the company or closely tied to the specific business of insurance. For instance, one mutual company includes as a part of its code of business conduct that " … alcoholic purchases will not be reimbursed by the company at any company event, on company property or in conjunction with any company business."[2] Through this policy the company has sought to focus attention on the issue of substance abuse and its impact on workplace safety.

Executive Session: The issue of whether boards should regularly meet without inside directors or staff present creates strong opinions on both sides of the argument. Many corporate governance advocates are on record in support of such sessions.[3] The principal argument supporting executive sessions is the ability of independent directors to speak more openly about issues, including management proposals and performance. A regularly scheduled executive session can also promote timely discussions and generate constructive board feedback to executive management about performance – helping to more promptly identify early any corporate or individual performance issues. Regularly scheduled executive sessions can also minimize any undue concern or suspicion that inevitably arises when an executive session is called spontaneously by the board.

Not everyone however, supports the practice of executive sessions. Some boards expect their members to be able to openly address any issue regarding executive management performance.[4] Forty percent of NAMIC farm mutual member companies surveyed report that they conduct executive sessions.

Board Member Expectations: These policies can cover a variety of behaviors that are expected of board members including: meeting attendance, preparation, and participation; costs/expense reimbursement; director compensation; etc. Such expectations can be incorporated into a written "position description" for board members, similar to those that may be prepared for a chairman or for the board itself. A formal written policy in this area can help in director selection, orientation, and evaluation.

Manager-CEO Evaluation

Board evaluation of the Manager-CEO is a natural outcome of the fact that the corporation is to be "managed by or under the direction of the board." Since boards delegate day-to-day management of the company to the CEO and staff, ongoing performance evaluation is a meaningful way of exercising the board's oversight function.

> *The board of directors has the important role of overseeing management performance … Its primary duties are to select and oversee a well qualified and ethical chief executive officer who, with senior management, runs the corporation on a daily basis, and to monitor management's performance and adherence to corporate standards. Effective corporate directors are diligent monitors, but not managers, of business operations.* [1]

According to NAMIC's governance survey, 46 percent of farm mutual companies surveyed conduct annual evaluations of the Manager-CEO. Surveys conducted by other business organizations that indicate nearly two-thirds of all companies systematically evaluate the CEO's performance. [2]

Companies will often use the compensation committee or the executive committee of the board to either conduct or oversee CEO's evaluation. Some companies believe that the evaluation itself should be done by the whole board [3], even though boards may ask the chairman (if separate from the CEO) or another director to actually deliver or discuss the performance review with the CEO. The specific methods used are perhaps less important than ensuring that the evaluation is performed regularly and competently. The advantages of a Manager-CEO review include:

- Setting clear expectations of performance – for the company and the Manager-CEO, including both short and long-term goals.
- Fostering clear accountability and rewarding success.
- Improving communication between the board and the Manager-CEO on key corporate issues.
- Mentoring the Manager-CEO in areas requiring improvement or development.
- Providing a pre-arranged method to identify performance issues early.
- Promoting teamwork between the board and Manager-CEO.
- Leading by example for the rest of the management staff.
- Providing a clear signal that the board is serious about its oversight responsibilities.
- Understanding when Manager-CEO replacement might be required.[4]

To aid in evaluation and improving accountability boards should consider providing a written position description to the Manager-CEO with a formal statement of performance expectations.[5]

Most CEO performance reviews include at least some of the following areas of accountability:

Integrity/Values: Setting the tone for ethical awareness and honesty.

Vision: Clear, compelling, and consistent.

Leadership: Empowerment, motivation and development of staff.

Judgment/Decision-making: The process used and the results obtained.

Accomplishments: Meeting corporate and personal objectives and goals.

Succession planning: Quality of candidates and plan.

Policyholder relations: Meeting member's interests.

Board relations: Respect for and candor with the board.

Strategic Planning: The quality of plans and process.[6]

Farm mutual boards should recognize that the Manager-CEO will also have expectations of the evaluation process and that these need to be addressed. Some of these expectations include:

Confidentiality: The discussions and evaluation remain with the participants only.

Effectiveness: This relates to the issue that expectations be clearly established and that the evaluation will be based on specific results or behaviors.

Participation: The Manager-CEO has an opportunity to contribute to the evaluation.

Timeliness: The evaluation is timely in relation to the performance being reviewed.

Manager-CEO Succession

Farm mutual boards are responsible to deal with the task of replacing the Manager-CEO. No one believes that leaving the future leadership of the company to chance is a sound governance practice. Boards understand that a successor to the CEO will be needed at some point, and it seems they are increasingly aware that it may occur in advance of current expectations. In fact, according to a recent business survey, CEO succession was the second highest concern of boards, having risen dramatically in recent years.[1]

As fundamental as the issue of succession is, many companies do not seem to have developed a capability in this basic board responsibility. For succession planning to become a meaningful and effective governance practice the following characteristics should apply to the process:[2]

The board must take the responsibility seriously – making sure a process is in place now.

The definition of "leadership" must be known and agreed upon – definitions vary from company to company and from time to time – but a definition is needed all the same.

There must be a reasonable opportunity to make a good decision – does the board have appropriate access to potential candidates before a vacancy occurs or a decision is needed.

The process must be a part of leadership development – succession choices are enhanced by an ongoing, serious leadership development (or identification) program within the company (or board).

Potential successors must be evaluated as leaders – by exposure to the board and conscious development opportunities.[3]

Boards will often ask the Manager-CEO to create a process for succession planning. The full board can then maintain an oversight responsibility over the entire process and/or delegate some portion of the preliminary work to a committee (executive or nominating/governance committees are frequent choices). Where other management staff make up a significant portion of the candidate pool (generally in larger companies), regular contact between the board and the senior management staff is an important part of an effective succession plan management.

Recently some mutual companies have begun to prepare succession plans that involve other members of management taking on Manager-CEO responsibilities in an emergency or transition period. In this way, companies avoid involvement of the board or chairman in the tactical or operational aspects of the company even during unexpected absences or departures of the Manager-CEO.

Executive Compensation

Management or executive compensation has become an increasingly complex and demanding task for boards. To address the matter of management compensation with confidence directors must deal with issues and trends in accounting, tax, insurance, and employee compensation and benefits. Adding to the pressure on boards in this area is the fact that management compensation is often intended to drive the behavior that will make the difference between average and outstanding company performance. Many boards or compensation committees seek expert advice on executive compensation for these very reasons.

Executive compensation can have an impact on several other important corporate governance practices. Executive *succession planning* can be impacted by the pay structure for senior executive management. Executive compensation is linked to Manager-CEO *performance evaluation*, which in turn, is often linked to *strategic performance objectives*.

Boards must also pay close attention to the *competition* – in the area of executive compensation it is of little help to know what good executive management talent is worth after it has left the company. At the same time boards must recognize that every organization has its own *culture, strategy and style* and directors must set the best and most appropriate compensation policy for their own company.[1]

A good approach to addressing executive compensation includes the following steps:

- Review your current plan/program. Times change and a program can lose its effectiveness.
- Consider everything. Pay, benefits, qualified and non-qualified, long-term and short-term.
- Get organized. Obtain the right legal, accounting or financial advice.
- Think strategically. Link the compensation to criteria that are strategic.[2]

Section II:
Board Structure and Organization

Introduction

Not only is it important to reflect on *what* boards do, but also to reflect on *how* boards accomplish their important governance tasks. Basic design issues like size, leadership roles, and meeting agendas can influence both the efficiency and quality of any board's effort. This next section will address these matters in the context of farm mutual companies.

Articles and Bylaws

States require corporate business entities to have certain organizing documents in order to do business. At a minimum these include articles of incorporation (or association) and corporate bylaws. *Articles* are often described as the "contract" of existence between the corporate entity and the state (or other appropriate legal authority). They are required to be filed with the state when the company comes into existence and any changes must also be filed with the state. Articles set out the basic framework and structure of the organization, the bodies or entities that will provide governance, the offices that comprise the basic management of the organization, the provisions regarding membership or ownership, the provisions for required meetings, etc.

Bylaws are the "contract" of existence between the business entity and the owners or members of the organization. Neither articles or bylaws are especially detailed – although bylaws are typically more detailed than articles. The additional detail in bylaws usually addresses the following subjects – the rights of members or owners, the basic roles or duties of the board and officer positions, the timing and notice of meetings, the method of board nominations and elections, the removal of directors, and any board indemnity provisions.

Articles and bylaws are essential documents in the governance of farm mutual organizations and the specific provisions of a farm mutual company's articles and bylaws are good examples of the diversity that exists between forms of business organizations. Within these documents the special vocabulary of mutual organizations appears – terms such as "member" and "association" as compared to "shareholder" or "company". In some articles and bylaws the policyholders are specifically referred to as "owner" (a term that is used by some state laws). These terms help set the expectations of policyholders, directors and management relative to the governance and operation of the farm mutual company.

Articles and bylaws establish the rights of mutual company policyholders to participate in the governance of the mutual insurance company. State law plays a significant role in this area, often defining or dictating practices such as use of proxies, notice of meetings, right to nominate directors, and matters requiring a vote of policyholders, etc.[11] Even a quick review of state law demonstrates that a variety of approaches exist regarding these issues.

An important part of a mutual company's governance practice is to review and maintain an effective set of articles and bylaws. In states where certain article or bylaw provisions are mandated by state law, such provisions must be identified and preserved. In other areas however, the directors are free to update and modernize as circumstances may suggest or demand. In any such review, special attention should be paid to any outmoded or obsolete ways of conducting business. For instance, do the articles or bylaws:

Specify the use of parliamentary procedures that are no longer well understood or observed?

Specify a meeting time and place that is no longer convenient?

Specify a meeting notice or other meeting procedure that may be outdated?

Allow the use of modern board communication technologies?

Allow board actions by unanimous *written* consent of all board members?

Allow the kinds of committees deemed necessary for conducting business?

Allow age or term limits for board members?

Allow the board to set the size of the board without policyholder approval?

Articles and bylaws are generally not changed or amended frequently, although there is an openness among farm mutual insurers to do so. In the 2002 NAMIC farm mutual governance survey, 85 percent of the surveyed companies responded that they change their bylaws "as circumstances require." Twenty percent of companies surveyed however, also conduct either an annual or periodic review of their bylaws and nearly 50 percent have made an actual change to their bylaws within the last five years.

Changing documents such as the articles and bylaws can be a sensitive issue for some farm mutual boards – tradition and continuity are important to many organizations and the mutual insurance industry has a very significant and meaningful history. Such changes should never be taken lightly or unadvisedly. The importance of tradition and history simply call for an abundance of careful thought before implementing change.

Policyholders are generally required to approve changes to the articles, whereas approval by the board may be all that is necessary for changes to the bylaws. States often require companies to submit changes in articles to the appropriate state department for approval and record keeping (and states may require filing of bylaw changes as well).

Board member orientation or education is an excellent opportunity to review articles and bylaws. Copies of both documents can be provided to directors when they join the board, along with other meaningful governance information (board policies, sample agendas and reports, etc.).

Board Size

Like other governance practices, board size will vary from industry to industry and from company to company. Trends have shown a gradual downsizing of boards over the years. [1] Governance advocates consistently state that smaller boards work more effectively than larger boards generally due to the ability of directors to interact more frequently and to become more "cohesive." [2]

Farm mutual boards will want to be sensitive to the influence of board size on director participation, the depth or quality of board discussions and the time needed for good decision-making by the board. This is a matter of balance – the board should be small enough to permit thorough discussion for each issue/decision and large enough for a variety of views. Boards may need to adjust their expectations in these areas if board size becomes an issue.

The factors that farm mutual boards should consider when addressing the issue of board size include:

- The role and philosophy of the board regarding its governance function.
- The number of board committees needed to be staffed.
- The desire for increased diversity or representation (is a strong community presence desired?).
- The size of the company itself.
- The complexity of the company.
- The stage of the company's development.
- The coordination and logistics issues involved with board size.

The preference among boards is clearly for boards of smaller size. According to a NACD survey, board members of public companies consider an *optimal* size board to be 8-11 directors and the average board size is eight seats.[3] NAMIC's 2002 governance survey shows that the average board size for mutual insurance companies that responded is eight directors. The minimum board size for a NAMIC surveyed company is five and the largest board totaled 22 directors. As a group, 89 percent of farm mutual companies surveyed have 9 or fewer board members.

Board Meetings

Setting the frequency and length of meetings is an important consideration for the board's leadership. Meeting time will often depend on the complexity of the business and the volume of issues requiring the board's attention. Farm mutual insurance companies with more extensive operations and activities will require more of the time and attention of its board members. This is where board committees can help to control the length and frequency of board meetings by distributing the workload of the board.

There is a trade-off in the costs and benefits of setting meeting times. Longer meetings allow issues to be explored more deeply and viewpoints and perspectives to be given ample time. Fewer meetings may be required if meetings are longer. Shorter meetings however, can be more frequent and allow directors to stay more current and engaged on board issues over time.

Some complaints about board meetings are not, in reality, related to time at all. Board meetings can be too rigid or too flexible, can address the wrong topics, or can waste too much time in non-business related discussions. Meeting management consisting of a good agenda, starting on time, as disciplined discussion can go a long way toward making board meetings more efficient. Avoiding a poor atmosphere is also critical, including situations where disrespect for the board is demonstrated by a Manager-CEO's lack of openness toward the board's questions or comments.[1]

A significant percentage of farm mutual company boards (41 percent) meet more frequently than quarterly – either monthly or bi-monthly. About 40 percent of farm mutual members surveyed meet on a quarterly basis. A recent survey of private companies conducted by the NACD found that a majority of directors (57 percent) believed that boards should meet five or fewer times a year.[2] A similar report among public companies reported that only 38 percent of directors surveyed believed that five or fewer board meetings were desirable.[3]

Agenda

Developing an agenda is a critical element of any meeting's effectiveness and efficiency. A variety of competing demands must be balanced in an agenda: flexibility; accomplishing tasks; adequate time for presentations, discussions and decision-making. Some criticisms regarding poor board meetings can be resolved through timely completion, publication and adherence to an agenda.

For many boards, the chairman is responsible for the board meeting agenda. If the roles of chairman and CEO are separated, or if a lead director is used, a decision needs to be made regarding who is responsible for development of the agenda. Many directors believe they should have a say in developing the agenda.[1] For that reason, a process for handling suggestions from directors for agenda items can be a helpful organizational policy. Board committee chairmen should work with the person responsible for the board agenda to help set agenda items concerning their respective committee's work.

Clearly in farm mutual companies the executive staff manager is very involved in setting the board agenda. In less than 10 percent of the companies surveyed does the Chairman (who is not the manager) set the board agenda. In all other cases the executive manager is involved – although in about 20 percent of the companies responding the manager does collaborate with the Chairman in establishing the agenda.

Farm mutual companies who participated in NAMIC's 2002 governance survey reported that they devote the following percentage of time during board meetings to these subject matters.

Subjects	Time
Current financial results (including annual audit)	25 percent
Strategic issues	16 percent
Financial trends and goals	14 percent
Corporate policies	8 percent
Management and Staff Compensation	7 percent

In comparison, the NACD reports that among directors surveyed, the following subjects are important board matters requiring their attention and action (listed in order of most important first):

- Corporate performance.
- Strategic Planning.
- CEO Succession.
- Corporate governance.
- Relations with non-shareholder constituencies.
- Change of control.
- Board/CEO relations.
- Compensation.
- Federal and state regulatory compliance.[2]

Board agendas are usually accompanied by information or materials pertinent to the board's deliberations or decisions. This information may be developed from a number of sources and must be assembled in a coherent and organized fashion. It is a matter of respect for the directors that the materials be delivered in a time and manner designed to facilitate the board action on agenda items. The information must be timely, complete, accurate and well organized/presented.

Board Qualifications

Successful boards are self-aware and will "*… monitor the mix of skills and experience of its directors in order to assess, at each stage in the life of the corporation, whether the board has the necessary tools to perform its oversight function effectively.*"[1] Farm mutual boards must each decide what mix of abilities, attributes and motivations are necessary for a director to be effective in their organization.

The specific tasks or competencies expected of directors help companies identify qualified candidates. These tasks include overseeing accounting and finance practices, reviewing management practices, responding to potential crises, approving strategic plans, and empowering and motivating the chief executive. Having directors with general business or insurance industry experience can be helpful in addressing and meeting these obligations competently. But insurance knowledge is not a requirement. In selecting any new director the question should be: *How can this individual most contribute to the success of our farm mutual company through decision-making or counsel to our board and management?* A variety of factors will influence the selection of a director, including:

Company situation

- Company size: Is this person familiar with a company of this size and structure?
- Stage of growth: Is this person familiar with a company with these growth expectations?

- Financial condition: Would special financial knowledge or experience be helpful?
- Competition: Would a specific industry background be helpful?
- Technological change: Would technology experience or knowledge be helpful?

Personal Experience

- Demonstrated track record in a specific area of needed expertise.
- Knowledge of the insurance industry or a specific customer market.
- Successful experience as a corporate director elsewhere.
- Experience or expertise in long-range/strategic planning.
- Experience or expertise in finance/accounting (perhaps specifically insurance accounting/finance). .
- Experience or expertise in technology/systems. [2]

Personal characteristics

- Integrity: A high ethical standard in their personal and professional life.
- Accountability: The willingness to commit the time required for the work of the board and to be responsible, both in taking warranted action and in being held accountable for it.
- Engagement: The ability to honestly discuss and evaluate management and corporate performance.
- Judgment: Informed and intelligent decision-making and the potential for good counsel on the range of likely business issues.
- Financial literacy: Knowing how to read financial statements and how to use financial ratios in an insurance company context (see section on financial literacy later in this section).
- Maturity: A willingness to listen, to be open to the opinions of others, to communicate both persuasively and tactfully.
- High performance standards: Personal or professional achievements.[3]

Personal characteristics can be very important since most boards try to create a collegial culture that has been linked in a positive way to overall company performance.[4] On the other hand, *collegial* should mean professionally compatible and collaborative, not *clubby*.

In an effort to improve board performance, boards may wish to formally establish certain expectations that come with service on their boards. This can be addressed in a written "position description" for directors, and several models exist that incorporate much of what is presented in this section.[5] About 25 percent of farm mutuals responding to NAMIC's recent governance survey indicate that they have such board position descriptions.

Recently, companies have also begun to limit the number of boards on which a current director can serve. As the demands on board members increase, service on several boards can interfere with the commitments of time and attention expected of effective directors on any specific board. This must be balanced against the helpful experience that having directors serving on other boards can provide to farm mutual companies.[6]

Finally, director motivation is a critical element of effective board service. Farm mutual company directors must be committed to the company, its mission and vision (including the "mutual" concept), its business plan, and the pursuit of policyholder value over the long term.[7] Directors should be motivated enough to ask good questions and the persistence to insist on accurate, honest answers from management.

One interesting statistic about farm mutual companies surveyed is that of those companies responding, only one company reported that none of their directors was involved in full time farming. Nearly 80 percent of the companies surveyed reported having three or more directors engaged in full time farming.

Director Independence

There are generally three categories of directors:

Inside – Any board member who is also a member of the management team currently running the organization. CEO's are the most obvious examples of inside directors. Other management directors may also be present on the board, by virtue of their position within the company or because of their capabilities or experiences.

Outside – Any board member who is not currently a member of management. This category may include former employees or others who provide services to the company and its management or board (e.g., lawyers, accountants, bankers, etc.). Sometimes these directors are called "affiliated non-management directors" (or even "gray" directors).

Independent – Any board member without a material, direct or indirect personal financial relationship or interest in the company (other than what is paid to the member for service as a director). Some definitions also require that the director be free from any direct or indirect personal or financial influence of management (e.g., business partners, family members, etc.).

A number of different definitions of "independent director" exist.[1] The differences are not always significant. In the more conservative definitions even a remote family or other non-business relationship with management will preclude independence. Interests that could impact director independence include:

- Reciprocal directorships.
- Consulting or service relationships with the company.
- Commercial relationship with the company (key customer, charitable contributions beneficiary).
- Family relationship (with a member of senior management).
- Employment relationship with the company (either currently or within a certain number of years).

In many – if not most – states, a mutual company board member is required to be a policyholder of the company. The question might arise whether this is a sufficient financial or commercial "interest" in the company to make the director non-independent. Generally speaking, owning an insurance policy would not be considered sufficiently material or significant (financially) to support such a view. Instead, policyholder status helps to align the interests of the mutual company directors with that of the policyholders whom they represent – in much the same way that board member stock ownership helps to do the same in stock companies. Unlike the stock company situation however, any personal interest (say for example, the desire for lower premiums/rates) would be balanced by an equal interest in the company's ability to meet its contractual obligations since a mutual company director is both a customer and an "owner".

One of the most widely assumed improvements that companies can make in corporate governance is to place a majority of independent directors on their boards.[2] The argument in favor of independent directors is that they are more likely to evaluate matters objectively – free from any undue influence or bias in favor of current management. The presence of independent board members is also seen as desirable by boards that want to appeal to outside interests who advocate the presence of such directors.

Another argument in support of having independent directors involves the issue of "management entrenchment." This is the argument that management is protected from being held accountable by virtue of having "captured" the board through the presence of inside directors on the board. The mutual insurance industry has been especially criticized for management entrenchment since the participation of policyholders in director elections is often so limited. At least one study however, concludes that mutual company managers are no more entrenched than the management of other companies.[3]

Not many people deny the advantages that come from having independent directors on a board. Independent directors can serve as a check on the 'bias' that insiders have towards their own internally generated proposals. They can also bring perspectives from other companies or industries that an inside director may not have.

The presence of insiders on a board also has its advantages. Insiders bring a greater knowledge or awareness of company strengths and weaknesses to board discussions and decisions. Inside directors can help counter any comparable 'bias' that may exist among independent directors who can't rely on a more intimate knowledge of the company to help make critical business decisions. Indeed, studies have shown that companies whose boards are composed of a substantial number of outside/independent directors often perform more poorly than those with a more balanced board of both inside and independent directors.[4]

Whether insurance agents should serve on the boards of companies they represent has been an issue for both mutual and stock insurance companies. About half of all farm mutual companies surveyed report having at least one agent on their board and ten percent of all farm mutual companies surveyed have two or more agents on their board.

Recently, a successful mid-west stock insurance company found itself in a controversy with a major institutional investor over this very issue. The insurance company was criticized by the institutional investor as having one of the "five worst corporate governance structures" because it did not have a majority of independent directors on its board (six of its 15 board members were agents and several other directors were company executives). In response, the insurance company cited the fact that shareholders had recently affirmed the presence of agents on its board (by a 75 percent vote) and also pointed out that " *… the interests of shareholders also need to be protected by board members who are not independent because they are shareholders and executive officers and insurance agents who sell our products, and thus have intimate knowledge of the company and its business.*"[5]

The debate over this issue will not likely be settled by this recent public dispute. Both sides believe strongly in the merits of their respective arguments, and each has relevant points to make. Certainly, agents are not "independent" as that term has been typically defined. Their presence on an insurance company board places them in potential conflict situations on matters that may come to the board involving claims, rates, commissions, underwriting or other issues. They may have difficulty in separating out their dual interests on any underwriting, agent commission/termination/approval, or other matters if these come before the board. Agents with large books of business can exercise undue influence on issues. On the other hand, many companies are committed to the value of having knowledgeable "agent directors" on their board.

At a minimum farm mutual companies should always keep the lack of director independence and the potential for conflict clearly in mind as matters come to the attention of the board. In situations involving a conflict, boards (generally through their leadership) should be prepared to take precautions to protect the integrity of board decisions (both legally and as perceived by other stakeholders). These precautions may include: excusing directors from discussion, requesting an abstention from voting, noting conflicts in the record, etc. Boards may also want to consider other measures to avoid board conflicts entirely, such as having agents represented in company governance through the use of advisory boards or councils.

There is also difference of opinion on how many independent directors should serve on a board. Most of the debate centers on whether independents should comprise a "simple" or "substantial" majority of the board. Some advocate that the CEO should be the only non-independent member of the board.[6]

The merits of independent directors or insider directors will be debated and researched for some time. In NAMIC's 2002 governance survey, companies reported that nearly 75 percent of their board members are non-employees and non-retirees. Within this group, 63 percent also have no material or financial relationship with the company. These results are also confirmed by a study that concludes that mutual property/casualty insurance companies, on average, have a higher percentage of outside board members than do stock insurers (the results of which are reported below):

	Outside Directors	
Insurance companies	**Average number**	**Average proportion**
All insurers (584)	5.47	.53
Mutual insurers (94)	8.27	.72
Stock insurers (490)	4.94	.50[7]

These results are confirmed in another study of the property/casualty insurance industry that reported that 81 percent of mutual companies reporting had a majority of independent outside directors on their boards.[8]

If farm mutual companies wish to increase the number of independent directors on their board, an important initial step is to agree on a definition of "independence" and use it in the search process for new directors. A farm mutual board should also decide on the number of independent directors it desires to have on the board. At least one author has suggested that the board should be a balance of inside, independent, and "gray" directors (former employees or current service providers).[9] This combination, it is suggested, has the advantages of both inside and outside directors, and provides a "moderator" role for the gray directors to minimize any polarization of the board.

Financial Literacy

One specific attribute of directors that is increasingly recommended (or even required of some companies) is "financial literacy." This attribute can be especially meaningful for insurance companies who operate in an environment of rather complex insurance accounting and financial regulatory requirements.

The essential definition of financial literacy is the ability to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement. Such literacy helps directors ask management the kinds of questions necessary for the board to perform its oversight role. Perhaps more importantly, financial literacy provides the director with the ability to evaluate management's response to those questions.

For insurance companies it is important to point out that the definition quoted above refers to a *company's* financial statements. Defined this way, financial literacy might also include the ability to understand financial information specific to a mutual property/casualty insurance company, including, for example: financial and accounting principles applicable to both GAAP and statutory accounting; types and impacts of various reinsurance arrangements; mutual company limitations on raising capital, etc.

Financial literacy is especially relevant for directors serving on an audit committee. Indeed, many organizations are advocating (or requiring) that at least one member of an audit committee also have *accounting or financial management expertise* in their background.[1] Farm mutual companies will want to consider whether at least one member of the appropriate finance or audit committee should have this expertise and/or familiarity with some of the more complex accounting/finance issues relating to insurance companies mentioned above.

Finally, farm mutual insurance company boards may also want to consider the extent to which financial orientation or training should be provided to board members. Most corporate governance advocates recommend that an otherwise qualified board member be allowed to join the board without requiring financial literacy – as long as it is acquired reasonably promptly after joining.

Board Legal Duties

All board members have individual board duties of a legal and fiduciary nature. A fiduciary duty is a duty owed by virtue of being in a position of trust and confidence. Directors occupy such a position within their companies, and these duties do not depend on whether the company is mutual or stock, private or public.

To this end, a director is obligated to discharge his duties as a director … *in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner he reasonably believes to be in the best interests of the corporation and its stakeholders*.[1] These obligations are often described or treated separately as the duty of loyalty and the duty of care. A duty of disclosure is also sometimes added or described in reference to board member responsibilities.

Duty of care: The duty of care translates into a practice of concern, attention and diligence in discharging the tasks of a director. As interpreted by the courts this duty does not require perfect judgment, but it does require assurance of thoughtful and good faith decision-making. *Good faith* basically means that the director:

1. Is not in possession of facts that are materially different than those presented to the board to justify the decision, and

2. Does not have a conflicting personal interest in the matter.

Generally a farm mutual director can be confident of meeting the requirements of this duty by following some common-sense guidelines: knowing the company; devoting an appropriate amount of time to the responsibilities of being a director (reading the board materials and attending meetings); actively participating in discussions; and making reasonable decisions.

Recently, two factors have combined to create something of an expansion of the duty of care. The two factors are:

1. The federal Organizational Sentencing Guidelines which allow courts to consider leniency for any companies convicted of criminal activity if reasonable compliance programs were in place, and

2. A 1996 Delaware court case that imposed a duty on boards to ensure corporate compliance processes are "… adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations." (*Caremark International, Inc*.)[2]

These factors have expanded the duty of care to include an obligation to ensure that mechanisms are in place that will promote corporate compliance with legal requirements. This expansion of the duty of care is especially relevant for insurance company boards because insurance is a highly regulated industry. Farm mutual companies often have special regulatory status under state law, and compliance with these and other laws (financial, employment, etc.) is an issue that deserves the attention of the board.

Duty of loyalty: The duty of loyalty is an obligation of a director to place the interests of the company above his/her self-interest. A director may not take advantage of the company and a director may not take personal advantage of information or business opportunities that rightfully belong to the company that are discovered while a director. Instead, the director must ensure that the company itself has the chance to take full advantage of any such discovered information or opportunities. The best practice here is to be above reproach in dealing with such information or opportunities and to disclose all such matters to the board.

Duty of disclosure: The duty of disclosure has most often been discussed in relation to stock company boards, requiring them to disclose relevant and material information to shareholders that might affect the shareholder's ownership interest. Mutual boards that are engaged in any activity requiring policyholder approval will need to consider their responsibilities under this duty. Policyholders, like shareholders, are generally entitled to all relevant and material information necessary for them to make any governance decision they are called upon to make as a policyholder.

In summary, these duties are very real and are very important to the exercise of sound governance practice on the part of farm mutual company board members. They are also critical in minimizing the risk of legal liability on the part of a board member. At a minimum, each board member should be familiar with the requirements of these duties. Board member orientations will often include a review of these duties fro this reason. Ongoing board education can provide companies another opportunity to review and update board members on the basis of these duties any court decisions expanding or elaborating on these duties. While 86 percent of NAMIC farm mutual member companies surveyed believe their directors are clear on their responsibilities as board members, a regular review of these obligations is advised.

Board Leadership

The choice of chairman – as anyone who has served on a board or committee knows – can significantly impact the effectiveness of such groups and the satisfaction of serving as a member. For these reasons, thoughtful consideration should be given to the selection of a chairman. The use of well-established and agreed upon criteria can enhance the selection process for a Chairman or as confirmation of responsbilities if the position is a part of the Manager-CEO's role. It is also a worthwhile board governance exercise.

A chairman's function within a board or committee will include some or all of the following tasks and responsibilities (some of these functions will depend on whether the position is separate from that of the CEO):

- Prepares agenda and conducts meetings.
- Collaborates closely with the CEO on board matters (if not the CEO already).
- Attends committee meetings as ex-officio member.
- Exercises powers and duties of the CEO in his or her absence (if not addressed in other succession planning policies).
- Participates in external activities to promote the company.
- Investigates and recommends ways to improve corporate governance.
- Presides at all policyholder meetings (this may be a CEO function in some companies).
- Recommends nominees to the board (or to the nominating committee).
- Advises the CEO on major operational issues (mentor role).
- Communicates the board's evaluation of the CEO's performance.[1]

Board leadership policy will determine who holds the position of chairman – i.e., whether the chairman is the Manager-CEO or a separate independent director. According to NAMIC's 2002 farm mutual governance survey, an outside director holds the position of chairman in nearly 69 percent of the farm mutual companies surveyed. No company reported that they had a retired Manager-CEO as chairman and in only about 15 percent of the farm mutual companies surveyed is the chairman also the Manager-CEO. This contrasts considerably with a recent survey of public companies in which 55 percent of all responding companies combine the roles of CEO and chairman.[2] However, this same survey indicates that the percentage of companies in which the positions of CEO and chairman are combined decreases substantially among smaller companies.[3]

One of the benefits of separating the positions of Manager-CEO and Chairman is that the chairman can often be more focused on important board tasks – e.g., management succession planning, director requirement, corporate governance, etc. In this way, separating the positions ensures that each role receives the time and attention it deserves.[4] Some companies have separated the two positions as a way of promoting greater independent governance by the board.

In the alternative, combining the roles of Chairman and Manager-CEO can provide a significant organizational link between management and the board of directors. This can help promote consistency and unity of action between these two primary areas of corporate control. Separating the two positions may have the effect of diluting the power of either position and creating the potential for division, indecision, or two spokespersons for the company.

Where the CEO is also the chairman, some boards have chosen to create the position of "lead director". The position of lead director can be a newly created position on the board, or simply a more formalized or expanded definition of the position of vice-chairman (if it currently exists). Many of the same functions of an independent board chairman would be contained in the position description for a lead director for a farm mutual:

- Collaborates with Manager-CEO/Chairman on board agenda and information.
- Counsels with Manager-CEO/Chairman on board member concerns and/or policyholder issues.
- Coordinates annual Manager-CEO evaluation process.
- Coordinates corporate governance initiatives.
- Represents the company at external events as agreed upon by the board.
- Chairs special committees or task forces.
- Assists the Manager-CEO/Chairman in strategic plan development and/or presentation to the board.
- Ex-officio member of any board committee.
- Serves as chairman in the Manager-CEO's absence (if a management succession plan is not in place).
- Coordinates succession planning and transition activities.
- Advises the Manager-CEO/Chairman on major operational issues (mentor role).
- Coordinates board orientation and training.

The lead director position attempts to realize the benefits of a combined Manager-CEO/chairman and of a recognized and formal independent leadership position on the board. [5] As mentioned above, the lead director can also serves as an automatic contingency for leadership during times when the Manager-CEO/chairman is absent or unable to fulfill the chairman's duties. [6]

As in other areas of leadership, written descriptions for any board leadership role is an excellent idea and a good governance practice to consider. Such documents are helpful where the positions of Manager-CEO and chairman are combined, since the roles are still distinct. They are also useful when the positions of Manager-CEO and chairman are separate, and especially useful if the board decides to use a lead director. Such descriptions help to provide guidance and set clear expectations. They also help to make periodic or ongoing evaluations of these board leadership positions more effective.[7]

Board Committees

Companies of all sizes utilize a board committee structure to help accomplish their governance responsibilities. The advantages of a committee structure are apparent – committees can apply more extensive experience and abilities (for example, financial or planning expertise) or more focused attention (for example, director recruitment, governance, investments) to significant areas of activity.

Some of the factors that help to decide whether a board should establish a committee include:

- The specific skill or experience required to understand the activity or issue and to propose recommendations or make decisions.
- The time commitment required to oversee the particular issue or activity.
- The importance of the issue or activity that is the subject of the committee's responsibilities.

Mutual companies and other corporations are not required by state incorporation acts to have any specific committees.[1] Among NAMIC members surveyed however, the following committees were identified (in order of most common first): investment committee, executive committee, compensation committee, and audit committee. The fifth most common committee is a nominating committee – one that is frequently mentioned as an important corporate governance function. (See the following sections for a more detailed review of these common mutual company board committees.)

All board committees are responsible to the board and need to keep the board informed of their activities. Agendas are usually worked out by the committee chairman in cooperation or consultation with the chairman of the board. The Manager-CEO may also be involved in committee meeting agenda setting if the chairman of the board is a separate position.

Increasingly, companies are providing each board committee with written charters that clearly identify and define their responsibilities.[2] A well written charter addresses such matters as the purpose of the committee, the specific functions and tasks assigned to the committee, the delegated authority of the committee (decision-making or recommendations only), and meeting and reporting time frames. Committee charters serve as helpful orientation material for new board and committee members. They are also helpful when a board or committee evaluation is conducted.

To utilize a board committee structure effectively, selection of qualified committee members must become an important board governance priority. Appointments should be made only after thoughtful review, including a consideration of the qualifications of the board member for the committee's specific tasks (a committee charter can help here too). As an example, the board may expect or require audit/financial committee members to be financially literate.[3] Companies may even expect or prefer that at least some members of a financial/audit committee, the chairman of the committee for instance, have actual experience in financial matters (perhaps even insurance financial or accounting experience).[4] In a similar manner, the board may decide that a compensation committee's effort can be enhanced if at least some of the members, or the chair, are knowledgeable or have actual experience in, the human resources area.

In addition to any specific knowledge or experience requirements, it is important for the chairman of any committee to have good organizational and leadership skills. These skills include the ability to create an agenda, conduct a meeting, facilitate discussion among committee members, and present committee reports to the full board in an effective manner.

The size of any particular committee is generally a function of its responsibilities, the nature of the subject matter, and its importance. As with any working group, a balance must be struck between the efficiency of a small group and the benefits of a larger group, including the variety of perspectives, more capacity for work, and greater knowledge or experience.

Boards will also want to ensure that each committee has the resources needed to perform their function adequately. In some cases this may include the support of management staff in gathering information or helping prepare reports. In other cases it may be the authority to hire outside expertise (legal, financial, etc.) to assist the committee in their responsibilities.

Finally, it can be a good practice to periodically review or evaluate the overall committee structure of the board to consider the following issues:

Committee Purpose:

- Is special knowledge or effort still required for this issue/activity?
- Can the work of any committees be combined?
- Should the work of the committee be expanded?

Committee responsibilities (as established by written charter):

- Is the authority granted consistent with the responsibilities delegated?
- Are the specific functions and tasks still relevant?

Committee size:

- Does size impact positively the level of discussion/review we desire?
- Does size allow the level of representation or expertise we desire?

Committee structure:

- Should the Chairperson have special expertise?
- Should an officer of the board serve on the committee?

Farm mutual companies have formed a number of committees for the benefit of in-depth review of key company activities and operations. The following descriptions apply to the most common committees that farm mutual company boards use to meet their oversight responsibilities.

Financial/Audit committee

Financial information and management practices are critical to any business organization since all companies must fairly and accurately report and utilize financial information. It is particularly important however, to insurance organizations because of the financial regulatory oversight they receive and the significance of sound financial practices to the service they provide their policyholders.

> *Management is responsible for the financial reporting process and internal control of the Company. The independent auditors are responsible for auditing and publicly attesting to the fairness of the Company's financial statements and, in connection therewith, evaluating the Company's system of internal control for the purpose of determining the nature, timing, and extent of their auditing procedures. The audit committee is responsible for overseeing the… participants in the financial reporting process and for reporting to the board of directors, which ultimately is responsible for the oversight of corporate performance … "*[1]

The financial literacy of members of a company's financial/audit committee has become increasingly important to boards. Committee members are expected to be able to read and understand insurance company financial statements as well as important financial ratios and terms.[2] The chairman of the committee is often expected to be knowledgeable and experienced in financial management, perhaps with a specific insurance accounting or financial management background.[3]

The specific tasks or functions of the audit committee are well established and generally include the following:

- Recommend or select the firm that is to serve as independent auditor for the current year and review the estimated fee (some recommend that the audit committee actually have the authority to hire/fire the audit firm);
- Review and discuss the audit plan with the auditor and understand the critical accounting policies, judgments and estimates being applied;
- Meet regularly with internal auditors and review the qualifications, independence, and work product of the auditor;
- Review with the auditors their proposed audit report and management letter, if any;

- Meet privately with the independent auditor from time to time to review the adequacy of management's internal controls and recommend corrective action as needed;

- Review with management and independent auditor the quarterly and annual financial statements of the company before such statements are filed with the appropriate insurance and other regulatory authorities or otherwise published, specifically inquiring as to the existence and resolution of any disagreements between management and the auditors with respect to such statements.[4]

Financial/audit committees are increasingly being asked to understand and review the business risks that the company is subject to and to oversee the risk assessment and risk management activity of staff as part of their responsibilities.[5] As a result, access to both outside expert resources and internal staff is important to assure good audit committee performance. In cases where companies lack the resources for a dedicated internal audit function, the role of the committee may also expand into this area and require access to outside resources. Boards will want to make clear to the financial/audit committee their authority regarding access to such resources.

The financial/audit committee is also one of three committees where the presence of independent directors has been identified as important.[6] Not surprisingly, highly regulated industries have the highest proportion of independent directors on their audit committees.[7] Boards will want to carefully consider the independence of the committee chairperson, since an inside director (and especially the CEO) faces the potential for clear conflicts as a result of the committee's audit responsibilities and role.

Nominations/Governance Committee

A nominating committee is generally tasked with finding, qualifying and recommending nominees for election to the board and/or its committees. This is a significant responsibility, and an increasingly time consuming one because of the rising demand for good directors. Recruiting quality directors appears to be especially important to the financial services industry. It is one of only five industries where the majority of companies in the industry have standing nominating/governance committees.[1]

Some nominating committees have a broader scope of responsibilities than simply nominating board members. These expanded responsibilities often include overseeing the company's corporate governance practices since " … *if good governance oversight is vital – it makes sense to form a board level committee that focuses specifically on how well the board and management is handling this crucial duty.*"[2]

The responsibilities of an expanded "nominating/governance" committee often includes matters of board structure, board committees and committee operations, board governance policies (ethics/conduct, conflicts, etc.), and board evaluations. Factors that a farm mutual board will want to take into account in the decision to create a nominating/ governance committee include:

- The importance attached to recruiting qualified board members in the future.

- The importance and advantages of a regular review of the company's governance practices.

- The relative need for a change in governance.

- The desire to create a focus on change and a process for overseeing corporate governance improvement activity.

The last point listed above is worth additional explanation. The creation of a nomination/governance committee (or expansion of the nominating committee's duties) can be an important first step for boards that believe their governance practices can and should be improved. Such an improvement effort may require a concentration of time, effort and resources that a committee structure is well equipped to provide to the board on important matters.

General responsibilities for an expanded nominations/governance committee could include:

- Establish criteria for board nominations and committee appointments.
- Recommend nominations for the board.
- Recommend committee appointments.
- Oversee policyholder governance relations and any policyholder participation issues and activity.
- Oversee the board-meeting process, including information reporting and meeting management performance.
- Develop governance principles, policies or guidelines for adoption by the board (conduct, ethics, etc.).
- Oversee board and/or board member evaluations.

Membership on the committee does not generally require any special background or expertise. Some governance advocates suggest that only independent directors serve on the committee to reinforce the idea that this committee is not unduly influenced by management and controlled exclusively by the board. Whatever decision is reached about the independence of its membership, the committee will need to work closely with the Manager-CEO in the discharge of its responsibilities.[3]

Compensation Committee

Financial service companies generally do not use compensation committees (sometimes referred to as *personnel committees*) as much as companies in other industries. [1] Since management compensation is both important and increasingly scrutinized, however, the justifications for a compensation committee seem more compelling than ever. For some companies the responsibilities of a compensation committee can be included as part of another committee's charter (e.g., the executive committee). The need to attend to compensation issues are the same regardless of the committee structure of the board.

Compensation committee responsibilities often include the compensation and benefits plans of the entire company, not just the senior management. The functions or tasks typically assigned to compensation committees include:

- Oversight of the company's overall compensation/benefits program.
- Setting the compensation/benefits of the Manager-CEO (or senior management).
- Ensuring linkage between compensation and long-term goals.
- Conducting or managing the process of the Manager-CEO's evaluation.

Compensation committees benefit from members, or the chairman, having knowledge or experience in compensation/benefits or human resources. The committee can also benefit from access to internal human resources department staff or outside compensation/ benefit experts. This is particularly helpful in mutual organizations where compensation plans must often be more creative to align management's interest to that of the company or its policyholder-members.

Here again, governance advocates recommend that only independent directors serve as members of the compensation committee. This reinforces the idea that the committee is not controlled or unduly influenced by management. Advocates also contend that an independent committee helps insulate the board from any inherent conflict where inside directors serve on the committee that oversees the CEO's compensation and/or evaluation. However, many companies choose to have the CEO as a part of this committee because of the CEO's knowledge of company information, staff and operations. All of these areas impact, and are impacted by, compensation committee decisions.[2]

Executive Committee

After investment committees, executive committees are the most common board committees among NAMIC farm mutual member companies surveyed. Executive committees fulfill a number of functions, including conducting the CEO evaluation/performance review (as an alternative to the compensation committee), initial development or review of important policies for the full board to consider and approve, and/or initial review or formulation of long-range plans.

The executive committee also serves as an emergency decision-making body on behalf of the board where expediency does not allow for a full board meeting. Executive committees generally possess the authority of the full board, unless the issue under consideration is a fundamental company matter (merger, sale of substantial assets, director dismissal, etc.). For some companies the executive committee has become unnecessary due to the presence of other more specialized committees or because the full board has been restructured to a more manageable size.

Investment Committee

According to the 2002 NAMIC governance survey, an investment committee is the most common board committee among mutual companies surveyed. The presence of this committee in so many company governance structures demonstrates and reinforces the importance of good financial management for mutual insurance companies.

Boards are ultimately accountable for the investment function of the mutual company. Often however, the board does not have the required skill, experience, or time to manage or oversee a portfolio of any size. Delegating the task to a single person is also unwise, since the responsibility is often too great for a single person to handle. A committee composed of knowledgeable and competent directors is a reasonable approach to this important function.

Generally, the committee is responsible to:

- Establish and maintain investment policies and guidelines for investments.
- Determine and monitor asset allocation for investments.
- Set expectations for diversification and security selection and asset performance.
- Monitor returns and review asset performance.
- Approve any investment transactions that exceed management limits of authority.
- Interview, hire and review any investment managers that may be needed.
- Review the overall effectiveness and appropriateness of the investment policies and management practices and recommend any changes.
- Report to the board on all of the above.

Board Selection

Boards of all companies are spending increasing amounts of time selecting qualified board members. Some businesses have started to use search firms to aid in the process and these firms report having to contact many more candidates than in the past before receiving an acceptance.[1]

Companies often look for candidates with specific backgrounds, skills or experiences that can assist the board in its role and in the board's development.[2] CEO's that are still active in their firms remain the top pick of most boards for director positions.[3] Their knowledge of the financial and operational aspects of running a company is invaluable experience as a director. Increasingly, other senior managers in the same or a related industry (not direct competitors) who have the capability to be a CEO are being approached for director positions. These “next generation candidates” are especially welcome if they have experience in an area where the board may currently be weak – for example technology, finance, or personnel/human resources. After these “next generation candidates” there is a preference for similar candidates outside the industry, then investors, and then professionals (attorneys or accountants).[4]

There is a growing perception that there is a limit to the number of boards on which one person can effectively serve. A majority of directors believe that serving on two outside boards is all that a current full-time executive can responsibly manage.[5] Studies have shown that outside directors spend an average of 173 hours on board matters annually (up from 157 hours just a year ago).[6] As time commitments increase for directors, candidates will not be as inclined to accept a board position as quickly as they might have in the past – especially if they are already serving on a board. This will certainly impact director requirement efforts for all companies in the future.

As a result, recruiting superior board candidates will require more planning and execution than ever before. Generally, the committee or person responsible for recruitment will want to review the ongoing role and function of the board, the current company situation, the present composition of the board, and the specific qualities and skills needed of the new director. A written position description that covers basic responsibilities and expectations is very helpful in recruiting candidate directors.

Most boards support looking for diversity when recruiting new members.[7] Mutual companies are marketing to an increasingly diverse marketplace, and a board that reflects that diversity is much more likely to help determine what it takes to succeed in such an environment than one that does not. More diverse talent is available to boards in the form of the ‘next generation’ candidates referred to above.

The following tactics can enhance the number and quality of board candidates for a farm mutual company:

- Get the word out to people who know you and who you trust – the company’s law firm, banking contacts, or other professional business acquaintances.

- Focus on candidates with skills not currently on the board – this may be in the area of finance or technology or human resources or global business.

- Compensate creatively since without stock options it might require something a little more or a little different – board retreats, non-cash benefits – to attract candidates.

- Review and improve overall governance practices – try to make board service a more rewarding experience.

Board Orientation and Training

Director orientation and training can be an significant part of improving board practices and performance for farm mutual insurance companies. Mutual insurance companies operate in a highly regulated industry and farm mutual organization and operation is not commonly understood. In addition, the insurance industry is undergoing significant change and the pressure for more change seems to be increasing. Director orientation can help new directors come to a quick understanding of the unique structure and function of the farm mutual insurance company. This understanding will assist new directors to more quickly participate in a meaningful way on board issues and give them helpful perspective for important decisions.

Board member orientation and training is part of the increasing attention being paid to ongoing board development. Development activities can also include providing relevant reading materials, briefings and formal training and education opportunities. Topics for orientation of new board members can include such subjects as insurance industry overviews, mutual insurance principles, company history, company organization and operations, current company strategy, senior staff profiles, significant business risks facing the company, board governance practices (including board member expectations and appropriate policies), and recently discussed key issues or decisions by the board. As mentioned earlier, directors that receive an orientation are able to contribute meaningfully to the governance of the company in as short a time as possible. The NAMIC governance survey revealed that 27 percent of farm mutual companies surveyed provide an orientation program for new directors.

Board training is another area of board development that is receiving attention by farm mutual companies. 33 percent of the NAMIC farm mutual members surveyed actually provide ongoing training for their directors. In that same survey, board orientation was selected most often (40 percent) as the topic that respondents would like to see addressed more by boards.

Board Evaluation

One of the areas of board governance that has received a lot of attention is that of board and director evaluation. The Business Roundtable and similar organizations suggest that a " … *board should conduct periodic – generally annual – self-evaluations to determine whether it and its committees are following the procedures necessary to function effectively.*" [1] These recommendations are based on the premise that any person, organization or process can be enhanced by evaluation of performance and dedication toward necessary change.[2]

Board evaluation is, however, a relatively new idea in corporate governance practice and it is not widespread among companies. Recently, 63 percent of CEO's serving as outside directors of public companies reported that they had never been part of a board evaluation. Of these same CEO's, 42 percent had never participated in a board evaluation for their own boards.[3] Despite these numbers, 91 percent of public company board members support regular board evaluations.[4] This suggests that CEO's and other key board members are willing for meaningful board evaluations to take place.

Only 13 percent of NAMIC farm mutual member companies surveyed conduct board self-evaluations.

The recognized advantages of board evaluations include:

- Strengthening overall board and individual member performance.
- Its effectiveness as an audit of current performance and of possible areas of improvement.
- A means for measuring progress and an aid to prioritizing improvement efforts.
- Raising individual board member performance issues in an objective manner.
- Regularly reviewing governance as a critical process for peak performance in a business environment of rapid change.
- Serving as a model/example to all in the company regarding performance evaluation and demonstrating the importance of organizational development based on feedback.
- Reinforcing the corporate governance responsibilities and objectives of the board and each member.
- Providing an opportunity for each member to reflect on both overall board and individual director contributions and providing explicit recognition of board success and important contributions from individuals.
- Answering critics who are expecting or demanding more accountability from the board.
- Minimizing errors or weaknesses in the governance process that might create public relations or legal issues later.

There is no better group to evaluate the effectiveness of the company's governance efforts than the board itself as directors appear to be very familiar with their areas of strength or weakness. Recent studies indicate that boards believe they are most effective in areas of board-management relations, corporate governance, compliance, executive compensation, and director recruitment/nominations. Boards believe they are less effective however, in such key areas as risk management/control, strategic planning, and CEO succession. [5]

Boards choosing to conduct self evaluations will first want to decide what kind of evaluations to conduct: the overall board; board leadership. The board will also want to select the method of evaluation: self-evaluations or peer evaluations.

Overall board performance evaluations generally include the following topics in an attempt to evaluate board "effectiveness":

- Board responsibilities.
- Adequacy and timeliness of information.
- Appropriateness of meeting agendas and time.
- Team work of directors, level of discussion, decision-making.
- Trust, candor, mutual respect, cooperation.
- Independence of thought and decision-making. [6]

Individual directors evaluations generally include the following topics in an effort to evaluate individual director "contribution":

- Meeting attendance.
- Degree of preparation.
- Active participation in meetings.
- Ability to communicate and express viewpoint.
- Willingness to listen, openness to ideas.
- Understanding of company and industry.
- Independence of thought and decision-making.
- Ability to work well with directors and management.[7]

Farm mutual companies that commit to a board evaluation process should be prepared to respond to likely anticipated negative reactions by some board members.[8] Evaluations are a considerable challenge for any work group – especially one composed of high-level managers, executives, business owners or professionals. Directors may be reluctant to engage in what is a new, challenging and un-bargained for evaluation process. As a result, proponents of evaluation should plan to address some of the following process issues:

- How to ensure board agreement on and commitment to evaluations.
- How to establish goals for board and board member performance to use in the evaluation.
- How to measure or evaluate progress or success.
- How to address issues of candor, confidentiality, and objectivity.
- How to formalize the process going forward.

- How to address any issues or areas of improvement opportunities.
- How to follow-up to ensure this is a helpful process.

Since board evaluation is a new area for most directors, it should be handled carefully and the process developed cautiously. This often means that boards will begin with just an overall board evaluation and/or individual board member *self-evaluations*. Eventually, if the board desires to move further in the area of evaluation, board leadership evaluations and individual director peer reviews might be implemented. Such an approach allows the board time to evaluate the progress and results of the evaluation process before committing to further and potentially more involved evaluation efforts. [9]

It can be helpful for a board to assign responsibility for the board evaluation process to a single board member, or a group of board members, or a committee. This delegation and accountability helps ensure that the evaluation process actually takes place and that it receives the planning and follow-up that it deserves. The chairman (if he is an independent director) or the lead director is a likely candidate for the responsibility if a single individual is selected to manage the evaluation effort. The chairman of a nomination/governance committee is also a good choice. If a group is assigned the responsibility, a nomination/governance committee, an executive committee or a board task force are likely the most appropriate selections. As an alternative, the board could hire an outside consultant to initially help the board through this challenging process. In making any of these choices, considerable thought should be given to the tact, integrity, confidentiality and other qualities deemed important for the evaluation to work well.

Board Compensation

Until recently, board compensation for many mutual insurance companies was not a significant issue. Mutual board members served for a variety of reasons, many of which were non-financial – self-esteem, peer group recognition and interest, image in the community at large, and a desire to contribute. Many of these motivations continue to be valid.[1] The increasing demands of service placed on directors has, however raised expectations for director compensation. Exposure to personal liability, even if the company has D&O insurance and indemnity provisions, has contributed significantly to the reluctance on the part of potential director candidates to serve as willingly as they might have previously.

Generally, larger companies will pay more for directors than smaller companies. This is likely due to the greater responsibility and time commitments connected to such companies, but also to concerns about the legal risks of serving as a director on the board of a larger company. Since companies, large and small, are competing for good directors – all other things being equal, the “price” of good, qualified directors has risen.

Farm mutual company director compensation generally takes the form of either cash or non-cash benefits. The compensation provided to directors often consists of one or more of the following:

Cash retainers: Regular fees for board or committee service (separate from meeting fees).

Meeting fees: Fees paid only for attendance at board or committee meetings.

Leadership fees: Fees paid in addition to any of the above for assuming lead director, chairman or committee chairman responsibilities.

Benefits: Travel expenses, access to company benefit programs, event attendance.

A more expanded list of benefits afforded directors of mutual companies includes: health insurance, life insurance, accidental death insurance, disability insurance, retirement plans, spousal travel, matching charitable gift programs, expense reimbursements, and deferred compensation arrangements.

To maintain competitive and purposeful compensation practices, boards can establish specific factors to be used in setting director compensation. This means identifying the characteristics, behavior or expectations that companies desire of their directors, and building these factors into the director compensation provided. These *compensable* factors can include: attendance at meetings, leadership positions assumed, time spent on board matters outside of meetings, special qualities or skills, etc. The board may also want to establish a variable component of director compensation that is based on company performance, which may require some creativity on the part of the board in fashioning an appropriate measure (see below).

The NACD reports that there have been two trends in director pay in the last 20 years that would impact mutual companies directly: a shift from compensation in the form of annual retainers toward attendance fees and a significant rise in non-cash forms of compensation for directors.[2] The move to base cash compensation on attendance is clearly intended to enhance the actual *participation* of board members in one aspect of their governance responsibilities – meeting attendance. In that respect, it is consistent with "pay for performance" concepts and trends. The trend toward non-cash director compensation however, runs somewhat counter to this "pay for performance" dynamic since such compensation is not tied to any specific behavior or achievement. It will be interesting to track the trend of director compensation in farm mutual companies over time and note any changes in these areas.

Perhaps the most interesting issue relative to director compensation is the prospect of making director pay more performance-based. In non-mutual companies this has been accomplished through the use of stock or stock options to compensate directors. In mutual companies this is more challenging, although a number of financial and non-financial performance measures are available and could be used for such purposes.[3] Steps should be taken to insure that long-term performance measures are used that do not create the problems that have plagued stock companies through the use of stock options for director compensation. In addition, performance measures linked to director compensation should also be general enough to maintain the appropriate involvement of the board at the strategic, not tactical, level of company performance.

If a farm mutual company intends to change its director compensation practices, the board may wish to address such changes in light of the following issues:

- What is the right combination of cash and non-cash compensation?
- How will company performance factor in board compensation, if at all?
- What compensable factors apply?
- How will the board transition from its current compensation program to the new one?
- Who is responsible to review the compensation of directors and recommend changes?
- What criteria and what input will we use regarding director compensation?
- How often should director compensation be reviewed?

There is, of course, an inherent conflict with boards structuring and setting their own compensation programs and levels. Using independent directors or management staff to make compensation recommendations does not insulate the board from this conflict. In an effort to manage this conflict, many boards use outside consultants or published or informal surveys as the basis of their director compensation decisions.

Boards should keep in mind however, that even the best compensation surveys gather and report data on the basis of company size, industry sector and geography. The compensable factors mentioned above (number of meetings, board leadership positions) are not usually tracked or reported in these surveys. For that reason, boards should explicitly refer to any factors they might decide to use whenever they attempt to justify departures from these survey sources when approving director compensation programs. Boards should also keep in mind that compensation surveys are dated (perhaps as much as 18 months) by the time they are published or available and adjustments to their reported numbers is needed to make them useful for director compensation matters.

NAMIC's farm mutual governance survey shows that of the 13 companies that provide retainers, 5 pay at least $1,000 a year and 8 pay less than $1,000. Inside directors, on average receive less than half of what outside directors receive for a retainer. An overwhelming majority of respondents pay directors per meeting attended, with 15 companies paying between $40-45 per meeting; 27 companies paying between $50-55; 15 companies paying between $70-75; and 14 companies paying between $100-125. NAMIC's annual compensation and benefits survey also collects information about board member compensation and benefit packages and would be a useful tool for any mutual company board to consult in this area.[4] According to the 2001 edition of NAMIC's annual survey, 96 percent of survey respondents pay directors some form of compensation – 92 percent paying a per meeting fee and 26 percent paying an annual retainer (most likely in addition to meeting fees). Forty-eight percent of survey respondents also paid *committee* members on a per meeting basis. The 2001 Survey provides additional detail by company size, geographic region and scope of operations (single state/national writer).

Board Terms and Retirement

In its monograph *Focus on the Future,* NAMIC reviewed the basic issues associated with using term limits for board positions.

> *Term limits ensure that the board remains dynamic and that, over time, no single director dominates the board's activities. However, term limits can also prove harmful to the company if they result in loss of historical knowledge and valuable skills.*[1]

About 52 percent of NAMIC farm mutual companies recently surveyed reported having established term limits for board members. These same companies report that the average length of a term for a director is 3 years. Very few NAMIC farm mutual companies surveyed (less than 3percent) limit the number of terms that a board member can serve. Only 10 percent of farm mutual members surveyed report having a mandatory retirement age. The average retirement age reported is 70 years (with a minimum age limit of 65 and a maximum age limit of 75).

Term limits, and mandatory retirement policies, are governance practices that can help ensure boards have the flexibility to evolve as time passes and new environments arise. These policies clearly communicate to existing and new directors that a board position is not a lifetime appointment. Term limits and mandatory retirement policies also allow the board to recruit and elect new board members with some regularity. These policies can be a way of handling the delicate issues of board rotation for directors who have not stayed current or who have failed to perform for the board as expected. These policies are especially helpful when there is no other mechanism to easily or tactfully remove such directors from the board.

Policyholder Relations

There is perhaps no area of corporate governance that better demonstrates the difference between mutual insurance companies and investor-owned entities than the rights and interests of mutual company policyholders. Neither is there any area that seems to create as much controversy for mutual companies. The publicity and controversy surrounding some recent insurance company demutualizations and restructurings is due, in large part, to issues regarding the status of mutual policyholder. The rights and interests of the policyholders of a mutual insurance company is an important subject for mutual company board directors to understand.

Mutual policyholders do have the power to elect board members. Generally, each mutual policyholder receives a single vote regardless of the amount of insurance purchased (some states do provide for other allocations of policyholder voting rights).[1] As a result, a single policyholder can only control a tiny percentage of the total outstanding votes of any mutual company.

Policyholders' exercise of governance rights varies dramatically among mutual insurers. Participation may be affected by a number of causes, including level of company communication, policyholder approval or disapproval of the insurer's current performance, the nature of the insurer's business or the mission of the mutual insurer, the lack of a personal stake (financial investment/stock) in the company, and the composition and specific interests of its members.[2]

Mutual company board elections, including the use of proxies, generally follow practices authorized in the bylaws of the company, as impacted or controlled by state law. Mutual policyholder rights also vary significantly among companies because of the diversity that exists in the sources of these rights – articles/bylaws, state law, insurance policy contracts, etc.

State law may contain rules for mutual company board elections that are substantially different from those required for companies in other states. For instance, some states require notification of annual meetings to mutual policyholders; some states require no notice at all; and still other states allow meeting notices to be printed on the policy form when issued. Only a few states require companies to send any financial information to policyholders and the law is silent in several states on the process for nomination of directors, solicitation of proxies, or for proposing resolutions at an annual policyholders meeting. Some states have no provision for the inspection of lists of policyholders.

> *Each state's laws will dictate to varying degrees how the members' rights to participate in the election of directors are implemented. Various laws generally recognize that there are significant distinctions between the interest of a shareholder, who has made an investment with the expectation of an investment return, and a member of a mutual insurance company whose expectations are primarily focused on the insurance policy itself.*[3]

In addition to state law there is the impact of the insurance policy itself.

> *Policyholders' interests in a mutual insurance company are derived from more than one source. The insurance policy itself establishes a defined set of rights which will differ from contract to contract and from state to state. In addition, policyholders of mutual insurance companies are members of the mutual insurance company and have certain other interests which do not accrue to the holder of an insurance policy from a stock insurance company. These mutual interests also vary from company to company and from state to state. Although the term "membership" more accurately describes the legal and contractual relationship between a mutual insurance company and its policyholders, it is often referred to as the policyholder's "ownership" interest in a mutual insurance company.*[4]

Policyholder Status as "Owner"

From a governance standpoint, the most controversial issue in defining a policyholder's interest is that of *ownership*. In actual legal fact, the *ownership* status of most mutual company policyholders has a very limited meaning. Generally, it means only governance/participation rights and includes no financial interest in the assets of the company (except perhaps in the relatively rare instance of corporate restructuring or the more common situation of a declaration of dividends). This narrow definition of ownership applies even in states that use the term *owner* in the legislation regulating mutual companies. [1]

> *Although it is commonly stated that policyholders own a mutual insurer, the membership interest of a mutual policyholder is not equivalent to ownership. In its most common sense, ownership usually implies a right of dominion and control over property, including the right to dispose of the property. In a mutual insurer, policyholders, or members, do not have the ability to sell or otherwise transfer individual ownership. The ownership interest arises out of the policy of insurance and does not survive the termination of the policy of insurance.*[2]

Excess Reserves

The *ownership* interests of mutual policyholders are sometimes asserted in the context of a claim that a mutual company possesses *excess reserves*. The phrase *excess reserves*, or *excess surplus,* refer, in theory, to a difference between the reserves or assets deemed necessary to operate a mutual insurance company and the amount of reserves actually held by the company. The issue generally arises when the amount of reserves are sufficiently large, in the opinion of the person bringing a claim against the company, to compel a distribution based on an "ownership" interest in those reserves.

State law (including statutes, regulations and court decisions) has repeatedly recognized that only the board of directors has the authority to determine the amount of reserves needed to operate a mutual company. As a consequence, only the board can determine whether any of the reserves are available for distribution to policyholders by declaring a dividend. The right to a dividend based on company reserves does not arise unless and until the board decides. The law has consistently refused to recognize a policyholder's right to compel any dividend based on a mutual insurance policyholder's *ownership* interest.

> *Accordingly, policyholders only have the right to receive a dividend if and when it is declared by the board of directors. They may also have the right to participate in the distribution of the company's surplus, but only if permitted by State statute and only if the board of directors and the policyholders approve either a decision to convert to stock ownership form or the company is liquidated. The right to participate in the surplus of the company is conditional, transitory and not guaranteed. No member has a right to "cash out" his individual membership interest.*[1]

The legal interest of the policyholder does not involve ownership of any undistributed portion of the assets of the company as long as the company is a going concern. It is more accurate to describe the interests of mutual policyholders as "members" of a perpetual risk sharing entity that holds reserves for the benefit of both current and anticipated future members.

Policyholder Communication

Farm mutual companies communicate in a number of ways with their policyholders. These communication methods generally include the use of annual meetings and annual reports. Very few companies use newsletters or websites to communicate with policyholders. The most frequently communicated information is the current financial condition of the company followed by changes in operations.

In this atmosphere of corporate governance interest and scrutiny, policyholder communications regarding governance is something companies should seriously consider. Enhanced policyholder communication may be one way the industry can proactively address any public concern regarding mutual company governance practices. In addition to the items mentioned previously, policyholder communication could also include the following items of governance practice:

- Board mandate or charter (roles and responsibilities).
- Board composition, size and proportion of outside or independent directors.
- Existence, purpose and membership of board committees.
- Existence of board evaluation process.
- Numbers of board and committee meetings.[1]

Certainly any communication that is consistent with the fundamental interest of the policyholder – the ability of the company to deliver on a claim – is an appropriate topic for policyholder communication. As noted above, it appears that many mutual insurance companies are doing just that – the information most frequently communicated to policyholders includes current financial information of the company.

Section III: Conclusion

Corporate governance issues are headline issues. Boards and executives are being challenged as never before to address what they do in new and significant ways. There are however, several underlying reasons for this interest in corporate governance that do not depend on the energizing power of recent scandals.

- People are more involved with and aware of "corporate America" than perhaps at any time in our history. By some accounts, more than 50 percent of Americans own stock – and own it in significant amounts. It has become the principal source of retirement funds for many people. The influence of institutional investors (some of whom are strong advocates of governance reform) can be attributed to this ownership interest on the part of many Americans.

- Many people realize to a much greater degree than before that they are relatively unable to act forcefully and directly as a group to affect corporate decision-making – they must rely on a board. Misreported financial information and scandal has eroded confidence in the basic corporate regulatory oversight mechanism in America - accurate financial disclosure. People perceive there is little to check the power of business in areas that directly impact their financial futures. It is often a short step from there to the opinion that "something must be done."

- There is a temptation to consider corporate governance to be a "stock company" issue. It is true that much of the current debate can be attributed to practices that arise predominantly in investor-owned companies (stock options, SEC disclosure violations, etc.). It may be difficult however, for mutual organizations to distinguish themselves enough to avoid the inappropriate result of being treated the same as stock companies on these issues. All businesses tend to get lumped together in discussions about 'corporate America' and the corporate governance debate is no exception. In addition, mutual policyholders are consistently compared to investor company shareholders by analogy and argument, and, judged on that basis, their current status and governance participation or protections found wanting. The complex and diverse nature of a policyholder's interest in a mutual company can quickly get ignored or forgotten in the push for immediate and substantial, even if inappropriate, reform.

These influences and trends are enough to make corporate governance practices a concern for any farm mutual insurance company. Irrespective of these issues however, farm mutual insurance companies should become informed and engaged in improving corporate governance for the following reasons:

Concern about accountability. The mutual insurance industry represents a significant amount of assets in our economy. Responsible accountability for these assets is something that the mutual industry has excelled at in the past. As concerns are raised elsewhere in the economy about corporate accountability, mutuals must be vigilant to stay ahead of expectations.

Competition against better boards, and for better boards. All mutual companies are in competition with other insurance companies that are becoming more effective and efficient at governance (whether willingly or not). Anything that improves corporate governance in other companies will make them better companies and better competitors in the long run. That market competition will also extend to the search for qualified board members. Companies with better governance systems will have an easier time attracting better candidates.

Change that is impacting the insurance industry specifically in unprecedented ways. Business strategy development and implementation will be an even more critical activity in the future than in the past. Changes in technology, employee recruitment and retention, company and industry consolidations, and regulation are even now impacting all insurance companies regardless of line of business or size. Companies with excellent boards (skilled, motivated, led) and excellent management will succeed. Companies without one or the other will suffer.

Cost of governance activity. It's true, good governance costs in terms of time and money. It doesn't cost as much however, as weak or poor governance. In terms of time, effort, and money, a governance system that does not contribute meaningfully to a company's performance is a waste.

There is tremendous opportunity in the insurance industry. Perhaps more than ever before the critical capability of the insurance industry to manage risk and enable a robust economy is understood by a number of consumers and policymakers. Such visibility can often invite additional scrutiny into critical operations and business practices – including corporate governance. Just as in the past, the mutual insurance industry is more than capable of meeting these challenges and exceeding all expectations.

Footnotes

Preface

1. The Business Roundtable - www.brtable.org; the National Association of Corporate Directors - http://www.nacdonline.org/
2. Ira M. Millstein, "The Role and Independence of Boards and their Advisors – and the Role of Compensation." The Corporate Governance Advisor, May/June 2002, volume 10, number 3, p5.
3. James Olan Hutchinson, "Board Silly", Financial Planning, April 2002, p81. There is considerable concern about the possibility of overreacting to the present 'crisis' in corporate governance:

    "Corporate governance is a hot topic currently. It gets a lot of press, particularly in the areas of compensation and board activism. In my view, there are many misconceptions surrounding the subject. Certainly there have been compensation excesses and management failures, but overreaction to them entails its own dangers. So it is important that everyone, business and government alike, consider all sides of this complex issue and learn everything we can, before adopting radical change."

    > Kinnear, James W., "Corporate governance: a system for accountability", Directorship, June 2002, p9;

    "Enlightened boards and managements are capable of governing themselves. External regulation is likely to prove rigid, cumbersome, and costly and is unlikely to accommodate company-specific differences. Regulatory action should be invoked only if voluntary action fails."

    > Report of the NACD Blue Ribbon Commission on Performance Evaluation of Chief Executive Officers, Boards, and Directors, NACD, (1994, 1995) p4;

    "Unfortunately, the combination of financial losses and corporate shenanigans create an emotional atmosphere that makes the understanding of intelligent policy almost impossible."

    > Edwin T. Burton, Corporate Governance: What Reforms are Needed?, American Legislative Council, 8/9/2002.

    "One has the sense that corporate governance is now at the center of a public relations game. Regulators seem more concerned about the impressions that their policies will create than about formulating policies grounded in rational principles and empirical evidence."

    > James D. Westphal, Second Thoughts on Board Independence, Corporate Board, Sep/Oct 2002, volume 23, issue 136, p6

4. Report of the NACD Blue Ribbon Commission on Performance Evaluation of Chief Executive Officers, Boards, and Directors, NACD, (1994, 1995) p4. In a similar vein is the following comment, also from another NACD publication, which also reflects this paper's approach,

    This report is intended to be forward-looking and aspirational, not judgmental. The Commission recognizes that board practices are evolving and trusts that they will continue to evolve in the direction it suggests. Such evolution does, and should, take time, and the rate of change will be individual to every board. Therefore, this Report is not intended – and should not be used – as a score card for grading the past or present performance of any individual board. It is, rather, a guide for directors to meet the challenges of the future.

    Report of the NACD Blue Ribbon Commission on Director Professionalism, 2001 Edition, National Association of Corporate Directors, xii.

5. Al Gini, Ethics in Leadership Working Papers, Academy of Leadership Press, Loyola University (Chicago, 1996).
6. Kinnear, James W., "Corporate governance: a system for accountability", Directorship, June 2002, p1.
7. Quote from Stephen Potts, Chairman of the Ethics Resource Center Fellows Program and former Director, U.S. Office of Government Ethics as contained in "National Experts in Corporate Ethics Meet", PA Times, September 2002, volume 25, issue 9, p1.
8. George W. Bush, *A call for higher ethical standards enforced by strict laws*, Speech, July 9, 2002, New York City.

Introduction

1. OECD, Principles of Corporate Governance, April 1999. Another definition of corporate governance that reflects the importance of both accountability and achievement is " … the mix of devices, mechanisms and structures which provide control and accountability while promoting economic enterprise and corporate performance". Helen Short, Keven Keasey, and Michael Wright, "Corporate Governance: Accountability versus Enterprise", Hume Papers on Public Policy, 2000, volume 8, issue 1, p70.
2. Joseph Nocera, "Hitting the Boards", Money, September 2002, volume 31 issue 9, p57 where the author quotes corporate governance activist Nell Minnow as follows, "I've spent a lot of time trying to fix companies, and changing the makeup of the board is the only thing that always works."
3. Rosalind Gilmore, Mutuality for the twenty-first Century, Centre for the Study of Financial Innovation, no. 33 (London, 1998), p1
4. J.E. Richard, Board of Director Compensation Guide, J. Richard & Co., (Montara, CA 1995) pI-13 referencing material from James Drury, SpenserStuart Board Index, 1994 Report (Board trends and Practices at 100 major companies), NACD Director Monthly. For another review of what the future board meeting will be like see, James F. Reda, "Committees: A Glimpse At the Future Boardroom", Corporate Board, Mar/Apr 2002, volume 23, issue 133, p21.

Section I:
Board Responsibilities: The role of the Board of Directors

1. Model Business Corporation Act, Section 8.01
2. Ira M. Millstein, "The Role and Independence of Boards and their Advisors – and the Role of Compensation." The Corporate Governance Advisor, May/June 2002, volume 10, number 3, p5. Another well known definition of the role of the board of directors is from The Business Roundtable,

   " … (the board's) primary duties are to select and oversee a well-qualified and ethical chief executive officer who, with senior management, runs the corporation on a daily basis, and to monitor management's performance and adherence to corporate standards. Effective corporate directors are diligent monitors, but not managers, of business operations." Principles of Corporate Governance, White Paper, The Business Roundtable, May 2002, p1.

3. Most of this information is taken from Report of the NACD Blue Ribbon Commission on Director Professionalism, 2001 Edition, National Association of Corporate Directors (Washington, D.C. 2001) p1.
4. Charles N. Waldo, Boards of Directors, Their changing roles, structure and information needs , Quorum Books (Westport, CT, 1985) p17,18. There are, of course, a number of ways to describe the role of the board of directors. For other perspectives and an overall 'theory' of board governance see John Carver, Boards that make a Difference, Jossey-Bass Inc., (San Francisco, 1990), p 13-18.
5. Richard M. Steinberg and Catherine L. Bromilow, Corporate Governance and the Board – What Works Best, The Institute of Internal Auditors Research Foundation, 2000, xiii.

Strategic Planning

1. In a NACD survey of public companies boards picked strategic planning as one of the top five "concerns" as corporate directors. While it ranked third as a top rated concern, it received the second highest rating overall as one of the five most important concerns for boards. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p6. In NAMIC's recent governance survey this finding was reinforced – strategic planning was a top

concern when directors were asked to identify the activity that could be done better by their boards.

2. A high percentage (96 percent) of public company directors surveyed by the NACD felt that the board should be "constructively engaged" with management in setting corporate strategy. Interestingly, only one in five directors felt their boards were "highly effective" in dealing with strategic issues. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p.9
3. This section is adapted from Richard M. Steinberg and Catherine L. Bromilow, Corporate Governance and the Board – What Works Best, The Institute of Internal Auditors Research Foundation, 2000, p2. The following anecdote may provide a real life example of a "constructively" engaged board from the former CEO of Medtronic –

   > "We assembled board members who had a broad range of experience, expertise, and opinions, and we worked hard to make sure this expertise was fully tapped. As CEO, I used this diverse group as a sounding board to explore new strategic directions, new business ventures, possible acquisitions, and sticky legal issues. Many times the board saved me from bad decisions or encouraged me to take significant strategic risks."
   >
   > William W. George and Gardiner Morse, "Imbalance of Power", Harvard Business Review, July 2002, volume 80, issue 7, p23.

4. The NACD survey indicates that about 25 percent of public company directors actually favor the creation of a board committee for strategic planning. This would make it the sixth most *popular* committee behind audit, compensation, nominating/governance, executive and finance committees. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p27.
5. Richard M. Steinberg and Catherine L. Bromilow, Corporate Governance and the Board – What Works Best, The Institute of Internal Auditors Research Foundation, 2000, p27.

Board Charter

1. For an example of a document that serves as a board and board member position description see, Report of the NACD Blue Ribbon Commission on Performance Evaluation of Chief Executive Officers, Boards, and Directors, National Association of Corporate Directors, (Washington, D. C. 1994, 1995), Appendix D, p27. The use of written guidelines for the board is increasing according to Korn/Ferry International (a recruiting firm) – 75 percent of surveyed companies have written guidelines (an increase from 69 percent in 2000 and 65 percent in 1999). "Board Members are Becoming more Independent and Accountable Study Finds", Corporate Board, November 2001, volume 22, issue 131, p26.
2. Michael D. Wagner, Bradford W. Rich, and Dan A. Bailey, Corporate Governance of Mutual Insurers and Reciprocal Insurance Exchanges, National Association of Corporate Directors (Washington, D.C. 1998) p21.
3. Richard M. Steinberg and Catherine L. Bromilow, Corporate Governance and the Board – What Works Best, The Institute of Internal Auditors Research Foundation, 2000, p72.

Board Policies

1. Richard M. Steinberg and Catherine L. Bromilow, Corporate Governance and the Board – What Works Best, The Institute of Internal Auditors Research Foundation, 2000, p23 Many of the items on this list are from this publication – the subject matter of "policyholder communications" was added due to the obvious importance of this subject to mutual insurance companies.
2. News Watch, "Florists' mutual adopts alcohol-free policy", American Nurseryman, 2/15/95, volume 181, issue 4, p14. (Florists Mutual is now known as Hortica Mutual Insurance Company).
3. Report of the NACD Blue Ribbon Commission on Director Professionalism, National Association of Corporate Directors (Washington, D.C. 2001) p7. Support for executive sessions can also be found anecdotally, such as the following statement from the former chairman of Medtronic, "CEO's who are uncomfortable about having the board meet without them should consider whether they'd rather have board members convening for a late-night rump session". William W. George and Gardiner Morse, "Imbalance of Power", Harvard Business Review, July 2002, volume 80, issue 7, p23.
4. For instance, during the tenure of Jack Welch at GE the board did not conduct executive sessions.

CEO Evaluation

1. Principles of Corporate Governance, White Paper, The Business Roundtable, May 2002, p1.
2. Gary J. Young, Yvonne Stedham, and Rafik I. Beekun, "Boards of Directors and the Adoption of a CEO Performance Evaluation Process: Agency – and institutional – theory perspectives", Journal of Management Studies, March 2000, volume 37 issue 2, p227.
3. "Inasmuch as CEO evaluation is a critical task of the board, it is inappropriate for the boardto delegate that task to one of its committees. A committee, naturally, can help frame the discussion, organize the process and do some of the necessary preliminary work. But the full board needs to discuss and –if it can—agree to the evaluation."

   Philip R. Lochner Jr., "Lessons in evaluating CEO Performance: Tell it like it is.", Directorship, October 2000, volume 26, issue 9, p1

4. Report of the NACD Blue Ribbon Commission on Performance Evaluation of Chief Executive Officers, Boards, and Directors, National Association of Corporate Directors (Washington, D. C. 1994, 1995.), p8.
5. According to the NACD survey, 99 percent of directors say boards should have a process in place to evaluate the performance of the CEO; 85 percent of directors surveyed support the use of a written job description for the CEO; and 78 percent say the process itself should be "formal/written". This is quite remarkable in light of the fact that many directors are CEO's themselves. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors, 2001, p8.
6. Report of the NACD Blue Ribbon Commission on Performance Evaluation of Chief Executive Officers, Boards, and Directors, National Association of Corporate Directors (Washington, D. C. 1994, 1995.), p10.

CEO Succession

1. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors, 2001, p 5. This concern may reflect not only the increasing number of CEO departures, but also the increasing amount of time and effort it takes to find replacements. The survey also reports that only one in five directors feel their board is "highly effective" in dealing with succession issues. 83 percent believe that a formal succession process is needed.
2. Randall S. Cheloha, "The Board and Effective Succession Planning", Corporate Board, Sept/Oct 2000, volume 21 issue 124, p7. Much of this material comes from the article by Chehola. On the subject of defining leadership,

   "Regardless of the definition of leadership agreed upon by senior management, they must make it work and communicate it to others. The company must wrestle with what leadership means to them. Through this process it distills important values that help clarify what is sought in CEO candidates. Failing to define leadership leads to confusion, ambiguity and, eventually, an acceptance of mediocre leaders."

   Randall S. Cheloha, "The Board and Effective Succession Planning", Corporate Board, Sept/Oct 2000, volume 21 issue 124, p7.

3. Randall S. Cheloha, "The Board and Effective Succession Planning", Corporate Board, Sept/Oct 2000, volume 21 issue 124, p7. While the author makes it clear that succession planning and leadership development are linked, they are still separate responsibilities.

   "Succession planning is about preparing someone to assume the role of the CEO, period. It focuses on a handful of internal or external candidates … Companies may ignore leadership development (and many do) but this does not release the board from the responsibility of having a successor in place."

Executive Compensation

1. James F. Reda, "The New World of the Compensation Committee", Corporate Board, Nov/Dec 1999, volume 20, issue 119, p18.

2. Greg A. McDermott and Daniel F. Miller, Crain's Cleveland Business, 9/23/2002, volume 23, issue 38, p28.

Section II:
Board Structure and Organization

Articles and Bylaws

1. Douglas Long, "Governance of Mutual Insurance Companies, A Call for Reform", 29 Drake Law Review, 693-742 (1980). See also, Richard A. Hemmings, "Who Owns a Mutual – A Legal Perspective", paper delivered to the NAIC Mutual Holding Company Working Group, 1997, p6. See also, J.A.C. Heatherington, "Fact v. Fiction: Who Owns Mutual Insurance Companies", 1969 Wis. Law Rev. 1068, 1071.

Board Size

1. While the trend has in fact been down over the last several years, the NACD noted in its most recent survey that the typical board actually increased in size from 7.8 members in 2000 to 8 members in 2001. The same survey showed that the "optimal size" of a board was from 8-11 members. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p12.
2. Principles of Corporate Governance, White Paper, The Business Roundtable, May 2002, p9.
3. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington D.C. 2001) p12.

Board Meetings

1. Richard M. Steinberg and Catherine L. Bromilow, Corporate Governance and the Board – What Works Best, The Institute of Internal Auditors Research Foundation, 2000, p70.
2. 2001-2002 Private Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p3.
3. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington D.C. 2001) p11.

Agenda

1. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington D.C. 2001) p11.
2. 2001-2002 NACD Private Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2002) p3.

Board Qualifications

1. Principles of Corporate Governance, White Paper, The Business Roundtable, May 2002, p9.
2. Report of the NACD Blue Ribbon Commission on Performance Evaluation of Chief Executive Officers, Boards, and Directors, National Association of Corporate Directors (Washington, D. C. 1994, 1995.), p20. The director experience categories listed are the top six categories according to 2001-2002 Public Company Governance Survey, National Association of Corporate Directors, (Washington, D.C. 2001) p34. The next most significant experience categories include: international expertise, expertise in marketing, expertise in accounting, expertise in human resources, expertise in mergers/acquisitions. The list of competencies is compiled from several sources including the Report of the NACD Blue Ribbon Commission on Director Professionalism, 2001 Edition, National Association of Corporate Directors, (Washington, D.C. 2001), p10,11. Other expertise that a board might find helpful in selecting a director are expressed in the following passage from another NACD report,

   > "A corporation should recruit and select directors on the basis of factors such as talent, expertise and accomplishment. The ideal board reflects a diversity of occupational and personal backgrounds. For example, a board may wish to draw on candidates not only from persons with backgrounds in general management, but also from persons with backgrounds in areas such as

manufacturing, engineering, marketing, law, accounting, research and development, human resources, finance and the public sector."

Report of the NACD Blue Ribbon Commission on Performance Evaluation of Chief Executive Officers, Boards, and Directors, National Association of Corporate Directors (Washington, D. C. 1994, 1995.), p20.

3. This list of attributes of directors is compiled from several sources including the Report of the NACD Blue Ribbon Commission on Director Professionalism, 2001 Edition, National Association of Corporate Directors, (Washington, D.C. 2001) p11.
4. Donald C. Langevoort, The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability, 89 Georgetown Law Journal, 797 (2001), p799, and see also, James D. Westphal, Second Thoughts on Board Independence, Corporate Board, Sep/Oct 2002, volume 23, issue 136, p6.
5. Report of the NACD Blue Ribbon Commission on Performance Evaluation of Chief Executive Officers, Boards, and Directors, National Association of Corporate Directors (Washington, D. C. 1994, 1995.), Appendix D.
6. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors, (Washington, D.C. 2001) p30.
7. Principles of Corporate Governance, White Paper, The Business Roundtable, May 2002, p3.

Director Independence

1. For a variety of definitions of director independence please consult the Report of the NACD Blue Ribbon Commission on Director Professionalism, 2001 Edition, National Association of Corporate Directors, (Washington, D.C. 2001), Appendix C, which lists definitions from federal tax and security laws, various stock exchanges, the American Law Institute, The Business Roundtable, the Council of Institutional Investors, a Fortune 500 Company, and the National Association of Corporate Directors. Other definitions can be found in Holly J. Gregory, Comparison of Board Guidelines and Best Practices – United States, 1999, p17,18.
2. See Holly J. Gregory, Comparison of Board Guidelines and Best Practices – United States, 1999, p15,16, where the sources referenced for that study advocate at least a majority of independent directors for the board.
3. James George Bohn, "Essays on the Organization and Regulation of the Insurance Industry", Harvard University PHD Thesis 1996, UMI Dissertation Services (Ann Arbor, MI 2001) p39. See also, W. Ocasio, "Political Dynamics and the Circulation of Power: CEO Succession in U.S. Industrial Corporations, 1960-1990." Administrative Science Quarterly, (1994), p285-312, where the author concluded that a significant number of outside directors on a board does not necessarily increase the probability that in a poorly performing company that the CEO will be replaced.
4. Donald C. Langevoort, The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability, 89 Georgetown Law Journal, 797 (2001), p799. An early study in 1964 found that insider boards outperformed outsider boards – Stanley C. Vance, Boards of Directors, Structure and Performance Oregon University Press (Eugene, OR 1964). Lately, these results have been supported by other work including that of John E. Core, Robert W. Holthausen, David F. Larcker, Corporate Governance, Chief Executive Officer Compensation, and Firm performance, 51 Journal of Financial Economics 371 (1999); Sanjai Bhagat and Bernard Black, "The Uncertain relationship between Board Composition and Firm Performance", Business Lawyer, 1999, volume 54, p 921, where the authors conclude,

   " … there is no convincing evidence that greater board independence correlates with greater firm profitability or faster growth. In particular, there is no empirical support for current proposals that firms should have "supermajority-independent boards" with only one or two insider directors. To the contrary, there is some evidence that firms with supermajority-independent boards are less profitable than other firms";

   and James D. Westphal, Second Thoughts on Board Independence, Corporate Board, Sep/Oct 2002, volume 23, issue 136, p6, where the author contends " … that high levels of board independence have unanticipated, negative effects on board effectiveness … the most important determinant of board effectiveness relates to director capabilities, not independence." Studies that were inconclusive or in which the author admits to concerns about the general applicability of their results include Richard Schmidt, "Does Board Composition Really Make a Difference", The Conference Board RECORD, October 1975, p40, and Charles N. Waldo, Boards of Directors – Their changing roles, structure and information needs, Quorum Books, (Westport, CT 1985), p53.

5. Susanne Scalfane, "Agent Board Membership is Challenged", National Underwriter/ Life and Health Financial Services, 5/13/2002, volume 106, issue 19, p30.
6. See, Frederick W. Wackerie, "The 10 red flags that signal dysfunctional boardrooms", Crain's Chicago Business, 11/22/99, p11. According to this author, the first warning sign of a dysfunctional board is that " … the board includes more insiders than just the CEO".
7. Lee Bongjoo, Ph.D, Ownership structure, corporate control, and firm behavior: Property and liability insurance industry, Doctoral dissertation Indiana University 1989, UMI Dissertation Services, (Ann Arbor, MI 2001).
8. David Jemison and Robert Oakley, "The Need to Reform Corporate Governance in the Mutual Insurance Industry", The Journal of Business Strategy, p55.
9. Donald C. Langevoort, The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability, 89 Georgetown Law Journal, 797 (2001), p815

Financial Literacy

1. Audit Committees: Providing Oversight in Challenging Times, Ernst & Young, 2002, p30.

Board Legal Duties

1. Model Business Corporation Act Section 8.30
2. The case of *Caremark* overruled the earlier law, established in a 1963 Delaware court case called *Graham v. Allis-Chalmers Manufacturing Company*. That case has long stood for the proposition that a board was only a policymaking entity and did not have an affirmative duty to ensure creation of a legal compliance program (absent some knowledge that a problem existed).

Board Leadership

1. J.E. Richard, Board of Director Compensation Guide, J. Richard & Co., (Montara, CA 1995), pV-4.
2. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p16,17.
3. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p16,17.
4. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p16,17. In this publication the major reason cited in favor of separating the functions of CEO and chairman is that it ensures board independence (50 percent). The next most offered reason, although it is a distant second, is that such separation helps in CEO and management succession planning – perhaps an indication that the position can devote itself to this important subject matter without the impediment of being the current CEO.
5. The comments of the NACD on the role of an independent leadership function (lead director) on the board are also helpful:

   > The purpose of creating these positions is not to add another layer of power but instead to ensure organization of, and accountability for, the thoughtful execution of certain critical independent director functions. The board should ensure that someone is charged with: organizing the board's evaluation of the CEO and providing continuous ongoing feedback; chairing executive sessions of the board; setting the agenda with the CEO; and leading the board in anticipating and responding to crises.

   Report of the NACD Blue Ribbon Commission on Director Professionalism, 2001 Edition, National Association of Corporate Directors, p 4.
6. The absence of a CEO can be the result of any number of circumstances, not just resignation or retirement. For instance, the CEO may be unable to act because the CEO's conduct requires investiga-

tion by the board, or where issues of competence have arisen, where death has occurred, or simply where executive sessions are regularly or spontaneously scheduled. Clearly some of these matters can be handled if, or when, they areise. In any of these situations however, the qualities of an effective chairman are very relevant and need to be considered beforehand.
7. J.E. Richard, Board of Director Compensation Guide, J. Richard & Co., (Montara, CA 1995), pV-6,7.

Board Committees

1. This contrasts with the requirements of publicly traded stock companies that may be under a legal or self-regulatory obligation to have an audit committee. The chief sources for such obligations come from the listing exchanges or the SEC (note more recently the attention to audit committees for publicly traded companies in the context of the Sarbanes-Oxley legislation).
2. Carter McNamara, "How Should the Board be Structured?", http://www.boardmember.com/network/index.pl?section=1086&article_id=10359&show , boardmember.com (Board Governance/General Governance).
3. Financial literacy is a subject that is addressed elsewhere in this paper in "Board Qualifications".
4. Interestingly, a majority of public company directors recently surveyed believes the higher requirements being imposed on audit committee members by recent listing rules or legislation are "unfair". 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p11.

Finacial/Audit Committee

1. Audit Committees: Providing Oversight in Challenging Times, Ernst & Young, 2002, p2. Audit committees were important to boards even before recent listing and other regulatory requirements regarding their existence and the requirements of membership. 99 percent of the over 5,000 US public companies tracked by the NACD have an audit committee. Audit committees are recognized and agreed to be one of the most important committees by 98 percent of public company directors surveyed recently (along with a compensation committee). 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p20.
2. There are a number of sources for a definition of financial literacy. One of the better sources is found in the Report of the NACD Blue Ribbon Commission on Director Professionalism, 2001 Edition, National Association of Corporate Directors, (Washington, D.C. 2001), Appendix C. Another source is the comparison chart compiled by Holly J. Gregory, Comparison of Corporate Governance Guidelines and Codes of Best Practices: United States , Weil, Gotschal & Manges, LLF (New York, 2000).
3. Audit Committees: Providing Oversight in Challenging Times, Ernst & Young, 2002, p30.
4. Audit Committees: Providing Oversight in Challenging Times, Ernst & Young, 2002, p37.
5. Audit Committees: Providing Oversight in Challenging Times, Ernst & Young, 2002, p13.
6. Report of the NACD Blue Ribbon Commission on Director Professionalism, 2001 Edition, National Association of Corporate Directors (Washington, D.C. 2001) p5.
7. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p21.

Nominations/Governance Committee

1. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p25.
2. Myron M. Sheinfeld, "The Corporate Governance Committee", Corporate Board Nov/Dec 2000, volume 21, issue 125, p1.
3. "The survey responses indicate directors' clear preference for a nominating process that is driven by an independent nominating committee with input from the CEO". 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p29.

Compensation Committee

1. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p23.
2. Insiders still serve on a number of public company compensation committees – only 61 percent of

compensation committees are composed of all independent outside directors. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p23.

Board Selection

1. Charles H. King, "The Director Recruiting Challenge", Corporate Board, Jul/Aug 2001, volume 22 issue 129, p 13. This article uses the 2002 Korn/Ferry Board of Directors study to show that 44% of surveyed boards find it increasingly difficult to recruit high quality outside directors – a figure that was up from 39 percent the year before. The study also showed that 75 percent of the CEO's participating in the study had declined an offer to serve on another board sometime during the two years preceding the study.
2. The importance of selecting the right candidate is reflected in the following statement-
"Each seat on the board of directors should be viewed as a valuable asset of the company, and when the opportunity arises to select a new board member, every effort should be given towards maximizing the value of that asset by selecting a person who will contribute the most to the company in light of the challenges then faced by the company and in light of the attributes, background and skills of the other members on the board." (Michael D. Wagner, Bradford W. Rich, and Dan A. Bailey, Corporate Governance of Mutual Insurers and Reciprocal Insurance Exchanges, National Association of Corporate Directors (Washington, D. C. 1998).
3. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors, (Washington, D.C. 2001) p32.
4. For an interesting review of the challenge of recruiting directors and the areas in which companies are looking see King, Charles H., "The Director Recruiting Challenge", Corporate Board, Jul/Aug 2001, volume 22 issue 129, p 13.
5. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors, (Washington, D.C. 2001) p30
6. King, Charles H., "The Director Recruiting Challenge", Corporate Board, Jul/Aug 2001, volume 22 issue 129, p 13.
7. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p35.

Board Evaluation

1. Principles of Corporate Governance, The Business Roundtable, May 2002, p23.
2. The following expresses the intent and impact of a board evaluation process.

   > "Every board needs to approach its own work not just in a collegial manner, but in a professional management context. Just as corporate management is responsible for devising a tracking system to measure its success, boards should devise ways to track and measure their own successes and challenges. Boards should begin to adopt and apply to their own processes some of these management tools that measure overall performance goals and assessments, with this key question in mind: does our board have the strengths needed to help the company achieve its goals?"

   Carolyn Kay Brancato, "Questions for the Board", Electric Perspectives, May/June 20002, p70.

3. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p35.
4. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p35.
5. 2001-2002 Public Company Governance Survey, National Association of Corporate Directors (Washington, D.C. 2001) p7.
6. Richard M. Steinberg and Catherine L. Bromilow, Corporate Governance and the Board – What Works Best, The Institute of Internal Auditors Research Foundation, 2000, p74.
7. Richard M. Steinberg and Catherine L. Bromilow, Corporate Governance and the Board – What Works Best, The Institute of Internal Auditors Research Foundation, 2000, p74.

8. There do exist some misgivings about individual board member evaluations and these include: the creation of a problematic legal record; pitting one director against another in peer evaluations that does not tend to develop cohesion or teamwork; the difficulty of acting upon the results due to the lack of any qualified board performance counselor. See James F. Reda, "Committees: A Glimpse At the Future Boardroom", Corporate Board, Mar/Apr 2002, volume 23, issue 133, p21.9. Mark Akerley, Managing Partner of Sigma Resources Group, identifies the following common mistakes and possible solutions in implementing board evaluations: 1) too much too soon – if you start with a 50-question formal assessment, most of your directors aren't ready, 2) spending too little time on the critical things that only a board can provide – spend time on the things your board needs to do to add value, 3) weak follow through – try assigning responsibility for items and reporting back at the next meeting, and 4) rushing into evaluating individual directors – once comfortable with evaluation, the board can move to this area, but give yourself at least a year.

Board Compensation

1. J.E. Richard, Board of Director Compensation Guide, J. Richard & Co., (Montara, CA 1995) p 4.
2. Report of the NACD Blue Ribbon Commission on Performance Evaluation of Chief Executive Officers, Boards, and Directors, National Association of Corporate Directors (Washington, D. C. 1994, 1995.) p48. A third trend noted by the NACD report is the use of stock and stock options to compensate directors. This is not a direct influence on mutual companies since no stock is available, absent a holding company structure, to compensate directors. However, in the competition for quality directors, it cannot be ignored.
3. Some suggestions include the use of the "balanced scorecard" or other corporate performance metrics that use both financial and non-financial factors to measure performance. Use of benchmarking reports for corporate performance can also be incorporated into a compensation program – such as that provided by Ward Financial Group in a program offered through NAMIC.
4. 2002 Compensation and Benefits Survey Report, National Association of Mutual Insurance Companies (Indianapolis, 2002).

Board Terms and Retirement

1. Focus on the Future: Options for the Mutual Insurance Company, Report of the National Association of Mutual Insurance Companies Structural Strategies Task Force (undated) p5.

Policyholder Relations

1. Douglas Long, "Governance of Mutual Insurance Companies, A Call for Reform", 29 Drake Law Review, 693-742 (1980).
2. Focus on the Future: Options for the Mutual Insurance Company, Report of the National Association of Mutual Insurance Companies Structural Strategies Task Force (undated) p3. See also, James George Bohn, "Essays on the Organization and Regulation of the Insurance Industry", Harvard University PHD Thesis 1996, UMI Dissertation Services (Ann Arbor, MI 2001) p12.
3. Focus on the Future: Options for the Mutual Insurance Company, Report of the National Association of Mutual Insurance Companies Structural Strategies Task Force (undated) p3. Some of these rules make sense when viewed as an administration issue for mutual insurance companies. At one time State Farm Mutual Insurance Company had 21 million policyholders and Met Life (a mutual life insurer) had nearly 47 million. By comparison at that same time, AT&T, one of the largest companies in America, had 2.1 million shareholders. It may be financially prohibitive for any large or medium size insurance company to mail proxies to each policyholder for the purpose of voting in director elections or annual meetings. David Jemison and Robert Oakley, "The Need to Reform Corporate Governance in the Mutual Insurance Industry", The Journal of Business Strategy, p54
4. James George Bohn, "Essays on the Organization and Regulation of the Insurance Industry", Harvard University PHD Thesis 1996, UMI Dissertation Services (Ann Arbor, MI 2001) p14,15.

Policyholder status as "owner"

1. The weight of case law on the subject adopts a contract- based view of the rights of policyholders. See, See, Richard A. Hemmings, "Who Owns a Mutual – A Legal Perspective", paper delivered to the NAIC Mutual Holding Company Working Group, 1997, p6. See also, J.A.C. Heatherington, "Fact v. Fiction: Who Owns Mutual Insurance Companies", 1969 Wis. Law Rev. 1068, 1071.

2. Focus on the Future: Options for the Mutual Insurance Company, Report of the National Association of Mutual Insurance Companies Structural Strategies Task Force (undated) p2. See also Richard A. Hemmings, "Who Owns a Mutual – A Legal Perspective", paper delivered to the NAIC Mutual Holding Company Working Group, 1997, where the author states

   It is common to see the policyholder in a mutual company casually referred to as an "owner" of the company. Even textbooks on insurance lapse into using this term. Unfortunately, the term "owner" is a misnomer which is more a short-hand way of expressing a complex relationship than a reflection of reality. The extent to which such conclusions are based on a simple process of elimination of any other party which might be designated as having rights superior to those of the policyholder is not clear … Policyholders are generally given the right be statute to elect the directors and to share in the surplus of the insurer upon liquidation … But such statements are not determinative of the question of whether the interest of the mutual policyholder is a property interest … there simply is no "universal truth" about ownership of mutuals. P2

Excess Reserves

1. Focus on the Future: Options for the Mutual Insurance Company, Report of the National Association of Mutual Insurance Companies Structural Strategies Task Force (undated) p4. See again, Richard A. Hemmings, "Who Owns a Mutual – A Legal Perspective", paper delivered to the NAIC Mutual Holding Company Working Group, 1997, where the following can be found

> The "rights" of any particular policyholder can be terminated by non-renewal of coverage, most of the surplus of virtually all mutuals today is not attributable to the current base of policyholders and policyholders have no means to share in the "profits" of the company except through dividends, which the courts have uniformly held to be payable, if at all, in the complete discretion of the directors. While you can argue that surplus belongs to the policyholders because it represents the excess of premiums paid over the cost of insurance, rates for property-casualty insurance are regulated. By statute, rates charged cannot be "excessive" or "inadequate". … As long as a mutual insurance company is a going concern, policyholders have no hope, much less an expectation, of sharing in a division of surplus beyond dividends. p2,3
>
> Members do have ownership rights – specifically voting rights for directors and for mergers, but they do not own an equity share of the reserves (net value) … the idea that a member can immediately lay claim to his share of the reserves is absurd. Reserves have been built up over years, mostly by past members … Current members do not own them. The board holds the reserves in trust for the benefit of both current and future members.

Policyholder Communication

1. Richard M. Steinberg and Catherine L. Bromilow, Corporate Governance and the Board – What Works Best, The Institute of Internal Auditors Research Foundation, 2000, p63.