David A. Nadler, Beverly A. Behan,

Mark B. Nadler, Editors

Foreword by Jay W. Lorsch

Building Better Boards

A Blueprint for Effective Governance

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Building Better Boards

A Blueprint for Effective Governance

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Foreword

I am pleased to write this foreword to *Building Better Boards* for two reasons. First, I have long had a high regard for David Nadler and his colleagues at Mercer Delta Consulting. I first encountered David in 1972 at Harvard Business School, where he was a first-year student enrolled in my course on human behavior in organizations. I soon realized that David had unusual insight and a special skill for understanding how groups of people function. With a great deal more education and experience, he has become one of the world's foremost experts on top management teams and groups.

David also practices what he preaches. He has built a first-rate and highly collaborative consulting firm, and he and his colleagues understand top management teams very well. Now, in this book, they are applying that understanding to an even higher-level group: boards of directors.

This is the second reason I am pleased to be writing this introduction. Boards of directors are critically important institutions to the success of business firms, and in fact, to the global economy. If boards fail, companies fail. We have seen this simple but important truth play out time and again in the United States over the past several years, and there is similar evidence in the United Kingdom and other advanced economies of Europe. Some of these failures are the products of accounting misconduct and fraud, such as Ahold and Parmalat in Europe and Enron, Tyco, and WorldCom in the United States. But there are other, less dramatic examples of the connection between board failures and company failures. The performance shortfalls, management succession problems, and strategic missteps

at companies like Hewlett-Packard, Merck, and Morgan Stanley are clear recent indicators that when companies have problems, they can be traced back to dysfunction in the boardroom.

Most proposed solutions to fix such boardroom failings have been in the form of new laws (Sarbanes-Oxley in the United States), new guidelines (the Higgs Review in the United Kingdom), or new regulations (U.S. listing requirements at NYSE and Nasdaq). Although new requirements help pressure boards to be more effective, they only take us so far. The real action is around the board table and among the groups of people we call boards of directors. That is what this book is about—how to improve the actual functioning of boards. Like my own recent book *Back to the Drawing Board: Designing Corporate Boards for a Complex World* (with Colin Carter), David and his colleagues put the focus on where the real action is—in the boardrooms of the world’s companies.

This book presents sound and practical advice about how to build effective boards. It is thorough in that it examines who should be on the board and how to judge the performance of these individuals, the leadership of the board, and the critical activities that boards should perform. In my judgment, the advice is sound. Although each board must adapt these ideas to its own circumstances, I have no doubt that doing so will lead to boards that are truly effective in governing their companies.

JAY W. LORSCH, *Louis E. Kirstein Professor of Human Relations at Harvard Business School*

Preface

It says something fairly significant about the evolution of corporate governance that throughout the first fifteen years of my career as a consultant to CEOs, I hardly paid any attention to boards. They just didn't matter.

For twenty-five years now, my colleagues and I have worked with CEOs on issues of organization, leadership, and change. This is closein, sometimes intense work on issues at the top of the CEO's agenda: the design of the organization, change management, leadership development, culture transformation, and strategy. But for our first fifteen years as a firm, through the mid-1990s, our work never directly involved the board of directors. Sometimes we'd help our clients prepare for board presentations on matters such as management succession or changes in the organization or the strategy. But we never engaged directly with the board; in fact, we rarely spent much time talking about the board with our clients. The board, as such, wasn't an important element of governance; it was just another meeting, a passive audience for presentations.

Things began to change in the 1990s. Like everyone else, we watched with considerable interest the dramatic and unprecedented boardroom upheavals of 1992-93, when directors suddenly shook off their lethargy and unceremoniously removed the CEOs of some of the leading U.S. companies. In addition, we had the good fortune to encounter some forward-thinking CEOs who wanted to engage their boards in new and different ways. They asked us to help them figure out how to involve their boards constructively in critical issues such as strategy and CEO succession. As we began to work with these CEOs and their

boards, we started to form some new insights into the board's historical problems and potential value.

We realized that boards were, at their essence, groups or teams of people trying to get work done, albeit in a very unique context and set of circumstances. We realized also that we had something to contribute, because we brought expertise in leadership and team effectiveness based on our years of consulting to executive teams in organizations.

Although we knew a lot about the dynamics of teams and behavior at the top of major corporations, we concluded we needed to learn more about boards. We put together a study group in our firm, led by our colleague Chuck Raben. We used a variety of means to explore the phenomenon of boards and corporate governance, including asking my "old" professor, Jay Lorsch, of Harvard Business School, to help us learn about the specific dynamics of boards. Finally, in the year 2000, as our company (Delta Consulting Group) was acquired by Mercer and we changed our name to Mercer Delta Consulting, we decided to officially launch a practice in corporate governance and board effectiveness. We added new talent with deep expertise, most notably David Nygren, a renowned expert on governance and adviser to numerous corporate and nonprofit boards, and Beverly Behan, a lawyer with extensive board-level experience.

Little did we know in the summer of 2000 how prescient our moves would turn out to be. This was before Enron, Anderson, and WorldCom imploded. No one had yet heard of Sarbanes-Oxley or the New York Stock Exchange listing requirements. It was a different world, but one that was soon to change.

So we began to work with boards, both as direct clients and through our CEO relationships. In the beginning, in the wake of the corporate scandals and the avalanche of new laws and listing requirements, most boards were narrowly

fixated on the issue of compliance. But as time went on, and it became obvious that minimal compliance was only remotely associated with improved governance, many boards began thinking about how to make a meaningful contribution to improving their companies' leadership and performance.

As our work expanded and our insights deepened, we followed our long-standing tradition of publishing what we were learning in a variety of venues. At a certain point, we concluded that we had something of value to offer to a larger audience—hence, this book.

Building Better Boards draws heavily from three sources of information. First and foremost, it builds on the work that we have done at Mercer Delta over the past decade with more than fifty corporate boards in the United States, Canada, and Western Europe. This opportunity to observe, advise, and interact with boards has provided us with a front-row seat on the inner workings of corporate governance, grounding our insights in real experience.

Second, this book draws on a broad and rigorously structured stream of research that has expanded our understanding beyond our firsthand experiences. In collaboration with Ed Lawler and the Center for Effective Organizations at the University of Southern California's Marshall School of Business, we conducted annual surveys of directors in 2003 and 2004. These surveys provided us with important insights into the changing practices at more than two hundred U.S. corporate boards. Throughout this book, we'll frequently refer to data derived from these USC/Mercer surveys.

Third, in 2004 we were active participants in the National Association of Corporate Directors (NACD) Blue Ribbon Commission on Board Leadership. Jay Lorsch and I cochaired this commission, and we were aided by our colleagues from

Harvard Business School and Mercer Delta Consulting. The NACD has conducted many Blue Ribbon Commissions over the years, and they have made outstanding contributions to our knowledge of corporate governance. For this commission, we decided to take a different approach, however. We formed a broad-based commission composed of about fifty directors, CEOs, chairmen, academics, and corporate governance experts (see the appendix for a list of commissioners). In advance of our commission meeting, our staff conducted in-depth, one-on-one interviews of at least an hour with each of the commissioners. We used direct transcripts to do a computer-aided content analysis of the interviews as input to our commission meeting and the final report. The interviews provided us with a rich database of more than two thousand discrete comments (usually a paragraph in length), and we have used this database (with the kind permission of the NACD) as a basis for important parts of this book. (These comments will be referred to as the NACD or Blue Ribbon Commission interviews.)

Our goal was to bring together our experience, the USC/Mercer quantitative data, and the NACD interview qualitative data into a meaningful set of insights. Our hope is that these insights, and the perspectives offered through this book, will be of use to all those engaged in the critically important work of building better boards.

October 2005

New York City

DAVID A. NADLER

PART ONE

Board Leadership and Dynamics

CHAPTER ONE

A Blueprint for Building Better Boards

David A. Nadler Mark B. Nadler

There's a story once told by Felix Rohatyn, the renowned investment banker who served on literally dozens of corporate boards during his illustrious career. In the 1960s, he joined his first board, at the Avis car rental company, and was welcomed by the CEO with this piece of wisdom: "A really good board is one that only reduces the efficiency of the company by 20 percent."[1]

That pretty well sums up the low esteem in which boards have been held over the years. It certainly captures the disdain harbored by many CEOs who viewed their boards as inconsequential at best, and at worst, as meddlesome obstacles to the efficient exercise of executive power. The possibility that boards might actually contribute some element of value just didn't factor into the equation.

It's time for some new math.

Today, boards have reached a historic fork in the road. In the wake of an unprecedented series of corporate scandals in both the United States and Western Europe, maintaining the status quo simply isn't an option. We've known for years that traditional boards were generally passive, compliant, and unproductive assemblages of individuals who would gather periodically to rubber-stamp the CEO's edicts. It

turns out that was the best scenario. The corporate scandals of recent years aimed the spotlight on one board after another where the pervasive cronyism, cowardice, and collusion produced a toxic combination of sloth and sleaze. Those revelations, and the public demand for corporate reform, are forcing boards to look in the mirror and ask themselves profound questions about what role they should play in governing their organizations and how to constructively manage the shifting balance of power between the board and the CEO.

Every board faces a choice. On one hand, they can take the path of least resistance—minimal compliance with the new technical requirements imposed by legislators and stock exchanges. To be sure, compliance is important, but in our view it represents nothing more than the lowest common denominator of sound governance, a corporate version of the Hippocratic oath: “Above all, do no harm.”

Our firm belief—and the premise of this book—is that directors and CEOs should choose the more difficult but ultimately more rewarding path of building better boards that actually contribute substantial value to the organizations they serve and the shareholders they represent.

It’s easy to understand the overwhelmingly legalistic thrust of the so-called reforms enacted in recent years. Yet, although they might provide comfort to those whose main concern is ensuring that boards do no harm, they do little to help boards create value. Transparency in financial reporting, appropriate expertise on the board audit committee, and an explicit code of ethics represent little more than the “table stakes” of adequate governance; they’re aimed at forcing boards to meet the basic legal requirements they should have been living up to all along. There’s no added value in any of that.

Now, as CEOs experience a diminution of their “imperial” powers and boards contemplate the best way to fill the leadership vacuum, there’s a unique opportunity for directors to commit themselves to a higher standard of performance. We are absolutely convinced that active and appropriately engaged boards, drawing on their members’ collective experience, insights, and intellect, can partner with senior management in an environment of constructive contention to produce better decisions than management would have made on its own.

Here’s the rub: boards can do that only if they learn to operate as high-performance teams, a role that represents a fundamental, even radical, departure from their deeply entrenched customs and practices. As we’ll explain throughout this book, building a better board is a transformational exercise, one specifically designed to overcome the inherent and powerful obstacles to the board’s capacity to function well as a team. Our goal here is to provide a blueprint for doing just that: for creating boards composed of the right people using the right processes to do the right work in an environment shaped by the right culture.

Here’s an example of what we mean by boards adding value.

Henry Schacht, the retired chairman and CEO of Lucent Technologies, recalls that when Lucent was spun off by AT&T in 1995, the new company set up shop in the Bell Labs headquarters, a serviceable but somewhat outdated building that had seen better days. Schacht, something of an architecture buff, asked world-renowned architect Kevin Roche to begin working on plans for a brand-new headquarters building. After months of planning, Schacht proudly took his proposal to the Lucent board, which essentially asked him if he was out of his mind in light of all

the other issues Lucent was dealing with at the time. “You know what? They were right,” Schacht told us later. “We had a tough discussion, and we ended up making a different decision than I would have made on my own, and that’s a good thing. That’s an operational definition of value-added.”

It’s more than an academic question to ask how much value Enron’s board would have contributed if it had questioned the bewildering off-the-books partnerships management was creating, or if WorldCom’s board had halted top management’s questionable accounting practices or loans to themselves, or if Disney’s board had exercised some control over Michael Eisner’s hiring and firing of top executives, or if Time-Warner’s board had stood up to Gerald Levin and blocked the merger with AOL, a move that ultimately erased more than $200 billion in shareholder value.

In each of those cases, the board not only failed to add value, it even failed to preserve value. The good news is that in recent years we’ve seen more and more opportunities where boards have been adding value—at TRW, for instance, where the board stepped in and held the company together following the new CEO’s sudden departure to Honeywell; at Lucent, where the board prevented Schacht’s successor from making a series of potentially disastrous acquisitions; at Best Western International, where a badly fragmented board came together to block the CEO’s proposed spin-off of the company’s non-U.S. operations and then took an active role in working with management to rethink the strategy, design robust new performance metrics, and reshape the corporate culture.

THE DUELING PHILOSOPHIES OF GOVERNANCE

Just to be clear: the idea that boards can be a source of value isn't new. There's long been a school of thought that the board—or more specifically, its individual members—might constitute a *resource.* Through their personal networks, directors could help the company establish contact with new customers or partners, tap into new sources of capital, or gain a foothold in new markets or technologies. Ideally, some directors might actually provide the CEO with sound advice and wise counsel from time to time.

But the resource perspective has traditionally taken a distant backseat to the prevailing view that the board's central purpose is *control*—to act as a watchdog to make sure that the shareholders aren't robbed blind by "the agency," the hired managers who run the company. The control perspective has provided the philosophical underpinnings for the governance reform movement in the United States. That movement surfaced quietly in the late 1980s, then took on new urgency with the boardroom revolts of the early 1990s, which saw the ouster of CEOs at iconic U.S. institutions such as General Motors, American Express, and Kodak. Shareholder activism gained momentum throughout the 1990s, fueled by the manic merger and acquisition activity that resulted in so many ill-considered, poorly executed deals that erased billions of dollars of shareholder wealth.

And then came the opening years of the new century. The tech bubble burst, the post-9/11 economy went into a tailspin, and the unraveling of artificially inflated corporate results revealed an alarming pattern of questionable business schemes, fraudulent accounting practices, and appalling management excesses. At first, the unprecedented scandals seemed to be a U.S. phenomenon, involving a nowfamiliar list of corporate culprits—Enron, Tyco, WorldCom, Adelphia, Rite-Aid, HealthSouth, and

Hollinger, to name a few. But Europe saw its own share of scandals at leading companies such as ABB, Skandia, Ahold, and Parmalat, while Canada added Nortel to the list.

Society's ire was targeted both at the CEOs who had abused their positions, either for financial gain or personal aggrandizement, and at the boards that had failed to stop them from running amok. It seemed that one board after another had either been bedazzled by a larger-than-life CEO, befuddled by business schemes they barely understood, or simply were asleep at the switch.

The response was swift and harsh, and it clearly reflected the control theory advocated for years by self-described governance watchdogs. The Sarbanes-Oxley legislation and the new listing requirements adopted by the New York Stock Exchange and Nasdaq had one clear purpose: to impose new structures and formal procedures that would minimize opportunities for financial mismanagement and conflicts of interest. Nearly all the reforms were about maintaining tighter control through tougher oversight.

At one level, it's hard to argue that reforms weren't needed. No one disputes that the governance process was badly broken at some companies. Yet so much of the public discourse and institutional response to the governance crisis has been shaped by the control theory and fixated on legal compliance as the source of good governance. For us, that creates some real concerns.

First, we reject the underlying notion that you can legislate board effectiveness. You can't mandate independent judgment, intellectual curiosity, constructive dissent, broad participation, or any of the other hallmarks of truly great boards. To quote Bill George, the highly respected retired CEO/chairman of Medtronic, Inc., "A lot of people who have not served on the inside think the reforms

can be imposed from the outside. These are necessary, but not sufficient conditions for good governance."[2]

Second, the governance reform dogma rests on some shaky articles of faith; for example, the conventional wisdom is that boards dominated by a majority of independent directors are superior to those that aren't. In fact, a widely cited meta-analysis of fifty-four different studies "showed no statistical relationship" between board independence and company performance.[3] The same holds true of splitting the chairman and CEO roles, an arrangement that prevails in the United Kingdom and Canada but is still resisted by more than 70 percent of U.S. boards. There are good arguments for both models, but no clear evidence that bifurcating the roles results in better performance. In fact, a recent study by Booz Allen Hamilton found that companies in both North America and Europe in which the roles were split actually averaged lower returns for investors.[4]

Third, the obsession among some governance watchdogs and journalists with the technical aspects of corporate reform perpetuates a "governance by the numbers" mind-set that directs attention away from the most meaningful elements of sound governance. Take *Business Week*'s annual ranking of the "Best and Worst Boards," which is partly based on a point system that rewards compliance with various good governance criteria. Using those standards, both Sunbeam (1997) and Lucent (2000) made the list of best boards just as their CEOs were driving them to the brink of disaster. Yet Apple Computer was named one of the worst boards in 2002 because CEO Steven Jobs flunked *Business Week*'s requirement for purchasing his own company's stock—although Jobs somehow went on to mastermind one of the most stunning turnarounds in recent corporate history.

Perhaps the most extreme example of governance by the numbers is the continuing campaign to have Warren Buffet, perhaps America's most astute investor, removed from the Coca-Cola board's audit committee. The argument goes that Buffet, the chairman of Berkshire Hathaway, can't properly represent Coke's shareholders because two of Berkshire's units have purchased $185 million in Coke products. The implication that Buffet is somehow a management stooge who can't look out for the shareholders' best interests ignores the fact that Buffet's company is itself Coke's biggest shareholder (owning stock valued at more than $8 billion) or that Buffet personally played a key role in the board's ouster of CEO Douglas Ivester. The campaign defies logic and common sense, but it illustrates the dangers of the watchdog mind-set at its most rigid and unreasonable.

Our fourth concern is that the new regulations may be forcing boards to spend disproportionate time on activities that aren't likely to create value. Our own research, for example, found that more than 40 percent of directors feel they're now spending more time on compliance and less time on corporate strategy.[5] We're also finding the Sarbanes-Oxley reporting requirements shower directors with more financial data than they can possibly put to good use, exacerbating the growing concern that directors are choking on meaningless data but starved for useful information.[6]

Our final concern is that a narrow focus on compliance can actually prove dangerous if it creates a false sense of security. There's a risk that far too many companies will spend way too much time and money convincing themselves and their shareholders that they have created good governance when, in point of fact, they've done little to reduce the risk of meltdowns or improve their leadership and governance. It's all too easy to have good governance

on paper and bad governance in practice; let’s not forget that the Enron and HealthSouth boards were widely hailed as models of quality and independence.

It would be a wasted opportunity of historic proportions if all the attention now being focused on boards resulted in nothing more than a few technical fixes and a thicket of audit reports. We should demand more than that, searching for ways to build better boards that add real value to the organizations they serve.

THE BOARD AS A HIGH-PERFORMANCE TEAM

As we mentioned earlier, there has always been a school of thought that individual directors could act as resources, providing value on an ad hoc basis. What’s new is the idea that the board, effectively constituted as a high-performance team, can provide ongoing collective value that’s far greater than the sum of its individual parts. It’s based on the belief that a board’s collective experience, skills, and insights, when properly engaged, can enable management to make better decisions and run the company more effectively than it would have if left to its own devices. We’ve been suggesting that idea since the mid-1990s, and it’s been gratifying to see others espouse the same notion over the years.[7,8]

But it’s easier said than done. As we’ll discuss more fully in later chapters, the board operates under unique circumstances that inhibit its ability to function like other teams. It has unique legal requirements, meets infrequently and for only short periods of time, consists of a group of powerful people who are accustomed to leading their own teams, and involves fluid roles and ambiguous power relationships—for example, when the same person is both

CEO and chairman, the person who leads the board as chairman simultaneously reports to the board as CEO.

So it's not enough to say the board should function as a team. The real question—and the question we hope to answer in this book—is this: Exactly how does a board go about transforming itself from a ritualistic appendage to a real team? Not only that, but in today's perilous corporate environment, how does it strike the proper balance between a do-nothing rubber stamp and an out-of-control lynch mob ready to assume management's rightful duties or prematurely toss the CEO overboard at the first sign of trouble? More specifically, a value-adding board has to address these three challenges:

- How do you create a board that is truly effective—one that not only meets its minimum legal obligations but also becomes a source of added value to its company?
- How do you design the work of the board so that it achieves an appropriate level of engagement without overstepping its proper role, which is to ensure that the company is managed effectively rather than to manage the company?
- How do you build an effective relationship between the board and the CEO, one that empowers the board without hampering the CEO's ability to lead?

Our research and experience indicate that a few boards have already figured out the answers, but not many. Most boards have a general sense that something's not working, but no clear idea of where they want to be, or how to get there. We hope that's what this book will provide: a blueprint for building better boards.

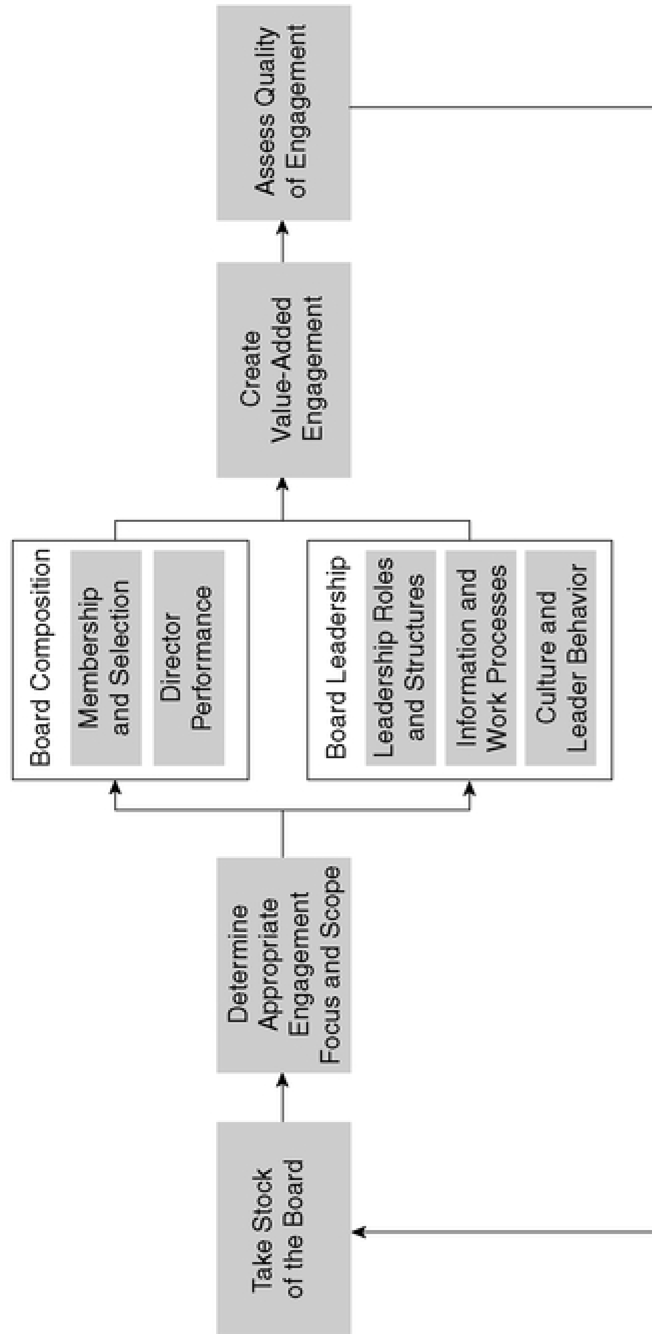
THE BLUEPRINT: BUILDING BETTER BOARDS

Every board is unique; each faces a particular set of challenges, and there's no quick fix that will solve every problem for every board. Nevertheless, based on our work over the years with more than fifty boards in the United States, Canada, and Western Europe, we have developed a board-building framework that suggests both a conceptual framework and some specific processes that apply in a multitude of situations. In this section, we'll describe the framework and explain how the remainder of the book is organized to provide a deep look at each step (see Figure 1.1).

Initial Steps: Taking Stock and Setting Direction

Later in this chapter, we'll dive into the first two steps in the process. The first step is what we refer to as *taking stock.* This is essentially a diagnostic phase, the necessary precursor to all the work that follows. The goal here is twofold: to identify the precise problems that are preventing the board from being as effective as it should, and then, even more importantly, to use a carefully facilitated process to build consensus about what the problems are and a board commitment to doing something about them. To be effective, board-building can't be forced; if the majority of directors don't think the work is important and worth the time and effort, the process will collapse in the starting block.

Figure 1.1. Board-Building Framework.



In the second step, the discussion turns into real work when the board and management survey the entire landscape of governance responsibilities and reach agreement on which work is primarily the board's, which is primarily management's, and which should be shared. This step is absolutely critical to shaping the board as a team.

The outcome provides both a road map for moving forward with real work—and an appropriate level of engagement—and the foundation for the final step in the process, which is to assess the board's effectiveness and to evaluate how closely its activity matches its aspirations.

Board Composition

Fundamental to the success of any team is having the right people around the table, and the board is no exception. As we'll discuss in Chapter Two, recruitment of new board members is one of the areas where the shift in power from the CEO to the board has been most dramatic. It's crucial for board leaders to create explicit profiles that will guide their recruitment and enable them to use each appointment to help shape a board that has the collective experience, skills, and personal attributes to do real work collaboratively and effectively. That will require robust recruitment strategies that search beyond the personal networks of the CEO and the board—the "usual suspects"—to find qualified candidates.

Selection is only the first step in making sure the board has the right people. In Chapter Three, we'll explore the aspect of composition that boards have been much more reluctant to address: the performance of individual directors. As directors often tell us, it's generally easier for most boards to remove an underperforming CEO than an underperforming director. In both the United States and the United Kingdom only about a quarter of all boards have established rigorous processes for regularly evaluating each director's performance and using the feedback to either improve performance or initiate removal. We'll describe some effective tools we've developed with boards to do just that.