Chapter 10

Creating a High-Performance Board

10.1 Managing Itself: A Board's First Priority

A strong and effective board is clear about its role in relationship to management and understands the difference between managing and governing. A board's principal duty is to provide oversight; management's duty is to run the company. A good board also understands that it, not management, has ultimate responsibility for directing the company's affairs as defined by law.

To meet these obligations, a board must take responsibility for its own agenda, or it will not be independent. Management cannot be responsible for directors' skills and processes and should not have more than a consultative role in decisions, such as choosing new directors. Boards can no longer be just "advisers" who wait for management to come to them. As fiduciaries, they must be active monitors of management.

The specifics of the board's role and modus operandi will vary with size, the stage and strategy of the company, and the talents and personalities of the CEO and the board. Clearly, "one size does not fit all." There are, however, basic legal requirements and "management" skills that boards can and should adopt regardless of their role and structure. The goal should be to *make the board perform as well as it wants the company managed*.

Two critical determinants of board effectiveness are the directors' individual and collective *motivation* and *capabilities*. The most effective boards score high on both dimensions; they know and respect the difference between governance and management and appreciate where and when they can add value. Conversely, boards that score low on both dimensions are likely to be ineffective and function mainly as a statutory body. Capable boards with low levels of motivation represent a missed opportunity, whereas highly motivated but less capable boards tend to meddle or micromanage.

10.2 What Defines the Best In-Class Boards?

What makes for a good board? In *Building High-Performance Boards*, executive search consultants Heidrick & Struggles observe that a high-performance board governs by continually challenging—in a positive way—every significant aspect of the company's operations: its business model, strategies, and underlying assumptions; its operating performance; and its leadership development. In doing so, a best in-class board should seek to create a culture of rigorous, relentless examination, and press for continuous improvement. This way it can set a "tone at the top" that reverberates throughout the organization—to employees, to customers, to shareholders, and to the communities served by the company. A best in-class board, therefore, is more than a roster of prominent names; it is a well-balanced team that leverages the diverse experiences, skills, and intellects of the directors to further the strategic objectives of the company. Members of such boards focus on the big picture yet know when to drill down on specifics; they have the fortitude to speak openly and candidly, and the humility to remember that they do not run the business. Thus, being a good director is both a skill and a mindset.Heidrick and Struggles (2006).

A recent study by Bird, Buchanan, and Rogers (2004) for Bain & Company concludes that truly effective boards concentrate on value growth and practice seven habits that build their effectiveness:Bird, Buchanan, and Rogers (2004).

1. *Effective boards own the strategy*. Strong boards contribute to strategic thinking and feel a sense of ownership of the resulting strategy itself. The authors cite the case of Vodafone, where each year the board helps develop the agenda for a multi-day strategy retreat with senior executives. Each director contributes to the list of key strategic decisions that need to be made at the retreat. The event begins with a highly analytic overview of Vodafone's markets and competitors, providing data that will inform those decisions. Instead of just including presentations by executives to the board, Vodafone's process fosters debate on options, investments, and returns. When boards understand the issues at this depth and ask critical questions early on—Is the strategy bold enough? Is it achievable?—they can respond more quickly to opportunities such as major acquisitions when they arise. Decisions unfold faster. Vodafone's swift consummation of the Mannesmann acquisition aptly demonstrates the value of such an approach.Bird, Buchanan, and Rogers (2004), p. 130.
2. *Effective boards build the top team*. As noted in earlier chapters, selecting, developing, and evaluating the top executive team are major board

responsibilities. A truly effective board understands the significance of developing leaders to creating market value, and therefore has a strong incentive to get involved. Yet, Bain & Company's analysis of 23 high-growth companies revealed that only a minority systematically try to develop new leadership through internal advancement.

3. *Effective boards link reward to performance*. Determining the right reward structure starts with how the company chooses to measure success—and how closely these measures are tied to the drivers of long-term value in the business, not with pay systems. Selecting the right approach is critical, because **CEO compensation**[1] remains a controversial issue for many companies. Effective compensation schemes measure what matters and pay for performance, with a real downside for mediocre results. They also are simple and transparent and focus on sustained value creation, balancing short-term and long-term focus.
4. *Effective boards focus on financial viability*. As noted in earlier chapters, ensuring a company's financial viability extends well beyond complying with the Sarbanes-Oxley Act and other applicable laws. It includes making other key financial decisions, such as choosing appropriate levels of debt and scrutinizing major investments and acquisition proposals. As Bird, Buchanan, and Rogers observe, worst practices can sometimes be instructive. They cite an investigation by former U.S. Attorney General Richard Thornburgh into WorldCom's $11 billion in accounting irregularities that concluded that WorldCom's directors were often kept in the dark, particularly in matters involving some of the company's more than 60 acquisitions. The study also revealed that the company's directors made little effort to monitor debt levels or the company's ability to repay obligations; yet, they "rubber-stamped" proposals by WorldCom's senior executives to increase borrowings.
5. *Effective companies match risk with return*. Most boards have a process in place for assessing and managing operational risk. Yet, as noted in Chapter 6 "Oversight, Compliance, and Risk Management" in the section on enterprise risk management, few boards understand the true risks inherent in their companies' strategies. This is critical: Almost three quarters of major acquisitions destroy rather than create value, and 70% of diversification efforts away from the core business and into new markets fail. Furthermore, Bain & Company estimates that more than 40% of recent CEO departures not related to retirement can be attributed to a controversial or failed "adjacency" move. The message: Boards need to understand and accept the risks inherent in their strategy and recognize the implications for required risk-weighted returns.

1. Pay for services to a corporation's CEO that is determined by the board of directors through the compensation committee.

6. *Effective boards manage corporate reputation*. Strong boards avoid the traps of "check-the-box" compliance and a short-term horizon; they target long-term value creation and ignore guidance by "analysts" and court investors who seek long-term value. Once a course is set, they focus on transparency and effective communication to enhance their reputation.
7. *Effective boards manage themselves*. An effective board chair sets the tone from the top and implements an effective governance model. Such a model (a) focuses the agenda on issues of performance and regularly reviews board effectiveness, (b) builds a team of directors with the right mix of skills and experience, and (c) is clear about the value a board can contribute, and (d) ensures that directors have ample opportunities to fulfill their roles.

10.3 The Right Leadership: The Key to Board Effectiveness

Independent board leadership capable of shepherding the board's priorities and providing a voice for the concerns of other outside directors is critical to board effectiveness. While not the only way to establish such leadership, a nonexecutive chair can strengthen the independence of the board and help create a healthy check-and-balance between management and the board. As an alternative, some boards have adopted the so-called lead director model. If they do choose to appoint a nonexecutive chair, boards should ensure that the individual selected for this position has the experience, temperament, and commitment to the role to be effective. An effective chair serves as the leader of the board, keeps directors focused on the board's major priorities, sets meeting agendas, leads discussions, and occasionally serves as a board spokesperson. According to consulting firm Spencer Stuart, the chair's specific responsibilities cover four main areas:

1. *Managing the board*. This involves chairing board meetings, as well as leading executive sessions of the independent directors.
2. *Communication*. This includes maintaining regular communications with senior management and other directors to set meeting agendas and to discuss information flow and emerging issues.
3. *Succession planning*. Nonexecutive chairs are well positioned to play a leading role in CEO succession planning.
4. *Board evaluations*. Best practice suggests that the governance committee should manage the board and director evaluation process, with the committee chair gathering director feedback. Nevertheless, the chair has a significant role to play in conflict resolution.Spencer Stuart (2008).

In addition to being a focal point for the board, the chair can also be an important mentor for the CEO. Many people, therefore, believe he or she should be a consensus choice of both the board members and the CEO. Also, as part of his or her duties, a chair should make him- or herself visible inside the company—by participating in major company meetings, by being easily accessible to employees (in person, via e-mail, or by phone). The rationale for creating visibility is that, if bad things happen in the company, employees should know they have a person on the board—namely the chair—they can go to.

Performing all these duties well is a tall order and requires a unique combination of experience, dedication, and the right temperament. To lead effectively, a nonexecutive chair must understand the function of each board committee and the role of an individual director, and must be conscious of not undermining the CEO's authority, especially in front of the senior management team. Learning on the job is not an option.

Beyond executive and board experience, good “people” and “communication” skills are essential. A nonexecutive chair must know how to create focus and how to build consensus on the board. He or she also needs to facilitate effective communication between the board and management and avoid becoming a barrier between the two. This requires diplomacy, an ability to be direct and concise without offending anyone, a passion for the job, and a minimal ego. An effective nonexecutive chair exercises leadership and avoids creating the impression that he or she is trying to run the show.

Who can fill these rather large shoes? According to Spencer Stuart, 73% of the nonexecutive chairs on Standard & Poor’s 500 boards are retired corporate executives. About half formerly served as the CEO of another company—experience that is extremely valuable to be effective in the role.Spencer Stuart (2008).

10.4 Understanding the "Sociology" of the Board

A board's primary role is a fiduciary one. It is not surprising, therefore, that most board processes are designed with this objective in mind—to ensure management is accountable to the board and the board to shareholders. Recent reforms also reflect this bias toward the fiduciary role of the board. Consider, for example, the focus on greater disclosure, director independence, executive sessions, increased communications with major shareholders, and on separating the offices of chairman and CEO. All these changes are aimed at providing greater transparency and increased accountability. They do not, however, address the deeper issue of how the board can function better as a group.

No group can operate effectively without a well-defined, shared understanding of its primary role and accountability. The ongoing debate about the fundamental purpose and accountability of the modern corporation has created a problem for boards as a whole, as well as for individual directors—what behaviorists call a heightened sense of role ambiguity and, in some instances, increased role conflict. For example, while recent regulatory reforms promote enhanced transparency and accountability, they also may well increase directors' anxiety about their ability to effectively carry out their responsibilities to say nothing about their personal exposure to legal and other challenges. If true, the outcome may be opposite of what is intended—a decrease in proactive conduct and more conservative "defensive" behavior on the part of directors, individually and as a group. And while recent reforms may clarify some of the formal rules that govern board composition and operation, little attention has been paid to what impact these changes are likely to have on the unstated or informal rules that govern much of actual board behavior.

Formal Versus Informal Rules

All group behavior, including that of boards, is governed by formal and informal rules. Formal rules include explicit policies about how often they meet, how they structure their meetings, who participates on what committees, and how issues are decided by discussion and vote. As with many groups, however, board behavior is also governed by a set of powerful unstated informal rules or norms. For example, asking management "tough, penetrating" questions about performance is formally encouraged and seen as part of a director's duty. At the same time, if a director pursues an issue too long or too vigorously, he or she may be seen to violate any one of a number of unstated rules about what the other directors consider "effective" board membership.For more on formal versus informal rules in the boardroom, see Carter and Lorsch (2004), chap. 8. See also Khurana and Pick (2005), pp. 1259–1285.

This is one explanation for why so many boardroom votes are unanimous. While it is acceptable to occasionally cast a dissenting vote, if a board member repeatedly votes “against” his or her peers, however, he or she may be asked whether he or she is “for” or “against” management, and whether he or she has a hidden agenda. Norms also influence individual behavior after the group has reached a decision. For example, many boards operate under an unstated rule that directors should not criticize or reexamine the board’s past decisions.

What happens when a director violates an unstated norm? While the consequences for breaching formal board rules are fairly clear, the punishment for violating informal rules is less well defined. Because informal rules are implicit, corrective action primarily takes the form of exercising “peer” pressure. Since directors generally do not interact very much outside the boardroom, any exercise of corrective peer pressure is mainly confined to the boardroom itself, and therefore governed by the board’s prevailing set of group norms. What is more, since directors do not have the power to directly remove ineffective or confrontational peers, the scope of such corrective action is limited. And, unless the breach is so disruptive that he has no alternative, the chair, especially if he is also the CEO, will likely hesitate before confronting the offending director.

These two factors—the difficulty directors have discussing, questioning, or reconsidering the appropriateness of various norms and their uncertainty about the repercussions of breaching formal or informal rules—also explain why boards have tended to search “among their own”—that is, other CEOs with board experience—for new directors. Potentially embarrassing problems can be avoided when boards choose candidates who likely already understand the “rules,” especially the informal norms, that govern board conduct.Carter and Lorsch (2004), chap. 7.

Group Influences on Individual Behavior

It is well known that individuals behave differently in groups than they behave when they are alone. In a group, much of our individual behavior is determined by the behavior of other group members. In a board setting, this raises an important question: What happens when an individual director’s beliefs and opinions differ from those of the other members of the group? Does he vote according to his conscience, or will he likely compromise and vote with the majority in the face of real or perceived peer pressure? This dilemma occurs more often than one might think. Consider the following questions directors routinely face: Should I go along with the compensation committee's recommendation for a substantial increase for the the CEO even though, deep down, I believe he is already paid too much? Do I vote "no" on the aggressive debt restructuring proposal when other members of the board clearly are for the proposal? How do I act when a senior board member who has mentored me before pulls me aside and urges me to go along with the majority for the sake of "unity" on the board? As these questions illustrate, group norms do not only strongly influence individual behavior—they may even dictate what perceptions, beliefs, and judgments are deemed appropriate. It is not surprising, therefore, that new board members often accept the judgment of more senior directors and choose to vote with them. This also explains why the current focus on director independence may well be misplaced; it has little or no relation to the underlying sociological issues that shape board behavior.

The above examples also illustrate how the presence of other more experienced and powerful group members can discourage individuals from participating up to their full potential. Sociologists label this phenomenon "social inhibition." It is expressed in several different behaviors: loafing (i.e., minimizing effort while hiding behind the work of others), self-handicapping (e.g., knowingly accepting a very difficult challenge to avoid the risk of failing at a simple task), or conforming simply to get along. All of these behaviors can be found in the boardroom, and all must explicitly be addressed to create a high performance board.

10.5 Time and Information Deficits: Barriers to Board Effectiveness

To carry out their responsibilities, directors need to know a great deal. They must be knowledgeable about the company's financial results, its competitive position, its customers, its products, its technologies, and the capabilities of its workforce; they must be aware of the performance and challenges of its top executives, as well as the depth and readiness of its broader talent pool. Boards also need to review information about the culture of the organization and about how customers and employees feel about the company. Finally, boards must closely monitor the company's compliance with legal, regulatory, and ethical standards. Because of a board's time constraints, the only effective approach is for the board to focus on lead indicators. The challenge is to know what the right lead indicators are—that is, which ones are unique to the company and its business model.

Available time is a major issue. Outside, independent board members usually hold significant leadership positions in their own organizations making it difficult for them to spend a large amount of time on board matters. Another is the inadequacy of the information provided to directors. Directors typically receive (a) operating statements, balance sheets, and statements of cash flow that compare current period and year-to-date results to plan and last year, (b) management comments about the foregoing that explain the reasons for variations from plan and provide a revised forecast of results for the remainder of the year, (c) share of market information, (d) minutes of prior board and some management committee meetings, (e) selected documents on the company, its products and services and competition, (f) financial analyst's reports for the company and sometimes for major competitors, and (g) on an ad hoc basis, special information, such as consultants reports, customer preference data, or employee attitude surveys. A strong argument can be made that this is no longer enough, particularly in fast-changing industries and in companies with an increasingly global reach. Questions, such as, Are we going in the right direction? Are management's assumptions about major trends and changes correct? Is the company doing the critical things to get the job done? Should our strategy be changed? cannot be answered meaningfully on the basis of mostly historical information or with summaries of proposed actions.

Dashboards and Scorecards

Originally created for CEOs, CFOs, and heads of business units to monitor hundreds of key financial, sales, and operational details, dashboards and scorecards are increasingly being introduced to the boardroom. Major companies whose boards use some form of dashboards include General Electric, Home Depot, and Microsoft.*Directorship*' July 11, 2008.

Web-based **dashboards**[2] and their less sophisticated predecessors, **scorecards**[3], can display critical information in easy-to-understand charts and graphics on a timely basis. The most sophisticated dashboards allow users to drill down for additional details. For example, to diagnose a negative cash-flow trend, a director can quickly probe whether the shortfall is due to a receivables problem or the result of excessive spending.

A major advantage of dashboards is that they can be tailored to specific needs. Of course, any director dashboard should have a basic menu of common information, such as financial, sales, and compliance-related data. Beyond this common format, however, the configuration of the dashboard can be tailored to responsibilities of a particular director; an audit committee member might want special information on the subject of fraud prevention and detection, for example. Other examples include the ability of a director who serves on the compensation committee to immediately see whose options have been exercised, or an audit committee director's up-to-the-minute update on Sarbanes-Oxley compliance progress.

Direct communication channels are also important. Directors should have access to top management other than the CEO. Effective boards have protocols in place that allow a director, with permission of the board chair and CEO, to speak directly with employees. Conversely, directors need to be accessible to management and employees of the organization.Brancato and Plath (2004). Many CEOs have historically followed a practice that all communication of information to the board from senior managers would flow first through the CEO, who would then relay that information to the board. This has the potential to obstruct information flow to the board. See also Ide (2003, March), p. 838.

Board Access to External Advisers

The board and board committees should, as needed, retain external experts, such as counsel, consultants, and other expert professionals, and investigate any issues they believe should be examined to fulfill the board's duty of care. These external experts and consultants should have a direct line of communication and reporting responsibility to the board and not management.

2. Typically, web-based displays used to note critical information on a timely basis and in understandable charts and graphs. Dashboards are increasingly being used in the boardroom.
3. Less sophisticated predecessors of dashboards.

10.6 Building the Right Team: Board Composition

The composition of the board should be tailored to the needs of the company. The board of an acquisitive company, for example, should be well represented with deal-making expertise and judgement, while the directors of a fast-moving technology company need a sound view of the industry's future direction. However, every board needs to have certain essential ingredients, with the individual directors possessing knowledge in core areas, such as accounting and finance, technology, management, marketing, international operations, and industry knowledge. The best directors enrich their board with the perspective of someone who has faced some of the same problems that the company may face in the future. In addition, organizations in the early stages of building—or rebuilding—a boardroom culture, often are best served by a knowledgeable, forceful advocate for exemplary corporate governance.Brancato and Plath (2004).

Behavioral characteristics are a major determinant of board effectiveness. Effective directors do not hesitate to ask the hard questions, work well with others, understand the industry, provide valuable input, are available when needed, are alert and inquisitive, have relevant business knowledge, contribute to committee work, attend meetings regularly, speak out appropriately at board meetings, prepare for meetings, and make meaningful contributions.

The NYSE recommends that director qualification standards be included in the company's corporate governance guidelines. Companies sometimes include other substantive qualifications, such as policies limiting the number of other boards on which a director may serve and director tenure, retirement, and succession. The chairman of the nominating committee should certify in the proxy that the committee has reviewed the qualifications of each director—both standing for election and on the board generally. Finally, every director should receive appropriate training, including his or her duties as a director when he or she is first appointed to the board. This should include an orientation-training program to ensure that incoming directors are familiar with the company's business and governance practices. Equally important, directors should receive ongoing training, particularly on relevant new laws, regulations, and changing commercial risks, as needed.

10.7 Board Self-Evaluation

In the aftermath of Sarbanes-Oxley, the stock exchanges mandated that boards of public companies and key committees, such as the audit committee, evaluate their own performance annually. Since there is no mandated or standard approach for such an evaluation, boards should select a process that best fits their needs. At a minimum, the director performance evaluation process should ensure that each director meets the board's qualifications for membership when the director is nominated or renominated to the board. Evaluation of the board and committees should also determine whether each has fulfilled its basic, required functions.For additional thoughts on this subject, see Anderson (2006).

In designing a suitable process, questions, such as, Why are we doing this? What areas do we need to focus on? How can we receive valid feedback? How can we act on that feedback to make a difference? Where can we find the required expertise, internally and externally? Who do we want to handle, analyze, and provide feedback to the board? To the chairman or lead director? To the CEO? To committees? To individual directors? must first be answered.

Many boards are not sufficiently aware of the type of expertise that is available to assist them in board evaluation and development. As a result, they may overestimate their own capabilities in this area and underestimate the value of external resources. One place for boards to turn is their internal or external counsel. A number of law firms are broadening their scope of service to include board evaluation. This makes sense in a litigious environment where the fear of shareholder lawsuits has arisen and where directors may be worried that the information revealed in a board evaluation process may make them more vulnerable. Retaining legal counsel to perform the evaluation may reduce this fear by having counsel assert privilege over such matters. However, even without legal privilege being asserted by counsel over the evaluation process and its documents, courts are likely to have a more favorable view of a board that chooses to take a tough look at how it can do better, documents the process intelligently, and acts on what it finds rather than one that does not evaluate itself at all.

Others may bring more important skills to the table. For example, professionals in industrial and organizational psychology often have relevant training. Depending upon a board's likelihood of being involved in litigation, it may be advisable to ask external counsel to work collaboratively with external experts specializing in board and director performance effectiveness.

While there is no single, best approach to board evaluation, best practice suggests that an effective board and director evaluation process is (a) *controlled by the board itself*—not by management or outside consultants; (b) *confidential and collegial*—it should foster an atmosphere of candor and trust; (c) *led by a champion*—alternatives include the non-CEO chairman, the lead independent director or equivalent, or the chair of the nominating and governance committee; and (d) *focused on identifying areas of improvement*—in areas such as creating a balance of power between the board and management, focusing the board more on long-term strategy, more effectively fulfilling the board's oversight responsibilities, the adequacy of committee structures, and updating the evaluation process itself.

A good process also *evaluates individual director performance*—through self-assessment and peer review. This should include consideration of independence, level of contribution, and attendance; take specific board roles into account; and provide a basis for determining the suitability of a director's reelection.