

## *Chapter One*

# **The Three Phases of a Board's Evolution**

Boards of directors have undergone a rapid transformation since the Sarbanes-Oxley Act of 2002. The shift in power between the CEO and the board is perceptible. Directors are taking their responsibilities seriously, speaking up, and taking action. It's a positive trend and an exciting time for boards.

But the evolving relationship between the CEO and the board has yet to find the right equilibrium in most cases. It's important that boards become active, but there is danger in letting the pendulum swing too far. Astute directors and CEOs sense the tension. They recognize that just as past practices have failed them, recent attempts to make the board a true competitive advantage are not always hitting the mark.

Here's one example. In the spring of 2003, a CEO approached me at a conference. "Something's gnawing at me," he said.

"What do you mean?" I asked, with some surprise. "I saw your latest earnings report and it looks like you're really delivering." This was true. I knew the company went through a period of adjustment following the recession, but business had rebounded and the company was turning niche products into real growth opportunities both domestically and abroad. "Is there some bad news that you're not making public?"

"No, no. It's not that, Ram," said the CEO, whom I'll call Jim Doyle. (He, like some of the other executives I spoke with in researching this book, would prefer to remain anonymous.) "The business is rock solid. We're executing well."

"Well, it sounds like you've got it all together," I said.

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Then came the punchline: “It’s the board.”

I let Jim continue. “I took over from Alan three years ago. Before that, I was president and I remember how Alan ran board meetings. There was essentially no dialogue; communication was a one-way street. When I became CEO, I wanted the board to help me. I wanted to make it a modern board. So we made all the structural changes that have been asked of us, like changing the composition of the Audit Committee. We now have eleven directors; eight of whom are independent by any definition. Only two directors are holdovers from the old board. We have eight full-day meetings per year, and everyone participates. The boardroom is very lively,” Jim explained.

“Sounds like you’re doing all the right things,” I said.

“I thought so. But lately, I’ve heard more and more questions in our meetings. Now I don’t mind fielding questions from directors. In fact, I consider it their job to ask questions and my job to address those questions. But some of the questions and the analyses directors ask for are off the wall. I’m getting sidetracked covering all of them. And the same questions keep coming up. It’s frustrating and I know some directors are frustrated, too.”

“Give me an example, Jim?”

“Sure. I presented our new strategy to the board several times and they tell me in the boardroom that they support it. But after some one-on-one chats, I began to realize that not everyone gets it. So we held a retreat last weekend, and I brought in the brand-name strategy firm that helped design the strategy to present it,” Jim said.

“Let me guess, they flipped through a deck of a hundred PowerPoint slides,” I conjectured.

“I admit that I probably let the consultants show a few too many slides,” Jim said. “But within thirty minutes, two directors began to go off on minutiae. Charlie told us he didn’t believe the media strategy was appropriate. Then he said he didn’t like the national TV ads he saw last week. He thought regional advertising would be more effective than national TV ads. This was during a discussion that was supposed to be dedicated to strategy. The other directors bit their tongues. Later on, Jeff started in on how he thought discounts were too high for large customers. He wouldn’t let it go, even though he knew we depend on our ten biggest cus-

tomers for thirty percent of our revenues. Needless to say, the retreat fell apart and we accomplished very little. When we adjourned, everyone told me, 'we support you,' but their body language said something different."

"How long has this been going on?" I asked.

"I'd say off and on for the past three meetings. Some directors keep coming back with the same questions over and over. It's very draining. I need to find a way to get us on track."

Jim's five-minute story matched what I've seen happen too often. Since Sarbanes-Oxley, I've heard variations of his story many times. Directors have turned the corner in their attitudes toward directorship and are devoting more time and energy to the job. But they are still searching for ways to make a meaningful contribution to the business.

### **The Real Risk of Value Destruction**

Jim's board, like most boards in the post-Sarbanes-Oxley world of corporate governance, is very different from its counterpart of a dozen years earlier. It's not that the directors themselves are markedly different. By and large, boards still consist of smart, trustworthy people—individuals with backgrounds of achievement and ability who are a credit to the firms on whose boards they serve. In some cases, in fact, the new directors of a dozen years ago are the very same wise sages on today's boards.

The change in boardrooms today is not marked by the people but rather by the social atmosphere. Boardrooms have more energy, liveliness, inquisitive interactions among directors, and thoughtful engagement by CEOs. The difference today is a mindset, an emerging collective desire to do something meaningful. It appears that boards of directors, as an institution, are coming of age.

Much of the public outcry—and resulting regulation—of recent years is based on the failure of boards to root out fraud, some of which destroyed whole companies. But boards are recognizing that they have failed in another, arguably more widespread, way: by allowing (sometimes inadvertently contributing to) faltering performance. Entire industries collapsed in the wake of the dot-com bust; too many companies failed to adapt their businesses to the different external environment after the recession began and

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after the 9/11 tragedy. No one could have foreseen global terrorism, but what about anticipating the fallout from the go-go years of the New Economy, or not recognizing the importance of emerging new channels? Couldn't boards have prompted their managements to pinpoint and consider these issues?

In some cases, boards have made costly mistakes. How about hiring a CEO from the outside who is a master of cost-cutting—when the company needed a leader who could grow the business? Or tying the CEO's incentives to the wrong goals? Or approving a grand growth strategy with an unhealthy appetite for risk?

Most boards want to do the right thing, whether it's complying with the new rules (and there are a lot of them) or contributing in substantive ways on matters of choosing the CEO, compensating top management, ensuring that the company has the right strategy, and providing continuity of leadership and proper oversight. Their commitment and level of engagement marks a new stage in their evolution.

The good news is that these boards are unlikely to commit the sins of omission that were common among the passive, CEO-dominated boards just a few years ago. The bad news is that they are now vulnerable to committing sins of commission. That's because past board experience has not fully prepared directors and CEOs for the challenges they face today. Without clear guidelines to take them forward, well-meaning boards such as Jim Doyle's can actually erode the vitality of the company and drain time and energy from the CEO. It's a real danger, and companies truly suffer when this happens.

To achieve their full potential, boards must continue to evolve. They must make a conscious effort to go to the next level.

### **The Evolution of Boards**

Boards began their evolution in the pre-Sarbanes-Oxley era of passivity. Back then, they were "Ceremonial" boards, because they existed only to perform their duties perfunctorily. Sarbanes-Oxley has driven many boards to a second evolutionary phase; directors have become active and "Liberated" themselves from CEOs who previously dominated the boardroom. But there is also a third phase awaiting boards, when active directors finally gel as a team and become "Progressive."

## The Ceremonial Board

A decade ago, when one non-executive director joined the board of a paragon of American industry, a long-serving colleague told him, in private, "New directors shouldn't speak up during board meetings for the first year." That attitude is untenable today and, in fact, that board is much different now. But such comments are indicative of the culture of passivity that permeated the Dark Ages of corporate governance.

Some readers may remember when such Ceremonial boards were commonplace. Management had all its ducks in a row by the time a board meeting began. There was a scripted morning presentation that was rehearsed to the second in a tight agenda. The CEO communicated very little with the board between meetings, other than with the one or two confidants the CEO trusted and worked with if the need arose.

These boards perfunctorily performed a compliance role. Many directors served for the prestige and rarely spoke among themselves without the CEO present. They made sure to fulfill their explicit obligations, including attending the required board meetings and rubber-stamping resolutions proposed by management. "An important trait of boards during this era," observes Geoff Colvin, senior editor at large at *Fortune* magazine and co-host of the Fortune Boardroom Forum, "is that they were largely anonymous to the public. The general interest media rarely reported directors' names. So back then, the prospect of shame and embarrassment when a company ran into trouble wasn't much of a threat." Such were the norms and expectations of directorship during this era.

Most readers will recall a few boards that fit this description at some point in time. Hopefully, it doesn't sound like any boards on which they now serve, though these boards do still exist.

## The Liberated Board

Most boards left their Ceremonial status behind after the passage of Sarbanes-Oxley. A new generation of CEOs now expects boards to contribute. And candidates for directorship now expect active participation as a condition of their acceptance. There is a general sense of excitement as directors embrace an active mindset.

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The transition to liberation had really begun about a decade earlier. In 1994, the General Motors board, advised by Ira Millstein, first published its “Guidelines for Corporate Governance.” The document was widely praised as a model for corporate boards. *BusinessWeek* even called it a “corporate Magna Carta,” referring to the document signed in 1215 by King John that stipulated, among other things, that no one, including the King, is above the law.

The comparison was fitting; GM’s CEO and Chair, Robert Stempel, stepped down late in 1992 after losing the confidence of GM’s non-executive directors. When the non-executive directors named one of their own as Chair, it signaled a distinct change in the general attitude of boards as passive bodies. No one dreamed such a thing would happen at the world’s largest company. Many directors around the country took note. In particular, the boards of several prominent bellwether companies, including those at American Express, AT&T and IBM, followed GM’s lead.

Still, not that many boards entered the ranks of the Liberated in the 1990s. Though board watchers and activists such as Bob Monks, Nell Minow, Sarah Teslik, Richard Koppes (of Calpers), and others pressed for reform, many companies under fire were reluctant to make wholesale changes in their governance practices.

There was no urgency for change until the scandals broke at Enron, WorldCom, Tyco, HealthSouth, Adelphia, and elsewhere. Then came the rapidly passed Sarbanes-Oxley Act of 2002, with its broad provisions on Audit Committee work, internal controls, and fraud prevention, along with the ensuing reforms enacted by the Securities and Exchange Commission and the stock exchanges, lawsuits filed against directors and corporate officers, and the public embarrassment of some very experienced directors. With so much shareholder and bondholder value evaporated in the scandals, the capital markets also began paying closer attention to corporate governance and to the possibility of pricing the perceived quality of transparency and governance into securities.

Directors saw their peers chastised and overwhelmingly heard investors’ calls to become active. Although some boards remain Ceremonial today, the pendulum swung decidedly toward Liberated boards. In many cases, incoming CEOs helped drive the change.

Liberation is good news. But while liberation can mean a high-functioning team, it can also mean each director singing a different tune. If it’s not handled effectively, liberation can inadvertently

make CEOs and management less effective, and can adversely affect the creation of shareholder value. It happens. Liberated directors often play to their own strengths individually, not as a collective body. They ask of their CEOs too many things, some of which are plainly minutiae or irrelevant. The limited time that these CEOs have to run their companies gets further diluted. This is the state in which so many Liberated boards sit today—though certainly not by intention.

### The Progressive Board

The intent of directors who have liberated themselves is for their boards to become what I call “Progressive.” They comply meticulously with the letter of the law, and they also embrace its spirit. Further, they aim, as Andy Grove, founder, former CEO, and current Chair of Intel, is quoted by *Fortune* magazine as saying, “to ensure that the success of a company is longer lasting than any CEO’s reign, than any market opportunity, than any product cycle” (August 23, 2004, p. 78).

To achieve this broader mandate, these boards become uniformly effective as a team, and they make their value evident while maintaining an independent viewpoint. Directors on a Progressive board gel into a coherent and effective group. All directors contribute to a dialogue that has lively debates, sticks to key issues while dropping tangents, and leads to consensus and closure. They challenge each other directly, without breaking the harmony of the group and without going through the CEO. Directors find the give-and-take in board meetings energizing. They enjoy the intellectual exchange, and they learn from each other. They look forward to meetings.

The board and the CEO have a working relationship that is constructive and collaborative, but board members are not afraid to confront hard issues. The lead director, or whoever facilitates executive sessions, is a liaison between the board and management who keeps executive sessions focused and running smoothly, and is very effective at communicating the heart of the board’s viewpoint, not a collection of opinions from individual directors, to the CEO. Feedback is constructive and highly focused in a way that helps the CEO. CEOs respect the Progressive board’s role and contribution, and are collaborative in their approach to the board.

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The Progressive board adds value on many levels without becoming a time sink for management. The diverse perspectives of directors on the external environment, including legislative affairs, economic changes, global business, and financial markets, are a boon to management's strategy-setting and decision-making efforts. Directors contribute most where their interest, experience, and expertise are greatest, and they know their viewpoints are expected. Directors also add value through their judgments on and suggestions for the CEO's direct reports.

Progressive boards take their own self-evaluation—of the collective body as well as of individual board members—very seriously. There is a sincere effort to implement the findings of the evaluation on both a board and individual director level.

In short, Progressive boards move the essence of their governance activities to comprise not only complying with changing rules and norms but also adding value to the long-term potential of the company. These boards are a competitive advantage in and of themselves.

Becoming a Progressive board is not beyond reach. Such boards exist at some of the largest companies in America, like General Electric, as well as at mid-caps like MeadWestvaco and smaller public companies, like PSS/World Medical. The completion of this transformation is very much up to the CEO and the board. The first step is to realize where you are today; the diagnostic at the end of this chapter can help a board realize where it stands and in what areas it could improve. Liberated boards like Jim Doyle's don't need dramatic overhauls. But they do need to recognize what is holding them back; the diagnostic can help. After that, it's up to the directors and management to take conscious steps to change. The next three chapters are designed to help boards speed their transition.

### Where Does Your Board Stand?

The following questions constitute a diagnostic to help boards figure out where they stand. Answering these questions is not an academic exercise. The goal is to identify how a board could improve and move to the next level. Indeed, the awareness of the need for continuous improvement is one characteristic of a Progressive board.

The numerical scores in the diagnostic don't lead to a "rating" of a board's effectiveness. Rather, the pattern of responses will reveal the areas that a given board might wish to address. Lower scores in any one category—group dynamics, information architecture, or focus on substantive issues—should be a flag that the board needs to focus on those issues.

#### *Group Dynamics*

1. Does the board consistently bring dialogue on critical topics to a clear closure, with consensus? Or is dialogue fragmented?

1	2	3	4	5
fragmented				consensus

2. Do all directors freely speak their minds on key points?

1	2	3	4	5
seldom				always

3. Do directors respond to each other during board meetings, particularly when they don't agree with each other? Or do directors engage in dialogue solely addressing the CEO?

1	2	3	4	5
CEO				directors

4. Have board meetings focused on the most important issues, as defined jointly by the board, the committee Chairs, and management? Or have they wandered into minutiae or tangents?

1	2	3	4	5
tangents				focused agenda



