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# A Blueprint for Building Better Boards

**How to Engage as a High-Performance Team**

In the wake of an unprecedented series of corporate scandals in both the U.S. and Western Europe, it's no longer an option for today's boards to simply maintain the status quo. Instead, they face a choice. They can take the path of least resistance—minimal compliance with the new technical requirements imposed by legislators and stock exchanges. Or they can choose the more difficult but more rewarding path of building boards that actually contribute substantial value to the organizations they serve and the shareholders they represent.

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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. 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.

Henry Schacht, the retired chairman and CEO of Lucent Technologies, recalls that when Lucent was spun off by AT&T, the new company set up shop in the Bell Labs headquarters, a building that had seen better days. Schacht, something of an architecture buff, asked renowned architect Kevin Roche to design a new headquarters building. After months of work, Schacht proudly took his proposal to the Lucent board, which questioned whether the plans were appropriate 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 exercise 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 dubious 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 did not just fail to add value; it even failed to preserve value. The good news is that in recent years we've seen more instances where boards have added value: At TRW, the board stepped in and held the company together following the new CEO's sudden departure to Honeywell. At Lucent, the board prevented Schacht's successor from making a series of potentially disastrous acquisitions. At Best Western International, 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.

Here's the rub: Boards can add value 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. 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. The blueprint we provide here offers a guide 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.

## The Dueling Philosophies of Governance

There has long been a school of thought that members of a board constitute a resource. Through their personal networks, directors can 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 can also provide the CEO with sound advice and wise counsel.

But the resource perspective has been eclipsed by the prevailing view that the board's central purpose is control—to act as a watchdog so that shareholders are not robbed blind by the hired managers who run the company. The control perspective has provided the philosophical underpinnings for the U.S. governance reform movement. 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 a 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 now familiar 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 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.

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. That creates some real concerns.

To start, we reject the underlying notion that you can legislate board effectiveness. You cannot mandate independent judgment, intellectual curiosity, constructive dissent, broad participation, or any of the other hallmarks of truly great boards.

The dogma also tends to place too much emphasis on the technical aspects of corporate reform, perpetuating a "governance by the numbers" mindset that directs attention away from the most meaningful elements of sound governance. Perhaps the most extreme example of such governance was the campaign to have Warren Buffet removed from the Coca-Cola board's audit committee. The argument was that Buffet, the chairman of Berkshire Hathaway, could not properly represent Coke's shareholders because two of Berkshire's units had purchased $185 million in Coke products. The implication that Buffet was somehow a management stooge who would not look out for the shareholders' best interests ignored the fact that Buffet's company is itself Coke's biggest shareholder or that Buffet played a key role in the board's ouster of CEO Douglas Ivester. The campaign defied logic and common sense, but it illustrates the dangers of the watchdog mindset at its most rigid and unreasonable.

Regulations, meanwhile, may be forcing boards to spend disproportionate time on activities that are not likely to create value. We're also finding that 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.

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 companies will spend too much time and money convincing themselves and their shareholders that they have created good governance when, in fact, they've done little to reduce the risk of meltdowns or improve their leadership and governance.

It would be a wasted opportunity of historic proportions if the attention now 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

An emerging idea is 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. A board's combined 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.

That's easier said than done. The board operates under unique circumstances that inhibit its ability to function like other teams. It has specific 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 individual 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 relevant question is this: Exactly how does a board go about transforming itself from a ritualistic appendage to a real team? In today's perilous corporate environment, how does it strike the proper balance between a do-nothing rubber-stamping body 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 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 the 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?

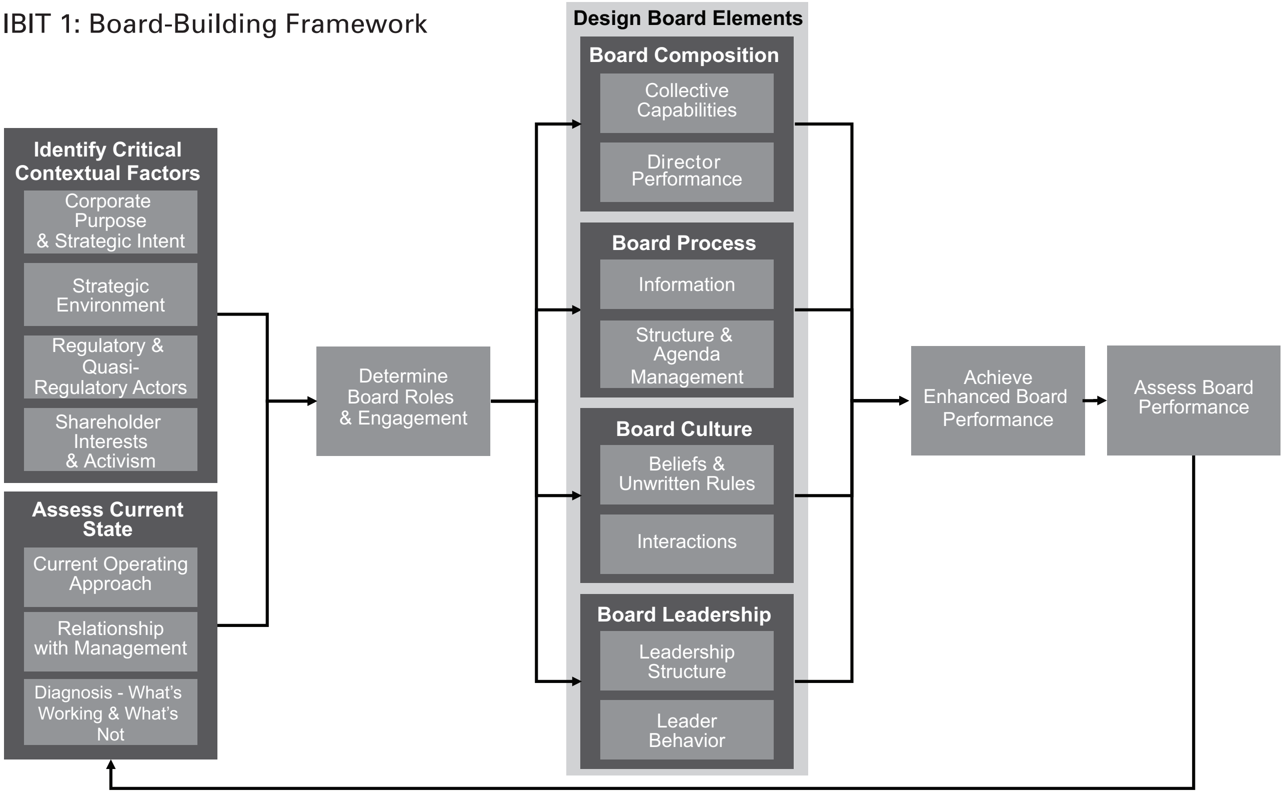
Our research and experience indicate that only a few boards have arrived at the answers. Most boards have a general sense that something is not working, but no clear idea of where they want to be or how to get there.

## The Blueprint

Although every board is unique, based on our work over the years with more than 50 boards in the United States, Canada, and Western Europe, we have developed a board-building framework that includes specific processes that apply in a variety of situations. It consists of six steps (Exhibit 1).

1. **Take stock.**
   The first step is essentially a diagnostic phase, the 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 be, and then to use a facilitated process to

EXHIBIT 1: Board-Building Framework




build consensus and a commitment to addressing them. Effective board-building cannot be forced; if the majority of directors don't think the work is important and worth their time, the process will collapse in the starting block.

2. **Determine the appropriate focus and scope of engagement.**
Next, the board and senior management survey the entire landscape of governance responsibilities and agree on what work is primarily the board's, what is primarily management's, and what should be shared. This step is critical to shaping the board as a team. The outcome provides both a map for moving forward with 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.

3. **Ensure effective board composition.**
Fundamental to the success of any team is having the right people, and the board is no exception. Recruitment of new directors 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 work collaboratively and effectively. Recruitment strategies must search beyond the personal networks of the CEO and existing directors to find qualified candidates.

Selection is the first step in making sure the board has the right people; the next is addressing director performance. As directors often tell us, it's generally easier for most boards to remove an underperforming CEO than an underperforming director. In both the U.S. and the U.K., only about one-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. It's shortsighted, however, to think that a board can enhance its effectiveness without addressing the weak links. Despite the discomfort involved, leaders must recognize when director performance problems need to be tackled and then address them with fairness and dignity.

4. **Focus on board leadership.**
CEO control over the board was unchallenged and absolute at most U.S. companies until recently. In the wake of corporate scandals, and the structural

changes that followed, CEOs no longer control the powerful compensation, nominating, and audit committees. Independent directors are filling a variety of leadership roles as lead directors, presiding directors, and nonexecutive chairmen.

The question of who should lead the board evokes passionate responses from those who advocate separating the roles of chief executive and chairman of the board and those who are fervent about combining the roles.

The debate over combining or dividing chairman and CEO roles will continue. Either structure can be effective, as long as there is a process in place to provide effective leadership for the independent directors on every board.

Another area for improved leadership involves addressing the quality and productivity of the board's work processes. This includes improving the flow of information to the board, shaping agendas to make the best possible use of the board's limited opportunity for in-person meetings, and maximizing the value of the independent directors' executive sessions, perhaps the single most valuable change to come out of the recent governance reforms.

For example,  many companies ensure that substantive topics won't get squeezed out of board meetings because of mandatory housekeeping by creating an annual agenda that identifies key topics to be covered and scheduling them far in advance. To streamline the pre-meeting reading sent to directors, some companies use summaries of the big issues that will be dealt with, highlights presenting the most salient facts, and appendices containing the supporting data for those who have the time, expertise, or inclination to dig deeper.

While it's important to get the right people doing the right work using the right processes, without the right culture, these three requirements won't matter. This is perhaps the biggest challenge for board leaders: to reshape a deeply entrenched, traditional culture of passivity, deference to management, and excessive formality into a culture that encourages independence, constructive dissent, broad participation, unfettered openness, and spirited inquiry. The burden falls squarely on the shoulder of board leaders; no one else can change the culture or keep it from either slipping back to the old ways or hurtling out of control into dysfunctional acrimony.

As one member of the NACD Blue Ribbon Commission on Board Leadership said, directors are looking to their leaders "to create a boardroom culture of openness where there are no dumb questions." If Enron directors had trusted their common sense, at least some of them would have looked at the array of complex off-the-books schemes and asked whether management was constructing a house of cards. Intuition should have told the Tyco directors that there was simply no way to keep swallowing up one acquisition after another. Board members, by and large, are smart, experienced people, but to be effective they have to operate in an environment where they're encouraged to trust their own instincts, ask questions regardless of how "stupid" they might seem, and then ask a follow-up question if the first answer doesn't make sense.

You cannot create a culture of engagement by edict; the gaping disconnect between actions and intentions robs the process of all credibility right from the start. To the contrary, the entire board has to be fully engaged at each step in the process and encouraged by its leaders to step up, speak out, and sign on. After all, that's what the new culture is about.

5. **Create value-added engagement.**
   If the board has successfully mastered the requirements up to this point, then ideally the outcome will be engagement that adds value to the organization. Beyond the area of audit and financial reporting, which has been the primary focus of the recent governance reforms, there are four areas where the board is uniquely positioned to add significant value to the overall quality of an organization's governance.

- *Corporate strategy.* Many directors believe that the development and oversight of corporate strategy is one of the board's most critical functions (the other being the hiring and firing of CEOs), but it's also an

## How Engaged Is Your Board?

It's not enough simply to decide that a board should be active, independent, and empowered. The real question is what does engagement look like for a particular board in a given situation, and what are the options? One way to start the discussion is to have directors describe their own view of where their board sits on the continuum, ranging from the least to the most engaged boards, shown in the exhibit below.

Boards typically slide back and forth across the scale, exhibiting different degrees of engagement with regard to different issues. A passive or certifying board, for instance, can suddenly find itself facing a crisis in which it has to act as an intervening board to remove the CEO, and it may then play the role of operating board until a new CEO is in place. Still, this provides a useful starting point as the board begins to grapple with questions such as, "Where and how can we best add value?" Ideally, that discussion leads to the next step in the board-building process: moving beyond generalities and specifically identifying exactly what work the board should be doing, and with what intensity and engagement.

EXHIBIT 2: Degree of Board Engagement

| The passive board | The certifying board | The engaged board | The intervening board | The operating board |
|---|---|---|---|---|
| • Functions at discretion of CEO<br>• Offers limited activity and participation<br>• Has limited accountability<br>• Ratifies management preferences | • Certifies to shareholders that CEO is doing what board expects; management is capable of taking corrective action when needed<br>• Emphasizes outside/ independent directors; meets independently without the CEO<br>• Stays informed of current performance; designates external board members to evaluate CEO<br>• Establishes an orderly succession process<br>• Is willing and able to change management to be credible to shareholders | • Partners with CEO to provide insight, advice, and support to CEO and management team on key decisions and implementation<br>• Also recognizes ultimate responsibility to oversee CEO and company performance; dual role of guiding/ supporting as well as judging the CEO<br>• Board meetings are characterized by useful, two-way discussions of key issues and decisions<br>• Board members need sufficient industry and financial expertise to add value to decisions<br>• Time spent and emphasis put on defining roles and behaviors required of board members; boundaries of CEO/board responsibility are set | • Typical mode during a crisis situation<br>• Board becomes intensely involved in discussions of key decisions facing the organization and in decision-making<br>• Frequent and intense board meetings, which are often called on short notice | • Board makes key decisions; management implements<br>• Not uncommon in start-ups where board members are selected to fill gaps in management experience |

area where they believe they've been least effective. A high-performing board, through its collective experience, expertise, and rigorous questioning, can add immense value to management's thinking. Ineffective boards either merely put a stamp on management's plans or get too involved in the details.

- *CEO performance evaluation.* Traditionally, the board mainly relied on lagging indicators of financial performance to determine the CEO's compensation. But an effective evaluation process should do much more. Although it needs to recognize the importance of the financials, it should also evaluate the CEO's leadership based on outcomes that are directly within his or her control, and use the evaluation process to shape organizational goals for the coming year.

- *Executive succession.* Increasingly, boards are demanding an active role in deciding who will be the next CEO. It's not sufficient for the CEO to come up with a single candidate and ask the board to ratify that choice. Boards need to get involved early to ensure identification of a range of candidates who will be evaluated, provided with opportunities to broaden their skills and experience, and exposed to the board in various settings. Directors are also realizing that their role doesn't end when the new CEO is selected; they have a unique responsibility to help the new chief executive get off to a good start.

- *Risk assessment and crisis management.* The board is uniquely positioned not only to oversee a rigorous process for assessing risk and planning for crises but also to take center stage when the CEO is the focal point of a crisis. That situation can arise for a host of reasons, as we have seen in recent years. The most obvious is the CEO's death or sudden departure for health reasons. The Sara Lee Corporation faced the unexpected departure of its CEO when Brenda Barnes stepped down after suffering a stroke, as did Micron Technologies, when CEO Stephen Appleton died in a plane crash. Or, as seems to be happening with increasing frequency, CEOs may leave when there is suspected malfeasance or misconduct – such as Mark Hurd's departure from Hewlett-Packard under a cloud of suspicion concerning his expense account reporting, or Scott Thompson's departure from Yahoo, after claims that he falsified his resume. But things aren't always so clear-cut, and sometimes the board's first duty is to determine whether the crisis creates a real or potential conflict between management's interests and the company's. The board can also contribute substantial value by insisting on a thorough analysis of the underlying institutional problems that might have led to a crisis in the first place.

6. **Assess the quality of engagement.**
The final step in the board-building process is for the board to regularly assess the quality of its engagement. Annual assessment, which was among the new requirements imposed on U.S. boards in 2002, is a stark example of the difference between minimum compliance and a robust process. A board can easily fulfill the NYSE listing requirements by checking off the boxes on a pro forma report cobbled together by some other company's lawyers, verifying whether it is in compliance with all the other technical requirements. But that won't tell you a thing about whether the board is doing the right work and doing it well. The assessment should flow from the board's decisions about what work it thinks is important and how deeply it should be engaged, and measure the gaps between its intentions and accomplishments.

## Implications: Engagement and Process

It's worth highlighting two themes that will recur throughout each step of the board-building process.

First, the fundamental issue is appropriate engagement. Although this discussion has been somewhat abstract, when the actual work is done, it will quickly become evident that there's nothing abstract about it. One of the critical questions in all six steps of the board-building framework is what role the board, its committees, and its leaders should play—whether it's selecting board members, developing corporate strategy or improving the board's internal work processes. In each case, the work has to begin with some shared vision of the respective roles of the board and management.

The second theme is that process really matters. It's not enough to say that the goal is a board that is active, engaged, and functioning as a high-performance team. The processes employed by board leaders have to model the culture they hope to create. You cannot mandate a culture of engagement. You cannot have two or three senior directors go off on their own and set the ground rules for broad participation. You cannot order members to think and act independently.

In short, the culture the board wants to create has to be reflected by, and consistent with, the processes it uses to achieve that goal. Board-building is about more than what work the board chooses to do; just as importantly, it's about how the board chooses to do that work.

## About Nadler Advisory Services

Nadler Advisory Services offers highly specialized consultation to CEOs, boards of directors, and senior teams to help enhance the quality of executive leadership, corporate governance, and organizational performance. Nadler Advisory Services is firmly focused on high-level, close-in advice and consultation to CEOs, boards and senior teams in the following areas:

- CEO Advisory Services
  - Personal leadership effectiveness
  - Building an effective leadership team
  - Organizing the leadership of the enterprise
  - Collaborative strategy development
  - Effective communications
- Board Advisory Services
  - Assessment of overall board performance
  - Analysis of board composition
  - Evaluation of individual director performance
- CEO Succession Planning Services
  - Navigating all phases of the succession process: initiating the conversation, identifying and developing candidates, selection, transition planning, and supporting the new CEO

To obtain further information about Nadler Advisory Services, please contact us at info@nadleradvisory.com or at 1-917-633-4480.

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