

Beyond the Law: Taking Governance Beyond Compliance

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Good afternoon.

This is an interesting time to be talking about corporate governance. As we sit here, the Enron trial is going on and governance is back in the headlines. It's therefore an interesting time to examine these issues and their impact in North America.

I'll start with a personal perspective. I've worked with CEOs on issues of organization, leadership, and change largely – but not exclusively – in the United States for about 27 years. For the first 17 years, I never set foot in a boardroom; I never even had direct contact with a board. Why? Because boards simply weren't relevant. The board was something that met once in a while, and it didn't have much to do with running the company.

The fact is, the game has changed and it has changed dramatically. Now, every CEO with whom we work is concerned with governance and the board. You can pick your tipping point – Enron, SEC listing requirements, Sarbanes-Oxley, or here in Canada, the Dey Report of the mid-90s – but the environment actually began to change a long time ago.

What we saw in the late 1980s, after a period of buyouts and takeovers, was the concentration of ownership among institutions. That meant increasing pressure from shareholders for corporate performance. But the real revolution began in 1992-93, when boards suddenly woke up. We saw this wave of what I call “regicide,” where the “kings” were “killed.”

Over a period of 10 months in 1992-93, boards began this dramatic move – firing the CEOs of Westinghouse, General Motors, American Express, and almost two dozen other major firms. They began to realize that CEOs might be accountable to boards, and boards might be accountable for the performance of companies.

Many of us thought this was a turning point, but the great economic bubble of the 1990s intervened. People started getting rich and, as shareholders, they became less concerned with the state of corporate leadership. Then the bubble burst. That brought about crises at Enron, Andersen, and – obviously, the U.S. didn't have a monopoly on this. In Canada, you had Hollinger, Nortel, and Air Canada. It became apparent that the governance system had failed.

By the way, studies indicate that not all failures have been caused by malfeasance, which is dramatic and makes the news. Failure due to poor management, which results in the loss of shareholder value, is probably 10 times more common. The issue is the same: Boards fail to understand their obligation to prevent bad things from happening.

Consequently, the rules have changed, and there are more changes to come. A year from now, we'll be talking about a different set of issues.

There have been some positives. At companies in the United States and Canada, we are seeing better corporate governance. We are seeing greatly increased management accountability. We are seeing better risk management. And, in fact, we are seeing a shift where CEOs now believe they work for someone other than themselves – that is, they recognize that they are accountable to the board and, ultimately, to shareholders.

There have also been negatives. There is a significant measurement and compliance burden. In many cases, this dissipates directors' time and effort. I have board members telling me they spend so much more time on compliance that they have less time to spend on making sure the company is run well. There is an obsession with scorecards, which focus on things you can count, when many of the board's most important contributions cannot be counted. There is risk-averse behavior and, in some cases, micromanagement by boards.

The consequence of all this is that boards are changing. For a long time, boards were basically ritualistic appendages. They didn't have much to do. A board was a bunch of people who were brought together to hear a series of pro forma committee reports and presentations, were given lunch, and then were sent on their way. Many of them sat on each other's boards. And that was fine, because there was no real work to be done.

Now boards have accountability. Now boards have visibility. Now boards have real work to do.

And now boards have to work as teams. The context is different for board members than for typical teams because this isn't their day job – they meet only 6, 8, or 10 times a year, and they have some specific requirements. But they are teams in that they are sets of people attempting to do together what they can't do separately.

We know a lot about the functions and dysfunctions of teams. The argument we make in the book *Building Better Boards* is that we can apply this knowledge to boards. Just as companies now regularly think about team building, the question is: Can you "build" your board?

We believe you can; in fact, we've done it. In the book we outline seven steps to think about in terms of moving a board to a higher realm of effectiveness. Let me go through them briefly.

The first step is to take stock of the board – to find out where the board is. One of the great danger signs is when a CEO tells me, "Don't worry, I know what's happening on my board." Consider what occurred about a year and a half ago: David Pottruck, who was removed as the head of Charles Schwab, commented to the press that he was surprised because he thought that as long as he ran the company well, he didn't have to worry about the board. He didn't know where his board was.

Boards, like any system, can over time get off track or become run down. Therefore,

assessment needs to be part of a board's normal process. Most formal instruments used to assess boards just check off boxes; they don't dive into the real issues. We've found that you need to take a much more in-depth look, including having confidential conversations with board members, to begin to understand how effective a board is, what the board is doing well, what it is doing poorly, and whether it is doing the right work, with the right people, in the right way.

The second step is to define the scope of engagement. One of the biggest issues facing a board in this new environment is to establish exactly what its role is versus management's role. Most boards we've worked with have a range of directors who go from one extreme to the other.

On one end is the old-line, passive, institutional director who shows up, does his/her prep, asks polite questions, assumes that management knows what it's doing, has lunch, and leaves. On the other end is the director who wants to run the company. At one firm I worked with, which merged with another company that had come out of venture capital, the VC board members would say, "In the old company, we used to sit in the CEO's living room and make the strategy for the firm."

Most of the time, when we take stock of a board, not only is there no clarity, there is also no agreement, and not just between management and the board, but also among directors. Imagine boards that have at one extreme the passive, institutional director, at the other extreme the activist director who wants to run the company – which is also inappropriate – and everything in between. As you talk to different directors, they don't agree on where the board should be engaged.

So defining management's province and the board's province is a major step. Where should the board make decisions and inform management? Where should management make decisions and inform the board? Where should they be making decisions together?

The third step is making sure you have the right directors. There's a major focus in the United States these days on independence – Sarbanes-Oxley pushes this issue heavily. But, ultimately, we believe that competence is more important than independence; having the portfolio of skills necessary to do the work of the board is what's critical.

The fourth step is to ensure that individual board members are performing effectively. We've seen competent, effective, communicative board members. We've also seen board members who don't show up for sessions, fall asleep in meetings, arrive inebriated, and behave in ways that are nothing short of atrocious.

We have also seen people with less dramatic but nonetheless significant problems – board members who are working their own agenda and those who are would-be CEOs and want to take control. In an interview I conducted recently, a peer of one board member said, "It seems like every thought that comes into this director's head has to come out his mouth."

Now in the old days, in the United States the chairman/CEO might have sat down with a director. You have a different system here in Canada, obviously, and that makes it a little easier. But I find that today the U.S. chairman/CEO is saying, “Wait a minute, this is my boss. This is the person who decides whether or not to keep me, who determines my pay. I’m not sure it’s my role to tell a director he or she isn’t performing well.”

So clearly, a board needs the right set of directors, which has implications for director selection, as well as for creating a process to deal with directors who aren’t performing effectively. This has led to the emergence of different board roles and the use of peer feedback.

The fifth step is to ensure effective leadership of the board. I think that one would have to say that Canada has been ahead in recognizing the need for leadership of the company that’s separate from leadership of the board.

Two years ago, I co-led the National Association of Corporate Directors’ Blue Ribbon Commission on Board Leadership. Now the commission did not recommend that we separate the chairman and CEO positions. In the United States, there are a number of reasons not to; we didn’t say that you shouldn’t do it, but that it is not a panacea.

However, we did say that boards with a combined chairman/CEO need to clearly designate a leader from among the independent directors – what we call a lead director – with continuity. We concluded that, given the changing rules of the game, you need independent leadership of the board as well as leadership of the company, and they cannot be the same person.

If you have the roles defined, the right directors in the room, and leadership in place, it then comes down to how the board does its work; this is the sixth step in creating a more effective board. There are two aspects that we think are particularly important.

The first issue is the board’s structure and process. This has to do with the board’s agenda. Most boards we assess say the same thing: “We spend most of our time listening to presentations – frequently ones that we received in the pre-reading – and there’s not enough time for discussion, not enough time for working through the issues, not enough time for considering the important questions. So it’s important to have the right topics on the agenda, the right balance of presentation and discussion, the right structure for committees and the work they do, and effective relationships between the committees.

The second is information. When we do assessments of boards, most directors talk about the problem of information: “We get too much. We get too little. We get it too late.” The biggest problem is that the information is of limited usefulness because it’s incomplete. It tells the directors how the company performed in the past; it doesn’t necessarily tell them how it is going to perform in the future, which is what the board is really responsible for.

The problem with the information most boards receive is that it’s frequently

retrospective – it’s backward looking, not predictive – and therefore doesn’t help the board make decisions and act. And it’s filtered, usually through the management and CEO. So a board needs to get that forward-looking information – the right measures and indicators of the health of the business and its value creation – to validate what’s happening and the information being channeled through the CEO.

The seventh and, we believe, most important factor in building a more effective board is fostering the right culture. This issue has to do with the norms and rules around preparation and collegiality. It’s the ability to create constructive dissent. Can the board and management raise issues in a way that adds value?

Ed Ludwig is the chairman and CEO of Becton, Dickinson and Company, and two years ago he served on the NACD Blue Ribbon Commission, which I mentioned before. Ed said something to me during my interview with him that stuck, and it relates to Enron and other corporate crises. He said, “The measure I have of the culture of a board is this: I am a reasonably experienced executive businessman, but in the boardroom, do I feel free to ask what might be considered a stupid question? Will the board environment support me? More important, if I ask that question and get an answer I don’t understand, do I feel free to say, ‘I don’t understand’?”

Malcolm Salter at Harvard Business School is just finishing a book on corporate governance and the social psychology of Enron. Based on many of the traditional measures that a GMI or an ISS uses to evaluate a company’s governance, Enron would have done quite well: They had a code of conduct, etc. So what was the problem?

Well, Mal found the problem was that in the boardroom, people heard things they didn’t understand, but they didn’t feel they could ask a question. If they asked a question, they would get an answer they didn’t understand and then they wouldn’t challenge it. There wasn’t that environment of constructive contention combined with collegiality, which enables a board to do its job. At the end of the day, the final question is: Does the board get engaged in a way that adds value to the enterprise? Does it create conditions that enable that to happen?

To sum up, our book outlines a set of recommendations we’ve developed to help boards raise their level of effectiveness.

1. From time to time, every board should step back and take an honest, systematic look at its own performance.
2. Every board and CEO needs to be perfectly clear with each other about which responsibilities are primarily the board’s, which are management’s, and which should be shared.
3. Every board should understand the difference between its current makeup and its ideal composition – and use every new director appointment to close the gap.

4. Every board should step up to director performance issues, an area where most boards still fear to tread.
5. Every board should formally designate, in one form or another, a leader of its independent directors.
6. Every board should design work processes that enhance its ability to raise important concerns, explore important issues, and make fully informed choices.
7. The most important responsibility of every board's leaders is to foster and maintain a culture of openness, independence, broad participation, and constructive dissent and contention.

We believe a new governance imperative for board effectiveness is emerging. The implication is that CEOs and directors need to think about board building.

Following the introduction of Sarbanes-Oxley in the United States, we saw an orgy of compliance work, which was great for law firms. Companies focused on "avoiding not being in compliance." They drew new charters and generated a lot of reports and checklists. All of the annual reports and compliance websites look similar because most followed a boilerplate.

In the past two years, companies have started to say, "Okay, we've done all that." But boards are beginning to assert themselves and say, "How do we actually make a difference? How do we add value and become constructively engaged?" We're seeing that happen in areas ranging from risk management and strategy to CEO succession. Data is accumulating that shows good governance is related to performance and risk avoidance over the long term.

Things are changing, and some very positive possibilities are coming out of this change. But it will require work on the part of both boards and CEOs, and they will need to work together.

The imperative – and the response – will require new perspectives, new knowledge, and new tools, but overall we think it's an exciting set of developments, and hopefully one that will leave the Enron and other sad stories behind us as we work to improve the system.

Thank you very much.

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