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Boards: When best practice isn't enough

Many boards have improved their structures and processes. But to become truly effective stewards of their companies, they must also instill the right mind-set and boardroom dynamics.

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Why is it that despite all the corporate-governance reforms undertaken over the past two decades, many boards failed the test of the financial crisis so badly? In North America and Europe, for example, boards of financial institutions that failed to check management's aggressive forays into US subprime mortgages saw their firms decimated during the 2008–09 economic meltdown. Indeed, the European Commission, the US Congress, and others found serious deficiencies in the way boards, particularly at financial institutions, guided strategy, oversaw risk management, structured executive pay, managed succession planning, and carried out other essential tasks.[1] But it's a sure bet that most of these boards would argue—and demonstrate—that they had best-practice structures and processes in place.

The answer, I believe, after years of examining and advising scores of boards, is that such best practice isn't good enough, even if your board is stacked with highly qualified members. Without the right human dynamics—a collaborative CEO and directors who think like owners and guard their authority—there will be little constructive challenge between independent directors and management, no matter how good a board's processes are. As a result, the board's contribution to the company's fortunes is likely to fall short of what it could and should be. Deficiencies in boardroom dynamics are a concern also for executives who are not directors but report to them, because it makes it harder for those executives to develop healthy and productive relationships with their boards. What's more, for executives who aspire to serve on boards one day, it's essential to learn the importance of the right human dynamics and what it means to be a good corporate director.

Identifying the contours of such a fluid interpersonal exchange isn't easy. But executive and nonexecutive directors can apply three tests to assess the human dynamics of their own boards.

1. Do our directors think and act like owners?

Boards are vital stewards, responsible for ensuring the long-term viability and health of companies under their charge for the benefit of current and future owners. It is therefore not unreasonable to expect boards to adopt an ownership mind-set. Yet while boards have improved as a result of reforms, many outside directors continue to be passive participants who do not believe that it is their role to challenge management beyond asking a few questions at board meetings. At one financial institution, the lead director mentioned privately to a colleague that "I didn't sign up for this" when it became clear that shareholders expected this director to step up his involvement after an activist investor started questioning the company's strategy and leadership structure.

[1]See, for example, "Corporate governance and the financial crisis," Organisation for Economic Co-operation and Development, February 2010; "Corporate governance in financial institutions: Lessons to be drawn from the current financial crisis, best practices," European Commission working paper, June 2010; David Walker, "A review of corporate governance in UK banks and other financial industry entities," HM Treasury, July 2009; and "The financial crisis: Inquiry report," US Financial Crisis Inquiry Commission, January 2011.

Contrast this with how the chairman of a large and successful family-owned construction firm describes the role of board directors in well-governed family enterprises: "Directors with an ownership mind-set—whether from the family or outside—have passion for the company, look long term, and take personal (as distinguished from legal) responsibility for the firm. They will spend time to understand things they don't know and not pass the buck to others. They will stand their ground when it is called for. Ultimately, the success of the company over the long term matters to them at a deep, personal level."

To embed an ownership mind-set in the boardroom, companies should look for energy, a "can do" attitude, and an independent mind when they recruit directors. It is useful to ask candidates the following questions:

- How should nonexecutive directors be involved in the development of strategy?
- What type of information would you need to discharge your responsibilities effectively and how would you obtain it?
- In your previous board roles, in which areas did you have the greatest impact?
- In a group setting, when have you taken a stance against the prevailing majority view and what was the outcome?

It's a clear warning sign when a candidate cannot mention an occasion when she or he disagreed with management. Indeed, boards that operate to their potential are characterized by constant tensions, coupled with mutual esteem between management and outside directors. Rather than leading to endless bickering, this virtuous combination helps to facilitate healthy and constructive debate and improves decision making. As former UK Financial Reporting Council chairman Sir Christopher Hogg has noted, "Good boards are pretty uncomfortable places and that's where they should be."

Boards should also gauge a candidate's inherent interest in their companies and the amount of time the candidate can devote to the job. Why? Because a shortage of either will hinder a director's ability to think and act as an owner. Finally, although the role of financial incentives should not be overestimated, becoming an owner can help a director think like one. When directors are paid with shares in their companies or use their own funds to buy a sizable amount of those shares, they may carry out their responsibilities more robustly—provided that the stock acquired can be sold only after retirement from the board.

Thinking like an owner means, in practice, that directors should get deeply involved in developing strategy and monitoring risk. On a few issues, particularly CEO succession planning and executive remuneration, the board must absolutely take charge; in other words, board members need to roll up their sleeves and drive the work. That said, the near-universal norm that listed-company boards should probe and offer guidance—but let management handle execution and other details—is sound advice for most matters that come before a board.

An owner's mind-set also requires outside directors to possess a strong understanding of the industry, so that they can challenge management effectively. Often, they don't have that kind of knowledge. In some financial institutions that collapsed during the recent crisis, it appears the nonexecutive directors largely failed to appreciate the risks these firms were taking and were genuinely surprised when their condition deteriorated rapidly. To ensure that board members can make meaningful contributions, efforts to develop their knowledge should focus on experiential activities, such as visits to facilities, suppliers, and customers. These will yield a deeper understanding of the business and industry dynamics than the passive absorption of written reports and lectures.

However, there are limits to how much deep knowledge outside directors can build solely through service on a board. Some companies have therefore steered toward having more nonexecutives with sector expertise. The British bank Barclays, for instance, requires 50 percent of outside board members to have a financial-services background.

2. Does our CEO have a collaborative mind-set?

At some companies, senior executives fear that if boards are empowered, management will inevitably be weakened. In recent years, there have been high-profile incidents of CEOs failing to inform or involve their boards on critical developments—for instance, merger discussions. Such breaches of trust often have ended up costing these CEOs their jobs.

Although executives are increasingly conscious of the importance of keeping their boards fully informed, directors remain vulnerable to manipulation by management. Therefore they need to assure themselves that a collaborative CEO is in place. Some new CEOs may not realize, for example, that they are not sharing the right type of information with the board. In these cases, it is possible to solve the problem by giving feedback. However, where a seasoned CEO deliberately keeps the board in the dark, it is hard to change the status quo short of firing the chief executive. One company tried to coach a CEO who didn't tell the board about the true state of the company's affairs but ultimately fired him because trust could not be restored.

A board should look for collaborative traits when selecting a new CEO. For instance, it should spend time understanding how a candidate who is a sitting CEO at another company interacts with its board. And a board should avoid, at all costs, candidates who give the impression that they see it as an entity to be "managed" rather than a body to which they are accountable.

Collaboration with the board should be built into a CEO's job description and feedback provided regularly. In the annual board evaluation survey, one UK chairman includes questions about the sufficiency of the information the CEO provided and how well the CEO got along with the other directors. The purpose is to signal to the chief executive that these issues are important to the board and to address any problems at an early stage.

Trust, of course, is built over time through repeated encounters. CEOs must be equally forthcoming about successes and failures and willing to ask for help. At many companies, discussions about the challenges facing the CEO take place in one-on-one meetings between the chairman and the CEO or in executive sessions where only the nonexecutive directors are present.

Boards can influence management's willingness to cooperate through their own behavior. For instance, they must gain the CEO's trust and confidence by demonstrating an ability to add value and not micromanaging the executive team. On the latter point, the chairman of an FTSE 100 company remarked that "the test is whether executives consider board counsel on matters within management's areas of responsibility as advice which they can accept or ignore. If they feel that they must follow it, the line has been crossed."

3. Does our board guard its authority and independence?

Boards must be ever-vigilant about protecting their standing and independence. Although few board directors like to say so, an increasingly successful CEO is one of the biggest threats to the board's authority, regardless of whether she or he is rewarded with the chairman's title too, as is common in the United States. In many industries, from financial services to entertainment to retailing, boards have seen their authority slowly chipped away as their CEOs experience ever-greater success. Tell-tale signs include less robust questioning of management's proposals and a readiness by the board to agree to unreasonable demands—for example, on executive remuneration. Some boards realize the extent to which they have relinquished their authority only when the CEO changes or something goes wrong, such as a crisis or scandal.

Boards can take a number of steps to protect their authority and independence. First, they should ensure that different individuals occupy the positions of chairman and of CEO. From a principled standpoint, it is problematic for a board, whose job is to oversee management, to be led by the CEO. Appointing a lead independent director in lieu of a nonexecutive chairman—the preferred option in the United States—is not enough, because most US lead directors do not have primary responsibility for developing agendas for board meetings, interviewing candidates for directorships, and other activities that safeguard a board's authority and independence.[2]

[2]For further information, see *2010 Spencer Stuart Board Index*, Spencer Stuart, 2010, p. 23.

Additionally, boards need to be on top of succession planning and leadership development, so that the CEO can't hold the board hostage with unreasonable demands, whether on pay or additional authority. At a European retailer, the failure of the board to identify a successor to the CEO enabled him to extract from it the chairman's seat as well.

Since a successful CEO's clout will grow, boards should also pay attention to the relative status of people in the boardroom. Discussions with chairmen and direct observations of boardroom dynamics have revealed that CEOs are not always attentive to the views of nonexecutive directors whom they perceive to be less qualified than they are. Outside directors who are in awe of, or intimidated by, a chief executive can also be overly deferential to management.

As a principle, boards should ensure that the stature of nonexecutive members is roughly comparable, and equal to or greater than the CEO's. At one UK company, the chairman has deliberately recruited to the board people who are chairmen at other listed firms. That way, the board is more likely to have the respect of the highly successful CEO, and nonexecutive directors will also treat each other with regard. At another company, a candidate will be nominated to the board only if all of the current nonexecutive directors support his or her appointment. The chairman reasoned that "the board's time is so precious that you cannot have a situation where one director is not respected by all others."

The relative stature of the chairman and the CEO is particularly important. According to a senior independent director of a UK company, "you need a person who can tell a CEO that he is acting like an idiot, when necessary." In the United Kingdom, chairmen are usually a decade or so older than their CEOs, which enhances the chairman's ability to serve as mentor to the chief executive.

Lastly, boards should put in place term limits for directors and CEOs, with some flexibility on the exact timing of exit, to ensure that new perspectives come into the boardroom and that boards remain sufficiently detached from management. At a food services company, the board—many of whose members had served for years—became too close to the CEO and did not challenge him on his undisciplined growth strategy. The strategy subsequently unraveled, forcing the company to undertake a costly and embarrassing restructuring and leading to the ouster of the CEO and all of the long-tenured directors.

One Canadian bank normally allows nonexecutive directors to serve for ten years. At a UK company that has no formal policy on term limits, the chairman usually seeks to rotate directors off the board after six to seven years of service. Correspondingly, limiting the CEO's tenure may help the board preserve its authority and force it to devote more attention to succession planning and leadership development. This approach may also inject a sense of urgency into the CEO's work. One American CEO who imposed a ten-year limit on his own tenure felt that it helped him become a better leader. He also devoted a great deal of time to thinking about the long-term health of the company and the steps he should take to sustain its success after his departure.

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When it comes to well-functioning boards, best-practice structures aren't enough. Without the right mind-sets and human dynamics between directors and management, boards will not be able to fulfill their potential.

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