What Makes Great Boards Great

The Character of Leadership & Governance
2001 – 2016

Professor Jeffrey Sonnenfeld Yale School of Management
Elise Walton, Principal, Organization & Governance Consulting
“I was on the cutting edge. I pushed the envelope. I did the heavy lifting. I was the rainmaker. Then I ran out of metaphors.”
GOVERNANCE BATTLE GROUNDS

• The Governance Challenges of 2000

• The Governance Challenges of Today
Governance Breakdowns

- Investor wealth & confidence
- Enterprise survival
- Customer confidence
- Employee morale
- Community collapses
GOVERNANCE BATTLE GROUNDS of the Past Decade

• Failed Diligence
• Failed Succession
• Cronyism
• Corruption
GOVERNANCE BATTLE GROUNDS
Remedies of the Past Decade

• Regulation & Compliance
• Transparency & Accountability
• Roles & Structures
• Proxy Advisors & Ratings
• Director Training
Regulation & Compliance

• Sarbanes Oxley

• Exchange Listing Requirements

• Dodd Frank
Traditional Roles of Board

• Auditing and Monitoring
• Linkage to Resources
• Advice and Support to Management
Key Fields of Board Responsibility

- Integrity of the Enterprise
- Mission and Purpose of the Business
- CEO and Top Leadership Succession
- Financial Health of the Business
- Responsiveness to Interests of Key Stakeholders
Collective Board Competencies

- Ethical Conduct
- General Management Skills
- Leadership Recruitment and Development
- Financial Analysis
- Compensation
- Industry Knowledge
- Good Radar Detection
- Shareholder Interests
- Backbone
- Time for Follow-Through
Ratings

Geithner
ISS Corporate Governance Quotient (CGQ) Rating System

Board Structure and Composition

Continuing Education for Directors

Director and Officer Stock Ownership

Qualitative Factors
  • Retirement Age
  • Meetings of Outside Directors

Charter and By-law Positions

State of Incorporation

Executive and Director Compensation

“CGQ”
“Basic economics – sometimes the parts are worth more than the whole.”
Conventional Wisdom on Governance Metrics

The Inadequacy of Conventional Wisdom

- Regular Meeting Attendance
- Equity Involvement
- Board Member Skills
- Board Member Age
- The Past CEO’s Presence
- Independence
- Board Size and Committees
- Lead Director/CEO Chairman Role Split
## CGQ: Most Influential Factors

<table>
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<tr>
<th>ISS CGQ Criteria in Order of Importance to ISS</th>
<th>Statistical Importance Score</th>
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<td><strong>Qualitative Factors</strong></td>
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<td>CEO succession plan</td>
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<td>Outside advisors available to board</td>
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<td>Directors resign upon job change</td>
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<td>Retirement age for directors</td>
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<td>Features of poison pills</td>
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<td>Capital structure</td>
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<td>Vote requirements</td>
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<td><strong>State of Incorporation</strong></td>
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<td>Takeover provisions applicable under state law</td>
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Meet Our Corporate Governance Watchdogs

Michael Dell should be happy closing the first quarter of this new year. Sales at Dell computer were up 21% despite the HP-Compaq merger. The company regained the top spot in market share of PCs and notebooks, among others. And in January, BusinessWeek named Michael Dell a best manager, while Fortune ranked Dell Computer #1 among its March 2003 list of America's most admired firms.

It would seem like time for champagne, but some governance entrepreneurs have thrown a cold bucket of water on any celebration. Leading companies are now feeling pressure to abandon things they already do right because of the prevailing scent of corporate misbehavior. In many cases this means tossing distinctive board practices to conform to generic formulas of governance peddlers and their institutional investor clients.

Good governance matters, it's just not easily managed. And part of the problem is our current ratings system. Firms like Governance Metrics Incorporated, one of the premier corporate governance rating services, ranks Dell in its lowest category. And Dell is hardly an exception: among the firms that rank at the top of Fortune's list and receive poor rankings from GMI are Southwest Airlines, UPS, and Wal-Mart.

Southwest? How does that fit in with the second most admired firm in the country and the only profitable major airline? UPS continues to lead its industry, as it has since the inception of Fortune's reputation survey over 30 years ago. Wal-Mart even topped the entire Fortune reputation list, the first time the nation's largest firm was also the nation's most admired firm. Its sales have soared despite the economic climate.

Surprisingly the firms which beat Dell, Wal-Mart, Southwest Airlines, and UPS in these "governance metrics" are such troubled souls as Citigroup, Merrill Lynch, AT&T and AOL Time Warner. What do the GMI notes that Fortune's survey pool of 13,000 execs and analysts around the world don't? Governance scores are determined by college students blissfully free of bias having never read proxy statements before.

More troubling than the rules are the elements. While Fortune looks at financial soundness, management strength, product quality, long-term investment value, and social responsibility, the governance peddlers uncritically staple together every governance reform dimension regardless of the existence of research support.

What then is Dell's governance shame? The board has " insiders" on it, including a 67-year-old former Dell vice chairman. UPS and Wal-Mart also have boards where most directors are independent, but enjoy the five or six thoughtful insiders. The toughest questions often come from their knowledge. All the outside names at Icorum and WorldCom didn't enhance diligence.

Some benchmarks used by governance experts like GMI are broadly trivial or useless. Making judgements based on such criteria as the separation of the CEO and boardchairman titles, the financial literacy of directors and strong attendance records make a joke of real corporate integrity. In the case of Southwest, the company got extra bad marks because older directors aren't forced out through arbitrary retirement policies.

Firms with directors serving at another firm that went bankrupt also are discredited. These courageous directors who joined the boards of WorldCom, Enron, and Kmart before bankruptcy filings are now discredited in these metrics. By the logic of GMI's corporate reform waltzes, diligent directors should respond to troubled waters by abandoning ship.

Some of the governance ratings agencies look dodgier than the companies they watchdog. If you purchase an accredited director training from Institutional Shareholder Service, another rating agency, for example, and purchase their consulting services to evaluate your director incentive packages, the client's payoff is a nice boost in scores. Now S&P and Moody's are entering the business with their own scoring system and coupled consulting services. Ironically, Moody's, with its chairman a former WorldCom director, earns low scores on GMI's governance ratings.

This starts to resemble the protection schemes of bullies or the conflicts of auditor/consultants which governance gurus decry. ISS directly sells advice to the institutional investors on rating their proxies while at the same time it sells advice to management on how to protect itself from those investors' proxies.

With director training programs sold by over 70 consultants, associations, and universities, forget selling time-management programs, diversity training, quality improvement, and re-engineering. As investors are sold the tautological definitions of good governance, the problem becomes not just bad governance but also bad governance gurus.

Mr. Sommefeld, associate dean of the Yale School of Management, is author of "The Hero's Farewell" (Oxford University Press).
Hidden Board Pathologies

- Group Think
- Obedience to Authority
- Diffusion of Responsibility
“Frankly, Mr. Wathersby, we’re looking for someone who can take it. We’re already well supplied with those who can dish it out.”
Building an Effective Board

• Create a Climate of Trust and Candor
• Foster a Culture of Open Dissent
• Utilize a Fluid Portfolio of Roles
• Ensure Individual Accountability
• Evaluate the Board’s Performance
Bill Donaldson’s Wisdom
GOVERNANCE BATTLE GROUNDS

• The Governance Challenges of 2000

• The Governance Challenges of Today
The Governance Challenges of Today

• Information Overload – Who needs what?
• Improved Succession
• Preparation for Crisis Response
• Seasonal Patterns – Proxy Battles - Titles, Compensation, Dividends
• Raiders as Activist Investors
• Inconsistent Global Standards
What Information Do Directors Need?

- Legality
- Profitability
- Soundness
- Volatility
- Complexity
- Controllability
- Positivity
- Magnitude of Change
“It’s lonely at the top, that’s why.”
What CEOs Want

The Missing Voice in Board Governance

• Focus more on the crucial risk to enterprise future
• Do your homework – come prepared
• Bring relevant knowledge to the table
• Do more to challenge strategy constructively
• Make succession LESS not MORE disruptive
Building Better Boards

- Expertise & Experience over Marquis Names
- Doers vs. Joiners
- Independent Mindedness Insiders vs. Naïve Outsiders
The Governance Challenges of Today

Improved Succession

• Institutionalize Process
• Partnership
• Not public grandstanding
• Varied Departure Styles
• Taking Charge – Board Guidance
“Thanks, Pop, but today’s kids don’t want money, they want leadership.”
CEO’s Interest in Personal Brand

• Heroic Mission
  – Net producer
  – Immortal Legacy

• Heroic Stature
  – Fusion of Identity
  – Eponymous brands
Heroic Departure Styles

- Monarchs
- Ambassadors
- Generals
- Governors
CEO Departure Styles

*Jeffrey A. Sonnenfeld, The Hero’s Farewell, 1988.*
“By God, Harris, it’s rare and encouraging these days to see a young windbag on his way up!”
The Governance Challenges of Today
Preparation for Crisis Response

• Voice
• Roles
• Values
• Resources
• Reputation
Enterprise-Wide Crisis Management
Toyota, BP, Goldman vs. J&J, Mattel, Jet Blue

- Delayed Responses – Stonewalling
- Poor Mastery of Facts
- Lack of Alliances of Shared Fate
- Failure to Embrace of Critics
- Preparation for Public Comment
- Lack of Central Official Voice
- Reframing the Situation
The Ability to Rebound

• Fight, not flight – *Facing up to the issue*
• Recruiting others into battle – *Using networks effectively*
• Rebuilding heroic stature – *Regaining reputation*
• Proving your mettle – *Getting back into the fray*
• Rediscovering heroic mission – *Getting your purpose clear*
The Governance Challenges of Today

- Seasonal Patterns - Proxy Battles - Titles, Compensation, Dividends
- Raiders as Activist Investors
“So, Jim, where do you see yourself in ten minutes?”
The Governance Challenges of Today

Recent Case Study Discussions

• Aubrey McClendon – Cheasapeake Energy
• Jamie Dimon – JP Morgan vs ISS
• Mike Pearson - Valeant
• Ellen Kullman – Dupont
• Indra Nooyi – Pepsico vs. Nelson Peltz
• Mike Ullman – JC Penney vs. Bill Ackman
• Michael Dell – Dell vs. Carl Icahn
• Tim Cook – Apple – Carl Icahn
Boards & Strategic Engagement

**PROS**
- Clarity
- Expertise
- Direction setting
- Avoiding mission creep
- Accountability
- Constituent responsiveness
- External legitimacy
- Ownership

**CONS**
- Distance
- Time for follow trough
- Link to execution
- Varied skills
- Complex motives
- Micro-managing
- Incomplete knowledge
Constructive Roles for Strategic Engagement

- Establishing Strategy Committee
- Periodic Strategic Reviews
- Domain – Not Tactical:
  - Mission
  - Values
  - Goals
  - Objectives
  - Resources
  - Changes
- Knowledge base
- Visionary Leadership
“That’s the way this job is, Bledsoe – interminable periods of boredom and brief moments of intense excitement!”
“But...but you can’t fire me. I’m on my way up!”
CREATING HEROIC LEADERS: Folklore & Politics to Business

• Humble Origins – *Common Identity*
• Call to Greatness - *Adventure*
• Separation – *Trials*
• Success Spiral – *Dragon Slaying*
• Crushing Setback – *Near Defeat*
• Mythic Rebound – *Resilience*
• Transcendent Mission – *Confidence/Competence*
“Of course he was cut down in his prime. Don’t you get it? We’re all cut down in our prime.”
Corporate Recoveries

FAILURES
• Digital Equipment
• Westinghouse
• Union Carbide
• Schwinn
• Lotus
• Excite@home
• AT&T
• REA Express
• Arthur Andersen
• Coca Cola
• Drexel Burnham

SUCCESSS
• IBM
• GE
• Johnson & Johnson
• Harley Davidson
• Microsoft
• Yahoo
• Verizon
• UPS
• KPMG
• P&G
• Sandler O’Neill
Media Frenzies: HP to BP
(HD, YUM, Ford, UPS, Amazon, Coke)

- Delayed Responses – Stonewalling
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• Rediscovering heroic mission – *Getting your purpose clear*
“I just have to create a few loose ends for other people to clear up, and then I can get out of here.”
Boards & Strategic Engagement

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• Knowledge base
• Visionary Leadership
1. *Expect change* and understand how it may affect the company’s current strategic course, potentially undermining the fundamental assumptions on which the strategy rests.

2. Engage with management on strategy issues on an ongoing basis, including early involvement to improve strategy development, adjustment, and monitoring.

3. *Evaluate strategy options* and underlying assumptions in good times, as well as in times of change or crisis (use multiple lenses to look at the company).

4. Divide the strategy plan into elements that are tied to the performance drivers and critical assumptions, and revisit those different elements throughout the year.

5. *Communicate* to the CEO and management the expectation that strategies are brought to the board in the early stages to allow for open discussion and engagement.
6. Establish an effective and *collaborative relationship* between the board and CEO via the chair or lead director

7. *Consider director experience and expertise* in relation to the strategic role of the board as part of nomination and re-nomination decisions

8. Develop *consensus* with management on the *forward looking metrics* specific to the company that will be early indicators of the success or failure of a chosen strategy

9. Hold *executive sessions* at the beginning and end of each board meeting to allow independent directors to freely discuss strategy

10. Establish a *relationship with key investors* when performance is good
Types of Strategic Activity

- **Strategic Thinking**
  Collecting, analyzing, and discussing the environment of the firm and broad business design alternatives

- **Strategic Decision Making**
  Making the fundamental set of decisions about the business portfolio and business design

- **Strategic Planning**
  Translating the critical strategic decisions into a set of priorities, objectives, and resource allocation

- **Strategic Execution**
  Undertaking initiatives and actions consistent with the strategic plan
Exhibit: Initial Work Plan

Staff Work Track:
- Assemble and review existing strategic work
- Analyze strategic alternatives
- Develop board materials and presentations
- Develop integrated strategy

Executive Team Track:
- Executive team builds process and work plan
- July meeting: Review vision, view of company and environment
- September meeting: Discuss strategic alternatives
- January meeting: Review integrated strategy

Board of Directors Track:
- July meeting: Lay out process and confirm board concerns
- Interviews: In-depth interviews with directors
- October meeting: Feedback, content, input, and alternatives
- Follow-up interviews: In-depth interviews with directors
- February meeting: Review and confirm strategy
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<tr>
<th>The “Passive” Board</th>
<th>The “Certifying” Board</th>
<th>The “Engaged” Board</th>
<th>The “Intervening” Board</th>
<th>The “Operating” Board</th>
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<tr>
<td>Functions at discretion of CEO</td>
<td>“Certifies” to Shareholders that:</td>
<td>“Partners” with CEO to provide insight, advice, and support to CEO and management team on key decisions and implementation</td>
<td>Typical mode during a “crisis” situation</td>
<td>Board makes key decisions; management implements</td>
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<tr>
<td>Limited activity and participation of Board</td>
<td>CEO is doing what Board expects; that Management is capable of taking corrective action when needed</td>
<td>Also recognizes ultimate responsibility to oversee CEO and company performance; dual role of guiding/supporting as well as judging the CEO</td>
<td>Board becomes intensely involved in discussions of key decisions facing the organization and in decision-making</td>
<td>Not uncommon in early “start-ups” where Board members are selected to “fill gaps” in management experience</td>
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<td>Limited accountability</td>
<td>Emphasizes outside/independent directors; meets independently without the CEO</td>
<td>Board meetings characterized by useful two-way discussions of key issues/decisions facing the company</td>
<td>Frequent and intense Board meetings, often called on short notice</td>
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<td>Ratifying management preferences</td>
<td>Stays informed of current performance; designates external Board members to evaluate CEO</td>
<td>Board members need sufficient industry and financial expertise to add value to decisions</td>
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<td>Establishes an orderly succession process</td>
<td>Time and emphasis spent on defining role and behaviors required of Board members; boundaries of CEO/Board responsibility</td>
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<td>Is willing and able to change management to be credible to shareholders</td>
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BOARD GOVERNANCE & CHARACTER OF THE ENTERPRISE