

## Perspectives from the Boardroom – 2009

Numerous corporate scandals and failures have characterized the first decade of the twenty-first century: from the burst of the dot-com bubble in 2000 to malfeasance at Enron, Tyco, World Com and elsewhere in 2002 to the demise of once-great automotive companies and the failures of banks and related financial institutions in 2008 and 2009. Each wave of business problems has been accompanied by accusations of failure on the part of corporate boards, and by calls for government action. Indeed, passage of the Sarbanes-Oxley Act in 2002 was a direct result of the failures of World Com, Enron and other mismanaged companies. Pressure from shareholder groups, the media and politicians have prompted the SEC to stiffen its requirements for reporting executive compensation in company 10-Ks, and recent proposals for “say-on-pay” legislation seek to provide for a non-binding shareholder vote on executive compensation. Senator Charles Schumer has proposed a “Shareholder Bill of Rights,” intended to create a federal law mandating how corporate boards are led and organized. And the SEC has floated a proposal granting shareholders the right to nominate candidates for membership on corporate boards.

This flurry of attention to boards of directors and corporate governance has not gone unnoticed at Harvard Business School. Early in 2009, members of the faculty’s Corporate Governance Initiative met to discuss the impact of the economic crisis on corporate governance in general and on corporate boards in particular.<sup>1</sup> We recognized the legitimacy of many issues raised by the media, the public and politicians about boards’ ineffective oversight of financial-service firms and other complex companies whose actions contributed to the current recession.

As we reflected on how and why boards had fallen short, we came to a tentative conclusion. The problems that surfaced in 2008 and 2009 largely differed, we believed, from those that had prevailed in 2002, when boards failed to identify and stop management malfeasance and fraud. By contrast, the more recent boardroom failures were primarily attributable to the growing complexity of the companies that boards are charged with governing.

By *complex companies*, we mean those that operate multiple businesses (in terms of both products and geographies). We concluded that these companies create unprecedented challenges for the executives who lead them and for the boards that oversee them. Such companies typically have at least two levels of general managers—those responsible for individual products or geographic units, making strategic, resource-allocation and human-resource decisions within their purview. These general managers in turn report to

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<sup>1</sup> The Corporate Governance Initiative has served since 1999 as a forum to discuss and encourage faculty research.

the upper echelon of general managers, including the CEO. Assuring an adequate and accurate flow of information from the lower level to the upper is a significant management challenge. Atop this management structure sits the board of directors. As we will see, board members are largely dependent on management for an accurate and transparent flow of information. We questioned whether the boards of complex companies receive adequate information to understand the performance issues and risks their companies face. The challenge for the boards of such companies, we postulated, is how to oversee such complexity within the limited time that directors can devote to the task. Time constraints clearly impose strict limitations on the thoroughness of board oversight.

We agreed that the best way to test these conclusions and explore the causes of board failures was to go directly to the source: directors serving on the boards of financial institutions and other complex companies. We decided to seek answers to two broad questions: how well did these boards function before the recession, and, more importantly, what aspects of board functioning troubled board members as they looked to the future?

The approach we chose will seem unorthodox to other academics, but we concluded that it would provide the most accurate and thorough answers to our two questions: eight senior members of our faculty, all of whom serve on boards themselves, agreed to interview five directors each. Each faculty member selected as interviewees (1) members of boards of complex public companies whom a faculty member both (2) knew personally and (3) believed to be both dedicated and respected by fellow board members. Clearly, this was not a random sample. It was intended to be biased toward experienced directors with whom we had prior relationships and therefore had reason to believe would be candid with us. We think that this approach has paid off handsomely.

We interviewed 45 directors. **Exhibit 1** characterizes the companies they represented (while preserving the anonymity of both director and company, a condition we established to encourage candor). We believe that the interviewees were frank both about their boards' strengths and about specific needs for improvement.

Interviewees' opinions varied about the difficulties that complexity poses for boards, but there was strong consensus that the key to improving boards' performance is not government action but action on the part of each board. Several directors worried that the government would take action if boards themselves did not. One director articulated the challenge: "How should the board help the company avoid embarrassment and reputational damage, and not allow the government to run the companies because we don't step up and do what we're supposed to do?" More state or federal regulations and rules were seen as unneeded and apt to produce unintended consequences that could damage boardroom effectiveness. In the view of these directors, each board must develop structures, processes and practices that fit the needs of the company and its business; the notion that "one size fits all" is viewed with extreme skepticism. In essence, there was a

**Exhibit 1**  
**Interviewees' companies by industry and size in 2008**

Industry	Number of companies	Average market capitalization, 2008 (in \$ millions)	Average sales, 2008 (in \$ millions)
Consulting	2	12,745	18,722
Consumer discretionary	18	28,485	47,618
Energy	2	34,064	34,164
Financials	14	16,601	24,535
Healthcare	11	30,797	19,475
Industrials	8	32,639	42,661
Information technology	16	23,812	18,713
Materials	4	6,776	18,816
Telecommunications	2	106,051	107,323
Utilities	1	15,739	13,094
<b>Total</b>	<b>78</b>	<b>\$26,210</b>	<b>\$31,346</b>

strong consensus that the key to successful governance rests in the hands of each board. Specifically, it resides in how directors work together and with management to oversee the company and make decisions. In the directors' view, these are matters that cannot be regulated by government.

The directors also expressed the view that organizations representing shareholders, such as RiskMetrics and Glass Lewis, have become too formulaic and prescriptive. This phenomenon has led to a check-the-box mentality whose efficacy several directors questioned. "I think there's a lot of focus put on meeting metrics set by outside parties today. I'm not entirely certain that's a good thing, but certainly . . . so-called proxy governance firms, like RiskMetrics and so forth, have become the de-facto regulators as it relates to corporate governance," one director said. "And increasingly these guidelines shift annually, requiring boards to monitor changes that are going on, and to adjust. So it's kind of become a bit of a shifting-sand environment in that regard." Another director concurred: "I saw . . . a certain attitude which was form over substance. In many board meetings, I realized, just 'Let's address the formal issues—tick, tick, tick the box—and now let's get to business.' I think people should be aware that form is not substance, and form should not be overdone; otherwise it goes to box-ticking."

The directors also agreed that they should function as long-term stewards of their companies. Given this perspective, it is not surprising that they also worried about the short-term focus on shareholder value that has come to dominate the U.S. economy. Specifically, they were critical of the agency theory promulgated by former Harvard Business School professor Michael Jensen. According to this theory, directors should act

as agents for their companies' shareholders. While recognizing their fiduciary duty to the shareholders who technically elect them, our respondents are typically acutely aware that they also have a legal responsibility for the long-term health of the company. Furthermore, they recognize that shareholders are often short-term investors with no long-term commitment to the company. In sum, these directors tend to be uncomfortable with the notion that they can or should act as shareholders' agents. As one senior executive put it, "We are transitory managers of a permanent institution."

This paper will first briefly explain how the interviewees characterize the strengths of their boards. Then we will examine in more depth six areas in which they identified shortcomings or needs for improvement:

- Clarifying the board's role
- Acquiring better information and deeper knowledge of the company
- Maintaining a sound relationship with management
- Providing oversight of company strategy
- Assuring management development and succession
- Improving risk management

Finally, we will discuss two issues that appeared not to trouble our informants but that our own experience leads us to view as significant: executive compensation and the relationship between the board and shareholders.

## **Pre-Recession Boards**

The interviewees generally reported that their boards had grown more effective in recent years, and that the quality of their fellow directors had improved. For one thing, the number of independent directors had increased. "There was a movement toward all independent directors, with the exception of the CEO," one director reported. These new directors also seemed better qualified than their predecessors. "I think the boards that I am on have all recruited new members," another director told us, "and I would say have significantly upgraded the board—fewer of the cronies and the old-timers, and more of the real professionals, experienced people who have some 'value add' to the board." Another commented: "I'm impressed by the quality of the people that are willing to provide time. They're frequently a mix of people who have expertise in a particular area that is important to the company, people who have operations or CEO experience, or people who have financial or Street experience. They typically are very impressive. I think it is important to make sure that there is some breadth of experience, because it does provide you with insights that are hard to get otherwise."

Some directors who remained uneasy about the insufficiency of relevant experience on boards questioned the regulatory emphasis on independence. "I don't think independence is anywhere near as important as people thought it was," one such director commented. "I think it was a red herring." Independence—a focus of recent regulatory changes—is a subject to which we shall return, related as it is to the question of how well directors understand their company.

Another positive sign is the growing comfort of boards' audit committees and other directors about meeting the requirements of the Sarbanes-Oxley Act. "I think by 2007 we kind of felt that the pendulum was swinging back," one director commented. "We felt comfortable about the company we were involved in, that there wasn't any monkey business, there weren't any backdated options, there were none of the various types of scandals that we tested for in all of these companies. And so I think we felt good about that, and so therefore could begin by 2007 to think again about strategy, big picture. Where are we really going, and where are the opportunities?"

## **Issues Highlighted by the Recession**

Though most of the directors believed that their boards had been on a positive trajectory, the credit crisis and subsequent recession raised deeper and more basic issues for many. Most frequently mentioned were two linked questions: What role is appropriate for the board? And how can the directors understand enough about the company to meet their responsibilities effectively? We shall discuss each question in turn.

### *The Board's Role*

Why so many directors were reflecting on the board's role is difficult to pinpoint. A partial answer undoubtedly rests in the fact that regulations and laws offer little guidance about what boards are supposed to do. In most states the basic statute that describes the purpose of boards is phrased very broadly. For instance in Delaware, which sets the standard for other states, directors find little help in the statute that defines their job: "The business and affairs of every corporation shall be managed by or under the direction of a board of directors" (Section 141(a), Delaware General Corporation Code Annotated, Title 8, available at <http://www.delcode.state.de.us>). This statute also tells directors that they may delegate the actual running of the company to its officers. The pertinent court decisions, related to director conduct, are largely focused on matters of process—that is, on *how* boards are to carry out their duties. For example, directors must exercise good business judgment and be loyal to the corporation. As one director told us, "Our board lawyers say, 'You know, the board members are not supposed to be making the management decisions. You're just supposed to be comfortable that the management is going through the appropriate processes to come to well-thought-out decisions.'"

Given the prevailing lack of specificity, most boards have gradually developed an implicit understanding of what their job should be. As long as the business was thriving, and management was comfortable with what the board was and wasn't doing, there was no need for greater explicitness. But the economic shock of 2008 appears to have caused many directors to reconsider what their boards had been doing and to question whether they could or should be acting differently. "I really do think it's time for a lot of reflection by boards right now about what we could have done better in the last six months to a year," one director said. "What did we miss? I think it's always great to have time to reflect backwards about what we learned about what we've just been

through, or what we're going through and how we could have served the shareholders better if we had spent our time a different way."

Directors' reflections on the board's role had multiple dimensions. For some, the question was whether and how exclusively the board should focus on compliance with applicable laws and regulations. In their view, the board's primary role is to be rules-oriented. Others viewed compliance as the job of lawyers and conceived of the board's job much more broadly. "I'm more comfortable on some boards than I am on others," one director told us. "Some people have really taken the value of governance, the importance of governance, to heart, and it pervades the company. Others have been slower to that realization, and tend to view governance as something that the lawyers are driving. And therefore it is something that, at the attitude level, slows things down; it's a cost to the enterprise. It gets in the way of being efficient about decision-making and moving forward."

This director and a handful of others seemed to be struggling with a hangover from the effects of Sarbanes-Oxley and other regulations, which absorbed so much board time a few years ago. To others, the financial crisis itself meant that boards should intensify their efforts at compliance: "In adversity, boards become more active by definition," one director said. "But what one has to ask is: Should they be more active when things are good, to make sure that the risk-management processes are in place, that the financial-control processes are in place, so that they're assured that the organization has the controls and procedures that will red-light or highlight risks when they need to be highlighted?"

Other directors disagreed, believing that the board should devote less time to compliance issues and more to substantive business matters. Doing both is not easy, as one director pointed out: "Just the challenge of fitting all of the compliance activities that boards and their committees have to execute on, while still doing these broader and perhaps more interesting things that boards are supposed to do—in terms of providing oversight of the business, oversight of management, particularly oversight of the CEO, as well as engaging in the strategy and the direction of the company—is difficult." For directors like this one, the central issue was how much directors could be expected to do. "I think that the expectation of what a board can or cannot do, either in the public perception or even in the regulatory perception, is overstated," another director said. "At times this is a big challenge for board members. They feel they should be doing more, but doing more is difficult to do." Such comments suggest that, in times of crisis, directors feel a responsibility to take a larger role but aren't certain how to do so.

One director pointed out a significant problem that arises when boards contemplate becoming more engaged: "I think the board is more involved. I think it's busier. I think boards have to be more focused. And I think they have to be careful that they don't start trying to manage the company. They have to give the guidance, or set the trends, but they can't be managing the company." Where to draw the line between the board and management troubled our interviewees. Two directors' comments effectively capture the two sides of the debate. One said: "In today's environment, where there is so much

pressure on directors, I think there can be a tendency for directors to want to cross the line a little too much sometimes, on the operating side, probing committees on every little subject that comes up.” In sharp contrast, another director said: “At the moment, boards are reluctant to be intrusive into the day-to-day operations. And I think they are reluctant to be intrusive on the personnel management, beyond the top guy and maybe the heir apparent, if there’s a change coming. And so they isolate themselves from understanding where the risks are coming from and what those risks are. I don’t think they can do the job without becoming more involved.”

While these directors puzzle over where the line should be drawn between management and the board, others believe that the crucial issue is how the board interacts with management around major decisions. “I’ve always thought the board should be a catalyst,” one director said. “They need to make sure that there’s really good open dialogue, and all the dimensions and possibilities are at least given some air time. I think the board’s role is to make sure that management, if they are not having these discussions with the board, does have these discussions with the board. And if they’re not working on it, they should be working on it.” Another director asserted that the board should be even more proactive: “I think the board has to lead more. And the shareholders may not even like that too much, and the management may not like it. But I think the board has to say, ‘Wait a minute, what steps are we taking while we’re still making that profit on one product? What are we going to do so that we’re ready in five years with another new product?’”

As we shall see, directors’ preoccupation with better defining the board’s role is also linked to their views on board involvement in shaping company strategy. And both questions turn on another matter: how well the board understands the company.

### *The Board’s Understanding of the Company*

The thoroughness of the board’s understanding of the company was second only to the issue of the board’s role in frequency of references during our interviews. We use the term *understanding* because it expresses what the directors seemed to be seeking. They often used the words *knowledge* and *information* as well, but their underlying concerns were clearly insufficient understanding on the part of some boards, the causes of this phenomenon and what they and other directors could do about it. This issue should be examined in the context of growing corporate complexity, since the companies in question are typical of the complex corporations alluded to earlier. Such companies are particularly difficult for their directors to understand.

One director spoke about what can transpire when a company is complex, and about the possible corrective effect of an expectation that the board should understand the company’s transactions: “I think a head of a company looking at the sustainability and the long-term future of the company should never allow somebody in the company to get in any deal which is not fully understood by the board and by the shareholders. And the best check is that the CEO should be able to speak about all deals which are made.” The same director emphasized the need for directors to fully comprehend the company’s

business model: “My experience is that it’s of utmost importance that the board has a full understanding of the business model . . . entry barriers, competitors, technological changes and so on. A full understanding of the business model—which includes, of course, what are competitors doing, what are the trends in the market and so on.”

As important as they believed it to be to understand the company, some directors admitted that complete understanding is an impossibility: “You really can’t understand everything that’s going on in the company, and the notion that you can is misguided,” one director said. “Unfortunately, I think people do expect directors to know a lot more than they sometimes do.”

A disproportionate number of those who attested to the elusiveness of adequate understanding were directors of financial-service firms. “We had the Enron era; now we have the financial era, where we’re taking down the whole world with us, and it can’t be because all these people are stupid,” one such director said. “It has more to do with the depth of understanding of what’s really going on.” Another was even more pointed: “[Two banks]—I think they crashed and burned. Neither one of them had anybody that I could detect on the board that’s had any serious financial skills. And it doesn’t look to me like those boards demanded to know what was happening off balance sheet.” A third director concurred but questioned top management’s financial skills as well: “The bank boards and the bank CEOs and leadership, obviously, with the exception of maybe one or two, did not understand the risks that they were managing. Clearly, the bank boards were in over their heads, just like the CEOs were. They didn’t understand the paper they were issuing and how the risk was being syndicated, all that.”

Finally, one director pointed out that even when a board meets as often as 10 times a year (the typical U.S. board meets six times) it is impossible for directors to understand complex financial companies: “One has to understand that, at the beginning of this, that board members show up, at a maximum, let’s say 15 to 20 days a year. Maximum. And the idea that board members would be close enough, informed enough, experienced enough, engaged enough to have seen some of this coming, and even more, to have been wise enough to figure out how to duck, is just naïve in the extreme.”

Such comments raise an obvious question: why do directors have such difficulty understanding their companies? Several directors commented on the scarcity of specific industry knowledge on most boards. “I think our thinking is going to be forced to be changed by virtue of the financial crisis, in that I think we’re going to place higher value on industry-specific knowledge and less on general knowledge of governance and the general experiential things that come with an all-purpose board,” one director said. Another echoed this view: “The board needs to be asking the right questions. One thing that I’ve seen just over the last couple of years, and been a champion of, is having at least one board member who is very knowledgeable about the business you’re in. . . . It really is helpful, particularly in executive sessions, when you don’t have the management there, and you’re debating something, or wondering whether you should be worrying about something, to have someone who understands the business a little bit better than you do.”

A third director went further, linking the shortage of specific company knowledge to corporate-governance reforms that called for more independent directors: “Strategy is harder, because it requires a familiarity with the business, and an understanding of it, in order to make any sort of informed suggestion. And clearly, I think, if you were to look at boards, there are still huge deficits in certain technical expertise and understanding of the business that persists at boards. . . . One of the things that’s been lost, in this notion of full independence and limited insiders and split chairmen and CEOs, is that boards have lost insight into the business as a result of not having, if you will, as free and consistent access to people who are steeped in the business as they might otherwise have.”

This final point deserves emphasis. We believe that a major reason directors find it difficult to understand their companies is that the typical board of a large public U.S. company consists entirely of directors who must meet the test of independence. As a practical matter it is difficult, if not impossible, to find directors who possess deep knowledge of a company’s process, products and industries but who can also be considered independent.

A second reason that directors have difficulty understanding their companies’ business is that they are heavily dependent on management, especially the CEO, to know what is going on. One director explained the frustrations of such dependence: “Whether [an automobile manufacturer] should close their European operation, [management has] much more insight and information than the board has, and they have gone through a thorough evaluation. They make a recommendation, and you’re more likely to agree with it than not, even after you have questioned them very closely, because you do not have nearly the amount of information they have. It’s not that they’re withholding the facts from you, but you’re just not as close to it. I find that very frustrating.” A second director agreed: “I think where the board gets caught, interestingly enough—and the board will probably figure out how to fix this—but it got caught relying far too much on the top guy to tell them what’s going on.”

A third director itemized specific aspects of the challenge that directors face in judging the validity and veracity of what management tells them; he also described the changes his board had implemented in response to a recent crisis: “It was significant in terms of information that we requested and management began to bring forward: the kind of information, the way it was brought forth, the form in which it was presented and the amount of time spent on some kinds of reports rather than others. We didn’t change the board structure or the committee structure. But we changed the info flow and the feedback and the transparency, one might say, between the board and management on certain issues.”

Directors do not merely have difficulty assessing the answers they get from management; they also have trouble knowing which question to ask. “A board only knows what it’s told. You can ask a question and be given an answer—but maybe it’s not the right question, or maybe the answer is true but doesn’t exactly get you where you need to go,” one director explained. “But more fundamentally, management basically provides the material at a board meeting, and if you don’t live day to day in the company, you’re not

going to know whether in fact you are hearing all the relevant aspects of it, the good, the bad, and the ugly. You're not going to know. And I've got to tell you, I've lived through too many of those."

So what can directors do to achieve greater understanding and deeper insights? Our directors discussed two approaches. The first was, as they put it, to "dig deeper" in discussions with management. "We always run with this concern that we don't want to manage the company. But we want to direct the company. . . . Asking detailed questions to understand more fully what's going on in a company is, I think, a requirement to be an effective director, not managing," one director told us. He added: "I have no insight about what we should do until I have significant insight as to what's really going on, and you can't get that by somebody doing a PowerPoint presentation."

Such comments imply that, to be effective, directors must be willing to keep pushing and questioning until they are confident that they thoroughly understand the issues involved in any decision or assessment they make. As we shall see, a complication of this approach is that it is off-putting to management to be pressed for answers. And, as we shall also see, directors want to maintain a cordial relationship with management.

A second approach—the two are not mutually exclusive—is to seek sources of information and knowledge beyond the management team. As one director put it, "Boards need to somehow find broader sources of information, so they're not relying on one or two people." Another suggested that directors need to seek out company stakeholders other than management to talk to: "Whether it's once in a while meeting with shareholders, once in a while meeting with the representatives of the employees, whatever, I think it's really important, particularly in difficult times like we are in, and are going to be in for some time, for the board to see actual underpinnings of the company."

A third director advocated seeking broader sources of information but acknowledged that such approaches eat up time: "There is no substitute for time spent meeting with management of the different divisions or sectors that are the next level down the corporate ladder, having them present directly to the board, visiting operations, . . . getting in the field, getting a sense of operations—not interfering, but understanding on a more hands-on level."

As this comment indicates, digging more deeply takes time, and directors already face constraints on the time they can make available, both for preparation and for meetings. The directors we interviewed seemed willing to invest the time needed, but at some point even they will encounter limits on the time they can devote to gaining greater understanding. Furthermore, as our informants noted, it is important to be sensitive to management's feelings, and to find ways to seek more profound understanding of the company without putting more strain on their relationship with management.

## *The Relationship between the Board and Management*

When directors spoke of management, they were often implicitly referring to the CEO. Meanwhile, however, they were aware that the board's relationship with the CEO is impacted by its relationships with other senior executives.

According to our informants, the board's relationship with management has several dimensions. Perhaps the most obvious, in their eyes, is the division of decision-making responsibility between the board and management—what both parties call “the line between the board and management.” This line is not drawn in concrete; it is more like a line drawn on a sandy beach, according to these directors, because it can be erased and redrawn elsewhere in response to circumstances.

One factor that affects the positioning of the line is the nature of the business challenges that the company faces. As one director told us: “[At one company that] has gone through some recent challenges, I would say the board started at a high level, and, with the challenges the company has had, it descended into deeper and deeper, longer meetings, and deeper involvement in the business. And in that case management is trying to figure out quite how this works. So the board and management are sort of working with each other, with respect and a high level of collegiality, but are also a little wary of each other as we try to redefine what the role is and how deep we get and how deep we don't get.” Another director was more succinct: “Even when a company is in trouble, the board gets more involved but still is limited in what it can accomplish other than replacing the CEO.”

A second factor that influences where directors draw the line is their degree of confidence in the CEO. “Where the CEO hasn't changed recently, my sense is—and my own experience is—that committee activity, board activity and board leadership, as opposed to CEO leadership, are still on the immature side,” one experienced director observed. “Where something cathartic has happened—there have been life-threatening experiences, CEOs change, maybe new people have come onto the board—my sense and my experience is that [board activity is] more advanced, and people take it more to heart and tend to see the value of it.”

And when the board is seriously challenged, the need for information also becomes more acute, as another director explained: “I think there will be more demand for more information in particular areas when a company is being challenged. And the board members try to ask more insightful questions, to be supportive and helpful to management in making their decisions. I think we've been doing this well at [company name] because [the CEO] encourages it, but still we may have to put more pressure on him.” As this comment indicates, reciprocal attentiveness to the emotions stirred up on both sides is another important aspect of the relationship between the board and management.

When directors set out to press management for more information, they report taking pains to do so tactfully and to communicate their continuing confidence in management.

As one director recounted: “When [management] walked in and sat down around the edge of the room, I said, ‘Folks, we’re very aware of all the work you’ve done. We’ve had a great review of all that. But there is an enormous amount of information here. You all, we know, have made very significant decisions to get to the conclusions you’ve come to. We suspect they are the right decisions. But the only way we will know, and be able to put our judgment on that, is if you’ll permit us the opportunity to test you in many ways during the next couple of days of discussions, so that we can get through the same small knotholes and decisions you did, in the same way that you did. And you’re going to need to be patient with us, if you’ll do that with us.’ They did, we did, and we got to a very common ground. But it took a lot more intense discussion, and an environmental change between the management and the board that says asking questions, probing deeply, is not bad, it’s good.”

The same director described his delicate dealings with individual managers: “I go very close to the line, I know that. But seldom have I crossed the line where I said, ‘Hey, Mike, I think you ought to do this,’ or ‘John, you ought to do that.’ But I do constantly inquire of them what is going on. I cross off the input that I get from all the different places, and where it’s not matching up right for me, I go back and say, ‘Hey, this isn’t fitting yet. John, this doesn’t sound good. I think you ought to go look at this, because I’m concerned that you think this will happen and I’m concerned that this is what’s really happening.’ And I think that involvement is necessary. Look, I’m not smarter than the people that are managing this day-to-day. But I’ve got the benefit of not being burdened by having 100 meetings on my calendar day-to-day, and I can take advantage of what it is I learned over 40 years and then help them see things that are getting by them that they don’t see just because they’re on the playing field.”

Yet another board member described what happens when a board lets the CEO dominate the discussion: “I think that what happens is you get this kind of groupthink on the board, where the CEO sets the agenda and after a while people stop objecting.”

According to all these directors, what actually transpires in a boardroom depends not only on the role the board adopts, implicitly or explicitly, or the understanding of the company the board gains. It also depends on how successfully the board builds a constructive relationship with management, especially the CEO.

Many directors emphasized that the board’s relationship with management depends heavily on the leadership of the board itself. Although there have been many calls in recent years for American companies to separate the job of board chair from that of CEO, most of the companies whose directors we interviewed had gone a different route. They had created the position of lead director, typically occupied by an independent director, whose main job was to lead discussion when management was not present.

As a number of our interviewees pointed out, selection of an effective lead director was important in improving management-board relationships. For one thing, a skilled lead director can assure open communication with management. “I’m really happy that on all my boards we have a lead director who can be very blunt with the CEO,” one director

said. “And if people don’t have a person like that on the board, or as part of the board structure, it must be set up.” Another director expressed a similar perspective: “Lead director is an idea whose time really has come, and should come. It gives a focal point for the board and is a good information conduit. And board members who don’t want to say to the CEO, ‘Look, I think you’re all wet on this idea’ can tell the lead director.”

The lead director, we were told, can also enable the CEO to raise sensitive issues with the board without damaging their relationship with him. “If you want the CEO to be transparent, . . . then you can’t take every little thing that he tells you is wrong in the company and then drill down on it and beat him up on it. That’s what gets management sometimes gun-shy about letting boards really know what’s going on,” one director said. “There’s a role there for a lead director, to help the management and the communications between management and the board be totally transparent, but on the other hand not be abused.”

Having a lead director, we were told, also helps boards deal with crises. When a board faces suddenly enhanced complexity and uncertainty, such a leader can help guide them. “Most people have lead directors now or presiding directors, or some such person. And I think that is one area that, in this crisis, had needed to be made a real job,” one director told us. “And boards who do well in this crisis are ones that are well led. It’s not just the naming of such a person, or presiding over [executive sessions]—it’s much, much more than that.”

The lead director typically works closely with the CEO on behalf of the board to assure that the board’s agendas include issues of importance to the board, and that the board gets the information it wants. “Several directors say to the chairman of the governance committee, who might also be the lead director, . . . ‘Look, we’re concerned about this. Would you bring it up with management when you have your regular chat, and ask management to set aside some time at the next board meeting to discuss whatever the issue is?’” one director explained. “I think that might work. I don’t think individual directors doing things is likely to work. But I think working through the governance committee or the lead director, . . . I think management would be responsive if it’s done that way.”<sup>2</sup>

### *The Board’s Activities*

The directors pinpointed three activities that they believed their boards should address differently in the future: company strategy, management development and succession, and risk management. (Obviously missing from this list is compliance with laws and regulations; since passage of the Sarbanes-Oxley Act, and partly because of it, the directors believed that their boards were already handling these matters well.) When

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<sup>2</sup> For more about the board’s relationship to its CEO, see Stephen Kaufman, “Evaluating the CEO,” *Harvard Business Review* (October 2008).

discussing these activities, the directors often related them to redefinition of the board's role.

***Board involvement in strategy*** The directors were clearly in agreement that the task of defining company strategy belongs to management; the board's job is testing, assessment and approval. As one director put it: "Boards really shouldn't be setting strategy—management should be setting the strategy. But, certainly, boards should be there to keep management honest, and to ask the right questions and to really figure out how we want to do it—appropriate milestones, appropriate questions, appropriate dashboard, to continue to monitor how things are going."

Another interviewee drew on experience to express a similar perspective: "In my experience, the strategy comes from management, not from the board. The board hears about the strategy, approves the strategy, insists that there *is* a strategy—but it is the management's strategy, not the board's strategy. The board approves it, like a lot of things, but in my experience I haven't seen a board craft a strategy."

Directors did have ideas about how the board might oversee strategy better. Several wanted to see the board press for a longer-term perspective in strategic planning. As one director said, "In terms of things that I think could be better, I still think—especially in this financial crisis—that the long-range planning tends to get put aside too much. And it's very hard to see really where we're going for more than about 90 to 120 days. We have plans and so forth, but I just think the long-term—where are we going to be in the three-to-five-year range?—I think that is still not paid enough attention to."

Some interviewees disagreed on the grounds that, in a financial downturn of this magnitude and scope, boards ought to focus on the short term, particularly in the financial-services industry. "At this time, there's a focus on understanding the nearer-term implications before returning to long-range planning," one said. "In fact, we actually decided that. We do a long-range strategic-plan offsite every spring, and we decided that it really doesn't make sense for management to spend a lot of time between now and then trying to gin up another five-year plan or three-year plan, and they would be better off focusing on nearer-term, and making sure that we see the opportunities in the near term. Because any market dislocations like these, or economic dislocations, there are opportunities as well as risks, and so we really want them thinking about that."

Other directors argued that their boards ought to be more proactive in shaping discussions with management about strategy. "And so what I am starting to see at some boards is the board is being more proactive, and perhaps a bit more directive, about framing the strategy discussion," one director reported. "So what do I mean by that? Management may want to talk about a series of interesting new investments and initiatives as the centerpiece of their strategy discussion, but the board may want to talk about competition, relative performance, other issues like that. So I'm starting to see boards say, 'Let's look at an outline of how you, management, want to discuss the strategy.' And the non-executive chair, the lead director, would share that with the other directors and kind of solicit input. It would sometimes be face-to-face, sometimes by phone, and [they

would] say, ‘OK, does the strategy discussion that management is proposing, does that fulfill your needs and answer your questions, or are there other topics that you want to talk about?’ And that way, the board perhaps asserts more control over the direction and the composition of the strategy discussion, as opposed to what management solely wants to talk about.”

A number of directors asserted that how a board involves itself in strategy ought to depend on the company’s circumstances. One interviewee observed, for example, that boards’ involvement in strategy should also depend on the experience and knowledge of the directors themselves: “Board role in strategy is going to vary a lot by industry and by director ability to contribute on the strategy side. So in a leading-edge, high-tech company, most directors are not going to understand the market, or the products or the technologies, well enough to play a substantive role in terms of contributing to strategy. The best they can do is make sure that management in its discussion and application of the strategy is internally consistent and is true to the things that they believe about market and strategy.”

In sum, in spite of differences of opinion, these directors considered it critically important to assure that management develops a strategy that the board can in turn assess and approve, and that can serve as a template against which to judge company performance. And they were searching for better ways to do so.

***Involvement in management succession and development*** The directors to whom we spoke considered a successful transition from one CEO to the next to be the board’s critical responsibility. “I think succession planning—thoughtful, careful succession planning—is critically important,” one director said. “And not just at the juncture whereby succession needs to pass, but years in advance to make sure there is depth of understanding.” Another director used McDonald’s as an example to argue that boards should always have a ready supply of CEO candidates in-house: “I think a board should never be in a position where they have no candidates in-house for the CEO. The poster boy for really good board planning on management succession is McDonald’s. Two guys die, and within 18 months! Remember that? Heart attack, cancer. Each time, they had a guy ready to go, and they’re doing fine now. Here you are, three CEOs in 18 months, tragically, and the third guy, I think, is still in charge. That’s the management succession that you need to be doing.”

A number of directors acknowledged that their own boards need to improve their effectiveness in this arena. “I have some experience with that, as I’ve been brought into three CEO positions now from the outside,” one said. “And what I found behind me upon arrival is a real dearth of detailed succession planning from the board.” Another described efforts to avoid other companies’ mistakes: “[Boards are] spending a lot of time on succession planning because we know a lot of companies haven’t done a good job with that.”

One director noted that one impediment to good succession planning is limited opportunity to expose up-and-coming managers to the board: “There are relatively few

companies that have had the luxury, in this period of enormous growth and highly specialized activity, to broadly expose somebody through cycles to enough of what's going on that you'd be confident he or she could take the seat." A second director noted the difficulty of assessing how well the CEO, who actually made the management-succession decisions, was doing so: "How do we really evaluate the CEO, and, more importantly, what's the CEO's succession plan beyond just putting a book together and letting it gather dust on the shelf between meetings?"

Another director explained why boards tend to defer this issue: "I'd say to some extent with all three companies, now that we have relatively new CEOs, we're probably less into a succession-planning dialogue because, at least right now, there's nothing imminent on the horizon other than the proverbial get-hit-by-a-truck kind of problem. And the real issue is much more of really beginning to identify some potential leaders deeper in the organization."

Often, thinking about succession and management development was deferrable. In a context in which boards typically have more tasks than time, the board is understandably relieved when a set of issues can be deferred. But deferring the topic can be problematic, too often leading to time-pressured recruitment from the outside. And as has been pointed out, selecting successors from outside the company can be problematic and costly.<sup>3</sup>

**Risk management** Another activity uppermost in the thoughts of the directors was, unsurprisingly, risk management. They had witnessed other companies, and in some cases their own, fail to anticipate and control risk during the financial decline. One director spoke for many: "I think now there is more and more concern that risk has to be a board-level activity." Though there was consensus on this point, opinions varied about who should manage which risks. One point of view was that all risks, even broad business risks, are the responsibility of the audit committee. "I would say, yes, risk assessment is an area that has taken on a lot of importance over the last couple of years," one director told us. "I've seen it handled quite effectively within the context of the audit committee—raising that to a higher level of importance, perhaps, among the charter responsibilities—and, as you sort of calendarized the charter to figure out what you're going to do at each meeting, whether it's telephonic or face-to-face, I've seen and I've done it, because I chair the audit committee at [company name]. And we have raised the profile of risk assessment, particularly in the food industry, with all of the reputational issues that that could bring to you if somebody gets food poisoning because the cheese on the pizza isn't good."

An alternative point of view is that only boards facing substantial financial risk need a risk-management committee. "Just judging by what I'm reading and hearing, the knee jerk seems to be 'Let's create a risk committee and we got it done.' And I think that's appropriate for [a large bank]. I don't think it's appropriate for [manufacturing

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<sup>3</sup> For more about the board's role in management succession, see Joseph L. Bower, *The CEO Within: Why Inside Outsiders Are the Key to Succession Planning*. Boston: Harvard Business School Press, 2007, and Rakesh Khurana, *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs*. Princeton, NJ: Princeton University Press, 2002.

companies],” one director asserted. “I think it is a board-level, not committee-level, responsibility to go through the major risks—after all, they’re supposed to be in the 10-K every year. Go through the major risks and how the company is managing them, and what oversight and where it should be provided at the board level.”

Others insisted that the responsibility for risk management rests with the entire board because of the broad experience required. “I think a big part of that is to help the management assess risk,” one director said. “It’s one of the things that a good board can do, because of all the experiences around that table from various industries. They can also help a lot with identifying those so-called strategic risks. . . . They may not know the business as well as the management, but they can certainly help identify risk outside the company.” Another director made essentially the same point in more detailed terms: “Enterprise Risk Management [ERM] evaluations are good, but they tend to be somewhat superficial. I think where risk really engages in a company is down, to some extent, in the weeds, and the ERM kind of flies over the canopy of the trees. I think that too much has been put on the audit committee to assess risk, and I think that’s coming out of trying to fix yesterday’s problem of controls and Sarbanes-Oxley. I think we’re still focused there. So I think risk should be a component of every committee, and not owned by the audit committee. It should be more focused on financial and operating risk in addition to control risk.”

Still other directors observed that boards are highly dependent on their CEOs for judging risk. “I think my lesson is that ERM only goes so far, and that in the end I almost think what we depend on as shareholders—I’m going to step back from being a director, and then we can go back into the director’s chair—but as shareholders, with these big, complex companies that we have, what we almost depend on is that the CEO has an intuitive feel for risk,” one director said. “It, sadly, can’t all depend on oversight. But the directors are in a position to have a feel for the CEO’s risk intuition. And in the end, that’s a very valuable protective tool.”

Many directors acknowledged that the prevailing preoccupation with risk is a reaction to recent events. “In this economy, I think, first, it has changed what the board is focusing on right now,” one director said. “And I think the second thing that it’s done has just so heightened the sense of risk, unknowability and, frankly, vulnerability of any institution and the kinds of consequences that can come from decisions.” Others considered it vitally important to take a longer term and broader view of financial crises. “Now there’s no excuse. Everybody—financial business or industrial business—has to have risk management as a much more important function, partly because energy is a derivative, a financial derivative,” one seasoned director pointed out. “We were very fortunate, just to watch the derivative risk five years ago, build a risk-management system, and now we’re taking it from commodities and moving it to money, and then moving to do geopolitics, and trying to come up with enterprise risk understanding that I think is respectably advanced in its thinking. But it’s because we started on this about five years ago.”

Still other directors agreed that risk management is something that boards should always have concentrated on: “I think risk management in general has to be much more on the

radar screen. And financial risk—even in how you manage your cash, how you manage your investments, pension funds and other things, if there is such a thing, and all those are going to have to be re-looked at,” one director said. “My sense is that a lot of management teams and boards gave lip service to risk, maybe looking at the more obvious risks. But I think the lesson of the last two years is: there are a lot of risks that we haven’t really thought about and we need to consider.”

These directors clearly believed that it ought to be a priority for their boards to focus on business risks, especially financial risks. But they disagreed about how to do so, or about how doing so would mesh with their other activities. This uncertainty is unsurprising, since the magnitude of financial risks is a recent discovery for many boards. As often happens when an institution confronts a new set of issues, some of the directors’ worries may turn out to be excessive, or to have to be addressed in a way that will not compromise their other activities.

### *What Was Not Said*

When a study employs open-ended questions, as this one did, it is often informative to identify the topics that respondents rarely raised. This was a particularly interesting exercise in the case of these directors, who barely mentioned two matters high on the governance agendas of shareholders and the organizations that speak for them, as well as those of regulators (especially the SEC): executive compensation and the relationship between boards and shareholders.

Shareholders’ most significant complaints about executive compensation are (1) that senior executives are paid too much, and (2) that their pay often seems unrelated to their own or their companies’ performance; some CEOs who have performed poorly are even granted lump-sum payments on departure. The directors we spoke to were aware of these objections, but less personally engaged with them than with the topics we have already discussed. We cannot be certain why this is so. One possibility is that the shareholders of their companies are not indignant about compensation. If so, these directors might see the debate about executive compensation as a matter of immediate concern to companies other than their own.

When we speak of the relationship between boards and shareholders, we refer to various attempts by shareholders and the organizations that represent them, and by regulators, to enhance shareholder influence over the company whose shares they own. Some of these actions are intended to reform the election of directors, notably efforts to abolish staggered boards, to revise majority-voting rules and to give shareholders access to the company proxy statement (as a new Delaware law provides and as the SEC is proposing). Other shareholders are simply asking for more direct communication with the board.

Traditionally, boards have left such matters either to the company’s legal staff, in the case of shareholder proposals, or to company executives (the CEO, the CFO or Investor Relations) in the case of communications. The underlying assumption is that it is preferable to let full-time employees speak for the company; there is more than a hint in

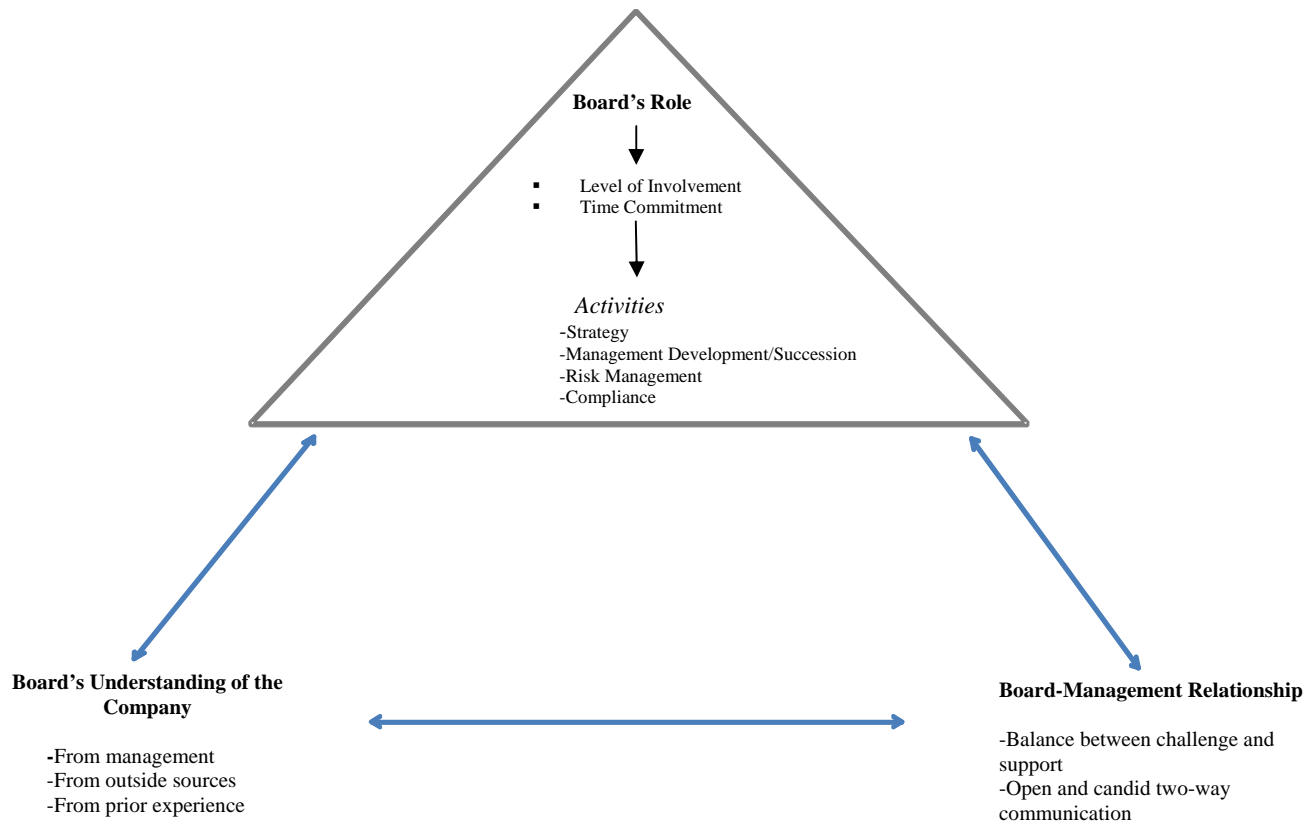
this stance that executives, as well as many directors themselves, fear that part-time board members could prove ill-informed or undisciplined in communicating with shareholders. This mindset may explain why even the experienced directors with whom we spoke did not consider the question a serious matter for their boards.

We believe, however, that these two issues cannot be ignored, if only because they affect public perceptions of business and therefore its social legitimacy.

## The Key to Improving Boards

These intriguing omissions aside, what is most noteworthy in our interviews is the overall thrust of the directors’ thoughts on what makes for effective boards. In their view, effectiveness has little to do with regulators and laws and everything to do with what transpires within individual boards. The determinants that shape boards’ behavior, in the eyes of our interviewees, are illustrated in **Figure 1**. What really matters, they told us in a variety of ways, is for each board to achieve clarity about its role—that is, about the extent and nature of its involvement in strategy, management succession, risk oversight and compliance.

**Figure 1**  
**Three Interrelated Issues**



This conception of the board's activities has several important implications. If, as our interviewees insisted, each board's effectiveness is directly attributable to its activities, it follows that boards have a responsibility to define their own roles with precision, and to decide how to perform those roles in light of the nature of the firm, its industry and its particular challenges. Furthermore, if boards are reluctant to look to others—whether regulators or other boards—for much guidance in deciding on their goals and activities, they must expect to invest extended time in hard-headed discussions of both, leading to concrete and actionable conclusions.<sup>4</sup>

Whatever the choices a board makes about its role, they must be consistent with the members' shared understanding of their company. Furthermore, though legally the board wields the ultimate power in the corporate hierarchy, as a practical matter it can execute its role successfully only if it develops and maintains a sound relationship with management. Such a relationship calls for explicit agreement, on the part of the board and management, about the role of each in leadership of the company. It also requires open two-way communication and mutual respect between the two parties.

To be effective, in sum, boards have to maintain a delicate balance in their relationship with management. They must be challenging and critical on the one hand and supportive on the other. They have to sustain an open and candid flow of communication in both directions. And they must seek sources of understanding outside management without offending management.

None of this is easy. It is all essential, however, for effective governance. Failure to achieve any component of this prescription can undermine the effectiveness of the board. And ineffective boards have contributed to the corporate failings that have recently been far too conspicuous on the landscape of the American economy.

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<sup>4</sup> For a complementary perspective see *Back to the Drawing Board: Designing Boards for a Complex World*. Boston: Harvard Business School Press, 2004.