BOARDS THAT EXCEL

Candid Insights & Practical Advice for Directors

B. JOSEPH WHITE

More Praise for *Boards That Excel*

"The book provides insightful discussions of the necessary skills, attitudes, and knowledge that any board member must have. It gives well-structured coverage of best board practices. It also offers contexts for those practices by including insightful personal reflections on the role a board plays in organizational leadership from one who has thought deeply about it and actually experienced it in many important organizations."

—Paul Danos, Dean and Laurence F. Whittemore Professor of Business Administration, Tuck School of Business at Dartmouth, and Director, General Mills

"Joe White and Dave Gray were the first nonfamily board members in our company's 100-year history. We attribute much of the growth and success to the insights and principles offered up in this outstanding book. Joe does not deal with the theoretical but, rather, the real and often difficult issues that boards and directors grapple with every day."

—Dan Gordon, Chairman, Gordon Food Service

"*Boards That Excel* is an essential resource for *all* directors, new and experienced, of both for-profit companies and not-for-profit organizations. It's the perfect blend of research data and real-world best practices and experience that can drive effective governance in an ever-changing environment."

—Mary Kay Haben, Director, Hershey and Bob Evans, and Trustee, Equity Residential

"*Boards That Excel* is a great book for students, investors, and directors to understand the essence of what makes companies tick. Joe White's insightful thoughts and observations can help anyone who reads them understand the impact directors and corporate governance principles can have on the corporation."

—Rick Hill, former Chairman and CEO, Novellus Systems, and Director, Arrow Electronics, LSI, Cabot Microelectronics, Tessera, and Planar Systems

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"Joe White is a leader in the increasingly important field of corporate governance. He is sought out as an advisor to major corporations, is a thought leader among academicians, and is an active participant in the boardroom. His book should be required reading for those presently sitting in the boardroom, those expecting to participate in the future, and those seeking the best thinking in the corporate governance world."

—Sheli Rosenberg, cofounder and former Director, Center for Executive Women, Kellogg School of Management, Northwestern University, and Director, Equity LifeStyle Properties, Nanosphere, Strategic Hotels & Resorts, and Ventas

"Joe White's book serves as a primer for new and seasoned board members. It is filled with relevant and personal anecdotes that provide valuable insights on how to function effectively on boards. It is a must-read for anyone who has said yes to a board invitation—and it should be handed out by those doing the asking."

—Tim Solso, Chairman, General Motors; Director, Ball; and former Chairman and CEO, Cummins

"As stewards of owners' interests, effective boards guide corporations to be creators of value. *Boards That Excel* walks readers through many critical leadership and governance issues based on the author's wealth of real-life experiences and academic knowledge. It leads caring corporate stewards to develop a comprehensive agenda on which excellent boards and directorships are built. Readers will agree that this is a 'must keep' reference book and will turn to it regularly."

—Bernard Yeung, Dean and Stephen Riady Distinguished Professor of Finance and Strategic Management, National University of Singapore Business School, and President, Asian Bureau of Finance and Economic Research

"Joe White's *Boards That Excel* is an in-depth effort to reconcile the importance of governance with the ultimate mission of a board of directors. Perhaps the most relevant of many insights in the book is the recognition that performance and return on investment are ultimate measures and that superior governance contributes to those positive results."

—Sam Zell, Chairman, Equity Group Investments, Equity Residential, Equity LifeStyle Properties, Anixter, and Covanta

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To Brian and Leisa White,
Audrey and Darren Imhoff
and my grandchildren—
Bernie, Hattie, Lizzie, Caleb, and Owen.

In the hope that you will live in a world
of companies and organizations governed
by wise directors and capable boards.

With love,

B. Joseph White
Champaign, Illinois
August 2014

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INTRODUCTION

Pay It Forward

The Purpose of This Book

We are products of our experiences. Two of mine have greatly influenced the views about governance expressed in this book. In both cases, I was there at the creation. The principals involved had high aspirations and a stewardship attitude toward governance. Results over more than two decades have been strong and positive.

My boss, Dean Gil Whitaker of the University of Michigan Business School, walked into my office in Ann Arbor with a guest. "Hi, I'm Paul Gordon," he said with a deep voice and a big smile. "We have a little family business in Grand Rapids. I'm wondering if you could help us with governance and a few other things."

Paul was a graduate of the school where I was a professor and associate dean. He was in his mid-sixties when we met. Paul had recently begun to think deeply about the long-term future of Gordon Food Service (GFS), the growing private company he headed with his brother, John. Gil thought I might be able to help Paul because I had just returned to the school after a six-year stint in the real world at Cummins, Inc., the diesel engine and power systems company in Columbus, Indiana.

Paul and I hit it off immediately. He told me about his family and the food service business. I related some things I'd learned at Cummins about quality, leadership and change. Together, we visited GFS's new, automated distribution center in nearby Brighton, Michigan. A few weeks later, I went to Grand Rapids and met his brother, John, and their three sons in the business. I liked them and what I saw. The feeling seemed to be mutual.

I learned later that Paul was having a similar conversation with another person, David L. Gray. Dave also passed muster with the Gordons. So, at Paul's and John's request, Dave and I began to work together to help the Gordons create a modern board of directors and an orderly senior management succession process. Together, we became the first outside board members in their ninety-year old, family controlled company.

That was twenty-seven years ago. At the time, GFS had revenues of $400 million, two distribution centers, a few retail

Gordon Food Service (private)

1987

- Revenue $400 million
- Two distribution centers, several stores
- Three-state market

2014

- Revenue $10 billion
- 20 distribution centers, 150 Marketplace stores
- Eastern half of U.S., coast-to-coast in Canada
- #34 private company

cash-and-carry stores, and a market area comprised mainly of Michigan and northern Ohio and Indiana. Today, revenues exceed $10 billion. The company has more than 20 distribution centers and 150 Marketplace stores that serve much of the U.S. and Canada. In 2013, GFS was the thirty-fourth largest private company in America in *Forbes* magazine's annual ranking. In December 2013, the employee profit sharing plan's assets exceeded $1 billion for the first time. It's been a remarkable business story.

Sam Zell called me on a summer day in 1993. By then I was dean of the University of Michigan Business School, Gil Whitaker's successor. I knew Sam; everybody at Michigan did. His one-page biography at the time began, "Sam Zell was born in Chicago and graduated from the University of Michigan." Sam liked to point out that the richer he got, the more interested the University became in him. So it was a surprise for *him* to be calling *me*.

I picked up the phone in my office.

"Joe," said Sam in his gravelly voice. "We're creating a new public company—a real estate investment trust. We believe this is a time of tremendous opportunity in the apartment business. We'll be doing an initial public offering soon. We're assembling a board of trustees. I'll be chairman. We'd like you to be a trustee."[1]

I knew, liked and trusted Sam. I recalled his sitting in my university office recounting how he and his late partner, Bob Lurie, got started in the real estate business in Ann Arbor when they were students. Sam and Bob worked briefly for Don Chisholm, a local real estate entrepreneur. It didn't take them long to figure out that they'd rather be owners than employees. So they began to buy apartments in Ann Arbor. Forty years later, Sam recounted to me the purchase of each property *in detail:* street address, owner, price, down payment, and terms of the mortgage!

After graduation, Sam and Bob set up shop in their hometown of Chicago. Over the years, their private firm, Equity Group Investments, became a major owner of apartment properties across the country. They invested in other businesses as well. But apartments were their first love.

By 1993, Sam was a legendary real estate investor. While his public persona was arresting (e.g., as the leader of Zell's Angels, buddies who rode fast motorcycles in exotic places), it was clear that he had an uncanny knack for finding value in real estate. One of Sam's monikers was the "grave dancer" in recognition of his penchant for scooping up unloved properties at rock bottom prices and making big profits on them. He also ran first class companies.

It didn't take me long to do my due diligence on EQR. I was impressed by the game plan and by members of senior management I met. So I accepted the invitation to join the board. Thus began my first adventure in the governance of a major *public* company, Equity Residential, Inc. (EQR).

Twenty-one years have passed and EQR has thrived. At the time of the initial public offering in 1993, the company owned 25,000 apartments and had an enterprise value of $800 million. Today, EQR owns over 100,000 apartments in premier properties on the east and west coasts, has an enterprise value in excess of $30 billion and is an S&P 500 company. Annualized total shareholder return since the IPO has been 13%. Like GFS, EQR has been a remarkable business story.

Equity Residential (public)

1993	2014
• IPO	• S&P 500 company
• 25,000 apartments	• 100,000 apartments
• $800 million value	• $35 billion value ∘ 13% TSR/20 years

GFS and EQR have grown and thrived over the last two decades. So have I—from a novice director of GFS and a new trustee of EQR to one of both boards' senior members and, at EQR, chair of the corporate governance committee. During those years, I completed a decade as dean, was the University of Michigan's interim president, and served five years as president of the University of Illinois. I also served on numerous nonprofit boards and reported to two as the chief executive officer of major public universities.

Professional school faculty at top universities get a lot of opportunities to do outside work related to their academic specialties. You have to be selective in saying "yes" because the university limits the amount you can do and your hard-earned reputation is always on the line. What attracted me to GFS and EQR were the high aspirations that both Paul Gordon and Sam Zell had for the companies they headed.

"We've been around almost a hundred years," said Paul. "We need governance that will enable us thrive forever."

"We're going to be a prodigious user of capital," said Sam when the board asked me to be the first chair of EQR's audit committee. "Your job is to make sure our credibility with the capital markets is rock solid."

The Gordons and the EQR board took a risk on me. As a business school dean and professor and former Cummins executive, I liked business and knew a fair amount about it. But I was green as a director. I also took a risk on GFS and EQR. Over the years, people have asked me whether they should join a particular board. I advise them to do proper due diligence on the company or organization involved then answer this all-important question: How do you feel about having your reputation in the hands of the company's chairman and CEO? In twenty-seven years with two chairmen and two CEO's at GFS and twenty-one years with Sam as chairman and three CEO's of EQR, my comfort has always been high.

I owe a debt of gratitude to the many people who helped me go from being a novice board member to an experienced and capable one. At the university commencements where I presided as dean and president, I always asked the graduating students to thank those on whose shoulders they stood: parents and family, teachers, coaches, counselors, friends. Now it's my turn to do the same. I thank the directors and executives of Cummins, where I supported the board. I thank members of the several volunteer boards of the University of Michigan business school who helped us achieve great things while I was dean. I thank members of the university boards to whom I reported: the regents of the University of Michigan who appointed me interim president and the trustees of the University of Illinois who appointed me president. I thank my colleagues on the many non-profit boards on which I have served including St. Joseph Hospital in Ann Arbor, the National Merit Scholarship Board, the American Council on Education, Argonne National Laboratory, and currently the W.E. Upjohn Institute for Employment Research. I thank my colleagues on other corporate boards of which I have been a member, especially Kelly Services and its executive chairman, Terry Adderley, and M Financial and its chairman, Peter Mullin.

You can never pay back all the people who created opportunities for you and helped you learn and grow. But you *can* pay it forward. That's why *my purpose in writing this book is to share with directors the most important things I have learned about how boards can excel.* This includes how to be a good director, how to ensure board effectiveness and how to serve as a positive influence on the organization—for profit or nonprofit—for which the board is responsible.

My goal is to help less experienced directors move rapidly down the learning curve to become effective and responsible stewards of the companies and organizations they serve. I also hope that my insights will serve as a reminder to experienced directors of things they may know but have not put into practice.

I have a broader audience in mind also. Because the boardroom is a place of privilege and privacy, most people never experience it. Yet almost everyone—investors, employees, customers, suppliers and communities—is deeply affected by what takes place there. I hope I can demystify governance and help readers understand it better.

Let me say a word about my perspective on boards. As a director and trustee, I am a governance practitioner. As an academic who teaches business and law students about boards of directors, I am a constructively critical observer. A large body of research on governance helps inform my views in both roles. I say *helps* versus *informs* because *few governance studies produce findings that a director can embrace or a professor can teach as definitive.* In this book, I will highlight a few insights that rise to this standard. But on many governance questions—such as whether the chairman and CEO roles should be filled by one person or divided between two—research findings are equivocal. Knowing this has helped motivate me to share insights from my experience so others can decide whether, when and how they apply to situations they face.

I learned at a young age that boardroom decisions are highly consequential and can affect people in deeply personal ways. I grew up in Kalamazoo, Michigan, a paper industry capital at the time. My dad was employed by a medium-sized public company, KVP-Sutherland, the product of a merger of two local family paper manufacturing businesses. As a boy, I thought that Kalamazoo was the center of the universe and KVP-Sutherland was a permanent fixture in my family's life.

One morning I woke up and discovered I was wrong. There was a new name on the main building. Brown Company had acquired KVP-Sutherland. Soon my dad left the company. Later, the Brown Company operations in Kalamazoo had yet another owner: James River Corporation. Eventually, James River closed down the entire operation and laid off everyone who worked there.

Equally stunning is the story of another public firm that everyone in Kalamazoo considered permanent: the Upjohn Company. Upjohn was a powerful, independent pharmaceutical company. The founding family was generous to the community.

In 1986, Upjohn celebrated its 100th anniversary. The chairman, Ted Parfet, a man I knew and admired, stated at the time how much he and the entire company were looking forward to Upjohn's *next* hundred years.

Nine years later, Upjohn merged with Pharmacia of Sweden, which then merged with Monsanto. The new Pharmacia focused on pharmaceuticals, retaining the G.D. Searle operations of Monsanto while shedding its agricultural businesses. Three years later, Pfizer acquired Pharmacia and all that remained of the original Upjohn Company. Today, Pfizer maintains some manufacturing activities in Kalamazoo and a veterinary medicines research group that has has been split off into Zoetis, a new public company. But employment is down drastically and the beautifully austere Upjohn corporate headquarters, designed by Skidmore, Owings and Merrill in the 1950s, has been demolished and the site returned to its original state: an open field.

Boardroom decisions contributed to these sad outcomes for my hometown in the same way that decisions made at GFS and EQR over twenty-plus years have led—so far—to growth and prosperity. While I accept the inevitability of creative destruction in a market economy, I want boards comprised of directors who know how to maximize the prospects for success.

Boards that excel provide great governance to the organizations—companies and nonprofits—in their charge. In my experience, the bookends of great governance are high aspirations and strong results. We begin, next, with these topics.

CHAPTER 1

High Aspirations and Strong Results

The Bookends of Great Governance

What is great governance? This is a question that boards seldom ask. Perhaps directors assume the answer is obvious and everyone is on the same page. I don't think that's the case.

In this chapter, I offer my answer to that question. I make the case that the bookends, or starting and ending points, of great governance are high aspirations for and great results by the company or organization the board is overseeing.

Directors are sometimes like the stone mason who, when asked what he is doing, replies that he is constructing a wall. *Less often, they are like the mason who explains that he is building a cathedral.*

It's easy to get absorbed in the work of governance—attending committee meetings; discussing strategy, plans, and results; evaluating the CEO—and lose sight of the larger purpose of board work. There is plenty of wall construction in governance, but directors should always have an eye toward cathedral building over the long term. Asking and answering the question, "What is great governance?" can help.

Let me say a word about the importance of this question. When I was a dean at the University of Michigan, I chaired the business school's executive committee. It comprised senior faculty elected by their colleagues to advise the dean on the most consequential policy and personnel matters, especially faculty promotion and tenure decisions.

I learned many lessons in working with distinguished faculty over a decade. The most indelible of them came from Karl Weick, an eminent scholar and one of the world's great social psychologists.

"The best research begins with the best questions," Karl would remind us. Research methods are important, but what matters most is the question we are trying to answer.

"What is great governance?" is a best question for three reasons:

- *It's consequential.* A board bears final responsibility and accountability for the performance of the organization in its charge. It's popular to say that the buck stops with a senior executive—the CEO or president or managing director. But in fact, the buck ultimately stops with the board, so directors should have a clear and agreed understanding on what constitutes doing their job well.

- *It's difficult.* Is the proper measure of great governance nothing more than company or organizational performance? What are the proper performance measures? Can great governance be achieved simply by recruiting outstanding people to the board? Does the way they work together matter too? Is great governance assured if a board checks every box on good governance scorecards? If not, then what is required?

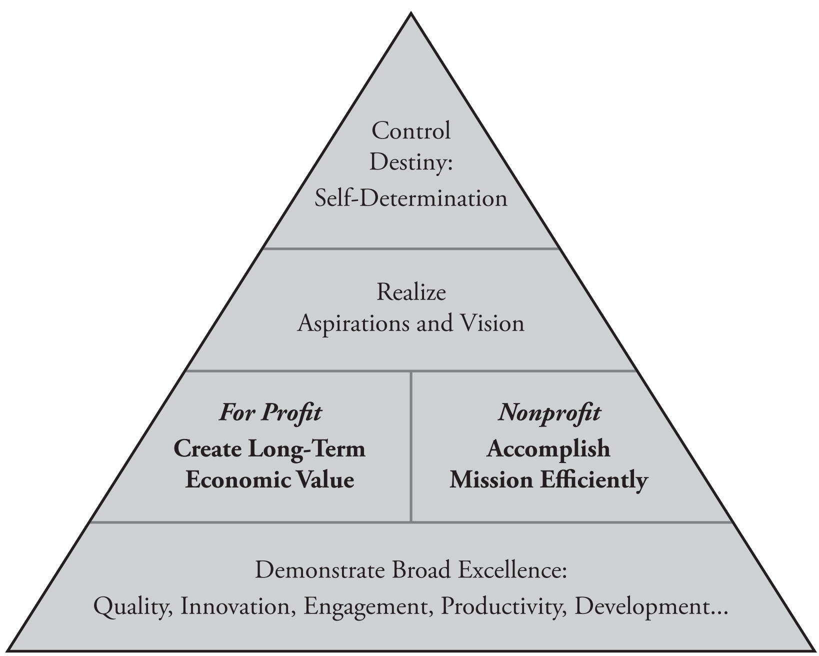
- *It's practical.* Shouldn't every board aspire to provide great governance? How can directors achieve this high aspiration without having a shared understanding of what it comprises? And don't those legislating, regulating, and evaluating governance practices need to understand the requirements of great governance?

The quality of governance is determined primarily by **results achieved** over a sustained period by the company or organization the board oversees. In the private sector in the United States, the standard measure of board performance is *economic value creation* *for owners over the long term*. In the nonprofit sector, the standard measure of board performance is *mission achievement with efficient use of resources*.

This view of governance is valid but incomplete. It is necessary but not sufficient. It fails to recognize the foundation on which value creation and mission achievement depend and the aspirations and vision they can help fulfill. It also ignores an aspiration shared by every board on which I have served: to maintain control of the organization's destiny.

My board experience has led me to a different way of thinking about the results of great governance. Value creation and mission achievement are central, but they are imbedded in the results that create them and the higher purposes they enable. A picture describes it best. I call it the Pyramid of Purpose.

Results of Great Governance:
Pyramid of Purpose



For companies, the most critical measure of board performance is *long-term economic value creation*, measured by market capitalization and total shareholder return for public companies and appraised or realized value for private companies. Return on invested capital over time is a good measure of economic value for both public and private companies. For nonprofit organizations, the most critical measure of board performance is outstanding *mission achievement* in sector-relevant ways in education, health care, human services, the arts, and so on. *Efficiency* is also important because nonprofit organizations are entrusted with resources to fulfill their missions and, usually, privileged with exemption from income taxes.

The foundation of value creation and mission achievement is *broad excellence*. This includes the company or nonprofit being admired and recognized as a leader in areas that matter such as quality, innovation, employee engagement and productivity, and leadership and people development. While no human enterprise is perfect, the customers or clients, employees, suppliers, communities, and others associated with organizations that demonstrate broad excellence value them highly. Some even love them.

That love is often based on the organization's aspirations and vision. For example, in his 2013 end-of-year statement to Apple employees, CEO Tim Cook reportedly wrote, "I am extremely proud to stand alongside you as we put innovation to work serving humankind's deepest values and highest aspirations." The best organizations provide a paycheck, of course, but they give people something more as well: purpose and ability to make a difference in the world.

Broad excellence, value creation or mission accomplishment, and achieving aspirations and vision provide the results, resources, and strength to enable the board to maintain control of the company's or nonprofit's destiny and its precious right of self-determination.

To be effective, directors must be crystal clear about the multiple purposes of the companies and organizations they oversee. Here's how we think about it at Gordon Food Service (GFS).

Start with broad excellence. For decades, John Gordon Sr. has reminded us, "Remember, our last name isn't Gordon; it's Service!" Sure enough, all around the company are visible reminders of the company's service performance: on-time deliveries, error-free orders, accident-free miles, and so on. Service excellence is part of GFS's broad excellence, which includes aggressive adoption of technology, strong employee engagement, high productivity, and development of leaders at every level. Broad excellence attracts customers and enables efficient operations, which together drive earnings—the foundation of economic value creation. Value creation enables the company to achieve its vision of providing customers the highest quality food-service products and services so they can be successful, contributing to the financial security of employees through profit-sharing and enabling the Gordon family to act on their deep Christian faith by funding missions through charitable contributions. The company's operational excellence and financial strength and its high aspirations and inspiring vision enable and motivate the board to maintain control of the company's destiny, allowing us to chart its course and maintain independence presumptively forever.

Here's an interesting illustration of the Pyramid of Purpose from the nonprofit world. Organization theorists have long been fascinated by the story of the March of Dimes. The reason is that if the sole purpose of a nonprofit organization were to achieve its mission, the March of Dimes organization would have closed up shop in the mid-1950s when its founding purpose in 1939—to combat polio as the National Foundation for Infantile Paralysis—was largely achieved with the invention of the Salk vaccine. But it didn't. Instead, leadership created a new and broader mission, one that wouldn't be so achievable! In 1958, the organization shortened its name to the National Foundation and set its sight on birth defects, arthritis, and viral disease, later narrowing its focus to prevention of birth defects, infant mortality, and premature birth.

Why did this happen? *Because nonprofit organizations and for-profit companies are about more than achieving missions or creating economic value.* They are bundles of competence and capability (at its best, broad excellence) that can be deployed to do useful things. Members and supporters become attached to these organizations because they provide structure, meaning, and relationships in their lives. The organization takes on a life of its own that can survive even beyond achievement of its mission. The leaders of these organizations, including the board, understand this, and like most of us, they are proud and independent. So directors strive to maintain control of the destiny of the organization for which they are responsible. Self-determination is success. Capitulation is failure.

In saying this, I do *not* mean to imply that every decision to sell, merge, or cease operations of a company or nonprofit is failure. For example, in 2007, Sam Zell (chairman) and the board of Equity Office Properties (EOP, a sister company to Equity Residential and at the time the largest owner of office buildings in the United States) decided to sell the company to Blackstone Group for $23 billion and Blackstone's assumption of $16 billion of debt. EOP ceased to operate as a company. This turned out to be a great governance decision by the board because 2007 was, in retrospect, the very peak of the commercial real estate market, and EOP's economic value was at an historic high. The board decided to seize that value and distribute it to shareholders. The sale of EOP was decidedly not capitulation. To the contrary, the board initiated the decision and maintained control of the company's destiny to the very end.

The four levels of the Pyramid of Purpose are interconnected and interdependent. That's why wise boards and smart senior executives strive to create a self-reinforcing, virtuous upward spiral of results across the four categories. The most challenging situation a board can face is a self-reinforcing, downward negative spiral that directors must arrest and turn around.

How does a board create a virtuous upward spiral? By setting high aspirations.

High Aspirations

> *Make no little plans. They have no magic to stir men's blood and probably themselves will not be realized. Make big plans; aim high in hope and work, remembering that a noble, logical diagram once recorded will never die, but long after we are gone will be a living thing, asserting itself with ever-growing insistency. Remember that our sons and grandsons are going to do things that would stagger us. Let your watchword be order and your beacon beauty. Think big.*[2]
>
> *—Daniel H. Burnham, Chicago architect (1846–1912)*

High aspirations are the foundation of high performance. This is as true for boards and the companies and organizations they oversee as it is for every area of human performance, team, and individual. High aspirations do not by themselves assure high performance. Execution matters too. Steve Case, founder of AOL, is reportedly fond of quoting Thomas Edison: "*Vision without execution is hallucination.*" But high aspirations are the starting point.

Burnham, the great architect of Chicago's stunning skyline and lakefront park system, had it right. Think about remarkable achievements. Here is an eclectic handful that I have observed in my lifetime:

- Landing a man on the moon and returning safely to earth
- Ending legal racial segregation in America and apartheid in South Africa
- Developing Singapore from a tiny, third-world country to an ultra-modern and prosperous city-state in thirty years
- Delivering letters and packages overnight anywhere in the United States
- Bringing together America's best college graduates and neediest kids in urban and rural classrooms
- Winning the Boston Marathon eight times in ten years
- Opening higher education—college and beyond—to people with disabilities
- Creating the iPhone

Though different in character, each of these achievements began with an aspiration that it could be, should be, *must be* done.

On May 25, 1961, in a speech before a special joint session of Congress, President John F. Kennedy set a goal of sending an American safely to the moon before the end of the decade. Eight years later, on July 20, 1969, Neil Armstrong landed on the moon and returned safely to earth.

On August 28, 1963, in a speech at the Lincoln Memorial that culminated a decade of hard work and leadership, Martin Luther

King Jr. called passionately and memorably for racial equality and an end to segregation. Less than a year later, on July 2, 1964, Congress passed the landmark Civil Rights Act of 1964. That same year, Nelson Mandela spoke of his hope for "a democratic and free society" while on trial in South Africa for his opposition to Apartheid. The system ended thirty years later with multiracial, democratic elections. Mandela, imprisoned for twenty-seven years under the old regime, was elected president.

Lee Kuan Yew led the development of modern Singapore as prime minister over three decades, from 1965 to 1990. On his watch, Singapore grew from third-world status to one of the most prosperous and modern nations in Asia. While some have criticized Lee as authoritarian and intolerant of dissent, Singapore's development in spite of its tiny landmass and lack of natural resources is a remarkable achievement and reflective of Lee's aspirations for the city-state.

While attending Yale University, Fred Smith reportedly wrote a paper for an economics class, outlining overnight delivery service in the Information Age. The paper may have received a C grade, but it was the origin of the idea that became FedEx. Today, the company has revenues in excess of $40 billion and employs 300,000 people.

In 1989, Wendy Kopp graduated from Princeton University. She did what thousands of Americans do when difficulty finding a job creates a crossroad in their lives: she became an entrepreneur. Reaching back to a paper she wrote for an undergraduate class, she began the arduous process of creating Teach for America. Since then, more than 38,000 participants have taught more than 3 million children nationwide.[3]

Jean Driscoll is an extraordinary athlete. She was born with spina bifida and grew up in Milwaukee. She was recruited to the University of Illinois to play wheelchair basketball. There, a coach, Marty Morse, spotted her as a high-potential distance athlete. The rest is history: between 1990 and 2000, Jean won the Boston Marathon, Women's Wheelchair Division, eight times in ten years.

Steve Jobs started a new company—NeXT—in the 1980s after being ousted from Apple, the company he founded, in a boardroom coup engineered by John Sculley, the man Jobs recruited from Pepsi to be Apple's CEO. (Jobs famously said, "Look, John, do you want to spend the rest of your life selling sugar water or do you want to change the world?") At an Educom conference around the same time, Sculley showed an Apple video, *The Knowledge Navigator* (watch it on YouTube). Almost twenty years later, with Jobs at the helm, Apple launched a revolutionary product: the iPhone. It was a product that no customer requested and no competitor imagined. It converted the fanciful product portrayed in *The Knowledge Navigator* into reality and supercharged the smartphone industry.

Shortly after leaving Cummins in 1987, I consulted with NeXT and had the unforgettable experience of being up close and personal with Steve Jobs. His biography by Walter Isaacson[4] captures Jobs perfectly. When it came to people-pleasing technology and amazing aesthetics, Steve *embodied* high aspirations.

I first heard the importance of high aspirations for organizations articulated by a wonderful leader, Bob Galvin, chairman of Motorola Corporation from 1959 to 1986. Bob said that the least leaders can do for their organizations is to articulate high performance aspirations. With them, he said, there's a shot at greatness. Without them, there's no chance. And leadership begins with the board.

Imagine if every board of every company and nonprofit organization in America explicitly agreed: *our aim is to provide great governance to the company or organization in our charge*. Imagine if they all understood what that commitment meant and then fulfilled it. The entire distribution of governance performance in America would shift higher. It would be a wonderful thing for companies, nonprofits, and the nation that would set an example for the world.

High Aspirations Governance: Two Examples

GFS and Governance

GFS had been around for almost ninety years when I met Paul and John Gordon in 1987. That was the year they decided to take steps to ensure quality governance, orderly management succession, and family control for generations into the future. It was not quite clear what those steps should be. Dave Gray and I helped the family identify and implement them.

GFS has been a remarkable story of growth and high performance in the ensuing twenty-five years. It has also been the story of a family dedicated to customers, employees, and service. The Gordon family practices servant leadership as a guiding principle in its stewardship of the company and expects the leaders of the company to do the same.

High Aspirations. The creation of governance arrangements for GFS was built on high aspirations for the company's future. Four stand out.

First, Paul and John wanted a governance structure that would enable the company to operate successfully for decades, even centuries, into the future—through multiple generational changes in family and management. They wanted, in other words, governance that would enable GFS to be a successful company *in perpetuity*.

We were acutely aware that few companies, public or private, achieve this goal. Corporate change and mortality statistics are sobering. Of the original companies in the Fortune 500 published in 1955, about 90 percent have disappeared from the list. This reflects the death of some companies, the absolute or relative decline of others, and the acquisition, merger, and loss of original identity of many. Few family businesses make it beyond two generations for a variety of reasons, including inadequate capital, scaling problems, failure to develop leaders, family desires for liquidity, estate taxes, and so on.

The stark reality of corporate mortality reminded us how important governance would be for GFS to have a chance to continue in perpetuity. Governance would have to anticipate and prevent or resolve all the issues that lead companies to lose control of their destinies, disappear, or die.

Second, Paul and John aspired for GFS to be a *high-performing growth company*. They wanted, somehow, to ensure the board would, every year, find the sweet spot between *stretch goals* and *acceptable risk*. This is a vital challenge for every board. Let me explain.

The board, as management's boss, must set goals, provide incentives, and monitor results to motivate high performance. Directors are also responsible for managing the enterprise's risk profile through project approvals and denials and balance sheet management. Deep financial strength is the best insurance policy against a company's becoming a mortality statistic. Excessive risk aversion leaves the organization lethargic and subject to decline and slow death (e.g., General Motors in the 1980s and 1990s). By contrast, extreme stretch goals and financial incentives can lead management to take excessive risks with crash-and-burn results (e.g., Lehman Brothers in the 2000s).

As entrepreneurial leaders of GFS, Paul and John managed this balance point personally. They constantly reinvested in the business by living modestly, thus minimizing their personal demands on company resources and enabling GFS to take prudent investment risks to expand and grow. Looking ahead to the time when the *board* would manage the balance point, they wanted to be sure the company became neither lazy and complacent nor excessively leveraged and risky.

Paul's and John's third aspiration was that GFS remain *focused on food service* and not be easily distracted by the siren song of unrelated diversification. They also preferred that the family resist the temptation to become passive investors. They understood that financial returns must be acceptable and the company would have to adopt and adapt to new technologies and circumstances. But the family had made its living for over ninety years in the food business, and they believed in its staying power. As Paul's wife, Dottie, liked to say, "It might be green beans or filet, depending on the times, but people will eat." Food service was not likely to become an obsolete industry.

Fourth, Paul and John made it clear that they wanted the company to have *strong leadership*. They understood the need for a board that expanded beyond the two of them and their sons in the business. But they had no appetite for management by committee. They emphasized the importance of a strong CEO. They also expressed the aspiration that GFS remain private, entrepreneurial, nimble, and intensely focused on customers and service even as it grew rapidly into a large and geographically far-flung enterprise.

Paul and John set high aspirations twenty-seven years ago as we wrestled with the task of creating modern governance arrangements. In summary, they sought

- a company that could survive in perpetuity;
- a high-performing growth company with stretch goals and acceptable risk;
- a company focused on food service; and
- a strongly led, entrepreneurial, service-oriented company.

Governance Structure and Philosophy. Dave Gray and I digested all this and, working closely with the Gordons, turned to the task of designing governance for GFS. We did homework on well-known and widely admired private companies, like Cargill and S.C. Johnson, that had survived beyond a couple of generations, grown, and performed well. But mainly, we thought deeply, envisioned the future through multiple generations of continued family control, tried ideas on each other, and gradually developed an approach.

Two main elements emerged: a two-tiered governance structure and a statement of philosophy from Paul and John to future generations of family and directors. I came to think of the structure and philosophy as hardware and software, the former comprising the *what* of great governance and the latter the *how* and the *why*.

The two-tiered structure was the result of long debates about the merits of a smaller versus larger board. By small, we meant no more than five people. Remember, just two people had governed the company for decades! The great attraction of a small board was that it could act decisively and move quickly. We also expected that fewer people would mean fewer politics. We figured out, in detail, how a five-person board could be appointed and operate in a way that maintained family control while ensuring a strong family or non-family CEO and bringing in at least one outsider (i.e., neither a family member nor company employee).

But as we thought about the governance requirements of a large and growing enterprise and the need to develop younger directors while retaining the wisdom of senior members of the board, having only five directors felt too limited. We considered creating a board of up to nine people but were concerned that control of the company might become cumbersome and politicized.

For a while, we were hung up on the horns of this dilemma. Then we arrived at a solution.

We decided that the governing body that would connect to the family and exercise control of the enterprise would be a five-person *board of advisors*. GFS would have a *board of directors* of up to nine members to directly oversee the company. To avoid duplication and confusion, we empowered the board of advisors to appoint themselves as the company's board of directors with the ability to appoint up to four additional directors. We sought the benefits of a small board to represent the family and control the company and a larger board to accommodate all of the talent required to govern.

The initial GFS board of advisors was composed of Paul and John plus Paul's eldest son, Dan, Dave Gray, and me. The board of directors was composed of these five plus Paul's and John's other two sons in the business, Jim and John Gordon Jr. Paul served as chairman and John as vice chairman of both boards. There were no committees; the board handled all matters.

In an exemplary act of leadership, Paul and John soon insisted that the five-person board of advisors be composed of their three sons, Dave Gray, and me (i.e., they gave up their positions as advisors). This membership of the board of advisors has remained unchanged for twenty-five years. We are preparing now for orderly succession during the next decade.

With regard to operating philosophy—the "software" of governance—Dave and I observed early on that Paul and John had strong views about business and life. Some had direct implications for governance and leadership, such as an attitude of stewardship about the company, a philosophy of servant leadership about the people, a very cautionary approach to debt, and a belief that the family should remain focused on the industry they knew. Other things were more personal, including their deep Christian faith, its guiding influence in their lives, and their desire to devote resources to spreading God's word around the world rather than living lavishly.

As Dave and I thought about the *in perpetuity* intention for GFS, it struck us that there would be future advisors and directors who would have no idea about the thinking of these entrepreneurial owners if we didn't capture and preserve it for future dissemination. With this in mind, we asked Paul and John to write a Letter of Wishes. The title was chosen carefully. The brothers wanted their thinking to be a guide and an inspiration, not a straitjacket or set of commandments. They understood that future advisors, directors, and family members would need freedom and flexibility to make sensible decisions for their times and situations.

The Letter of Wishes makes permanent Paul's and John's high aspirations. It is a profession of their Christian faith. It addresses their views about the purpose of the company, the perpetuation and growth of the business through future generations, the role of family in the business, and the structure, financing, and focus of the company.

EQR and Governance

When Sam Zell called me in 1993 about joining the board of EQR, he made it clear that the goal was to build a great public real estate company. As the board came together and began its work, we breathed life into the aspiration Sam had articulated and came to understand what it would mean for the company and its governance.

High Aspirations. Three things defined greatness for EQR.

- First, *being a leader in creating the new, public real estate investment trust (REIT) industry*. The industry had been tarnished two decades earlier by the failure of companies with too much debt and egregious related-parties transactions (deals that benefited company insiders at the expense of other shareholders). The industry needed a reset. The liquidity crunch experienced by private real estate companies in the early 1990s encouraged or forced many to go public and provided the reset opportunity. Sam was enthusiastic about what quality public companies could mean. For shareholders, he said, they would provide liquid real estate—attractive yields in the form of dividends and capital appreciation of real estate assets with the liquidity of public company stock. For the industry, public ownership held the promise of more rational capital allocation and a reduction of the boom-and-bust development cycle that had long plagued commercial real estate.

- Second, *capitalizing on the unique window-of-opportunity in the early 1990s to acquire real estate assets at great prices*. Distressed owners and the federal government were unloading an unprecedented amount of property on the market. Sam coined a mantra for the struggling commercial real estate industry in 1991: "Stay alive 'til '95!" Meanwhile, a new public REIT could build a once-in-a-lifetime portfolio of quality real estate assets at rock-bottom prices. There were two requirements: speed and capital. From the outset, being smart, decisive, and quick to act were EQR core competencies.
- Third, *being a leader in value creation*. This would require serving residents well, operating buildings efficiently, and buying and selling properties advantageously. Central to EQR's investment thesis was that strong demand and limited supply would drive earnings and value creation.

In these three ways—leading creation of a new industry, capitalizing on a unique window of opportunity, and creating value—Sam set high aspirations for EQR and its board from its birth as a public company in 1993.

Governance Structure and Philosophy. What were the implications for governance? In terms of people, EQR needed a board composed of individuals who could quickly develop mutual respect and trust and excellent teamwork because timely decision-making was of the essence. The board required a mix of real estate professionals and people with other skills such as finance and law. From the beginning, EQR had a majority of independent trustees. As board colleague Jim

Harper told me at the time, Sam counted on EQR trustees to have real, not just technical, independence. "Joe," he said, "Sam is a force. He's smart and opinionated and no shrinking violet. He'll be counting on each of us to think independently and speak up."

Structurally, the board had a chairman (Zell) and CEO (Doug Crocker). From the outset, the board had three committees: executive, audit, and compensation. Speed combined with good judgment would require an executive committee of Sam, Doug, and independent trustees in whom the entire board had confidence to make transactional decisions between board meetings. The audit committee was charged with maintaining high credibility with capital markets. This required quality financial reporting and internal control. The compensation committee was charged with designing pay for performance (i.e., incentives for management to focus on value creation to benefit owners). The 1990s were a period of great ferment in corporate governance. Accordingly, the EQR board established a governance committee to ensure board practices in the best interests of the company's shareholders and stakeholders.

It was apparent from the outset that the EQR board would be fast company. Zell, Crocker, then-CFO (now CEO) David Neithercut, and trustees like Errol Halperin, Sheli Rosenberg, and Jim Harper were among the smartest business people I've ever met. Over the years, I would tell trustee candidates, "You need to be quick on the uptake!" There has never been room for bureaucracy on the EQR board. Detail work is done in committees. The board focuses on the big picture (strategy, risk, acquisitions, and divestitures), financial matters (operating results and the balance sheet), and the leadership team, especially the CEO. Things move fast. But when a matter is not obvious or there are differences of view, Sam as chairman slows the action to get viewpoints aired, then pushes for decisiveness. This fast company process fits EQR's business situation (multiple windows of opportunity when the combination of scale and speed is a competitive advantage) and the people around the table.

There have been many chapters in EQR's history since 1993, including its governance. The board has been as small as nine people and as large as fifteen. The company's focus within a framework of strong value creation has shifted over time: from pell-mell acquisition in the early years, to operational effectiveness, to repositioning the portfolio from garden apartments across the United States to top-quality medium- and high-rise buildings in high barrier-to-entry markets on the east and west coasts. A strong balance sheet has always been a priority. The approach to development has been conservative. There have been only a few small missteps. For example, our adventures in the furniture rental business served to remind us what our core competence is and is not.

In line with Sam's high aspirations, EQR has been a leader over the last twenty-one years in creating a vibrant public REIT industry. Today, many investment advisors recommend that REITs be part of any well-diversified portfolio. EQR's value creation has been strong. Between the initial public offering in 1993 and the end of 2013, EQR's stock has quadrupled. REITs are required to distribute at least 90 percent of their taxable income to investors, so EQR has provided a steady stream of dividends to investors during two decades of paltry interest rates on bonds and savings accounts. As Sam predicted, the modern public REIT industry has made liquid real estate a reality for investors. EQR has helped lead the way.

Conclusion

Great governance produces strong results in the form of economic value creation for companies and efficient mission achievement for nonprofits. This performance is built on a foundation of broad excellence, facilitates achievement of aspirations and vision, and enables the board to control the organization's destiny.

Great results are built on high aspirations. This is as true for companies and nonprofits as it is for individuals. The first task of the board is to set such aspirations for the enterprise and itself.

With this done, directors need to develop the proper mindset with which to oversee the company or organization in their charge. A few guiding ideas compose the stewardship thinking that underlies great governance. We turn to them next.

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CHAPTER 2

Understand the Role

Stewardship Thinking

How a person approaches board service and thinks about the role of director really matters. Is there a proper metaphor to describe the job?

In my experience, the best directors think of themselves as *stewards*. They ensure careful and responsible management of the company or organization with which they have been entrusted. They are tough-minded monitors of and thoughtful advisors to those charged with managing. As representatives of owners and stakeholders, they insist on high performance and strive to grow value through prudent risk taking. As stewards, they consider matters not through the lens of self-interest but through the lens of what is best for the organization they oversee.

The metaphor of governance as stewardship yields many insights for a director. It has led me to think carefully about the privileges and responsibilities of board work. It has guided me in handling difficult situations like being a director of a failing company and managing a potential conflict of interest. It has helped me clarify what real director independence is and what director effectiveness requires. It has served as a reminder that in the leadership of organizations, there is a distinct difference between governing and managing.

I have been privileged to work with some wonderful directors. They were diligent in their work and wise in their judgments. They asked penetrating questions. They challenged management with high aspirations and stretch goals. They monitored results and rewarded high performance. They worked through knotty problems. They made tough decisions and took hard action when required. They helped renew the board by leaving when the time was right. They were great stewards.

Regrettably, I have also had experience with lesser directors. Their self-opinions were inflated. They expected to be served more than to serve. Their inattentiveness was embarrassing. Their contributions were of the Johnny and Judy one-note variety. Their disregard for boundaries undermined the chain of command. They folded in the face of conflict and controversy. They were poor stewards.

In this chapter, I share some guiding ideas for great governance—what I call *stewardship thinking*. Because I have experienced both the best and worst in governance, I know what a difference it makes when directors adopt a stewardship attitude toward their duties. The cornerstone of stewardship thinking in governance is to understand and embrace both the privileges and responsibilities of being a director.

The Privileges of Board Work

By any measure, being a director is a privilege. It's true that some people have abundant board opportunities from which to choose. But in my experience, most people are pleased and even thrilled to be invited to serve. If a primal human need is confirmation that "I'm here and I matter," an invitation to serve on the board of a good organization, for-profit or nonprofit, is one of life's confirming experiences.

Being a director includes the privileges of service, membership, protection, pay, and respect.

The Privilege of Service

We talk about "serving" on a board. Service is the mindset that directors and trustees should bring to their work. It is best described in the work of Robert Greenleaf on *Servant Leadership*.[5]

Greenleaf's view was that the best leadership begins with a desire to serve, not ambition for power, position, privilege, or prestige. Servant leadership is marked by humility, dedication, and deep recognition that what matters most is the organization and its people. Privileged positions are seductive. An attitude of servant leadership helps directors maintain proper focus in what can be a heady environment.

Servant leadership, like stewardship, reminds directors that they are not at the pinnacle of the organization; they are part of a strong base. The people of the organization do not serve the board; the board serves them. The future of the company or nonprofit is not assured with directors simply along for a prosperous ride; rather, every entity is at risk in a dynamic, competitive environment. In evaluating their own performance, directors must ask, "Has the company or organization entrusted to us thrived on our watch? Do we continue to control its destiny?"

The general concept of servant leadership is ancient. But it is associated in many people's minds with Christian beliefs, even though the New Testament and life of Christ do not appear to have been the conscious inspiration of Robert Greenleaf's work. I suspect the association is due to the revolutionary leadership example Jesus set by associating with the poor and ministering to those in need, regardless of status: "For even the Son of Man did not come to be served, but to serve, and give his life as a ransom for many."[6] Christian business leaders like the Gordons and Max DePree of Herman Miller embrace servant leadership and strive to make it a bridge between their work lives and their Christian beliefs.[7]

The Privilege of Membership

Board service is not just a group activity. It's a team sport. Membership on a board is satisfying because companies and organizations compete, and it's really fun to win.

The board is just the beginning of belonging for a director. She becomes associated with the organization and industry of which it is part. She develops networks of relationships that last for years with fellow directors and people who work with the board, including members of senior management and outside experts.

A good board bonds. Experiences over time create shared history and a collective memory of crises handled, obstacles overcome, problems solved, and goals achieved.

Does this focus on belonging imply that boards are, as some charge, clubby and incestuous, insulated and self-perpetuating? They can be. But one of the most impressive things about an effective board is its ability to manage competing values, like being simultaneously independent and collegial, critical and constructive.

Directors need both unity and occasional dissent. Too little unity and the board can't come to decisions and give clear direction to management. Too little dissent and groupthink sets in with all its perils. Too much unity and the multiple views and different takes of individual directors are lost. Too much dissent and the board dissolves into a destructive conflict.

It is important for directors and management to remember that while they all belong to the organization's leadership, their roles are distinct and different. The board governs. Management manages. The board's job in a company is primarily to represent owners. In a nonprofit, it is to represent stakeholders. Directors are obliged to monitor management with vigilance, ensuring integrity and high performance. Directors must emphatically not manage. One good description of the board's proper role is *nose in, fingers out*.

The Privilege of Protection

Directors make decisions that sometimes don't work out, such as appointing a CEO who turns out to be a dud or overpaying for an acquisition only to write down its value later. Companies can go bankrupt on a board's watch. We live in a litigious society. When things go wrong, people are encouraged to sue, and they do.

So a natural question is "At how much risk are directors?" The answer is not much, if risk means directors having to pay money out of their own pockets.

There are two reasons. One is the business judgment rule. The other is that company assets and directors and officers insurance provide resources to help satisfy successful claims against the board.

The Business Judgment Rule. A director or trustee is a *fiduciary*. A fiduciary is a person to whom property or power is entrusted for the benefit of another. As such, the director has certain duties. He or she also has protections under the law. Arguably the most important for directors is the business judgment rule.

The rule specifies that courts will not review the business decisions of directors who performed their duties

1. in good faith;
2. with the care that an ordinarily prudent person in a like position would exercise under similar circumstances; and
3. in a manner directors reasonably believe to be in the best interests of the corporation.

The business judgment rule does not necessarily protect directors from charges that they wasted corporate assets or committed fraud, misappropriation of funds, or others. Nonetheless, the rule creates a strong presumption in favor of boards, freeing members from possible liability for most decisions that result in harm to the corporation.

The business judgment rule, along with limited liability for investors and the rule of law, are key underpinnings of modern, developed economies. They facilitate pooling capital and taking risks required to develop products and services and produce and distribute them on a large scale. They allow individuals, including directors, to act in ways essential for economic development while keeping personal liability at an acceptable level.

Company Assets and Directors and Officers Insurance. Companies can indemnify their directors through provisions in their bylaws or certificates of incorporation. This means that company assets are available to defend directors in legal actions and to settle claims. In companies rich in marketable assets with conservative balance sheets, this provides a lot of protection. In companies with few tangible assets, it provides little protection. In the case of bankruptcy, it may provide no protection at all.

Directors and officers policies, commonly called D&O insurance, provide cash to cover most or all settlements or judgments in cases against directors. In large companies, such policies may be written to provide $50 to $100 million or more of coverage.

Do directors ever pay settlements out of their own pockets? Rarely but occasionally. For example, it was reported in 2005 that directors of WorldCom and Enron agreed to settlements that included personal payments.[8] Ten former outside directors of WorldCom agreed to a $54 million settlement for their roles in the company's $11 billion accounting fraud. A third, or $18 million, was paid by the directors personally with the balance paid by D&O insurance. The $18 million reportedly represented 29 percent of the directors' cumulative net worth excluding primary residences, retirement accounts, and judgment-proof joint assets. Ten former directors of Enron agreed to personally pay $13 million of a $168 million settlement for their alleged role in Enron's fraudulent accounting practices. This was 10 percent of their personal pretax profit from Enron stock sales.

These were rare exceptions to the norm of directors seldom paying settlements personally. Nonetheless, there are certain risks from which no one can indemnify a director. One is being vastly underpaid when the work of a board is most difficult, like in a crisis. Another is being sued and spending hours producing documents for plaintiffs' attorneys and testifying in depositions. And directors' reputations can suffer when things go wrong.

The Privilege of Pay (for-profit boards)

Let's be honest. A part-time job with interesting work, good colleagues, and only occasional heavy lifting that pays (in the case of corporate boards) five or six figures is an attractive proposition.

There are exceptions. For directors who are CEOs or independently wealthy, board compensation is chicken feed. When serious trouble strikes, directors would gladly return all they've earned just to make it go away.

Still, for most directors, board compensation is meaningful money, and because of the way the pay is structured, it can be a path not only to current income but also to long-term wealth building.

What do directors earn? We know with certainty what public company directors are paid because companies are required to disclose it, in detail, in their annual proxy statements. (Comprehensive data on private company board pay is not available. My impression is that it varies greatly from company to company, as do the duties of directors.) Not surprisingly, boards of the largest public companies earn much more than those of smaller companies.

These days, the value of what directors are paid depends a lot on how company stock performs. This is because most directors are paid, in part, in stock or stock options. The purpose is to focus directors, as well as management, on growing the company's earnings and enterprise value.

Surveys of public company director compensation suggest that directors are paid, on average, between $100,000 for smaller companies (those with revenues up to $500 million) and $250,000 for the largest companies. There is, however, substantial variation around mean compensation levels.

There are variations in how directors are paid. A normal arrangement is a two-part pay package. First is a base retainer plus committee fees, which can be taken in cash or deferred until retirement from the board and, until then, invested in the company's stock or, sometimes, other stock and bond funds. Second is equity-based pay, that is, restricted shares of the company's stock (restricted because shares are granted then vest over a period of time) or stock options (the right to buy company shares in the future at the price on the day of the grant).

Paying directors in stock and options is a development of the last twenty years. A fellow director, older than I, once told me that in the 1960s and '70s, directors were paid relatively nominal amounts and only in cash. In fact, he said, independent directors were forbidden or discouraged from owning stock in the companies on whose boards they served because it was considered a conflict of interest! The shareholder value revolution twenty years later changed all that. Directors owning company shares became *de rigueur* on the theory that the practice would align the board's interests with shareholders who elect them. Today the smallest public companies pay about half of director compensation in equity, and large companies pay nearly 80 percent in equity.

Another change in practice over the last twenty years is the elimination of most forms of compensation for directors beyond cash and stock. Large companies used to provide directors with pension plans and perquisites, such as the right to direct a corporate contribution to nonprofit organizations of their choice. The shareholder value movement argued, correctly in my view, that directors should not be incented to remain on the board for the purpose of accruing service that would increase their pension benefit. This could reduce director independence and impair healthy board turnover. Director-designated corporate contributions were deemed a misuse of shareholder resources because they would likely benefit the director more than the company.

The Privilege of Respect

Being respected by others is a basic human need. Respect is a central theme in film and drama.

In the great film *On the Waterfront*, Marlon Brando as Terry, laments his lost boxing career to his brother, Charley: "You don't understand. I coulda' had class. I coulda' been a contender. I coulda' been somebody!"

In the central line of Arthur Miller's great drama *Death of a Salesman*, Willie Loman's wife, Linda, cries out plaintively about her struggling husband: "Attention, attention must finally be paid to such a person!"

Being a director is being somebody. Attention is paid to directors.

The Responsibilities of Board Service

Serious responsibilities are involved in joining a board.

The proper context for understanding these responsibilities in the private sector is what academics call agency theory. The board exists to solve the *principal-agent* problem of separation of ownership and control. The owners of a public company, the shareholders, benefit from limited liability (they cannot lose more than they invest), but they need someone (an agent) to lead and manage the company on their behalf. Shareholders have ownership, but as a practical matter, most of the time management is in control. To solve the problem, shareholders elect directors to represent them. The board selects and oversees management on behalf of the owners.

The problem of competing interests between owners and managers is not theoretical. Consider this:

Interests of Owners	Interests of Managers
Maximize value	Maximize compensation
Safeguard assets	Enjoy perquisites of the job
Lead to create value	Lead to satisfy multiple stakeholders

Given competing interests, the board's responsibilities are to (1) ensure the interests of owners dominate those of management by being vigilant about the use of company resources and (2) align the interests of owners and managers through the design of incentives (pay for performance) so that management wins when, and only when, owners win.

As duly elected representatives of the company's owners, the board of directors is responsible for maximizing value over the long-term. There is long-standing debate[10] over whether the proper focus of directors is on shareholder value or stakeholders' interests. While thoughtful directors recognize and are responsive to legitimate interests of multiple stakeholders (owners, employees, customers, suppliers, communities), the cornerstone of board responsibility in the United States is to maximize shareholder value over the long term.

There is an important exception to the criterion of maximizing long-term value. When the board is considering a transaction that involves an inevitable change of control or breakup of the company, directors generally have a fiduciary duty to maximize the value of the company by considering alternative transactions and selling to the bidder offering the greatest *short-term* value. Once the sale or breakup of the company is inevitable, the board's focus turns to obtaining the most value in the short term for the company.

As fiduciaries, directors have specific legal duties. They also have professional responsibilities. These duties are similar for company and nonprofit boards.

Legal Duties

Directors have fiduciary duties of *care* and *loyalty*.

Duty of care requires that directors, in the performance of their responsibilities, exercise the care (watchfulness, attention, caution) that an ordinarily prudent person would exercise in the management of his or her own affairs under similar circumstances. Actions that do not meet this standard may be considered negligent and any damages resulting may be claimed in a lawsuit for negligence.

Directors are required to make informed business decisions by considering all material information reasonably available to them, including adequate review of key transaction documents, either by reading them or having them explained by experts.

Duty of loyalty requires that directors put the interest of the company above their own interest and that of any other organization when a conflict exists. It prohibits self-dealing by corporate directors. They may not use their position of trust and confidence to further their own interests or entrench themselves.

Professional Responsibilities

As a director, I have seldom found it difficult to exercise my duties of care and loyalty. Doing so is my natural inclination. In addition, directors receive reminders and guidance about discharging their legal duties from the board's counsel. They also have access to investment bankers, compensation consultants, and other experts.

What has proven more challenging to me and, I suspect, many directors is sorting out what my broader responsibilities are in difficult circumstances. Here are two examples.

What to do about a failing company? I was on the board of a rapidly expanding retailer. Top line growth was high due to increases in same-store sales as well as new store openings. Earnings were good and the balance sheet was leveraged but not excessively.

Then things began to go less well. Revenue growth came increasingly from new stores as same store sales stagnated. Gross margins declined as management cut prices to try to juice sales. Earnings went flat then started to decline. Cash flow was strained as a result of flat earnings and continued expansion. I found myself paying close attention and feeling concerned. I extrapolated trends. I didn't like where things were going.

During this time, management tried to be reassuring. But in the process of what psychologists call sense-making, that is, figuring out what various bits of information might mean, four things occurred in close succession that unnerved me.

First, the very talented president and CEO of the company resigned and took a bigger and better job elsewhere. I thought we should appoint an interim and do a search for his successor. The rest of the board was comfortable with an internal promotion and felt that an interim title would signal weak support and failure would be a self-fulfilling prophecy.

Second, one of the directors pointed out in a board meeting especially poor performance of one of our stores and asked management for an explanation. The new CEO said, "A Walmart opened down the street and that hurt us. But I've competed against Walmart; if we hang in there, they'll let up." I thought this was the dumbest assertion I'd ever heard in a business meeting. I challenged it. The executive softened his stance but only a little.

Third, we did a tour of the company's distribution center. The purpose was to show off the inventory management system, but what I noticed was poor housekeeping. There were boxes in aisles, open cartons, and a general sense of disarray. Soon after, my dad was looking for a particular product that I was sure would be carried in one of the company's stores because we were a category killer retailer. We went shopping. Sure enough, the store carried it, but that day it was stocked-out. My dad wasn't impressed, and I was embarrassed.

Fourth, we decided to borrow money because earnings were stagnant, the balance sheet was strained, and growth was chewing up cash. Management told the board what the interest rate would likely be, and we deemed it acceptable. I'll never forget learning soon after the bond offering that the final rate was more than a third higher than we had expected—a junk bond rate! I was shocked. The public debt market was telling us something very different about the risk profile and credit worthiness of the company than we were hearing from management.

I sat down over a weekend and thought about what I had been experiencing. Something about it seemed familiar. Then I remembered a presentation by John Hackett, the brilliant chief financial officer of Cummins, I had heard a decade earlier. His title was "How Companies Fail." It was a "stages" approach, like Gail Sheehy's life phases in *Passages* or Elisabeth Kubler-Ross's process of grief in *On Death and Dying*. I was stunned to realize, based on Hackett's stages of how companies fail, that I was a director of a company midway through a process that could result in bankruptcy.

The question was what to do? This was a difficult situation for a director. I had legal duties of care and loyalty and the protection of the business judgment rule. But I was deeply concerned about the company's prospects. Financial failure would be the antithesis of my responsibility as a fiduciary, deeply harmful to shareholders and stakeholders alike. But in conversation, I found that others on the board were not nearly as concerned as I, and management was relentlessly reassuring.

I had a great desire to flee. I felt like a passenger on the Titanic who was convinced we'd hit an iceberg and were likely to go down while everyone around me was still enjoying dinner and dancing. Resigning from the board was an option, of course, because directors can do so at any time and are not obliged to provide an explanation.

But it seemed to me that cutting and running without making the best case possible to my board colleagues as to what I believed was happening and, more important, *what actions needed to occur to rescue the situation* would be irresponsible.

So I put together a short presentation and shared it with the chairman and independent directors. It included five actions the company had to take for me to continue in good conscience as a director: conserving cash, halting new store openings, closing money-losing stores, discontinuing a related diversification, and evaluating whether we had the right CEO or needed to recruit one fully up to the difficult job facing us.

The board discussed my analysis and recommendation. They disagreed. I resigned. Eighteen months later, the company declared bankruptcy.

I took no pleasure in it, and I don't intend this as an "I told you so" tale. Rather, it is a story of the real nature of a director's responsibility in a difficult business situation. Absent extreme good luck, most directors will experience some failures because pursuing returns for shareholders involves risk. I've always liked my dad's notion that in tough situations your conduct has to allow you to look yourself in the mirror in the morning. That's a good standard to guide a director in a tough spot.

What to do about a possible conflict of interest? Directors have to be attuned to potential conflicts of interest when they consider joining or remaining on a board. They must honor their duty of loyalty to the company if push comes to shove. And independent directors must be prepared to challenge the prevailing wisdom, including backing up conviction with resignation if necessary.

It would be nice if conflicts were all crystal clear. Then deciding how to handle them would be easy. But they're not. I had an experience that illustrates the point. The story is short because my board service lasted exactly one meeting.

It occurred while I was dean of the business school at the University of Michigan. I became acquainted with Sam Wyly, one of our graduates. Sam was a successful, colorful, and sometimes controversial Texas entrepreneur. We had several meetings. Sam visited the school, and I ultimately asked him to consider a $10 million gift to fund half the cost of constructing a much-needed new building on campus. Through this process, we got to know each other, and Sam invited me to join the board of a public company, Sterling Software, of which he was chairman. He and his brother Charles were major investors.

I engaged in careful due diligence and determined that the company was solid and had a good reputation. I was confident in my ability to be independent in thought and action as a director because that's my makeup. (Like most university professors, I am skeptical of authority and don't like anyone telling me what to do.) So I joined the board.

I thought things would be fine until I attended my first meeting. There, I was surprised to find myself thinking and feeling uncomfortable about the concurrent timing of Sam's major gift to the school and my joining the board as an independent director of a public company he chaired. Could I be as independent as I naturally was? With Sam, his brother, and his son all on the board, I wasn't sure I could. I decided to play it safe and never find out. I went to Sam after the meeting and told him I was concerned that I could find myself in a conflict between my roles as dean of the business school to which he was a donor and an independent director. Out of an abundance of caution, I had decided it would be best for me not to serve on the board. Sam was gracious, and that was the end of it. It was a decision that cost me a lot of money—several million dollars in light of stock and options and the later sale of the company—but it passed the "look yourself in the mirror" standard.

The Rise of the Independent Directors

Independent directors now dominate the boards of public companies, holding over 80 percent of board seats. Only independent directors can serve on three key committees: audit, compensation, and governance.

An independent director can only fulfill her duties—legal and practical—if she resolves to be truly independent as well as candid and constructive.

Independent. Corporate boards used to be composed mainly of company executives and professionals who served them, such as bankers and attorneys. This was good in terms of directors' knowledge of the company and their ability to come to agreement and get things done. It was often not good in terms of directors putting their own interests (jobs, compensation, and benefits for inside directors, professional work and related fees for outside directors) above those of shareholders. It also hindered tough-minded monitoring and dismissal of underperforming CEOs. Relationships were too cozy and reciprocal.

The shareholder value revolution of the 1980s had profound consequences for board focus, size, and composition. Total shareholder return (share price plus dividends) became a key measure of board performance and effectiveness. A vigorous market for corporate control was reflected in acquisition and merger activity.

As a result, the human makeup of boards changed dramatically. Independent directors came to dominate public company boards. Boards became smaller: nine to twelve directors is customary now instead of fifteen or more. The chairman and CEO roles, previously united, are now frequently divided. The board's agenda, once the exclusive domain of the chairman/CEO, is now set in consultation with a lead independent director. Executive sessions of the independent directors occur regularly whereas previously they were rare and almost always signaled that the CEO was in trouble. Board compensation is now substantial because independent directors are no longer paid indirectly through legal and consulting fees and banking relationships.

The rise of independent directors has created an important question: What does *independence* really mean? It's useful to draw a distinction between *technical* independence and *real* independence. Technical independence, as required by the SEC and stock exchange listing standards, increases the odds of, but does not ensure, real independence.

In my experience, real independence is rooted in a director's attitude and state of mind combined with a willingness to speak up and, if required, act in ways not in one's immediate self-interest.

Independence requires a director to

- *be curious*, with a big appetite for facts, concepts, insights, ideas, and people from whom the director can learn so that independent thinking is well-informed;
- *question and challenge*, especially traditional practices, conventional wisdom, and majority views;
- *trust but verify*, one of President Ronald Reagan's favorite phrases;
- *have perspective* that puts current issues and events in context: past and future, related matters, and relative importance. This is sometimes called the helicopter view; and
- *be creative*, offering novel and innovative solutions to problems with which the board and management are wrestling.

Hallmarks of independent behavior are

- *asking questions* more than broadcasting;
- *drilling down* when warranted;
- *precipitating conflict* when required;
- *tolerating discomfort*;
- *speaking truth to power*;
- *searching for common ground* and solutions around which the board can unite; and
- *resigning from the board* if legal and professional duties or the dictates of conscience cannot be fulfilled.

The independence of a director is of little value unless it is combined with two others qualities: candor and constructiveness.

Candor. Candor is a fiduciary duty in addition to care and loyalty.

Directors are selected for their judgment, above all. The board, senior management, and the company only benefit if directors are candid, that is, speak out honestly about what is on their minds. They call things as they see them. They raise questions, including uncomfortable ones.

Of course, directors have to be selective. Is the issue worth addressing? Has someone else already made the point? Are they talking just to hear themselves speak? The most valued directors listen a lot and speak selectively. It's important to protect the value of your verbal currency.

Being candid sounds easy, but it's not. I served on the board of a small, family-owned company with a long history. The family CEO had done a good job with the company on his watch. But it was a difficult, cyclical business, and he had weathered several recessions with requisite cost cutting, including layoffs—always a difficult task.

One day I got a call at the office. I could hear the emotional distress in the CEO's voice. "I have to see you," he said. "I want to sell the company. I'm talking with each director."

I was shocked. There had been no warning of this, and the company had been in existence for many decades. I agreed to meet with him that afternoon.

When he walked in, I could see the stress on his face. He saw bad times coming and did not—*did not*—want to be at the helm through another recession. He had put out some feelers and found a buyer willing to purchase the company for a particular sum. He asked what I thought.

The answer he was looking for was obvious. He was seeking support to do what he desperately wanted to do. Providing it would have been easy. I had no ownership stake in the company, I served as a director at his and the family's pleasure, and the modest directors' fees were of no great consequence to me.

Yet with several hours to consider the matter, I had decided what I thought and was candid with the CEO:

> I understand. I had to lay people off at Cummins, and it was the hardest thing I've ever done professionally. So I empathize. But I cannot in good conscience advise you to sell the company or support your doing so. This is a family business built over generations. I believe its market value is exceptionally low right now because you're

> not the only one who believes a recession is coming. A fire sale of the company today at a low point in its value would be wrong—for you and the family. I urge you to lead the company through this downturn and use the time to fix everything that will increase its value when volume returns. Then, reconsider whether to sell the company at a value that reflects the work that you, your father, and others have done over so many years to make it what it is today.

The CEO was disappointed and disagreed. We all like to hear what we want to hear, not necessarily what we need to hear. One of a director's most important duties is to be candid and honest, especially when doing so challenges a consequential direction that management or the board wants to pursue but with which the director disagrees.

The end of this particular story is a good one. Other directors expressed views similar to mine. The CEO led through the recession. Three years later, revenues and profits were strong, and he sold the company with the full support of the board and family for *four times* what he had been offered just thirty-six months earlier. That's the difference directors can make at a critical time in a company's and an executive's life. Candor is required, even if it is uncomfortable or inconvenient.

Constructiveness. I have found there is a big difference between quality academic research and successful leadership and management. In their search for truth, faculty must be analytical and *deconstruct* what they examine. Leaders and managers should be analytical, but they must also take *constructive* action in order to create value and move their organizations forward.

I have enormous respect for the scientific method and the value it brings to a world drawn to fashion, fads, false correlations, and fatuous theories. But I also deeply appreciate that leaders and managers must go beyond analysis and understanding to action and results.

This is the reason for a culture gap between academics and leaders/managers. Academics are inclined to be skeptical of leadership slogans such as "The Way Forward," a recent theme and name of a restructuring plan at Ford Motor Company. They can also be skeptical of their colleagues whose work appears to be longer on inspiration than evidence.

The need for constructive action is why I sometimes say to executives considering a change, "Remember, you need to be right twice!" It's usually not hard to figure out what you want to *stop* doing when a person or course of action isn't working out. The harder part is figuring out what to do *next*, such as recruiting the right person or embarking on a new strategy.

Good directors understand this. So they push themselves when opining on a situation about which they are concerned to share not only their analysis but also what might be done to make things better. As a director, when I'm concerned but can't come up with good alternatives, I will simply describe the communication of my concern as "sharing agony" and admit I don't know what to do about it. This is better than either of the alternatives—worrying in silence or offering a lame suggestion in which I'm not confident.

Leading the Company: Governing versus Managing

Directors must wrap their minds around the role of the board versus the role of senior management in leading the company.

It's challenging because while the board has ultimate *accountability* for company performance, it is definitely not the board's job to *manage* the company.

One governance reform that has been suggested is making directorships full-time jobs to level the playing field between senior management and the boards to which they are accountable. This is a terrible idea. There are sound reasons that the CEO reports to a board of able, committed part timers versus full timers.

The CEO reporting to a group ensures that multiple points of view and time for deliberation will be reflected in major decisions. This is not a guarantee against reflexive, impulsive, and occasionally catastrophic decisions, but it helps.

The board being part-time reduces the odds of ambiguity and confusion over who is in charge. Unity of command is the principle that no one in an organization should report to more than one person. It may seem a little quaint and antiquated in a world of matrix structures and network organizations, but it is essential at the most senior level. People must understand that the board appoints the CEO, the CEO reports to the board, and everyone else reports directly or ultimately to the CEO.

Take my word on this. It's based not only on sound management theory but also on my own hard-won and unhappy experience. In one of my jobs reporting to a board, several board members developed the habit of going directly to one of my subordinates to get what they wanted. Neither they nor he informed me. It ended badly, as such things usually do.

The board's being part-time does not guarantee unity of command, but it helps reduce the potential for directors to compete with senior management over who performs executive and operational functions of leadership. The executive function of management is to execute policy, direction, and decisions that, at a high level, are made by the board, usually on management's recommendation. The operational function of management is to operate the company on a day-to-day basis, fulfilling the organization's mission, doing its business, and attending to myriad details. Neither the executive nor operational function is the work of the board.

What, then, is the board's work? In a word, it's *governance*.

In later chapters, I will discuss in detail what constitutes the substance and process of great governance. Suffice it to say that governance involves four key functions of the board:

1. Appointing, incenting, evaluating, and, when necessary, removing the CEO and senior management.
2. Setting aspirations and direction and approving strategy and policy, plans, (annual and long-range) and performance measurements. This includes making the most consequential decisions that define the entity's
    - risk profile (strategic bets and capital structure);

- culture (tone at the top, beliefs, values, style); and
- future (major initiatives, capital investments, mergers and acquisitions).

3. Monitoring results and verifying the integrity and accuracy of disclosure, especially of financial condition and results.
4. Self-monitoring and renewal of the board.

When the board performs these functions well, it enables senior management to lead the company effectively and facilitates the work of the organization.

A different take on governance, wholly consistent with these four functions, involves a paradox, one that seems little understood by many governance reformers. The board has two responsibilities vis-à-vis management:

- *Monitoring and holding management accountable* for performance and results
- *Supporting and helping management succeed* in achieving high performance and intended results

There is nothing novel about the coexistence of these functions. They can appear contradictory but don't need to be. Parents face a similar challenge. We have to expect a lot of our kids, monitor their behavior and performance, and ensure proper consequences. We also need to support, advise, and occasionally reassure them as they face new challenges, difficult situations, and trying circumstances. *Tough love* comes to mind.

Done well, the board's performance of these dual roles has complete *integrity*, in the purest sense of the word. They are performed seamlessly and are mutually reinforcing. They engender respect.

They can be done wrong, however. I remember a director whose day job involved doing depositions; his style was skeptical and intimidating. He had the same style as a board member interacting with management. I also remember a director whose transparent need for acceptance and affection made her incapable of asking hard questions or being straight with management about performance failures.

Her questions were all softballs, and her evaluative comments about management were relentlessly complimentary.

Like the best parents, good directors know that monitoring and disciplining are necessary but not sufficient conditions for growth, development, and high performance. The same is true of help and support. A rich mix of both is essential.

Boards in a Goldfish Bowl

Corporate (and to a lesser degree nonprofit) directors function in a charged environment these days. More than ever, directors are held accountable for performance. Shareholders and stakeholders expect the board to attend to their many, often competing, interests, claims, and concerns.

Boards are under increased surveillance because of highly visible calamities that have befallen some companies. Think Lehman Brothers and General Motors. Over and over, the question has arisen: Where were the boards?

Investors and the public are understandably skeptical about the attentiveness and effectiveness of boards, especially in light of the power, privilege, and rewards their members enjoy. The authors of a recent book titled *Money for Nothing: How the Failure of Corporate Boards is Ruining American Business and Costing Us Trillions*[11] are unrestrained in their indictment of directors. From inattentiveness to excessive executive compensation, their criticisms are relentless.

Yet there is no shortage of institutions and individuals setting ground rules for boards, looking over directors' shoulders and advising or urging governance reform. A short list would include traditional parties like Congress, the SEC, and stock exchanges and more recent entries like proxy advisory services and activist investors.

Proxy advisory services such as ISS and Glass Lewis analyze companies' annual proxy statements and governance practices and advise institutional investors on how to vote their shares. Matters include director elections, executive compensation, and various initiatives put forth by management and investors who qualify for proxy access.

These services have become quite powerful because their advice is influential on voting outcomes.

Also influential are activist shareholders such as Bill Ackman, Daniel Loeb, Nelson Peltz, and Carl Icahn and the investment vehicles they control. Institutional investors are also a powerful force. They target boards and companies for change, sometimes on their own, sometimes in partnership with activists. The largest of them, such as Blackrock, Calpers, and TIAA-CREF take an interest in governance because their size does not permit them to do the "Wall Street Walk"—that is, sell shares if they disagree with the company. Others, such as union pension funds and religious orders, choose to stand and fight on principle rather than sell and exit.

In short, boards may meet in private, but they live in a goldfish bowl.

Conclusion

Great governance requires directors who understand the role of the board. Governance is best thought of as stewardship.

Directors should know and embrace their responsibilities as they enjoy their privileges. The best directors are independent in the deepest sense—attentive, curious, challenging, and unafraid to take action when required. They monitor management and hold them accountable while providing help and support.

Effective stewardship requires a deep understanding of the entity being governed. This is the subject to which we turn next.

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