HBR.ORG
Harvard Business Review
MARCH 2014
REPRINT R1403H

The Boardroom's Quiet Revolution

Forward-looking boards have been discreetly transforming themselves. *by Richard D. Parsons and Marc A. Feigen*

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IN the past 10 years—under pressure from shareholders, stock exchanges, and state and federal governments—corporate boards have changed dramatically. A director returning to his or her boardroom after a 10-year sabbatical might recognize little more than the paneling on the wall.

Today regulations require that a majority of directors be independent, a practice that was previously optional. If the chairman is also the CEO, most boards (97% of the S&P 500) appoint a lead or presiding independent director, who has much more influence in and out of the boardroom than before. The independent directors regularly meet in executive session without the CEO in the room—a relatively new practice. Shareholders are permitted to review decisions by the compensation committee, and audit committee members have significantly expanded responsibility and accountability. Individual directors are required to attend meetings more often, to spend more time with management, and to be more knowledgeable about the companies they direct.

Unfortunately, however, externally driven reforms have proved rather ineffectual when it comes to improving boards' managerial oversight. As Marty Lipton, a leading governance lawyer, has noted, the reforms suffer from a "one size fits all" problem. Improving oversight involves something more than

ILLUSTRATION: ANGUS GREIG

imposing a structure, or requiring attendance at board meetings, or installing independent, supposedly impartial people. "We can quote board best practices like catechism," says Don Gogel, the CEO of

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the private equity firm Clayton, Dubilier & Rice, who sits on many boards, "but the best boards have a certain magic." In other words, they can pull together to achieve extraordinary results. Estée Lauder, for example, hired Fabrizio Freda from outside to run the company and charged him with transforming the entrepreneurial family-run operation into a professionally managed one, creating more than $19 billion in shareholder value. The board supported him every step of the way. Notable for its diversity (out of 15 members, seven are women, two are African-American, and one is a Chinese national), Estée Lauder's board has an unusual ability, in part because of its family heritage, to plan 10 or 20 years into the future while ensuring that it has the management capability and the strategic vision to deliver. (Disclosure: Richard D. Parsons sits on the Estée Lauder board.)

To understand how such magic occurs, we interviewed two dozen directors from the boards we most admire and coupled their insights with our own broad experience leading, serving on, and counseling boards and CEOs. We've observed a process of quiet yet dramatic self-reform and continuous improvement. Because the emerging practices take place largely behind closed doors, they are not widely known or discussed. Their impact on the quality of board governance, however, appears to be greater than the impact of changes that come from outside the boardroom (the dismissal of directors, the introduction of policies) and that are often highlighted in the financial press.

In the following pages we present some striking innovations in board practice in four main categories: strategy and talent oversight, board composition, the quality of board discussions, and the board's relationship with the CEO. These innovations can help boards dramatically improve the governance of their enterprises.

Overseeing Strategy and Talent

In the past, a typical board's approach to understanding the company's strategy often consisted of listening to one manager after another give formal, highly rehearsed, and lengthy presentations. One director we know calls presentations like these "death by slide."

Today a good board understands that directors must engage in a process of continual two-way learning about strategy and talent. Raj Gupta, a director at Delphi Automotive, HP, Tyco, and Vanguard, notes, "Traditionally, directors sat in the boardroom. Today they are out visiting the businesses." The former Honeywell chairman Larry Bossidy recalls that his directors knew "our growth prospects by business, where to invest, where to divest, and where to grow." The agenda for boards has also changed. The chairman of the Vodafone board, Gerard Kleisterlee, insists that his board spend little time scrutinizing the previous quarter's results. "I want to move to strategic topics and people," he says.

Increasingly directors are learning more about the business and are applying their insights and understanding. For instance, Irv Hockaday, a former lead director at Ford, told us that more software

Idea in Brief

THE PROBLEM
Externally driven reforms have made corporate boards better at preventing fraud and protecting stakeholders' rights but have had little effect on board performance in setting strategy and supervising management.

THE SOLUTION
The authors' study of successful boards suggests that many of them are regulating themselves and developing best practices in four key areas:

Strategy and talent oversight. Good boards learn about the business and take an active role in succession planning.

Board composition. More executives from other companies are recruited, performance is more closely monitored, and diversity gets more emphasis.

Quality of discussion. Directors are better prepared and more likely to actually visit operations. They consult independent advisers more often.

Relationship with the CEO. Good boards encourage the CEO to draw on their collective expertise. They also protect their independence by having a strong lead director or nonexecutive chairman.

now goes into the Ford Focus than went into the first space shuttle. Accordingly, Ford's board is deeply engaged in learning to run a technology-driven company. Fabrizio Freda spends hours with his directors to be sure they understand Estée Lauder's deeply researched 10-year "compass." This goes far beyond the horizon of the typical (though significant) three-year plan.

Board leadership is especially important on issues of corporate social responsibility. As Lipton recently wrote, "Boards are expected to establish the appropriate [tone] to actively cultivate a corporate culture that gives high priority to ethical standards." It is increasingly up to the board to ensure that the company is attuned to the needs of customers, suppliers, communities, government, and the public. At Time Warner, for example, the question of what kind of music is appropriate for children and young adults became a board matter, and properly so. Ultimately, with the board's concurrence, management decided to sell one of the company's music labels because its standards were not aligned with Time Warner's.

Another key role of effective boards is to review their companies' top talent and discuss succession plans to maintain a deep bench. Aetna's management team, for instance, shares with the board the key development needs of each of the company's top 200 executives. Ron Williams, a former chairman and CEO of Aetna, says, "It is important that the board understand the talent management process and the data on each of the top executives. This is even more important than meeting executives, which is open to subjective interpretation in a rarefied environment and, frankly, the luck of the draw. It shouldn't be about just seating executives next to directors at the dinner table, useful as that can be."

This growing understanding of companies' talent is showing up in the statistics around CEO succession. According to an annual study of CEO succession at 2,500 public companies conducted by Booz & Company, over the past four years from 70% to 80% of CEOs have been promoted from inside, suggesting that more boards are identifying and readying internal talent for the top job.

Getting Board Composition Right

Many directors serving on U.S. boards today are people of great business judgment and long and valuable experience. But they serve only part-time as directors and often lack industry expertise, making it difficult to apply all their talents.

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That is in part a consequence of the push for independent directors; it is challenging to find someone with deep industry knowledge who isn't associated with a competitor or a related business. The result, as the Harvard Business School professor Jay Lorsch points out, is that many directors today are generalists. That can be problematic. "Directors who don't know my business," says the former CEO of a global *Fortune* 50 company, "are often off base. We have to humor them and manage them, but in truth they don't add much."

Various approaches have been recommended to get around the problem. In "The Case for Professional Boards" (HBR December 2010), Robert Pozen argues for a new class of "professional director," to be recruited largely from the ranks of retired executives. Although that solution is somewhat extreme, more and more boards are looking for relevant experience. According to the global executive search firm Spencer Stuart, of all S&P 500 directors, the proportion who are leaders of major business divisions and functions in other companies has risen to 22% from just 7% a decade ago, and the percentage of CFOs, treasurers, and other financial executives who chair audit committees has soared to fully a third, up from a mere 4% in 2002.

Boards are also more actively monitoring the contributions of individual members. At one *Fortune* 50 company each director is asked annually to nominate five other directors whom he or she would wish to keep on the board. A director who makes no one's list is asked to leave. The CEO says, "It impacts other directors if you tolerate a weak board member. It's hard, but you have to step up to the plate."

More and more boards value independent directors who can actually contribute. We know of one who resigned from the Sprint board because he believed he lacked the technology savvy that the company's strategy required. We also met three directors at a *Fortune* 100 company who have a private deal: If one of them learns that the other two—or the board as a whole—are disappointed in him or her, that director will change or resign. Certainly an effective board knows that directors should be able to take meaningful part in discussions about strategy and that the judgment of independent directors must be informed by facts, knowledge, experience, and expertise. Gut instinct is not enough.

The push for more-relevant experience should not come at the price of diversity. Like-minded individuals are susceptible to groupthink, and variety in age, gender, and ethnicity as well as in experience and training is needed to guard against the self-confirming biases—and too easily reached consensus—that often endanger businesses. Again, the statistics are moving in the right direction: Today 17% of S&P 500 directors are women, up from 12% in 2002, according to Spencer Stuart.

"[Some board meetings took place in] the land of the perfect question. Unless you posed the exactly right question, management could respond without getting to the real concern being expressed."

A *Fortune* 50 board member

Managing the Quality of the Conversation

One director complained to us that discussions between the management and the board of his *Fortune* 50 company took place in "the land of the perfect question." "Unless you posed the exactly right question," he said, "management could respond without getting to the real concern being expressed." Good directors are also aware that when meeting with the board, even well-intentioned managers may succumb to a normal human tendency to overstate opportunity, understate risk, or sugarcoat problems. Both points reflect the shortcomings of the discourse in many boardrooms, and conscientious directors work hard to get below the surface to the key issues.

We see individual board members spending more time with management in preparation for board meetings, and directors at some companies take tutorials to deepen their understanding of critical areas of the business. Kleisterlee explains, "That way, you can roll straight away through every board meeting to the critical issues we face." The practice often triggers positive behaviors. When P&G directors report their findings after a personal field trip, they're in friendly competition to be insightful and informed.

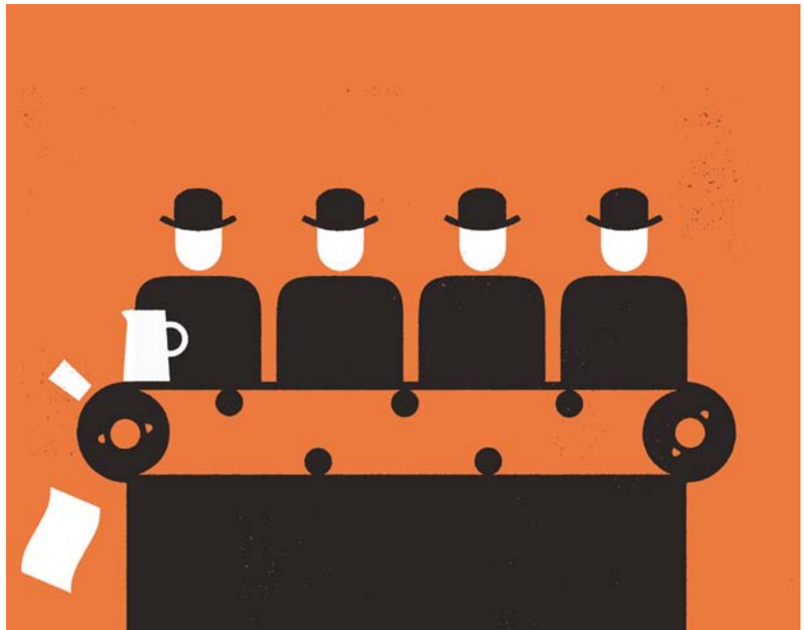
Fact-finding is not about substituting the board's judgment or authority for management's. "You don't want to crowd your CEO's real estate," warns Ron Sugar, a board member at Apple, Chevron, and Amgen and a former chairman and CEO of Northrop Grumman. "You have to let your CEO and management do their jobs."

Great boards get out of the boardroom as a group. Directors today often travel together and hold a meeting yearly or every other year in the field. Most boards conduct annual strategic offsites at which issues are aired and discussion is detailed. For example, The Hartford's chair and CEO, Liam McGee, holds a two-day offsite each year with his directors and management team at which the most challenging business issues are discussed. In the three years The Hartford has held these and similar sessions, the board has developed a deep understanding of the performance opportunities the company faces and has supported management in making tough decisions that have driven strong results.

Finally, a growing tendency to engage outside experts has improved the quality of board decision making in recent years. Good boards now bring in governance experts to review their practices and provide clear feedback—and, of course, they routinely engage consultants when they are putting together compensation packages for the CEO and other top executives.

Experts are especially helpful when there's a risk that the interests of management and of the company diverge—as with decisions about compensation. When both the board and management have advisers on the same subject, the two sides can discuss the quality of each other's advisers and work together to ensure that even if they don't agree, they understand the issues at stake.

When the board engages expert advisers, however, it may be tempted to get involved in the day-to-day management of the business. Good boards therefore make sure to respect the boundaries. The Citigroup board, for example, has its own regulatory and fiduciary counsel but is careful to limit their advice to its role as a board.



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Ron Sugar, a board member at Apple, Chevron, and Amgen and a former chairman and CEO of Northrop Grumman

As good as some boards are becoming, they can do more to enrich the quality of boardroom discussions. We would like to see them cooperate with management on crisis simulation. No one knows how a board will react in a crisis until one occurs. Human nature—in terms of creativity, responsiveness, and leadership—is unpredictable in group situations where people are put under pressure. Few companies escape crises altogether; rehearsal, unusual as that tactic may be, might help boards better prepare for them.

Engaging with the CEO

Smart CEOs know the value of good communication with the board and invest a lot of time in keeping close to their board members. McGee views his board as a team. "Because I joined The Hartford from the outside," he says, "the board and I took the time we needed to build trust. As a result, when we have to face tough challenges, we face them together. What makes this work is total transparency and very frequent discussion."

Bossidy is another CEO who took the trouble to engage with his board. "The more you educate the board, the less concerned you are," he says. "They know what to expect. I tell the board everything. If you think a storm is coming, tell them." Trevor Fetter, the CEO of Tenet Healthcare, agrees. "Keep the conversation in the room," he says. Ivan Seidenberg, a former chairman of Verizon Communications, grounded his board in the idea of growth: "I [wanted] them to think about building our business for the next 100 years before thinking about the quarter or the equity value." With this orientation, the board approved a $10 billion capital project to revolutionize Verizon's digital capabilities—essentially betting the company. A smart bet, as it turned out.

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Ivan Seidenberg, a former chairman of Verizon Communications

When Ed Breen took over at Tyco, it was on the edge of bankruptcy after a major scandal. While Breen focused aggressively on saving the company, he also beefed up and invested in a world-class internal audit function and sent his directors (Tyco had an entirely new board) into the field to hold risk discussions with each business unit leader.

The chairman and CEO of Frontier Communications, Maggie Wilderotter, assigns each senior manager a director who acts as a coach, benefiting both the manager and the director—who, by being a teacher, becomes even closer to the business and the team. Ron Williams would travel to the home or office of each Aetna director every year to further board conversations, opening additional lines of communication and ensuring that all points of view were properly heard.

Close CEO engagement of this type is valuable. But boards must also retain their independence from the CEO, because it is all too easy to be captivated by a charismatic and powerful leader, especially when he or she is also in the chairman role. How boards support, challenge, and evaluate their CEOs can be a bellwether of board effectiveness. The growing practice of executive sessions in which the independent directors meet alone is, according to the governance expert Ram Charan, "the single most important innovation in governance to date." We agree. Executive sessions enable directors to discuss concerns in a candid manner without fear of offending or alienating management. When they work well, everyone gains—especially the CEO, who gets additional developmental support.

At Tenet Healthcare each board meeting includes two executive sessions, one before the main meeting and one after. Fetter says, "It is imperative that [these] be scheduled. This avoids an awkward moment, present in some boardrooms today, when the chairman or lead director at the close of the meeting looks around the room—with the CEO present—and asks, 'Does anyone see the need for an executive session?'" Fetter insists that executive sessions be held, without him, even if it appears that they are unneeded.

The key challenge at companies that hold executive sessions is how best to communicate unwelcome conclusions to the CEO. The lead independent director must be effective in providing feedback. The best boards will often invite the CEO to return to the room after every executive session to hear about their discussions and concerns, and will wrap up the meeting with an agreement on next steps. It may be useful to put the feedback in writing, giving the CEO an opportunity to correct the written record before responding.

THE PRACTICES we've described add up to a quiet revolution in how boards behave, the work they take on, the decisions they make, and the manner in which directors interact with one another and with management. Viewing themselves as direct contributors to corporate performance, many U.S. boards have worked to improve the governance of their enterprises. As a result, they are rewarding their shareholders and driving long-term value for employees, customers, and communities.

HBR Reprint R1403H