Question 1.

IS OUR BOARD COMPOSITION RIGHT FOR THE CHALLENGE?

The role of the board has unmistakably transitioned from passive governance to active leadership with a delicate balance of avoiding micromanaging. It's leadership as a group, not leadership by an appointed person. This group needs the right composition to succeed, and that composition will have to change, sometimes abruptly, as conditions do. With the right composition, a board can create value; with the wrong or inappropriate composition, it can easily destroy value.

In April 2008, Citigroup added an extraordinary job posting to its website, seeking individuals with "a particular emphasis on expertise in finance and investments." What made the post so unusual were the positions Citigroup was trying to fill: directors. It took $18 billion in write-downs in the fourth quarter of 2007 and capital infusions of over $20 billion for the largest bank in the world to realize its board lacked finance and investment know-how.

The financial services meltdown in the fall of 2008 exposed the stark reality that Citigroup was not an isolated case of a board lacking the crucial expertise it needed to act like an owner. As we now see all too clearly, Bear Stearns and a host of boards in the financial services industry did not have enough depth of knowledge or experience to ensure their companies stayed on track. It has been a devastating lesson for those companies, some of which are now extinct.

But don't be fooled into thinking it's them, not us. The lesson applies beyond financial services to all boards: directors as a group must have the specific skills and perspectives needed to carry out their responsibilities. These skills must match the needs of the company in its current macro-economic and competitive context, and they must evolve with the times.

Too many boards don't know what they're missing until it's too late. A great board grabs hold of its own composition and does *succession planning* for the board itself. It objectively examines the membership of the board to ensure it has the skills that are needed, periodically asking, "If we owned this business, what expertise would we need to govern it? And how will that change in the next few years?"

How Do We Figure Out What Our Board Needs?

Functional expertise—accounting, marketing, and technology, for example—or CEO experience are crucial and expected. But you can't just run through a generic checklist to figure out what your board needs. Boards have to ensure their members have the specific expertise to ask the right questions to make a good CEO better, to affect the company's choice of short- and long-term goals, to judge and approve the strategy, and to maintain relationships with stakeholders like activists and regulators. For instance, a company that is planning a footprint in the Chinese market will benefit from having at least one board member who is an expert on the political workings of China and its culture.

Few boards consider the expertise they need with such *clarity* and *specificity*. In 2002, the collective lack of boards' audit abilities so appalled regulators that Congress rushed through the Sarbanes-Oxley Act, which included the requirement that every board have accounting expertise. Uncertainty over how it would be interpreted and implemented prevailed for many CEOs and CFOs, who now had to personally sign off on financial statements. And it set off a rush of searches for new directors who qualified as accounting experts under the new rules.

General Electric was ahead of the curve. A year earlier, the GE board, along with CEO Jeff Immelt, anticipated the growing importance of board accounting expertise and recruited Bob Swieringa, a professor of accounting who had also served as chairman of the Financial Accounting Standards Board. Swieringa's command of the evolving vagaries of financial reporting was a vital addition to the board's expertise—and the GE board was ready for Sarbanes-Oxley before its rules came into force.

Similarly, a Fortune 500 company in a low-margin, highly capital-intensive business, in which logistics is the third highest cost component, had a high-powered board of retired CEOs and CFOs but lacked expertise to add value in the logistics area. They actively recruited a director who had a CEO viewpoint and also had deep knowledge of global logistics. That director has spent a lot of time getting to know the managers and processes involved in the supply chain, and now asks questions and makes suggestions the other directors would not have thought of.

Initially, management was apprehensive about whether the director would micromanage, as might be the case any time a director with deep expertise in a subject or domain joins a board. But he was not intrusive. He handled himself as a coach and helped management see a different view. This effort resulted in better cash flow and cost productivity in logistics. Management has come to regard him as a highly valuable resource. His inclusion has made a huge difference in the board's ability to monitor operations and add value. That board also continues to discuss what expertise it should look for in future directors.

The governance committee plays a central role. It should help the board do the careful thinking needed to pinpoint and anticipate future needs based on how the business and the external environment are changing. Directors should think not only defensively—on risk and compliance—but also offensively, about areas where a board must add value. It takes time to search for and vet candidates, so the board should start looking for such director candidates right away and plan three to five years ahead.

Of course, you have to understand what skills you already have in order to figure out what skills you need. Hellene Runtagh, director of Lincoln Electric, Harman International, and NeuStar, describes a successful practice: “Some of my boards employ a simple but effective process. They have each board member complete a skill assessment matrix. They then aggregate this input and get a good overview of where the board is strong, as well as where they would benefit from additional talent. A board may find they are light on consumer industry experience, technology, or strategic skills. The board can then target those weaknesses as they select new board candidates. The Nominating and Corporate Governance Committee usually owns this process.” Some other boards use this same idea of a skills matrix (see Table 1.1 at the end of the chapter). The governance committee chair or Lead Director can ensure that the matrix accurately reflects each director’s skills, expertise, and experience.

The process is important because a board full of generalists is not good enough anymore. Boards still need generalists, directors who have a broad perspective on the business, but they also need domain expertise, be it in IT, logistics, or Indian culture. True, sometimes the need for domain expertise is only temporary, in which case a consultant could provide advice to the board. But if it’s a critical, ongoing issue, a director must bring that expertise to the board.

Consider what new skills will be needed as times change. It could be new knowledge—of structured credit, global logistics, or accounting standards. Or it could be specific experiences, like a turnaround or cross-industry disruption. The combination of Google’s ascendance and Apple’s ubiquitous iPod digital music player have completely rewritten the rules for different parts of the media industry, such as music labels, newspapers, television networks, and ad agencies. In one of those sectors, a board with an ownership viewpoint might consider adding someone with insights on rapidly shifting alliances with partners in their ecosystem, or someone with experience acquiring and integrating companies such as social networking startups that embody the new media landscape. One respected newspaper chain is seeking directors who understand the technologies that are driving cross-industry disruptions in that business.

The knowledge of talent evaluation and compensation that a human resources professional brings is especially important for some boards. Deep understanding of capital markets, IT, logistics, consumer behavior, retailing, innovation processes, or how policy is evolving might be important for others. So, too, might deep knowledge of the business and political climate in a region or a country.

You also need to find the right balance among those skills, which a skills assessment matrix helps you see holistically. Most directors have a particular expertise or orientation—be it finance, branding, or manufacturing—that they bring to the dialogue. Every board benefits from a diversity of perspectives. Too many directors with the same orientation can skew boardroom dialogue, even bogging down in minutiae as they talk among themselves.

Group discussions often gravitate toward certain *bents*. For instance, a board that has several vocal directors with deep operating experience and limited exposure to strategy naturally skews toward productivity or cost cutting and could neglect other fundamental areas requiring investments, areas like innovation and future market development. A board with an overly domestic orientation might miss out on asking vital questions about the global context, such as what global drivers affect currency volatility and inputs like commodity prices. Thus, a balance of skills and expertise is needed so that a board does not develop too strong a bent in a single area. Boards have to be conscious of their bent and seek new directors who can keep it balanced.

The governance committee needs to be observant and *reflect upon the bent that emerges* in board or committee meetings. It only takes one or two members who are powerful or personable to influence the bent. It's a natural phenomenon of any group.

Given the surprises that any corporation can face, a board might even consider ensuring it has directors who can quickly take an interim corporate leadership role if the executive team falters badly. The fallout from the subprime mortgage debacle drove the boards of several banks and financial services firms to take interim leadership positions. It's not an ideal circumstance, but boards need to be prepared for virtually any possible eventuality.

How Do We Get the Right People for the Job?

Candidates need to be assessed not only for their skills and experiences, but also for how their personalities gel with the other directors. Different backgrounds will lead to different questions and points of view, but directors must be able to express their views without offending others or shutting down debate. They must also be willing to be influenced by others if the board is to get anything done.

There are a couple of things to watch out for. As J.P. Millon, a director of CVS Caremark, Cypress Bioscience, and InfuSystem, for example, says: "When you have eight to twelve people around a table, group dynamics and chemistry are fundamental. You don't want two extremes: first, the hyper-interventionist and disruptive person who because you say one thing is going to say exactly the contrary; second, somebody who never opens their mouth."

A few other personality traits are generally a negative to the group dynamic. Some people are too narrow in their thinking: they can't get away from talking about their bent. Others are too controlling: they are so used to being in charge that they unconsciously begin to assert power in the boardroom and put the management team on the defensive.

But the biggest red flag is a big ego; I remember how a search consultant was told by a governance committee chair why a person on his list would be unsuitable for that board because the potential director wouldn't be able to contain his ego in the boardroom. Successful people have sizable egos, but an egomaniac will almost certainly destroy boardroom dynamics.

On the other hand, some personality traits are indicators that a director could make great contributions. For example, does a director have the humility to invite a counterpoint in a manner that is constructive and not argumentative? Will she put herself in the company's shoes and not just expound on her own successes? Will he have the courage to engage in debate with a fellow director or the CEO? Will she have the temperament to make her point and be willing to accept that not all her fellow directors will agree with it or even be willing to debate it? Will she have the inner humility to invite opposite viewpoints and be willing to change her mind?

Appearances can be misleading. Directors should have the ability to speak up, for example. Yet I would take a quiet director who spoke infrequently but with great wisdom and authority over a well-spoken director with a compulsion to talk. I observed one board meeting in which one director spoke probably only three times. But when he said something, it was always a powerful observation or an eye-opening question. Other board members are all ears to this director's discourse.

Success or failure as a business leader is not necessarily a telling indicator, either, of whether that person will become an effective director. I met one person who had been forced out of his job as CEO but was a great director on a different company's board. He's a powerful thinker who was humble and articulate; he just couldn't execute when he held the chief executive's role.

Getting at those personality traits takes time. Governance committees might be accustomed to interviewing candidates over dinner and doing background checks to ensure compatibility. Those can be revealing, especially if the right questions are asked and the interviewer is a keen listener. In one case, the governance committee chair asked a director candidate to give an example of how she had helped the CEO of another board she sat on. She said she had recalculated the cost of capital. She was proud that through her persistence, she had been able to get the CFO to change the cost of capital from 7.2 to 8.2 percent. The governance committee chair had served on many boards, and during this interview he sensed that she might be a nit-picker and probably lacked the broad strategic thinking the board was looking for. The more the chairman continued to ask questions, the more he became convinced that she did not have the altitude of thinking his board was looking for.

Standard reference checking is not enough. Governance committees must make the commitment to vigorously check a candidate's references by talking to other people in the board's own social and professional networks.

You'd be surprised what turns up. Asking questions about a potential candidate such as whether he or she can disagree without being disagreeable, pushing a personal agenda forward, or feeling the need to show off their knowledge in a narrow area of expertise goes a long way toward uncovering a candidate's true colors. "Somebody who might seem easygoing and personable in the interviews," says Millon, "could be described as being pretty disruptive in interactions with a group." That's somebody you don't want on your board, regardless of their skill or expertise.

What Does the Board Succession Process Look Like?

If finding the right directors sounds like a lot of work, consider what it takes to construct a board from whole cloth. That's what Jack Krol did as Lead Director of the Tyco International board (the post–Dennis Kozlowski Tyco, by the way) when he built new boards for spin-outs Covidien and Tyco Electronics. That meant identifying and selecting twenty directors in six months and ensuring they would provide the kind of effective governance needed to restore credibility—an intense, pressure-cooker version of the board succession process. His approach is instructive for every board.

The traditional approach would have been either to let the CEO nominate a few of his or her trusted peers and then let those peers bring in a few directors from their cliques or to get a headhunter to bring a full slate to him. And while those approaches might have produced lists of smart and experienced individuals, they would not have resulted in high-functioning groups.

Krol took a different and more time-consuming course. He was very attuned to how personalities would combine to yield the most effective CEO/board relationship and group dynamic. So he dedicated himself to interviewing, checking references, and ensuring that the mix of both skills and personalities was appropriate.

The CEO works closely with the board, so it stands to reason that he or she would need to be comfortable with the individuals involved. So Krol talked with Tyco International's CEO and chair, Ed Breen, about what they wanted for their new boards, in terms of background, expertise, and types of personalities. He also involved the incoming CEOs of the spin-offs, both of whom were divisional heads at Tyco International. Together, they constructed a matrix of criteria against which potential directors could be *viewed as a group*. There was quite a bit of up-front work before any candidates were considered. And the CEO was kept apprised throughout the process.

Using a search firm to come up with a list of candidates was important at this point. "It used to be that the CEO selected his or her buddies [for the board]," says Krol. "What we've got to watch for now is that the Lead Director or nonexecutive chair doesn't select his or her buddies. We don't want to transfer the buddy system from the CEO to the nonexecutive chair or Lead Director. We need to find the best people and the best mix, and make sure they're independent, so we use a third party to come up with the candidate list for us."

On other boards, I've seen four or five directors who worked together in some past capacity form cliques because of their particular bent and comfort level working together. At times, these cliques can unintentionally evolve into a shadow board. They often begin to draw more attention from management and disrupt the functioning of the full board. To minimize that risk, it's a good idea to reach beyond personal networks to find candidates.

In Krol's case, there were twenty positions to fill, so a search firm was essential. One note on using search firms: it can be a tricky business using a large search firm that is conducting simultaneous searches. How will the firm balance among its clients when a candidate emerges with the right skills and experiences for more than one active search? The governance committee and the search firm should talk through potential conflicts before they emerge.

Boards have to work closely with their search firms to personally vet candidates. They can't fall into the trap of deferring too much of the process to the headhunter. As candidates emerged, Krol used references to personally test each individual's personal make-up and character. "A lot of times, the people that I talked to had experiences with [the candidate] on another board," Krol says. "That was very important because they could tell me what the personality of the person was like. 'Were they just sitting there and saying nothing?' 'Were they antagonistic?' 'How did they make suggestions to the board?' 'Were they a good listener?' 'Did the candidate push the board's effectiveness and dialogue forward?' 'Did the person help crystallize the important issues?' Those things are important in terms of what your relationship is going to be with your other directors and with management." He had to rule out many people after these interviews, including one candidate who was imminently qualified on paper and had a great reputation as a leader but was antagonistic toward the CEO on other boards he sat on. Krol and the search firm were in constant contact as new candidates emerged and were assessed.

The references had to come from individuals within personal social networks—that feedback is the most candid and frank you can get. The more trusted the individual the better. "There's always somebody that I knew well and so I could have a confidential conversation with them," Krol says. "You'd be surprised how much comes out just by asking them to talk. And you should go to at least two people when you're doing this, because you never know when somebody has a bias that might be unfair."

In the end, Covidien and Tyco Electronics both got strong, independent boards with a range of expertise, effective leaders, and cohesive group dynamics. To be clear, I'm one of the directors on the Tyco Electronics board and a member of its governance committee. I can genuinely say that board is among the highest-functioning boards I've observed. In less than ten months and fewer than five board meetings, the camaraderie of the directors is palpable and the discussion gets right to the critical issues and has, in the view of the CEO, added value. This information is based in part on feedback from management to the board about the board's functioning and contribution.

Although spin-outs and other events that call for new boards are not that uncommon, Krol's challenge was not something that most boards experience. Still, the steps he took are an accelerated version of what every board must do: treat board succession as a process, identify the board's needs, plan several years ahead, vet candidates through social networks over time, and be diligent in assessing candidates for their fit in terms of experience, expertise, and personality.

The Governance Committee's Pivotal Role in Board Succession

Organizing board succession is one of the central responsibilities of the governance committee and it should be part of its charter. It must take this role very seriously; if the composition of the board is not appropriate, it is a failure of the committee. The board must empower the committee to *actively shape* the board composition.

In many cases, the CEO still has a lot of influence over the selection of directors, points out Roger Kenny, president of Boardroom Consultants. But if the board is to grasp the reins of governance, the governance committee and not the CEO must have the ultimate say in director nomination.

Ever since Sarbanes-Oxley, companies have complained about the lack of availability of good directors. Many sitting CEOs, for example, have reduced the number of boards on which they sit to just two, and some sit on no boards but their own.

Qualified people are out there, however, if a board expands its search. Boards could expand their radar to consider people who are not necessarily CEOs and CFOs today but have the potential to be or have other vital experiences. That logistics expert I mentioned earlier has a military leadership background. Do not hesitate to identify people who meet your criteria and are first-time directors. In fact, research shows that many of the new directors being appointed are joining a board for the first time.

There might be a three-year lead time to fill some board positions as directors retire or move on. But boards can't afford to passively wait. If the board has an urgent need for a particular expertise, it should go out and get it right away. And to make room for the new director, the committee should encourage an incumbent to retire sooner.

"We say board succession is an ongoing process and shouldn't be left to retirement or events," Roger Kenny says. Boards are increasingly coming to his firm, Boardroom Consultants, with forward-looking, ongoing board successions rather than just to execute an immediate search. An ongoing board succession process gives them time to contact potential directors now, get to know them, and let them get to know you. Don't assume a given director doesn't want to serve because he or she has rejected other offers. Board service is always more attractive when the prospective director knows the board has its act together—that the board is thorough in covering its bases and functions well as a group.

The governance committee must not only recruit new directors, but also design and execute a formal succession process that accommodates the *transition of directors off the board*. Research shows that boards are not perfect in selecting directors, nor are they courageous in moving out those directors who either were mistakenly selected or whose presence in the boardroom is hampering the board's effectiveness. My research has found a few companies that do informal reviews of each director, usually conducted by the CEO or governance committee chair. In those reviews it's not unusual to discover at least one director who is no longer welcome on the board. In any human group, some people progress while others regress. Given the speed of change, the process of transitioning directors off the board is a must for the board to remain a competitive advantage. A transition process also prevents excellent directors from leaving in frustration. I have personally known two situations in which very good directors resigned because of frustration with their colleagues.

Some companies put in term limits to avoid awkwardness and create a natural attrition of directors. Governance committees would do better to create a climate in which a director stepping down is not a sign of personal failure but rather one of *fit*. Individual directors, for their part, should be attuned to their own contributions and how they are affecting the board's dynamic. They shouldn't stay on a board for the wrong reasons (see sidebar).

In order to keep board composition in tune with the speed and architecture of external change, the governance committee should ask at least once per year: How do we figure out what our board needs? How do we get the right people for the job? What does the board succession process look like? How can the

Are You Staying on Your Board for the Right Reasons?

Just as a board succession process requires a board to add members as needed, it also implies that directors must leave. One of these days, you could be one of those directors and volunteer to move on. Don't forget, there is more demand for than supply of good directors. You will be needed on other boards.

Board transitions are often perceived skeptically in the press, who like to infer that the transition represents either discord on the board or a director's inability to contribute. This can make it awkward for boards to make changes to their memberships and for directors to step down. But having a formal board succession process and letting shareholders know about it actually makes it easier to leave a board without the departure being viewed negatively. The company's reputation will remain intact—and so will yours.

Some boards have mandatory retirement ages. While directors may grumble at the arbitrary ages at which they must step down, mandatory retirement offers the benefit of creating a natural transition for the board to inject itself with fresh blood. And whether or not a board has a mandatory retirement age, it should consider having a diversity of ages present at all times in order to allow for attrition over time.

What I've also found is that conscientious directors will want to stay on a board for as long as they think they are making a contribution. And when they feel their contribution is dropping, they start to put feelers out for other opportunities.

On the other hand, there are a few individuals who fight to stay on a board because of the prestige, regardless of their contribution. *It is the job of the governance committee to decide* when it's time for someone to move on—whether it's because they've served for fifteen years or because they're not adding enough to the boardroom dialogue. The committee should do it gracefully, of course, and not make it seem like it is pushing the individual out. "The Lead Director or the head of the governance committee needs to be able to tell directors, 'You've done a great job, but that chair needs to be filled by someone with x, y, z skills,'" says Roger Kenny, president of Boardroom Consultants. It's the committee's duty to keep the board fresh and effective with a relevant mix of expertise.

If you find yourself in the position where, reading in between the lines, you hear the governance committee suggesting that you not serve for another year, hear the committee out and have the maturity to recognize that your expertise may no longer be crucial to that company. Better yet, sense when a change is needed before such situations arise. Anticipating when it's time to leave gives you the chance to explore other opportunities to wield your expertise.

governance committee improve board succession? Clearly, the board of Citigroup, among others, failed at this role prior to the subprime mortgage meltdown.

Once a year, the governance committee should present its deliberations on board composition and succession to the board, as well as its future plans for making the board the best it can be. In doing that, it must address:

1. The anticipated requirements of the board composition over five to ten years. Staggering the ages of directors on a board is important—that's why a ten-year view is needed.
2. A clear plan of what will be required, in stages, of nominating new directors, including the process of recruiting those directors, the time line, the pipeline of candidates, and the interview priorities. If three directors are expected to retire in the next five years, for example, how will those slots get filled?

3. The skills currently present on the board that are not going to be required or should be reduced in concentration (to make room for new skills).
4. The process of de-nominating directors—including board members who have become ineffective. The board's self-evaluation and peer evaluation are vital inputs to this process.

This is a serious responsibility. It demands commitment, time, and meticulous attention. If the governance committee is not actively working on board succession, every director should feel empowered to raise the question.

However, I don't want to give the impression that the mix of directors alone determines the effectiveness of a board. Far from it, in fact. Some of the greatest governance failures in history, like Enron, have taken place with a world-class assemblage of directors on their boards. These were highly decorated individuals with (previously) impeccable resumes. Rather, it takes a lot of other factors, including group dynamics, effective leadership, and each individual's personal adoption of the ownership mindset, for the directors to combine into an effective board.

Key Points

- Hardworking, conscientious boards can fail when their members lack crucial expertise.
- Boards must do their own succession planning with lead time to ensure they have the right mix of skills, experience, and expertise at all times. The board as a whole must be able to add value and provide proper oversight on the range of issues that are emerging.
- Personality is a hugely important criterion in selecting directors. Directors must be able to work well together for the board to be effective and yet be independent.

Table 1.1 Sample Directors' Skills Matrix

	Senior Leadership Experience (CEO/ President)	*Business Development/ M&A Expertise*	*Financial Expertise (CFO)*[1]	*Public Board Experience*	*Diversity*	*Independence*	*Innovation*	*Industry Expertise (Aerospace or wireless)*	*Operational/ Manufacturing Expertise*	*Global Expertise (Especially China)*	*IT/Technical Expertise (Academic/ Industry)*	*Brand Marketing Expertise*	*Government Expertise (State or Federal)*	*Governance/ Legal Expertise*
Ellsbury		X	X	X		X	X	X	X	X		X		
Pedroia	X			X		X	X	X						
Ortiz	X	X		X	X	X			X	X			X	
Ramirez			X	X	X	X			X		X	X		
Drew	X	X		X		X		X		X				
Lowell	X			X		X			X		X			X
Youkilis	X			X		X		X	X			X		
Varitek				X		X				X			X	X
Lugo	X					X				X			X	
Matsuzaka	X	X				X	X	X		X		X		

[1]As defined under Sarbanes-Oxley § 404

- The governance committee owns the process of having the right composition of the board at all times. The committee must have a clear process on what skills and experiences will be needed when, and how changes will be made along the way.

Table 1.1 is an illustrative example of a directors' skills matrix, adapted from one used by a successful board. The names and skills have been modified from the original for anonymity.