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## The New Paradigm of Governance

# Tribal Values: Guidelines for CEO Succession

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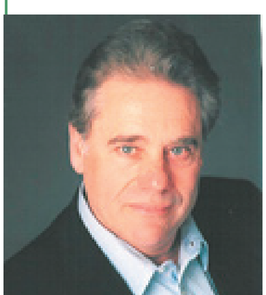

***Editor's Note:*** *Criminal malfeasance in the boardroom has provoked a legalistic counter-reaction in the past four years. In this issue of* Perspectives, *Academy President Rinaldo Brutoco argues that when independent board members stick only to the letter of the law, not only do they not serve themselves well, they also fail to make their best contribution to the corporation and its various stakeholders.*

*The highest calling of independent directors, he says, is to ensure optimal CEO succession. In this article he lays out a specific process indepedent directors can follow. In fulfilling these duties, they are performing in a role analagous to that of "tribal elders," ensuring the perpetuity of the business tribe.*

In the post Sarbanes-Oxley world, coercion and negativity have midwived the majority of incentives for improved corporate governance. Threats of duress and menacing statutes coerce the lowest common denominator of compliance. Indeed they do raise the bar, but not in such a way as to elevate the expectations of the societies at whose pleasure these companies do business. What needs to be found are the ways to inspire corporate leadership to a new level of social responsibility.

The barrage of luridly publicized corporate and mutual funding industry scandals has deeply eroded trust in business.[1] Negative coercive statutes like Sarbanes-Oxley, even if necessary to maintain only a minimal threshold of ethicality, will never approach the crux of the solution: we must inspire boards of directors and corporations so they will aspire to something higher than the minimum. The higher it aims, the farther a company must fall to find itself in a state of disgrace. It decreases the likelihood that companies will face an ethical crisis. More importantly, it will result in corporations' beginning to meet their broader duties to society. Never before have so many elements of society demanded that corporations fulfill these perceived obligations.

Anyone who serves on a board, particularly a public company board, wants to do more than grapple with the question, "How do we avoid getting sued?" It is safe to say that all directors who agree to serve today do so knowing the significant legal and moral responsibilities they are shouldering, and do so out of a motivation to do some good for the corporation on whose board they serve as well as for themselves. Ideally, boards and corporations would equate the observance of ethical standards above statutory minimums with the advancement of their own self-interest, the best interests of the corporation, the best interests of society and quite a bit more. When boards begin the journey by taking the higher road beyond statutory minimums, they walk beneath a gateway inscribed with a deeper and more interesting question: "What is our real job?"

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Clearly, outside directors now increasingly perceive themselves not only as representatives of the corporate shareholders, but also as advocates of the broader population of stakeholders. As a pragmatic reality, this broader portfolio of responsibility provides the surety of a healthy, sustainable, profitable corporation. For example, when independent directors assume an explicit fiduciary trust on behalf of the stakeholders called "employees," the stakeholders called "customers," the stakeholders called "vendors," and the stakeholders called "the communities in which these companies operate," they provide balance and stability as the corporation navigates through the marketplace.[2] In the daily course of commerce, such a corporation or business entity enjoys deep relationships with each component of society. This web of honorable dealings undeniably helps to fortify the firm's best commercial and social instincts through the years.

In charting such a path, independent directors truly behave in the modern role-equivalent of tribal elders. Today the term "tribal elder" conjures more images of the rainforest than it does of the boardroom. But consider that this role has been written into the memetic code of the social institutions primarily responsible for mankind's survival for over 99% of our temporal existence on this planet. Surely the tribal elder concept must have contributed something of merit as it successfully passed through thousands of generations on all continents whenever and wherever human beings have united to work toward a common purpose.

Tribal elders bear a simply stated responsibility: they protect the long-term viability of the tribe. In this article, we are defining the tribal unit as a corporation or a business enterprise. This is our thesis: in performing their fiduciary/statutory role, independent directors are insuring the long-term success of all stakeholders (i.e., all the members of the tribe), and specifically the long term success of those stakeholders/tribal members called shareholders. At the very least, they will thereby secure the prosperity of the shareholders' investment. And, by hewing to this longer view these "tribal elders" will insure the long term survival of the tribe-as-corporation. In its most successful form this type of tribal eldership will in fact produce levels of prosperity for each and every member of the tribe superior to those that a group with less mature oversight ever could achieve on its own.

*[When they act in the interest of all stakeholders] independent directors truly behave in the modern role-equivalent of tribal elders.*

As a corollary, one detects the absence of egregious ethical problems when independent directors perform in the capacity of tribal elders. There will be no Enrons, no Adelphias, no MCIs, no WorldComs, no Parmalats, because the elders protect, and indeed advance, the overall collective cultural values of this group of individuals called "the business tribe." They constantly scrutinize these values and seek effective means to insure, enshrine, and promulgate them into the future. That truly is the role of the independent director acting on behalf of all the stakeholders.

Diligent independent directors should undertake many specific tasks to fulfill their fiduciary duty as tribal elders. I believe the single most important obligation of a tribal elder, among a series of other duties[3] to be elaborated in subsequent articles, is to ensure good CEO succession. The most effective boards have approached this challenge by creating systems, methodologies, and approaches that maximize the probability of selecting a highly effective successor to the current CEO. The tribal elders must see themselves performing this function devoid of any desire, perhaps even ability, to become the next CEO. This separation must be absolute. To proceed otherwise would invite a conflict of interest and corrupt the entire process.

A thoughtful director will reframe this matter as follows: "How can we most carefully anticipate and execute our duties as tribal elders to select the next chief of the tribe?" In the book *CEO Succession*[4], Ogden and Dayton offer a persuasive articulation of the importance of CEO succession among a board's sundry responsibilities. They even suggest some internal mechanisms to assist management in developing high caliber candidates to succeed the current CEO in the event of his or her sudden demise (e.g., a plane carrying the CEO and one or more senior executives might crash) or through the natural passage of time. However such succession may occur, the book makes a powerful point: one cannot wait for a disaster to catalyze the process of CEO succession. There won't be time to act. Similarly, prudent organizations do not wait until the eve of a CEO's resignation to initiate a succession process. In either case – sudden emergency or thoughtful succession – a board's rightful role is to create a process which at any given moment over the long term will hone and refine the extant choices for a successor. The goal of this process is to maximize the likelihood of selecting the optimum candidate as the new CEO when the time arrives.

Excellent as far as it goes, the book *CEO Succession* certainly commends itself as required reading for every independent director. But the book doesn't go far enough.

Therefore, to augment one of the best published works in the field, the remainder of this paper proposes what might be an optimum systematic practice to raise the probability of identifying and selecting the best CEO candidate to lead the tribe.

The challenge of optimizing CEO succession demands three actions:

*The single most important obligation of a tribal elder… is to ensure good CEO succession.*

1. **Refocus on defining the role of a tribal elder**. In the World Business Academy we would submit that the principal role of the tribal leader is to ensure the survival, in perpetuity, of the tribe's core values and beliefs. In this way the benefits of those belief systems will inure to future stakeholders. Of course, belief systems, like everything else in the world, change over time. But core beliefs vary little even with the passage of decades and centuries. What, in business, might some of those core beliefs and values be?

One core value is commitment to employees. Another core value is integrity. Another is compassion. Another is choosing to work with people you like and choosing to like the people you work with. Another is the encouragement of "smart mistakes," recognizing that mistakes are not only unavoidable, they are healthy in an organization that seeks to renew itself.[5]

2. **Identify and clearly articulate tribal values, and ensure their consistent application.** The tribal elders must develop processes for: identifying the core values of the corporation on an ongoing basis; recommending the means by which those values are routinely referenced in the decision-making used by the CEO and those who serve beneath him or her; and verifying the ultimate application of those values in those decisions. This leaves the chief executive with the responsibility of identifying organizational priorities, defining operational choices, and leading by personal example in the application of those values as an integral component of the everyday decision-making process. Above all, tribal elders must make good on their responsibility for perpetuating those values, understanding that ultimate implementation depends upon other members of the tribe.

For example, Enron's board claimed ignorance of the gross malfeasance of many of the corporation's officers. This expression of narrow legal innocence scarcely diminished their culpability for dereliction of the stewardship they ought to have provided on behalf of the stakeholders of the company – the bankrupt future pensioners, the stakeholders in institutional investments, the electricity ratepayers and their economic dependents, taxpayers who must pay the interest on bonds issued to cover the Enron crimes, etc.

Since, as noted above, a principal goal of independent directors is to select the next CEO when the time arrives, the process for reviewing prospective CEOs should be transparent, objective, and efficient. Long before an actual candidate is considered or a CEO would assume power, a thoughtful CEO selection process demands clear and effective articulation of values pertinent to the selection. In public companies the majority of the board is independent, so in effect, the independent directors' job is to elect the next CEO.

Value definition and CEO selection live at the core of the independent directors' responsibilities.

*Three actions required to ensure good succession…*

As a practical matter, when directors identify the core values referenced above, they should also record them in matrix format, in order to create a screening tool with which to evaluate likely candidates who otherwise possess all the required business competencies. This introduces the third and final action:

3. **Seek analogs or examples of how a system of creating such a values' matrix has been applied to enlighten the selection process.** For example, an excellent analog in fact exists in the methodology historically used to assist in the selection and approval process of certain federal judges. Undoubtedly there may be others, but we will focus on this example as a way to illustrate the point:

By tradition, whenever a candidate was considered for nomination to the Supreme Court of the United States or the circuit courts of appeal, a neutral, politically non-biased panel convened by the American Bar Association would evaluate the qualifications of the prospective candidates based on a number of agreed-to criteria[6]. The panel would then submit that evaluation in the form of a rating of the jurist's competence, as measured by the application of the neutral criteria, to the President, the Attorney General, and the Senate Judiciary Committee for deliberation. This rating becomes a key consideration for the Senate as it determines whether to confirm the appointment. These ABA findings are a matter of public record. (In the case of CEO succession, I recommend that the review by the independent directors remain private and be shared only with the CEO.[7] ) Until the current administration, these ratings exerted great influence over whether a judicial nominee would be aggressively pursued or, in effect, withdrawn.

The Bar Association ranks the jurists as "Well Qualified," "Qualified," or "Not Qualified." They avoid any form of numerical grading. When their Panel rates a candidate as "Not Qualified" the determination should in theory and practice influence the President's decision. Unfortunately the current President no longer invites the reports into the pre-screening process[8] although the Senate Judiciary Committee still waits for the report before initiating the necessary hearings.

This is an excellent system. How do we emulate it in the context of a corporation? Here is a proposal:

- Independent directors, as a key component of their prescribed duties, would be required to develop the matrix of values they think are integral to maintaining the corporation's core strengths.

- Independent directors, with full input from inside directors, would then need to develop a screen to measure the relative strengths and weights of each criterion. For example, the truthfulness of a candidate might be weighted with a value of 10, while compassion for co-workers and other stakeholders might obtain a value of three in that particular corporation. However these values are determined by the board, they would be tabulated to form a screen. If the number of independent directors on the board exceeds five, it might be prudent that a committee of independent directors be authorized with this task (i.e., the creation of the screens and the investigation and report). Alternatively, the Governance Committee could manage the task. Whoever ultimately assumes the responsibility, however, must as a group revisit both the application of the criteria (i.e., the screen) and the very criteria themselves at least once a year. It is strongly urged that the corporation's bylaws be amended to provide that neither the requirement for annual review nor the process itself could be changed without a supermajority vote.

*Corporations can learn from the historical process by which the Senate approved federal judges.*

• The CEO's obligation would be to send the name of every potential candidate in the line of succession to the independent directors for their review. The report of the independent directors could not be concluded, and therefore no action could be taken on the candidate, until such time as the candidate had appeared in person, and also had supplied whatever other information the independent directors had reasonably requested in their review.

• The board or a subcommittee of independent directors (e.g., the Governance Committee) would then apply the screen to its direct and indirect knowledge of the candidate. For example, in a given company candidates who lie when truthfulness has received a high weighting might preclude themselves from serious consideration despite a top score in the criterion of compassion. Conversely a candidate with very little compassion, but who is scrupulously honest, might survive the screen.

• The next step of the process links the results of the screen with the rank-categorization of candidates. I would recommend that the report, along with its foundational assumptions, be forwarded to the CEO in strictest confidence. The findings would accord each candidate with a ranking of: "Unacceptable," "Acceptable," "Good," and "Extraordinary."

As noted above, independent directors would review this screen and its supporting criteria annually to insure that it continues to reflect the core values, beliefs, and characteristics of the organization. In this way, the independent directors assume the obligation to scrutinize the corporation's integral core value set on a regularly scheduled and systematic basis. In the example of the ABA, the panel of jurists utilized such criteria as:

• How often has this person been reversed on appeal? (This provides a proxy for the accuracy of the candidate's application of the law.)

• How much respect do other jurists in their jurisdiction hold for him or her?

• How much respect and esteem are accorded this candidate by members of the bar who practice before them?

• What is the quality of their written opinions?

• How frequently are their opinions cited in law review articles as an example of forward-looking or erudite jurisprudence? Boards can deduce similar criteria related to the activities of the individuals when measured against whatever the board perceives to be "core values" of the organization.

• As also noted previously, the by-laws of the corporation should be amended to require a 2/3 (super-majority) vote of the board in order to suspend the preceding CEO succession methodology from occurring to insure that the independent directors and management have played their respective optimum roles and the tribe's long term safety is assured.

This approach for CEO evaluation is a revolutionary concept, and based upon the scandals we have seen, perhaps the precise medicine that will cure the corporate patient. If every public company adopted the process described above, the planning for CEO succession would improve by a degree that would astonish skeptics. The quality of the CEO selected as a result of that process would be dramatically higher.

Notice that the decision to make a recommendation to the board of a successor CEO still resides with the existing CEO. The group is supplying the CEO with information in advance as to how the board regards that candidate, based on these critical criteria. The CEO can make his or her own judgment about the business competency of the candidate – their skills in operations, finance, administration, etc. All the while, the board examines the values that underlie the entire corporation and makes sure that those values are reviewed as a critical part of the process. This rarely occurs today in any form of CEO succession planning, and exceeds the recommendations of the Ogden book cited earlier.

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As referenced above, the CEO's duty therefore is to identify every person currently in the corporation who could become a chief executive, even if the CEO-prospects are currently working more than one level below in the organization. The CEO would forward these names to the directors for review, as well as the names of any outsiders the CEO would currently like to have in consideration. The directors would then conduct their review expeditiously and forward their report to the CEO in confidence.

If, after having observed the candidates for an extensive period of time – perhaps one or more years – the CEO felt that the candidate had significantly progressed in those areas which the board felt required improvement, the CEO could request a re-evaluation of that employee at any time by the independent directors and the issuance of a new follow-on report to further guide the CEO's supervisory oversight of the employee. This would permit, indeed encourage, the possibility of growth in the core values the CEO and the organization hold dear.

As noted above, outside candidates would also pass through the same process[9] at such time as they wish to receive active consideration as a potential CEO. This most likely would occur at a time closer to the selection deadline for the new CEO, as outside candidates rarely like to "float" their names prematurely.

In a sense this inability to screen outside candidates provides the inside candidates with a distinct advantage: their alignment with core corporate values will be constantly evaluated and approved over time. This is a highly desirable outcome. It will greatly improve the chances for promotion from within, which itself adds to the stability of the corporation. It is always preferable for a tribe to find the next chieftain from within its current ranks. Only in those rare circumstances where no one has the suitable set of skills should a tribe look to the outside for its next chief.

One could argue that the absence of a process like the one discussed in this paper has in fact contributed to the recent trend that sees corporations far too often looking outside their current executive group to find the individual skillful enough to become the next CEO.

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One question remains: "Is it really that important that the next CEO fully embrace and represent the core values of the tribe?"

It appears to us that the question literally answers itself. How can any tribe survive – aboriginal, indigenous, or corporate – if it does not embrace certain core values that define its very essence? *A fortiori*, how can a tribe select any new leader who does not understand and embody the best chance for the group's core values to maintain the collective existence into the future? The greatest technical skills of a CEO, (e.g., financial, administrative, operational or legal) will prove inadequate to produce long term corporate success unless those same skills are imbued with the essence of the core corporate values. There is no more common tragedy than gifted technicians who fail to understand the organizations within which they must operate.

Conversely, one rarely sees a corporation more successful than the one in which a founding entrepreneur displays currently relevant executional skills while maintaining his commitment to the blend of core corporate values. More than any other insight, that fundamental awareness does more to explain the multi-decade success of organizations like Starbucks, the Men's Wearhouse, and Southwest Airlines. In fact, the history of corporations proffers abundant examples of organizations that blended the perpetuation of core values with excellent and contextually appropriate execution, (e.g., IBM under Thomas Watson, Walt Disney) only to lose that balance. In the process the tribe almost lost control, to the point where an outsider had to take charge in order to re-launch a new set of executional skills matched with an entirely new set of corporate values. The sheer size and mass of IBM afforded Louis Gerstner the time to effectuate such a massive reorganization. Hats off to him for the achievement. The tragedy remains. It should never have been required at all.

The corporate tribe faces real danger when it neglects its core values and assumes that excellent execution is the only prerequisite for success. Over the past two years, the business journals of the world have broadcast the concerns of Walter Hewlett: in acquiring Compaq, he feared HP was in imminent jeopardy of losing its core values. And, although the technical integration of HP and Compaq was probably the most successful event of its kind ever achieved by organizations of their comparative size, it appears in hindsight that Walter was right.

In the process, HP is generally perceived at this time to have "lost its way." Does this mean that Carly Fiorina is a bad person? No, but it does imply that she chose not to accord proper weight to the question of values, in contravention to Walter's wishes. And as Walter correctly surmised, to ignore this question was to imperil the tribe. All neutral observers agree that HP is destined for a period of further restructuring and reorganization. More summary management "executions," as have occurred within the last few months, will not alter the necessity for HP to submit to the painful process of determining what its new core values are, and how management intends to act on them.

Clearly, in whatever way the HP board may have assessed Walter's original challenge, it is now essential for that board to begin to perform the fiduciary duty this article describes.

It was not Carly Fiorina's responsibility to set the core values of HP; that was the board's responsibility.

It was not Carly Fiorina's responsibility to judge whether her technical execution of the Compaq integration coincided with those values. (That would be analogous to asking a star professional athlete both to compete and simultaneously act as an umpire.)

It is therefore clear that the challenge for HP now rests at the level of the board. The approach outlined in this article could be one way for that board more effectively to execute its fiduciary duty to all stakeholders in the future.

There need be no recriminations for mistakes made in the past.

There need be no recriminations for how any corporation, including HP, got to the state where it desperately needed to assess its core values.

Whatever has happened in the past, with HP or any corporation, has happened. It is history. It is over. Rather, this article deals with the larger, more constructive issue: how to create the future in a way that optimizes the long term success of each corporate tribe within the context of the group's self-defining core values.

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*HP is generally perceived at this time to have "lost its way."*

1. A Harris Interactive poll (1,022 adults, December 2003) shows that investor confidence closely aligns with companies' compliance with the Sarbanes-Oxley Act. Three in five investors believe that the law will help protect their stock investments. Additionally, 57 percent said they would be very unlikely to invest in a company that failed to comply with Sarbanes-Oxley. Another Harris poll (2,023 adults) in November 2002 found 87% of all adults believe that most top company managers are paid more than they deserve, and that they become rich at the expense of ordinary workers. Most (85%) of those who think top managers become rich at the expense of ordinary workers are angry about it, and 46% are very angry.

One major indication that attitudes toward business leaders have become more hostile as a result of the recent scandals is that two-thirds (66%) of all adults believe that rewards in the workplace are distributed less fairly today than they were five years ago.

2. This practice leads to socially responsible investing. Investors in values-based companies seek long term profitability. Those who seek short term gain will tend to migrate to other stocks to jump in and out of, thereby reducing the volatility of the companies that are values-based. In fact, this

phenomenon enhances the long term safety of individual investors and pension funds.

3. These would include: making a profit; assessing values; clarifying and helping to set the mission and vision, ensuring optimum corporate governance at all levels; ensuring compliance with all corporate values and ethics (including financial compliance); and maintaining a perspective for the corporation's trajectory into the future, among others.

4. Dennis Carey and Dayton Ogden, *CEO Succession: A Window on How Boards Can Get It Right When Choosing a New Chief Executive*, Oxford University Press, 2000.

5. When individuals or organizations make mistakes, they continue to learn and grow.

6. These criteria are: integrity, professional competence and judicial temperament. See http://www.abanet.org/scfedjud/backgrounder.

7. If one of the candidates is actually nominated by the CEO or otherwise comes before the board as a candidate for CEO, that report could be shared with other directors, including inside directors, but otherwise would not be.

8. Breaking with a 57-year tradition, President G.W. Bush in March 2001 announced that he would no longer invite the ABA into the pre-screening of candidates, but would welcome ABA participation "on a more equal basis with any organization," once he has nominated a candidate's name to the Senate. Notwithstanding this attempted presidential reduction of status, the ABA persists in performing its duty for society by preparing the ratings, and making them available.

9. When corporations look for CEO candidates, many if not most employ search firms. This proposed policy does nothing to diminish the role of retained search firms. Unfortunately companies tend to rely too heavily on the search firms' own assessments of the candidates' business and values sets. This new process returns to the board the appropriate role of articulating the precise set of core values as well the responsibility of assuring that these values receive their due consideration in the process. In fact, were the board to supply the firm a copy of its screen, it would clarify the requirements and so expedite the search.

**About the author:** A leading international executive, writer and keynote speaker for over twenty five years, Mr. Brutoco is widely recognized as a practical visionary, change agent and futurist. Rinaldo uniquely combines theory and practice to assist executives and organizations in adapting to change with"breakthrough" ideas.

An accomplished futurist, Mr. Brutoco has served on the board of The Men's Wearhouse, a $1.3 billion-dollar retail sales New York Stock Exchange company, for over a decade from its initial IPO to the present time. During that same time period, Mr. Brutoco was CEO and Chairman of the Red Rose Collection, which was named for three consecutive years to INC Magazine's 500 fastest growing privately held companies.

In 1986 Rinaldo founded, and currently serves as President of, the World Business Academy, a collaborative network of mindful individuals collectively exploring the leading edge of business and a pre-eminent publisher of new paradigm business literature.

On moving to Ojai, California, Rinaldo formed The ShangriLa Consulting Group where he consults, as principal, on The Leading Edge of Business, International Micro and Macro Economics, Internet and Technology Architecture Strategies, Relationship Building, Enterprise Stakeholdership, Servant Leadership, Technology, Finance and Future Studies.

RInaldo obtained a degree with highest honors in Economics and Philosophy in 1968 from Santa Clara University and a Juris Doctorate, Order of the Coif, from UCLA School of Law in 1971.