World Business Academy

PERSPECTIVES

Volume 19
Issue 5

Rekindling the Human Spirit in Business

September 22, 2005

The New Paradigm of Corporate Governance:

The Buck Stops Here

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Independent directors are a mandate of Sarbanes-Oxley. Many people believe that independent directors are the main line of defense against more corporate corruption.

But what makes for a successful group of indendent directors?

Academy President **Rinaldo Brutoco** and **Gerry Czarnecki** continue the Academy's Corporate Governance Series arguing that a board of directors that meets the letter of Sarbanes-Oxley will likely not fulfill its responsibilities unless additional pre-conditions are met. These include a particular type of group consciousness, role clarity, an appropriate budget, full access to information, and more. They also provide a practical tool for dividing responsibility between boards and management.

Boards of Directors, comprised of individuals who came up the corporate ranks through such a system, worked in a similar fashion.

Most successful executives began their careers as individual performers. Back then, they did their job and that was it. They reported to somebody who called the shots. That person decided what they did and what it cost to do it. In short, they were resources to a superior and to the organization. Life was defined as: work, go home, and get a paycheck.

Up Through The System

Boards of Directors, comprised of individuals who came up the corporate ranks through such a system, worked in a similar fashion. The chairman of the board, who likely also served as the CEO, packed the board with friends and acquaintances because they shared overlapping business interests. The expression "old boy network" was coined to indicate that each member of the board saw it as their duty to assist the CEO in achieving his (or very rarely, her) objectives for the corporation. Independence received frequent lip service, but rarely was practiced. In fact, the principal criteria for accepting a new board member were whether they "got along" with the CEO and the rest of the board and how well they could assist in achieving the predetermined objectives laid out for the board. Everything went along in a fairly smooth and predictable fashion. Remarkably, even the increasingly high rates of CEO turnover that have occurred in the last two decades did little to upset the "clubby" atmosphere in most boardrooms until the tremendous corporate scandals of the last few years and the passage of the Sarbanes-Oxley law.

"The Times They Are A'Changing"

Now…fast forward. It's 2005. Kozlowski and Swartz have been convicted from Tyco; Bernie Ebbers and five others have been convicted from MCI; John and Timothy Rigas were convicted from Adelphia; Frank Quattrone was convicted from Credit Suisse First Boston; Andrew Fastow has been convicted at Enron with Ken Lay and Jeffrey Skilling awaiting trial; the insurance industry titan Hank Greenberg of AIG stands in the dock awaiting his fate; and the list goes on and on. Two questions should immediately come to mind:

• Where were the boards of these formerly prestigious companies while all of this criminal and fraudulent conduct was going on?

• Secondly, given the amazing fact that no directors have yet received criminal indictments, what is the probability (also known as "risk" for directors) that standards are going to have to be dramatically higher if liability for boardroom performance is going to remain behind the levee of management?

Already in two high profile cases (Enron and MCI) individual board members have consented to be held personally liable for damages to third parties. While some consider the penalties these directors paid to be relatively minor given the scope of the financial disasters that occurred on their watch, the very fact of personal liability for directors has sounded a "wake-up" call throughout the world's boardrooms. And well it should!

As recently as the late 1990s your job as a director was relatively safe and simple. You went to meetings, you listened to management's presentations which focused you on what management wanted to discuss; you asked questions of management about what they asked you to discuss and relied almost exclusively upon management for the validity of what management told you; you deliberated upon the issues presented to you (usually with management in the room); and, then you voted on the issues management asked you to vote upon. It seemed to you that you were ably doing your job, you received lots of perks and a nice "paycheck", and you went home. Here's the place for two more questions:

1) What's wrong with what was just described?; and

2) What has changed in boardrooms?

A Servant of Two Masters Serves Neither

In answering the two questions posed above, let's look at "what's wrong" with the friendly board/management system just described. What's so "wrong" about it is that boards in serving such a "cozy" relationship with management were failing in their primary responsibility to maintain their independence under every conceivable system of corporate governance. Until just the last couple of years (and continuing on in some corporations to this day) boards of directors have so badly failed to act independently that they, knowingly or unknowingly, abdicated their primary responsibility to oversee management on behalf of all business stakeholders. In attempting to serve management as its master, the board has failed twice: it neither serves management (consider all the management convictions referenced earlier), nor does it serve the other stakeholders of the organization as "the master" on whose behalf the board was appointed. Those failures are not just "wrong." They reveal a fatal flaw in our traditional notions of corporate governance that stands out larger than any other single factor in creating the permissive business culture that spawned virtually all of the corporate scandals of the last two decades.

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What Has Changed ?

As to the second question above -- What has changed? -- the answer is "Quite a lot," even though a great deal more must change before we have fully addressed the underlying governance crisis. The resolution of this issue lies in the critical path as we march toward the goal of rebuilding the corporate economic system.

Most of "what has changed" still deals with the role of management. Sarbanes-Oxley and related regulations have sent shudders through corporate ranks with their mandatory provisions that executives actually sign sworn statements to the SEC under penalty of prosecution. That corporate executives should be honest in their disclosures is hardly novel. Nor is it novel that they have had an affirmative duty since 1977[1] to seek out, disclose, and eradicate inappropriate corporate behavior by assuring that there were appropriate controls in place. "What has changed" for management is that we now have severe penalties for failure.

In a similar vein, for accounting firms "what has changed" is that Anderson, KPMG and many others have been held accountable for what they did and are required to achieve a new level of independence in order for investors to have full confidence that auditing decisions are made based upon auditing standards and not upon either cozy relationships or the pursuit of unrelated business income.

This is "what has changed." Now let's look at what hasn't changed enough. In our view what must change now is the role that absolutely every board of every successful company, public or private, absolutely must change in order for our capital markets' system of economic organization to succeed.

The Ultimate Responsibility

According to the law, the board holds ultimate responsibility for everything that happens in the corporation. Can you imagine the significance, as some public company directors are beginning to, of that concept when wedded with the public's growing displeasure with corporate scandal and the commencement of personal liability for directors? Forces that can only be described as tectonic have been unleashed.

It is therefore critical that directors cease seeing themselves as "hired hands" and begin to conduct themselves as a separate group within the broader corporate organization or "tribe."

As directors, we may appropriately delegate much of our responsibility to the CEO and the management team, but that does not relieve us from owning the ultimate responsibility.

As directors we are the final legal authority for every corporate act. We are "in charge" of the corporation while the management team is "in charge" of executing the corporation's vision. It is therefore critical that directors cease seeing themselves as "hired hands" and begin to conduct themselves as a separate group within the broader corporate organization or "tribe." The board must begin to see itself as a separate organizational unit called the Board of Directors. Directors must begin to see the board as the board, an entity separate and distinct from the company itself. The board must see itself as the organizational unit apart from the corporation while at the same time it is charged with being responsible for the corporation.

The latest literature about corporate governance has addressed board member independence, but it scarcely mentions our contention that boards of directors as "entities" must be independent. We believe that the law is groping for, and the investment community will increasingly demand, boards being able to function as independent entities, as opposed to being just a collection of independently selected people. Boards must have a functional group structure that enables them to execute their responsibilities to all the various corporate stakeholders. They must carry out those obligations with a conscious awareness that they are acting as a group. To reiterate for emphasis: the board must see itself as an independent entity or council within the organization, while at the same time separate from the larger business entity of which it is a part, charged with the obligation to see that the business entity itself is run in perpetuity for the benefit of all stakeholders.

Directors seeing themselves as a functioning organizational *group* is a paradigm change in corporate governance. To accomplish this dramatic shift in perspective, and to execute the responsibilities that come attached to this perspective, boards must have the leadership as well as the human, intellectual, and financial resources required to operate effectively and carry out their responsibilities.[2]

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Director Independence Requires Board Independence

Under the current governance climate Sarbanes-Oxley mandates many changes in how directors function in their roles as fiduciaries. Most importantly, the law creates a strong regulatory incentive to enhance the role of independent directors. "Independent" encompasses the requirement for both a critically independent perspective, as well as a consistent pattern of independent behavior. Though many people today discuss the matter of independence in many different ways, this is the essential point: in counterpoint to management, board members are lawfully bound to think and act independently.

Even if the current regulatory environment did not address behavior (which it does), any meaningful commonsense definition of independence would encompass the characteristics of independent behavior which this article proposes.

American legislators, regulators, and the investing public place high expectations for better governance on directors, all the while chanting the mantra of independence.

Director independence in daily behavior and board duty performance, as determined by the board rather than by management, is essential to a well functioning capital markets' system. In a similar vein, the board's independent directors need to possess clearly articulated selection criteria pertaining to the processes for nomination and election of new directors rather than delegating that task to senior management or to management directors. Viewing director responsibilities in this light will go far toward disconnecting the "old boy" network of the past. No doubt, better and more truly independent directors will find their way onto the boards of all business organizations in increasing numbers. This in turn will produce healthier, more responsible companies.

Likewise, selection and articulation of core organizational values, organizational ethical standards and rules about conflicts of interest must be set by the independent board members utilizing their maximum objectivity and highest level of diligence.

There is one other pre-condition to effective governance. In addition to directors assuming the responsibilities outlined in this article, and in other articles in this governance series (e.g. *The Demise of the Imperial CEO*, CEO Suc-

Boards must have control of the financial resources that govern their activity. Equally important, the CEO and management team must know what the board will "cost," just like any other expense or cost center.

cession, etc.)[3], effective governance also requires that directors in a new and meaningful way take responsibility for the success and failure of the companies they serve. Attempting to define how to assume this responsibility, while still permitting "management to manage," has become one of the most critical challenges for any astute business theorist looking at the post-Sarbanes-Oxley world. Successfully meeting this responsibility requires boards to think and act in totally new and different ways.

"He who pays the piper picks the tune": The Need for Board Budgets

When directors embrace their accountability as a group, unit or organization, they will realize that they have to organize and structure themselves to form an independent, goal- and task-setting entity called "The Board."

In the management hierarchy of all corporations, organizational units are established as "budgeting units," and the owner/manager of the specific function must create a business plan and a financial budget. If the board is an organizational unit, then the board must decide what it will do, how much it will spend, and how much it will be responsible for in the budget it approves.

Thinking back to our former days as CEOs, we both recall that it was extremely rare for us to consult with the board when establishing the annual financial plan. The accepted practice was that management estimated what would be spent on board meetings, put that figure into the budget along with all the other line items, and submitted it to the board for approval. When approval occurred, it was likely that there was no substantive discussion of the board expense line, if it showed up in the presentation at all. It is remarkable how many meetings we have each attended over the years, and we can scarcely recall a single thoughtful conversation about what material resources the board would need to accomplish its job on a yearly basis, nor what the budget for doing that job would be, nor how the board ought to organize itself and its resources to meet the fiduciary requirements of the job.[4]

Although many of the board's basic duties have changed in the post Sarbanes-Oxley world, at least one thing remains the same: boards do not see themselves as independently budgeted units. This practice may actually be the most critical step in changing the board's perspective on its governance role and activities.

In the world of the "Imperial CEO," this would not have been considered. In the world of engaged boards, planning board activities and the budgets required to support them are essential. Boards must have control of the financial resources that govern their activity. Equally important, the CEO and management team must know what the board will "cost," just like any other expense or cost center.

Board and Management Must Remain Constructively Separate

Management commands the most frequent access to most of the organization's human capital, information resources, and thought leadership. If the board is to direct, verify, and oversee the activities of a sophisticated and complex organization, then it too must have a sophisticated organizational commitment or it runs the risk of ceding "control" of the company to the management.

When the board exclusively relies upon the support functions of the management organization, the board becomes unduly dependent upon the management organization. When the board relies solely on management for information and analysis, directors may be fully independent, but the board as a whole will be fully "dependent."

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In the same way that staff organizations provide information, boards must have fully functioning support structures that ensure their ability to perform their separate and distinct jobs. For example, only recently has acceptance been won for the practice of requiring independent auditors actually to report to the board audit committee rather than to management. Only a very few years ago the auditors perceived themselves as hired by the CFO with the consent of the CEO to do the job of independent auditing. Cascading corporate scandals have exposed the fallacies underlying this approach. Today, no one disputes either the necessity or the wisdom of having auditors who are truly independent of management. In a similar vein, it is clear that a company's internal audit function must also report to the board's audit committee. Nonetheless, many boards have been less willing to deal with their overwhelming reliance on management for every other critical function of the corporation where independence is required but very often sacrificed.[5]

All of the foregoing observations in support of an independently operated board, supported by its independent organization, are precisely the prescription shareowners are demanding to insure adequate management oversight. An independently supported board organization is the only way the shareholders can be sure that corporate management adheres to established board policies that are congruent with stakeholders' interests.

Boards must do more to protect the shareholders, not just themselves. The excuse of "I had no idea what was going on, and management failed to give us a complete story" may protect directors' financial assets and keep them out of jail,[6] but it does nothing to prevent future abuses. Directors must move oversight to the next level and establish an organizational structure that is fully independent of management.

What Makes For An Effective Board Organization?

Any group of individuals forming an organization must have a clearly stated mission with strategies, tactics, and action plans. That group must also have the ability to understand and assess the threats, risks, and opportunities to the organization. A permanent structure, adequate staffing, division of work, standards of performance, processes, information systems, and communication mechanisms all provide the basis for execution. In most corporations these elements already are in place; however, they exist to serve the management organization, not the board. For the board to be effective, it too must have independent access to all of these elements.

The most important barrier to this goal is the board itself. Few boards have accepted the requirement of such structure and discipline in their role; even fewer are willing to tell management what they believe is required. Many directors are concerned that if they create "too much organization" they will usurp the role of management. Yet if boards do not substantially increase their commitment to organizational discipline and process, board ignorance will once again lead to more of the tragic governance failures that we've seen over the past several years.

Where the Board's Role Ends and Management's Begins: The "Corporate Continuum"

We believe an elegant "Corporate Continuum" exists, making it very simple to understand and distinguish between the board's role and that of management.

One of the most vexing questions plaguing the corporate governance debate in today's world is the issue of how the board performs its independent duty while allowing "management to manage." More than any other single factor, fear of stepping "over the line" into areas of management prerogatives has caused the most frequent dereliction of board duties. Why? Obviously, the board by its very nature should never "run" the corporation. Conversely, we believe that management should never set the policies that govern the corporation's behavior, nor should managers be the final arbiters of what is best for each stakeholder of the corporate community.

In previous articles[7] we have outlined the practical and legal need for the board ultimately to set policy. In matters both of law and good corporate practice, the board is the final authority of the corporation. As we noted at the outset, it is where "the buck stops."

We believe an elegant "Corporate Continuum" exists, making it very simple to understand and distinguish between the board's role and that of management. We suggest the following guidelines:

Consider pure policy (i.e., Values) on one end of the continuum and pure execution (i.e. Tactics) being on the other. We believe:

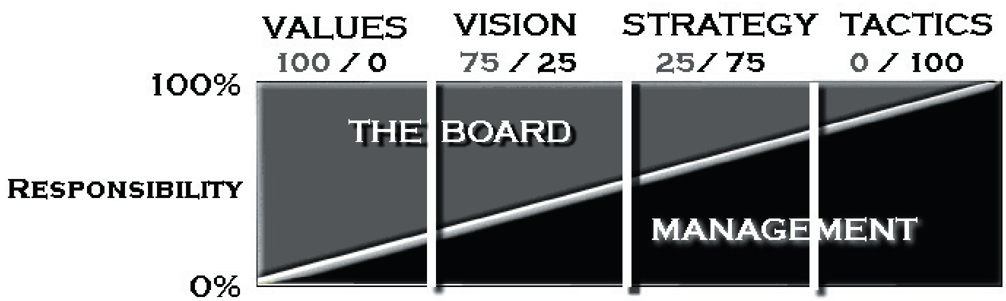
1) The board is 100% responsible for defining and establishing corporate Values.

2) Understanding how these values will play out in the marketplace, that is, creating the "Vision" for the corporation, is a joint activity between the board and management, wherein 75% of the responsibility remains with the board and 25% of the responsibility belongs to management.

3) Translating the Vision into practical outcomes requires a Strategy which is derived by a 25% board participation and a 75% management participation. And, finally…

4) The Tactics by which the Strategy is implemented are completely the province of management.

The following graph helps to lay out the respective responsibilities in this Corporate Continuum.



With such transparent guidelines, it will be very unlikely for anyone to perceive the board as "meddling" in management's purview in the areas of Strategy and Tactics, nor will it be possible for the board to duck its ultimate responsibility for the conduct of corporate affairs in the area of Values and Vision. As you can see, those items which are the broadest in concept and application remain with the board. Those items that exist exclusively in the area of execution remain entirely within management's boundaries. So ends the great dilemma – and with it ends the last excuse of any board to fail to meet its independent responsibility.

It's Too Late To Be Shy

Assertive board leadership will change routine behavior and move boards to create an organizational mindset. Assertive leaders will foster a disciplined culture at the board level and will compel the board to engage in processes that ensure better governance. The simplest first step is insuring that a non-executive chairperson or the equivalent be in charge of the board's own process. Title is not important. Sometimes this is referred to as the "Lead Director" where the CEO is a management member. It is key that a single named individual is acknowledged as having the precise recognized role of organizing and directing the board's process while marshalling the board's resources for its collective use. Separating the leadership of the board from the leadership of the company, while recognizing two distinct organizations with separate responsibilities, is the critical milestone on the path to true independence.

The board must set its own agenda. When boards stop being shy, the board organization will accept management's input to the board's agenda, not the other way around. As noted before, setting the right agenda requires the knowledge and resources to identify potential issues, risks, and problems in multiple disciplines.

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The agenda should naturally evolve out of the annual calendar. While leaving sufficient scheduling flexibility to address unforeseen problems as they arise, the annual calendar nonetheless should assure the board's focus on key issues such as compliance with corporate values and ethics, integration of Vision with Strategy, Strategy review and approval, risk assessment, and operational and financial oversight within the confines of the Values and Vision unique to that corporate organization.

Summary

...the heavier the hand comes down, the more the target tends to jump to the side.

If you are serving on a board, what will these recommendations summon from within you? We have said that you cannot be shy, but at the same time you must also appreciate much that is subtle. There is nothing understated about Sarbanes-Oxley. Precisely for that reason, just as anyone who has raised children knows, the heavier the hand comes down, the more the target tends to jump to the side. SOX alone will not get us where we need to go. More than anything else, this is a call first to awareness and then action. While the corporate governance continuum tool provides clear boundaries, independent directors must transit the interpersonal and organizational whitewaters amongst themselves and management to guide the corporation to a harbor of responsible governance. Turning these recommendations into reality will require a self-awareness and cohesiveness of the directors as a group and a mastery of nuance. But then, this deftness of touch is exactly what business demands and, presumably, the very quality that society demands of business.

It's high time to complete the reformation and redefine the role of independent directors. Let us begin.

FOOTNOTES

1. See *Sarbanes-Oxley & Section 404: "*Old Dog/New Teeth," Gerry Czarnecki, World Business Academy *Viewpoint*, March 31, 2005. (http://www.worldbusiness.org/articles/2005/vp033105.pdf) In this essay the author traces the history of American governance legislation and makes the point that many key provisions of Sarbanes-Oxley went into the books in 1977. They simply were not enforced.

2. We are not here making a case for increased compensation, though it could be strongly argued that most directors are underpaid for the level of duties we believe directors should undertake in the current environment. We intend to address this compensation issue in a subsequent article as it merits a thorough review.

3. See "The New Paradigm of Governance: Tribal Values / Guidelines for CEO Succession, "Rinaldo Brutoco, World Business Academy *Perspectives*, January 20, 2005, http://www.worldbusiness.org/articles/2005/pr012005.pdf. This essay presents a number of tools for selecting appropriate directors; "The Role of the Board of Directors in Global Compliance," Ronald Loeb, World Business Academy *Viewpoint*, March 17, 2005 http://www.worldbusiness.org/articles/2005/vp031705.pdf examines the role of directors in outsourcing; "Stewardship, A Revolution in Governance," Peter Block, World Business Academy, March 1993; http://www.worldbusiness.org/articles/March_1993/pr0393pb.pdf; examines the directors in light of an approach akin to servant leadership.

4. The only exceptions to this observation were the rare occasions in the past few years where we have been required to obtain counsel from beyond company's in-house counsel in order to properly review a specific company policy or issue within a limited time and scope. Once separate counsel dealt

with the issue, however, the situation returned to "normal."

5. E.g., in the apparel industry the board must rely upon representations of management that worker conditions in developing countries meet all applicable corporate standards, but the very individuals in management responsible for employing those foreign workers are precisely the same management individuals who "certify" to the board that management is in compliance with board policy. Numerous other examples exist in virtually every other area of corporate activity.

6. This "defense" is working less in the courts than in days of old as Bernie Ebbers recently discovered. The same has held true for directors of MCI and Enron who have paid personal judgments for lawsuit settlements based on what they didn't do.

7. See Footnote 3, particularly "The New Paradigm of Governance: Tribal Values / Guidelines for CEO Succession," Rinaldo Brutoco, World Business Academy *Perspectives*, January 20, 2005 http://www.worldbusiness.org/articles/2005/pr012005.pdf

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