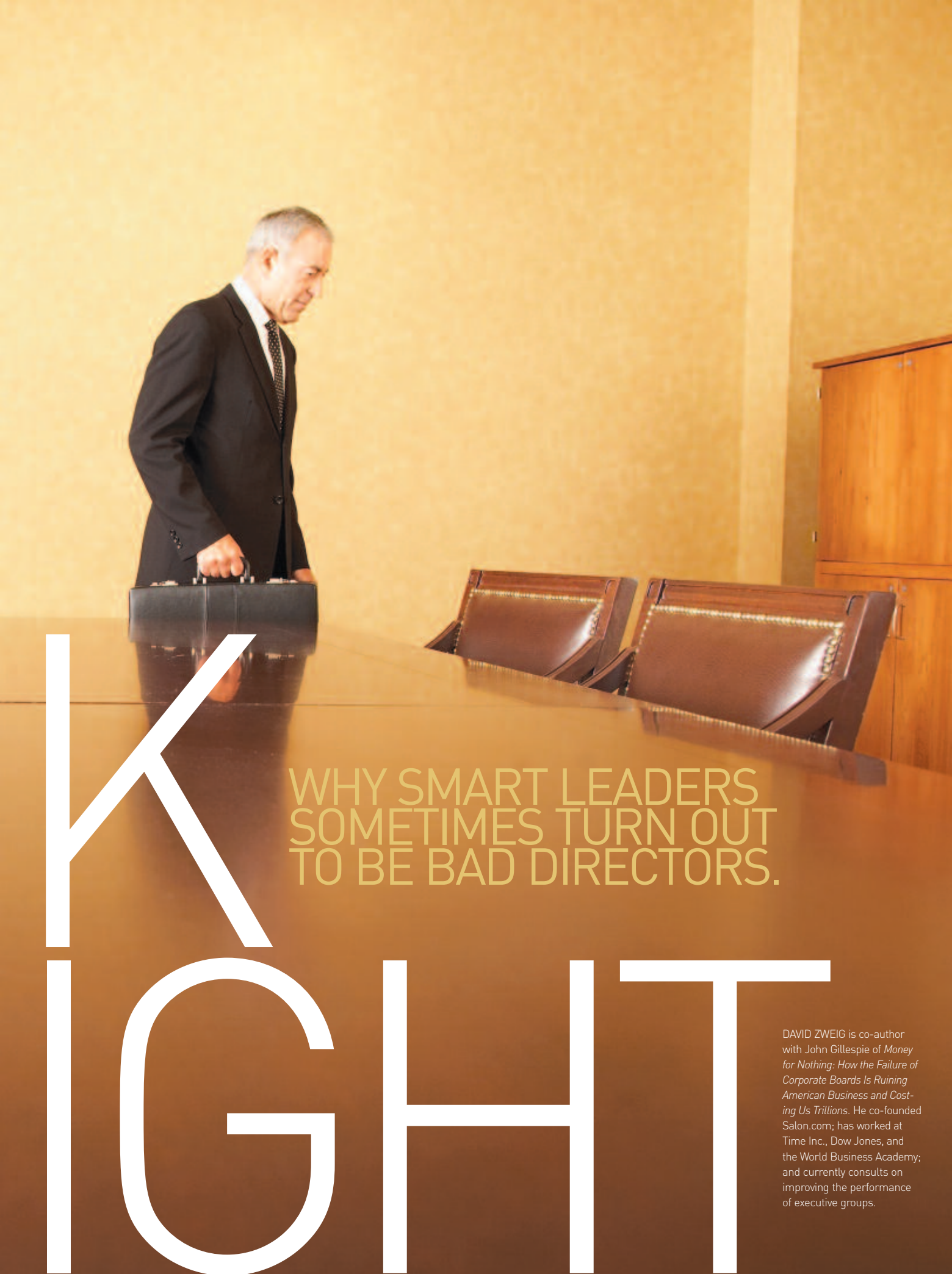




THE BOARD  
THAT COULDN'T

BY DAVID ZWEIG

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WHY SMART LEADERS  
SOMETIMES TURN OUT  
TO BE BAD DIRECTORS.

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DAVID ZWEIG is co-author with John Gillespie of *Money for Nothing: How the Failure of Corporate Boards Is Ruining American Business and Costing Us Trillions*. He co-founded Salon.com; has worked at Time Inc., Dow Jones, and the World Business Academy; and currently consults on improving the performance of executive groups.

# “IF YOU’RE SO RICH, WHY AREN’T YOU SMART?”

That inversion of the popular taunt fits nicely with a major theme for politicians, pundits, and sundry populists from the left and right. Ever since the Great Recession vaporized three of the nation’s largest banks along with trillions—not mere billions—in corporate profits and individual life savings in the broader economy, the blood-sport posses have careened through town in search of villains suitable for lynching.

CEOs and Wall Street bankers have thus far been the prey of choice. But amidst this current outbreak of outrage, too few people have stepped back and calmly asked the question: *Where were the boards?*

Most of the condemnation heaped upon Merrill Lynch, Bear Stearns, Bank of America, Citigroup, Lehman Brothers, and Countrywide has fallen not on the non-executive board members but upon the CEOs. The tallest trees take the lightning hits. Perhaps their directors have escaped ignominy because they are perceived as feckless, the human analog to “parsley on fish—decorative but useless,” in the words of U.S. Steel chairman Irving Olds some six decades ago.

Today, directors certainly have many more duties than in Olds’ time, and they have already been a focus of structural and legal reforms such as Sarbanes-Oxley and exchange rules on director independence—reforms and rules aimed at preventing yet more leadership failures in our largest companies. The problems were compounded by compensation systems that encouraged short-term strategies and excessive risk-taking.

More remarkable and less excusable: the C-suite chaos and recruiting scrambles at companies such as Citigroup, General Motors, AIG, and Merrill Lynch after their CEOs were relieved of their duties. Rarely has succession planning been so inadequate and so public. While the power forfeitures by so many experienced directors temporarily served the CEOs’ self-importance, they decidedly did *not* serve investors and other stakeholders.

Looking at boards these days, critics like to ask, “*What* were they thinking?” It might be more important to ask, “*How* were they thinking?”

To answer the first question first—concerning the boards’ whereabouts—the boards mostly were in the boardroom, working harder than ever. Directors report that the time they devote to their duties has more than doubled in the past decade, thanks to SarbOx and other regulatory changes—and it’s even greater for members of audit committees and those unfortunate enough to be directors at troubled companies. Yet for all their effort, it’s not clear how much incremental value boards are providing their bosses: the shareholders.

Only when tacitly accepted bad behavior becomes sufficiently serious to violate what Harvard’s Lucian Bebchuk calls the “outrage constraint” do outside authorities step in and attempt to “reform” boards with measures such as SarbOx.

Scandal and reform. Rinse and repeat. A long list of incremental procedural changes has been debated to death, often

literally. Many of the same ideas bob up year after year: increased disclosure, a division of the director/CEO roles, more power for “independent” directors, rigorous internal controls, director term limits. Recent additions include say-on-pay, proxy-access liberalization, mandatory risk-management committees, and a lessening of Delaware’s hegemony over corporate law. Whatever their merits, these measures probably would not move the good-governance needle half as much as would reforms that focus on cultural and perceptual improvements and lead to even one additional good director sitting at the table.

In researching our new book, my co-author John Gillespie and I became convinced that while the pitchfork mobs of reformers are tearing headlong down the alley that leads to structural changes, the more powerful solution lies in a comparatively quiet and deserted place: in a reappraisal of the way directors *think* and *behave* as individuals and members of a group.

## LEADERS IN THE FIELD, FOLLOWERS IN THE BOARDROOM

Aerial reconnaissance of the smoldering craters of the failed banks reveals a distinctive pattern. We see it in other sectors as well: Directors weren’t thinking straight and consequently performed poorly; among many other lapses, they failed to challenge managers with tough questions and capitulated to groupthink and their CEOs’ hubris. Even if we were to awaken tomorrow to find that list of procedural governance reforms miraculously in place, human beings will always be the weakest link in the tenuous chain that begins with investment capital and ends in sustainable profits. As governance expert Nell Minow wisely observes, “You cannot fix behavioral problems with procedural solutions.”

Here’s a shocker that no procedural reform could prevent: Lynn Turner, the former chief accountant of the SEC, told us that a veteran director from one of those failed banks said to him after booking billions in write-downs, “If I knew then what I know now, I would not have done anything differently.” When a space shuttle explodes, there’s an inquiry that grills everyone conceivably involved, and safety improves. At the very least, the catastrophic error is not repeated. But when tens of billions of dollars crash and burn, this director vanishes into the woodwork, re-emerging to “serve” again on another board.

Putting such incurious people on a required new Risk Committee won't change the way they think; it won't inspire their colleagues to judge them unfit for their role. If such directors are unwilling or unable to learn a single lesson from an eleven-figure loss, perhaps *self*-awareness would be a reasonably modest thing to expect from their peers. Alas, three years ago a Heidrick & Struggles/University of Southern California survey reported that 95 percent of directors believe they are doing an "effective or very effective job." CEOs, on the other hand, consider only 10 to 20 percent of directors as being truly effective, according to consultants who conducted the study. Another survey of CEOs found that only 56 percent agreed that non-executive directors are well-prepared for board meetings, while 63 percent said directors need to spend more time learning about their company's business.

**A**s we talked with scores of board members, executives, consultants, investors, and governance experts, we began to wonder why such an overwhelming number of exquisitely capable people make lousy directors. We became fascinated by this paradox: Many men and women, leaders in their field, become timid followers at the boardroom table. People with brilliantly successful careers and impeccable reputations slipped on the same banana peels that brought down their board colleagues. Such hazards include compensation plans that reward failure, acquisitions based on overly optimistic assumptions, condoning a lax ethical tone at the top, rubber-stamping executives' proposals, ignoring blatant conflicts of interest, neglecting to prepare for crises, and missing obvious strategic shifts in the market.

Perhaps the problem begins with the board-selection process itself. From the moment they're identified as candidates, applicants for CEO and board seats receive different treatment. Search firms frequently subject CEO candidates—no matter how extensive their work history—to a battery of psychometric tests and simulations, but when it comes to board candidates, these tests are never used. As a result, boards have little sense of how they and their colleagues think. (From my own work with thousands of psychometric test administrations, I've seen a shocking propensity for executives to hire only people whose preferred "thinking and doing" styles closely match their own.) The vice chairman of a highly regarded global search firm says that his clients consider such testing inappropriate for the culture of boards.

This reluctance must end. Given the disasters of the past decade, if directors are truly to be part of the solution and not simply ornaments on a corporate tree—as Harvard Business School professor Myles Mace famously dismissed them forty years ago—they should not expect, nor should they want, con-

tinued treatment as a special caste. After all, directors have responsibilities no less serious than those of the CEOs they are entrusted to hire and fire.

Once elected, however, directors are fiduciaries who often have no meaningful accountability to their constituents. An opaque cloak shrouds the competency of individual directors. They are further protected by a vast squadron of lawyers,

## DIRECTORS WEREN'T THINKING STRAIGHT AND CONSEQUENTLY PERFORMED POORLY; AMONG MANY OTHER LAPSES, THEY FAILED TO CHALLENGE MANAGERS WITH TOUGH QUESTIONS AND CAPITULATED TO GROUPTHINK AND THEIR CEOs' HUBRIS.

accountants, investment bankers, and other professional-services gatekeepers who keep them out of trouble for a price. Boards provide one of the last bastions of secrecy amidst a world transformed by the new value of "transparency." To escape the predations of plaintiffs' attorneys, boards shred their notes and excise dissent from their meeting minutes.

The result is inevitable: Boards carry bad directors—those who leave their spines and better judgment at the door—far too long. This continues because boardrooms are black boxes from the shareholders' perspective, and I suspect that the vast majority of directors adamantly believe they should remain so. Such secrecy is necessary, they argue, "so we can do our jobs." There is no way to tell which directors are, indeed, doing their jobs well, and they thus escape real evaluation.

### BOARDROOM BEHAVIOR

Directors—good directors, anyway—should welcome evaluation. With ever more onerous demands and strictures, serving as an effective director is terrifically difficult and deserving of deep respect. Yet for all the external constraints that hobble them, directors can be their own worst enemies. Research from

three disciplines—biology, psychology, and cognitive science—suggests that being a good director is even harder than is generally thought.

First, there is a matter of hormones—specifically, how they affect the way we deal with issues of risk. Researchers at Cambridge University encamped with phlebotomists early in the morning in the City, London's version of Wall Street, and monitored the testosterone levels of male traders during the day. The scientists compared them against the traders' financial results, with unambiguous results: "A trader's morning testosterone level predicts his day's profitability." Unsurprisingly, they also found that the trader's cortisol (stress) levels rose with the variance of his trading results and the market's volatility. "Testosterone and cortisol are known to have cognitive and behavioral effects, so if the acutely elevated steroids we observed were to persist or increase as volatility rises, they may shift risk preference and even affect a trader's ability to engage in rational choice."

Of course, the evaluation, assumption, or avoidance of risk pervades the core work that traders, CEOs, and boards perform. And attitudes toward risk go far beyond hormones. Jennifer Lerner of Harvard's Kennedy School measures the relationship between risk perception and emotions such as anger and fear: Using a variety of biometric data, she finds that Americans are more prone to anger than people in many other cultures, and that the effects of being in power can closely resemble those of being angry. Angry executives, it turns out, have substantially more appetite for risk and more optimism about the outcomes of their gambles. Lerner identifies additional attributes of angry thinking—attributes reminiscent of arrogant CEOs: "Not feeling you need more information. Underperceiving risks. Being prone to taking risks. Attribut-



## WHOM DO YOU RECOMMEND?

The University of Michigan's James Westphal has produced a long and highly original stream of research into board behavior; his typical study involves thousands of time-series surveys, interviews, and intense statistical analyses. (Remarkably, hundreds of CEOs and thousands of board members have cooperated.) Sometimes the findings show that troublesome board psychology produces profound, unintended consequences for broadly supported governance-reform strategies, such as increasing the numbers and power of independent directors.

After the Enron-era scandals, reformers engineered a major increase in the power of independent directors, but Westphal's research suggests that its effects may not be entirely salutary. A paper entitled "Corporate Governance and Knowledge Management: How Board Independence

May Increase CEO Paranoia, and Lead to Increased Top Management Team Homophily" found this disturbing result: The presence of more outside directors induces CEOs to show signs of non-clinical paranoia, to huddle more frequently with their own top managers, to circle the wagons and share less information, and to promote more executives similar to themselves. These reactions can have major adverse effects on a firm and its stakeholders.

Yet another two-year Westphal study, titled "Flattery Will Get You Everywhere (Especially If You Are a Male Caucasian)," surveyed hundreds of directors at 350 of the Fortune 500 firms and showed that

those who indulge in ingratiating behaviors and avoided monitoring or controlling behavior were much more likely to be recommended for positions on boards where the CEO already served. White males who did not attend elite colleges had to ingratiate more for the same effects. Women and minorities who were nominated to boards were even more likely than white males to engage in more ingratiating behaviors, confounding the belief that a "diverse" board leads to diverse viewpoints. (Women also serve on audit committees in disproportionate numbers: This work is by far the most laborious on most boards.) Directors who had ever disagreed with the CEO were much less likely to be recommended.

Westphal concludes that "the current convention, by which many board members receive appointments on the recommendation of current board members, must change. Otherwise, corporate boards will not provide the kind of oversight that could enable them to be effective watchdogs for shareholders." —D.Z.

ing causality to individuals rather than situations. Simplistic thought."

To mitigate such emotions' harmful effects, Lerner suggests changing the context and the environment in which executives operate, especially through what she terms "predecisional accountability to an audience with unknown views." In an experiment, angry decision-makers who knew they would have to explain themselves to a knowledgeable group whose opinions they didn't know made far more careful and well-thought-out decisions than those who lacked such accountability. The ramifications for corporate directors are clear and straightforward: If we require greater board accountability to shareholders, directors will likely make better decisions and reduce the risks of disastrous governance failures.



## ANGRY EXECUTIVES, IT TURNS OUT, HAVE SUBSTANTIALLY MORE APPETITE FOR RISK AND MORE OPTIMISM ABOUT THE OUTCOMES OF THEIR GAMBLERES.

Group dynamics also play a major role in boardroom behavior: Directors frequently do what they do to avoid looking foolish, to avoid angering the CEO, and to be liked. The deference afforded CEOs stems from the perception that, as one director put it, “when we are in the boardroom, we are on his territory.” This is a little like saying the pilot owns the corporate jet, but the comment highlights a major problem: Directors tend to forget whom they represent and simply align with the CEO.

The go-along-get-along collegiality stems from the self-perpetuating system by which boards choose who will be nominated for directorships, as well as from the empathy that relatively undiversified groups such as boards—still overwhelmingly dominated by older, wealthy, white male executives—naturally exhibit toward one another. Researchers have found that the more outside CEOs who sit on a board, the higher the pay for the CEO. It also helps to explain why directors will rarely fire a CEO until his failures are so glaring that the company and its shareholders have already sustained a great deal of damage.

**E**motions make up a major part of personality, and while most directors would agree that emotions should be kept under control in the boardroom, they clearly have a great deal to do with what gets decided there. Dacher Keltner of U.C. Berkeley studies the evolutionary role of emotions—particularly positive ones, such as compassion—and looks at how they affect decision-making. “Emotions give rise to our most important decisions,” Keltner says, “about what is right and what is fair, about whom to trust and what is risky, about what to do about human suffering and how to find purpose in the big scheme of things.” For two millennia, he says, “we have been cynical about the role of emotions in decision-making. We turn to metaphors of madness, illness, and disease to describe what emotions do to the mind. Judges ask jurors to ignore their emotions when making legal decisions. Economists

and moral philosophers completely ignored the role of emotion in decision-making.” Keltner believes that “a new science of emotion and reason suggests that our emotions, rooted in embodied responses shaped by millions of years of evolution, guide decisions to the great questions in life.”

In his prior work, Keltner looked at the determinants and effects of power, hierarchy, and social class. One of his more famous projects was the “cookie experiment.” Two students were given a shared task; a third was assigned to evaluate their work and set their pay. Thirty minutes into the process, they were served a plate bearing five freshly baked cookies. Everyone took one. No one would take the fifth, but which person would take the fourth? The taking of this fourth cookie required no negotiation or awkwardness.

How did executives fare in the experiment? Disproportionately, the bosses snatched the fourth cookie. Not only that, they ate with their mouths open, and scattered crumbs around the table and on the other participants. The conclusion: Power rapidly disconnects people from their inhibitions. Keep in mind that in 62 percent of Fortune 500 companies, the CEO also serves as chairman. No one could be more powerful.

And those chairmen are well aware of that power. A surprising number of the directors with whom we spoke mentioned CEOs who routinely tolerated little or no dissent from their boards. Independent directors, lions in their full-time jobs, become lambs in the boardroom; dissenters suffer social ostracism by other board members as well as the CEO/chairman. The University of Michigan’s James Westphal examined this phenomenon and proved that independent directors who advocate shareholder-friendly positions such as splitting the CEO and chairman roles or terminating a poison pill frequently endure significant ostracism from other directors. The lower the director’s standing and seniority, the worse it is. Such directors don’t get invited to outside social events as much; their comments are more frequently ignored in meetings. And, tellingly, word spreads to other boards.

## THE WAY WE THINK

Another area of research considers the types of thought errors to which boards may fall prey. These come under the headings of cognitive biases and heuristics, or rules of thumb. One influential study was undertaken by Israeli psychologists Daniel Kahneman and Amos Tversky and led to a Nobel Prize in economics. In a series of experiments, they found that people would take much greater risks to avoid losses than they would to make gains. People's attraction to or rejection of two deals with identical expected monetary values will completely reverse when they are presented as avoidance of a certain loss

or as winning of a gain. This may be the reason boards enable CEOs to double down on investments that have gone bad. (In the recent crisis, boards misperceived financial engineering as almost risk-free, thanks to the generosity of the rating agencies, reliance on AIG, and utter lack of comprehension of the sophisticated instruments themselves.)

Another major bias concerns the way we apportion credit, blame, and responsibility and is called attribution bias. People generally attribute their own success to skill and talent, and discount environmental contributors—even obvious elements such as a rising market. When these same people fail, they

# THE SUPERDIRECTOR

In exploring how to improve the social and cultural systems within the boardroom, one of the more promising ideas is the concept of the full-time, independent superdirector. The best directors have relevant experience and the time and energy to devote to their duties. They understand the company's business and know how groups work. They are willing to challenge managers, demand sufficient information, and ask tough questions, while maintaining trust and civility. They remember that, as former American Express CEO and boardroom turnaround expert Harvey Golub put it, "The board is not the CEO's friend—it is the CEO's boss." The activist investor Ralph Whitworth told us, "The best board members know they are not there to be liked, but they are likable."

Some of this entails better initial and ongoing training for the job. Most of the current one- or two-day training programs acquaint board members with the latest kerfuffle over SEC Reg. 14(a)-8, revisit leadership bromides, promote the services of participating sponsors, and then send the directors home.

My co-author, John Gillespie, and I propose a new class of highly qualified, independent public directors who would be trained in four areas: an industry sector, finance and accounting skills, the legal/regulatory requirements of corporate governance, and, perhaps most important, the dynamics of group processes, particularly as it pertains to power, decision-making, and risk.

Who would serve? Many top executives, by late middle age, have had successful careers and might be persuaded to shift to this new full-time calling; they would work full time with at most two or three corporations. Corporations might be required to put, say, three candidates from this pool on their ballots for shareholder elections, replacing an equivalent number of incumbents. They would be trained by a consortium of major business schools, in a program that we propose to be separately endowed to provide ongoing training for all directors as well.

Good governance is hardly free, but it's a bargain compared to the cost of bad governance. Covering the current compensation of one-third of the directors of all the Fortune 500 companies would amount to less than \$400 million annually, a trifle next to, for instance, U.S. taxpayers' bailout costs resulting from AIG's corporate-governance failings. The consortium—and possibly the superdirectors' compensation as well—could be financed by the companies directly, perhaps, or by a small transaction fee levied against equity trades (each one-hundredth of one cent per share at today's volume would yield \$50 million annually) or even publicly. RiskMetrics and the other governance-rating agencies would consider the presence of superdirectors as a "plus" on their scoring algorithms.

The ultimate job of the superdirector, put simply, is to work with the CEO and chairman to get the best out of the group. Surely that's a worthy goal—and one that well serves shareholders. —D.Z.



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blame external factors. Conversely, we tend to attribute *other* people's success to the environment (not talent), and their failure to personal weaknesses. It follows that when boards identify with CEOs, they overpay even when a rising economy is lifting all boats, and excuse poor performance as due to "a challenging marketplace."

Economists and psychologists have now identified scores of biases and heuristics that people use to guide their decisions. "Merrill Lynch, Citigroup, S&P, and UBS—all of these financial firms practiced very poor process in the sense of planning, incentives, setting standards and goals, and sharing information," says the University of Santa Clara's Hersh Shefrin, a founder of behavioral finance. "Those core processes are the key places where organizations go wrong, where the psychological biases that afflict individuals come together with the organization and wreak havoc."

Among the errors to which boards are particularly prone, Shefrin includes confirmation bias (the tendency to validate only information that confirms a preconception) and overconfidence. Boards are more prone to overconfidence because

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"many of them are CEOs in their own right. There is a natural tendency to be excessively optimistic. If you are overconfident, it means you also downplay the risks. Excessive optimism and excessive confidence tend to go together in successful people."

Directors have a big challenge: "Psychological impediments to behavior along the lines of full rationality, full information, those psychological impediments are just hard-wired and huge. So the question is, is there anything we can do to deal with them? I think there certainly is something we can do. And it will start in the same way you do in a twelve-step program—admitting you have a problem," Shefrin concludes.

Shefrin believes the solutions lie not with isolated individuals but within groups: "If you build your culture so that woven into it is an awareness by everybody that we are all prone to these particular psychological tendencies, and there are things we can do if we have checklists and leaders who set the tone right, people can help themselves to take steps that mitigate our vulnerabilities," he says. "While groups can amplify individual errors, we have to do it as groups. We will never do it at an individual level."

Underlying boards' poor performance is an array of fracture lines and poor integration. Directors and CEOs don't confront tough issues or challenge each other frequently enough. Boards deny their own psychology from their decisions. Directors lack awareness of their own conceptual errors. For CEOs, the received wisdom is to lobby directors separately before the board meeting—divide and conquer. This makes for smoother, more predictable sessions, perhaps, but vitiates the wisdom of the group.

A brilliant mentor of mine, the late Michael Doyle, invented the practice of "meeting facilitation" in the 1970s. Whether working with the leadership team at Ford, Hell's Angels, the Carnegie Foundation, Silicon Valley venture capitalists, or impoverished Brazilian *favelistas*, he saw that human beings did their best work in groups of seven to fifteen. Most corporate boards fit in that sweet spot. Unfortunately, he believed that most group problems arise from misapplying power, content, and process. Executive groups, he found, focus overwhelmingly on content (such as PowerPoint presentations and board books) and rarely on process (*how* the meetings happen). With a few exceptions, a CEO/chairman running the show is a perfect storm of bad group design: He controls the content, usually ignores the process, and has all the power. It's remarkable that anything gets done well.

With all the impediments imposed on directors, it's little wonder that many talented people are shunning the job. That's just what we don't need. Our recent collective national experience underscores how essential better corporate governance is to preventing devastating losses and ensuring our economic security. Boards can play the single most effective role in advancing the future opportunities and prosperity of our families, our communities, and our country. If we expect and demand more of them, they will rise to the challenge and answer that call. ■