Directorship
Boardroom Intelligence

The New Governance Paradigm

The Board's New Role in Ensuring Healthy, High Performing Firms

by Nathaniel Foote and Michael Beer | September 8, 2009

The board members of Lehman Brothers, Bear Stearns, AIG, and Merrill Lynch in 2008 read like a who's who of American society. These were not renegade individuals who were personally making huge sums of money by taking outrageous gambles with other people's money. They included captains of industry, university professors, public servants, and foundation trustees. Yet they presided over a disastrous set of decisions that nearly brought down the global financial system.

What went wrong? It is far too simple to blame it on individual failure. Who among us thinks that if only he or she had sat on the board of AIG that its collapse could have been prevented?

What we have is the failure of a governance system. We must ask ourselves a set of very tough questions: What are the barriers to effective board governance? How can they be overcome? What would have been required for these well-meaning individuals to have fully exercised the stewardship with which they were entrusted and which they sought to provide? How could they truly have ensured the long-term health of the institution for which they were responsible?

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It is time to probe beyond the obvious and well-worn barriers. It is too easy to focus, for example, simply on the mismatch of time and expertise in seeking to exercise "lay" oversight of these large, complex institutions. More fundamental rethinking is required. We do not claim to have all of the answers, but based on our research and experience the outlines are clear. A more effective governance model will be based on three core characteristics:

- A redefinition of what a 'healthy' institution looks like—one that emphasizes sustainable long-term success
- Board insistence on a well articulated purpose and related performance goals, and set of values for the enterprise that provides a fundamental compass to ensure the enterprise stays on track
- Board oversight of how effectively the purpose, goals, and values are being realized throughout the organization, based on governance processes that ensure transparency and voice from deep within the organization

What should board governance be seeking to achieve? What metrics should directors use to know if they are performing their duties properly?

Clearly, it is not just quarterly financial performance. To effectively steward shareholder interests, boards need to be concerned about long-term value creation and the sustainability of performance. As anyone who has modeled corporate cash flows knows, the first three or even five years typically represent only a modest portion of the total value—the majority is in the terminal value.

David Langstaff, chairman of the advisory board of The Aspen Institute's Business and Society Program, stresses the pervasive and corrosive impact of "short-termism." It is even more invidious when it is the investors—those whose interests anchor the legal structure of corporate fiduciary responsibility—who are focused on the short term. In 2007, even before the recent financial meltdown, The Aspen Institute issued a set of guiding principles for corporations and investors to help refocus on long-term value creation.

Commitment: The Missing Ingredient

Equally fundamental is a shift from a predominant focus on financial performance to a broader definition of health that includes the quality of the corporation's relations with key stakeholders. Corporations are social systems as well as economic systems: the quality of relationships matter. The consumer trust that is the basis for brand equity, the customer loyalty that shapes future purchasing, the employee loyalty that keeps high performers from leaving, the supplier relationships that differentiate Toyota from General Motors—these are all important predictors of long-term performance.

A corporation's ability to nurture these relationships and to build the reservoirs of goodwill that create the resilience to respond and adapt over time depends on its health as a social institution; specifically, on its ability to generate high levels of emotional commitment, first and foremost from their employees, and then from customers, suppliers, and other key stakeholders.

The acid test for employee commitment, in the sense that we mean it, is whether the individual is prepared to put the interests of the firm ahead of their personal interests or those of their particular department or unit. If the focus is strictly on performance, then individual interests can increasingly dominate. Without the requisite commitment to the collective good, the firm becomes increasingly self-seeking, bound by the current power balance and entitlements, to the point that a great enterprise like General Motors can inexorably decline over a 30 year period.

At the extreme, without commitment individuals can become increasingly willing to take risks for personal gain that put the institution at risk. It is patently clear this is what happened inside Lehman Brothers, AIG, and so many of our other leading financial institutions, to the point they not only put their own institution at risk, but the entire financial system.

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Thus, corporations that are built to succeed over the long term are characterized not just by high performance, but also by high commitment.

Psychological and Performance Alignment
We describe these types of companies and what it takes to build them in a new book: *High Commitment, High Performance: How to Build a Resilient Organization for Sustained Advantage.*

High commitment, high performance companies are found in nearly every industry and sell a variety of products, but all achieve three core goals:

- Performance alignment. The company's strategy is aligned with the requirements of its environment, and the company's organizing approach, management processes, and culture are aligned to execute the strategy.
- Psychological alignment. Employees and other key stakeholders have a strong emotional commitment to the mission and the values of the firm.
- The capacity to learn and change. Externally, management is alert to the changing requirements for competitive success, while internally it is open to learning what is going right and wrong within company operations and leading the necessary changes.

Langstaff elaborates on the central role of mission and values in psychological alignment: "If people believe they work for a company that is doing something worthwhile and has clear values that they can embrace with no compromises, they will be happier, more energized, and more committed," he says.

Langstaff also describes how psychological alignment was central to the strategy of Veridian, a government defense contractor (now part of General Dynamics), where he was formerly the CEO. "We wanted to brand ourselves throughout the industry as the employer of the best, most innovative, and customer responsive people," he says. "Our goal was to create an extraordinary work environment for our employees. When we lost a contract, I wanted our people to prefer to stay with Veridian, rather than move on with the contract to the winner, as is customarily done."

Veridian derived competitive benefit from this practice. "I wanted customers to know that if they chose against us, they could not count on having our talent move to the next contractor," Langstaff says.

He then illustrates the distinction between performance alignment and psychological alignment. A defense contractor purely focused on short-term financial performance, he notes, would pursue any profitable work they could expect to win—and a number of companies have followed exactly this strategy.

But a focus on psychological alignment would lead them to be far choosier in the kind of work they took on out of concern for their implicit contract with employees. "Is having all employees on the same benefit plan important to you?" Langstaff asks. "Is investing in training and development and giving all employees access important? Is employee retention a core value? If so, there are some kinds of work that you'd better not get into, because you won't be able to afford to do all those things and compete cost effectively."

To achieve psychological alignment is not simply a question of human resources policies. It starts with a compelling corporate purpose that gives meaning to work and a set of values that people identify as consistent with their own personal values. It extends to the fundamental ways the company is operated.

“To deliver this work environment,” Langstaff notes, “we needed to break down internal barriers to collaboration and open lines of communication. I wanted every employee to feel that they were supported by, and could deliver, the strength and capabilities of the entire corporation.”

What is true for a technology and professional services business like Veridian, also turns out to be true for airlines, steel, or any number of other industries. Companies like Southwest and Nucor that are able to combine psychological alignment, performance alignment, and the capacity to learn and adapt are the ones best able to sustain long-term performance.

Lessons from Family Businesses

Would this redefinition of what a truly healthy firm looks like actually make a difference? What if boards made creating a high-commitment and high-performance enterprise the basis for their stewardship?

A path-breaking study by Danny Miller and Isabelle Le Breton-Miller strongly suggests that it would. They noted an anomaly: family-controlled businesses are over-represented among corporations that are highperforming over the long term. In their book, “Managing for the Long Run,” they explored why that was. Their conclusion? These family-controlled businesses have been pursuing a leadership and governance model in which their picture of health conforms to our depiction of high commitment, high performance. They invested more in capabilities, cared more about stakeholder relations, worried explicitly about institutional longevity, and created high levels of emotional attachment to the institution. In short, they were serving as stewards to ensure healthy, resilient, successful organizations.

What will it mean then for boards genuinely to serve as stewards of enterprises capable of sustained high performance? The clarity of the company’s purpose and values, the health of the company culture and the level of commitment from key stakeholders—these will need to become as much a focus of the board as the financials and the robustness of the company’s strategy.

Moreover, the board will need to become a positive force, participating in defining the long-term direction and character of the institution. Most boards are reactive. They function as an oversight check, focusing on compliance, ensuring that the CEO and management do not stray “out of bounds.” Or they function as a sounding board, helping test and challenge the robustness of management’s thinking. But if the organization is to be characterized by a higher purpose and a set of guiding values that are truly stable over time, then those need to be anchored, not just in the person of the CEO, but in the board.

Lessons from Hospital Boards

To see how boards may evolve, we can usefully look to developments currently underway in the governance of not-for-profit hospitals.

Board discussions at hospitals have been just as heavily weighted towards focus on their financial performance as any for-profit institution. But hospital performance on clinical safety and quality has become a national concern. Studies by the Institute of Medicine and by the

Institute of Healthcare Improvement have shown that hospital care is far more dangerous than it need be, with avoidable deaths of more than 100,000 per year. And safety is also becoming recognized as good business—costs drop by reducing lengths of stay, complication rates, and malpractice suits.

Improving board governance of clinical safety and quality has therefore been targeted as a priority by a number of institutions pioneering health-care reform. Blue Cross Blue Shield of Massachusetts (BCBSMA), for example, in partnership with the Massachusetts Hospital Association, has developed an education program to help trustees play a more active role in governing quality and established various innovative programs and incentives to accelerate adoption by hospital boards.

Beth Israel Deaconess Medical Center (BIDMC) was an early participant in this board education initiative. Stimulated by their participation, the Board of Trustees chose to set an ambitious goal to eliminate all "preventable harm" by 2012. Several other hospitals in Massachusetts have followed suit and set similarly stretching goals for improved safety and clinical quality.

When the board puts this kind of "stake in the ground" it can have a powerful galvanizing effect across the institution. Most visibly, it creates urgency to develop strategies and plans to meet the goal.

At a deeper level, it helps align the multiple constituencies who all need to work together in the hospital, by making clear the high priority the board has set on clinical safety and quality.

Lastly and most fundamentally, board commitment can ensure continuity through a change in CEO. In hospitals where there has been a leadership transition, the board commitment has informed the hiring criteria and the successor CEO has been as fully committed to the safety and quality agenda as their predecessor.

New Depth of Oversight

Ensuring a clearly articulated corporate purpose, related performance goals, and set of guiding values is only a first step. Boards will also need to establish new governance processes that provide visibility into the extent that the values are being lived in practice and the degree to which the organization is genuinely achieving both performance alignment and psychological alignment.

Enabling people deep in the organization to speak honestly about leadership and organizational effectiveness issues is difficult. But our work with numerous companies has shown it is possible if certain principles are followed. It can also be transformative. Southwest Airlines has for years enabled truth to speak to power using a culture committee that interviews widely and reports to top management, with the findings made available to the board.

We can turn again to the health care setting to see some of the emerging themes. To support their increased focus on clinical safety and quality, several hospitals have found they need to increase time expectations of board members and create or expand the board subcommittee that addresses safety and quality issues.

They have also found it essential to send strong signals about the importance of disclosing medical errors and using them as learning opportunities to ensure that the root causes have been identified and addressed. Several of the boards now start their meetings with a case review of a recent medical incident.

Beyond just reviewing errors, a number of boards are also seeking to create a climate in which staff feel fully empowered to "call out" situations that could lead to subsequent safety or quality issues. The BIDMC Board, for example, now gives out a regular "caller outer of the month" award to celebrate a staff member who has spoken up about potential safety or quality issues.

A New Governance Model

The recent financial meltdown, and earlier governance failures from Enron to WorldCom, are extreme examples of a system of corporate governance that is not providing effective stewardship. As an economy and as a society, we need a better model. The direction we need to move is clear.

Boards need to adopt an expanded understanding that truly healthy corporations combine both high commitment and high performance. Boards need to play a more active role in ensuring the corporation is developing and sustaining not only performance alignment, but also psychological alignment and the capacity for learning and change. And board members themselves need to step up to new roles in anchoring the fundamental purpose and character of the institution.

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