FEBRUARY 2013
McKinsey Quarterly

Board governance depends on where you sit

William George

William George, former CEO of Medtronic and a veteran of ten corporate boards, reflects on common governance pitfalls and how to overcome them.

Board governance is frequently discussed and often misunderstood. In this article, I offer an insider's perspective on the topic. Over the years, I have had the privilege of serving on ten corporate boards, as well as being chairman and CEO of Medtronic, chairman only, and CEO only. I have also observed dozens of boards from outside the boardroom and engaged in numerous confidential conversations with members of these boards about the challenges they faced and how they handled them.

What I have learned from these experiences is that one's perspective about a board's governance is strongly influenced by the seat one holds—independent director, chair and CEO, CEO only, or chair only. That's why it is essential to look at corporate governance through the eyes of each of these positions.

In surveying governance through the lens of different roles, I hope to address a problem in the prevailing dialogue: many of the governance experts exerting power over boards through shareholder proposals, media articles, and legislative actions have never participated in an executive session of a major board. It's no surprise, therefore, that their proposals deal almost entirely with formal board processes and "check the box" criteria that generally have little to do with the substance of how boards operate.

I worry, in fact, that many of these proposals could weaken the performance of boards by burdening them with an excessive amount of ministerial details. That would be a shame, because corporate boards have made progress since the scandals of recent years, with a new generation of CEOs sharing with boards more openly, listening to them more closely, and working to achieve a healthier balance of power with independent directors.

Role #1

The independent director

The combination of new governance regulations and rising expectations makes serving as an independent director much more important—and difficult—than it was in years past. The greatest challenge these directors face is to stay fully informed about the companies on whose boards they serve.

Information asymmetry is often at the root of this challenge. When directors are truly independent of the companies they serve, they generally lack the wealth of knowledge about the industry or business that their senior-executive counterparts have. Moreover, independent directors typically have limited engagement with the company and its board, meeting perhaps six to eight times a year. Consequently, management has far more information than independent directors can ever absorb. I recall this challenge well: of the nine boards I served on as an independent director—across a range of industries—I had industry-specific knowledge in exactly none of them.

In one instance, I recall asking why a company wanted to implement an aggressive stock-buyback program when it might be better to preserve cash to take advantage of opportunities or to use as a cushion if cash flow turned negative. My question was not well received. The CFO argued that the company had always been able to raise cash when it was needed and had never passed up an opportunity for lack of cash. A fellow director told me that I simply didn't understand the industry and that stock buybacks were routine. So I backed off.

However, a year later the company became so concerned about volatility in financial markets that it suspended all stock buybacks and began an aggressive program of increasing its liquidity. That was a good thing, because the following year the markets completely shut down when the credit and liquidity crunch occurred. Had the firm not had a large cash reserve, it might have wound up insolvent, like many of its competitors.

Whether or not my questions a year earlier helped nudge management in this direction, I strongly believe that independent directors can provide leadership and contribute to the companies they serve in ways that go beyond meeting the basic legal requirements and fiduciary responsibilities inherent in board service. In addition to asking tough questions, three opportunities stand out.

Be an advocate for sound governance

Independent directors should be advocates—and enforcers—of sound governance principles. This is especially important in challenging times or when the company is in crisis. Too many directors accept board governance as it is, without suggesting the kinds of process improvements that would make a difference; some directors even resist them.

Yet process matters hugely in the boardroom, and not just to make sure a company abides by governance rules. Process steps help to keep board members engaged and able to fulfill their responsibilities and, more important, establish the proper balance of power between management and the board.

Perhaps the most useful aspect of the governance rules passed a decade ago in the United States is the requirement that independent directors meet in executive session without the CEO present. These sessions give directors the opportunity to share concerns about the company and to ask for improved governance steps or additional reviews. They are also a time to discuss privately any concerns that directors have about management and to ensure that directors are fully informed. Finally, the sessions are useful in building chemistry among the independent directors.

Good chemistry is important. The director of a major European company shared with me his frustration when he challenged its CEO and the direction in which the chief executive was moving the company, but received no support—just silence—from his fellow directors. Later, when the board went into executive session without the CEO in the room, the directors around the table unanimously agreed with this director, saying that the CEO was not providing the right leadership or taking the company in a sound direction.

Leadership succession

Nearly all independent directors say that selecting the right leadership for a firm is their most important role. Yet in my experience, the time spent on succession is far too limited and the discussion not nearly candid enough. All too often, board members settle for a "hit by a bus" contingency plan. Such plans are crucial, of course, even if just for an interim period. Yet oftentimes the person ultimately identified to lead is just the most obvious interim leader, not the best long-term successor.

To better prepare for succession, boards should have multiple discussions each year to identify the company's next generation of leaders. They need to create ways to get to know these candidates personally and observe them in crises and under pressure. The board should also create a series of assignments to prepare prospective CEOs and other senior-executive candidates.

If succession isn't taken seriously, directors may find that when the time comes, they do not have confidence in the internal candidates. Faced with this situation, directors may react—or overreact—by immediately initiating an external search, which bears substantial risks of its own. Outside hires may look good on paper and have been successful elsewhere, but it is not uncommon to find they do not understand the company's culture and values and do not take the time to identify the people who make the organization run successfully.

The board should instead conduct detailed leadership-succession-planning sessions to review candidates and their progression, ensuring that they have the necessary experiences to get them ready for the top jobs. In these reviews, the age of the potential top leaders matters. They should not be so close in age to the CEO that they would be unable to have a sufficiently long tenure as CEO prior to reaching mandatory retirement, nor can they be so young that there simply isn't time for them to have the experiences they need for such a major task. Thus, the process of identifying candidates for top roles must start early—typically, with leaders who are barely 30 years old.

On one board on which I served, the long-time CEO, who was doing an excellent job, steadfastly resisted the board's insistence that he develop potential successors. Frustrated by his inaction, the compensation committee (of which I was not a member) voted to provide him with a special bonus for grooming a prospective successor. He then reluctantly initiated an external search for a chief operating officer.

However, before any candidates were identified, he set up an off-site meeting with the independent directors to recommend that the external search be canceled because "it was causing too much disruption." Instead, he proposed to the board that he would develop some much younger candidates who not only were several years away from being viable successors but also, in some cases, seemed unlikely ever to make effective CEOs.

That was enough for me. I decided to resign rather than remain part of what I viewed as a charade. The CEO stayed for many more years, eventually stepping down after two decades in the job. Even then, he continued to occupy his CEO office at company headquarters. His successor, who was quite junior to him in age, found that managers routinely took problems and opportunities to the old CEO, thereby undermining the new CEO's authority.

Leading in crisis

The real test of a board of directors comes when the company is in crisis. Independent directors, in particular, are counted upon to step up to their responsibilities in difficult times. Their accumulated wisdom and judgment are crucial to make sound decisions under the pressure of time and media attention.

The overarching lesson I have distilled from the crises I've experienced (among them, the termination or resignation of CEOs, external financial crises such as the 2008 financial-market meltdown, major governmental action against the firm, and an unexpected takeover attempt) is that board members need to understand and trust each other. Only when they can have candid conversations will they ultimately reach a consensus that has positive and far-reaching implications for the company. Trust becomes even more important when meetings are conducted by telephone, which is often the case in crises.

The bottom line for independent directors is that their responsibilities and obligations are so great these days that they cannot serve on a board and expect to preside while fulfilling only the minimum requirements. Rather, independent directors must be fully engaged, do their best to learn the business, and stay connected between meetings. Otherwise, they won't be prepared to lead when a crisis hits. For many independent directors, this will mean not serving on as many boards as they did in the past—a change that's appropriate given the time it takes to be an effective board member.

Role #2

CEO with nonexecutive chair

In 1991, I became CEO of Medtronic, two years after joining the company as president and chief operating officer. My predecessor, who had just turned 65, continued as chair of the board. I was quite satisfied with this arrangement. His wealth of experience and wisdom were valuable to me as CEO, and he had the board's full confidence. He was also more than willing to take on difficult assignments at my request regarding delicate government and legal issues.

This dual structure—the standard model in Europe—is preferred by most governance experts and some regulators. The split clearly distinguishes the role of management (to lead the company) from that of the board chair (to take responsibility for the board and governance).

Yet as obvious as the structure seems in principle, I have seen no evidence or research to demonstrate that split roles create superior performance or even provide greater stability at the top. Anecdotally, the opposite is often the case.

In practice, the model's effectiveness depends on the relationship between the two individuals in these roles. If they are not squarely in agreement about the direction, leadership, and strategy of the company, an unhealthy separation may emerge within the board, and between management and the board. The result can be a lack of clear direction for the company—a state of affairs that leads to malaise or confusion within the employee ranks and, ultimately, to dissatisfied customers and shareholders. In the worst case, the two leaders engage in a power struggle that paralyzes both management and the board, thus preventing the company from making important decisions and responding quickly to changing conditions.

As much as I initially supported the separation of roles when I became CEO, over time the arrangement became more difficult. For example, some board members seemed confused about whom they should look to for strategic direction, especially in the case of acquisitions. In addition, the chair felt he should be “the eyes and ears of the board” in the company. Over time, this led to some confusion within management about his role. The board was also somewhat confused about whether I reported to him or to the board as a whole, an issue that was never fully clarified. Quite naturally, I felt that I reported to the board as a whole and that my responsibility and authority to lead the company depended on those relationships.

Tension also developed because board members seemed hesitant to give me direct feedback or to talk openly about their concerns. When I became board chair as well as CEO, this tension evaporated quickly, and I found myself spending far less time on board governance. In part, this happened because communication lines opened up and were more direct. By contrast, when the roles had been separate, I found I had to spend more time than I had expected involved in board governance and in responding to issues raised by the board.

Role #3

The dual mandate

North American CEOs strongly prefer the dual mandate of being board chair and CEO, as it puts them squarely in charge and avoids the likelihood of conflicts or power struggles within the boardroom. The downside of this model is that in the past it often encouraged complacency by boards and discouraged them from getting deeply involved in issues until it was too late.

In practical terms, a leader is most effective in dual-mandate roles when he or she starts by keeping independent directors well informed through a combination of telephone updates, monthly progress reports, and candid comments in executive sessions with the independent directors about the real-time issues facing the company. The leader must be responsive to the independent directors’ concerns and either take action on them or put them on the board agenda for discussion by the full board.

Such a leader also must learn to perform a delicate balancing act: facilitating open discussions on the board while at the same time representing management's position to it. If this individual argues his or her case too strenuously, he or she may shut down thoughtful comments from the independent directors. On the other hand, if the individual acts solely as a facilitator of these discussions, the directors won't get the full benefit of management's thinking and rationale.

Having served on several boards with a single leader in the combined roles of chair and CEO, I have learned that a board is most effective when the leader clearly understands the difference between these two roles and bends over backward to respect the board's independence. This independence extends to the directors' need to have open discussions without the CEO present, to ensure that important issues are addressed privately.

Similarly, when I had this dual role, I did whatever I could to open up meaningful discussions within the board, especially by drawing out the opinions of its quieter members. This was particularly challenging when the board was discussing important strategic issues or acquisitions and needed the benefit of my judgments and insights. I had to learn to withhold my opinions until others had the opportunity to offer theirs and then work them into the context of my conclusions. Frequently, this meant delaying decisions until the board had time to digest the ideas or management could undertake additional analyses.

One of the benefits the board and I had was an active, capable lead director with whom I could work closely. He did a superb job in guiding the issues of the independent directors and in keeping me fully informed of any concerns and issues the board might have. When it came time to select my successor, he developed a sound process that we both agreed upon and led the board through it.

The rise of the role of lead director, elected by the independent directors, is contributing to a better separation of governance from management. To make the position work effectively, it is essential that this role have a separate job description that is publicly available and respected by the chair and CEO. The most effective lead directors view themselves as "first among equals" and can coordinate the opinions of all directors and facilitate open discussion among them.

Role #4 Non-CEO chair

The role played by a non-CEO board chair will depend heavily on the experience that person brings to the position. If this individual was the previous CEO—a common situation—he or she will bring a wealth of experience, a keen knowledge of the other directors, some strong opinions about what the company needs, and oftentimes a legacy to nourish or at least maintain. Therein lies the difficulty: no matter how hard old CEOs try to restrain themselves, they may have a tendency to overshadow or, worse, override new CEOs.

This problem is exacerbated by independent directors who still rely heavily on the ex-CEO's opinions and may trust his or her recommendations more than they do those of the current CEO. Still, when former CEOs can restrain themselves, recognize that it is time to let go, and do everything they can to support their successors, they can be very effective in the role of board chair.

In my case at Medtronic, I was committed to a seamless transition with my successor and to ensuring his success and the company's. Also, the board and I had agreed upon a timetable of just one year for me to serve as chair, so I was clearly in a transitional mode. I was still in my 50s and looking forward to turning my attention to other interests.

Nevertheless, it didn't take long before I faced a board-level challenge. It came at an off-site board meeting just a month after the CEO transition. For 15 years, dating back to my predecessor's tenure, Medtronic had pursued publicly announced goals of 15 percent per annum growth in both revenues and profits, compounded over any five-year period. These aggressive goals provided discipline within the company and a consistent benchmark for shareholders. We had been successful in exceeding these goals, but not without risks and challenges.

At a board meeting, however, one of the independent directors argued forcefully that given the company's larger size, it would be impossible to continue to achieve such high rates of growth. Although I was tempted to jump into the discussion and defend the importance of the goals, I held my fire. My successor held firm, and the company stayed the course.

Many people make a strong case that a former CEO is not the right person to serve as board chair and that he or she should leave the board immediately. An alternate choice could be one of the existing directors.

Many people make a strong case that a former CEO is not the right person to serve as board chair and that he or she should leave the board immediately. An alternate choice could be one of the existing directors, provided there is a well-qualified candidate available. An equally good choice is to appoint someone who has served as chair, CEO, or both at another company. In some countries, the board chair may be an independent attorney or financial expert, but this approach risks ending up with a candidate who has insufficient knowledge of the company, its business, and what it takes to lead it. Regardless of who holds the position, it must have a well-defined job description to keep accountability strong. A nonexecutive chair should be formally evaluated at least annually by fellow board members. Finally, the position should have a defined term of office, after which a new nonexecutive chair is elected or the existing chair is formally reelected.

Reflections

The diversity of perspectives that board members bring to the role can be a considerable strength for the companies they serve. How can organizations make the most of it? Here are three suggestions.

- The board should acknowledge that no single structure works in all cases. Boards must be pragmatic enough to adapt to the individuals involved rather than put a rigid structure in place.

- All parties, but especially CEOs, should acknowledge different points of view and work to minimize the conflicts that inevitably arise from them. This requires high-level listening skills, the ability to see situations from the other person's perspective, and the wisdom to understand the basis for the different points of view.

- All directors, but especially CEOs, can benefit from holding different positions, either within the company or on other companies' boards. Nominating committees should seek out prospective board members with diverse experiences. Boards should also encourage CEOs to serve on at least one outside board to give them the experience of being an independent director and seeing firsthand the challenges outside directors face.

If these basic guidelines are followed, I believe that board governance will improve markedly. As a result, companies will have a steady hand in the boardroom to sustain their achievements through successive generations of leadership and board membership. ○

William George, a professor of management practice at the Harvard Business School, is a board member of ExxonMobil, Goldman Sachs, and the Mayo Clinic and previously served on the boards of Novartis AG and Target, among others. From 1991 to 2001, he was the CEO of Medtronic, whose board he chaired from 1996 to 2002. This article is an adaptation of a chapter George contributed to *The Future of Boards: Meeting the Governance Challenges of the Twenty-First Century*, edited by Jay W. Lorsch (Harvard Business School Publishing, July 2012).