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When a Fish Rots, It Rots From the Head.

Ask Three Questions about the Board of Directors.

In 1768, Sir James Porter wrote a book about Turkish customs. He said that there was a common saying: “the fish stinks first at the head.”

The observation is not biologically correct. But it is correct from a leadership and corporate culture perspective.

In our work with Nominating & Governance Committees of Boards we often find a distinctive form of dysfunctional communications. When we talk with middle management, we find a similar communications dysfunction. And these middle managers have never attended Board meetings. They do not even know the names of the Board members!

This should not be surprising.

There is sound research evidence that emotions are contagious. Why shouldn't dysfunctional communication also be contagious?

The Board serves as the highest level role model for the corporate culture.

We often find that it is impossible to create an innovative corporate culture when the Board refuses to engage in valid, ongoing Board Self Evaluation.

When a fish rots, it rots from the head.

Helping Senior Candidates Ask the right Questions About the Board.

We work with candidates for Board roles and candidates for CEO roles in companies.

Few senior level job candidates ask focused questions about Board structure and governance systems in job interviews. Your failure to be inquisitive can be harmful for your career.

Consider asking these three questions: (1) Is the CEO also Chair of the Board? (2) Tell Me About the Outside Directors and (3) Tell Me About the Annual Board Self Evaluation Process.

1. Is the CEO Also the Chair of the Board?

One of the important roles of a board is to review the CEO's performance. How can the Board fulfill its fiduciary responsibilities when the Chair of the Board is also the CEO?

How can the Chair conduct a fair and impartial meeting when the focus of the meeting is the CEO's performance?

The United States does not require separation of Chair and CEO roles but some countries do require it.

The counter argument is that separation of Chair and CEO roles dilutes accountability. You want to have unity of command in the person of the CEO who also is the Chair.

The Conference Board's Matteo Tonello (2011) reports that in the United States, the unity of command framework has the upper hand. He also notes the lack of clear cut empirical evidence in support of separation of Chair and CEO roles.

In 2011 only 16% of the S&P 500 companies split the CEO/Chair roles with truly independent Chairs.

The Korn Ferry Market Cap (KFMC) is a list of the one hundred largest market cap public companies in the United States. KFMC lists only 9% of Boards who split the roles.

Braun and Sharma (2007) looked at the relationship between the power structure and levels of family ownership in public companies. On its own, separation of CEO and Chair roles do not seem to impact shareholder value. The real moderating factor is the percentage of family ownership in family businesses.

The separation of Chair and CEO roles is most effective when the family is one of several owners in the company. The separation of roles helps keep the non business family dynamics in check so the company can focus on economic shareholder value.

If the family dominates the Board because of its high percentage of equity, it does not make any difference. Economic and non-economic family dynamics will impact corporate performance regardless of whether the CEO and Chair roles are separated.

One popular option among life science companies we work with is to create the role of Lead Director to chair actual meetings if the CEO also is Chair. At least the Lead Director can insure that there is façade of impartiality in setting agenda items, and keeping meetings running on time. The Lead Director can also become the voice of the Board in having difficult conversations with the CEO/Chair.

2. Tell Me About the Outside Directors.

In a small, stable family-dominated business, one could make the case that the interests of family members and the interests of the business are aligned.

The unity between family goals and business goals easily falls apart:

> The founder SHOULD begin to seriously think about leadership succession. If the founder is not ready to deal with this issue yet the business requires the issue be confronted, you have a problem. There is no impartial structure to address the issue. Leadership succession becomes too emotional and too easy to postpone….until it can't be postponed. And when it can't be postpone it is often too late to do effective succession planning.
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> Growth can only take place by bringing in non-family talent. And non-family employees' goals revolve around their personal economic interests. These economic interests may conflict with the non-economic interests of the family. In time, the business becomes dependent on its non-family employees. What's good for the family is no longer be good for the business.
>
> The founder dies and subsequent generations succeed in leadership roles. "What's good for the family is good for the business" gets increasingly complex. A classic case is a second generation family business where elderly aunts depend upon consistent payment of dividends to support their lifestyle. On the other hand, the competitive demands of the business require spending more money on R&D. Additional R&D funding can only come from a reduction in dividends.

Given the dynamics of business growth and generational changes in families, the accepted wisdom is that outside board members can be better stewards of long-term family shareholder value than family members themselves.

The evidence is in agreement.

Ronald Anderson and his colleagues (2004) examined Board composition and shareholder value in Standard & Poor's 500 public companies between 1992 and 1999. Banks and utilities were excluded because government regulations have such as large impact on shareholder value. They found 141 public companies with family ownership and 262 firms without family ownership. The average family holding was 17.9% of total equity, which gives these families a very important role on the Board. 2,686 corporate returns were analyzed and then compared with Board composition:

We find that the most valuable public firms are those in which independent directors balance family board representation.

In contrast, in firms with continued founding-family ownership and relatively few independent directors, firm performance is significantly worse.

Powerful, Independent Directors.

Kathy Fogel and her colleagues (2014) show that the core issue is not Director independence. The core issue is Director independence and power.

One can legally be "independent" as a Director yet not have enough freedom of action to truly vote against the wishes of the CEO. An example might be the family business CEO who asks his college roommate to be the "independent" director. The same dynamics take place when a nonprofit brings the partner of a communications consulting firm to its Board, yet the CEO has authorized an annual retainer between the nonprofit and the communications consulting firm.

We see the same dynamics when an “independent” Director is placed on the Board of a private equity dominated company. The private equity partner says that the new Director is “independent, but the CEO knows that this “independent” Director owes her past and future economic prosperity to the private equity partner.

Independent and powerful Directors can have a major economic benefit relative to only Independent Directors. When Fogel uses the term “Power,” she means people who have many network connections at a deep level. They thus do not depend on one or two people for their economic viability. They can afford to tell a CEO, “You are wrong.”

> *"Elevated market valuation is linked to powerfully independent directors' constituting a majority of independent directors. Sudden deaths of powerfully independent directors significantly reduce shareholder value, consistent with independent director power “causing” shareholder value. Further empirical tests associate powerfully independent directors with fewer value-destroying M&A bids, more high-powered CEO compensation and accountability for poor performance, and less earnings manipulation."*

These results suggest that independent directors and non-CEO chairs can be effective if they have sufficient individual power to challenge the CEO.

3. Tell Me About the Board's Annual Board Self Evaluation Process.

We often hear this phrase in conversations with Board members:

> “*As a Board, we are collegial, open, and frank.”*

When a Board elects to thoughtfully evaluate its own processes, it risks damaging this self-perception.

Board Self Evaluation is like picking up a rock. “No telling what you might find under that rock. The best thing is to leave it be……..”

Another version of negative bias against effective Board Self Evaluation:

"As Board members, our time is limited. We are too busy to spend time evaluating each other. We know how good we are. If you force us to engage in self-evaluation, we will simply go through the motions. Our attorneys or CPA firm will give us an adjective check list that will take 15 minutes a year. It may not be effective but at least we can say we 'checked the box.'"

There are two problems with this attitude.

One problem is that if the Board is not the role model for continuous self-improvement, then who is? The failure to embrace serious and annual self-evaluation sends a strong downward message that infects the corporate culture.

A second problem is that the rejection of continuous self-improvement through Board self-evaluation runs counter to the evidence.

In *Harvard Business Review*, Yale University's Jeffrey Sonnenfeld examined what makes a great Board. And he found that consistent Board Self Evaluation was one of the hallmarks (2002).

Herman & Renz (2000) examined effective and ineffective nonprofit organizations to see what Board processes separated the two. Keeping industry sector and size constant, they found that a continuous use of Board Self Evaluation was one of the three critical Board factors separating the effective versus ineffective companies.

The Nominating & Governance Committee drives Board Self Evaluation. There are many ways to conduct self-evaluations, ranging from "check the box and be done with it" to overly complex and time consuming individual feedback sessions. Stybel and Peabody (2005) provide an impartial review of Board Self Evaluation techniques as a function of cost, Board member time, and governance impact.

Board Structure and Your Ability to Be Effective.

We began with the ancient Turkish saying:

When a fish rots, it is from the head down.

The Board of Directors is the legal and fiduciary head of the organization.

Its dynamics serve as the role model for organization corporate culture.

Accountability for corporate culture has to start somewhere. If that “somewhere” is not the Board of Directors, then where should it start?

If you are a leader interviewing for a role on a Board or a C-Suite role at a company, ask our three specific questions about board structure.

If you don’t get the answers you were hoping for, at least you cannot later complain that you were deceived during the interview process.

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There are 200 Arbora Global consultants in 25 U.S. cities and 32 countries.

Bruce Farr Creative has published Maryanne and Larry's perspective about how to manage careers in the 21st Century.

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