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THINKING ABOUT JOINING A BOARD OF DIRECTORS?

Even experienced CEOs and Board members sometimes fail to ask three basic questions prior to accepting a Board role.

Those questions are (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?

A crucial board role is hiring the CEO, evaluating the CEO's performance, and firing the CEO. 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. Some countries require it.

The U.S. 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 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.

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.

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 seep into the Board room.

One popular option among life science companies we work with is to create the role of Lead Director. The Lead Director chairs the Board meeting. At least Lead Director can ensure 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.

This logic behind this idea falls apart if one or more of the following three conditions are met.

The first condition is when the founder begins to approach the time to seriously think about leadership succession or fails to think about 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 is too late.

The second condition is if the business grows. 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 third condition comes about after 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.

Evidence:

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 a 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 few truly 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 his past and future economic prosperity to the private equity partner.

Fogel and her colleagues examined public company independent Board members on an objective measure of “power” called Zpower.

Created by Zinoplex, Inc., it measures how “deep” within other people’s networks the individual is. This network depth comparison is different from LinkedIn’s counting of how many people are willing to click and link or Klout, which is a measure of how many times a person is measured in social media. Fogel and her colleagues write:

"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 selected external Board members have the emotional, economic, and political freedom 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:

There is an ancient Greek 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 model for organization corporate culture. There have been times we have worked with Boards on Board effectiveness. And when we start talking with middle managers, we find that their communication problems mimic the same problems we are dealing with at the Board. These middle managers have never been to a Board meeting. They do not even know the names of Board members. And yet the culture has filtered down.

Accountability for corporate culture start somewhere. If “somewhere” is not the Board of Directors, then where do you look for leadership?

Summary and Conclusions:

We suggest you ask three specific questions prior to joining a Board.

If you don't get the answers you hoped for but still accept the opportunity at least you will not be able to complain that you were deceived.

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