HBS focus: The reality of corporate boards

As Harvard Business School celebrates its first century, it can take pride in being a pioneer in exploring what transpires in the boardroom … and how it helped shape the evolution of enlightened governance. **By Jay W. Lorsch**

As Harvard Business School (HBS) marks its centennial this year, it is an appropriate moment to reflect on the role its faculty has taken in shaping the functioning of corporate boards.

Most familiar to readers of Directors & Boards will be the work published in the last decade by myself (*Pawns and Potentates: The Reality of Corporate Boards* with Elizabeth MacIver [1989] and *Back to the Drawing Board: Designing Corporate Boards for a Complex World* with Colin Carter [2004]) and by Rakesh Khurana (*Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs* [2002]), and numerous articles in Directors & Boards, *Harvard Business Review,* and other publications by myself and colleagues like Elizabeth Montgomery, Krishna Palepu, John Quelch, William Sahlman, and Walter Salmon.

More interesting and less well known is the fact that HBS faculty interest in and writing about corporate boards goes back 50 years, and in spite of the passage of time there are consistent themes underlying this work. There have been three bursts of interest in the topic — in the 1940s, in the 1970s, and that which I described above during the past decade.

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The work in the '40s was stimulated by Prof. Melvin T. Copeland, who, at the time, was director of HBS's Division of Research (an internal funding foundation and publishing arm). Copeland had been interested in corporate boards for over 30 years and stimulated several younger faculty members to do research on the topic (John C. Baker, later president of Ohio University; Myles Mace, whom I shall discuss later; and Andrew Towle, who was hired to work on the project). The work was initially developed and overseen by a faculty committee including Baker, Copeland, and two other senior professors, including one from Harvard Law School.

Three books were completed between 1945 and 1948: *Directors and Their Functions: A Preliminary Study* by Baker, *The Board of Directors and Business Management* by Copeland and Towle, and *The Board of Directors in Small Corporations* by Mace. The three books, while distinct in their findings and conclusions, had three things in common. All were short and were based on cases collected by the authors about specific companies and their boards. And all three were descriptive studies of boards — who was on them, what they did, how they related to management, and the difficulties they could encounter in carrying out their duties.

Research of continuing relevance

Perusing these books recently, I was struck by how many of the issues raised still had currency 50 years later. For example, Baker wrote about the board's role in selecting the president (now, of course, the CEO) and other senior officers and assuring management succession; in approving policies of broad significance (now we would call it strategic

decisions); and in checking on the progress of the company, not only in immediate profits but also as to its devotion to fundamental responsibilities. Copeland and Towle presented a similar list of duties, but added that boards could and did encounter limits to their legal power, because of such factors as falling shareholder confidence, lack of support of the executive staff, or the limits of public opinion. Like Baker, they provided a list of qualities to use in selecting directors, which sounds very modern (see sidebar). Finally, they provided a list of the reasons directors serve on boards, which also seems very relevant today: to make a contribution; associate with outstanding people; business relationships; and, least important, money.

Mace's book was an outgrowth of his doctoral dissertation and his interest in new enterprises, and, in many respects, followed the structure of the other two books, but emphasized how these issues changed in the situation of new companies. For example, one point which seemed especially relevant in today's world of venture capital-backed boards is Mace's admonishment that directors in smaller companies must be mentors to their inexperienced executives.

In fact, Mace's more important contributions were to come a quarter of century later, because until then the interest in boards had waned at HBS. Then, in 1971, Mace's second book, *Directors, Myth and Reality,* was published. Former HBS Dean Larry Fouraker encouraged Mace to focus on boards again, perhaps because he, like Mace (and, in fact, all the other faculty interested in boards then and today), were directors of public companies themselves. While Mace's book was again based on interviews with directors, he recognizes that the working hypotheses for this research were shaped by the thousands of hours he spent on boards in the intervening 25 years since his first book.

Recognition of new responsibilities

The myths and realities to which the title refers are about what directors actually do. In reality, Mace concluded that directors offered advice and counsel to top management, but that they also provided a source of discipline to these executives. That is, having to appear before a board caused top managers to do a more careful and thorough job of preparing their ideas, whether about past performance or future direction. Finally, Mace concluded that only when the president (still not called the CEO) had to be replaced either because of his demise or poor performance was the board placed in a decision-making role. In fact, as he pointed out in a *Harvard Business Review* article the same year, "Yet I found in most companies directors do not select the president, except under the two crisis situations: when the president dies or fails to perform."

Harvard Business School

Myles Mace's important contribution, starting in the 1940s and into the '70s, was to clarify the 'myths and realities' of what directors actually do.

This conclusion might leave the impression that Mace was comfortable with boards in which the president (or CEO) dominated the board. However, the final paragraph of the article suggests otherwise: "If corporate management is to survive in anything like its present form directors will have to take on new responsibilities. They must make certain that corporate goals are consistent with the larger goals of U.S. society. And they must monitor management to see that it pursues these goals effectively, including the basic objective of earning a

Criteria for selecting directors

Sixty years ago Harvard Business School research was targeted at a better understanding of corporate boards. Early research findings included these conclusions about what makes a good director — a spec sheet that sounds very modern more than a half-century later:

- Honesty-integrity
- Compatibility
- Interest in the welfare of the company
- Long-range point of view
- Ability to evaluate changing conditions
- Courage
- Ability to ask discerning questions
- Balance of skills and experience

— *Jay Lorsch*

reasonable income and keeping the company out of the bankruptcy courts."

Further, Mace, in this conclusion, also recognized in 1970 a key issue directors face today (almost 40 years later): "The problem of the modern director is to define his role so that he does not meddle with day-to-day management but nevertheless knows what is going on and makes his influence felt in the determination of broad policy."

Mace made other important contributions by editing a regular column in *HBR*, titled "From the Board Room," beginning in 1975 until 1977, when he was succeeded by Ken Andrews, *HBR*'s editor at the time. Andrews, who had long taught Business Policy, the capstone required course in the MBA program, had himself served on corporate boards and thus had a strong interest in them. Of the many columns he wrote, the one which most bemused Andrews was when he proposed that boards have a "strategy committee." He later told me this column stimulated more mail than any of the others from directors who felt such a committee would undercut a primary purpose of the *entire* board. Andrews stuck to his guns, arguing that asking the entire board to discuss strategy was impossible because of its large size.

New attitudes, new ideas

After these columns disappeared from *HBR*, there was a hiatus in board-related writing at HBS until the publication of *Pawns or Potentates* in 1989 and then the spate of faculty-authored articles and

A steady and steely eye on governance

Ed. Note: Jay Lorsch has regularly reported in to *Directors & Boards* on the evolution of governance and how boards work. Here are excerpts from several of his past articles as well as a passage from his groundbreaking book, *Pawns or Potentates*.

Boardroom — the word alone conjures up visions of power, wealth, and privilege in the minds of most Americans. Almost every publicly owned corporation in America has a boardroom, impressively designed and furnished in a fashion that does nothing to undermine the popular view. The boardroom's core, the symbol of its power, is a massive highly polished table around which the directors are presumed to make the decisions that govern the corporation and affect the wealth of its owners — the shareholders — and the livelihood of its employees.

This symbol of power seems as appropriate to the company's employees, including many of its managers, as it does to the general public who invest their savings, directly or indirectly, through mutual or pension funds in the shares of the companies. This perception of the role and power of the board of directors meshes, too, with the traditional legal view of corporate governance.

Directors, however, are less sanguine about their power and capacity to govern. While they don't see themselves as pawns of management, as did their predecessors of a decade ago, they acknowledge a number of constraints on their ability to govern in a timely and effective manner. Such constraints include their own available time and knowledge, a lack of consensus about their goals, and the superior power of management, particularly the CEO-chairman.

These are the major conclusions of our research into corporate governance in U.S. publicly owned companies, an investigation prompted by the obvious malaise of U.S. business performance over the past decade.

— *Pawns or Potentates: The Reality of America's Corporate Boards*, Harvard Business School Press, 1989

We recommend that those companies that do not have a nonexecutive chairperson designate one of the outside directors as the lead director. The lead director would be consulted by the chairperson/CEO on: (1) the selection of the board committee members and chairs, (2) the board's meeting agendas, (3) the format and adequacy of the information directors receive, and (4) the effectiveness of the board meeting process. The lead director would also coordinate an annual evaluation of the chairperson/CEO by the outside directors.

Finally, if the outside directors are confronted by a crisis because of the incapacity of, or failure of performance by, the chairperson/CEO, they would have a designated leader in place and would not lose time in organizing to deal with the problem.

While the immediate reaction of many chairperson/CEOs to this proposal is negative, we believe it is a critical factor in making boards more effective. In fact, we believe that in many boardrooms today such a leader is already recognized by management and the outside directors.

— "The Lead Director," Spring 1993, an excerpt from "A Modest Proposal for Improved Corporate Governance," an article by Martin Lipton and Jay Lorsch published in *The Business Lawyer*

Changing the quality of a typical board's membership has traditionally been a slow and very difficult process. Most of the new faces on boards, even today, appear because existing members have reached retirement age or tenure limits. Deadwood persists because boards typically have had a hard time getting rid of subpar performers. Directors simply have found it very difficult to face up to noncontributing peers. They are colleagues, often long-standing ones, and it is difficult to ask such people to resign. Further, very few boards have any concept of offering education and development for their members (or much motivation to do so). So even those board members who would otherwise grow into their roles in an exemplary way if given the right kind of training are at a disadvantage. The assumption is that every director knew all he or she needed to know before joining the board and can now dispense that wisdom at the boardroom table.

The difficulty of improving the quality of board members is exacerbated by a perceived

Back to the Drawing Board in 2004. During these 15 years, attitudes among HBS faculty about corporate governance changed dramatically.

The reverence and deference with which boards were treated by our predecessors diminished. Boards, like other high status institutions in America, were fair game for criticism! And they had many critics among lawyers, shareholders, the media, and now HBS professors. Not only were we critics, we had hands-on boardroom experience and we had concrete ideas about how directors could do a better job, and were not shy about expressing our opinions — see, for example, "A Modest Proposal for Improved Corporate Governance" (1992) in *The Business Lawyer*, which I wrote with Martin Lipton, or my most recent *HBR* article, "Leading from the Boardroom" (2008) with Robert Clark.

In fact, I believe that one thing that distinguishes me and my HBS colleagues from most other scholars who study and write about boards is that we have not only studied them close up by interviewing directors and soliciting their opinions in written questionnaires, and by writing teaching cases for our courses and seminars in the MBA and executive education programs, but we have actually served on boards. We understand that they are truly complicated human and social institutions and that improving them requires an understanding of that complexity. ■

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shortage of good, qualified directors. Everyone wants the same few people — who are almost always older men with substantial management experience. Everyone seems to want prominent CEOs or people who were recently CEOs of major corporations. But do the math: There are more than 10 board seats for each CEO position; if this is the only talent pool from which directors are sought, there is always going to be a shortage of talent.

— "A Visit to Board 'Central Casting,' " Fall 2003, an excerpt from *Back to the Drawing Board: Designing Corporate Boards for a Complex World* by Jay Lorsch and Colin Carter, Harvard Business School Press

There is an untapped pool of talent that shares most of the positive qualities of active CEOs. They would be commonly labeled as retired CEOs (and other very senior executives). I hesitate to use the term "retired," because the executives I have in mind are certainly not out of active work. They have left their first careers as leaders of major companies but are still in their early to mid-sixties and are energized to enter second careers.

The fact that second-career directors have more time and flexibility than active senior executives makes them valuable board members not only in the regular course of events, but also when their company faces special issues — such as a succession crisis or a major acquisition. In these instances, directors are often required to interrupt their normal schedules. In my experience, second-career executives are willing and able to do this, while active CEOs usually cannot. This is why so many second-career directors have been at the center of boardroom changes.

It is important to note that adults are living longer and healthier lives. People in their 60s and 70s continue to affect profoundly the law, medicine, nonprofit institutions and, of course, several branches of the government. The business community should take far greater advantage of this pool of talent.

— "Second-Career Directors," Spring 1995

There has been a big swing in the influence of boards *vis a vis* management, which has been quite healthy.

In seminars, symposiums, and boardroom discussions about creating more vital boards, one of the hot new topics is what directors should do about evaluating their own performance. As boards become more involved in monitoring and evaluating their CEO's and company's performance, many directors are asking the natural next question: Shouldn't there also be an evaluation of the board's conduct and activities?

In such discussions and as a few leading-edge boards evaluate themselves, directors are concerned with two aspects of the board's conduct. One is how well the whole board is doing in carrying out its responsibilities; the other is the performance of individual directors. Leading-edge boards are having more success in evaluating their overall performance than in evaluating individual directors.

— "Performance Assessment In the Boardroom," Spring 1994

When the book [*Pawns or Potentates*] was published, I suddenly found myself in the middle of what I called the "circus" of corporate governance. It was clearly a case of being in the right place at the right time, because the book was published in an environment where there was an immense amount of interest developing in corporate governance generally, and in boards specifically, on the part of institutional investors, the legal establishment, and directors themselves. And I have been involved in corporate governance ever since.

The big issue that we dealt with in the book, reflected accurately in the title, was whether directors were going to be the pawns of the CEOs or were they going to be the potentates — which is what the law indicates they should be. At that time, they were probably more like the pawns. Today, they are more like potentates. There has been a big swing in the influence of boards *vis a vis* management, which has been quite healthy.

— "An Oral History of Corporate Governance 1976-2001," interview with *Directors & Boards* Chairman and Publisher Robert Rock for the journal's 25th anniversary edition, Fall 2001

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