The Myths of Corporate Governance

Corporate governance, like every performance area, has developed a "culture" that is sometimes informed by myth as much as reality. These are some of our favorite corporate governance myths.

Myth #1: **Responsible, credentialed people can make superior fiduciary decisions without any sophisticated support tools.** It goes something like this: talented, responsible professionals will make good fiduciary decisions in the board room precisely because they are talented, responsible professionals and because they are able to make good decisions in their field.

We have long believed that we must place our most responsible people on boards. We want our most responsible people in those positions of authority and power – because we understand that the **decisions** they make will inevitably impact the lives of many, many people.

The genesis of that Myth lies in the distinction between a body of knowledge that defines a particular professional discipline and *the judgemental algorithms that are used to operate on that content information.*

Consider a comment that we have heard before – "these people are the tops in their field. You cannot find people to serve on your board who are more brilliant and more responsible than these."

We understand – the patent lawyer may be tops in her field. The union organizer may be tops in his field. But neither of them – generally speaking – are informed about the consequences of *violating stochastic transitivity* or what it means to fail *to structure choice alternatives as a Pareto optimal efficient frontier*. These are terms with which experts in human judgement and decision making routinely deal. In the same way that you would not ask your expert union organizer to function as a patent attorney – so you don't ask your patent attorney to function as an expert in human judgement and decision processes.

An experienced Baker will tell us that the first requirement for making a pretty and tasty cake is buying the best ingredients. But you don't get the delicious cake without combining all of those best ingredients in a particular order, using specific techniques and specialized tools and operating on the mixture in various ways at each stage. Without following the recipe – the instructions for combining the ingredients – you never get a cake – you just have a counter top of assorted ingredients – eggs, a sack of flour, a canister of sugar, a bottle of vanilla.

Consider a board room of blue-chip fiduciaries. The best ingredients. Top executives, bankers, union officials, financial executives, policy experts, engineers, experts in many content areas. This group must examine and combine all kinds of content information and then extract inferences and make decisions.

Unfortunately, however, because our exemplar Board has no specialists in human judgement and complex decision making - they do what most people do when we are faced with information overload. Behavioral scientists tell us that when even the most capable people are faced with information overload conditions – they respond by adopting *intellectual shortcuts* of different kinds. These intellectual shortcuts – which are called *judgemental heuristics* – are very useful because they empower us to make decisions when, otherwise, "paralysis-by-analysis" would often prevent our being able to do so. Accordingly, these judgemental heuristics are very adaptive. The downside, however, is that they introduce a characteristic distortion into the inferential judgement. This distortion of judgement is especially problematic when you consider that scientists have identified three or four dozen of these judgemental heuristics – and each one delivers a different kind of distortion.

Behavioral scientists, primarily experimental psychologists, have long known about the depth and breadth of human judgemental fallibility. The line of research that discovered and documented these judgemental heuristics was developed in 1971 by our colleagues Daniel Kahneman and Amos Tversky. Much of their work is embedded in our ad hoc decision audit – which is the third stage of our Smart Governance program. Dr. Kahneman was awarded the Nobel Prize in Economics for 2002 for this line of research in judgement and decision making. Unfortunately, Dr. Tversky had died a few years earlier and by the rules of the Nobel Committee was ineligible.

And, by the way, isn't it curious that people are happy to tell you about how bad their memory is. They will share long, detailed and comical stories about how bad their memory is. But you never hear anyone referring to how bad their judgement is. A person's judgement is perceived to be like their character or moral fiber. A sure-fire way to insult somebody is tell them you don't think their judgement is very good.

Myth # 2: **With some good training – our talented Directors can discharge their fiduciary duties to the company.** To satisfactorily manage fiduciary decision making – you must implement a *refereed decision environment*. A *refereed decision environment* is one in which decision making specialists facilitate the fiduciaries' decision making process by structuring the decision tasks, monitoring the fiduciaries' judgemental activities and holding them accountable to the highest standards of decision making. And, then, by grading their performance and attesting to that performance in a written document.

A bestselling book by John Molloy published in 1988 – Dress for Success – was written for people who wanted to accurately simulate the way American executives routinely dressed in the office place. If you were finishing up your MBA or law degree and wanted to look like you would easily assimilate in to Morgan Stanley or Goldman Sachs - you could read this book and carefully follow the coaching guidelines and dress like a Fortune 500 executive.

It is not true; however, that you can read a book about behavioral decision theory or decision analysis and then go apply the principles in challenging real world decision making situations.

Perhaps Jethro Bodine of the Beverly Hillbillies can explain it better than we can. Remember Jed Clampitt, Granny, Ellie Mae and Jethro from the old television series? Jethro was always trying to improve himself and get ahead in life – but he never quite understood the complexities of modern life. He frequently promised his Uncle Jed that he wanted to take a correspondence course to become a brain surgeon.

Directors and officers and other fiduciaries can no more learn how to manage complex decision making processes by taking a two day seminar than Jethro Bodine can become a brain surgeon *via* a correspondence course. This is not about fiduciaries being slackards in intellectual firepower – it is about one type of decision task that is now too difficult for the

brightest humans to dispatch without support from experts. **The culprit is the complex futurity decision rendered under conditions of risk and uncertainty.**

For the most part, organizations like pension funds, public companies and others have been relatively unaware that they need a *refereed decision environment*. And here's why: they are unfamiliar with the *Fundamental Fiduciary Error.* We'll get to that in a minute.

Myth #3: **The #1 criterion for being a good Director – for performing well in behalf of the shareholders and other stakeholders is – purity of intent and steadfast effort.** We all know that the performance of our fiduciaries must be the most responsible kind of behavior that we can imagine. Responsible behavior must be behavior characterized by a certain quality of intent, a certain amount or intensity of effort – but also it must be accompanied by some threshold-level capability. *Intent, effort and capability*. We know that the fulfillment of good intent requires some minimal amount of effort and that the effectiveness of that effort assumes a certain level of capability. *Intent, effort, capability*.

Consider the *Fundamental Fiduciary Error:* the failure to provide a normative control mechanism at the locus of decision making events that can measure, grade and remediate fiduciary performance – that is, the quality of those decisions.

Without such a control mechanism, there is no evaluative framework with which to discuss Director Performance or governance practices.

Consequently, there is no way to imagine progress or to contemplate improvement. "If you can't measure it, you can't manage it."

Contemporary "best of breed" governance practices provide for no metric at the locus of decision making events – which implies that there is no management of the decision making process – and we know that decisions are the predicate act of fiduciary performance. Therefore, contemporary "best of breed" governance practices provide no reliable way for Directors to regulate the quality of the Board's fiduciary performance.

So, the fiduciaries have no way of knowing when they are in danger of being sued and losing.

So, while intent and effort are necessary to drive acceptable fiduciary performance – they are not sufficient; capability is also required – and competence in one's area of expertise is not enough.

Myth #4: **Many states have passed "director protector" statutes in their attempt to limit the personal liability of directors and officers. If the corporation is domiciled in one of those states and given that the corporation has indemnified the directors from such liability and given, further, that the corporation makes a substantial annual investment in D&O liability insurance – why should the Board consider strategic use of the *Smart Governance ad Hoc Decision Audit ™*?**

Liability attenuation issues are no less important because of the passage of "director protector" statutes. These statutes limit the liability of directors only for violations of the duty of care. Violations of the director's duty of loyalty are excepted, as are self-dealing and "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."

Legal scholars have predicted that in coming years as plaintiffs face dismissal of "care" claims on the basis of a protection statute, many plaintiffs will elect to "recharacterize their claims and tailor them to fill one of the excepted categories." The duty of loyalty exception is a particularly likely "backdoor" for such litigation since the line between the *duty of care* and the *duty of loyalty* is not always clear. Inevitably, the same set of circumstances previously

characterized as breaches of the duty of care will be framed as breaches of the duty of loyalty. Recall our suggestion that the relationship between "care" and "loyalty" derives from conceptual roots of "effort" and "intention." We understand that, conceptually speaking, amount of effort can be perceived to be a function of intent --- in the sense that a very modest effort may raise the question of the purity of intent.

By this reckoning, the "director protector" statutes will provide only limited and temporary relief. And, importantly, the *business judgement rule* cannot be invoked for loyalty violations and D&O liability insurance does not apply to the excepted categories. **Clearly, the net effect of "director protector" statutes may be a major increase in director and officer liability exposure because future complaints will be recharacterized in terms of those fiduciary breaches which are uninsurable.**

Further, a recent phenomenon reported in Business Week magazine (February 27, 2006) underscores the danger of relying on D & O liability insurance as a major risk attenuation strategy. Several of the larger institutional shareholder plaintiffs in class action securities cases have been declining to accept court-approved settlements – preferring instead to follow through with the litigation in the belief that a court-adjudicated settlement will achieve a much higher financial award. Accordingly, the traditional practice of relying on one's D & O insurance to settle out of court and avoid a trial – has, itself, become a questionable idea.

Myth #5: **Fiduciary performance – at its core - is about compliance with laws, case law precedents, SEC directives, ERISA regulations, DOL Memoranda and other legal nostrums.** One of the significant reasons for the perseverance of the governance crisis in the boardrooms of Corporate America has been the dominance of a legalistic approach to governance regimes. It is very understandable and eminently forgivable that in the early days of corporate governance – directors and officers looked to their legal counsel for direction on matters of fiduciary compliance. And so began, quite innocently and rationally – a strategic misdirection in governance thinking that, arguably, is the root of governance deficiencies today.

Commercial organizations – whether they're primarily custodial franchises – like pension funds or more expansive in their outreach like public corporations – are, necessarily and thoroughly – at their core – value creation operations. Their mandate is not primarily about compliance with somebody's rules – but, instead, about methodical and reliable value creation performance for its constituencies.

Smart Governance may be thought of as a specialized value creation-risk attenuation platform. Despite that, there is merit in reviewing one aspect of the value creation platform that is typically under-addressed in our discussion of the Smart Governance program. The usual emphasis on the methodical elicitation of optimizing decisions tends to ignore one of the most important features of the value creation architecture. The teleological or purposive element is premised on the *sine qua non* of capitalism for a commercial operation - which is the achievement and maintenance of competitive advantage in its marketplace(s). **It is only by the programmatic achievement of competitive advantage that a firm can simultaneously deliver a superior value to its customers and deliver a superior return to its shareholders**. For that reason, the core purpose of the business entity is the aggregation and alignment of its resources for the express purpose of creating value that will allow its offerings to be perceived as the best (value) in the marketplace.

The first decision for fiduciaries is always – "what decisions should we make?" "Making the right decisions" is as important as "making decisions right." Without a *values foundation* – there would be no way to determine "what decisions we should make." Preferences are primitive, root realities; they derive from values that may have no logical or intellectual genesis. The **FIG Value Creation Architecture** derives its *values foundation* from the fundamental mission of the American corporation – which is to engage in activities calculated to pay shareholder return to the investors – typically some combination of *dividend pay-out* and *net share-price appreciation*.

The *values foundation* embedded in the **FIG Value Creation Architecture** assures that the right decisions will be made. Making those decisions competently is something else altogether - not only about mission preferences – but about managing the decision making process. Nevertheless, the important observation is that decisions with instrumental value must not only be sound from the management of the inferential process – but the assumptions that lead to placing a decision task on the agenda must also be managed correctly. And this begins with the adoption of the proper *values foundation*. Lest we seem to be emphasizing a miniscule point, we should note that the course of corporate governance practice has been misdirected for two centuries because of the failure to get the *values foundation* laid correctly. Consider the role of attorneys from the earliest days of corporate governance.

In the early 19th century the corporation was not only a legal construct given birth by state jurisdictions – it was also a politically volatile construct to many Americans because of their sense of abused privilege that characterized their perception of British charters of 17th and 18th century origin. Though the American corporate form was to morph into a distinctively different creature by mid-nineteenth century – the evolutionary path was not always clear and apparently resulted in a dependence on the advice and counsel of attorneys. The clearly reasonable practice of directors and officers relying on barrister perceptions in the Antebellum Era for navigating the legal paths of commercial conduct – generalized in the late 19th century and decades following to a dependence on legal advice for demarcating the domain of fiduciary responsibility. No one would realize until the late 20th century that this lapse in judgement would elicit the "train wreck" of dysfunctional governance practices in post-WW II 20th century.

Return to our observation about the importance of the *values foundation* in driving the fiduciary's ability to make the right decisions. The *right decisions* are decisions about how to achieve and maintain competitive advantage in the marketplace in order to deliver super value to customers and simultaneously return a superior value to shareholders. Determination of how much authority a board has in pushing the limits of executive compensation, for example, is not one of those *right decisions* that a board should take on. The right decision must be about the pursuit of a commercial outcome with a correlated economic result – and the determination of how much must be paid to a leader who can deliver that result.

The CEO compensation question or any other issue before the board must be examined from an economic/value creation perspective rather than from a legalistic perspective. And, so – we discover the counterintuitive finding that lawyers are and have always been - part of the problem – not part of the solution. Ultimate culpability, of course, must be laid at the feet of the fiduciaries – not the attorneys - who are simply providing legal advice and doing what lawyers do. Though a legal construct – the American corporation exists primarily for an economic purpose – not a legalistic one. When fiduciary decisions are made based on matters of competitive advantage – CEOs do not get paid a few hundred million dollars as part of their separation package. That kind of result does not compute when the frame of reference – the values foundation – is about *achieving and maintaining a competitive advantage.*

Compliance with laws or norms without a pro-active mission to accomplish something … is similar to *not thinking about the end of your nose* – difficult to do and stay on task at the same time.

The fiduciary duties of directors are cast in terms of the way their decisions are made. They must be imbued with care, loyalty, independence and candor. But the decisions are not first and foremost about "coloring within the lines" or being compliant with law. The frame of reference of fiduciary decisions derives from economics and equity – creating substantive value and distributing it among the stakeholders in equitable ways.