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OVER THE HORIZON
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EUROPEAN CORPORATE
GOVERNANCE – IN THE PIPELINE
PART I - On Corporate Governance
PART II - On Shareholder Engagement

THE LECTERN
LUDO VAN DER HEYDEN
SETTING A TONE OF FAIRNESS
AT THE TOP

FOCAL POINT
ROMAN ZYLA
PUTTING GOVERNANCE
INTO PRACTICE

GOVERNANCE
SCOTT KILLINGSWORTH
ETHICS IN THE EXECUTIVE SUITE:
THE BEST, THE BRIGHTEST
AND A WICKED PROBLEM

THE GAVEL
SYLVIE C. BLEKER-VAN EYK
THE EXTRATERRITORIAL WEB

SPEAKER'S CORNER
JONATHAN LEDWIDGE
WHY ARE WE HERE?

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THE LECTERN
SETTING A TONE OF FAIRNESS AT THE TOP

*By Ludo Van der Heyden**

The Oxford English Dictionary defines governance thus: The action or manner of governing a state, organization, etc. It is, to be frank, inadequate. Governance covers a multitude of considerations, actions, structures, hierarchy and processes that lead to outcomes of infinite variety. At its base is the creation of a framework destined to facilitate decision-taking. Despite the fact that it is a discipline as old as mankind, governance has been, and has remained demonstrably imperfect through the ages, as kings, politicians, executives and individuals fail society time and time again. In all of these examples, it is, alas, the human element that appears to be the common denominator. In this article, Ludo Van der Heyden seeks to identify the source of this human frailty and argues for the imperative of *fair practices at the top of organizations*, and presents simple operational ways to implement such an agenda. With the promise of both greater and more sustainable value creation for a corporation's stakeholders and increased societal trust in business practices, a reflection on how we might improve our exercise of discretion at the decision-making table would appear a venture worthwhile.

Why governance has to be fair and why it too often appears not to be

Since the financial crisis, governance has found itself in a continuous limelight. What has made this attention so drastic and unprecedented is the compounding of fault, especially within the financial sector, at various levels:

- Corporate (through unchecked issuance of high-risk financial instruments)
- Industry (the financial industry did not rise to warning signs)
- Regulatory (since regulators, led by the US and the IMF failed to spot emerging systemic risks and, even

* **Ludo Van der Heyden**, Mubadala Professor of Corporate Governance, INSEAD, Fontainebleu, France. As Guest Editor, Ludo Van der Heyden's full biography appears in the final section of this issue.

worse, contributed to it through their "loose" policies), and finally:

- Governmental (US Government fuelled the fire through their policies, the biggest one being the repeal of the Glass-Steagall Act that separated retail and commercial banking from investment or "casino" banking).[2]

The governance crisis has not been limited to the financial sector, however. Let us consider another, now well discussed, example of value destruction. The HP Board now holds the dubious record of having fired three CEO's in a row (Fiorina, Hurd, Apotheker) and seeing its three last Chairs (Fiorina, Dunn, Lane) resign. The fall in HP's share price has been equally spectacular, as has been the number of lawsuits involving directors, executives and shareholders. Governance should preserve and deliver value creation; yet the HP governance system appears to have been the subject of a virus attack causing directors to evidence behaviour that is value destroying. That CEO Hurd was forced to resign for sexual harassment and a lack of transparency in (small) payments for corporate services (including by the woman he allegedly harassed), while still receiving a US$ 40 to 50 million severance payment from HP, appears as gratuitous as it is fortuitous. At the expense of HP shareholders, employees and other stakeholders – innocent of wrongdoing – this value destruction was manifestly unfair.

Cultivating the Luck of the Devil

Hurd was furthermore investigated by the US Congress for insider trading for the "timely" sale of HP stock that occurred just prior to announcements that were likely to reduce HP's stock price. Research[3] on repeated cases of market abuse by CEO's and directors is damning in that it confirms that the Enron, Parmalat and other Worldcoms are only the Olympic

2 See the article by Nobel Prize winner Joseph Stiglitz in *Vanity Fair* (January 2009) entitled "*Capitalist Fools*" or our own "*Public and Corporate Governance after the Crisis*," in *The European Financial Review* (June 2011).

3 See e.g. the article "*Lucky CEOs and Lucky Directors*" by Y. Grinstein, U. Peyer, and L. Bebchuck, in the *Journal of Finance* (2010, Vol 65-6).

"Fair" business practices are better business practices, for business, for the people involved … and ultimately for the environment

medals of what is a much less visible hive of unfair activity and evidence of a completely wrong "tone at the corporate top."[4]

Cultivating Fairness

The point we wish to argue here is for the absolute imperative for *fair practices at the top of organizations*, and how over time, this leads to both greater value creation for a corporation's stakeholders and increased trust of society in business practices. Fairness is not an option; it is a must, intimately linked with *sustainability*. History has shown us convincingly that in the medium and longer term, fairness prevails, and that unfairness tends not to last. It was the clouds of unfairness created by political tyranny and religious intolerance in Europe that drove the early pilgrims to seek their silver linings in America, and it is America's continued quest for fairness that lead many to join it to this day.

Fairness is indeed a powerful social construct and a Darwinian necessity: Tribes where fairness prevailed would grow, where unfairness would destroy and disperse. Fairness, and particularly prolonged unfairness, is a powerful motivator for action, as the French and Russian Revolutions have shown, and also – closer to our concerns here – as the SOX governance reform in the US has shown.

That is the sense for fairness in governance: "Fair" business practices are better business practices, for business, for the people involved (including shareholders) and ultimately, for the environment (societal and physical). That tone must be set at the top.

Governance: A Quest for the Right Balance and Fairness

To identify frameworks and tools for supporting a tone of fairness, we need to define our subject. The best way to start is with the largely agreed OECD definition of governance as consisting of the *"procedures and processes by which an organisation is directed and controlled. The Corporate Governance structure specifies the distribution of rights and responsibilities among*

4 *Corruption: The New Corporate Challenge*, by N. Kochan and R. Goodyear, Palgrave MacMillan (2011).

the different participants in the organisation – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making." Operationally the matter is more difficult, if only because governance is practiced in a national and legal context, where although there is growing convergence around the concept, practice may differ substantially across countries and regions.

One and Two-Tier Board Governance

Germany hosts the biggest European economy. Its stock corporations have supervisory boards ("*Aufsichtsrat*") consisting of a mixture of employee and shareholder nominees who by law must act in the best interest of the company and must not obey instructions from "third parties" (including the bodies that appointed them). Executives are by law prohibited from serving on their supervisory boards and meet in the management board ("*Vorstand*") instead. The UK, which has had the most active discussion of governance over over recent years, defines a *Board of Directors* as one that comprises both executives and non-executives, and can allow its Chair to have executive powers. The notion of the *Senior Independent Director* (or SID) has been introduced recently to ensure greater independence from executives, and also ensuring that the voices of the other directors are truly heard by the Chair.

Finding the Balance

One of the fundamentals of good governance is finding the right balance between competing aims and opposing tensions. Dodd and Favaro[5] demonstrated that winning companies are those that are able to manage three fundamental tensions between:

- The need to produce profits and to invest;
- Short term imperatives and longer term goals; and
- The needs and aims of the company as a whole and that of its (functional or regional or business) parts.

5 Dodd, D. And K. Favaro, *The Three Tensions: Winning the Struggle without Compromise*, Jossey-Bass (2007).

A good trial has an implementation virtue, whereby those sentenced will accept their fate or the decision of the court more fully if they have been heard

Finding the right balance, and doing so dynamically over time as contexts change, is specifically one of the main functions of the board.

The Fair Process of Justice

This search for balance is precisely what defines the legal process in a court case. The judge needs to find the right balance between the interests of the prosecution and those of the defendant(s). A good trial has *an implementation virtue*, whereby those sentenced will accept their fate, or the decision of the court more fully if they have been heard – even to the point of admitting guilt; whereas, those steadfastly refusing to acknowledge evidence can be subject to harsher sentences.[6] Similarly, families of victims can be very upset when denied a trial (e.g. due to plea bargaining or out-of-court settlements).

In the court of law, the big stakeholder is *society at large*. Likewise, at the level of the board of directors, it is the company's society; its shareholders, employees and clients, amongst others, who constitutes the big stakeholder. One of the aims served by a good court trial is to heal and keep society together, just after the perpetration of an offence that tends to fracture it, by evidencing fairness and "due process." On the contrary, lack of application of the law – such as when a criminal is let free, or worse, strikes again when he should have been in jail serving a previous sentence – is perceived as unjust, makes people cynical towards the law and their government, and weakens the strength of the contract between the people and their government. So too does the absence of a just and fair due process and accountability destroy any belief in organisational justice in the firm, leading to the disintegration of its social fabric.

Judges of the Corporate World

Our point about corporate governance is precisely that: boards and their directors are *the judges of the corporate world* – and, although the context differs, they largely serve the same purpose and obey the

6 On the contrary, obstinate refusal to accept the evidence typically leads to harsh sentences, as was the case with the Enron verdict where former Chair and CEO Lay was facing a 45 year sentence when he died in prison, while former CEO and COO Skilling was sentenced to 24 years and 4 months in prison.

same principles. Fairness in governance is key for keeping corporations, their directors, executives, shareholders and many stakeholders "glued" together in a common faith; inclinations to the contrary will lead to fractures, loss of talent and energy, and finally value.

In other words, fairness is just as important to the boardroom as it is to the Court; one major difference is that courts deal with the past, whereas boards largely deal with the future. Except for this caveat, the sociological and psychological aspects of interactions are largely the same: evident shortage of fairness eventually leads to value destruction, whilst demonstrable fairness in governance is fundamental for sustained value creation; and more broadly, for trust in the capitalistic system, including the role of corporations and shareholders.

How then to ensure "fair governance"?

The first fundamental point to make about fairness lies in the distinction between "fair play" – or fairness of process – and "fair share" – or fairness in outcomes or results. Directors and executives often are unclear about the distinction, thinking of fairness in terms of "fair share" only. Let us start with defining "fairness in shares" or "fair division of the pie."[7] Philosophers have argued about fairness for more than 2,000 years and have identified 3 principles – and only 3 – for a fair division of the pie:

- *merit* where shares are proportional to an individual's contribution to the production of the pie (or common goal);
- *equality* of shares; and
- *need-based*, where shares of the pie are proportional to an individual's needs.

The most important point to be made regarding these principles is that they are *substitutes* – in that the application of each principle leads to different outcomes for the individuals concerned. A distribution based on merit leads to very unequal shares (as we see in private markets), and will not necessarily deal with individual

7 See "*Why Fairness Matters*," by L. Van der Heyden and T. Limberg, in *The International Commerce Review* (2007, Vol 7).

Fair play boards tend to be more performing, and fair play companies tend to attract and ultimately retain better directors and also executives

needs (which are best addressed by not-for-profit organisations or within the family). Public shareholders insist on equality of information and dividends (per share). Mothers distribute their time and love unequally amongst the children, their most needy children receiving most of their attention, leaving the more endowed or older ones to fend off for themselves.

Indeed, the consort of fair share is that of *fair play* – or *fair process*. Again, philosophical debate over more than 2000 years has identified 5 *complementary and mutually reinforcing* characteristics of fair play:

- *Consistency* – or uniformity of treatment across people and time;
- *Clarity* – or transparency;
- *Communication* – or the ability to give all a voice which they can exercise without fear of retaliation);
- *Changeability* – or the ability to change course as a function of new information or new facts; and
- *Culture* – or the commitment to aim to "do the fair thing" not only superficially, but deeply and fundamentally.

Contrary to our mutually exclusive definitions of fair share, all 5 criteria are complementary and must be validated for people to be seen to behave fairly. For example, we listen to those who speak truthfully and fairly. Consistency without changeability mutates to rigidity and might become dictatorial, in particular when the dictator punishes those that do not speak "his" truth physically or psychologically.

The virtues of fair play are most easily argued by invoking cases of non-fair play, for example at board level. Bias, a lack of transparency in decision taking, the censure of speech, rigidity of stance, and finally, a suspicion of hidden or personal agendas all impede board effectiveness. Fair play attracts and commits people to constructive board confrontations, while unfair play worries people and ultimately leads them to abstain from engaging, and ultimately lead to groupthink. Fair play boards tend to be more performing, and fair play companies tend to attract and ultimately retain better directors and also executives.

Formalizing the Board Process

Fair play is more about the "How?" of board work. In order to have a good

5E and 5C of Fair Process Leadership

normative description of board work, we still need to define the "What?"

THE BOARD PROCESS

- *Defining the question to be resolved*
- *Structuring a confrontational debate*
- *Deciding and explaining the rationale*
- *Executing, controlling and rewarding*
- *Outcome review and adjustments*

As with court proceedings, the board needs to follow a particular sequence that is indicated in the exhibit above. The first step in the process consists in *defining the question* being submitted for consideration and decision. What are the issues at hand? The risks? The ethical dimension? The scope of stakeholder impact? What are the facts, the options and possible outcomes? This is where in Court, the prosecutor and the defence spend much time engaging people who have information and are engaged in the matter. This crucial stage ends with a particular "framing" of the issue at hand; the wrong framing can only result in value destruction. For example, if the Board approves a cost cutting priority, when in fact the problem is a lack of revenue generation, any cost cutting will only exacerbate the problem.

The next step consists in the *confrontational debate* amongst the "pros" and the "cons" of particular options. That is where board competence and diversity are of the essence, enabling a thorough examination of contrary views. In strategic decision-making, this is also the time to examine the "counters" to the proposed strategy: what could go wrong if this decision is implemented, what are its risk factors? Certain options are eliminated while others gain credibility and precision.

Finally, comes the time when, having heard the evidence, it is the time to

decide and prove to oneself that one has the right rationale to reach an objective decision. A judge will come out of her deliberations to announce her decision and its consequences communicated to the various parties as to the implications of the decision reached. Transparency and clarity of decision, then unambiguously explained and communicated to all concerned, is key to generating perceptions of fairness and confidence in the leadership.

Execution can then start, hopefully leading to the full realisation of expected results – in a way that is consistent with the decisions announced at the previous step. And upon successful execution, rewards – or sanctions – are given.[8]

The last step corresponds to the Court of Appeals – where one adapts the verdict as a function of new information not available at the time of the trial. Given that board work is about the future, this step is in part to ensure performance is as intended, but it is also about revisiting questions of future strategy in light of recent progress. It is about the board evaluating outcomes generated and learning about the pertinence of its past decision, of the organization's competences, including its ability to execute, and of the need to adapt decisions, structures and people in the context of a changing world.

Benefits and Implications of Rooting the Board and the Chair in Fair Process

What then, is the value to such formalized approach to board work? For one, board members have a tendency to come to the board with entrenched positions, turning the board into a negotiation session between particular sub-interests. This is a perversion of the board process, which is a collegial body whereby board members contribute to the best decision for the organisation – even if this decision goes against particular interests or private agendas (which may have motivated their initial position). Secondly, just as in the court of law, it allows board members to fully appraise context, facts, and issues – and individually contribute to the outcome. A good board co-creates a decision – which

8 We observe that in court, successful execution of the sentence leads to recovery of full civil rights of the condemned – society again welcoming the individual in its midst, with the full rights of a "free" individual.

is a key success factor for implementation. All of us are always more committed to a decision that we contributed to, than a decision that is imposed on us and which we tend to initially reject, precisely because it is not ours.

The Fair Process model provides a good description of the dual roles of non-executive and executives directors. Executives have specific, operational responsibilities and therefore, typically do most of the analysis and fact finding. They also are responsible for the execution of the decision. Non-executives help bring perspective and objectivity to decisions on major corporate issues such as C-level leadership, strategy, policies, and corporate architecture,[9] all in the best interests of the organisation.

Finally, the Fair Process model provides a clear operational template for the Chair, who is responsible for board effectiveness. No process survives a bad leader – only procedures do. The distinction between the two is that a process is characterized by human interactions amongst process participants, whereas procedures apply regardless of leaders and participants, and are ideally enforced by all. In the board, the Chair is the process leader – and fair process leadership theory states that the quality of the outcome will be largely the consequence of the quality of the board process. This implies that the Chair ought to have a certain detachment regarding the outcome – and be open to input from board colleagues. Anchoring one's leadership in the board process is quite distinct from anchoring it on any particular outcome; in fact, it is precisely – as the HP example implies – the rigid pursuit of particular outcomes that lies at the root cause of the dysfunction of the HP Board. The latter contains numerous examples of unfair process (repeated leaks indicating lack of transparency in meetings, unclear expectations, culture of deceit, inconsistency in CEO treatment, etc.). So does the unwinding of the US financial sector.

9 By architecture we mean the configuration of sub-units, such as divisions and business units, functional units (finance, marketing, engineering …), defining more broadly how the organization tackles product, process and geographical diversity.

THE LECTERN – SETTING A TONE OF FAIRNESS AT THE TOP

The application of the Fair Process Leadership framework by the Chair will result in the more effective engagement of directors with each other, and with the executives, leading to improved social interactions at board level. The effects of asymmetries in accessibility to information and in time committed to company activities by the executive and non-executive directors will be positively mitigated. This rather "linear" conclusion has been validated in a number of interventions at board and management level.

One fundamental caveat remains: fair process requires a certain amount of time and information commitment up front, but the effect of such investments in engagement and exchange is typically amply rewarded by better decision making and improved execution. Engagement and commitment typically rise quickly amongst boards not used to function in this manner.

This leads to the question as to the limits of Fair Process Leadership.[10] A Chair not willing to listen to the arguments of others – because of private agenda issues not revealed to fellow board members – would find the model's prescriptions futile. The robustness of the fair leadership process, however, is that it makes the concealment of objectives difficult. The application of the process, widely communicated and explained to those impacted by the decisions reached, leads to improved acceptance, engaged execution through a sense of fairness, trust and justice.

Conclusion

We conclude this article with a point on compliance. Compliance is not merely a matter of following a prescribed set of rules or procedures, but that Chairs and their boards ought to comply with a value-based practice that has been well tested in society, namely that of due or fair process. It is our conviction that boards and their Chairs who follow and apply this prescription – taking into account contextual factors such as time and culture – would serve their organizations better – and hence be a credit to the capitalistic system. The converse is perhaps even a greater truth.

10 "*A Model of Fair Processs and Its Limits*", by Y. Wu, C. H. Loch, and L. Van der Heyden, in *Manufacturing and Service Operations Management* (2008, Vol.10).