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# *Board Oversight of Corporate Culture*

2007 NATIONAL DIRECTORS INSTITUTE

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## Board Oversight of Corporate Culture

Because a corporate culture significantly influences a company's long-term financial performance, a board of directors should consider oversight of corporate culture as one of its duties. However, just as corporate culture is not a one-size-fits-all proposition for organizations with different characteristics and objectives, the appropriate role for directors regarding corporate culture varies with each organization and its circumstances.

"Board Oversight of Corporate Culture," a featured session at Foley's sixth annual National Directors Institute on March 8, 2007 in Chicago, was moderated by Michael Kirwan, of counsel, Foley & Lardner. Other panelists included James Duffy, executive vice president and general counsel, NYSE Regulation, Inc.; Gregory Holland, senior vice president, chief legal officer and secretary, MPS Group, Inc.; Alice Peterson, president, Syrus Global; and Mary M. Sawall, vice president, Human Resources, Huron Consulting Group Inc.

### The Importance of Corporate Culture

Much as the traditional definition of "culture" includes the values of a group, the norms defining group behavior, and the institutions and structures that groups create to organize a human population, the culture of an organization translates to "how we do things around here, and how we behave." Corporate culture, though intangible, creates a framework that guides individual and organizational behavior when there are gray areas or "gaps between the rules" — and a healthy corporate culture helps ensure that people do things the way they should.

Such a framework not only affects behavior, but can also be the difference between organizational success and failure. Quantitative research findings illustrate that companies with higher corporate culture scores have enhanced valuations and are better performers. "Ethics equals economics," and even persons skeptical of the benefits of a healthy corporate culture should consider measuring the long-term economic impact of a failed corporate culture — including the cost of fines for wrongdoing, the inability to hire and retain employees, and the often irreparable cost of reputation damage to the company. An example illustrating the importance of corporate culture at a make-or-break moment is Johnson & Johnson's handling of the Tylenol poisoning crisis, and the link between that company's response and its long-held credo as the archetypal example of a positive, embedded corporate culture having a significant, beneficial, and long-term impact.

Accordingly, corporate culture should be an important area of focus for directors, officers, and corporate counsel. While the discussion of "corporate culture" in years past has mostly focused on matters of executive compensation, in today's environment the concern with corporate culture must reach much deeper within each organization.

### Assessing and Shaping Corporate Culture

A formal assessment of a company's culture often requires the assistance of experienced outside consultants. Tools employed during this process may include anonymous, attitudinal surveys that reveal what employees really think about the company's policies and leadership; information from a company's ethics-reporting hotline; and analyses of employee turnover (too much employee turnover, or too little, may indicate a culture that

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needs shifting). A comprehensive assessment may also require consultation with vendors, customers, and other constituencies outside the organization.

Informal tools for directors include simply "keeping one's antennae up" during interactions with management, and observing how people interact at different levels of the company. Directors must ask themselves: is there a sense that management can be trusted and that there is an open sharing of ideas among officers, or is there instead a "cult of personality" or some other destructive aspect of corporate culture? Directors should also evaluate the degree to which senior management is visibly communicating ethics- and values-related messages to all members of the organization (for example, through the use of speeches, newsletters, E-mail, CEO blogs, or other means).

A company's good position in an economic cycle can mask underlying problems in corporate culture. Board members shouldn't wait until there is a problem before taking appropriate action to assess and adjust a corporate culture. Typically, "if you incent it, you get it," and thus a company's compensation program has a significant impact on corporate culture. A director should examine compensation policies and philosophy to see whether such programs incentivize positive behavior. Companies must consider not only whether results are rewarded, but also whether the company bases such rewards on how the desired results are achieved. For example, if managers and employees are rewarded only for "hitting their numbers," then that compensation program provides strong incentives for achieving short-term numerical targets at the expense of other factors affecting long-term performance.

When a company faces an ethical dilemma, taking appropriate action with the persons involved is only part of the process; for the lasting benefit of the organization, it is also very important to publicly discuss the issue and ensure that employees know how the problem was resolved. As a result, the company will then have a "template" for handling such situations, and employees will know that they are expected to disclose wrongdoing. For example, if a company with a strong sales culture investigates some ethics complaints about a select group of high-performing managers, and determines after investigation that serious violations had occurred, the subsequent decision to terminate these top-producing sales personnel imposes short-term negative consequences for the company, but it also provides reinforcement of the company's commitment to ethical behavior.

Not every ethical dilemma is the result of crisis. For example, a corporation may enter into a related-party transaction that does not present a conflict at first, but which creeps up over time and crosses the threshold of acceptability. To prevent such situations from arising, boards should strive to erase even the perception of a conflict of interest. Even if there are short-term financial consequences from passing up a lucrative transaction, there are long-term benefits from sending the appropriate ethical message to everyone in the organization.

**The Role of Directors**

Because a directorship is a part-time job, directors cannot know all that management is trying to accomplish. Aside from crisis situations, board members should take a "light approach" to corporate culture issues, provided that directors fundamentally feel that they can trust management. In the case where there is a particular corporate-culture issue

about which a board member feels strongly, that member should ask management for a report on the topic. Additionally, ethics issues (including the resolution of ethics-hotline complaints) should be presented to the directors as part of the regular reporting process.

It is not enough, however, merely to establish an ethics and reporting program. Such programs must be maintained and valued by management. If ethics programs are not taken seriously, employees can sense it and become cynical — which leads to an even worse situation than before. For example, while CEO blogs are one method for communicating corporate culture issues to a large number of employees, this option requires a sustained commitment from the CEO in order to succeed. Likewise, even though an ethics-reporting hotline is viewed as a fundamental requirement, there are many different factors that affect the ultimate success of such a program.[1]

From the perspective of investors, a healthy corporate culture is one that makes money. Therefore, directors should ensure that there is a proper fit between the corporate culture and the value proposition for which the entity is supposed to be employing its capital. If people are focusing too narrowly on compliance matters and risk aversion, a company may fail to take the risks that are necessary to its business success. In a similar vein, a company's culture and performance are not necessarily improved by an increasing reliance on disinterested directors. There are consequences to vesting too much decision making authority in persons having no significant economic interest in a company's success.

Corporate culture is among the matters to which current and prospective board members should direct their due diligence. Prospective board members should interview company leaders, talk with vendors, and understand all of the constituencies that are important to the success of the organization. At times, this process of evaluation may lead some prospective directors to conclude that there is a mismatch between themselves and the corporate culture, and that service on the board would not be productive. But those who serve as directors have a solid opportunity to shape the corporate culture — both by their directives, and by their example. Directors should be cautioned that they too — by their actions and comments in the boardroom and elsewhere — are setting the tone for senior management, and in turn for the company.

**CEO Evaluation and Succession**

Corporate culture often begins with "tone at the top," and many failures of corporate culture can be linked to the characteristics of particular CEOs. The presence of a strong CEO, however, is not necessarily positive or negative for a corporate culture. For example, a corporate culture can benefit if the strong CEO is the purveyor of that positive culture. In contrast, it can be difficult to impose or adjust a particular corporate culture in the absence of a strong leader or group at the top.

Boards should incorporate ethics and corporate culture into a balanced scorecard as part of the CEO's annual review process, as one method of ensuring that the organization's

[1] These factors are analyzed in Ms. Peterson's article "Looking for Risk in All the Right Places," which is available at http://www.syrusglobal.com/sg/pdf/Looking_for_Risk-Internal_Auditing.pdf.

short-term results are achieved in a manner consistent with its long-term objectives. Also, if the board is seriously dissatisfied with a CEO's approach to corporate culture, then termination should be considered.[2]

Succession planning is one of the most important issues for directors to address — and also one of the most difficult, partly because CEOs may question the board's intentions. While succession planning is an important responsibility of the board, it can also be a positive, developmental exercise for directors and for management. As one example, the planning process helps the board recognize and evaluate "up-and-comers" within an organization.

Directors should seed the idea of succession planning during a meeting of the directors, and then collectively decide how to approach the CEO regarding the topic. If a "crutch" is needed to begin the succession planning discussion, directors can reference the NYSE Corporate Governance Standard 303A.09, which lists succession planning as one of the topics that must be addressed by a corporation's publicly-available corporate governance guidelines.

When evaluating prospective CEOs from outside (or inside) the organization, board members should ensure that there is proper alignment between what the company is seeking, and the candidate's own track record — meaning not only the candidate's past financial results, but how those results were achieved. As one tool, board members can consider 360-degree evaluations from the persons with whom a CEO candidate has previously worked. Additional information regarding the compatibility of a prospective CEO may become evident during the process of negotiating compensation.

Also, because a new CEO would be stepping into an existing corporate culture, board members should consider carefully whether they want to make a culture shift, or whether the corporation would be best served by sticking with the values and culture that are embedded in the organization and have served it well in the past.

The logic for evaluating the corporate culture fit of a prospective CEO also extends to potential M&A transactions, and directors need to make culture a significant part of an acquisition strategy. Even two cultures that are healthy and well-functioning in their own right may be extremely difficult to meld. Issues of cultural incompatibility can appear early in the transaction process, and may often themselves justify walking away from the transaction.

**Summary**

Corporate culture has a significant effect on the performance of an organization, and thus must be viewed by managers and directors as a serious issue. Although many of the initiatives and policies that affect corporate culture fall under the purview of management, directors have opportunities to provide appropriate oversight of corporate culture by (i)

[2] CEOs and other managers can fail with regard to corporate culture, even without being unethical themselves. In a December 2004 speech entitled "Tone at the Top: Getting It Right," Stephen M. Cutler, Director of the Division of Enforcement at the SEC, recommended disciplining or terminating managers for failure to create a culture of compliance, even if such managers are not directly involved in violations. http://www.sec.gov/news/speech/spch120304smc.htm

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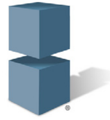

ensuring that fundamental infrastructure components, such as ethics-reporting hotlines, are established and properly maintained; (ii) reviewing compensation programs for proper alignment with ethics objectives; (iii) insisting on regular, public discussions of ethics and the organization's resolution of ethical challenges; (iv) setting an ethical "tone at the top" for management and other constituencies; and (v) making corporate-culture concerns a key part of the process when evaluating current managers, prospective managers, and potential mergers or acquisitions. "Talking the talk" of a healthy corporate culture is easy, but not enough; success requires actually "walking the walk" through a sustained, collaborative effort by directors and management.

**For More Information**

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the panelists directly.


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Save the date! The 7th Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.

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