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The Social Contract

The heart of the idea of the social contract may be stated simply: Each of us places his person and authority under the supreme direction of the general will, and the group receives each individual as an indivisible part of the whole. . . .

JEAN-JACQUES ROUSSEAU, *THE SOCIAL CONTRACT*

Directors and CEO's alike are entrusted with remarkable responsibilities. The key to the successful leadership of a company is a strong partnership between these two parties. With the collapse of the housing market and the bankruptcy of such giants as Lehman Brothers and General Motors, the importance of this relationship has come sharply into focus, and it has become increasingly clear that CEO's cannot be held solely accountable for failures such as these. When the news of Lehman's demise broke, for instance, the question raised by the *Wall Street Journal* was, "Where was Lehman's board?" It noted, "As the world nervously awaits the effects of the unprecedented Lehman Brothers liquidation, one can't help but wonder how and why this board let its longtime chairman and patron, Richard Fuld Jr., cling to both hope and power."¹ It is time to reexamine the role of the board and to explore how board members can best achieve their role as "the CEO's boss."

A Productive Partnership: Tyco

If an unsuccessful relationship between the board and the CEO can lead to disaster, then a productive one can help restore or avert it. A recent success

story is the rescue of Tyco International through the partnership of Jack Krol, lead director, and his CEO/chairman, Edward D. Breen. Breen, previously the president and COO of Motorola, was appointed the new chairman and CEO of Tyco in 2002 and came to the company in the midst of a devastating failure in leadership. The former chairman and CEO Dennis Kozlowski and former CFO Mark H. Swartz had been accused of stealing \$600 million from the company, and in 2005, after a retrial, both men were sentenced to 8 to 25 years in prison.

Breen believed that drastic change was needed to save the company, and he saw it as his responsibility to be hard on the problems facing Tyco. Bringing a world-class leadership team with him, he immediately acted to stabilize the company and restore shareholder confidence. To this end, he committed to replacing the board of directors and the leadership team under Kozlowski with a team of independent directors. In August 2002, with the priority of improving the company's corporate governance, Breen announced the appointment of Jack Krol as lead director.² Like Breen, Krol believed that big changes and tough decisions were necessary to get the company back on track. The stage was set for a partnership based on strong but shared beliefs.

By the end of 2005, Tyco's revenue had reached nearly \$40 billion under this leadership team. However, despite the company's renewed success, on January 13, 2006, Tyco and its board of directors announced its intent to separate Tyco into three distinct, publicly traded companies. According to Breen:

In the past several years, Tyco has come a long way. Our balance sheet and cash flows are strong and many legacy financial and legal issues have been resolved. We are fortunate to have a great mix of businesses with market-leading positions. After a thorough review of strategic options with our Board of Directors, we have determined that separating into three independent companies is the best approach to enable these businesses to achieve their full potential.³

This decision further emphasized the difference between the dysfunctional leaders that had left and the pro-active team that had taken their place. Following the separation, Breen remained at the head of Tyco International.

In October 2007, at a meeting of the Outstanding Directors Exchange (ODX) in Chicago, I attended a table discussion with Jack Krol in which he and Ed Breen discussed the recent changes that had taken place within the

company. Although their presentation on the separation was interesting, what was most compelling to the audience was the story that Krol and Breen told about their partnership as lead director and CEO/chairman. The men talked about how they maintained a successful relationship by being clear with each other on their strategy, priorities, and the gaps they had to close. Coming into the job, both knew that the business was in a turnaround stage in its life cycle and that they had to challenge the status quo and make informed decisions to save Tyco.

Adding force to their determination was their collective commitment to their Ethical Conduct and Board Governance Principles, a document that acted as a Social Contract to promote and ensure integrity, compliance, and accountability. Breen and Krol, in their presentation at ODX, emphasized how these three principles were the foundation for their partnership. Without these behavioral standards, they could not have clearly defined the change they envisioned for Tyco. Over their 5 years together, these three principles were expanded to today's Tyco Vision and Values.

TYCO VISION AND VALUES

Tyco International's Board of Directors is responsible for directing, and providing oversight of, the management of Tyco's business in the best interests of the shareholders and consistent with good corporate citizenship. In carrying out its responsibilities, the board selects and monitors top management, provides oversight for financial reporting and legal compliance, determines Tyco's governance principles and implements its governance policies. The board, together with management, is responsible for establishing the firm's operating values and code of conduct and for setting strategic direction and priorities.

While Tyco's strategy and leadership evolve in response to its changing market conditions, the company's vision and values are enduring. So too are five governance principles, and along with the company's vision and values, they constitute the foundation upon which the company's governance policies are built.

Tyco believes that good governance requires not only an effective set of specific practices but also a culture of responsibility throughout the firm, and governance at Tyco is intended to optimize both. Tyco also believes that good governance ultimately depends on the quality of its leadership, and it is committed to recruiting and retaining directors and officers of proven leadership and personal integrity.

TYCO VISION: WHY WE EXIST AND
THE ESSENCE OF OUR BUSINESS

To be our customers' first choice in every market we serve by exceeding commitments, providing new technology solutions, leveraging our diverse brands, driving operational excellence, and committing to the highest standards of business practices—all of which will lead to Tyco's long-term growth, value, and success.

TYCO VALUES: HOW WE CONDUCT OURSELVES

Integrity: We demand of each other and ourselves the highest standards of individual and corporate integrity with our customers, suppliers, vendors, agents and stakeholders. We vigorously protect company assets and comply with all company policies and laws.

Excellence: We continually challenge each other to improve our products, our processes and ourselves. We strive always to understand our customers' and suppliers' businesses and help them achieve their goals. We are dedicated to diversity, fair treatment, mutual respect and trust of our employees and customers.

Teamwork: We foster an environment that encourages innovation, creativity and results through teamwork and mutual respect. We practice leadership that teaches, inspires and promotes full participation and career development. We encourage open and effective communication and interaction.

Accountability: We will meet the commitments we make and take personal responsibility for all actions and results. We will create an operating discipline of continuous improvement that will be integrated into our culture."⁴

Jack Krol left the Tyco board in March 2008, but his reputation as an "outstanding director" was acknowledged at ODX in 2007. Quoting from the *Agenda* article that profiled Krol's accomplishment: "When Breen signed on, he believed that Tyco's core manufacturing businesses were solid, but he wasn't sure how far across the organization the corruption reached. Nor was he exactly sure how to avoid bankruptcy. He needed a partner, and fast. . . . Krol's reputation and total commitment to the task were major factors in both saving the company and restoring its respectability."⁵

Prescription: The Social Contract

A Social Contract, if developed correctly, can provide a prescription for strengthening and maintaining the partnership between the board and its CEO. I am defining a Social Contract as a clear set of behavioral statements willingly subscribed to by the board and CEO that details the mutual expectations of their partnership. In layman's terms, the Social Contract puts forth "the rules of the road." The roots of the Social Contract are in the postconventional moral reasoning that is at the core of a democratic government. (See Kohlberg's Moral Development Theory, Stage 5, which is Social Contract driven.⁶) As an alumnus of Saint Louis University, I consider my education Jesuit in nature, with a core emphasis on philosophy and all its applications. Thus, although my real academic focus was management, I have maintained an interest in the philosophy behind it. The Social Contract is particularly interesting to me, as it is fundamentally a philosophical document that results from a philosophical discussion. It is a contract between a board and its CEO that is developed through a conversation about what's important to ensure their commitment to the welfare of the business. *Each of us places his person and authority under the supreme direction of the general will*—in this case, the board/CEO partnership.

From my experience as a board chairman, I have found that the best way to start a discussion of a board/CEO Social Contract is to come up with five behavioral standards to present to the CEO. Five is a deliberate choice—I'm a believer in Miller's law, the work of cognitive psychologist George A. Miller of Princeton University's Department of Psychology, who measured human short-term memory capacity and found a 7 ± 2 limit.⁷ I prefer keeping the number at the lower end of the range so that the standards can be readily remembered. The five I use are

- *Commitment to values*: a leadership credo that answers the question, "What do we stand for as an organization?"
- *Commitment to the stakeholders*: customers, employees, shareholders, and community.
- *Commitment to risk assessment*: a willingness to manage the company's risk profile.
- *Commitment to transparency*: complete honesty in financial and nonfinancial matters.
- *Commitment to coaching*: supporting the CEO and board's continuous improvement.

These five standards can help the board consider the critical aspects of the company and discuss its general leadership expectations.

Commitment to Values

I've worked with a number of boards to develop a leadership credo by articulating an answer to the question, "What do we stand for as an organization?" It may sound simple, but it goes to the core of the way things are done around the organization—its culture. The culture of the company dictates the general will and behavior of the CEO and the board.

Johnson & Johnson has one of the most noteworthy credo statements of any company. As the company states on its Web site:

The values that guide our decision making are spelled out in Our Credo. . . . Robert Wood Johnson, former chairman from 1932 to 1963 and a member of the Company's founding family, crafted Our Credo himself in 1943, just before Johnson & Johnson became a publicly traded company. This was long before anyone ever heard the term "corporate social responsibility." Our Credo is more than just a moral compass. We believe it's a recipe for business success. The fact that Johnson & Johnson is one of only a handful of companies that have flourished through more than a century of change is proof of that.⁸

OUR CREDO

We believe our first responsibility is to the doctors, nurses and patients, to mothers and fathers and all others who use our products and services. In meeting their needs, everything we do must be of high quality. We must constantly strive to reduce our costs in order to maintain reasonable prices. Customers' orders must be serviced promptly and accurately. Our suppliers and distributors must have an opportunity to make a fair profit.

We are responsible to our employees, the men and women who work with us throughout the world. Everyone must be considered as an individual. We must respect their dignity and recognize their merit. They must have a sense of security in their jobs. Compensation must be fair and adequate, and working conditions clean, orderly and safe.

We must be mindful of ways to help our employees fulfill their family responsibilities. Employees must feel free to make suggestions and complaints. There must be equal opportunity for employment, development and advancement for those qualified. We must provide competent management, and their actions must be just and ethical.

We are responsible to the communities in which we live and work and to the world community as well. We must be good citizens—support good works and charities and bear our fair share of taxes. We must encourage civic improvements and better health and education. We must maintain in good order the property we are privileged to use, protecting the environment and natural resources.

Our final responsibility is to our stockholders. Business must make a sound profit. We must experiment with new ideas. Research must be carried on, innovative programs developed and mistakes paid for. New equipment must be purchased, new facilities provided and new products launched. Reserves must be created to provide for adverse times. When we operate according to these principles, the stockholders should realize a fair return.⁹

A joint commitment to a common set of instrumental values between the board and the CEO is central to a healthy partnership. Without a collective agreement as to the company's values, the leadership team will not have a complete set of tools to navigate through good and bad times.

In 1982, Johnson & Johnson proved just how committed it was to its Credo, and how the Credo helped shape strategic decisions, with its response to the Tylenol crisis. On September 29th of that year, a 12-year-old from Chicago died after taking a capsule of Extra Strength Tylenol. Another Chicagoan died shortly thereafter, as did his brother and sister-in-law after taking pills from the same bottle. There were two more deaths in the area before investigators discovered the Tylenol link. They believed that someone had stolen bottles of Tylenol off the shelves of various supermarkets, poisoned them with solid cyanide, and then replaced the bottles. This suspicion was confirmed when three doctored bottles were found in supermarkets.

I have worked with a number of "Big Pharma" companies and have referenced Johnson & Johnson's response to this incident as a clear example of a company that stuck to its credo in a crisis. The company warned hospitals and distributors, issued a nationwide recall of Tylenol products, and offered to exchange all capsules already purchased by the public with

solid tablets. This recall of Tylenol products had a retail value of more than \$100 million.

These decisions were strategic and could only have been guided by a clear set of principles that served as both a moral compass and a recipe for business success in a time of crisis. As a result, Tylenol was able to navigate through this difficult time with the Tylenol brand intact. The market share of Tylenol, which collapsed from 35% to 8%, rebounded in less than a year, and the brand regained its former popularity after coming back on the market in a triple-sealed package.

Commitment to the Stakeholders

One of my custom clients at Executive Education refers to his list of stakeholders as the “four legs of the stool” of the business. If any one of the legs is weak, the entire organization is out of balance. If you look back at the Johnson & Johnson Credo, you’ll see that these four stakeholders constitute the focus of the company’s values, and all four were considered in its reaction to the Tylenol crisis.

M&T Bank is another example of a company with a clear commitment to its stakeholders. Its Vision Statement reads, “M&T strives to be the best company our employees ever work for, the best bank our customers ever do business with and the best investment our shareholders ever make.”¹⁰ It then speaks about its role in the community: “M&T Bank has a long tradition of being involved in the cities, towns and neighborhoods in which we operate. As a community bank, we understand that the well-being of our company is connected to the well-being of the communities we serve.”¹¹ This clear statement of commitments has helped M&T Bank’s longtime CEO and chairman, Bob Wilmers, and his board turn the business into one of the twenty largest bank holding companies in the United States. A recent article in *Fortune* magazine captured the essence of M&T’s Credo in its lead headline, “Banking the Buffalo way: At a time of crisis in the financial system, the big boys could learn a lot from the success of a thriving regional player, M&T Bank.”¹²

In Columbia Executive Education’s M&T Bank Executive Leadership, which I directed from 2006 through 2008, we focused on strategic management, leadership, and growth. I saw a calm resolve from the company at the onset of the banking crisis in 2008, and this attitude was based on the executives’ shared commitment to employees, customers, sharehold-

ers, and the communities they serve. Without this credo, I doubt M&T could have weathered the turbulence of its industry.

Commitment to Risk Assessment

The recent financial crisis has highlighted the importance of risk management, and it is incumbent on boards to see that the CEO makes a commitment to manage the firm's strategic risk profile. A failure in risk management was one of the major factors in the Lehman collapse, and when the company went under, the press asked, "How much was Lehman's board monitoring the company's risk as it began accumulating its portfolio of real-estate assets and securities? In 2006 and 2007, the board's risk committee met twice each year, according to SEC filings."¹³

Michael Raynor's research has shown that a compelling vision, bold leadership, and decisive action, even though they are the prerequisites of success, are almost always present in failure as well. In his book *Innovator's Solution*, written with Clayton Christensen, he talked about maximizing the results of the business, but in his book *The Strategy Paradox: Why Committing to Success Leads Corporations to Failure . . . and What to Do About It*, he confronts the realities of managing risk.¹⁴ His research calls on boards and CEO's to design their organizations so that managers at every level of the hierarchy understand the time horizon and degree of strategic uncertainty they deal with in order to make the right strategic choices. He introduces the phrase "Requisite Uncertainty" to describe this organizational design principle.

In 2007, right after the release of *The Strategy Paradox*, I was a participant on a podcast panel with Michael Raynor in which we discussed the book's content and implications. At the time, it was more in vogue to discuss maximizing results than to consider risk management. Now, only a few years later, it's clear that Raynor was onto something crucial. In today's economic crisis, boards and CEO's need to make a commitment to manage their risk if they are to survive.

Commitment to Transparency

In an ideal world, it would be a given, rather than a behavioral expectation, that a company's CEO is honest. In reality, it's important for the

board/CEO Social Contract to make it clear that complete honesty is essential. This can help avoid gray areas by necessitating, for instance, full rather than partial disclosure. When CEO's withhold information from the board because they know it will be read as bad news, this is not dishonesty, but it isn't complete honesty either. When a Social Contract is developed correctly, the board and CEO establish the mutual expectation of full disclosure, which will help them solve their problems together. The underlying ethic is that this partnership is "hard on problems, not on people," and that the bearer of bad news should not be held immediately responsible. Although the ideal of "complete honesty" is hard to achieve in practice, the Social Contract does hold the board/CEO partnership to a commitment to transparency as the code of behavior. Transparency, when used in a Social Contract, implies openness, communication, and accountability.

The collapse of Lehman Brothers illustrates how a failure in transparent communication between the board and the CEO can lead to disaster. Most objective observers have concluded that Fuld did not fully disclose Lehman's financial matters, nor was there an honest assessment of nonfinancial matters, such as Fuld's leadership, by the board. Bad news was withheld until too late. The price that Lehman Brothers paid for these errors of omission or co-mission will be the work of the FBI investigation and lawsuits brought by its shareholders.

Commitment to Coaching

It has become common practice for boards to support the continuous improvement of their CEO's performance and to provide a professional coach to assist in the CEO's professional development. CEO's should be allowed to choose, with the agreement of the board, the coach that they feel can best provide helpful resources. I've served as a coach for a number of CEO's, and I've learned that the strength of the relationship between the coach and the CEO translates into a comparable strength in the partnership between the board and CEO.

In many instances, my first conversation with a new CEO client begins with a query of how things are going with the board. Inevitably, the CEO's will bring up the concerns of the board and one or more areas of the CEO's performance that are bothering them. I usually structure the rest of my coaching sessions around determining the root cause of these performance gaps and exploring the implications for the CEO's agenda, prac-

tices, and style. These are the various aspects of the CEO's behavior, and I explain them more fully in chapter 3. In the end, the goal is to align the CEO's performance with the needs of the business, and to determine what is required to close any remaining performance gaps.

However, continuous development goes beyond coaching for the CEO. The board has a comparable need to improve its skills and abilities in corporate governance. During the last three years, I have worked with ODX in its nationwide educational meetings. These directors-only conferences cover the most challenging boardroom issues. In addition, members are provided ongoing research and information through ODX publications like *Agenda*. Columbia Executive Education is another organization that offers support to board members by coaching directors to higher levels of performance in their corporate governance role.

The Social Contracting Process

In its final form, a Social Contract answers the question of "what we stand for" in a board/CEO partnership, and details the beliefs and behaviors that define their collective leadership. The process that I have successfully used with boards and their CEO's to create the Social Contract is straightforward and takes less than a day of the board's retreat to complete. The schedule that I usually follow is this:

- Review the strategy and strategic priorities of the business.
- Discuss the board/CEO partnership and the key challenges to achieving the business's strategy and priorities.
- Individually reflect on and list the three to five most important areas to build and maintain the board/CEO's partnership and a behavioral statement under each that would guide their work together.
- Reach a consensus on the common areas within the defining behaviors that the board/CEO will commit to as a statement of their Social Contract.
- Post the Social Contract in the boardroom and on the board agenda so it can be referred to as a standing agenda and behavioral guide.

The first two steps of the process set the stage for creating the Social Contract. The strategy and priorities of the business should be readily

available for review by the board when it begins. With that in hand the board and CEO can begin to discuss the key challenges facing the company. In most instances, these will be performance or opportunity gaps they want to close. This discussion is meant to allow for a collective understanding of the strategic context and intent of the business.

The next three points in the process gather individual input and flesh out the details of the Social Contract. During the third step, each individual compiles his or her own list of priority areas along with a behavioral statement. A list that follows my five preferred behavioral standards might look like this:

1. *Commitment to values:* We are a value-driven organization whose credo defines the way we do things. Our values are clearly stated for all our stakeholders (customers, employees, shareholders, and community) to know what we stand for as an organization for them.
2. *Commitment to the stakeholders:* We know our commitment goes beyond just doing well as a business. We feel a compelling commitment to do what is right for our customers, employees, shareholders, and communities in which we work. Seeking the right balance between and among these stakeholders is the key to our overall stability and success.
3. *Commitment to risk management:* We understand that we can fail if we don't manage our risk. As much as we want to maximize our growth, we also need to constantly monitor our risk profile.
4. *Commitment to transparency:* We have a fiduciary responsibility that is supported by our commitment to transparency with our shareholders and complete honesty within our board/CEO team regarding our financial and nonfinancial matters. We respect the requirements of confidentiality where they apply but do not withhold information from our decision-making process.
5. *Commitment to coaching:* We believe in the continuous development of the board/CEO skills and abilities, and therefore commit the time and resources to learn how we can better perform in our respective roles. We view this as an obligation to our stakeholders and an investment in our future success.

Once everyone has put a list together, I ask each member of the board to read his or her individual statements while others listen for items that

are similar to their own. Once everyone has read aloud, the next step is to reach a consensus on common priority areas and defining behaviors. To facilitate this process, I define a “consensus” as a selection from a list of mutually acceptable alternatives and suggest that the group combine items from individual statements and refine them as necessary, leaving out items that anyone strongly objects to. In the end, there will be a list of statements to choose from that everyone can support. With this list in front of them, I ask board members to choose their top three. After recording their individual preferences, it usually becomes clear that a select number of items receives a clear majority of support. Again, there can be some further refining and combing, but, following Miller’s law, I try to hold the board to 7 ± 2 . The board/CEO will then commit to these as a statement of their Social Contract.

Finally, I ask the board to post the Social Contract in the boardroom and on each member’s board agenda so it can be referred to as the behavioral guide in their work together. My follow-on recommendation to the boards/CEO’s I work with is that they revisit this document as needed, and at least at every scheduled retreat. I suggest, for these continued discussions of the Social Contract, that they use a facilitator who is trusted by the group. This can be either an outside consultant, as in my case, or an internal consultant knowledgeable about group dynamics and decision making and is viewed as an objective and trusted advisor.

The fundamental idea behind the Social Contract is that a board/CEO partnership cannot be sustained by good intentions alone. There must be an explicit statement of the beliefs and behaviors that are essential for the general will of the organization. With the creation of the Social Contract, a foundation is in place for a successful and productive partnership between the CEO and the board.