

Corporate Governance – Beyond the Scandals and Buzzwords

1.1 EVERY COMPANY HAS A CORPORATE GOVERNANCE

The corporate governance (CG) of large, stock market-listed corporations dominates the academic and public debate. This has actually created the (wrong) impression that CG is predominantly an issue for these types of companies. Every organization – not only corporations – has a governance system: governance concerns the distribution of power and responsibilities and, consequently, accountability for the organization's performance.

We distinguish, however, between the governance of different types of organizations such as membership vs. capital-based organizations, and public vs. private companies. CG concerns companies that, in modern economies, are characterized by specific features:

- The license-to-operate is fundamentally an economic one: to competitively provide goods and services to customers who are willing to pay. This does not mean that companies should ignore the social and environmental impact that is the side-effect – 'externalities' – of their task.
- The central benchmark of success and survival is a profit – the monetary value added comprised of the difference between the costs incurred and attained revenues.
- Corporations are hierarchical organizations that may differ in their degree of hierarchy (e.g., number of layers, power distance, etc.), but always have an identifiable 'apex'.
- The ultimate 'say' in a company is based on property rights, not on (democratic) principles such as 'one vote per person'.

The license-to-operate depends on compliance with the many restrictions that society has placed on companies: competition rules, national security, protection of creditors, of employees, of natural resources and/or of the environment, etc., but within this 'corporate life space' the company is free to act.

However, what may appear as restrictions on the enterprise level, are often essential preconditions to make a market-based capitalism work on the macro level. To name just a few: defined property rights, enforcement of contracts, a predictable 'level playing field', social and political stability. As the situation in emerging markets clearly indicates, these market preconditions are not easy to develop and synthesize. The economic system in Europe and the USA is by no means 'natural', but relies on a sophisticated legal infrastructure and fundamental values, developed over centuries, to guide behavior.

One of the fundamental principles of this economic system is that all people are responsible and held accountable for the decisions that they (or the institutions that they represent) take. The principles are intended to guarantee the responsible use of power and respect for others' interests.

These principles have been partly codified in laws and regulations and are partly unwritten but understood as expected behavior. On the whole, they ensure ‘freedom with accountability’, although societies vary in how they implement these principles in detail. The extent to which someone is accountable to a variety of stakeholders for corporate actions’ results or for violating restrictions differs. In a small business, it might just be the owner who has to account for a loan that has not been serviced or labor laws that have been ignored. In large, specifically global companies, this accountability might be more complex and not easy to relate to a specific person. Whatever the case, it is CG’s key task to establish this accountability and create transparency in this regard for stakeholders.

Our ‘managerial’ definition of CG is therefore:

Corporate governance establishes clear structures regarding accountability, responsibility, and transparency at the head of the company, and defines the role of boards and management

This definition differentiates CG from other management themes in several ways:

- First, it deals only with the company’s top management (but sometimes also with *specific* CG implications further down the corporate ladder, such as subsidiary governance or compliance insurance).
- It does not deal with the content of a specific strategy and the organization as such, but specifically with how accountability and responsibility are allocated – especially between the top management and the board – and how this is made transparent to the stakeholders. In short: who is responsible for what.
- Transparency is not only concerned with the accountability dimension, because it would be difficult to hold someone accountable without being able to benchmark performance. CG does not, however, justify this benchmark, it simply describes the process; how a specific corporation has identified this benchmark.

The definition of cultural governance is also culturally neutral and, consequently, globally applicable, as it does not favor one form of governance over another, such as a two-tier or a one-tier board, or specific types of ownership.

Definitions cannot be either right or wrong; they can only be useful for a specific purpose or not. Our definition is shaped by our focus on examining real-life corporate governance processes and shedding some light on the working of boards. If one were to examine the definition from a primarily compliance perspective, the definition might have a different focus. One example of a compliance perspective is the OECD CG Guidelines, which were the foundation, as well as the umbrella, for many national CG codes. The OECD definition reads as follows: ‘Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders, and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.’

1.2 THE HISTORY OF CORPORATE GOVERNANCE – A TALE OF CRIME AND CRISES

Although the term ‘corporate governance’ only appeared in the mid-1980s, the underlying problem started with the modern corporation’s evolution after 1840. The huge investments required by the railroads and the growth of banks separated investors from those who were running the company, creating what is today called the ‘principal–agent theory’ or the Means–Berle dilemma after the two Harvard professors who first suggested separating management from ownership in 1932.

Until then, practically all major US companies were either family businesses or state owned. It was early industrialization with its tremendous and intransparent risks and uncertainties, as well as its potentially high stock growth rates and attractive dividends, that lay at the heart of the first UK/USA stock market crash in 1856. At that time, the continental European markets were not sufficiently developed to have a crash of any significant proportion and remained relatively unscathed. Eventually, however, they usually followed the USA and the UK in the big crashes.

It should be noted that the pattern of, and the behavior during, asset price inflation have not changed since then, as revealed by the dot.com bubble: the huge speculative gain in the stock market attracted many hit-and-run investors interested in getting rich fast. Once the bubble burst, the scam was discovered with many (especially small) investors losing substantial sums. Although German historian Heinrich von Treitschke already noted the ‘unlimited stupidity’ of these get-rich-quick investors in 1873, the incentive to participate has not changed in 150 years: one should know that the assets are overpriced, but everybody hopes to soon find a ‘bigger idiot’ to sell the assets to at an even higher price. Only when this stops, does the bubble burst and punish those who arrive too late at the party, normally small investors.

Government reaction too has remained unchanged in 150 years: punish the ‘bad apples in the basket’ to restore investors’ confidence and draft new regulations. The stock market crash of 1873 eventually resulted in the external auditing of company books, and the crash of 1929 in regulatory stock market supervision.

The response to the dot.com crash did not differ from this pattern. One could, however, argue that the crime was more sophisticated and required a bending of the rules.¹ For economists and everyone else with common sense, the main point is rather to prevent bubbles instead of adding even more regulations, which merely generate creativity in circumventing them. This leads to the discussion whether central banks should not only prevent customer price inflation, but also asset price inflation. It also casts a critical eye on the role of (investment) banks, which have always fueled bubbles. And last but not least, if regulations are needed, is there an intelligent design that can enforce the rules and provide incentives to comply? There are good reasons to assume that the US rule-based system is not the optimal framework.² It is also a never-ending story: in 1970, when regulation was still relatively light, 117 of 1043 US companies (or 11%) had contravened the regulations. This ranged from straight-forward fraud, price fixing, to bribery, etc., and was not just limited to restatement of the books.

The following description of corporate governance rules should therefore be regarded in the light of the criteria: did they really work and achieve their set goal? The latter is

¹ For details see Hamilton, S. and Mickethwait, A. (2006). *Greed and Corporate Failure*. Palgrave Macmillan, Houndmills.

² Also see Hamilton’s book for a more detailed discussion.

sometimes difficult to answer when a new regulation is driven by public outrage – usually as a vent for frustration after another bubble fiasco. A related question is therefore: did the law of unintended consequences lead to counterproductive side-effects, which might have outweighed the regulation's benefits? This last point is especially relevant when national regulators do not take into consideration that we are living in a global economy . . .

Diffusion of corporate governance regulation

The beginning of the 21st century has experienced great 'excitement' with regard to corporate governance. Many corporate governance issues are currently regulated and regulators don't seem to tire of introducing new legislation to govern the relationship between companies' stakeholders and their management. Furthermore, there are sufficient codes and best practice catalogs with regard to corporate governance in the business community to satisfy a variety of stakeholders.

Even though the topic of corporate governance is as old as managed entities themselves, it splits ownership and management, giving rise to a principal-agent problem. The term 'corporate governance' was not used until the 1980s, despite prior recognition of the need for shareholder and owner protection against management fraud, as the establishment of the Securities and Exchange Control in 1934 illustrates.

At the beginning of this century, investors' trust was severely shaken, not only by the collapse of Enron in 2001 – a trite if useful example – but also by other corporate disasters such as Vivendi in France in 2002. Table 1.1 gives an impression of how extensive the major business scandals were.

Table 1.1 Corporate governance scandals

Company	Year	Country	Detail
Daewoo	1998	South Korea	Accounting fraud and embezzlement by former CEO
Flowtex	1999	Germany	Insolvency after exaggerating sales figures
Enron	2001	USA	Bankruptcy of the seventh largest US company due to accounting fraud
Marconi	2001	UK	Bankruptcy due to overpriced acquisitions and to neglecting of controls
Swissair	2001	Switzerland	Insolvency due to wrong strategy, inefficiencies of the board
HIH	2001	Australia	Stock market manipulation
OneTel	2001	Australia	Overstretching of budget for overambitious acquisitions
Allied Irish Bank (AIB)	2002	Ireland	Loss of \$691m in unauthorized trading
Worldcom	2002	USA	Company collapses with \$41bn debt due to fraudulent accounting
Tyco	2002	USA	Overstretching of budget for overambitious acquisitions leading to bankruptcy
Vivendi	2002	France	Overstretching of budget for overambitious acquisitions leading to losses of \$23.3bn
Royal Ahold	2003	Netherlands	\$500m accounting fraud
Parmalat	2003	Italy	Undisclosed debts of €14.3bn
Volkswagen	2005	Germany	Abuse of corporate funds to provide inappropriate benefits

The incidents did not stop there though. After recognizing the gravity of these scandals, authorities felt the need to react and to create and amend corporate governance regulations. The most prominent corporate governance regulation is the United States' Sarbanes–Oxley Act, which became effective on 30 July 2002 and is still being amended.

One cannot help thinking that in order for change to happen, crises have to happen, but was it only due to the scandals that corporate governance became this regulated? The following sections analyze the pattern of corporate governance regulation's diffusion in France, Germany, the UK, and the USA – four of the world's major economies – over the last 40 years and explore the drivers of, as well as the barriers to, corporate governance regulation convergence.

Developments in corporate governance regulation in the 1970s

At the beginning of the 1970s, Mace (1971) challenged the abilities of the board – probably the most important instrument of corporate governance – to fulfill its following functions:³

- Establishing basic objectives, corporate strategy, and board policies.
- Asking discerning questions.
- Selecting the president.

In order to re-establish the board's control and supervising functions, there was a strong call for independent outside directors and for more checks and balances at board level in the USA. This appeal originated from investors, as well as the Securities and Exchange Commission (SEC), with the SEC even calling for standing audit committees to be composed of independent outside directors. This regulatory movement was followed in the UK where, based on Sir Brandon Rhys-Williams' call for the employment of non-executive directors and the use of audit committees, a Green Paper was produced to this effect.⁴ This Green Paper, however, failed to find supporters in Parliament.

On a European level, the European Economic Commission's Fifth draft Directive suggested replacing the unitary boards system with the two-board system, as practiced, for example, in Germany. In the UK, this proposal was criticized for requiring employee representatives on the board. Furthermore, English directors regarded the one-tier board as viable and therefore could not see the need for change. Following this European directive, the Bullock report was published in the UK, suggesting that the unitary board be continued but with worker representation. Again, this report was not received well by British directors.

These demands and suggestions for changes in corporate governance behavior and corporate governance regulation, although the term 'corporate governance' was not yet used at that time, were driven by a number of issues: in the USA, shareholders had become more litigious and started to sue companies and their auditors when investors thought this was lucrative. To be better protected against such lawsuits, it was suggested that the control should be improved, with checks and balances being provided between the supervisory and executive part of the company. In Europe, the main driver of corporate governance regulation was the aim to create a harmonized European market.

³ See Mace, M. (1971). *Directors: Myth and Reality*. Harvard Business School Press, Boston, MA.

⁴ See Rhys-Williams, B. (1976). *The Case for Audit Committees*. *Accountancy Age*, London.

Developments in corporate governance regulation in the 1980s

In the 1980s, the term ‘corporate governance’ first appeared, spreading through the literature, indicating a growing awareness of corporate governance issues. This attention was partially due to a number of high-profile initial public offerings (IPOs) in conjunction with the privatization of state-owned companies. In order to increase state-owned companies’ profit orientation and, obviously, to fill the treasury, the telecommunication, mining, and electricity industries were privatized in the UK, creating revenues of US\$96.7bn for the UK treasury between 1985 and 1995. In the following years, other developed nations followed this approach in order to increase shareholder-value. Germany, for example, privatized its telecom industry in 1995, almost 10 years later than the UK.⁵

The increased attention on corporate governance issues was also due to a number of corporate failures and scandals. In the USA there was Ivan Boesky, Michael Levine, and Michael Milken’s insider trading and in the UK, the Guinness share-trading fraud, which attempted to influence the stock market to increase the value of Guinness stocks. Furthermore, a growing number of people depended on the stock market, either directly as a result of personal investment or through pension fund investments, etc. This is best illustrated by the equity market value in the UK, which increased from £36bn in 1971 to £514bn in 1989 or the growing number of shareholders in the USA, which grew from around 31 million in 1970 to around 51 million in 1990.

Developments in corporate governance regulation in the 1990s

As can be seen in Figure 1.1, the late 1990s saw a further rise in the awareness of corporate governance in all the focal countries. A host of reports, guidelines, and best practice codes calling for more transparency, checks and balances, conformance, and compliance at board level were issued in various countries.

In 1992, the Cadbury Report was published in the UK, which dealt with directors’ service contracts, interim reporting, the effectiveness and perceived objectivity of auditing, and the role of institutional investors. This was a landmark event for corporate governance, as this report’s recommendations became obligatory for companies listed in the UK in 1993. This was what is called a ‘comply or explain’ regulation, meaning that any divergence from it had to be explained from 30 June 1993 onwards.

In France, a number of embarrassing business scandals led to the creation of the Rapport Viénot, which was further spurred by the Cadbury Report. The Viénot Report suggested that cross-shareholdings and cross-directorships should be prohibited and that nomination and remuneration committees should be established. In 1995, the Greenbury Report on directors’ remuneration was published in the UK, recommending full disclosure of management payment.

In 1998, more reports were published on corporate governance: the Hampel Report (‘Combined Code: Principles of Good Governance and Code for Best Practice’) in the UK and in France the second Viénot Report. The Hampel Report combined the Cadbury and Greenbury codes and concluded that in general, corporate governance regulations shouldn’t be

⁵ This time lag was partly due to a different perception of the market for corporate control, as, especially in the UK, the constant threat of hostile takeovers was regarded as an incentive for strong board-level performance [see Tricker, B. (2005). Corporate governance – a subject whose time has come. *Corporate Ownership & Control* 2(2): 11–19]. In Germany and France, however, this market didn’t exist to this extent, due to a less diffused stock-ownership structure and the banks’ stronger role, nor was the market for corporate control regarded as a threat for German companies’ strategy.

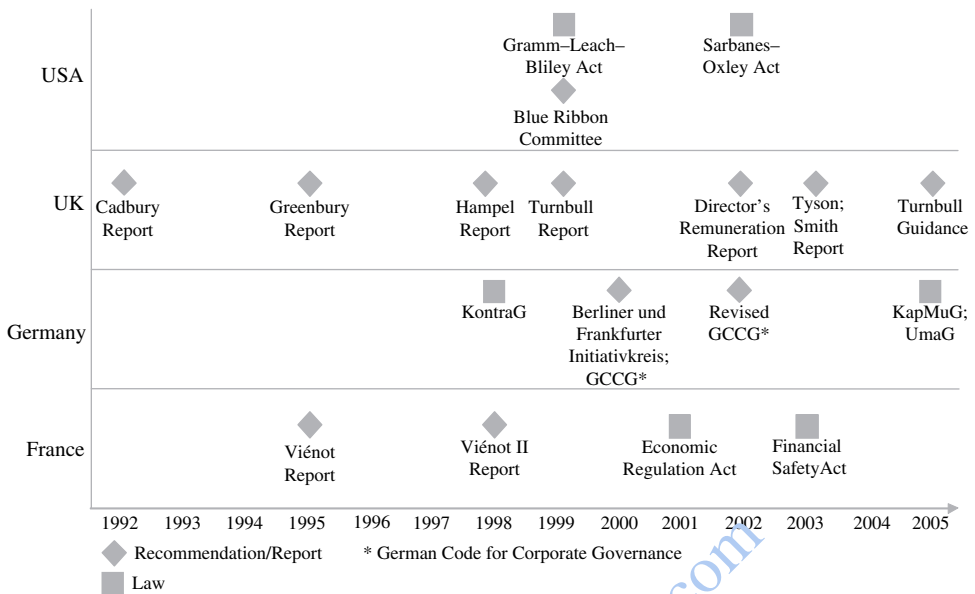


Figure 1.1 Major laws and reports on corporate governance 1992–2005

mandatory, but followed voluntarily. It furthermore suggested that the board should only be accountable to the company's shareholders – a clear statement in favor of corporate governance's shareholder orientation instead of a broader stakeholder approach. The report also suggested that the role of the CEC and chairman of the board should be separated.

The second Viénot Report of 1998 aimed to change the secondary goal of achieving shareholder value in French companies by stressing greater transparency in response to investors' demands. This report also called for a pay-for-performance type of remuneration for top managers, as well as the disclosure of the directors' remuneration policy (not the disclosure of individual directors' compensation). The second Viénot Report thus again embraced the Anglo-Saxon practices of good corporate governance.

In Germany, two laws that were passed concerning corporations' transparency and control (KonTraG) and their access to capital (KapAEG) demonstrated that there was movement with regard to corporate governance. The KonTraG was the first major company law reform since 1965 and had to satisfy the prevailing demands for shareholder protection, as well as effective employee representation on supervisory boards required by codetermination laws. The law dealt with, for example, cross-shareholding, the use of 'golden shares', which allowed for disproportionate voting rights, transparency, and shareholder democracy. It was passed after a number of corporate scandals like that of Daimler-Benz AG, which disclosed losses of more than a billion dollars when its annual report was published with GAAP calculations after reporting profits under German accounting rules.

In 1999, the USA too saw changes to corporate governance regulations through the Gramm–Leach–Bliley Act and through the recommendations of the 'Blue Ribbon Committee'. The latter provided 10 suggestions about issues such as transparency, external auditors' accountability, and external directors' independence with regard to audit committees and

aimed to improve the effectiveness of corporate audit committees. The NYSE, NASDAQ, and AMEX made the recommendations compulsory in 1999.

These reports on and laws for the improvement of corporate governance, as well as the growing awareness of corporate governance issues, were driven by the economy that had changed worldwide, as well as by individual events or the described crises in the various countries.

Other drivers of the diffusion of corporate governance regulation in the 1990s were:

- Technological advances. The spread of the Internet rendered communication and information sourcing easier, faster, and cheaper. The boundaries of information continued to vanish ever faster and, with it, the barriers to international investment, leading to more internationalized capital markets.
- A stronger focus on shareholder-value. In Germany the banks, which had formerly been more interested in companies' long-term success and which held a high proportion of seats on supervisory boards, became increasingly interested in short-term benefits. They believed that more money could be made through underwriting and in the lucrative market for buying and selling companies. The share of German banks' chairmanships of the 40 largest German companies therefore fell from 44% in 1992 to 23% in 1999.⁶

Development of corporate governance since 2000

In January 2000, after much criticism from international investors because of its opaque corporate governance regulations, the Frankfurt Commission for Principles on Corporate Governance and the Berlin Initiative Group started to document the German corporate governance system. The 'German Code of Corporate Governance' was introduced in June of that year. It deals with the responsibilities of the Vorstand – the executive part of the German two-tier board – and makes recommendations on issues like performance-linked remuneration, the use of the Internet for reporting and annual meetings, the use of international accounting standards, the creation of audit committees, and the use of a sufficient number of independent directors. A 'comply-or-explain' regulation was passed for the compliance with the code in its revised form in 2002.

The creation of this code was driven by international shareholder pressure but also – again – by corporate failures such as Flowtex AG, Cargolifter, and Philipp Holzmann AG. Losses of DM 2.4 billion surfaced in November 1999 at Philipp Holzmann AG; Flowtex had to file for insolvency after a debt of DM 3 billion and years of dramatically exaggerated sales figures were revealed. In 2001, the French legislature passed the Economic Regulation Act, giving shareholders the right to sue members of the board in cases of company bankruptcy due to management mistakes and conflicts of interest.

In 2002, the US legislation passed the Sarbanes–Oxley Act (SOX), the most far-reaching reforms of American business practices since Franklin Roosevelt's presidency from 1933 to 1945. This Act had a serious impact on the corporate governance of US companies, as well as foreign companies listed on American stock exchanges. Major regulatory changes that SOX brought about by amending prior regulations included:

⁶ See Hoepner, M. (2001). Corporate Governance in Transition: Ten Empirical Findings on Shareholder Value and Industrial Relations. Discussion Paper 01/5, Max-Planck-Institut für Gesellschaftsordnung, Cologne.

- CEO and CFO have to certify the accuracy of corporate financial reports.
- Companies are required to publish information related to material changes in their financial situation in a timely manner.
- Companies must prepare reports that assess and describe the effectiveness of their internal control structures and financial reporting procedures.

The Act's drivers were a number of major corporate failures in 2001 and 2002, of which Enron, Tyco International and Worldcom, all involving accounting frauds, were the most (in)famous.⁷ The US legislation felt the need to pass this comprehensive act in order to enhance corporate responsibility, financial disclosures, and to combat corporate and accounting fraud and certainly to re-establish investors' trust.

On the other side of the ocean, the EU pushed the harmonization process of the European market by issuing a number of directives and recommendations in 2005. These directives dealt with the disclosure of management remuneration, management's personal internal liability with regard to the company (external liability is subject to state regulation), the publication of half-year and full-year reports as well as interim reports when necessary, the use of international accounting standards as well as the use of nomination, remuneration, and audit committees. The directives furthermore affirm the freedom to choose between a one-tier or a two-tier board. Some of these directives (e.g., the publication directive) resemble the Sarbanes–Oxley Act. According to the Winter Report, the European Union is merely interested in harmonizing national regulations through directives and recommendations and not in the establishment of a European Codex for Corporate Governance.

A number of the EU recommendations and directives, such as the management's personal liability in respect of shareholders, became law in Germany in 2005. Filing lawsuits on behalf of small investors has become easier, thus increasing minor shareholders' power. Furthermore, the German government required managers' remuneration to be published, a highly controversial decision in Germany. The French legislature also introduced a law requiring publicly traded companies to disclose directors' and general managers' remuneration, as well as retirement bonuses in 2005. Furthermore, sociétés anonymes (limited liability companies) were required to publish information on their board organization as well as the company's internal control procedures, similar to what the Sarbanes–Oxley Act required. Unlike the other focal nations, France does not yet have a corporate governance code.

Analysis of corporate governance regulation diffusion, its drivers and barriers



Corporate governance regulation convergence and its drivers

Table 1.2 shows the evolving nature of corporate governance and the diffusion of corporate governance regulation over the last 10 years. The latter does not converge in just one direction, i.e. from the Anglo-Saxon model to the continental-European model. A more differentiated view has to be taken, as corporate governance approaches and rules do sometimes diffuse from the Anglo-Saxon model – as, for example, with remuneration disclosure, regulation regarding transparency, and the use of audit committees. Other issues diffuse from continental Europe, like the distinction between the executive and the supervising members

⁷ Accounting problems and fraud visible, for example, in financial restatement announcements became increasingly significant in the USA, increasing from only 92 financial restatements in 1997 to an estimated 250 in 2002 [see Coffee, J. (2005). A theory of corporate scandals: why the USA and Europe differ. *Oxford Review of Economic Policy* 21(2): 198–211].

Table 1.2 Diffusion of selected corporate governance issues 1994–2005

CG issue	Country	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Remuneration according to performance	Germany												
	France												
	UK												
	USA												
Remuneration disclosure	Germany												
	France												
	UK												
	USA												
Audit committee creation	Germany												
	France												
	UK												
	USA												
Audit committee independence	Germany												
	France												
	UK												
	USA												
Board independence	Germany												
	France		**)				***)						
	UK												
	USA												
Removal of cross-shareholding	Germany												
	France												
	UK												
	USA												
Liability of board	Germany												
	France												
	UK												
	USA												
Comply or explain	Germany												
	France												
	UK												
	USA										****)		
Separation chairman/CEO	Germany												
	France												
	UK												
	USA												

 Recommended
 Statutory/common practice

*) 'Sufficiently independent'
 **) 2 independent directors
 ***) 1/3 independent directors
 *****) Law driven

of the board, as well as the division between the chairman of the board and the CEO. While the USA had only 8% split roles between the CEO and chairman in 1998, this number rose to 29% in 2005 for S&P 500 companies. A variety of drivers, as described above, led to this diffusion of corporate governance regulation. The main drivers identified were:

- Scandals and corporate crises.
- Internationalized capital markets.
- The harmonization of capital markets through political powers.
- The growing importance of investment for a broader part of the population.
- Privatization.

Persistent corporate governance differences and the barriers to diffusion

Differences do, however, still prevail in corporate governance. Barriers to the further assimilation of corporate governance laws and manifold differences in the regulations have been specifically mentioned in this chapter. The main barriers can be summarized as:

- Differences in the capital/financial structures.
- Differences in remuneration policies.
- Differences in the law system.
- Differences in the economic systems and economic environment.

In the Anglo-Saxon system, the financial community culture is characterized by a highly dispersed ownership structure and arm's length investment. The continental system, on the other hand, is still characterized by a long-term commitment to block-shareholding and cross-shareholding, the state's strong involvement (France), and that of banks (Germany). In Germany, for example, cross-shareholding has just experienced a new increase, with Porsche AG having bought a sufficiently large enough stake in Volkswagen to avoid the necessity of a full takeover offer. The various approaches to controlling an economic entity through either the market or major shareholders' influence do differ and, hence, the need for regulation.

Remuneration policies differ significantly between the various countries. US and, to a lesser extent, British managers still receive a much higher proportion of their compensation in equity (in 2001 it was 66% for US CEOs) than their German or French counterparts do. Furthermore, senior management income expressed as a multiple of the average employee compensation is essentially higher in the USA and the UK (531:1 in the USA in 2004, 25:1 in the UK in 2004) than in France (16:1) or Germany (11:1). Managers whose remuneration is partly in equity feel the need to push the stock price, even by means of artificial and illegal financial statement inflation, so that they can sell the options/stock profitably. A different approach to corporate governance might therefore be necessary, as governance protection that works in one system may easily fail in another.

Another barrier to corporate governance regulation's unitary diffusion that has not as yet been mentioned, is the difference between the UK/US and German/French law systems. The UK and the USA have a body of common law, in which precedent decisions and their analogies mostly determine the law. As long as there are no incidents or scandals, laws will not be enacted within this common law system. This is exemplified by the corporate governance system in the UK to date generally relying on guidelines, whereas

corporate scandals have triggered the SOX in the USA. This does not imply that the other focal countries, for example Germany, do not have statutory regulations with regard to corporate governance systems, but rather that the US corporate governance system ‘prefers the hammer of Sarbanes–Oxley, while the Europeans lean towards a voluntary approach’ (Melnitzer, 2003, p. 36). Germany and France, on the other hand, have a body of civil law with codified laws. In Germany, for example, many of the issues addressed in the German Code of Corporate Governance are a summary of already existing laws amended with recommendations with regard to best practices (currently a comply-or-explain regulation). From this point of view, a unitary diffusion of corporate governance regulation is unlikely, since the regulating approaches already differ in the various systems.

The last barrier to be discussed here concerns the cultural differences in the economic system. The most important of these differences lie in the differing perceptions of the market and the individual. The Anglo-Saxon corporate culture emphasizes self-responsibility; the individual is therefore able to act without immediate state constraint. Consequently, the USA and the UK are classified ‘liberal market economies’. Germany and France, on the other hand, are considered ‘coordinated market economies’, as the state regulates many issues – in an effort to integrate a variety of stakeholders – and self-determination and self-responsibility are more limited. This again makes the need for differing corporate governance regulations apparent.

Summary

Overall, the diffusion of corporate governance regulation is found in many issues, but a global convergence towards one corporate governance model – whatever it may be – is unlikely, due to the number of cultural, regulatory, and structural barriers. Convergence is therefore unlikely to occur within the near future.

1.3 WHAT ARE THE BASIC PARADIGMS OF CORPORATE GOVERNANCE?

There are two dominant CG paradigms. They are, however, not alternatives – but in fact, often combined. The first is the (neo-classical) ‘principal–agent’ theory. In its most basic form, it states that the principal (for example, the owners of a company) cannot trust the agent (for example, the management) to act in the principal’s best interest, but to follow her/his own. The principal’s problem is that the agent knows the situation much better than she/he does, due to the information asymmetry, and that, furthermore, supervising the agent means that the principal incurs costs, which are called agency costs. The principal is therefore focused on how to specify the right incentives for the agent in a contract so that she/he acts in the principal’s best interests, who can then minimize her/his agency costs. This was also the theoretical foundation of stock options. Corporate governance is therefore concerned with a typical agency problem: how can the owners ensure that management, which is mostly separated from ownership in larger companies, acts in their interest, maximizing shareholder-value and not building ‘empires’ at the owners’ expense?

The theory has been refined, detailed, and varied in many aspects. Today’s versions often use game theory’s mathematical models to simulate the outcome of specific principle–agent dynamics. The theory has, however, also been heavily criticized. The main arguments are:

- The assumptions about human behavior are too simplistic; for example, the agents are regarded as only being ruled by opportunistic self-interest. Furthermore, the theory does not explain how the players' perceptions of their interests are formed in situations of uncertainty.
- By assuming that the firm is a 'bundle of contracts', power relations are overlooked (which explains, for example, the practice of 'repricing' stock options once they are 'under water').
- It applies only to specific types of ownership. For example, the thousands of shareholders in a widely held stock-listed company can hardly be regarded as 'principals', given individual shareholders' limited rights; they have more incentive to exit and sell their shares than to take the trouble to voice their concerns.

But the principal–agent proposition is a useful framework when CG is viewed as a broad range of different principal–agent situations that can occur in different circumstances and guides an analysis of the situation. Questions in this regard are, among others: what are the players' different interests? Based on the incentives provided, what are the agency costs? Such agency situations are relevant in respect of institutional investors and their clients, which the aftershock of the corporate scandals in the USA revealed, in respect of boards and top management, and corporate management at the headquarters and subsidiary management, etc.

This specific, more applied, approach to the principal–agent theory is often combined with contingency theory. Basically, this conceptual principal–agent framework requires an analysis of a specific situation, the influencing factors, and the interests. All of these often shape a company's articles of foundation and the different players' incentives, restrictions, and interdependencies. The contingency framework looks for a fit between the outside factors, which cannot be influenced, and the decisions taken to adapt to these – changing – factors, thus, for example, developing a specific organization to fit volatile market conditions.

In this book, we thus apply the principal–agent proposition as the dominant framework, combining it with contingency theory. Together, they form the conceptual underpinning of the cases and concepts.

1.4 BASIC CORPORATE GOVERNANCE INSTITUTIONS

As the principal–agent theory implies, you need at least two players or institutions: the principal (in the case of companies, the owners) and the agent (the management). This description might suffice for smaller, closely held companies in which the ownership and management are obviously separated. For most global, larger companies this description is not adequate, as you need four basic entities for a comprehensive analysis:

- **The general assembly/annual meeting**, where all owners meet (or to which they are invited) and take decisions as described in the corporate articles of foundation, or receive reports for which they have asked. The content and duration of these meetings vary considerably. In a widely held stock market company, there is very little that the shareholders can decide or approve. In a limited partnership with few owners, this gathering will make major decisions regarding investments or strategy, and if it meets regularly, it can even function as a board. The differentiating criterion is, however, the meeting (or, at least, the invitation) of *all* owners.

- **The board.** In our terminology, the board is the apex that carries the company, ‘it’s where the buck stops’, whether this is legally described or not. A board has several characteristics: (1) regular meetings (more than once a year); (2) defined tasks and rights, but no operational or functional tasks, it therefore does not ‘run’ the company; (3) it is elected or appointed by the owners and there is no higher authority other than the owners. According to the criteria, the meeting of the limited partners can act like a board. However, common practice and legal foundations specify that it is the meeting of the owners, if they meet regularly, that has the final power to make decisions that go beyond mere operational decisions. The issue of power goes beyond a one-tier vs. a two-tier board, or whether boards only represent owners. The decisive criterion is who is ultimately responsible, both towards society (regarding compliance with the laws) and with regard to the company’s performance, even if owners or boards have delegated the daily business to the management. This delegation of power does not release the principals from their responsibility. They need to prove that they have lived up to the professional standards required of those in authority. In an individual case, this can be controversial – but the principle is clear. No wonder, therefore, that boards are regarded as the central CG body and that their work – such as selecting a successful CEO – has the greatest influence on corporate development.
- **Management** (either a CEO or a board of management) is defined as having to report to the board (even if the chairman of the board and the CEO are one person) and is held accountable by the board for its actions and results.
- **Outside stakeholders** include a wide variety of interest groups: regulators, employees, financial analysts, local communities, and society at large. There is no generally accepted answer to the question regarding the extent to which stakeholders should or could influence the decisions taken in the CG system. Even in the US states, corporate law allows the board to consider or represent other interests than that of shareholders. In the spirit of the contingency theory, this question can be left open and specific situations can be analyzed.

1.5 THE SHAPING FACTORS OF CORPORATE GOVERNANCE

Much of the corporate governance discussion is focused on legal and ‘soft’ regulations such as codes of conduct. Compliance with these rules and regulations is, of course, important, but does not really indicate how a board or a company ‘ticks’. Take the example of the much-discussed one-tier vs. two-tier board systems. BP, for example, has an independent chairman with a majority of independent, non-executive directors serving on the board and the CEO and CFO acting as executives. The chairman and the independent directors regard their roles as basically (1) defining ‘space’ for the CEO by, for example, approving strategy, large acquisitions and (2) monitoring performance and ensuring that boundaries are not crossed. This is very much what a two-tier board does. The supervisory board, which by definition has an independent chairman and directors, rarely meets without the management board if the executives know that trouble is brewing. But if the chairman of the supervisory board, who goes to his corporate office every day, is a significant shareholder and perhaps even a former CEO, which happens in larger, family-controlled businesses, then the current CEO is at best a ‘managing director’ and the shots are called by the chairman. In such a case, one could argue, even if this does not comply with corporate law, it is at least a gray area – but who is going to complain when the company is performing?

Consequently, it makes sense to go beyond the formalities and look at the important drivers, the shaping factors of a specific corporate governance system. Through our research, we found four determinants. They are:

- **Personalities.** To take an extreme example: US management hero and guru Jack Welch was definitely an outstanding industrial leader, but not a CG standard bearer. He left it to his successors to comply with the new ‘best practice’ standards. Nobody ever complained as long as GE was delivering double-digit profit growth. Who would have dared – either inside or outside the boardroom – to challenge a CEO with such a stellar 20-year track record? Whether formalists, purists, or legalists like it or not, personalities do matter. A CEO with an outstanding performance or a towering, resilient chairman with long experience, wisdom, and diplomatic skills will shape boardroom discussions – and the resultant decisions – whatever the formalities may be. As our colleague Stewart Hamilton has shown, the formalities and the directors’ qualifications were close to perfect in most of the widely held companies that went down the drain as a result of fraud, e.g. Enron and Worldcom, or without fraud, e.g. Swissair. But where were character and stamina when the very visible warning lights were ignored?
- **Business model and industry context.** Companies are successful in the market because they are different and try to differentiate themselves (otherwise we would have a static commodity market). This is also reflected in their business models, which we define as a combination of strategic value drivers and a selection of markets with a good fit providing a company with sustainable economic survival. Companies operate in different stages of a lifecycle – start-up vs. mature – and are confronted with very different strategic challenges. A mature company might struggle to regain momentum and avoid decline, a start-up struggles with the impact of growth: how to move from ‘friends of innovation’ to a well-organized company? A good business model also reflects the specific needs of an industry: risk management is paramount in the financial service industry, where rapid innovation is required for survival, just as is the case in the mobile phone industry. Heavy assets industries – steel, automotive, and chemical – need different capital structures than entertainment services do. All of this is also reflected in a specific company’s CG – and in the persons who act as directors or corporate officers. Any ‘one-size-fits-all’ standard would neglect these differences and would therefore lead to many non-value-added activities: a bank might have good reasons to install a risk management committee on the board, while this would be pretty useless for a food retailer.

On a personal level: can a retired manufacturing manager from a commodity industry bring value to a rapidly growing service start-up’s board discussions? The question is more than rhetorical, because, on the one hand, diversity in the boardroom is a way of avoiding ‘groupthink’. But how much diversity is required? How large can the business and cultural distance be for you to still understand and ‘feel the beat of business’? This question has been raised recently, as there seems to be a trade-off between a director’s ‘independence’ and the industry expertise in widely held public companies. CG might therefore be perceived to run counter to the many efforts to establish CG codes of conduct. This perception is only true to a certain degree, as the codes are for large, widely held public companies and focus on transparency and reporting requirements, the board’s composition, and certain minimum standards. These issues are only relevant for these groups of companies.

- **Ownership.** As discussed before, most of the corporate governance themes are derived from the ‘principal–agent’ situation that regards ownership and management as very often being separate. However, company ownership can take a wide variety of forms: from one owner to hundreds of thousands; in all possible variations, from founder-owned, family-owned; with varying degrees of institutional investors, such as, for example, pension funds; can be fully owned by a private equity fund, be majority privately held, be a minority on the stock market and vice versa; be listed on all stock markets, or on one or several markets, etc. Since CG should align owners’ and managers’ interests and provide adequate monitoring while minimizing agency costs, the owner composition has to be reflected in the design of CG systems. A rule of thumb is that the more dispersed the ownership is, and the less aligned the owners’ interests are, the more crucial the board’s role is. Furthermore, there is a difference in the board’s role if a company is fully family-owned, or if it is fully stock market quoted.
- **Legal and political environment.** Last, but not least, companies – even global ones that are often described as ‘footloose’ – do not operate in a vacuum. There are many ties to the non-business environment in a specific country: local communities, regulators and authorities, industry associations, and professional organizations. In the process of globalization, some of the links have loosened, but on the whole they still matter. Complying with complicated legal frameworks is often not a simple question of ‘yes’ or ‘no’, but a matter of interpretation and discretionary decision by the enforcement agency, its readiness for dialog, and consensus solutions. Beyond written rules, there are certain dos and don’ts in any culture. Decisions can be perfectly legal, but nevertheless regarded as completely unacceptable by society at large and the relevant stakeholders. In the USA, for example, it is quite normal for companies to sue government agencies. In Japan, this would be unthinkable. History and cultural tradition influence laws and their enforcement in subtle but lasting ways. In Europe, you still have different legal approaches between ‘Latin Europe’, ‘Germanic Europe’, and ‘Anglo-Saxon Europe’ that date back to Roman times. These differences influence companies’ framework conditions, but do not explain individual CG systems. There is always the ‘Gaussian law of equal distribution’ and the variety of CG systems within one legal system is considerable, given the other shaping factors.

If one dares to look at the (fictitious) ‘median’ company, one finds CG systems as described below.

1.6 TYPES OF CORPORATE GOVERNANCE SYSTEM

These four shaping factors, with their many variations, lead to an infinite number of company-specific CG systems and even if you cluster the variations on a Likert-scale of 1–7, more than 65,000 versions of CG result. As far as it is possible to use the four shaping factors as a framework to analyze the specific governance system of a company, it would not make much sense to describe here many unlikely, unrealistic, hardly seen variations. From our research, we found four relevant clusters around one dominant feature – that means, these clusters do not exist in a pure form – which influences most of the work of the board and other governance institutions. So these clusters can help to kick off the CG analysis of a company, not replace it.

The involvement of the board is highly dependent on the basic CG model. Figure 1.2 and Table 1.3 capture the differences between a CEO-centered model and a check-and-balance model in detail. Consistent with the basic features of the CG models, in the latter case, the board is far more involved, but with specific value-adding contributions and in an interactive

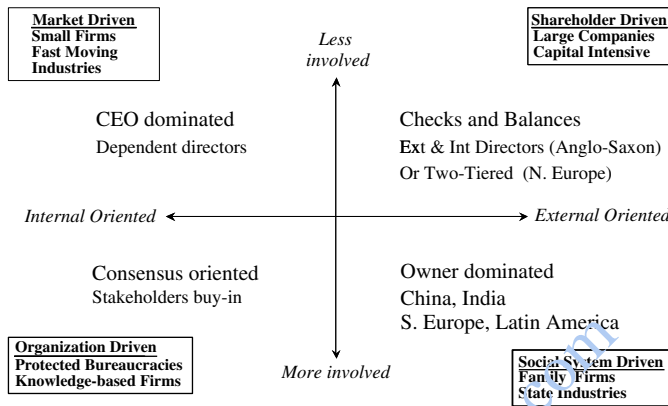


Figure 1.2 Characterization of corporate governance systems

Table 1.3 Typical board involvement in the strategizing process

	CEO-centered model		Checks-and-balances model	
	Top management/ staff	Board	Top management/ staff	Board
Scanning/early awareness	Done by management and specific functions (e.g. marketing), hired outside experts	More informal input, often at social occasions	Brings own and board input together	Systematic input expected
Deciding on strategic options	Management debates alternatives, tests robustness, etc. and then 'sells' results to the board	Only after management has come to a conclusion and presented to the board limited possibilities to compare options and test robustness	Preparation of options, but final decision after strategy retreat of the board	Thorough evaluation of assumptions, consequences, consistency with business model, mostly during a strategy retreat
Detailed planning	Done by management in negotiation with subsidiaries, functions	Submitted by management for approval	Driven by management in negotiation with subsidiaries	Review of consistency with options chosen, resources, and financial restrictions

Table 1.3 (Continued)

	CEO-centered model		Checks-and-balances model	
	Top management/ staff	Board	Top management/ staff	Board
Implementation	Driven by management, as part of regular meetings reporting to the board	Supervision based on key performance indicators, no 'hands-on' knowledge	Driven by management, reporting to the board, review part of regular meetings	Supervision based on key performance indicators, but also first-hand experience through personal discussion with line management, visit of subsidiaries
Design of strategy process	Design by management only	More informal input	Proposed by management	Assessed and agreed

dialog with management. The space for management is unavoidably smaller than in the CEO-centered model, where the board is more approving of what management proposes as strategy and actions. Our point is not to argue in favor of one model or the other, but to indicate what a board's strategy work could look like when it is consistent with the basic CG model.

These classes are not stable over time. A long-time successful CEO might today dominate the board, but this may change rapidly. A crisis might shift power back to the board as in Disney's case, after a shareholder revolt. A change in the business model or the core strategy might alter the governance model too, as, for example rapid decision-making may become more urgent now compared to the hitherto prioritized checks-and-balances model.

Also, political and economic trends affect the preference for certain clusters: before the dot.com bubble burst, the clearly preferred model of Wall Street was the CEO-dominated model. The crash, and a recession that revealed what auditors did not, made institutional investors push for a checks-and-balances model with more transparency. That is the basis of the new mantra of the more vigilant board.

1.7 THE TYPES OF BOARD

It is pretty obvious that the role of the board varies widely in the different variations of CG systems. We can take the classification one step further and outline a typology of boards in the following. In any case, to add value to the company, the board's contribution has to be unique. This means that only the board can perform such tasks. Three typical board tasks stand out in this perspective:

(1) Monitoring and supervising

In this role, the board is concerned with compliance ensuring and performance monitoring. Even if it delegates the operational implementation to the CEO/management, it has to decide on the compliance mechanism and controls and has to be sufficiently involved to see if the system is working or not. Compliance covers a wide range of issues: legal compliance, meeting financial reporting requirements, codes of conduct, compliance with own policies, ranging from travel costs to safety standards, etc. The previous practice that the external auditors report first to management has been scrapped, now the board (or specifically the Audit Committee, which is responsible for the daily grind of financial compliance) is in charge of hiring and firing the external auditors, the setting of their mandate, and the amount of additional consulting work, and receiving their reports. In some cases, in the USA through Sarbanes–Oxley or in banks, even the internal audit reports to the Audit Committee. Performance monitoring is the definition of Key Performance Indicators (KPIs) for the company and observing them over time – and of course acting, if there are serious deviations. It is not an easy task to differentiate early between noise, random fluctuation, and an emerging trend.

This task of compliance insurance and performance monitoring is the baseline of any board work. To fail here can have disastrous consequences for the company. The recent legislation (especially in the USA), the stock market listing requirements, and the code of conduct for CG have detailed this task by an order of a magnitude – up to the point where more bureaucracy and box-ticking might be generated than effective supervision.

(2) Selecting, evaluating, and coaching top management

The days when an outgoing CEO picked his successor are over, at least in many more cases than some years ago. Most of the boards today would claim that they are in charge of the CEO succession planning, but also of other senior corporate officers as well. This includes regular evaluations of the CEO. This is not only focused on financial performance, but also on leadership behavior, communication style, and interaction with the board – a ‘Balanced Scorecard’ approach – however, prominently focused on financial performance and most bonuses are solely dependent on financial performance. As a rule, one could state: as long as the financial performance of the company is good, a CEO gets away with a lot of bad behavior, but as soon as the performance declines, the lack of soft skills undermines the CEO.

Coaching should be part of the normal work process of the board, when directors give the CEO feedback and advice. However, to separate the coaching part is not easy. Given the importance of the top management performance for a hierarchical organization like a company, any mistake in the selection of the top team can be costly – not only in financial terms. Therefore the right selection and good coaching can be an important value added by the board.

(3) Substantive input in the corporate evolution

The work of the board should also lead to better decisions. The formal process of approving budget, strategy plans, investments, etc. does not ensure this. Take strategy: after all the executives, expert staff, plus consultants have worked on this document for months, what can the board add that is specific and unique? But there are other areas of opportunity for adding value, too: one is the development of a specific code of conduct that spells out clearly

the core values of a company, its vision, and mission – hopefully both beyond the usual ‘motherhood and apple pie’ statements – and mechanism of conflict resolution. The basic organizational design, e.g., the dominant axis of management, the headquarters–subsidiaries relation, is another area, where the board could give substantial input.

Value-adding board work is therefore a good balance between the ‘supervising/monitoring’ task and the ‘substantive input/coaching’ dimension. However, depending on the governance system and the role of the board, this balance can be very different, depending on which axis the emphasis is laid on (see Figure 1.3).

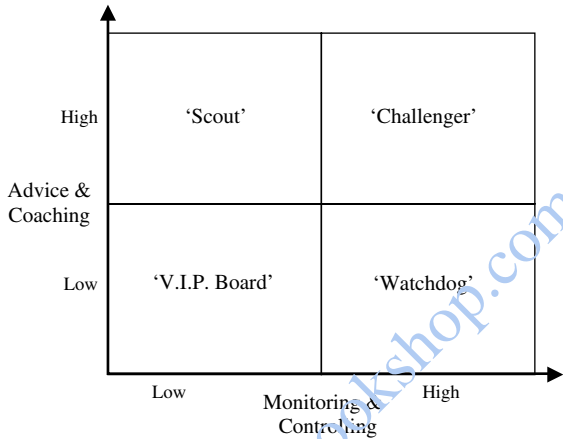


Figure 1.3 The four main types of board

The ‘watchdog’ board is the type now required by Sarbanes–Oxley and institutional investors. It loads its Audit Committee with heavy control tasks and predominantly examines the financial figures of past performance.

The ‘scout’ board is often found, for example, in privately held companies, where the owners themselves look after their money and use boards to alert them to new trends, bring new ideas, and challenge the management to avoid complacency.

For the ‘VIP’ board, the performance on both axes is low. We call it the VIP board as such a board is often stuffed with VIPs, who have little intention of looking at the nitty-gritty of the business. One recent example was the board of Hollinger International, where Henry Kissinger – former US Secretary of State and an eminent historian – served next to other, mostly retired, but still to all intents senior government officials.

The ‘challenger’ board combines high performance with the ‘scout’ and the ‘watchdog’ dimension of board work. But honestly, we haven’t seen many practical examples of such boards performing very highly on every axis, as the integration of the two tasks represents a dilemma.

But whatever type of board is a good fit for a company, in the end it matters how the directors and corporate officers all work together and are able to contribute. This personal dimension is especially important when, in tough situations, the players have to stand and act together.

1.8 TYPICAL DILEMMAS FOR THE BOARD

As far as board work differs, depending on the shaping factors of CG, there are some typical dilemmas, which any board of a global company has to address in one way or another:

1. *Drive for shareholder value in global markets vs. expectations of society regarding the corporate license to operate.*

Especially in Europe, but increasingly in the USA too, companies are confronted by dilemmas resulting from the different expectations in the home market and the pressure of capital markets. Closing a factory in Europe despite its profitability can easily end in a PR nightmare. To shift manufacturing to China can invite political pressure groups in the USA to call for a boycott. The reason is always that the perceptions of the opinion leaders and the public at large differ widely from the management elite and their perceptions about needed actions for survival in a cut-throat competition. The board also has no solution to this dilemma. Remember, dilemmas cannot be solved, but they need to be managed. But the board has to give guidance and define the space in which management has to make its decisions. Clear values and strategic priorities from the board at least allow a company to appear thoughtful and honest, even if not everybody can agree with the decision.

2. *Eroding boundaries in global companies vs. national and cultural framework.*

The boundary-less organization with a seamless flow of information in global processes has become the ideal of many organizational theorists. But national boundaries as a cultural divide between customers still call for a segmented organization. This makes most global companies unbelievably complex, as we will illustrate, for example, in Chapter 8 on subsidiary governance. How can these conflicting demands be reconciled? How can needed differentiation be allowed, but 'fiefdoms' not? How can such a complex organization be supervised? This is definitely the area where the board has to guide the organizational development, set criteria, and step in from time to time to reduce the naturally growing complexity.

3. *Risk taking vs. tight financial control.*

Companies want their local leaders to take risks, otherwise profitable growth opportunities are missed and the subsidiary declines into a bureaucracy. But what is the difference between an expected, entrepreneurial risk taking and betting the company? At the fringes of the wide spectrum it is easy to tell, in a larger gray area it is not. What are the (financial) control mechanisms to ensure accountability and create organizational transparency but not burden the organization with huge reporting and other transaction costs and restrict opportunity taking? Again, here the board has to be clear on the balance to be struck.

4. *Micromanagement vs. detachment.*

In any checks-and-balances model, but also in the ownership-centered or consensus model, it is vital to define the space in which management can act and that for which they are held accountable. Boards can err on both sides: to micromanage and get involved (not to say immersed) in operational decisions. On the other hand, boards can be too detached, and not really know what's going on – to the point where it is too late for a smooth correction. Again, here the board has to find a transparent and shared understanding. The board then has to ensure management knows about it. It must be crystal clear what space the board will give to the management and where the board is in full control.

As we have seen in previous sections, the corporate governance revolution with more active boards has clearly narrowed the space for management in recent years. A case in point is that CEO succession is now much more under board control than it used to be. In respect of the USA it would be fair to say that tight financial control has increased and the impact on risk taking will be felt in the years to come. Few companies will be able to combine an ‘HP culture’, which was said to be the role model for an entrepreneurial spirit, with tight financial controls.

The ongoing process of globalization and complexity drives the dilemmas. If one observes declining or failed companies, one often sees that the board failed to develop a workable answer to the four dilemmas. Often boards flip-flop, switching from one extreme to another, accompanied by dramatic changes in top management. The focus on the – indeed horrible – fraud cases both in the USA and Europe tends to see only the tip of the iceberg, and not the lurking widespread problem of non-performing boards that do not violate any laws.

One case which stands out is the bankruptcy of Swissair, once one of the most admired airlines in the world (see Section 1.13 for a full report). The board never addressed the question whether Swissair could be a profitable international carrier in a deregulating market without a relevant home market. The first-tier position was a national mandate, but this idea was never tested against its economic feasibility. This was the first dilemma. The board allowed an acquisition spree into third-tier airlines, which carried huge liabilities as the second dilemma, which the board did not understand. Ultimately, it was too Swiss in its mentality. Remember, the case takes place in a country where the last serious strike was in 1936. It was obviously unthinkable that the unions would fight the company and go on strike, even if it sank the company, which was the third dilemma.

And most of the board was too detached and ignored red warning flags, except the one board member who had developed the strategy in his previous job, as a McKinsey consultant, and pushed it through with the CEO to the bitter end, which represented the fourth dilemma.

Nevertheless, from the outside, the Swissair board met all the criteria of ‘best practice’. It had – by law – almost exclusively independent members, which represented the Swiss business elite, including the top banks. It had committees such as an audit committee, met regularly, and followed the accounting rules. At least the external auditors, one of the top four, did not balk, and the board met reporting requirements. Illegal operation could not be detected in a criminal investigation. But the bankruptcy was spectacular . . .

1.9 CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE

Ultimately, the additional cost of corporate governance should be overcompensated by the added value, which ultimately should be seen in the financial bottom line. But it is notoriously hard to detect there.⁸ In empirical studies, a wide range of board aspects have been explored, such as board composition, the impact of committees and their structures, role and effects of independent directors, ownership issues, the role of individuals, and diversity among top managers, to name but a few. In the quest for ‘low-hanging fruit’ on insights into

⁸ For an overview, see Dalton, D., Daily, C., Elbstrand, A. and Johnson, J. (1998). Meta-analytic review of board composition, leadership structure and financial performance. *Strategic Management Journal* 19: 269–290.

corporate governance, a plethora of studies have been conducted to identify a few corporate governance aspects with larger performance. However, these studies too often relied on:

- Convenience sampling in individual studies in terms of a smaller set of easy-to-collect indicators, instead of a more comprehensive set.
- A large variety of indicators overall, making integration and comparability of results across studies difficult.
- Only data for public listed companies being available, overlaid by many other influencing factors such as business cycle, industry trends, M&A activities, etc.
- The lack of expected analysis of measurement properties for selected corporate governance indicators.
- Shortcomings in the understanding of the number of dimensions (or constructs) necessary to comprehensively depict or assess corporate governance.
- Weaknesses in the conceptualization of proxies, e.g., percentage of external board members for independence.
- The incomparability of samples used.
- The preoccupation with the statistical significance of results instead of explanatory power, especially the ‘scientific’ ones.
- And last, but certainly not least, a too linear thinking (do A to achieve B, always, in all settings, at all times), during which interactions between governance aspects are hardly considered.

But as Wharton Professor Larcker and his colleagues show, the empirical foundation is indeed weak. He screened the 39 most important factors commonly linked to performance, reduced them to 14 governance factors through principal component analysis, and could only explain 6% of the cross-sectional performance variation.⁹ In other words, even the most established variables cannot explain a noteworthy part of performance.

As a result, one can easily question the importance of corporate governance based on the simplistic success hypotheses currently proposed and measured. What is needed is a revised understanding of such studies that board performance is heavily contingent upon specific factor constellations in each company. The role of boards and individuals, such as the CEO, varies over time. Simplistic calls for undifferentiated to-dos beyond compliance will lag behind their inherent potential if they remain unadapted to each case. There are further key points to bear in mind.

The notion of what good CG means in detail is shifting. Depending on the research question and methodology, or the time frame and selected indicators, a lot of contradictory and difficult-to-interpret results are available. Sometimes CG is defined in a way that is hard to distinguish from good management in general. Only one thing is certain: none of the individual characteristics of today’s ‘good CG practice’, such as independent directors, audit committee, etc., lead to superior financial performance, but obviously do not harm it either. Exceptions abound. In the global auto industry, General Motors ranks top in CG, but is unfortunately a lousy financial performer. Toyota and Porsche are the notorious and deliberate violators of the best CG practice on various dimensions, but their financial performance is top in the industry. The influence of CG is more indirect and mediated.

⁹ Larcker, D. *et al.* (2005). How important is corporate governance? Working Paper, The Wharton School, University of Pennsylvania.

It should lead to better decisions in terms of strategy, organization, and selection of top management, but it is hard to detect a linear, mono-causal relationship.

Suggested further reading

Colley, J. *et al.* (2003). *Corporate Governance*. McGraw Hill, New York.

Demb, A. and Neubauer, F. (1992). *The Corporate Board – Confronting the Paradoxes*. Oxford University Press, New York.

Hilb, M. (2004). *New Corporate Governance*, Springer, New York.

Melnitzer, J. (2003). US presses Europeans to implement governance reforms. *Corporate Legal Times* 13(137): 36–37.

Suggested key websites

The Conference Board: <http://www.conference-board.org>

The Institute of Directors: <http://www.iod.com>

1.10 WHERE DOES CORPORATE GOVERNANCE SPECIFICALLY ADD VALUE?

The last section concluded with the cautious finding that the relation between CG, board performance, and corporate (financial) performance is probably looser than we would like to see, given the importance of CG for companies. Although we are not able to detect statistically meaningful correlations, or even cause-effect relations from the structured feature of CG, does not mean that the value of CG cannot be discovered and specified or not quantified on the level of an individual company. Here is where contingency theory comes in, not least because it is also important to know not only how but also for whom this value added is created. It is in the foundation of a pluralistic society that interests can and will differ. Markets are platforms where the different economic interests are reconciled between creditors and investors, customers and suppliers, employees and owners, etc. But the rules of the game must be transparent and sufficiently stable. How CG contributes to answering the question ‘who is creating what value added and for whom’ is the core of this chapter, which goes beyond the analysis of structural features.

What are the potential areas of value-added?

(1) Corporate evolution.

Corporations are often described as living organisms, they evolve – they not only grow, but also regress. They constantly adapt to a changing business and political or social environment. As in nature, this process is dangerous. Many companies fail to reach the next level, miss the needed adaptation, or change too slowly. If this happens, the root cause is never operational ineffectiveness – such failures start at the top. Normally the board had not seen the indicators for adaptation and changed too early, or failed to act accordingly, or did not understand the dilemma with which they were confronted correctly, and had to balance and manage the conflicting goals. Companies in such situations often flip-flop, moving from one extreme to the next, or send confusing, even contradictory, signals about their strategic intent. The board has to be a guardian of permanent vigilance to ensure the evolution of the company. What options are available to achieve this goal?

(2) *Values and code of conduct.*

Companies have to make a profit to survive in a market economy – but the how, the conduct, the way by which these goals are achieved is by no means determined. Companies can be ruthless, aggressive, and selfish or be honest, caring, and compassionate – and both behaviors can be successful as long as everybody in the organization knows what the values are which guide behavior and customers accept certain behavior. The ‘tone at the top’ communicates the values for which a company stands, and the expected business conduct in one way or another. Actions, decisions, the way people work together at the top speak most loudly. In a hierarchical organization only the apex, the board, can set the values and define the code of conduct. If this is not clear, confusion and political infighting are a very likely result.

(3) *Transparency and accountability.*

A key precondition for corporate evolution and value-based decisions is – internal as well as external – transparency and accountability. Especially in global – and that means always – complex organizations this is not a trivial task, and in a hierarchical organization it either starts at the top or not at all. The questions are simple. What should be known by whom, and when? Who is accountable for what? But the answers are not straightforward and can only be found in a design that serves the business (remember: structure follows strategy) and is as simple as possible. The reason why boards need to get involved in the basic design of an organization lies exactly in this responsibility to establish accountability and transparency – not allowing the proliferation of headquarters bureaucracy to blur the lines and generate too much politics.

But the transparency and accountability includes the board itself. In today’s mobile, networked society, conflicts of interest are nearly unavoidable for board members. As an example, one favorite question that recently arose: does it already constitute a conflict of interest if you are a board member and also a major investor? If you try to bring only people to the boardroom who cannot, according to their CV, have any potential conflict of interest, then you end up with the US problem of selecting a jury in a high-profile murder: you have to choose the most ignorant people. Therefore the question is, when (as early as possible) and how (as openly as expected by the most critical stakeholder) to reveal cases of conflict of interest when they emerge and how to solve them – thereby setting a standard for the whole organization. The more clearly the board has defined its own role and that of its individual members, the better the issues around the conflict of interest can be managed.

(4) *Core processes.*

Standardized, and this does not mean centralized, processes are one of the effective simplifiers in complex, global organizations and the only means to ensure transparency and accountability throughout the whole organization. The board needs to evaluate those processes and the principal designs on which they are built. This makes life for a board easier, since it is easier for board members with diverse business backgrounds to evaluate the effectiveness of processors than to go into the detailed content. It also helps board members to understand the basic underlying assumptions and the risks of a strategy better, as they examine the process of strategizing. But given the complexity of today’s CG, the board is well advised to design its own processes as a role model for the organization. It starts with the sensitive issue of CEO and top management succession to the evaluation of its own performance, the way conflicts of interest are handled, the chapter of committees, etc.

(5) *Select top management and set incentives.*

One of the areas most difficult to quantify, but with an extremely high value-adding potential, is found in just making the right personnel choices. This is a question which, unfortunately,

can only be answered in hindsight. But to select a wrong CEO can cost the organization dearly, as many examples indicate, especially when companies suddenly find themselves in a turnaround situation – or worse. As we will discuss in Chapter 6, it is not a one-time decision, but a constant process of monitoring, evaluating, giving feedback, providing coaching – and setting the right incentives to keep the CEO and his top team on the right track. Especially the setting of incentives is more difficult than usually appreciated. The example of stock options indicates, however, how easily things can go wrong. Remember the law of unintended consequences, especially if you naïvely apply a theory. Perhaps even the principle–agent theory is a bit naïve here, assuming that the principal can set incentives through his own enthusiasm and not be manipulated by the agent.

How do stakeholders benefit from good CG?

‘To restore the trust of investors’ were the magic words motivating the US Congress to embark on the massive regulation named after the congressional co-sponsors Sarbanes–Oxley. However, trust is not a category of the principal–agent theory, which is built on the assumption that agents behave opportunistically according to their own interests. Trust might be a result of longer experience, but is never per se the core of a regulation. In economic terms, it would be more precise to talk about lowering the risk premium for investors and with that lift share prices up – again – through higher price–earnings multiples. When investors see their investments are at additional risk, because they can be ‘ripped off’ through manipulation by managers, majority owners, or regulators, they demand a higher return from that investment to compensate for the risk. This is the simple reason why the price–earnings ratios in most emerging economies are much lower than in more developed countries. Hence, good CG simply lowers the risk premium for investors as they can look inside the company through the reporting requirements and assume that their interests are institutionally protected. This is the fiduciary duty of the board.

But to comply with a defined and known set of rules of the game is not only beneficial for investors, but the fundamental precondition for a market economy – otherwise transaction costs would be simply too high (e.g., if one cannot assume that the company will pay its invoice for a delivered product or service) – and a lot of commercial transactions would be more costly. Similar considerations are valid for M&A, any supply chain, and other cooperation agreements. And it helps that the government not only enforces laws, but that compliance is also institutionalized in the company itself.

As far as good CG leads to better corporate decisions – as argued before this is hope, not a certainty – everybody would be better off: the employees, the customer, the local communities within which a company is operating, and society at large, e.g., through higher taxes.

1.11 THE CONTINGENT ROLE OF BOARDS

The previous sections examined possible contributions, value-added, and financial performance. In the following, we outline how this matters when designing roles for boards. Many discourses on boards and directors often emphasize such roles and responsibilities, as the relationship among the various participants in determining corporations’ direction and performance is central to corporate governance. Previous research indicated the large variety

of roles boards can play.¹⁰ In particular, the role of the board in firm strategy has long been the subject of debate. There is a frequent call for more active and contributing boards, and criticism of mere ‘rubber stamp boards’ limited to signing off CEOs’ decisions.

In addition, each corporate governance model, in which boards operate, shows distinctive strength and weakness profiles and can adapt to new requirements over time, thus alluding to dynamics within boards’ roles over time. In general, there is no lack of normative studies calling for improvements in boards’ performance, but there is a lack of studies and of a comprehensive framework describing the actual dynamics in boardrooms based on rich description, triggered by a strong mono-method bias in the corporate governance field.

Such a framework for boards’ contingent role that considers dynamics over time was proposed by our colleague at IMD, Paul Strebelt.¹¹ Depending on various conditions, boards’ driving role can vary between an auditing, supervising, coaching, and steering role, as described in Figure 1.4. ‘Driving role’ therefore refers to the subset of activities that dominate, but never completely replace, others.

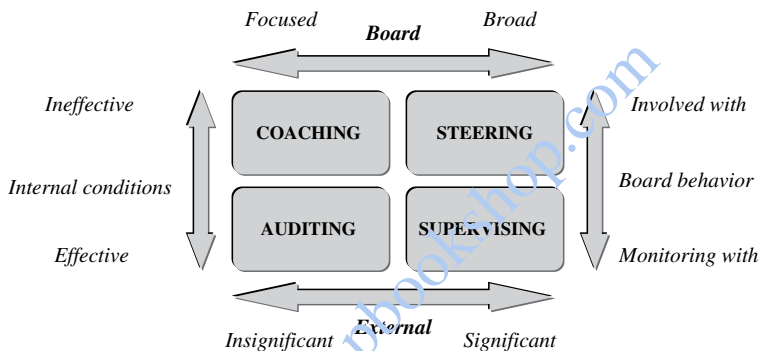


Figure 1.4 The contingent role of boards

Source: Strebelt (2004), p. 62.

The framework allows for less board involvement in the execution of decisions whenever the management in place appears to be effective, and externalities’ scope and nature appear rather insignificant. Sound auditing would suffice in this phase. But more board involvement is called for when the management functions ineffectively, necessitating true coaching. When externalities such as, for example, safety or pollution risks become more significant, the board can either adopt a more supervising role whenever management seems to function rather ineffectively, or needs to become involved with the execution of decisions, adopting a steering role as long as needed. The board perspective must therefore be larger and more long-term than just focused on auditing. This holds especially true when the board’s perspective is too narrow and the board is encouraged to act more as a coach whenever the management appears ineffective, while externalities tend to be insignificant. The ABB case presented in Section 1.14 will demonstrate how this model works in a specific case.

¹⁰ See, for example, Demb, A. and Neubauer, F. (1992). The corporate board: confronting the paradoxes. *Long Range Planning* 25(3): 12–17.

¹¹ See Strebelt, P. (2004). The case for contingent governance. *MIT Sloan Management Review Winter*: 59–67. Also: Amann, W., Breilochs, J. and Steger, U. (2005). The contingent role of boards – the case of ABB’s turnaround. European Academy of Management, May, Munich.

Learning nuggets from the cases

As a learning platform for this consideration, we present two cases here. The first, ‘Developing corporate governance at Highfly Logistics Software – but how?’, presented in Section 1.12, deliberately did not choose a public quoted company, but a venture capital setting, to underline the notion that CG is not just an issue for public, stock market-listed companies, but an issue for every company (and not a potential distraction for students by focusing on legal requirements that should be avoided). It should really concentrate on the question: what, in the specific situation, is the value-added of a more developed CG system? What can better CG contribute to the further corporate development? And for whom is this a value-added, and for whom not?

Contingency theory can help to identify the misfit between the shaping factors of CG and the current situation. Usually the growth of a company requires different CG frameworks and models for leadership accountability, while an enlargement of the investor base requires more transparency. But this general notion does not determine what exactly should be done. The core of the controversy is the evolution from a CEO-centered model to a checks-and-balances model. This raises the following specific issues:

- Are the higher transaction costs compensated by the better decision-making process? As this is uncertain upfront and even hard to quantify *ex-post*, one can argue – sometimes very emotionally – about this point. It would probably help to clarify the different roles and personal interests (‘what is in it for me?’) to understand the different positions: that of the CEO, who might feel a loss of control and power; that of an investor, who might regard it as a less risky investment; that of a top management team, who asked for more a rational decision, etc.
- CG unavoidably has to do with personalities, and therefore the issue is always if key people can make the move to the ‘next level’ of CG or if they are so fixed in their current role that the change in CG means also a change in key people (here the CEO).
- But also the board has to ask what its new role means in terms of workload, processes, responsibilities, and – last but not least – what this means for the behavior and contribution of an individual board member and his personal responsibility (if not liability) that goes hand-in-hand with a more active and involved board.
- Last, but not least, it depends on the design of the processes and the level of elaboration, e.g., of risk management, which are chosen. The ‘what’ cannot be meaningfully decided without looking at the ‘how’, which is not only true for CG. It might be helpful for such a decision to rapidly develop a prototype of the process, which is envisioned, for example, regarding risk management, focusing on key design characteristics, and the benefit such a process would generate.

We have already outlined the dilemmas in the Swissair case. The subsequent ABB case, ‘Corporate governance during a turnaround’, presented in Section 1.14, focuses on one specific issue of the value-added by CG: the role of the board in strategy formation. A turnaround is a moment when the previous conventional wisdom and the ‘way we do things around here’ needs to be fundamentally challenged as it probably contributed significantly to the downfall. But a more active board role in strategy formation raises some fundamental issues too:

- First and foremost here is: how? After all, boards are less informed than management. At least, this is a basic assumption of the principal–agent theory and if this assumption does not hold true – well, then the company has an additional problem. Can boards, or in this case the strategy committee, obtain and process the necessary information unbiasedly, in time, and can the board members make sense of it? How much information do they need to understand the specific market segments of a business unit, the specific value drivers, the technology trends, etc. to make a meaningful contribution? On the other hand, can their different knowledge and expertise add value by giving the strategy a fresh perspective (after the old one obviously didn't work) and push through the needed strategic shift, which the previous 'insiders' had been unable to do as they were too locked into an unworkable paradigm and unable to change in time. But to make such a different perspective work needs more than just a challenging idea. It needs time-consuming detailed work to think through the application within the specific unit and the competences and resources for implementation. The board members' unavoidable time expenditure can easily become the real bottleneck in this process, as this work is more time-consuming when boards challenge the robustness of the strategic planning assumptions or look at the way the strategy process is organized.
- The second issue is the division of labor between management and the board – and the responsibility and accountability that goes with it. If management proposes a strategy, the board approves it after some debate but it basically remains unchanged – the 'usual' situation. The board can still hold the management accountable if their strategy does not work for whatever reason. But what if the board has designed the strategy to a large degree, and it did not work? The question can only be raised here as in the ABB case, the redesigned strategy seems to work. Also, from the management perspective, it should be considered what it feels like if the board were to move too much into the management's 'territory', degrading them, in the worst case, to mere implementers of what others have decided.
- Third, in a turnaround situation much can be accepted, as every manager has a very personal struggle to improve nearly every aspect of management and keep morale high despite layoffs. Every helping hand is welcome. But as soon as things get back on track, how sustainable is a solution that was acceptable in the stress of a turnaround? Probably it needs – as contingency theory will recommend – another adjustment to the new business situation, but without repeating the old mistakes.
- Fourth, the strategy work of the board has to fit into the dominant CG model and the way other decisions are made. Section 1.11 outlines our main contingency framework on how boards work.

Conclusion

The 'learning nuggets' from the two cases could therefore be summarized. CG is – beyond the legal requirements – a value-adding institutional set-up, which needs to be negotiated between the key players in a company (including investors) and answers the question: value-added for whom? The CG system also depends on contingency factors such as size, business situation, personalities, and ownership, and therefore evolves over time. There is a need for synchronization with corporate evolution. The board has to be specific in the value-added of its work, establishing transparency and accountability as two outcomes of its work, which need to be ensured under all circumstances. Selecting the right people for top management, setting the values and incentives according to the fundamental strategic

direction, and ensuring the integrity of the core process designs are other areas where a board can add significant, but hard-to-quantify, value-added.

1.12 CASE STUDY: DEVELOPING CORPORATE GOVERNANCE AT HIGHFLY LOGISTICS SOFTWARE – BUT HOW?

6 JUNE 2005, IN HIGHFLY'S BOARDROOM AT 11:47AM. Tom was angrily looking at Arno, not even trying to hide his emotions:

More corporate governance...?! You want to bring bureaucracy to us, killing the entrepreneurial spirit and speed that has made this company so successful?

Loosening his tie, Tom looked around at the other members of the board of directors. Reminding himself that he wanted to become a team player, he stopped and asked:

What do you think?

There was no immediate response, as the members of the board of directors were obviously unsure and needed time to reflect. Tom was the co-founder, chairman, CEO, and master brain of Highfly Logistics Software, a London-based software company specializing in logistics solutions since its inception seven years ago (see Figure 1.5 for Highfly's organizational structure). Surviving the burst of the dot.com bubble, Highfly had grown rapidly in its market niche, doubling headcount and revenue year by year. The fast growth seemed to be slowing down the organization as some of the board members had pointed out during the discussion around the previous agenda item. To better serve its customers, the original 'one-size-fits-all software program' had been split into three distinct product lines for: truck companies, retailers, and warehouse companies. Highfly employed a highly qualified and technically trained sales force, which not only installed and upgraded the software, but also helped customers with a broad variety of issues: training for their workforce, 'fire fighter

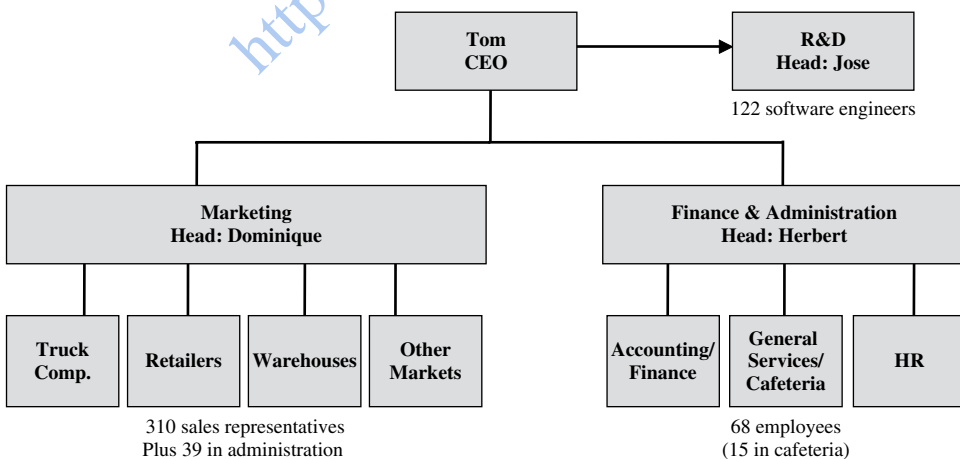


Figure 1.5 Highfly's organizational structure

teams' for emergency situations, adaptation to company-specific needs, etc., all very much to the satisfaction of its customers.

Recently the company had ventured into other geographic markets, establishing sales and support offices in four bigger European countries. Competition was gearing up slowly, but continuously, from both a French and a German competitor. Now, a team was working on entering China, but Tom's real dream was to conquer the USA – if Highfly could afford it.

Highfly's need for organizational adaptation

Herbert, the CFO and the longest-serving executive next to Tom, with three years of Highfly experience, warned a month ago that if revenues and profit margins continued to fall, as they had over the last six months, the company would slide deep into the red by the first quarter of 2006.

For Tom, Highfly's success – which had largely been his own success story – had to continue. He had seen too many start-ups disappearing almost at the same speed as they had mushroomed in the first place, and he did not want Highfly – and himself – to become the next victim. After analyzing recent developments, Tom determined that Highfly's costs were outpacing revenue growth for several reasons. He then developed what he called a corporate fitness program that included the following points, which he communicated in a 'letter from the CEO' to his key people:

- Too much duplication in adapting efforts for customer needs.
- The customer did not cover the full cost of additional services and developments.
- The marketing and sales organization wanted to keep the customer in 'their domain' instead of involving R&D for specific applications. As they were lacking sufficient technical competence, this resulted in quality problems, which were expensive to fix.
- The newly established country organizations still lacked sufficient access to the R&D base and occasionally bought expensive software modules and consultants on the market instead of using the available in-house resources.
- The general overheads (HR, cafeteria, accounting, etc.) had been exploding after moving into a new office building nine months ago. The much appreciated and frequented cafeteria costs alone were a considerable £144¹² per employee per month.

To conclude his most recent 'letter from the CEO' to his key people, Tom proposed the following:

- To impose a hiring freeze.
- To close the cafeteria.
- To outsource the HR, accounting, and general services function to external providers.
- To demand that subsidiaries rely on internal solutions exclusively and participate in more knowledge sharing.
- To establish a goal of reducing administration costs by 5% and R&D costs by 10%.

But closing the cafeteria and cuts in R&D were strongly opposed by José, an old buddy of Tom's with a similar 'techno-freak' background. José was responsible for R&D and strongly

¹² £1 roughly equaled €1.45 or US\$1.82.

defended any move which could possibly have a negative impact on his domain. After all, R&D was ‘his baby’, which he had to protect.

Dominique, the youngest member of the executive team, joined Highfly as chief marketing officer in late 2002. As an exception, Dominique had been allowed to join the ongoing board meeting in order to provide an update on the international expansion. He was also opposed to Tom’s ideas as he was unsure if they had been well thought through or if Tom was merely ‘shooting from the hip’. Dominique definitely did not want to narrow the managerial discretion of the subsidiaries, which needed the freedom to get established to ensure a lasting return on investments.

Arno was one of the most active members of the board of directors. He understood Tom’s desire to continuously develop the organization but also saw room for improvement elsewhere. As Tom was about to close the meeting by asking if there was any further business to discuss, Arno came up with the proposal to re-examine the actual contribution of the board of Highfly. Half an hour earlier, Arno had commented to Herbert during a coffee break for the board in the cafeteria:

Tom is a real incarnation of the classic imperial CEO. Ok, I have heard he does delegate if someone comes up with a promising idea, but what do we as the board actually do? We have no checks and balances in place – no real outside experts on the board level, no annual evaluation, simply nothing. We are no longer a start-up – one brain cannot do it all alone. Our challenges are just too complex – and it will get worse. We need to change something; we need to become better and better. While we tend to demand greater efforts from others, nothing is moving in this part of the organization. It is not right. Our real value potential is not in internal restructuring, but with our clients out there. We need to provide fresh stimuli – on an ongoing basis. Don’t you agree?

Herbert nodded with a sigh, sipping from his hot latte macchiato, for him the best there was among all cafeteria offers. He did not know what to add.

Corporate governance at Highfly

The initial business success overshadowed an area of Highfly that saw few changes in the last seven years – corporate governance. Tom felt he had a clear vision of where Highfly needed to be 10 years down the road, so he tried to avoid having long and tedious board meetings. Highfly’s board usually met four to five times a year for no more than two or three hours. While attendance was quite good, it was not unusual for a member to be absent. The board consisted of five people:

- Tom Svensson, Chairman & CEO.
- Herbert Jones, Chief Financial Officer.
- Van Chu, First Stages Capital.
- Arno Levin, Venture Partners.
- Kevin Garzias, Independent Director with several board assignments.

Van and Arno represented two private equity investors. First Stages Capital originally invested £5 million in exchange for a 30% stake. Venture Partners came on board later and financed the second round of expansion, with £25 million, and now owned 40% of Highfly.

In contrast to Arno, who had just recently replaced a retiring colleague, Van had been on the board for almost seven years. Herbert remembered Van's comment during one of the previous board meetings:

We are more like passive investors. We really try to understand the business model and market opportunities, but then we have to let the CEO and his team run the show. Strategies need years to fully deploy. We stay in the background and can hopefully watch how the value of our investment increases. Tom has done a good job so far.

Tom and his co-founders (most of whom had left the organization) owned the rest of Highfly. Tom thought back to the moment when he decided to open the company to outside investors to spur growth:

If only I had kept it within my family and group of friends . . . then I would not have to deal with all of this.

Things went pretty well for Tom in general. He had great relationships with the independent directors, especially the two representatives from the investor side. Also Arno, who was extrovert and still rather young, fitted in perfectly shortly after joining the board. Both Arno and Van knew that every business required special knowledge that was gained from being 'at the pulse' of the business to sense the intricacies of new developments. They were happy with the performance of Highfly so far, and Tom never had a problem keeping them impressed with his convincing style and charisma.

Kevin was the remaining person on the board. After retiring from his professorship at London Business School, he continued to have several board assignments. The other co-founders and co-owners brought him in when they significantly reduced their shareholding in Highfly and left the board in 2004. They trusted Kevin's neutral stance and long-term view. After all, he was a renowned business professor and author of a range of business books for managers. Kevin liked the intelligence hidden in Highfly's software and was keen on promoting start-ups and entrepreneurship in general. As Kevin had board experience to offer, he was deemed to be a highly suitable candidate for the board. In spite of being retired, he seemed to continue to be extremely busy with speeches and social engagements.

A moment of truth in Highfly's boardroom

Tom usually navigated smartly through the board meetings. He set the right tone at the top, which had always been frank and positive – until today. While his style was sometimes perceived as too fast, he nonetheless succeeded in checking off items on the agenda quite efficiently. For a surprisingly long time, there was little trouble on the horizon as Highfly emerged as a key player from the vanishing heydays of the Internet boom, and corporate governance at Highfly saw few changes.

Arno's proposal was rather clear and simple. He suggested the following:

- Double the number of board meetings.
- Increase the involvement of the board in the strategy process.
- Build a risk management system.
- Introduce an audit committee, which would also be responsible for the risk management system.

Everybody in the ongoing board meeting knew that Tom truly hated conflicts and ‘administration’ (as he called everything outside of product development and delivery). After personal coordination, he ‘let everybody run their own show’. His usual recommendation to any suggestion was:

Grab the ball and run!

And now this . . .

Tom looked into the faces of the board members, waiting for a response. Nervously ticking his Mont Blanc on the table, he was still breathing hard after the unusual outburst towards Arno. There was no ambiguity in the room – he wanted to know from them what Highly should do now about corporate governance, if anything needed to be done at all.

1.13 CASE STUDY: DID CORPORATE GOVERNANCE FAIL AT SWISSAIR?

[By Ulrich Steger and Helga Krapf]

4 OCTOBER 2001. The protestors were walking down Zurich’s Bahnhofstrasse. Many held placards with one word: ‘CHAOS’. Tabloids that day exclaimed:

What a shame. Switzerland is a banana republic. Everything we are proud of went down the drain. Honesty. A sure eye. Dependability.¹³

The reliability of Swiss trains, airlines, and watches is legendary and seen as a synonym for the functioning of the country. The Swiss could not understand why one of their national icons – and their whole country – was suddenly hit by crisis.

What had happened? On 2 October 2001 Swissair, Switzerland’s national airline, had suspended all flights because of liquidity problems. Some 40,000 angry passengers worldwide were stranded.

On October 3 bank officials and Swissair executives blamed each other for the grounding. Christoph Blocher, Swiss politician and entrepreneur, commented:

The disastrous linkage of politics, country, cantons, trade associations, big companies and the ruling parties turned Swissair into an untouchable symbol. Swissair was a temple, a god and a juggernaut.¹⁴

But who was responsible for the grounding? Was the corporate governance system overstretched as a result of managing a company whose corporate boundaries had begun to erode because of strategic alliances? Or was national politics too involved in a global business? Would tighter financial controls have been necessary to control risks taken in implementing a global strategy? Could the board have balanced the aims of a charismatic CEO? Had the board been too detached from management and could they have prevented such a disaster?

¹³ Scotsman (Edinburgh), 4 October 2001.

¹⁴ Aargauer Zeitung (Aargau), 5 November 2001.

Consolidation in the global airline industry

The still heavily regulated aviation industry was the subject of liberalization worldwide. The American aviation industry had been going through a deregulation process since 1978, which encouraged more than 50 new companies to enter the business. The resulting overcapacity triggered strong price competition. Most of the start-ups, as well as some of the older airlines, eventually went out of business.

The European market for air transport had grown dramatically over the years – in 2000 it was 32 times bigger than it had been in 1960. The European Community gradually established a single market for air transport. Between 1980 and 1993 issues such as market access, capacity control, and fares were deregulated, with similar effects as in the United States. New ‘no-frills’ airlines added further pressure on prices. In 2000 these airlines accounted for 5.2% of the intra-European air travel market. A rapid growth in their market share had been forecast. Despite the liberalization, mergers and acquisitions were difficult due to complex legal situations. Airlines tended to join European or global alliances instead (refer to Figure 1.6 for membership and global ranking).

Too big to be small: Swissair in search of a new strategy

In 1992 Swissair flew to 109 destinations in 66 countries when the Swiss voted against integrating the country into the European Economic Area. Swissair had to remain globally competitive or run the risk of becoming an insignificant regional airline, since it was no longer operating under the same conditions as airlines in the European aviation market. At that time Swissair was part of Swissair Group, with:






- Crossair, a regional European airline.
- Balair and CTA, two Basel- and Geneva-based charter airlines.
- Swissair associated companies, which included hotels, catering, etc.

The board and management were challenged in a new way as a result of the Swiss vote. In 1993 an initial merger plan with Scandinavian Airlines (SAS), Austrian Airlines (AUA), and KLM Royal Dutch Airlines met with resistance from the public, the governments involved, and trade unions. Heated debates began, especially in Switzerland, where one Bundesrat (Swiss government) member claimed:

Replacing the William Tell¹⁵ statue in Altdorf with a statue of the Dalai Lama would give rise to the same political feelings as if Swissair merged with a foreign airline. But politicians cannot ensure the survival of a company with today’s competition; it’s the market that decides in the end.¹⁶

¹⁵ William Tell: Swiss legendary hero who symbolized the struggle for political and individual freedom against Austrian authority in the 13th and early 14th centuries. However, the historical existence of Tell is disputed.

¹⁶ *Neue Zuercher Zeitung* (Zurich), 17 June 1993.

	MEMBER From...	1999 PAX (mill)	WORLD TRAFFIC Rank	% Share	HUBS	
 STAR ALLIANCE	United Airlines	May-97	87.0	2	Chicago, Denver, Los Angeles, Washington	
	LUFTHANSA	May-97	41.9	8	Frankfurt, Munich	
	Air Canada	May-97	16.2	20	Montreal, Vancouver	
	Thai Airways International	May-97	16.0	21	Bangkok	
	SAS	May-97	22.0	14	Copenhagen, Oslo, Stockholm	
	Vang	Oct-97	10.3	31	Rio de Janeiro, Sao Paulo	
	Air New Zealand	Mar-99	7.2	38	Auckland	
	Ansett Australia	Mar-99	11.8	29	Melbourne	
	All Nippon Airways	Oct-99	42.7	7	Tokyo, Osaka	
	AUSTRIAN AIRLINES GROUP	Mar-00	6.2	44	Vienna	
	Singapore Airlines	Apr-00	13.5	26	Singapore	
Mexicana	Jul-00	7.8	36	Mexico City		
BMI BRITISH MIDLAND	Jul-00	6.5	40	London Heathrow		
ALLIANCE		289.3				
 oneworld	American Airlines	Feb-99	81.5	3	Dallas, Miami, Chicago	
	BRITISH AIRWAYS	Feb-99	35.6	10	London Heathrow	
	Qantas	Feb-99	16.8	19	Sydney	
	Cathay Pacific Airways	Feb-99	10.5	30	Hong Kong	
	IBERIA	Sep-99	21.9	15	Madrid	
	FINNAIR	Sep-99	6.1	45	Helsinki	
	LanChile	Jun-00	4.3	62	Santiago	
	AER LINGUS	Jun-00	6.3	42	Dublin	
	ALLIANCE		183.9			
	 SKYTEAM	Aeromexico	Jun-00	8.7	34	Mexico City
AIR FRANCE		Jun-00	37.0	9	Paris CDG, Paris Orly	
Delta Air Lines		Jun-00	105.2	1	Atlanta, Dallas, Cincinnati	
Korean Air Lines		Jun-00	20.4	17	Seoul	
CSA Czech Airlines		Apr-01	1.9	95	Prague	
ALLIANCE			173.5			
 The Qualifier Group	SWISSAIR	Mar-98	13.3	27	Zurich	
	SABENA	Mar-98	10.0	33	Brussels	
	TAP	Mar-98	4.8	56	Lisbon	
	TURKISH AIRLINES	Mar-98	10.1	32	Istanbul	
	AOM	Mar-98	2.9	80	Paris Orly	
	Crossair	Jul-98	2.7	82	Basel-Mulhouse	
	Air Europe	May-99	1.2	110	Milan Malpensa	
	LOT	Jan-00	2.1	89	Warsaw	
	PGA	Jan-00	0.8	132	Lisbon	
	Volare	Jan-00	0.7		Milan Malpensa	
	Air Littoral	May-00	1.6	100	Nice	
Air Liberté	Sep-00	4.0	66	Paris Orly		
ALLIANCE		54.2				
 WORLDWIDE RELIABILITY	KLM	Nov-92	15.5	22	Amsterdam	
	Northwest	Nov-92	57.5	4	Minneapolis, Detroit, Memphis	
	ALLIANCE		72.9			
World Total Scheduled Traffic		1,560.0	≅ 100%			

Source: AEA/CAQIATA

Figure 1.6 Airline alliances: membership and ranking

In spring 1994 McKinsey Switzerland, headed by future Swissair Group board member Lukas Mühlemann, presented three basic directions:

- Stay an independent airline.
- Buy stakes in smaller airlines to become number three or four in Europe.
- Become a partner of a bigger European airline but give up its independence.

Swissair Group decided on a dual strategy:

1. Grow Swissair (then commonly referred to as the ‘flying bank’) and become an attractive partner for Delta Airlines.
2. Become a global player in airline-related businesses such as catering, ground handling services, and maintenance.

Management decided to pursue an aggressive acquisition strategy rather than entering into lengthy talks about cooperations. The first acquisition target was Belgian state airline Sabena, which had chronic financial problems and a reputation for bad service. Fleet and workforce reductions, as well as customer service training for the remaining employees, had failed to improve the financial situation. In May 1995 both airlines finally agreed that Swissair would take a 49.5% stake in Sabena, a foothold for the Swiss airline in the European market. The Belgian government withdrew from the operational level. Swissair appointed 5 of the 12 directors and sent a new CEO. He soothed some of the problems, but at the cost of increasing staff from 6900 employees to more than 12,000.

In 1997 McKinsey developed plans to form another airline alliance in competition with StarAlliance and OneWorld. The consultants advised Swissair Group to behave like a ‘hunter’, aiming for 10%–25% stakes in the European partners of Delta (Austrian AUA, Portuguese TAP, Finnish Finnair, Hungarian Malev, Irish Aer Lingus). They estimated the investment volume to be SFr 400 million. Swissair’s board decided to implement the Hunter strategy.

Corporate governance in a globalizing company

Responsibility in Swissair Group was split in accordance with Swiss law. The day-to-day business was left to executive management but the board had ultimate responsibility for leading the company (Gesamtleitungsfunktion). Board members (Mitglieder des Verwaltungsrates) were entitled to request information from management and had the right to apply to the chairman to be shown books and files. The chairman played a critical role in ensuring communication and the exchange of information between executive management and board members. However, industry insiders questioned the backgrounds of the chairmen:

- Hannes Goetz, chairman 1992–2000, had no previous experience in the aviation industry.
- Eric Honegger, chairman 2000–2001, had a civil service background but no previous international experience.
- Mario Corti, chairman 2001–2002, had previously worked in banking and as chief financial officer at Nestlé but had no turnaround or operational experience.

In 1997 Swissair Group adopted a holding structure and changed its name to SAirGroup. SAirLines then consisted of Swissair, Crossair, and Balair/CTA Leisure. Figure 1.7 shows the development of group structure and executive management between 1997 and 2001.

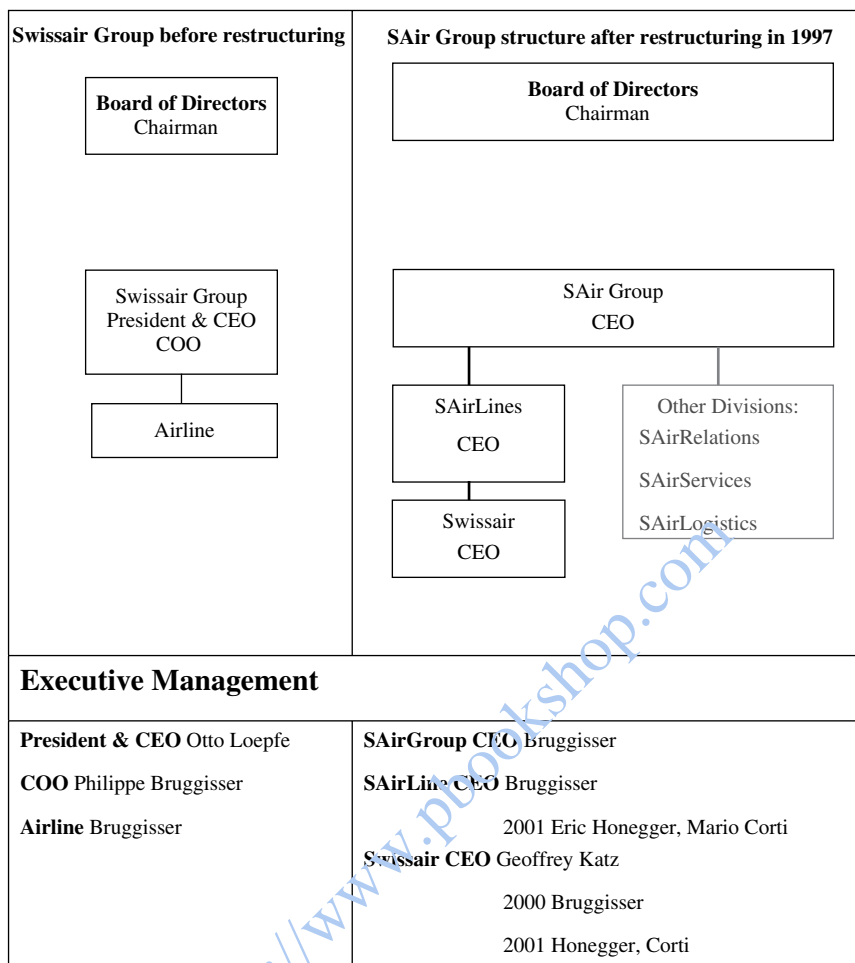


Figure 1.7 Development of group structure (simplified)

The board

Swissair Group's board members were elected for a period of three years, with the possibility of re-election. Bénédic G.F. Hentsch, managing partner of a private bank, who joined the board in 1989, remembered:

The Swissair board was like a legion of honor. When I joined it had 32 members and I was told point-blank that it would be clever not to ask too many questions during my first two periods of tenure since I was still young. The real decision makers were the members of the executive committee of the board of directors.¹⁷

¹⁷ Cash, 16 November 2001.

The complete board met about five times a year for half to one day. The executive committee, which consisted of the chairman, the two deputy chairmen, and four or five other board members, met monthly. The financial, organizational, and remuneration committees each had three members and usually met twice a year for half a day (refer to Figure 1.8 for duties of board and committees).

In 1999 Swiss aviation law changed and public representation on the board was no longer necessary. The board was reduced to 10 members, who met every month. The three committees remained but the executive committee was abolished. Instead, an advisory board

The duties of Swissair's board were stated in the company's Articles of Association:

1. To ultimately direct the corporation and issue the necessary directives.
2. To determine the corporate organization.
3. To organize the accounting, financial control, and financial planning to the extent that such organization is required for the overall management of the corporation.
4. To appoint and dismiss the person entrusted with the management and representation of the corporation.
5. To ultimately supervise the persons entrusted with the management of the corporation, including their compliance with the law and the corporation's Articles of Association.
6. To prepare the annual report and the shareholders meeting, and to implement the latter's resolutions.
7. To inform the legal authorities in the event of overindebtedness.

Financial Committee

The duties of the Financial Committee shall comprise in particular:

1. Considering issues relating to accounting, financial, investment, and fiscal policy, and the Group's operating accounts and associated strategies.
2. Monitoring the efficiency of management and information systems and other internal controls.
3. Defining the duties of the external and internal auditors, and assessing the scope and results of their audits.
4. Monitoring the efficiency of the audits conducted.
5. Assessing the Report of the (external) Auditors and the internal auditors' reports.

Organization Committee

The Organization Committee shall familiarize itself with the business and operations of the Group subsidiaries and form an opinion of whether the Group divisions are suitably equipped to meet future business needs. The Organization Committee shall also monitor Group personnel policy.

Remuneration Committee

The Remuneration Committee shall determine:

1. The remuneration of the Chairman of the Board and the salary and other terms and conditions of employment of the Group President & CEO.
2. The salaries and other terms and conditions of employment of the other members of Group Executive Management and the heads of business units within the Holding Company (based on recommendations by the Group President & CEO).
3. Any salaries in excess of an upper limit set by the Remuneration Committee. The Remuneration Committee shall generally meet twice a year, or additionally at the request of at least two of its members.

Figure 1.8 Board of directors and committee duties

Source: Organization Regulations of the SAirGroup; issued by the Board of Directors on 22 November 2000 (supersedes the version of 6 May 1999).

Size	1997		2000	
	Hunter strategy			
	Industry	14	11	
	Public Inst.	4	0	
Executive Committee	Chairman	Goetz	Honegger	
	Deputy	Hoefliger	Hentsch	
	Chairmen	Schmidheiny	Schmidheiny	
	Other Members	<ul style="list-style-type: none"> • Hentsch • Honegger • L. Mühlemann • Staehelin 	Members not in committees: Corti, Fischer	
			Financial: Hentsch, Staehelin, Spoerry-Toneatti	
Committees			Organization: Hoeflinger, Leuenberger, L. Mühlemann	
			Remuneration: Honegger, Staehelin, Schmidheiny	

Corti, Mario: Swiss, born 1946; joined SAirGroup board in 2000. **Current:** Chairman of the board Swissair. **Career:** *Kaiser Aluminium and Chemical Corporation*, California: 1972–76 corporate planner. *Swiss National Bank Zürich:* 1977–86 director and deputy head of the banking department. *Federal Office for Foreign Economic Affairs*, Berne: 1986–90 ambassador and delegate of the Swiss government for trade agreements. *Nestlé:* 1991–93 senior VP and chief administrative officer, USA; 1994–95 executive VP and CFO, USA; 1996–2001 executive VP and CFO, Switzerland.

Goetz, Hannes: Swiss, born 1934; joined Swissair board in 1991, chairman from 1992–2000. **Career:** *Sika AG:* 1961–70 different positions in Switzerland and USA; 1971–79 CEO; 1979 board member and president. *Georg Fischer AG:* 1981 board member; 1983–92 board member and CEO.

Gut, Rainer E.: **Current:** Chairman of the board Nestlé. **Career:** *Lazard Frères & Co:* 1968–71 general partner, New York. *Swiss American Corporation* (Credit Suisse investment banking): 1971–73 chairman and CEO, New York. *Credit Suisse:* 1973–82 executive board member; 1982–83 president of the executive board; 1983–2000 chairman of the board of directors of Credit Suisse; 1986–2000 chairman of the board of directors of Credit Suisse Group (formerly CS Holding – renamed 1 January 1997).

Hentsch, Bénédict: Swiss, born 1948; joined Swissair board in 1989. **Career:** *Morgan Guaranty Trust of New York and Sao Paulo:* 1976–82. *Hentsch & Cie private bankers*, Geneva: 1982, 1985–2001 managing partner.

Hoefliger, Paul-Antoine: Swiss, born 1939; joined Swissair board in 1978. **Current:** Chairman of the board and president of Comptoir Suisse, Lausanne. **Career:** *Comptoir Suisse:* joined 1969; 1978 general manager; since 1990 board member, CEO and general manager.

Honegger, Eric: Swiss, born 1946; joined Swissair board in 1993, chairman 2000–2001. **Career:** *Municipal council of Rueschlikon:* 1974–78 member. *Parliament of the Swiss Federal State of Zürich:* 1979–87 member, 1983–87 president of the finance committee. *Government of the Swiss Federal State of Zürich:* 1987–91 head of construction, 1991–99 head of finance.

Figure 1.9 Members Swissair/SAirGroup committees 1995–2000

Source: Public information.

Leuenberger, Andres: Swiss, born 1938; joined Swissair board in 1995. **Current:** Vice chairman of the board and deputy CEO of Roche Holding Ltd, Basel, chairman of the board Swiss Life Insurance and Pension Company. **Career:** *Roche*: joined 1968; 1970 manager (Pharma Marketing), Tokyo; 1973–80 president and CEO. *F. Hoffmann-La Roche Ltd*, Basel: 1980 member of executive committee; 1982 vice chairman of the executive committee; 1983 board member and managing director; 1986 COO; since 1989 present position.

Mühlemann, Lukas: Swiss, born 1950; Swissair board 1995–2001. **Current:** Executive chairman and CEO of Credit Suisse Group, Zurich. **Career:** *IBM*, Switzerland: 1973–75; *McKinsey & Company*: 1977 management consultant; 1982 principal; 1986 director; 1989 managing director for Switzerland. *Swiss Reinsurance Company*: 1994 CEO and MD; 1996 also deputy chairman. *Credit Suisse*: 1997 CEO; 2000 also chairman.

Schmidheiny, Thomas: Swiss, born 1945; Swissair board 1980–2001. **Current:** Chairman of executive committee and chairman of board of directors of Holcim Ltd (formerly Holderbank), Switzerland. **Career:** *Cementos Apasco*, Mexico: 1970–71 technical management; *Holderbank Group*: 1975 managing director of Swiss cement companies; 1976 responsible for Middle East cement companies, member Holderbank executive committee; since 1978 chairman of executive committee of Holderbank; 1980 deputy chairman of board of directors of Holderbank Financière Glaris Ltd.; 1984–2001 executive chairman of Holcim AG; since 2002, majority shareholder of Holcim AG and president of the board of directors of Holcim AG.

Spoerry-Toneatti, Vreni: Swiss, born 1938; Swissair board 1989–2001. **Career:** *Municipal council of the city of Horgen*: 1978–86 member. *Prefectoral council of the canton of Zürich*: 1979–83 member. *National councillor*: 1983–95. *Councillor of state*: since 1996.

Stahelin, Gaudenz: Swiss, born 1923; Swissair board 1984–2001. **Current:** President Swiss National Committee, International Chamber of Commerce. **Career:** *Advocate*, in Basel: 1953–59. *Swissair*: 1960 assistant to chief legal advisor; 1961 deputy secretary general; 1981–86 secretary general. (Also, *Advocate*: 1984; *Lecturer in civil and comparative law*: 1985.)

Figure 1.9 (Continued)

with 15 members from multinational companies, the Swiss government, and cantons advised on strategic and geopolitical issues. This group met two or three times a year.

Swissair's board read like the *Who's Who* of Switzerland (refer to Figure 1.9 for an overview of board and committee members). The interconnectedness of Swiss companies had been the subject of criticism. A 1980s study came to the conclusion that Switzerland was effectively run by an elite of 300 people from industry, banks, and trade associations.¹⁸ Board members were often invited by their friends or because of their connections to politics or banks. Swiss law required the majority of board members to be Swiss nationals or residents. As a result, some Swiss held up to a dozen board seats. Ultimately, this led to situations where the CEO of one company was the chairman of the board in another and vice versa.

In the case of Swissair, chairman Eric Honegger was a director of UBS. UBS's chairman of the board, Robert Studer, was a Swissair board member. Financial committee member Vreni Spoerry-Toneatti and deputy chairman Thomas Schmidheiny were directors at Credit Suisse (CS). In turn, Rainer E. Gut, CS chairman and mentor of Lukas Mühlemann (who later also became CEO of CS), sat on the Swissair board.

¹⁸ *Bilanz*, October 2000.

Philippe Bruggisser: developing into a dominant leader

Mühlemann and two other board members stimulated discussions about the need for changes in executive management to implement the new strategy. In October 1995 the board appointed Philippe Bruggisser as chief operating officer (COO) of Swissair Group. At the end of 1996 he became CEO of the Group.

Bruggisser faced a dilemma right from the start. He had advised against taking a stake in Sabena, but he also knew who had made him COO. In 1997 an internal study came to the conclusion that it would be better to write off the Sabena stake. However, Mühlemann, who had only joined the board in May 1995, used his dominant influence and defended the strategy.

Bruggisser had to accept the decision but succeeded with his second goal, an international management team at Swissair. He planned not only to break up old structures in the management but also to be revolutionary and appoint a non-European CEO of the airline.

Table 1.4 Consolidated financial results SAirGroup (SFr million)

	2000	1999	1998	1997
Operating revenue				
SAirLines	7,166	6,414	5,925	5,619
SAirServices	3,183	2,412	1,941	1,805
SAirLogistics	1,712	1,546	1,280	1,221
SAirRelations	6,218	4,839	3,863	3,663
Holding company	154	83	81	42
Intragroup revenue	(2,204)	(2,092)	(1,793)	(1,794)
Total operating revenue	16,229	13,002	11,297	10,556
Total operating expenditure	(15,626)	(12,328)	(10,694)	(9,997)
Net profit/loss	(2,885)	273	361	324
Net cash inflow from operating activities	1,809	2,196	1,427	969
Net cash inflow from investment activities	(2,237)	(3,172)	(1,021)	(677)
Net cash inflow from financing activities	933	1,291	153	(431)
Net (decrease)/increase in disposable funds	505	315	559	(139)
Assets				
Current assets	7,201	5,986	5,080	4,628
Fixed assets	13,014	11,868	8,620	8,002
thereof intangible assets/goodwill*	2,274	1,767	503	446
Total assets	20,215	17,854	13,700	12,630
Liabilities				
Current liabilities	4,624	2,955	2,157	2,091
Non-current liabilities	8,161	6,853	5,418	5,030
Accrued liabilities & provisions	6,078	3,653	3,126	2,857
Liabilities	18,863	13,461	10,701	9,978

* This item consists largely of the goodwill acquired via various acquisitions since January 1995.

Source: SAirGroup Financial Statements 2000, pp. 8, 9, 11, 12, 22; SAirGroup Financial Statements 1998, pp. 10, 11, 13, 14, 22.

Geoffrey Katz, who had worked all his professional life for American Airlines, was signed as CEO for Swissair.

After net losses in 1995 and 1996, Bruggisser had managed to turn Swissair around by the end of 1997. The press celebrated him as a national hero – the company achieved a profit of SFr 324 million (refer to Table 1.4 for 1997 results).

The new CEO was not universally popular, despite his successes. His decision to stop inter-continental flights from Geneva was met with massive public criticism. But at least Zurich would be saved as international hub, which many thought was essential for Switzerland's status as an international financial center. Internally, Bruggisser controlled the flow of information to the board. But the board liked and trusted him as the sole source of power and major source of information in SAirGroup.

Implementation of the Hunter strategy

In 1998 Bruggisser started his hunt for partners with the aim of achieving 20% market share in Europe. Talks with Aer Lingus and Finnair failed, but by the end of the year shares in national, regional, and charter airlines amounted to SFr 3.2 billion – the equivalent of a 20% stake in BA. Most of these airlines joined the new Qualiflyer alliance, while continuing to operate under their own brand. The group planned to achieve economies of scale by combining all necessary back-office activities such as a common booking system, maintenance, and catering. Swissair played a key role by providing all these services to the remaining group.

SAirGroup continued to acquire stakes in different airlines (refer to Table 1.5 for an overview of SAirLines holdings acquired from 1995 to 2000). Outsiders openly questioned the value of some of these investments. Not only were some of the targets experiencing financial difficulties, but they were also operating in lower market segments. Some analysts thought SAirGroup should concentrate on diversifying into its successful airline services like catering, retailing, and cargo handling rather than increasing global alliances. The Qualiflyer members also started to voice criticisms, but Bruggisser continued to pursue new acquisitions. Deputy chairman Hentsch remembered:

Some of the board of directors thought Bruggisser was playing a lonely powergame when he suggested acquiring airlines in France. He was the leader but his strengths were also his weakness: he didn't leave much room for others.¹⁹

In 1999 Bruggisser secretly discussed taking over a 9% stake in Austria's AUA from another airline. The negotiations were not successful but Bruggisser lost AUA's confidence. When AUA's board started discussions about joining another alliance, Bruggisser did not intervene, although he was a member of AUA's board. In September AUA finally decided to leave the Qualiflyer alliance. Soon afterwards Delta announced it was forming another alliance, with Air France–Sky Team.

The year was not only a difficult one in terms of managing alliances. Fuel costs for European airlines increased by more than 40% but SAirGroup still showed a net group

¹⁹ *Aargauer Zeitung* (Aargau), 16 November 2001.

Table 1.5 SAirLine holdings acquired 1995–2000

Airline	Stake since	Home base	Holding(%)	Profit/(loss) from associated undertakings		Book value	
				2000	1999	2000	1999
<i>National airlines</i>							
LOT Polish Airlines	2000	Poland	37.6	7		154	
Sabena	1995	Belgium	49.5	(51)	35	0	50
South African	1999	South Africa	20	16		169	355
<i>Regional airlines</i>							
Air Littoral	1998	France	49	(3)	(31)	0	0
AOM + Air Liberté	1999	France	49.5	(237)	(104)	0	0
<i>Charter airlines</i>							
LTU	1998	Germany	49.9	(498)	(167)	0	0
Volare Group + Air Europe	1999	Italy	49.79	(30)	(134)	0	19
<i>Agreed, but not executed</i>							
TAP	2000	Portugal	20				

Source: SAirGroup Financial Statements 2000, pp. 18, 24.

profit of SFr 273 million (compared with SFr 361 million in 1998). Other divisions compensated for the increased costs at SAirLines (refer to Table 1.4 for SAirGroup results in 1999).

Into the new millennium with baggage

Increasing fuel prices and a strong dollar exchange rate added to problems in 2000. Chairman Goetz resigned in April. Potential candidates for his succession were L. Mühlemann, Hentsch, and Honegger. However, the first two could not assume the responsibility on top of their other duties. Honegger became chairman due to his political skills and national connections. In July, Katz resigned as CEO of Swissair, and Bruggisser took over again. Although some thought he had the ideal background and knowledge to implement the Hunter strategy, others feared it would stretch management resources too much.

In October 2000, Honegger was still vaguely optimistic for the coming year:

We have fuel costs, which are still a major item. We have some restructuring costs in France and with Sabena and Delta. But we've made provisions for all those problems, it should be a normal 2001.²⁰

²⁰ Scotsman (Edinburgh), 27 October 2001: 4.

Nevertheless, the board started debating future prospects and the direction of the Hunter strategy. Hentsch commented in November:

You would have to be blind not to notice that the current strategy is proving more difficult to implement than expected.²¹

The troubled airlines LTU, Sabena, Air Liberté, Air Littoral, and AOM required further financial aid. Analysts estimated a demand of around SFr 3 billion within the next two years. However, it was not clear whether that would lead to profit. The necessary restructuring measures also faced heavy political and social opposition, especially in France, where militant trade unions organized strikes frequently (in Switzerland, by contrast, the last public strike had taken place in 1936). The board decided in November 2000 to continue with Hunter. A public opinion poll concluded that 92% of Swiss thought Switzerland needed a national airline. This result led one Swissair manager to the optimistic conclusion that the survey was the best thing that could have happened. He reckoned that after that there would be only little scope for the board. He was mistaken. Hentsch remembered:

We asked Bruggisser the crucial question in December: had the Group enough liquidity to solve the problems with Sabena? Bruggisser didn't seem to be able to admit the whole situation. He had never been so lonely before, he didn't really listen to anybody anymore.²²

Fighting crisis

SAirGroup reported a net loss of SFr 2.9 billion for the previous business year in January 2001 (refer to Table 1.4 for SAirGroup results in 2000). The board finally decided to abandon the Hunter strategy due to financial, time, and management capacity restraints. This decision and its results had far-reaching management consequences. Chairman Honegger, who lacked Bruggisser's entrepreneurial drive, became temporary CEO of SAirGroup. On 15 March 2001 'Super Mario'²³ Corti took over as chairman and CEO of SAirGroup. Later it was made public that he had been paid five years' salary in advance as compensation for professional and personal risks associated with his new assignment.

The annual general meeting (AGM) in April was eagerly awaited. Corti had to present the worst results ever in the company's history. The shareholders at the meeting voted against legally discharging the directors, with the exception of Corti. Pascal Couchepin, the Swiss economy minister, summarized their feelings:

Voting against the normal legal discharge was a way to say that I have a number of questions and I am awaiting a special audit to decide whether I will start a civil suit.²⁴

²¹ *The Times* (London), 20 November 2000: 26.

²² Touristik R.E.P.O.R.T., 30 November 2000 (Reuters).

²³ The media dubbed Mario Corti 'Super Mario'. The first video games featuring this action hero were released in the 1980s and built the foundation for Nintendo's global gaming empire.

²⁴ *Aargauer Zeitung* (Aargau), 16 November 2001.

Seven of the ten board members resigned at the AGM – among them the four longest-serving board members (who had been on the board between 13 and 23 years) and ex-chairman Honegger. When asked whether he thought that the board had acted with due diligence, L. Mühlemann justified:

The board of directors has to rely on management, which is responsible for the operational business. The board has to have a careful look at management's ideas and proposals, it has to ask critical questions and if necessary demand alternative scenarios. Our trust in the management was justifiable with the record results of 1997 and 1998. Directors cannot know as much about the market, competition, customer requirements and organization of the company as the management.²⁵

The working style of the board changed in the months following the AGM. The members received the financial figures every month and met every other month for half a day to discuss all the details about Swissair Group. A number of desperate rescue measures were initiated. In April, Swissotel Hotel & Resorts was sold to Raffles Hotels for SFr 520 million. The sale of non-core activities and minor airline stakes, including holdings in French AOM and Air Liberté, was announced. In June and July, Swissair discussed with Sabena being released from increasing its 49.5% stake to 85%. The parties finally agreed on a payment of SFr 430 million.

In June 2001, PricewaterhouseCoopers resigned as auditors of Swissair Group after many years of service. For four years their statements had been identical – not even minor deficiencies had been reported, especially with regard to risk associated with the different holdings or activated goodwill (refer to Table 1.4 for consolidated SAirGroup results 1997–2000). Observers wondered why the board did not question this – did they simply not know or were they ignoring the writing on the wall?

On 31 August 2001 the new auditor, KPMG, published re-audited 2000 accounts. Among other items, aircraft leases, which had previously been off balance sheet as operating leases, were then classified on balance sheet as finance leases. The previous accounting for pension funds and own shares was adjusted and reduced equity. The presentation of the figures for the first half of 2001 revealed that Swissair's financial position was much weaker than previously reported:

	End of year 2000	Revised end of year 2000	End of June 2001
Net debt position	SFr 6.4 bn	SFr 9.4 bn	SFr 10.4 bn
Equity	SFr 1.2 bn	SFr 716 m	SFr 555 m

Passing the buck

The terrorist attacks in the USA on September 11 aggravated Swissair's situation. On October 1 the company filed for bankruptcy protection. The same day, UBS agreed to take over 51% of Swissair's stake in Crossair, and Credit Suisse (under CEO Mühlemann) the remaining 49%. With the change to the winter flight schedule Crossair was supposed to

²⁵ *Financial Times* (London), 19 April 2001.

take over two-thirds of Swissair's flight operations. However, on October 2 Swissair's cash requirements skyrocketed when all suppliers demanded cash payment. Swissair did not have enough liquidity to maintain its services. The complete fleet had to be grounded. Thousands of passengers were stranded and left to organize alternative transportation.

Two days later Swissair resumed its flight operations with the aid of a government lifeline of SFr 450 million. But the image of Swissair and Switzerland had been damaged.

On October 5, L. Mühlemann, who had been a member of the Swissair board for six years, resigned. The board of directors had only three members left: Corti (on the board for 1 year), Hentsch (12 years), and Leuenberger (6 years). Controversial, often acrimonious, debate accompanied every step in the massive restructuring, such as who should form the new leadership and board.

A Swiss private banker commented:

This incident will be remembered as a watershed. From now on corporate governance in Switzerland will be divided into pre- and post-Swissair.²⁶

1.14 CASE STUDY: ABB – CORPORATE GOVERNANCE DURING A TURNAROUND

[By Paul Strebel, Ulrich Steger, and Wolfgang Amann]

ABB HEADQUARTERS, ZURICH, 3 MARCH 2004. Jürgen Dormann leaned back in his chair as he reviewed the media response to his announcement the day before that he would be stepping down as CEO. Fred Kindle (44), the previous CEO of the Swiss technology concern Sulzer, would succeed him at the beginning of 2005. Dormann would stay on as chairman of the board. What a contrast with the coverage when he became CEO after Jörgen Centerman's sudden resignation on 5 September 2002. Then there had been talk of a 'spiralling crisis',²⁷ 'dangerously close to collapse',²⁸ combined with the lingering question 'can the new boss of ABB stop the burnout in the rotten technology company at the last second?'²⁹ Now, it was 'return to stability'³⁰ – no mean feat after four CEOs in seven years, and three major reorganizations in five years. The financials looked reasonable, but Dormann knew that ABB was like a patient that had just left hospital – not yet fit enough to compete in any industry Olympics.

He felt confident that due to the massive improvements in corporate governance, the fundamental changes triggered would last, and their positive effects would continue to be felt as the new values and behaviors trickled down through the organization. But how would the new division of labor – and power – between him and the CEO work out? What new dynamics would emerge? Could, and indeed should, board involvement remain as high as it had been during the turnaround? What kind of contributions could be expected as the new strategy was formulated in the near future? A high-performing business model was still under construction – now was not the time to rest on his laurels . . .

²⁶ *Cash*, 4 May 2001.

²⁷ *Financial Times*, 6 September 2002.

²⁸ *The Economist*, 26 October 2002.

²⁹ *Wirtschaftswoche*, 12 September 2002.

³⁰ *Financial Times*, 3 March 2004.

‘From admired to mired: a powerhouse adrift’³¹

As an industry leader in power and automation technologies resulting from the merger of ASEA (Sweden) and Brown Boveri (Switzerland), ABB generated US\$18.78 billion of revenues in 2003 with its 105,000 employees worldwide. Dormann remembered only too well that until the late 1990s, ABB had always ranked near the top of the list of most-admired companies. Percy Barnevik, ABB’s chairman (up to 2001) and CEO (up to 1996), was widely praised as the European equivalent to the US management hero Jack Welch, the former head of General Electric. However, with hindsight,³² it became clear that ABB’s fortunes had started to wane with the crisis in Asia in 1997, an area where ABB had seen massive expansion. Overpaid acquisitions and a botched and costly attempt to position ABB as an e-business had added to the company’s woes.

Then came ‘the perfect storm’, reducing ABB’s market capitalization by 95%. The hang-over from the e-bubble affected the technology industry in particular, as investments slowed across the world. The asbestos liabilities in the USA exploded, as did the pension scandal – the discovery that two former CEOs, Percy Barnevik and Göran Lindahl, had amassed US\$160 million of pension benefits without proper board approval.

The intention of the Financial Services Division to finance long-term obligation with short-term debt turned sour. ABB’s largest shareholder, Martin Ebner, pushed for a share buyback in early 2001 to raise ABB’s share price – not least to get him out of a squeeze as falling stock prices turned his double leverage financial business model against him. Not only did his conflict of interest trigger a liquidity crunch, but his persistence as a shareholder advocate finally made the board aware of the pension issue. Jürgen Dormann summed up his experience as a new board³³ member:

The ABB board was not really performing effectively. There were too many boys’ games between Barnevik and Ebner, a continuous influence of Swiss and Swedish investors, which did not reflect the global activity of the Group and too little challenge and serious debate. It was all about the chairman and the CEO, and their interactions. Barnevik had patriarchal tendencies and clearly monopolized the flow of information. It is today clear that too much power was concentrated in the hands of one person for too long.

Immediately after assuming the role of chairman of the board on 21 November 2001 and then suddenly being appointed CEO on 5 September 2002, Dormann deemed that an overhaul of the corporate governance system was vital for ABB’s turnaround.

Things got worse before they got better

Dormann remembered:

The problems were bigger than I imagined. I had to realize that from a financial point of view things were becoming pretty narrow and dangerous. However, I underestimated the complexity and mind-set of the company. People in the factories, even middle

³¹ *Financial Times*, 11 March 2003.

³² For a full account of ABB’s development, see the IMD case series by Paul Strebler and Nanci Govinder (IMD-3-1241, IMD-3-1242, IMD-3-1243, IMD-3-1244).

³³ Board refers to the Board of Directors or Supervisory Board or Verwaltungsrat in the Swiss corporate governance context (which consists primarily of non-executives), in contrast to the Group Executive Committee at ABB, which consists exclusively of inside executives.

management, did not realize that we were close to bankruptcy and that nobody would come to our rescue. We are not in France. But nevertheless, under such circumstances, one can act very quickly and decisively.

Or, as one newspaper put it, ‘Jürgen Dormann’s job: to save ABB from itself’.³⁴ It was not an easy ride: barely six weeks into his tenure, on 28 October 2002, Dormann was forced to deliver a profit warning. The figures his top team had presented and he had come to believe were too optimistic. An outcry from financial analysts and the downgrading of ABB by the Standard & Poor’s (S&P) rating agency accompanied the unfolding drama. As one observer noted:

The business community loves nothing more than a hero becoming a loser.

Three top priorities

First, ABB had to retain customers and ensure liquidity. Dormann, along with members of top management and the board, visited customers extensively, while the new CFO, Peter Voser, worked on stabilizing the financial side. Tom Sjökvist, Head of the Automation Products business area, remembered:

We had to convince our customers that we were going to be around. After one year we were out of the doldrums.

Second, the overly complex ‘hybrid front/back-end organization’, the darling of organizational consultancies for the attractive fees it earned them, needed to be abolished. Björn Edlund, Head of Corporate Communication, pointed out:

It simply did not work. Instead of dynamics, we had confusion. Everybody was doing what they wanted. And a lot of turf wars.

Within weeks, Dormann had restructured the previous four sales divisions and the two manufacturing divisions into two, abolished the Group Processes Division, which produced more overhead cost than results, and put parts of Financial Services, the Building Systems business in various countries, and the Oil, Gas & Petrochemicals Division up for sale. Within the remaining core divisions, the relevant unit of strategic consideration was the business area. Under the new structure, these were reduced from 33 to 9, which achieved integrated responsibility for both the important production lines and the markets. Dormann described the emerging structure as ‘back-to-basics and reality’, which was urgently needed to revive ABB’s former entrepreneurial spirit, which had drowned in bureaucracy and convoluted reporting lines.

Third, a new leadership team had to be formed: within weeks, half of the executive team left. The simplification of the organization did away with more than one-third of senior executive positions, the Executive Committee was down to five, with only two of the old committee remaining. The three newcomers (including Dormann) were able to bring a new perspective (see Dormann’s letter on his ideas for communication among them in Figure 1.10).

³⁴ *Fortune*, 18 November 2002.

**Letter from the CEO No. 7:
Clear, concise and direct communications**

Oct. 11, 2002 – In his latest letter to employees, CEO Jürgen Dormann emphasizes the need for clear, concise and direct communications. We should stop presenting to each other, rather discuss, analyze and find solutions, he says.

Dear Colleagues,

Today I'd like to share with you some reflections of a newcomer into the operational management culture of ABB. The newcomer is me, of course.

...

Last week, I wrote about trust and leadership – about saying what we mean and meaning what we say, about showing as leaders that decisions are taken on merit, with the Group interests put first, and our own unit's second. Now, nearly every time I have asked for information in the past month, I have received a sizeable PowerPoint file. Is this the corporate language? I thought it was English.

I know we need presentation materials, and we need presentation skills. But consider this: somewhere among the dazzling presentation techniques, which ABB people steeped in a good engineering culture, have mastered, I sense a creeping loss of substance. I don't want to be sold to when we are discussing real-life business issues within the company – I want facts, views, arguments, context. I don't want self-promotion, I want someone to lay out the issues at hand so we can examine them and find solutions.

You may feel it is frivolous to talk about such matters. I don't think so – the constructive search for solutions starts with setting the right expectation levels. And if what I see is typical, which I'm fairly sure it is, how much time is spent – and lost – in our company as we spin stories to each other across the world?

I know one thing for sure. The world around us, our customers, the families of our employees, the media and the financial markets, have limited interest in us spinning a story. They don't want to be sold a story. They want to understand what our situation is, what we are doing about it, and when we will deliver what results and implement what actions. A plan of action, explained in clear and simple terms.

This starts with removing all the fanciful trappings. These can be virtual/physical trappings – the PowerPoint effects. Or it can be those too-familiar lists of excuses, exceptional items that we are invited to ignore when we review ABB problems.

I know this may sound harsh. So, let me summarize what I mean in a positive way:

- Let's start exchanging information instead of just presenting to each other.
- Let's concentrate on facts – both hard and soft – and analyze their context.
- Let's share, understand, discuss, weigh options and decide.
- Let's stop boiling down complex managerial reality to charts, which few understand.
- Let's cultivate the art of concise memos, with complete sentences.
- Let's listen to each other and practice assuming each other's points of view.

I'm not saying we should ban PowerPoint slides and stop presenting to each other. I'm saying, let's minimize it. Let's build a culture of analysis, dialogue, decision-making and disciplined action. Not my plans against your plans. Our plans.

Cultures don't change easily. I'll do my best to set an example. I never use PowerPoint unless it is absolutely necessary. In my experience it very rarely is. Instead I write down what I want to say, and, in doing so, discover small inconsistencies or get new ideas and insights, as the thoughts become words and sentences.

I'm sure I'll be seeing some of my words on PowerPoint slides soon. OK, as long as they help us increase the operating margins and the cash flow. Otherwise, where's the Power? And what's the Point?

...

Kind regards
Jürgen Dormann

Figure 1.10 Selected extracts from a letter from the CEO

Source: Company information.

A rigorous evaluation was needed to answer the following questions: what are ABB's competitive advantages? What is a truly sustainable strategy? And, above all, how to drive the changes necessary to move from crisis management to excellent performance – and make the changes last? This affected the interactions in the upper echelons of ABB and corporate governance patterns in general. Dormann explained:

We needed to focus on corporate governance in this situation for three reasons. Firstly, only the board can provide the orientation on the future, the required values, and the core strategy. Secondly, we needed to give leadership examples at the top for more honest communication, transparency, and focus on performance. Thirdly, the way we wanted to work together and to design an organization that supports this kind of accountable leadership needed to penetrate the organization – with no exceptions – and definitely starting at the top. The development of the new strategy is an example.

Dormann reflected on what kind of process would be appropriate for deciding on the strategy and what role, if any, the board should play.

ABB (B): The formation of the strategy committee

[By Paul Strebel, Ulrich Steger, and Wolfgang Amann]

ABB had to form a new strategy. As part of his 'back-to-basics' approach, Dormann had a weekly letter to all employees posted on the company's intranet in the 15 key local languages to keep the people of ABB informed of the key issues and the progress already made (refer to Figure 1.11 for a key sample). In his letter from 15 November 2002, he wrote:

Letter from the CEO No. 28:
We are charting a new strategic roadmap

Mar. 21, 2003 – In his weekly letter, Jürgen Dormann, says that while ABB concentrates on strengthening its core businesses, a longer-term strategic review is also being undertaken to ensure profitable growth. He spells out the next steps, and outlines some of the key questions that need to be answered. 'Everyone in ABB will feel the positive effects once our new strategy is acted upon', he says.

Dear Colleagues,

Today, I'm going to write about ABB strategy.

...

Let me now turn to ABB, and to our future. It lies in our core businesses – getting more value out of what we know best. It lies in doing what we do best even better.

We are waging an intense 18-month campaign to repair ABB's finances, focus our portfolio through divestments and restore our competitiveness. But we must also use this period to shape ABB for 2005 and beyond – so that once again we can actively lead industry developments. For that, we need a clear strategy.

The strategy starts with a broad idea – focus on the core and blossom from the core. It offers guidance and direction. It must be externally focused: what do our customers rely on ABB for? Strategy also means taking certain risks to counter the biggest risk of all – standing still.

Figure 1.11 Selected extracts from a letter from the CEO

Source: Company information.

What is our strategy for profitable growth over the next 10 years? We will use this year to find the answer. Here is how: Strategy formulation is the duty of the Board of Directors, under Swiss corporate law. So, as chairman of the board, I recently initiated a strategy review, which will unfold at three different levels. It will remain a central issue for the board. At the Annual General Meeting of shareholders on May 16, we will propose the election of two new members – two experienced industrialists – in addition to our current directors. And after the shareholder meeting, the board will create a new strategy committee.

I'm also driving this strategy project at the group management level, together with my colleagues on the Executive Committee. At the market level, top managers from Zurich and around the world are involved – from growth markets such as China and India, as well as mature markets like the U.S. and Germany, where we need to improve. Naturally, the project will build on our existing strategies, challenging them where necessary. At each level, we are supported by consultants from Bain & Company.

Implementation will begin after the board members have formulated our future strategic roadmap, based on the strategic options put before them. Not one single strategic route, but alternative roadmaps. More roads than one lead into the future. In our unpredictable world, alternative strategic scenarios are a must.

This week, we held a kick-off meeting with key managers, so I wanted to share our aspirations with you. I will continue to keep you informed as we proceed. Let me now revisit some basic issues, so you can see why we embark on this project.

ABB is a technology-based provider of power and automation products, systems, solutions and services to utilities and industry.

Our core strengths rest on three pillars – technology leadership, a pioneering spirit, and a sustainable approach to business, possible because we are at home where we do business. In other words: strong technologies, strong market presence, strong people. But despite our leadership in power technologies and automation technologies, our core businesses do not achieve the operating margins of our best competitors. Why? Are we in the right sections of the right markets? What are the right markets? Should we concentrate on solutions and service or on products and systems, or on all? Do we have too many factories, or too few, or in the wrong places? Where are the future key value-adding technologies? Do we have access to them? Do we shape them? Are our businesses linked logically, or strung together based on our historical development? Where will our customers invest? How are their value chains developing? Beyond market share, where does profitable growth come from?

As you can see, the strategy review will look at our business beyond organizational or geographical boundaries – at customer needs, market dynamics, industry life cycles, competitor dynamics, capabilities, technology and value chain. It would be arrogant – even foolish – to think that anyone holds the answers already, or that the choices we will make will be easy to implement. That's where the proof of any good strategy lies; making change happen and making it stick.

Asking questions is always the best start. We approach this with open minds, from the outside in. Relatively few people will be involved in seeking the answers and plotting our future course. But everyone in ABB will feel the positive effects once our new strategy is acted on. This is an investment in our future.

Figure 1.11 (Continued)

There are many ways to define a strategy. I, for one, save this word for the most important things, that I, as the CEO can do with the executive team. Strategy to me is a pattern of action that takes an organization to its goals. It's not planning, it's not vision. It's concrete action, making the most of our strength. Building on our leadership in power and automation technologies for utilities and industrial customers – that's our strategy put in clear, simple terms. The pattern of action – that's the execution of this strategy.³⁵

³⁵ Letter No. 12, 15 November 2002.

As a first action step, the Strategy Department, which was ‘buried’ somewhere in the Finance Department, started to report directly to him. But this clearly did not suffice to cope with the challenges.

Tobias Becker, Head of Corporate Strategy, was convinced:

When Dormann assumed responsibility, he certainly had a vision for ABB, but also needed to keep options open – at least for some time.

Dormann already encouraged direct interaction between board members and the executive committee when he became chairman in November 2001 (refer to Figure 1.12 for changes in the relationship between the board and the executive committee). He was pondering about setting up a strategy committee on the board, headed by Louis Hughes, ‘someone with extensive industrial experience’ (refer to Figure 1.13 for the intended new structure of the board). Peter Smits, Head of the Power Technology Division, would make a good secretary of this committee.

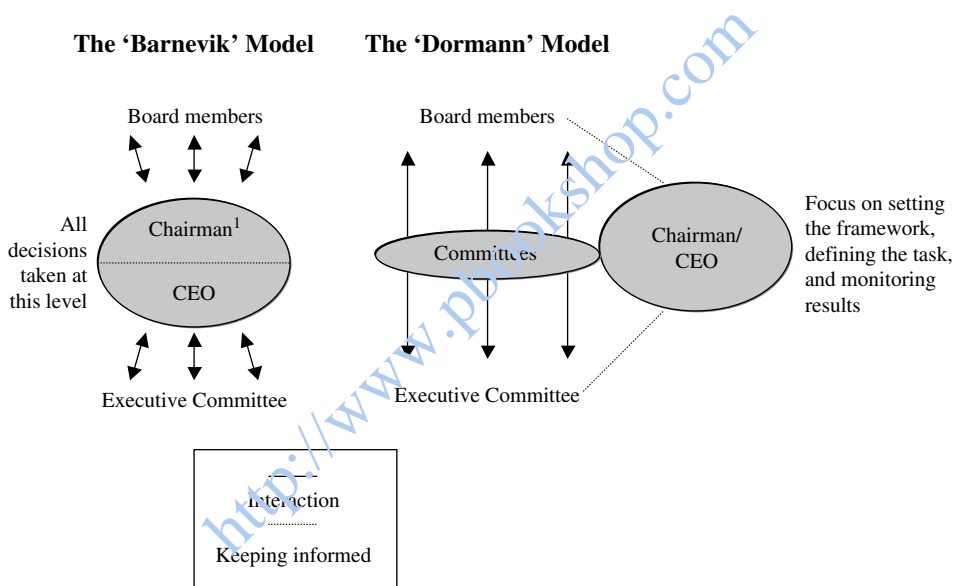


Figure 1.12 Changes in the board and the executive committee

¹ In case of separation of CEO and chairman, the two interact closely with each other and relay then to the organization and the board.

² These board committees represented both board members and managers from the executive committee.

Source: IMD.

ABB (C): The strategy committee in action

[By Paul Strebel, Ulrich Steger, and Wolfgang Amann]

Overall, the first meeting of the strategy committee went extremely well. Hughes analyzed the strategizing process:

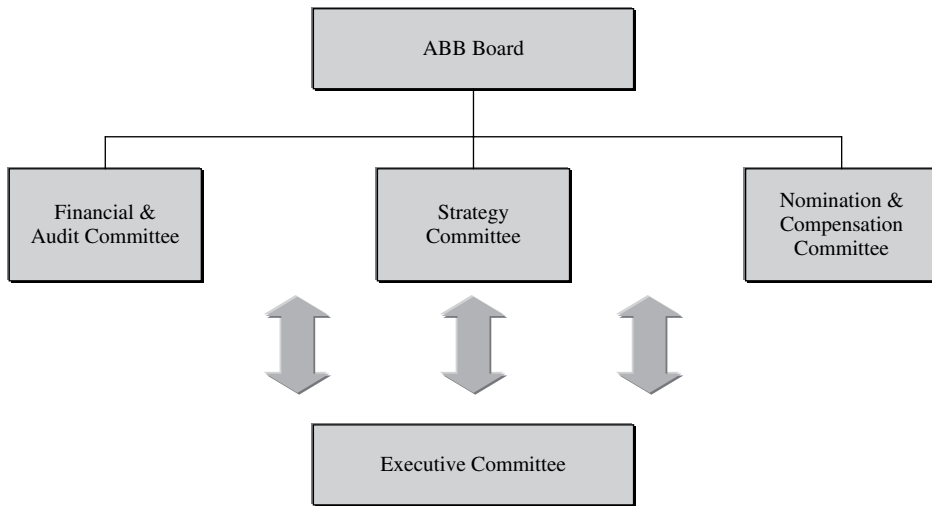


Figure 1.13 Intended structure of the board

Source: IMD.

It was like an intensive dialog. The strategy committee's starting point was: What is strategically needed for sustainable growth and value creation? The executive committee was starting to think: What is strategically possible from an operational view? And then you have to work on the issues in depth – in the end you have to find the match.

All members of the executive committee were to attend the meeting of the strategy committee, but only the full members of the strategy committee could make presentations. Dormann wondered if the meeting would fulfill his expectations. Afterwards, Hughes described the balancing act:

In this dialog, you need *fair* or *Fingerspitzengefühl* not to blur the lines between the board and executive committee's responsibilities in such an intensive process.

Since the committee consisted of highly experienced members with relevant and complementary backgrounds, it could get started with its work right away. Hughes, for example, especially contributed international experience (e.g., for North America). Michael Treschow ensured the fit between strategy and organizational design, and Hans Ulrich Märki added the structure for multiple profit and loss accounts, while the entire team agreed on a systematic approach from the very beginning. Following a clear scheme, the committee started by gathering facts as a basis for deriving prospects and priorities for the portfolio as well as the implementation phase. Progress was closely monitored. Smits remembered:

It was true teamwork. As the crisis was primarily on the financial side, it turned out to be helpful in determining where we wanted to head. Based on an in-depth analysis of facts, it crystallized very soon what was the core of the business and what wasn't. We wanted to grow further and needed to find an answer to where and how to do it. We jointly identified key enablers for future success to be tested in selected markets.

Smits also remembered how the necessary input for the strategy development process was gathered:

We proceeded with a high degree of bottom-up involvement. People from various crucial countries and functions contributed. This turned the results into more solid ones and decreased the risk of unwanted surprises. We also scrutinized the details with the Board of Directors much more than had previously been the case. Regarding the board's interaction with the executive committee, it was true coaching. Nobody stepped over his lines of responsibility.

As a consequence, the extensive interaction between the board and the executive committee at the top level entailed more involvement from the entire organization in general. Input came from throughout the organization.

The board welcomed this approach, but wanted to have Bain consultants accompanying the process from the beginning to ensure that the proceedings always remained systematic. As the entire board was more involved than before, an even better understanding of key pressure points was created. It was primarily due to this widely shared basis and understanding that good dialogs and consensus were reached more easily. Some follow up meetings were held, together with all board members. The latter received detailed information upfront, while the actual meetings were highly focused (refer to Figure 1.14 for a formalized structure of the new strategy development process).

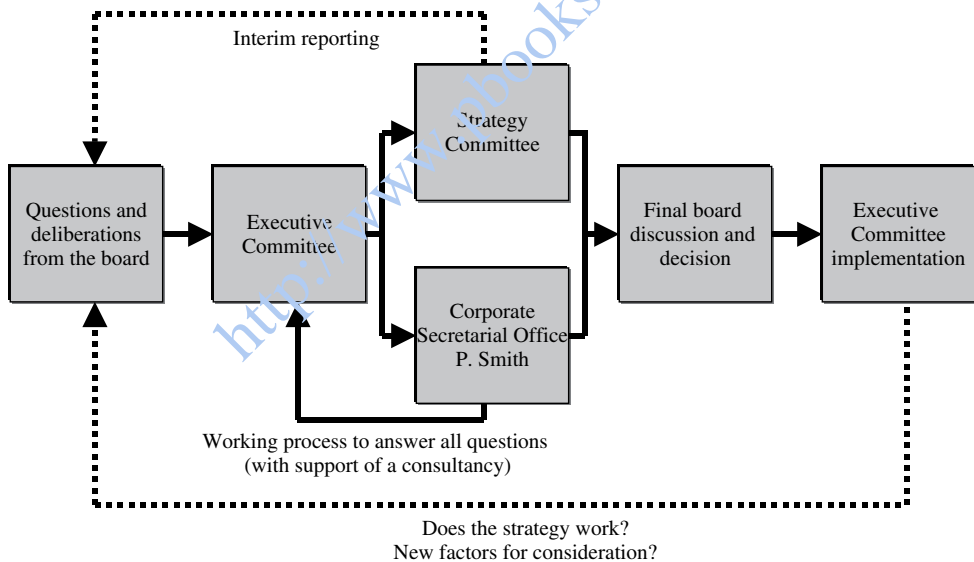


Figure 1.14 The work of the strategy committee (simplified flow chart)

Source: IMD.

During the time of the turnaround, all members of ABB's executive committee knew that the coming months would test their competence in strategic thinking, mastery of the issues and, above all, ability to implement the strategy. The committee chairman, Hughes, wrote the extensive protocol for each meeting, which he admitted sometimes took longer than

the meeting itself. Dormann was kept informed, but not leading the process. As Hughes described:

He knew what was presented and we discussed the results so far in between the meetings. We also talked about the way forward.

One issue was rigor in evaluating the facts and being ready to draw radical conclusions. One example was the Oil, Gas & Petrochemicals Division: despite previous assumptions, the potential synergies with ABB's core business were estimated at only US\$36 million. The consequence was clear: divestment. To ensure the openness of the process and thinking in terms of scenarios rather than 'right' or 'wrong', Dormann stressed, time and again:

We do not have the answers, sometimes not even the questions.

Tobias Becker, Head of Strategy, described the new process:

Strategy is more like strip mining than blast mining, meaning it is a continuous process where you work on the issues systematically one by one, depending on the life cycle of key products, which vary between 2 and 25 years, not a one-time-every-five-year event, where you turn everything on its head.

(For more details on how Dormann kept the staff up to date with the new strategic roadmap, core businesses, and strengths such as technology leadership, a pioneering spirit, and a sustainable approach to business, see the letter in Figure 1.15.) The organization understood the message. Tom Sjökvist, Head of Automation Products, shared his experience:

Letter from the CEO No. 49:
Charting the strategic road forward

Sept. 5, 2003 – A wide-ranging review of ABB strategy has been continuing, with consultations in recent weeks at different levels of the company. In his weekly letter, Jürgen Dormann looks at some of the issues raised and discussed, and says the review shows that units need to improve their ability to work together.

Dear Colleagues,

During the summer months, we have pressed ahead with our global strategic review, looking at ways of increasing profitable growth in our core power and automation technology businesses. We are seeking to define the best customer segments for our core businesses, and our ability to win within each segment. The process is driven by fundamental questions. How can we improve the way we work? How can we reach our leadership potential in markets where we are already strong?

How can we improve in those markets where we are not strong enough? How can we position ourselves better with some of our products and markets, and capitalize on key competitive advantages, such as speed? In addition, we are examining what needs to get done to increase transparency between our units that collaborate on bigger projects, and how we can speed up our internal processes.

The review is still ongoing, but there are a number of very positive indications I would like to share with you.

Figure 1.15 Selected extracts from a letter from the CEO
Source: Company information.

The way the review is being carried out has been very heartening. Working with an independent company, we conducted a deep analysis of our businesses, markets and our ability to capitalize on our strengths, at all levels – country, business area, regional, executive committee, and board of directors. The teamwork is truly global. We started at country level. Previously such research had always started at business area level. The new approach proved beneficial, drawing in another set of information and opinion.

The findings are highly informative and thought provoking. For example, our discussions with the board, both with individual members and the board's strategy committee, resulted in great input from 'outsiders' with strong business and industry backgrounds.

As part of the review, an extensive customer survey was carried out. The results confirmed our image as a market leader. ABB's quality, service and products are highly regarded by our utility and industry customers. The survey also confirmed that the ABB brand is very strong, particularly in Europe and Asia. Now, we need to translate our customers' appreciation into increased market share and profitable growth, and improve in areas where we are not so strong.

Two pieces of news this week showed how powerful the ABB brand can be. The Power Technologies division won a contract with a mid-western utility in the United States that turned to us to act as an asset management consultant on ways of strengthening grid performance in the Ohio region, and to manage the utility's transmission and distribution equipment, in the wake of the power outages in mid-August.

My colleague Dinesh Paliwal this week visited a customer based in San Diego to confirm a frame agreement. It was won against strong competition because of our brand quality. Also as part of the strategy review, a benchmark of competitors was also carried out, raising question marks about our performance in such areas as strategic cost management. This will be addressed.

It is also clear there is potential for greater synergies across our businesses, in areas such as R&D, manufacturing, raw materials, sales and technical skills, and the customer base. We could identify significant top and bottom line potential in our current businesses, allowing us to define ambitious goals. All data has now been collected and we are examining the different scenarios in detail. We will conclude this before the end of the year.

The current strategy is the correct one going forward, but it needs to be refined. Strategy never stops. There will be changes as a result of the strategy review, but they will be done in a well-planned manner so as not to upset our business progress. We are talking about evolution not revolution. The past year has shown that everyone, at all levels of ABB, is open and prepared for change – when it is clear to our people what we are changing and why.

...

Figure 1.15 (Continued)

The new management drives strategy along the lines of clear thinking. No 'strategy of the year', it's a no-nonsense approach. Better have the facts ready and know your market.

The strategy development process was only one example of how the board and executive committee worked together. A similar process was set up to develop a new HR policy. Gary Steel, member of the executive committee, described it as follows:

It aimed to link people to strategy. We spent much more time physically together, very interactive, but also with social events. We know our roles, especially that we are responsible for making the strategy work. But this mutual involvement creates commitment and the ability to tie everything together at the top.

ABB (D): Leadership in a decentralized governance structure

[By Paul Strebel, Ulrich Steger, and Wolfgang Amann]

The decentralized governance structure at ABB very much fit the leadership style Dormann developed at the helm of Hoechst. There, he had been the CFO for a long time, and subsequently CEO. At that time, he redirected Hoechst to focus on Life Sciences activities while decreasing its industrial chemical exposure. He divested specialty chemicals, and merged the pharmaceutical division with Rhône-Poulenc to create Aventis, where he first became Chairman of the Management Board and later Chairman of the Supervisory Board. Dormann had extensive experience with such restructuring. In an earlier interview he described it as follows:

My job is – besides setting the tone – to impart the principle of competition, bring in values, and exert an influence on important personal and strategy decisions. Beyond this, I tried to keep out of the business. For most issues, there is someone in the company who can do what has to be done better than I can.³⁶

When referring to competition at ABB, Dormann meant to trigger a ‘competition for more responsibility, not more turf; for more opportunity, not bigger teams; for more real results, not a bigger share of an internal cake’.³⁷ He clearly emphasized:

This is definitely not ‘soft’. First the transparency we create by not neglecting the formal process side is the basis for clear accountability and responsibility of individual managers. And secondly, it focuses on performance, results delivered and confronts everybody with the questions: Is my behavior promoting our performance? Are the values I live promoting our strategy?

This focus on the values and behavioral side explains why, in the new ‘people strategy’ for the first time after the crisis, one essential part concerned the values and business principles (refer to Figure 1.16).

Referring to a string of irregular, questionable, or even illegal activities, which caused negative headlines for ABB in 2002, Steel observed:

It was urgently needed, as the standards for the conduct of business were eroding dramatically.

As the person responsible for the Step Change Program, ABB’s productivity improvement program initiated in October 2002 (and to be finished by 2004), Steel’s message was clear:

A major and increasing part of the actions in Step Change will aim to achieve organizational and cultural change. If all we do with Step Change is to take out \$900 million, and nothing changed in ABB, we have totally failed.

³⁶ Scharmer, O. (2002). Leadership is about setting the tone: an interview with Jürgen Dormann. *The Society for Organizational Learning Journal* 4(2): 19.

³⁷ Letter No. 6, 4 October 2002.

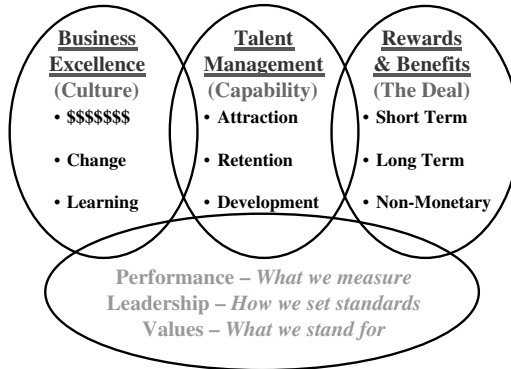


Figure 1.16 ABB people strategy

Source: Company information.

At the top of the list of changes were:

Fewer rules, but more compliance, less bureaucracy and more responsibility. This is what the board expects us to deliver – rightly so.

Another subtle change needed to get these leadership values trickling down through the organization was the style of communication. One tool was Dormann's weekly letter to all employees, addressing critical issues (e.g., the downgrading of ABB's rating, but also future growth; refer to Figure 1.17 for an example), but also setting the tone for debates

Letter from the CEO No. 51:
A plan for profitable growth

Sept. 19, 2003 – Profitable growth is key to ABB's lasting success, Jürgen Dormann writes in his weekly letter. To get there, we must recognize our strengths, simplify the way we operate, and make the most of opportunities in growth markets.

Dear Colleagues,

As we press ahead with our efforts to put ABB on a better course for the future, let us not forget the key to sustained success – growth. We must, and we will, settle the asbestos issue once and for all. We will also make our planned divestments, and ensure a sound economic base for the company. But now, as the first signs of a broader recovery are showing up in the world economy, I would also like you to think about the next chapter. And that is profitable growth.

Why is it important for a company to grow? I'll share my view with you. In the next few years, I think we will see a change in how companies are perceived by the markets. I think that given sound fundamentals, which are a must, the ability to grow organically and profitably will again be recognized as a real measure of a company's leadership, and the basis for its valuation in the markets. And here is the underlying reason for the strategic review of ABB's portfolio. We want to create a high-growth strategy. How can we do this?

...

That's how we begin to position ABB for real growth.

Figure 1.17 Selected extracts from a letter from the CEO

Source: Company information.

and good standards for interacting with one another. His criticism of the excessive use of PowerPoint presentations became legendary in the organization. In addition, Dormann believed that the focus on strategy formation at the board level perfectly fitted the Swiss model of corporate governance, where the board explicitly had overall responsibility, the so-called *Gesamtleitungsfunktion*. As he explained:

In the German model, the Management Board develops the strategy and gives notice to the Supervisory Board. In the US system, the CEO prepares, but gets real input from the Board. But in the end he does what he thinks is right. In France, in a two-tier system, the Board often changes what Management proposes and they comply. In Switzerland, the strategy is defined by the Board – and that is what I will focus on in the future.

As he sat at his desk at ABB's headquarters in Zurich, Dormann reflected on his 18 months as CEO and the challenges that lay ahead in the next 9 months as he prepared to hand over the reins of CEO to Kindle. ABB had two extremely strong fields, power technologies and automation technologies. He knew that the key question for him would be how to turn these two ships into a fast catamaran, able to outpace others. And to ensure the best navigation possible for this catamaran, he also wondered about what role the board should play after this crucial turnaround phase.

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