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It's Time To Change Outdated Corporate Models, Marc Morgenstern Leadership Interview Part 2

Greg Selker: Marc, I'm interested in your thoughts on what you think is the ideal role a Board of Directors can take in bringing about a higher level of accountability across their company's executive ranks?

Marc Morgenstern: Let's go back to my first proposition which is understanding "the mission". If we're talking about a Board holding an executive team to a higher level of accountability, my first question is – "what did the Board ask the executive team to do?" Some Boards don't actually ask their executive leadership to do anything. The executives' goals are translated as this year's budget. That's not a lot of direction.

Now I will also tell you that I have lots of maxims that I have developed through the years, and one of **"Morgenstern's Maxims"** is, "**an expectation unarticulated is a disappointment guaranteed".** The core of that is that you obviously have articulation and expectation.

So what's the desired corporate outcome? Is it change or is it innovation? Is it de-leveraging the capital structure? Is it getting more liquidity or driving higher profits? Is it increasing market share? Is it a 3 year or a 5 year goal?

Pretend for a moment that you had ten simultaneous Boards for each public company. Even if each Board was very responsible, you might still have ten legitimately different views of what the goal of the company should be; and therefore, different views on the goals the executives should be held accountable for producing.

So when you say, "holding a team to a higher level of accountability", I'm not quite sure what that means. Does it mean that if they don't reach the desired goal, they should be fired or have their pay reduced?

The consequences of that would be that executive teams would be fighting with Boards all day long to make sure that the budget and goals were lower so they didn't fail on their assigned tasks.

Greg Selker: Well, Marc first of all, I would say that a base level of accountability would be that a Board seriously engages their executive team in having this kind of discussion. Fundamentally starting with, "what are we committed to as a company?" And secondly, I would say that established goals are not only defined in financial and budgetary terms, but that they encompass values and behavioral areas as well.

Marc Morgenstern: And I agree with that. I guess part of my point is that it's a two-way street. Boards can't hold executives to a higher level of accountability until executives can hold Boards to a higher level of accountability.

Greg Selker: I agree with you 100%. And I think that we could probably forward a pretty solid argument that says that today, a Board for a complex global company that meets on a quarterly basis does not actually have enough insight into the business to even hold their executive team accountable.

Marc Morgenstern: Yes. In fact the problem is that much of corporate behavior is still driven by models that were created in the 1890's, worked in the 1950's and maybe even the 1970's, but may not work today. This is very true of the concept of quarterly Board meetings. In the 1950's or 60's, the world moved at a pace where certainly much less happened in any 3 month period than in any 3 month period now.

Greg Selker: The rate of change has accelerated not only because of our global nature, but also with the speed of decisions and actions that are being taken given our communications networks.

Marc Morgenstern: Yes. It makes sense to ask ourselves, 'what was the quarterly meeting a proxy for?' To me it was a proxy for, 'we meet often enough that we're not likely to be tremendously surprised by information that we do not know.'

And you almost have to assume that if a quarterly meeting worked in 1960, quarterly meetings do not work in today's world. And then the question becomes, "What is the right model today? Is it six times a year; twelve times a year?"

Again, the answer, depending on the nature of the company, could be different. Maybe it makes sense to go to a 2-day board meeting quarterly, and a one to three hour update every month. I think there are lots of perfectly viable alternatives. But they all depend on greater frequency of Board and management interaction, and achieving greater Board involvement. It's funny, because the Boards of many **public** companies still meet four times a year. This is always a surprise to me, because most of the **privately-held** emerging growth companies I'm involved with meet monthly.

Greg Selker: Right, and there is greater contact between the CEO, the executive team and Board Directors.

Marc Morgenstern: This also means that Directors are then more a part of pro-active planning than commenting on something that has already happened.

Greg Selker: Right.

Marc Morgenstern: So in my opinion, a critical area to talk about is how the role of the Board of Directors needs to change, but it needs to change both from a business perspective and a legal perspective.

If we look at the statutory words about Boards of Directors going back to the late 1800's and early 1900's, a Board is spoken about as a body that manages the company and oversees the executive team.

Well this was a time when businesses were all located in one city. Remember, there were no multi-state businesses until Henry Flagler figured out, on behalf of John D. Rockefeller, how to do interlocking trusts. This was in the 1860's and 1870's and represented the first time you had businesses that crossed state lines. Though for many years post this, 50-80 years, most businesses in one way or the other were local or regional. They simply weren't national. And they were smaller.

Let's translate this into today's world. If you're a really conscientious Director of a company doing $10 million dollars a year, I would bet you know an awful lot about the business, down to very small decisions being made, and you can impact these decisions and the company.

Now let's take the opposite end of the spectrum, and by the way, my observation is not driven by recent events. I've been saying this for several decades. How can anybody suggest that a Director of a company like Citibank could conceivably know what was going on in the myriad businesses, even if they spent every day, all day, talking to the CEO? How could you ever know what was going on in a business doing a billion dollars a day?

And so with scale, this means there is an inability for a Director to perform the duties charged. You're simply too far removed. In a company like Citibank, there are so many layers between a Director and the operational reality, that they're reading paper of a paper of a paper of a paper of a paper. Their data is tremendously filtered. Not because someone is trying to do something malevolent. It's filtered because you're ten thousand miles away from the operation geographically and organizationally.

And so as that separation between a Director and an asset gets farther and farther away, what do we all really think those nice people could do? They're sort of left with the only thing they can do, which is to try to do a lot of talking with senior management, and maybe the management layer below that. And after that, what else could they do?

Maybe a company like Citibank should have ten Boards of Directors as an example. You know, why is there a concept of only one Board? Why is it only at the top? Maybe we need to find a different definition? Maybe there should be three Directors for any division that's greater than a billion dollars? I can think of lots of alternatives.

But what I believe is that no matter how many people are on the Board, no matter how often they meet and how well meaning they are, there is no way that a Director of Citibank could ever really claim to have the same knowledge and involvement of the company than a Director for a $10, $50 or $100 million business. And yet it's the same statutory word, it's the same legal charge, and it's the same mission. And I simply don't think that works.

Greg Selker: Well, this makes sense to me. How do we go from this philosophical discussion of trying to alter the corporate reality of Boards, to putting it into action? What are some of the suggested steps that you believe could be taken to bringing about change, besides broadening this conversation to include more people?

Marc Morgenstern: I guess that first you'd have to get a fairly broad consensus that the overall concept of a Board of Directors is outdated. It is a buggy whip manufacturer in the automobile age. And then, we need to engage in a serious discussion knowing that this is not a one day discussion and it's not a simple answer.

Greg Selker: No, not at all. And as you said, there could be multiple, valid structures each depending upon the company and the context.

Marc Morgenstern: So the classic American approach for this would be to default to the fact that it is State law, and not Federal law, that overall governs Boards of Directors. It is the State law of the corporation that says what the Director's charges are.

And in general, different States have taken different approaches to the same problems. Over a period of time, you have enough data to say, – "You know what? The State of Maryland had what seemed like a great idea when in 1990 they passed this law. But now that we've had a chance to look at it in the real world for ten years plus, we see a lot of flaws with it."

Then Montana passed a law approaching this problem differently, and at the time we thought it was a **bad** idea. But you know what? Fifteen years later we've seen how it works, and it's really a **good** idea.

This state by state approach often leads to consensus that the three good things in the Maryland law and the two good things in the Montana law should be combined and evolve to a common standard.

But what's unsatisfying to people about this approach is that it's messy, and it takes time. And you have to allow things to play themselves out so that you can see what things work, what things don't work, and what things work okay but could be better. And that's a 5 to 20 year process.

At the end of the day, there will be a tremendously improved society, but along the way you may have had a lot of very bad individual experiences. And so we come back to the whole concept of risk and reward, but at a societal and governmental level. And to me, the benefits of that sort of experimentation justify the risk.

I think over an extended period of time to end up with the best answer to this dilemma by permitting state variation creates a very acceptable risk-reward ratio. Other people could comfortably disagree and I would understand that.

But still, almost everything in life comes down to risk-reward or cost-benefit. I'm prepared to live with short-term uncertainty and short-term failures, if in the longer run we produce a much better legal and business foundation for the next hundred years of our society. Some people would not be okay with that.

Greg Selker: Marc, you're on a number of Boards. Have you brought some of these concepts of restructuring, rethinking the core definition of what the Board of Directors is, to the companies in which you're a Board Director?

Marc Morgenstern: The short answer would be yes. But not necessarily because it was driven by me, but because I tend to be on Boards and involved with Boards of people who are at least like-minded enough that what I'm saying is not emotionally or intellectually dissonant to them.

And so what I would tell you is that I think that really smart CEO's are changing Board behavior because in theory, while it's the Board that calls the Board of Directors meeting, in the real world it's the CEO.

So number one, good CEO's attract and recruit good Boards. And good CEO's, for either offensive or defensive purposes, want more relationship between the Board and management. And I say relationship rather than meetings, because meetings are just a proxy for information exchange and relationships.

So I'm not involved with any public companies that literally only have four meetings a year. Whether they have four or six formal meetings varies. They almost all have extended phone conferences in-between meetings. They almost all provide monthly information packets that are very intelligent and well designed by management and the Board through an iterative process where management says, "I think this information or format is what's helpful". And the Board looks at it and says, "yeah that's great, but we'd like this report prepared differently", or "we'd like two more reports or whatever it is the Board thinks they need to see to get good information.

Board meetings are much longer today than in the past. There are many more off-site meetings to make sure that management isn't distracted. There are many more meetings that take place at an operating headquarters or operating division. Because that's one of the ways that a Board can get a much better feeling of the person managing a large division; we've only ever heard their name a hundred times – let's go meet the person. And let's go meet the person who's their number two or number three person.

And by the way, let's make sure that the division knows that the Board of Directors was there – that there really is a Board of Directors and they really are paying attention, and Directors are real people. And so you de-mystify some of the concepts of a Board of Directors. As opposed to what usually happens, which is, the

Board of Directors is usually only "real" to about a handful of people: CEO's, General Counsel, CFO's, COO's, and the Treasurer. All the people who typically directly and routinely interact with the Board.

The Board of Directors needs to be real to many more people. The Board can go to the people, which is a very good solution. Or, what many companies are doing is that at every Board meeting, they bring in the next three officers in a division, or the head of Sales and Marketing. People who do not ordinarily appear in Board rooms. And this person prepares and gives a presentation and is available for Q and A.

This sort of interaction creates the potential for open-ended questions and immediate management responsiveness, almost like a built-in stress test. Can this person stand up to that kind of inquiry? If they succeed, that's great. If they don't, do they go away determined to improve now that they have a better sense of how a Board of Directors thinks? Hopefully, they will.

Greg Selker: One of the best corporate practices that I've run across when it comes to Board and executive interaction, was a $3 billion company that had an annual retreat to which the executive team, plus the next layer down of the folks who were identified as high potential succession candidates, were invited.

There were group presentations made to the Board, and different Directors were paired up with executives on a rotating basis throughout the weekend, and from one year to the next. This meant there was real interaction that occurred over a 2 or 3 day period between a Director and an executive or junior executive, not just the typical two to three hour presentation..

Marc Morgenstern: I think whatever venue and whatever the format, more interaction is better than less interaction.

Greg Selker: I would agree.

Marc Morgenstern: There is real benefit to informal one-on-ones. Some people are not particularly comfortable presenting to a group that's very formal – it's not what they do all day long. But sitting talking to a human being one-on-one, is normal and comfortable, and they're much more likely to - not that they would be dishonest in the Board environment - but they would be more open and honest in a different way in a one-on-one environment.

Greg Selker: Yes, that is a different kind of interaction that's invites a deeper level of conversation and communication.

Marc Morgenstern: And the development of individual trust and intimacy. This also sets the stage for a Director to call two months later and say, "You know, I'm hung up on something we discussed, can we talk about it?"

Greg Selker: Yes, absolutely. It becomes an opportunity for mentorship for a Board Director who has more experience and knowledge to be able to impart that to a younger executive, while at the same time enabling the Director to provide some insight into who that person is to the CEO and the senior team.

Marc Morgenstern: Another benefit is that you've really both talked and listened to somebody one-on-one. If you're getting reports from them later on, you'll always read the reports differently because you'll have a better understanding that when Jane uses the word "must", she may mean it would be helpful. If John uses the word "must", he may mean this is absolutely a condition precedent. So understanding people and therefore, understanding their vocabulary, simply lets Directors listen and gather data more efficiently and effectively.

Greg Selker: So you are saying that part of the redesign of a Board of Directors is taking its mandate seriously of directing a company and become more involved, however that is structured or constituted.

Marc Morgenstern: Well, not necessarily. Because more could also be meddling. A Director can't be a micro-manager. And you probably couldn't have five Directors each calling the same person, and then each reporting back to the Board, – "Gee, I had a discussion and the person said "X", and another Director says no they said "Y". Because the Directors probably asked different questions, thinking they're asking the same question. You have to manage against disconnects.

Greg Selker: Absolutely, right. I didn't mean that the Board should begin to be engaged in the management of the operations of the company.

Marc Morgenstern: Yes. You know, there's a fine line between a Board having greater involvement, on the one hand, and end-running the CEO on the other. And you know there's a reason why, in effect, people always come to a single cusp point at which a CEO is talking to a Board. Some of that's very good, because there's a monolithic management voice saying something.

Some of that's very bad, because there's a lack of permeability between the Board and the rest of the company. So I don't think there's a simple balance, or even by the way, a balance that is true of the same company across time.

It's always changing. Probably the single greatest problem facing people generally today is the rate of change. What was a good answer yesterday…

Greg Selker: …isn't a good answer today or tomorrow.

Marc Morgenstern: And if you extended that to laws, it's the same thing. This is truly the most fundamental disconnect as we talk about Boards, regulation and accountability. The length of time it takes to put laws in place and the bureaucracies, regulatory environment and people to manage them. No matter what change you make, by the time it's spun through a system, the stimulus that caused the change, in today's world, by definition has changed. And so the final managerial or legislative response, if not inadequate, was responding to a different stimulus.

This is the same issue with a Board of Directors. Anything that we're saying right now is probably directionally accurate. But a year from now there could be a technology that would totally alter the way in which the problem is looked at, and what the best response is. This is one of the things we really haven't touched on with respect to where we began our conversation, the under-utilization of technology by the SEC, Boards of Directors and many other groups.

Why don't most Boards of Directors have (in effect) a LinkedIn equivalent with the top 50 executives in a company, or the top 10? Why isn't there an open-ended online forum? Why aren't documents being exchanged more frequently and annotated in that fashion rather than by hard copy? If you have companies that are increasingly not in one place, however the phrase "not in one place" is defined, you really have "distributed teams". Then you have to find a way to work more collaboratively.

There are so many evolving forms of collaborative software, annotation software, and community and communication software. There are devices like Skype. Most people do so much better if they're looking at someone's face while talking to them. We communicate words, and we communicate with words, gestures and body language and many other things. I don't want to **call** the CEO – I want to **see** the CEO. And yet I will just tell you that many company's IT infrastructures, including most major law firms, don't accommodate Skype. Most companies are more concerned about the security of their IT system, the **risk** side

of the equation, than the **reward** side, which is better communication. So people's personal technology access may be greater at home than in the workplace. That's a problem.

For many companies the risk-reward ratio is focused on **security**. That's largely driven by MIS and IT people. The discussion isn't driven by senior management and the Board focusing on the **reward** side of the question with the degree of priority it deserves. If somebody gives you the answer, "We can't do Skype", not too many Directors say, "Well then we've got a problem with our network infrastructure and we better change it so you **can** do Skype." They just accept it. This is disturbing and a very common pattern and something that I think needs to be talked more about.

Greg Selker: Marc, we've talked about board accountability in terms of the board's responsibility to give guidance to and develop a successful relationship with executive management; let's talk about board and corporate accountability in a different context. I'm interested in your thoughts on what you think constitute best practices around measuring, reporting and compensating performance, and in particular, if whether or not the pressures around quarterly reporting unduly influence both executive and board behavior.

Marc Morgenstern: Now we could say that quarterly measurements are good or bad. I tend to think they're bad. But as long as it is what it is, then you're going to have executive and Board behavior that are tremendously influenced by this. Even though people always decry the measurement of short term profits, the fact is, that's what is rewarded in the market place.

So if the driver of behavior is reward for short term profits, why would anyone expect a different result from rational people dealing in a known universe? And I think the answer is, you really can't.

If the Board says, we don't care what the market place thinks – we want you to do A, B and C, and the executive does exactly what the Board wants, and the Board really believes this course of action is in the best long term interest of the company over five years, the Board truly sets compensation based on its desired outcome. But in those five years, the market says, "**We're** not interested in these things. We don't have the patience for that, and we'll take your stock from $100 to $8." What happens then? Employee stock options are worth nothing and you can't attract or retain the best and the brightest. People say, "They're a fallen angel – they used to be good, but now they're bad." There's tremendous negative reinforcement – and by the way, danger.

Because if the stock price is $8, and a long term strategic buyer says, "Boy that company is worth $100, I'll go in and offer $16 and I'll tell the Board you have to take it because it's in the best interest of the shareholders because it's a 100% premium over current trading price" What Board of Directors is going to turn down a 100% premium? That's pretty tough. Make it a 200% premium on $8, I'll pay you $24. It's still worth $100.

So if it's worth more to the private market place than the public market place, guess what – it will end up in the private market place. So a lot of the behaviors we see are the self-defense of public companies who perform in the arena in which they're placed and act in accordance with the way in which they're judged.

Greg Selker: So it seems we may need to radically change both the communication mechanisms and those in which results are reported and evaluated and considered by shareholders and by the public market place.

Marc Morgenstern: Yes, but you can't do this from inside – you can only do this from outside.

Greg Selker: Well this basically brings us back to the SEC, but certainly other kinds of agencies or regulatory commissions or committees that could look at and address these issues at a more systemic level.

Marc Morgenstern: And, I could put an outrageous proposal on the table. As soon as I say it, you'll recoil - Instead of quarterly results from a public company, why don't we just give annual results?

Greg Selker: I don't recoil at all. Personally, I think that is a good idea. Because I believe wholeheartedly in the principles in which you're describing and have believed them myself for years. Short-term reporting tends to skew executive behavior to the short-term.

Marc Morgenstern: Yes, but here's why the world **would** recoil. They would say, "Well, transparency is the current God". And if you only report once a year, I don't have any transparency. So I equate **transparency** with an **immediacy** of data. And as soon as people value immediacy of data over information, then you've lost the whole battle.

And so the world says **more** reporting (and more reporting in granularity) is a good thing because that's what they think transparency is. And particularly again – going back to a world that changes so quickly. If a company went a year without reporting, it could be a completely different company. But if you're a truly long term investor, a private investor, you couldn't care less about the quarter. It's an absolutely arbitrary, meaningless measurement. It's no more logical than once every four months – or once every two months. It's just what's existed for a very extended period of time.

Let me say just one more thing. The shorter the measurement period, the more the data and less the information.

Greg Selker: Got it. So if a company has systems in place that allow accessibility and transparency of data, the difference between quarterly reporting would be a management report that consolidates that information, and says, here's what it means.

Marc Morgenstern: You know right now we have sort of a hybrid which says that it's okay to give people information quarterly, which if you're a public company, you do with the 10-Q. But there are a fair number of things that if they happen, we can't wait for a quarter to learn about them.

So for instance, you have the 8-K's which are used to report major events. If you've made an acquisition, a director resigned over disagreement on major policy, major changes in compensation, changes in the share ownership of Executive Officers and Directors, all these things go under the 8-K or Form 4 filings.

So there's a mechanism now for things in between quarters. There's a tremendous amount of work involved in a 10-Q. Outside of the filing there is the whole internal management discussion and analysis, and the external public reporting of the results with the accompanying analysis and discussion. And if you think about it, part of the obligation of public companies is to discuss trends. If I've got a year to report something, I've got a year's data to observe – I could probably tell you what a trend is or isn't. However, the shorter the period of time I'm looking at, if I look at only three months of data, it's much harder to discern what is and is not a trend. Is a "change" the effect of seasonality, is it an aberration? Is it a result of a currency fluctuation? I don't know. And to pretend that I could magically report once a month, what does one month's data really mean?

You know last year at this time, the company had 22 shipping days in January while this year, January only, we had 19 shipping days. I mean variables like that produce incredible differences. If you're a retailer looking at comparable quarters, did Easter fall in the second quarter or the first quarter? Was Christmas a six week selling season or a four week selling season?

And so it's very hard to actually give an analysis or provide information that is more than just data. I can give you the data – the sales last year were $10, and this year they were $9 – that's a $1 difference; that's

data. But what does it **mean**? I don't know. It could simply mean a shorter selling season. It could mean I had the same level of inventory and orders to be shipped, but three trucks broke down and so the shipment was delayed. Or the last shipping day of the month last year was a Friday, and this year is a Monday.

So the shorter the time period – no matter how conscientious you are, the harder it is to really give an **analysis** that is a genuine **analysis**.

Greg Selker: So in the spirit of trying to deliver accessibility and transparency, how would a company go about doing this to provide not only the immediacy of information, but also some sense as to a consolidated, kind of high level view of what this information means?

Marc Morgenstern: Well, let me address some of this at a philosophical level. As an example, every company that I've ever been involved with as a director or lawyer that has gone through the IPO process, upon their public offering, I have encouraged them to make a blanket policy statement that they **do not** endorse analyst earnings, nor do they make their own projected earnings. Just a flat out statement.

This frequently causes a lot of aggravation with the underwriters of that process. They say, 'Your stock price won't be rewarded and people won't follow you." But if you don't put yourself under the pressure of the system of projected/reported quarterly earnings, then you don't have to engage with your own projection. And every quarter if something is wrong, you don't have to say – "Oh gee, we projected 12 cents – now we think it's going to be 9 cents". And so you simply can avoid an enormous amount of aggravation by doing it this way and ultimately, it creates a safer environment.

Again, reasonable people can disagree. Some people will say, "They're not getting 20 analysts to follow me." Well maybe, maybe not. But generally, if you're a profitable, good company, analysts **will** follow you. But you will have reversed the game on them by refusing to play the way they want to play. They will still make their own estimates. There's nothing you can do about that. But it will be **theirs**, not **your** estimates. So you won't have an obligation to amend, modify and update your own disclosures. And you will make the task of being a public company much easier.

By the way, if 500 public companies all said collectively "We're not going to provide projected earnings", you would almost immediately change the whole global investment evaluation process. But that's what it would take – it would probably take 10 or 20 of the top 50 companies. If AT&T,IBM or several other large companies just said, "We're not going to project earnings. We're comfortable enough that you're going to follow us anyway." In my view, you'd create an enormously better environment because you would take the betting aspect out of it, and truly make it much more like long-term investing.

Greg Selker: So it would have a ripple effect to much smaller companies?

Marc Morgenstern: Yes, if $50 to $100 million dollar companies did the same thing on their own, it's largely irrelevant.

Greg Selker: Right.

Marc Morgenstern: This is a place where scale matters – mass matters – and branding matters.

So as is true of many things – it used to be that if it's good for General Motors, it's good for the country. I'm not so sure GM is the right metaphor anymore, but you get my point.

Greg Selker: Right. Well this kind of brings us to really talking about enlightened leadership, because I believe that's what it would take in order to bring some of these changes about. What do you see needs to happen in order to bring about this level of enlightened leadership?

Marc Morgenstern: Well I think it's a combination of enlightened leadership at an individual and a company level. But I think there are also lots of organizations like business roundtables, for example, where those leaders gather together, and that's one of the places where you can reach an agreement across 20 companies of what you think a recommended course of action is. So if an umbrella organization of enlightened leaders says to its enlightened leaders – "this is what we recommend", then you can really get change.

Greg Selker: Yes.

Marc Morgenstern: And by the way, Why don't you see activist shareholders, if they're so concerned about short term profits, why don't you see them demanding **longer term** goals and **less** reporting and **fewer** projections? And you know why. Most activist shareholders want **more** projections and **more** data allowing them to make shorter term decisions, rather than more information.

But there is no reason why genuinely enlightened shareholders shouldn't be involved in pushing for these kind of changes, as well as enlightened leaders and Boards. In fact, if the pressure for change exists from each of these perspectives, that will increase the likelihood of change actually happening.

Greg Selker: Well Marc, this has been a fascinating conversation and I know that we could talk for several more hours on additional topics. Thank you so much for your insights.

Marc Morgenstern: You're welcome Greg. This was fun and a good dialogue.