Lecture Text

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Irrational Succession:
The Role of the Board in CEO Selection

(*edited for clarity*)

Introduction

I thought I would talk to you a little bit and try to combine a couple of different things about getting to the question, "How do we improve this process?" And I have an article that will be distributed shortly that actually lists out, in terms of best-practices ideas, specifics about improving the selection process. And I think it has broader applicability, not just at the CEO level, but there are elements of this that play out for different levels of organizations.

There is another thing that I thought would be helpful to do, because before we can start recognizing where we need to go, we have to figure out how we got here in the first place. It is about, "What is the context and environment?" And we talked a little bit about this that was raised in the earlier questions, "Don't these individuals have track records?" and, "Isn't this how this works?" And I mentioned that this is actually a relatively recent phenomenon, but it's probably a little bit more of an enduring phenomenon than was originally expected.

The Age of the Celebrity CEO

We have just been living through the age of the celebrity CEO. In recent years, charismatic leadership became an important qualification for anybody who was even being considered for the CEO position. And I think today, with each passing week—if not each passing day, sometimes—the follies of relying on a process like this, which maybe sometimes produces the right person and sometimes does not, which sometimes ends up looking more like throwing a dart than a kind of rational succession process, I think, are becoming apparent to those of us who are involved in watching the leaders of probably some of our most important institutions in this country. And I think we're recognizing the folly of that.

In fact, I think we are now living in an age—at least in a business age—that's probably been unheralded with respect to the impact that it's had on business. Today, for example, business executives are actually seen as less trustworthy than Washington politicians. This is not a good thing. But there's a great deal of skepticism toward business executives, and low trust in many companies. There's an increased scrutiny, for example, on decisions that nobody would even have thought of as important, or that were of concern before, such as, "Who is your auditor?" That was not something that people paid a lot of attention to. They didn't pay much attention to the composition of the board of directors. They didn't pay attention to governance. I mean, one of the best ways that I found to put people to sleep at a cocktail conversation used to be for me to talk about my work and governance. And suddenly it's a topic that is of great interest. And I think there's a great deal of scrutiny on these kinds of decisions.

But I think, in some ways this greater reliance on this type of process, this greater reliance on outsider CEOs, highlights the weaknesses of the dismantling of what really had made, at least in western organizations, probably the envy of the world, which used to be the ability to develop people, to take people, put them inside organizations, and over time, give them the skills and the requirements that they needed to become effective managers and leaders.

And I'll show you the data for some examples of how we've moved away from what really was one of the major aspects and major characteristics of organizations that created a great deal of value not only for themselves, but also for the society in terms of employees, suppliers, investors, etc.

Now at one level, I think, we also have an opportunity here. I believe that there are periods in one's life, for example—at least individually, whether it's the death of a loved one or a major personal transition—that really give us an opportunity to reexamine our point of arrival. And I think the same thing exists for organizations and even societies. The transition from one leader to another, changes in technology, changes in external views about how people view you, give us all an opportunity to reexamine our point of arrival. And I think we exist in that kind of opportunity, to really improve the process by which we select and develop leaders in our society.

Agenda

So let me tell you about what I thought I would do in the remaining time that we have together. And I want to encourage you to interact, as well.

Let me talk about how the CEO position came to be open in the first place, in terms of something that largely had been done internally for the significant amount of history in U.S. corporations. How this, in turn, gave rise to the sort of charismatic leadership, celebrity-driven CEO model, and how that, ironically—supposedly the opening up of the CEO position to more people—actually in itself became even more closed to a restricted group of people than even internal selection had been. And how the search process—and I'm not going to spend much time on it, because we talked about it a lot already—but how the search process is conducted today.

But I'm going to talk about ways that we can think about changing the process a little bit—that I've noticed from doing some different types of research—where you can basically get away from some of the weaknesses of what we saw in the Bank One situation, and how we improve that process. And then discuss the implications, I think, broadly more for all of us, and why I think this is an important issue.

Ownership and Control

So, I am going to give you a really short history of business history. This is a course that normally takes thirty sessions and I'm going to do it in about three minutes.

Owner-managed companies

So, the way you can understand business history in the contemporary United States, at least—and this is also true for other countries—for most of the nineteenth century, in companies where the owner and the manager were one and the same person. They were often small organizations in which ownership and control were one and the same.

The managerial revolution

With the onset of the Industrial Revolution and the ability and the development of broad national markets and changes and revolutions in communications and transportation, suddenly it was possible to grow much larger companies. And in order to fuel that growth, companies would begin to get outside capital. They began to tap into capital that wasn't just the retained earnings that the company itself was generating, but in fact would sell stock to investors in order to get more money. They basically helped build the New York Stock Exchange. The New York Stock Exchange enabled this. And this was the beginning of the separation of ownership and control in the United States. Basically, increasingly, as these companies became larger, who controlled the companies became distinct at some level from who owned the companies, because companies were using this to fuel their growth, so much so, that this was actually, in fact, referred to as the Managerial Revolution. And as the robber barons who, with the Carnegies and the Rockefellers and the Fords, passed on, basically you had what were professional managers taking over these companies. And in fact, the elite business schools like Harvard and Tuck and Wharton were built in response to this demand for managers, which was very different from the demand for, say, ownership-entrepreneur owners.

Concentration of ownership
Now, we were celebrating this victory of managerial capitalism, and you can see what happened, ironically, is that just as we were sort of celebrating it things began to change. Ownership once again began to be more concentrated in terms of the total stock not among individuals, but rather among institutions.

And so you have—just as we were celebrating the peak of managerial capitalism in the 1950s and '60s—a reverse in the trend toward more concentration of ownership. It wasn't just a small group of people who owned the stock, and very dispersed were the widows and orphans, as they would sometimes refer to them. But increasingly, in concentrated forms through third-party institutions, like mutual funds, through institutional investors like pensions plans, it began to concentrate. So much so that today 60 percent of all the stock in the United States is controlled by these third parties, like institutional investors.

Decline in corporate profitability
Now, what happened during this period was very interesting. As this concentration was going up, things were happening inside companies that were quite different and very unexpected. As we were celebrating, again, the arrival of managerial capitalism, in the late 1960s overall corporate profitability began a sustained decline in the United States.

Now, in part, some of that decline was created by the oil shocks that happened in the early '70s. But even after that, performance continued to decline. Overall corporate profitability in the United States continued to decline. Now, at first, the thought was that companies were too regulated. This was the mantra that many of the corporate executives argued—that there was too much regulation in U.S. business.

Deregulation
And so beginning in the late 1970s under Jimmy Carter, and then accelerated under Ronald Reagan, a massive deregulation took place in the United States. And if you don't remember, airlines were once regulated. So they became deregulated. Financial institutions began being deregulated—savings and loans institutions. The Glass-Steagall Act began to become weaker. Trucking was being deregulated, and transportation. There were enormous amounts of deregulation taking place.

Now, what's interesting is that even after this deregulation started taking place in the 1980s, performance still declined. Originally the CEOs had blamed deregulation on unions, etc., for the decline, and when those institutions were made weaker, they had no explanation. And increasingly people started thinking, "Well, maybe the problem is the executives in the United States"; that it's not just the sort of external factors of deregulation. But it could also be that there's a problem with the people who are running this, as well.

The takeover market

And one of the consequences of financial deregulation was that a new market began to be created in the United States, the takeover market. And the takeover market began to result in, initially, smaller companies being taken over, the executives removed, and their subsequent performances being improved. But by the time we got to the mid- to late-1980s, the largest companies were all vulnerable to this takeover market. I don't know if you remember RJR Nabisco. I mean, this was a Fortune-50 company that became vulnerable to the takeover market.

Now the CEOs said, "This is not what we expected when we asked for deregulation. This is not really what we wanted," because they were increasingly being removed and forced out of their own positions. And so they began to lobby. Basically, they started with the federal government to strengthen anti-takeover laws, but they were largely met with a deaf ear in the first Bush Administration, who said, "No, this is what you wanted—deregulation. We're not going to go re-regulate the financial markets."

So executives began to operate on a state-by-state level to begin passing tougher anti-takeover laws. In the United States, corporations are not nationally chartered, but they're chartered state by state, and at the state level they found a much more sympathetic ear. And so, state by state, you began to see tougher anti-takeover laws, starting first with Pennsylvania. And pretty soon, two-thirds of the major states with most of the corporations in the United States had pretty significant laws that prevent a hostile takeover from happening very easily. And the unions supported this; the executives supported this.

The Opening of the CEO Position

Now, the institutional investors didn't really like this, because one of the major forms of disciplining device, the takeover market, now had suddenly been removed from the ability to discipline CEOs who were underperforming in their companies.

Focus on the board of directors

And so the institutional investors began to turn their targets more toward the boards on which there was poor performance and on the CEOs who reported to those boards where the performance was poor. And so what you saw in the late '80s and the early 1990s emerge was this new focus on the board of directors, the one that had sort of direct control over the CEO of the company.

And so, CalPERS and other organizations—the Teamsters with their union funds; *BusinessWeek* and the media; the Lens Fund, which was actually an institutional investing fund that would go after boards with underperforming CEOs—basically started showing up at shareholder meetings and asking very hard questions, and they began to talk about the best and the worst directors. And they started putting pressure on directors to get rid of underperforming CEOs.

And this had an enormous effect in the United States. I mean, you can't imagine—Robert Stemple being removed at General Motors, John Akers at IBM, Jim Robinson at American Express, Michael Jordan at Westinghouse, Ken Olsen at Digital. These companies were untouchable. In the era of managerial capitalism, when ownership was relatively diffuse and weak, you couldn't touch these companies. These were the largest corporations. And suddenly the largest corporations in the world, coming under pressure from institutional investors, were being able to force the dismissal of their executives.

And part of what enabled this, which was really important, was there was also part of the deregulation process that allowed for things like institutional investor—IIC and IRC—to basically coordinate their activities. It used to be forbidden in the United States, under previous regimes, that institutional investors—say, Fidelity—could coordinate with CalPERS on how they would vote, for example, for certain shareholders. They couldn't communicate. But basically, one of the consequences of asking for all this deregulation was that they allowed institutional investors to coordinate their activities. And although no single institutional investors owned a lot of General Motors, or owned a lot of IBM, together—as I had pointed out earlier—they owned a significant block where they could exercise some voice. This had a huge impact. And this is just to demonstrate that this wasn't just sort of isolated to a few big companies. This is a sample of how the 850 largest companies in the United States looked at over a seventeen-year period. And it's the probability of a CEO being fired.

So the way to read this chart is that, if you were a CEO that was appointed in the mid-1990s, you were three times more likely to be fired for the same level of performance than you were in 1980. So the hazard rate of being a CEO—the sort of occupational hazard of it—went up significantly, from where it was almost unknown to being very large. Our conceptions of what CEOs should be doing began to be changed, as well, during this time. Because part of what happened is, suddenly when you started firing all these CEOs, the question is, "Who's going to replace them? Who are you going to get?"

Leadership-consulting-industrial complex

And I think this is where the leadership-consulting-industrial complex emerged in this country. And I think the cultural marker—you know, just as we have this structural marker of the changing nature of ownership and control—the cultural marker here was really Lee Iacocca's hiring at Chrysler.

Now, it's hard to remember how well regarded this individual was. When I was a kid, I remember my parents had taken us to the celebration of the refurbishing of the Statue of Liberty. And it was on the Fourth of July, and they were unveiling the cleaned-up version of the Statue of Liberty. And there was some very polite applause when the first person was announced. And then the second person was announced. It was Lee Iacocca, and there was this huge cheer in the crowd. Now, the first person who was announced was Ronald Reagan. I mean, this guy was bigger and larger than life. He was seen as single-handedly, for example, saving a company, with the help of a $2 billion guaranteed government loan. But, you know, he was sort of single-handedly seen as credited with stopping the Japanese onslaught, in terms of manufacturing—saving an icon in the United States.

And this began to change the conception of what our CEOs should be like, right? And so the outsider-CEO who came in to rescue a company became quite important. And part of what the leadership-consulting-industrial complex began to portray was, the most important trait was not knowing, necessarily, something functional about your business, but about being a leader, right? That leadership was what was important, and that this could be navigated across a variety of settings. And, boy, did the leadership-consulting-industrial complex deliver! You know, you had Mike Armstrong at AT&T; you had Tim Koogle at Yahoo; Al Dunlap—Chainsaw Al—first at Scott Paper and then Sunbeam; Carly Fiorina at Hewlett-Packard; and the sort of poster boy for all the benefits an outsider-CEO can bring to you, being Lou Gerstner from IBM.

Personalization of the CEO
Moreover, what also changed, in some ways, is that the CEOs themselves began to be personalized, rather than the firm. And in some cases the CEO began to be known better than the firm. Part of this goes back to that changing nature of ownership and control. One of the consequences of changes in deregulation is that in the United States we moved away from what used to be called "defined benefits pension plans" to "defined contribution pension plans." And we also introduced 401(k)s, and IRAs, and those kinds of things. And suddenly, there were a lot more participants in the American Stock Market than had existed in its prior history. And one thing that people care about is their money. And so the whole business press began to become a very important part of what people paid attention to, because now they couldn't just rely on the company to pay its pension plan. They had to make investing decisions.

And basically what you saw is that there was a greater emphasis not on the companies, because for the typical person it's hard to understand the accounting that GE Capital uses, or an off-balance sheet. But they could pay attention to the person on top. And just to give you an example of the changing nature, you look at *BusinessWeek* covers of Fortune 1000 CEOs. This was the number of times the person appeared, rather than the firm or the industry, per year. And by the time we get to 1999, from what used to be one time a person would—basically the CEO—grace the cover, to a significantly larger amount. So the person began to be paid as much if not more attention to than the company. The CEO became "the brand" in some ways.

But you began to see this personalization: "How Jack Welch Runs GE"; "The Most Aggressive CEO"; "Remaking Ford," you know, the individual, right? Just take General Electric, for example. This is a company that has 300,000 people who work for it. It's probably one of the largest, most complex organizational business entities that has ever been known to modern society. And to somehow simplify the explanation for its performance to somebody who overcame a stutter when he was seven years old—and that gave him the verve to run a large, complex business—really began to be the attribution. It was Jack Welch running GE. What people often forget was that, in fact, Jack Welch was a product of GE.

And in fact, GE has, for a century, produced a string of outstanding CEOs. And moreover, if you take away the PR machine, if you take all the CEOs and value created, in terms of return to shareholders, he's seventh of all the GE CEOs. Now, he had a larger base in which he had to create this value. You know, his predecessor, Reginald Jones, was as highly regarded, if not more so, than Jack Welch himself. But we began to personalize the firm. And moreover, we also began to personalize this idea that the single individual was the most important thing for a firm's performance.

Factors affecting firm performance
So, if we want to understand firm performance, if that's what we would call in our sort of statistics lingo, our dependent variable, what are the factors that we know affect firm performance? Well we know there's, first, what industry are you in? This accounts,

depending on the study that you're looking at, for somewhere between 20 percent and 30 percent of firm performance. It's very consistent. So the best-performing mining company, over a five-year period will do less well than the worst-performing pharmaceutical company because the pharmaceutical companies have basic advantages in their industry, like patents and R&D, etc., which allow them some barriers to entry, some competitive advantage. Whereas mining, for example, is a commodity. It's very consistent with Warren Buffett's adage, which is if you take a good manager and you put him in a bad business, it's usually the reputation of the business that stays intact. So that's the first factor.

The second factor, we know, is: what is the economic climate like, the general economic climate? And we usually do this by what we call a year-to-year dummy variable. This accounts for about 15 percent of firm performance.

Now the third factor we know is what strategy the firm is following, in terms of how aligned it is around a differentiation strategy—like British Airways or Virgin Airlines—versus a cost strategy like Southwest Airlines, and the alignment around that. After that, it's statistical noise. Now, this is not to say that CEOs don't matter for firm performance.

__: How much is strategy? You didn't give a percentage for strategy.

PROFESSOR KHURANA: Fifteen percent. So, this is not to say that CEOs don't matter for firm performance. But if they do matter, they matter in much more complex and contingent ways than we typically understand them, and the way that they were typically portrayed, say, by the business media or by other people—even the theory that, say, the First Chicago directors or the Bank One directors had in their mind about what affects an organization's performance.

But you see this personalization: "Can this Man Save Chrysler?"; "Can Chris Galvin Save his Family's Legacy?" You know, this was the process that got created. Now, a lot of CEOs say, "Well, you know, it was all these guys who kind of went overboard." But they got into the self-promotion business themselves. I mean, Lee Iacocca, again, wrote the number one best seller—he created the business book category. There was no business book category before. And you could ask the people at Harvard Business School Publishing. You know, this was it. He developed it single-handedly. He had the largest best-selling biography, ever, in history. But they got into the business of self-promotion themselves. You know, "Jack on Jack"; *Jack: Straight from the Gut; A Passion to Win; Bloomberg on Bloomberg;* Al Dunlap. All of them, themselves, got into this self-promotion business, which fed this leadership complex. Go ahead, David.

__: There's something that's even more worrying, which is, how are they measured? Now, when people turn around and say, "No, actually, I want a short-term return because the change of ownership," what happens is, they measure the CEOs by that short-term return.

Investors' short-term focus
PROFESSOR KHURANA: I think this is a very important point. For example, going back to the case that we did this morning, the stock price of Bank One went up 30 percent the day it was announced that Jamie Dimon was the new CEO. Nothing had happened in the company yet. On the day it was announced that Mike Armstrong was going to be the CEO of AT&T, the market value of that company went up $4 billion. So, the expectation—the person hasn't done anything yet—began to be based on these short-term moves. How will the

market react to this? And this goes back to how the board themselves were thinking about the situation, which is, “How will the stock market react to this choice?”; “How will the media react to our choice?” with very little consideration of, “What is this in terms of the long-term implications for our company?”; “What does this mean for addressing the problems that our company is facing?” And so, Al Dunlap’s arrival at Sunbeam—you know, “Al Dunlap Done Good at Scott Paper; Al Dunlap Will Do Good at Sunbeam”—this became the kind of attribution that was made.

The fundamental attribution error
The social psychologists actually have a term for what this is. It’s called the fundamental attribution error, which is that, when we look at complex causes, we make simple explanations to explain them. So, for example, if the economy’s doing well or poorly, it’s because of Alan Greenspan. You know, it’s a little bit more complicated in terms of how that translates—not that he doesn’t have a role, but it’s a little more complicated. Probably a weaker one is that if the economy’s not doing well or poorly, it’s because of the president of the United States. You know, these are much more complicated and nuanced relationships than that simple kind of view.

You know, the way I like to think about it is the way H. L. Mencken says it. He said, “For every complex problem, there’s a simple solution. And it’s usually wrong.” This is the way I think we saw that boards and investors saw that whatever the complex problems that the companies were facing, there was a simple solution to them.

So, let’s just take three of them, for argument’s sake: AT&T, Kodak, and Xerox. These were all companies that went outside for savior-CEOs in the 1990s. Now, AT&T was a formerly deregulated monopoly with the long-distance market. After $150 billion in acquisitions by a board that didn’t even question one thing that Mike Armstrong did, the company is now in the process of unwinding those acquisitions. And what is the company today, still? A formerly regulated monopoly with a declining core market. Now the only problem is that they made $150 billion in acquisitions and AT&T went from having the best balance sheet in corporate America, with about $5 billion of debt on its balance sheet, to now having $60 billion of debt on its balance sheet, all the while now that it’s unwinding all these acquisitions that it made to become this Internet-everything company. And the only ones who’ve made money are the investment bankers that cheered on the acquisition strategy and Mike Armstrong, and the investment bankers who were cheering on the diversification strategy and Mike Armstrong.

Changing a company’s strategy
The reality is—this is another thing that I think is a really important point to underscore, and this now is going to be disturbing, and it’s always disturbing—it is very hard to change a strategy of a company. In fact, if one looks at populations of industries—the firms—it is very difficult. It is very difficult, for example—let’s take a simple industry where you would think strategy-change would be very easy—the airline industry. Boeing or Airbus will sell their planes to anybody. An airport will sell its gates to anybody. Why is it that American, Delta, United, have a hard time beating Southwest? There are lots of reasons underneath for Southwest, but you could take an industry where you would think it would be very simple to change a strategy.

So imagine if you’re in the business of AT&T with long-term, and now you’re trying to become an integrated computer service and hardware provider. These are the problems and people look for simple solutions. And then they're willing to sort of give leeway. This is not, again, to say that one shouldn't attempt to make these changes, but they should be done in a rational way that doesn't end up destroying value, but at least preserving, if not creating, value. Go ahead.

__: But isn't it the CEO who would drive that change in strategy? So, the value of the CEO is immense. They have a huge role.

The effect of acquisitions
PROFESSOR KHURANA: Potential role, through acquisitions and those kinds of things. Well, what do we know about acquisitions? We actually have some data on this.

__: Fifty percent failed.

PROFESSOR KHURANA: Right. They never achieved. But what happens in acquisitions, often, is now the CEO gets a larger empire to run. And CEO compensation—one of the first variables that determines the size of your compensation is the revenue of your firm. And so there are all sorts of perverse incentives, too, in the whole process, for how we manage this transition. And, Bob, your point is very well taken. I do think that CEOs do play a role in shaping the strategy. But if we don't recognize the constraints within which they operate, boards will have these hugely outsized expectations about, first, how quickly that will be done. So will the market. And what are the resources they need to provide to this individual in order to make sure that they're successful in this? Because two quarters later, if you haven't delivered, you get that curve I just showed you of being fired three times more likely. And so you end up with this constant churn at the top, in which people are looking for scapegoats, rather than really identifying, "How is it that we're going to move from 'Point *A*' to 'Point *B*' to solve the problems of this company?" David?

Cultural shift
__: And the core thing is that none of these people on any of those magazines you showed started those businesses. Not one of them had the entrepreneurial spirit, and courage, and risked their own livelihoods to start those businesses.

PROFESSOR KHURANA: This is such a beautiful point that you just made because I think this, in some ways, describes part of the cultural shift and the logic that happened here. Many of these individuals self-styled themselves as entrepreneurs. You know, "casual day" was introduced. If you put on a black mock turtleneck that does not mean you're entitled to the same rewards that Bill Gates or Steve Jobs was entitled to.

But what happened in these firms, also, is that these CEOs saw these young entrepreneurs, in the beginning of the high technology in the late '80s and early '90s, making all this money, and said, "Well, why am I not getting this?" And one of the things they did was they imported a mechanism called stock options that was designed for a very particular set of firms, small high-risk firms in which you didn't want to pay a lot of cash in the form of salary, and let people share in the potential upside. They took that mechanism and, in part, cheered on by some people in academia, diffused them into companies that were already running cash-flow positive and where people were making huge salaries already, to get themselves access to the kind of princely rewards that they saw entrepreneurs getting.

And you saw this kind of self-styled entrepreneur. You know, Mike Armstrong was featured on one business magazine cover riding on a motorcycle. I mean, he was a product of two of the most conservative companies in the United States: General Motors and IBM. But everybody took on this kind of image that they were entrepreneurs.

And even insiders who got selected tried to present themselves as outsiders. So you take Jack Welch, or Jack Nasser at Ford. Both of them were thirty-five-year career insiders. But somehow, instead of changing our theory to fit the facts, we changed the facts to fit the theory. Because Jack Welch came from plastics somehow he was an outsider. I mean, I remember watching the movie *The Graduate*. Plastics was like the Internet of the 1960s. Or Jack Nasser was an outsider because he was from New Zealand or Australia.

But somehow those people are such wild outsiders, so, instead of changing our theory to fit the facts, we would change the facts to fit our theory. And in fact it was a liability to be an insider. Anne Mulcahy was passed on at Xerox for Rick Thoman, who nearly brought the company to its knees, because she was insider. Rich McGinn was brought into Lucent because he was an outsider, passing over the other qualified insiders.

This was the imagery and this was the mentality that took place. Whether Istock was the right person or not, you could just see in the case of Bank One what happened in that kind of situation. The weaknesses of insiders were amplified, and their strengths were discounted. The reverse happened for outsiders, that we discounted their weaknesses. You know, “So what, Al Dunlap likes to scream and yell and belittle people? He’s a good person.”

And we would amplify their strengths more than they deserved to be, especially since the information—the only strength we were queuing off—was the performance of their company, not knowing whether it was being achieved through real growth and real means, or through padded revenue stuffing, the channels, or whatever it was.

__: I just want to make a point on Jack Welch. I think it’s unfair to compare him with Chainsaw Al, or some of these other guys. I mean, he was a product of GE, he was picked by Reginald Jones, and frankly he was, I think, very effective early on.

The myth of the all-important CEO
PROFESSOR KHURANA: I don’t want to take any credit away from him on this. All I’m saying is that he contributed, in part, to the myth that the CEO was the most important thing for a company. And he did some really great things at General Electric. I completely agree with you. He was a phenomenal CEO. I wanted to make a distinction that he got lumped in.

Let me give you an example. When I was doing my research, I would interview directors to try to find out why they selected a particular CEO, etc. And I went out to lunch with one director afterwards. And then he said to me, “Rakesh, where is *our* Jack Welch?” As if some curse had befallen his company. And I asked him, “What have you done to develop your Jack Welch?” We know lots of things that companies like General Electric, Procter & Gamble, and Johnson & Johnson do to create more leaders than they could possibly even use inside their own companies. They invest heavily in development; they recruit largely from within; they spend months and years thinking about matching people to positions. Succession takes years, not days and weeks. Those things are actionable, whereas this director was thinking that the best hope for him was that President Bush wouldn’t outlaw cloning!

And I think that is where the danger is, Jim. It comes from that mentality. Not what Jack Welch did and paying attention to what he did at the firm, but somehow saying that *that* was the only factor that mattered. That one doesn't need to invest in processes, develop other people, and to also think about just crediting the single individual. If teamwork is important in an organization, think about when the lion's share of rewards goes to one person. Think about how that affects teamwork. Think about the situation in which one person gets the credit for activity that is supposedly a collective. You don't need a firm if what you can produce doesn't require cooperation and coordination of other people.

__: Now the only thing I would add to that, though, is if you think about the CEO's position, he is in the prime spot to determine what the portfolio of businesses will be. And so from that perspective, I think we shouldn't underestimate the importance of the CEO.

PROFESSOR KHURANA: Right. And I think, again—and it gets into a way that the CEOs are important, but in ways that are much more complex and nuanced than simply, "They show up at the door and we should send the stock price up 30 percent." So, I just want to make that distinction. I completely agree. And in fact, they also play a very important symbolic purpose in the organization. They help articulate what an organization is supposed to be, and be about.

But again this also gets into part of the issue. Leadership got simplified, and it just goes to this. We gave a lot of academic credibility to the idea that this was the only thing that mattered in an organization. There were lots of books—*Primal Leadership*, *On Becoming a Leader*—and these were colleagues and friends of mine. But I think often what happened is that their message got oversimplified, and that this legitimated the idea that all that mattered was who your CEO was. It didn't matter what their functional background was. Even in the case of Jamie Dimon. He was being considered for jobs at Home Depot, Amazon, Barclay's, with very little sense of what his specific skills were. He was offered opportunities in all those other places. And I think this is where it doesn't matter what those substantive skills are. What matters, simply, is what your symbolic skills are.

And also, you know, political and social capital in an organization matter. Followership matters. Now, you could appoint the greatest leader, but if people don't give them the authority—because they believe they're not legitimate, or they were selected illegitimately—you can't get anything done. You can ask lots of presidents of companies, and new outsider CEOs, about their opportunity to affect things when they can't get everybody behind them.

The analysts' view
Part of this also, I think, is that even the people we pay to be skeptical were taken in by this entire image. So these are some examples. These are analysts. There was a huge rise in the number of analysts in the United States, because of the large number of participants in the stock market. And this is how they would react. These are people we paid to be skeptical. "We're psyched. The stock is going higher and higher." This is about George Fisher's selection at Kodak: "A world-class executive. We certainly think he has the ability to solve Kodak's problems. He's also the right age. He's got lots of vim and vigor left, and I think it's going to work out well." I mean, Kodak's biggest problem is digital photography. The gross margins in digital photography are a fraction of the gross margins in chemical photography. And no matter who you put in there, it's not going to change that basic idea.

"AT&T appears to have gotten the superstar CEO it needs to firmly guide the company through the transition from the fully current long-distance oligopoly to a fully competitive U.S. and Global telecom world." "This should satisfy any investors that might have been worried that Skilling might go elsewhere. There's a huge premium of Enron stock related to management quality, and Jeff is at the helm." It is this kind of crowding out of the rational thinking about how Enron really makes its money. How did GE smooth its earnings, which is a statistical impossibility, for twenty-one years, to meet, to the penny, in a large complex business that's operating across the world? The role of GE capital, and the way they've managed and accrued for acquisitions? This forces out rational critical thinking. So whatever Jack Welch has done, it in many ways creates a phenomenon in which undue deference is given to that individual. And whatever rewards they have the chutzpah to ask for are granted to them.

The Search for a New CEO

I think there is a lot more skepticism that's being built into the system right now, in fact, both legally, as well as boards of directors have become more skeptical. My worry, for example though, is the following. If one simply looks at—and I continue to do research here—the spec sheets that are now generated for CEO searches, you're seeing things like "vision" and "mission" being replaced with "integrity," "authenticity," and "values." So all we've done is replace one set of personality characteristics with another set of personality characteristics. So the same shibboleths are being used. And my worry is that it's still not starting in some ways with a rational succession process.

The composition of search committees

And so, for example, if one would go back—and I just turn to this slide—if we looked at how the composition of the search committee was even done in Bank One, or, in cases of most firms, the way it's done is actually a voluntary process. The way most firms do search committees is, "Who has their most time on their hands?" Not people who have the deepest understanding of the company's problems. Not the people who have the deepest understanding of the culture or the environment. There's no explicit attention paid to who makes up the search committee. And so what ends up with search committees? People end up choosing people who remind them of their favorite person—themselves.

And so, as a result of that, I'm still not convinced that we've moved quite away from understanding that we should be focusing on the processes by which we develop leaders, rather than, "Now we want people of integrity and authenticity." Well, nobody ever denies having integrity and authenticity, by the way. It's not something you can actually easily observe, unless you grow people from within and actually see whether what they say is consistent with their actions.

The specification sheet

We talked about some spec sheets and about how useful they were. In one of the interviews I did, Al Zeien, who was the CEO of Gillette said, "The spec sheet is the most important thing that the board agrees upon. It lays out their qualifications."

We only have a few minutes left, but if I showed you the spec sheets you would just see this list of, basically, clichés: "Decisive but integrative"; "Take-charge but very humble"—these things that necessarily even contradict themselves. And what they continue to do, not unlike the Bank One, is they emphasize individual characteristics; they're a collection of personal traits; they ignore concrete skills; very little discussion of the situational context.

There's a high degree of similarity between them. I could show you, they all look the same. If you turn to the book, there are a few of them in there. You can't tell what industry is for what person because they're grounded in nature and reason. And no normal human being could possibly meet them. And I think what happens is that the spec sheet itself, in firms in which they do this well—so now I'll use GE as a good example—was they basically spent a lot of time thinking, "This is a natural punctuation mark for us in the organization. What does the strategic context look like? What are the skills that we're going to need, not only in our CEO but in the Executive Team, to meet that strategic context? What kind of cultural impact will that person have on our organization?" So you could really use the spec sheet. In some ways it's useful.

So it's not something you put together and then never look at again, and just end up comparing candidates against each other and who has the nicest personality. But you actually use the spec sheet as a kind of strategic document that helps you guide and compare the skills that you believe are going to be necessary, against the skills of that person. So you're not just looking for Michael Jordan. You're looking for the skills *like* Michael Jordan. But what happens is that they end up focusing, otherwise, just simply on the individual, giving them undue negotiating ability and control over the board.

Boards need to be involved in the process of developing CEOs. They can't simply just rely on the CEO to do it, and not know who the candidates are, and simply have one presented to them. I think part of this, again for the spec sheet, is to think through how an insider would be treated versus an outsider.

But, again, these are the things that you could really use as a deliberate process rather than as a Rorschach, where you just sort of project what it is you think is important about leaders. And really use it as a way of guiding what the direction of the firm is. Because if you don't know where you're going, anyone is going to take you there. And so you would be less susceptible to sort of the charismatic personality aspects of this.

Candidate identification
One of the things that we talked about was that following the spec sheet, they begin the candidate identification. And I just want to show some generalization of that. You can't simply expect the search firm to identify these candidates. That is not what happens in the way search firms are doing it. Moreover, search firms are not as capable of evaluating CEO talent as those who've managed and led. And I think this is an important aspect of it.

As I had mentioned, the career backgrounds of search consultants is not very much in having managed and led, but often more in individual contributor-type of roles, like in investment banking or management consulting. But what search firms can be used for effectively is to manage the expectations of the directors and the candidates. And so there is a very useful role for them, but I think it's a different role than the one that we've come to expect, or one that they actually currently perform.

One of the things that happens in this situation is that once you start with a more rational succession process, the issue is that you're not being interviewed by the candidate anymore. Rather, you're doing the interviewing of the candidate. Moreover, because you've had some real definitive skills, you're not just going after the usual suspects, but rather have a broader choice among which to choose people.

And so, you can be more realistic. In the case of Jamie Dimon, you could say, "Look, there might be a chance you don't get this job at the end of this process." And you can also be clear with the board, "Look, there's a chance that there's still a lot more to do, even if you hire this person. You can't just simply say, 'Okay, we hired him and now we can walk away from any more responsibility,' and two years later come back and fire this individual. But, rather, create the conditions for this person to be successful."

And I think search firms can be useful in that. They can also be used to basically help create a good working relationship between the boards and the CEOs. This article that will be coming out actually talks a little bit about some of those aspects of this issue.

One of the things that I wanted to demonstrate was some of the insights that you guys had, which is, where are the CEO candidates coming from? Right now, the idea was that they're coming from a very narrow pool. And I like this last quote in particular, which is, "The first hurdle for myself is the laugh test. If we actually named this guy and told the employees and shareholders that he was the new boss, what would they think? Then there is a tendency to find people who look like the job. You start by whacking down the job to a set of alternatives. So you consider things like performance, the company, the company they are coming from, and who they have worked with." "From there, you start to find people who look like the position."

And that actually ends up being fairly true in predicting who the pool is from which outsider CEO candidates are being chosen. So rather than getting more variance into the system, which we would like to do when we go outside, we actually get a lot less variance. Seventy-five percent of CEOs are already CEOs or presidents from their previous company. They're coming from high-performing companies, so they make the attribution that firm performance and CEO quality are highly correlated. Again, a much more complex and nuanced relationship than exists. And they're coming from a well-regarded company, a high-status company.

Choosing among the candidates

How do they choose among the candidates? Here's what some directors would say: "I would look at how they verbalize their thoughts, conceptual abilities, ability to express themselves clearly, talk about other people, how they rationalize their actions; their posture, mannerism, and way of dress." "I liked the subtleties of his presence, his inflections, and how he talked to others. I also liked how he was raised. He had good parents, tremendous genetics. All the right things were present: responsibility at early ages, commitment to community. I also noticed how other secretaries blushed, and seemed so genuinely glad . . ."

If this is the way we're choosing the leaders of the institutions in which we've given a vast majority of society's resources to, this is a worrisome way. These are the kinds of theories people are operating with. You know, "A top executive must have stature and pose. Someone who needs to move with focus, crisply and gracefully. They need to make the first move to shake hands—two strong shakes." "I know if they're listening if they lean forward when they sit. They should be able to lead with small talk but quickly get to the heart of the matter. They can't appear to be too easily flustered." "I have to have the impression that someone else—a secretary, or assistant—is handling the details of their life. David didn't display any of this, so he was off my list." You know when people use code words like "chemistry" and "fit"? This is what those code words are for. And we wonder why these cycles reproduce themselves in such robust manners.

Improving the Process

And I think there's a way we can begin to change this. It's about going back and amplifying the insiders, the people who actually understand the companies; people who have firm-specific skills who won't capture all the value that's created but, rather, create the value for the company and for the organization.

Why is this important? Well one thing is, I think it's just important from the idea that when you take organizational resources and give them to one individual, which don't get reinvested back into the company, which create a cynicism among investors and society's members when business is more important than ever, that this is a fixed game; that it's a sucker's game; that it's a game that not everyone can participate in with a fair hand.

CEO pay

You could just look, for example, at CEO pay. Two to one; sixty-two to one, in terms of the presidency of the United States. If the minimum wage had risen as fast as CEO pay, it would be twenty-four dollars instead of five dollars and fifteen cents. In 1980—the only reason I know this is because I presented this data last week at a conference—the ratio of CEO pay to the average worker was forty-two to one. In 1990, it was I think something like eighty to one. Today it's 562 to one.

The responsibility of boards

And I think in some ways, again, how do we start beginning to fix this process? I think some of the responsibility also relies on corporate boards. More deliberate, rational succession processes. Define the candidate pool more broadly. Avoid investing too much hope in the insider or the outsider candidate.

The responsibility of investors

Investors have a responsibility in this. They have to overturn the current consensus among professional investors about the validity of this model. Educate investors about the organizational realities that are distorted by popular myths about heroic corporate saviors. And I think part of the silver lining in all of this is that there is more skepticism among investors, who were completely uncritical here.

The responsibility of business schools

I'll even take some responsibility for this. I think, in our own educational process with our case method, it's easy to equate a sexy protagonist to some outcome. I mean, I love teaching cases like this because all of the students are so engaged and you don't have to pay attention to the tables, and the financial statements, and the strategy, and all the things like that. Because you think, "Oh, my God, it's John Reed [CEO of Citicorp]. He did it. He's the only person in the whole wide world that could have done this. And he was the right person, at the right place. Thank God we had him there. He deserves everything he got." And I think we had some role, again, to play in feeding this model, at least among the younger set, who end up being the people sitting in front of the screens and doing this.

And with that, I want to thank you very much for your patience, for staying an extra twenty minutes. And, more importantly, I actually think—with the kind of group here—I actually think the only way this things starts changing, in some ways, is if you go back to your own organizations; as you make your own hiring decisions; as you participate on your own boards of directors, and you choose, and select, and develop people. If it's not going to be you, who else can it be? We only see people for a couple of years, and maybe even for one session or two sessions. But I think, really, the impact is in the actions you go back and take in your own organizations.

You've been a really delightful audience, and I really appreciate your time here today. So thank you very much.