

*This paper makes the case for judgment as the genome of CEO leadership. The selection of a new CEO is a bet on a leader who can make great people judgments (who is on the team or off the team), strategy judgments (where we head to make money) and crisis judgments (how we deal with the inevitable crises threatening the organization). We present a framework for analyzing the leader's past judgment performance for use as a guide to project future judgment capability. Boards of Directors need to explicitly review CEO candidates past judgments, carefully discuss future judgment dilemmas CEO candidates may face, and assess how well their experiences have prepared them. The paper also lays out how to build a leadership pipeline that both assesses and develops good leadership judgment.*

## **WANTED: CEO with Extraordinary Leadership Judgment**

By Noel Tichy and Chris DeRose

CEO succession has never been more important globally as the world works its way through the worst financial crisis since the great depression. No matter where you have been in the last year, the topic of CEO judgment has been pervasive. As any thoughts of a decoupled global economy vanished, and the extent of the financial crises has worsened, everyone from investors to employees to board members was left wondering how their companies ended up in such bad shape. Many CEOs of financial institutions – Stan O Neal at Merrill, Chuck Prince at Citi, James Cayne at Bear Stearns, Fred Goodwin at RBS to name a few – lost their jobs as their flawed judgments became painfully apparent and their institutions faced failure or bail out. Many more corporate leaders will be tested in the months to come by recession, depressed consumer sentiment, and unfriendly capital markets. How well companies fare amid the crisis, we believe, will rest ultimately on the judgment of their CEOs.

First, we are not suggesting that there are CEOs who, by genetic gift, have the judgment to single-handedly lead their organizations to success in today's complex environment. There have been many academic debates regarding the forceful, visionary CEO versus the humble, soft-spoken CEO. As we look at CEOs of the future, our experience tells us that there is not a one-size-fits-all character profile. The men and women who steer corporations come in all shapes and sizes. What does unite them is that they live or die by one thing: judgment.

Leaders at all levels – especially CEOs – make judgments in three critical areas: people (who is on or off their team); strategy (the business model for future success); and crisis (handling the inevitable organizationally threatening events).

The current financial crisis has only brought into sharp relief something that the best management boards have known all along. Namely, that selecting a CEO with good judgment is critical. Eavesdrop on board discussions around the world and you hear a common theme: how do we ensure that we have a strong successor with good judgment. There are role models in companies such as P&G, Pepsi, Intel, and GE, with strong track records of preparing internal leaders for the toughest job. Understanding judgment capability in succession planning will be paramount for companies in the coming decade. Look at the Fortune 500 list and fully one-third will likely face succession in the next five years. Consider the BRIC economies, and many companies in growth markets are making this delicate leadership transition for only the first or second time.

The global demands for leadership have never been greater. To name only a few of the complex geopolitical issues facing CEOs: global economic interdependencies, terrorism, environmental issues, energy policy, changing global demographics, and wealth distribution. This perfect storm raises the bar and sets a new standard for CEOs around the world.

## **The Essential Genome of Leadership**

Judgment is the essential genome of leadership. Ultimately, a leader is judged by others on the performance of his or her organization. That performance is reliant on many factors; some large such as who to put in key jobs, while others are smaller such as how to manage a product introduction or policy change. Each of these performance factors, whether big or small, requires judgment. That is, they demand that a leader use however much data is available to know when to act and what to do. CEOs make leadership judgments in three big areas: People, Strategy, and Crisis. These determine their ultimate leadership success or failure.

The last few months have demonstrated both successes and failures in these three judgment areas. It is now well documented that the root cause of CEO failures at Lehman Brothers and Bear Stearns was their endorsement of a strategy and complex financial products whose risks were not understood. As more details have emerged, it has also become clearer that Stan O'Neal's failure at Merrill Lynch stemmed from poor people judgments. O'Neal failed to build a team that could debate and influence judgments. Looking to crises, we see the denial that led many global firms to initially assume that the credit predicament was solely a U.S. problem. Royal Bank of Scotland, for one, had just finished a capital consuming acquisition of ABN AMRO but insisted that it had little bad debt exposure and would not face a capital shortage. Only months later, the CEO was ousted and the U.K. government was required to inject new capital.

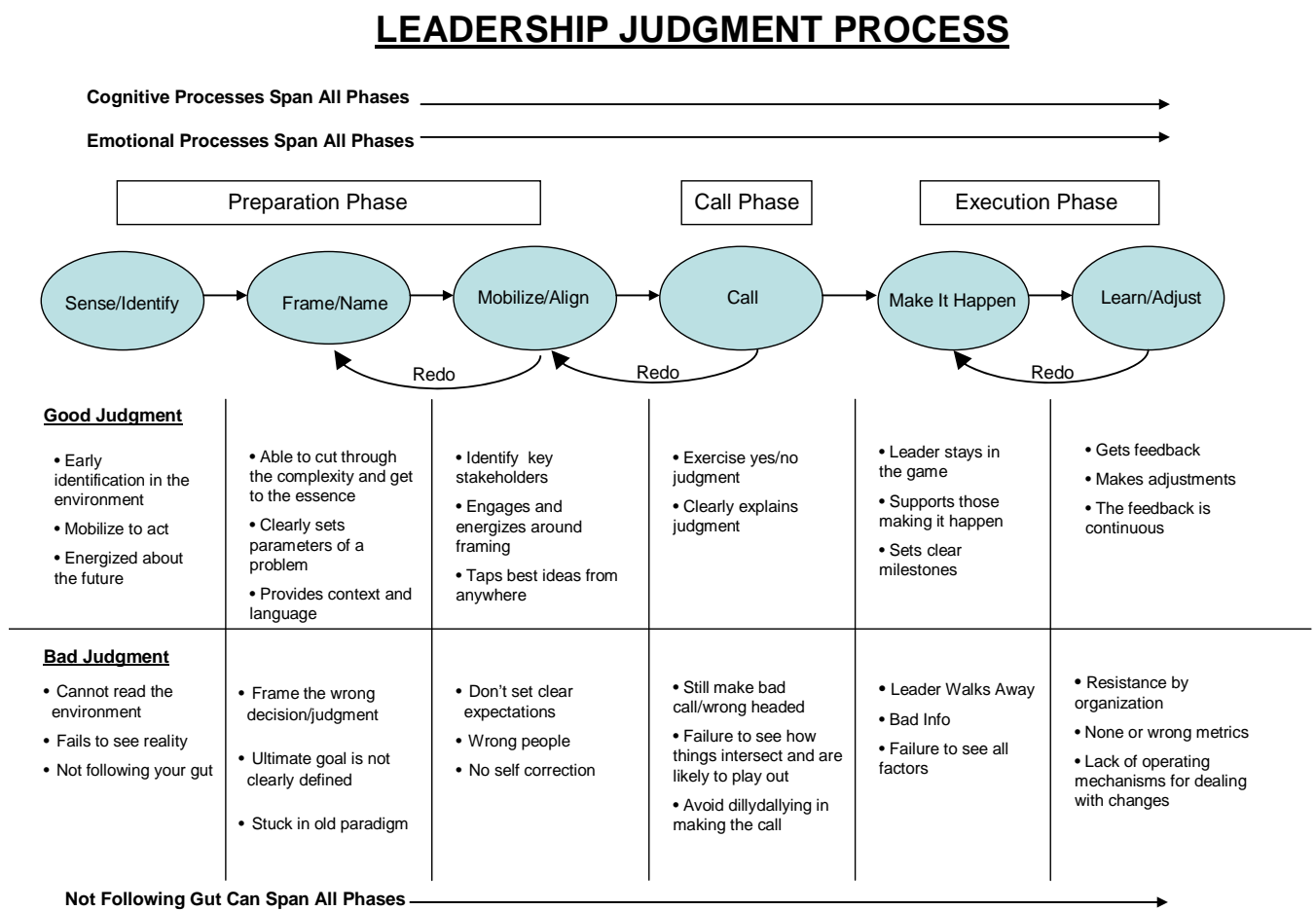
On the flip side, why is it that Jamie Dimon, CEO of JP Morgan Chase, so assiduously avoided the strategic and financial risks that toppled his competitors? And how is it that some investors – such as Warren Buffet of Berkshire Hathaway, whose investments in GE and Goldman Sachs look like guaranteed winners – so quickly capitalize on crisis?

## **Leadership Judgment Framework for Selecting a CEO**

Leaders must succeed in all three judgment domains of people, strategy and crisis. The selection of a CEO is placing a bet on good judgment. Therefore it is important to carefully understand and frame what makes good and bad leadership judgment. The process is the same for all three types of judgment calls, but the challenges differ. People calls are foundational because they influence who surrounds the

leader and who influences the biggest organizational judgments. While misjudgments in any domain can be fatal, the one where a misstep is most damaging is poor judgment about the people on your team. Only with the right people can you set a good strategy and rise to the occasion during inevitable crises.

We argue that Board level reviews and deliberations of who should be the next CEO, as well as evaluations of the current CEO, should be explicitly built around the judgment framework. The framework is used to examine a leader’s past judgment as well as guide for predicting how well the leader will do with tomorrow’s judgments.



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As Exhibit 1 shows, there are factors that contribute to good or bad leadership judgment. The leader can make mistakes and still have a good judgment outcome by using the redo loops to continuously self-correct. The test of leadership is how well the leader adapts during the process to drive a successful

outcome. There is no such thing as a good strategy in theory but lousy in execution. A leader sets her organization on a course based on the premise that it will lead to success. Recognizing execution limitations during the judgment process is as vital as having intellectual clarity about a potential breakthrough strategy. Similarly, people judgments rest on whether people put in leadership positions are able to do the job with integrity and courage as they deliver results.

Bill George, former CEO of Medtronic and currently a Harvard professor, shared a story during an interview which encapsulated the sentiment that a judgment is only as good as its outcome. During a wildly successful career that included growing Medtronic from \$1.1 billion in market capitalization to over \$60 billion, George appreciated the balance between action and deliberation. In discussing his leadership judgments he underscores an important element, good judgment doesn't mean that a leader must make the right call on the first try. Rather, as the diagram above depicts, the leader can go back to earlier stages of the judgment call process to correct mistakes. We call these "redo" loops. This openness to learning and self-correction should not be mistaken for lack of commitment. As Bill George said,

"My style is I don't second guess myself...I may be wrong and we may have to change it but I don't say, 'why didn't I do that' or 'why did I go for that'. You don't know if something's going to work until you go...You just have to hang in there because you don't know."

## The Re-Do Loop

We have yet to find a CEO who says that one of his or her most important judgments unfolded exactly as planned. In 2000, A.G. Lafley took over at Procter & Gamble, a company deep in crisis at the time. He had to make numerous judgment calls, initially focusing on people judgments. One in particular highlights the importance of the redo loop. As Lafley took over he famously put the consumer at the center, over employees and shareholders, which gave him a framework for subsequent decisions.

He quickly identified the problems that most needed solving, chief among them a serious slump in baby care, the company's biggest category after laundry. From Lafley's point of view, baby care was failing to delight the consumer, and that's because, as he put it, "the machine guys and the plant guys were running the show. ... The machine was boss." The people in charge didn't have a relationship with the consumer. Lafley then made the tough call to find a leader who could connect with the consumer, regardless of technical know-how. The candidate he selected, Deb Henretta, had come up through laundry, with no experience in baby care. She didn't care about how the machines worked. What mattered to her was an understanding of what the consumer wanted, and then making the machine work for her. She also had a reputation for brand-building and effective marketing.

Lafley felt sure of his call, but he skipped over a vital part of the preparation phase: mobilizing and aligning the team. Henretta hadn't been in the candidate pool. Lafley didn't seek his team's advice, and

the reaction to Henretta’s appointment amounted to, as he said, “almost a revolt.” Fortunately, and wisely, Lafley took advantage of the redo loop. He invited his top team to a meeting where each had a chance to make a case for a favored candidate over Henretta. He took their input seriously, but at the end of the day he still believed he’d made the right choice and then he explained in detail his reasoning—solidly grounded in his storyline, which he had relentlessly drummed into their heads. The outcome may not have satisfied everybody, but Lafley had neutralized their resistance. The important thing is that he did not try to slam dunk his decision. He made time to set the stage for success before moving on.

In the grand scheme of remaking P&G, it would have been easy for Lafley to avoid opening the staffing decision up to debate, or to have simply labeled some of his team members as resisters and ignored their criticism. However, Lafley understood that his people judgment was connected to fundamental strategic change at one of P&G’s biggest businesses – a move that would ultimately impact the company’s overall success. He also knew that without the support of his team, Henretta was destined to fail. By calling a timeout and engaging his team in a redo loop, Lafley set the necessary conditions for Henretta to revive the business and her eventual promotion to lead all of P&G’s Asia operations.

As complexity and uncertainty increase, the importance of redo loops also rises. Like Lafley, CEOs in the future will need increased sensitivity to know when to reconsider or revise their judgment calls. Knowing when to stop the music instead of letting the band play on relies on the leader to have a good sense of the industry, market conditions, stakeholders and employees.

## **Deep Knowledge Needed For CEO Judgment**

Great leaders have a high percentage of good judgment calls. Achieving this requires the leader to have knowledge that spans beyond a “just the facts” analytical capability. It requires deeper knowledge in four areas. CEO candidates need to be assessed in these areas:

- **Self-Knowledge:** Awareness of one’s personal values, goals, and aspirations. This includes recognition of when these personal desires may lead to a bias in sensing the need for a judgment or interpreting facts. It also includes the ability to create a mental storyline for how judgments will play out and the results they lead to.
- **Social Network Knowledge:** Understanding of the personalities, skills, and judgment track records of those on your team. This includes how they supplement or bias your judgment process.
- **Organizational Knowledge:** Knowing how people in the organization will respond, adapt, and execute. This also includes personal networks or mechanisms for learning from leaders at all levels in the organization.

- **Contextual Knowledge:** Understanding based on relationships and interactions with stakeholders such as customers, suppliers, government, investors, competitors, or interest groups that may impact the outcome of a judgment. This entails anticipating not only how they will respond directly to a judgment but how they will interact with one another throughout the judgment process.

Successful leaders, we've found, weave their knowledge from these four domains into a vivid and specific storyline describing their vision for the company's future. Those who are most successful talk about their storyline as though it were a movie running in their head. They are able to see how specific actors respond to situations, imagine dialogues, and envision alternate endings. As they learn more and circumstances unfold, a leader must constantly ask how new information could impact and reshape that storyline.

CEOs, and leaders in general, must increasingly have the awareness of weak signals or environmental changes that trigger the need for a new judgment. During the preparation phase, leaders are evaluating how their new knowledge fits or discomfits their storyline. Getting this knowledge requires CEOs to have networks that extend far beyond formal hierarchical and organizational boundaries. They must be able to tap into those who are on the frontline, as well as experts and analysts who sit at a distance from their organization.

Once the need for change is established, leaders must have the fortitude to make the call. The call phase is when the leader must manage the team dynamics to go from analysis and dialogue to judgment. As Jeff Immelt, CEO of GE, describes his process, he gets input from everywhere and spends time wallowing in debate with his team, then "boom, I make a decision." It is incumbent on the leader to establish the rules of engagement for the process: who will make the call, based on what, and when. If the leader fails to be transparent about who has the authority to make the final call or fails to articulate why a call is made, he risks being viewed as an autocrat by his team.

Once a call has been made, the execution phase is where the rubber meets the road. Many discussions of judgment and decision-making have ended with making the call. In reality, a call is made only to get to a desired end point. Like looking at a map and deciding which city to visit, it only gets interesting once you are on your way.

The leader's responsibility is to see the judgment through to execution. This requires personal selling, engaging directly with stakeholders, facilitating smaller judgments to make the call stick, and constantly assessing progress. As the leader learns more, he adjusts the execution plan to keep the judgment on track. The process is dynamic and, if disconnects between execution and the call occur, the leader must engage in a redo loop.

## **Assessing Judgment Capacity of CEO Candidates**

A key selection screen for any leader – and particularly a CEO – should be the leader’s judgment capacity and track record. The screen for this is a careful audit of the leader’s past leadership judgments. The best way to develop good judgment is through real life exercise; a lot of exercise with consequences and learning along the way.

The stories of HP and Dell in recent years illustrate how a CEO’s experience and judgment can dramatically impact a company’s fate. The selection of Carly Fiorina as HP’s CEO in 1999 was initially lauded by the media and most onlookers. What was overlooked was the fact that Fiorina’s most significant leadership experiences had occurred at Lucent as a sales leader during a high-growth phase in telecom. There is no doubt that HP needed strategic reinvigoration and someone to shake up its staid culture. However, while Fiorina’s sales experience helped her to shape the strategy and paint a compelling vision, she had no track record of driving operational execution. Her inability to mobilize her team and the broader organization led to unclear execution plans, job losses, and a 50% decline in market capitalization. In retrospect, there was nothing in Fiorina’s track record to suggest that she had the gritty operations experience to overhaul a badly broken manufacturing company facing constant margin pressure.

Fast forward to 2005, when Mark Hurd replaced Fiorina, and we see how experience impacts judgment. Hurd, who had spent 25 years at NCR and led a dramatic operational turn-around as CEO for two years, made few changes to the strategy that Fiorina established. As incoming CEO, Hurd framed HP’s performance crisis as one of operational execution, not that the company needed further strategic overhaul. What was different was Hurd’s ability to pick people who were operators and to build organizational routines that reinforced execution. The judgments that Hurd emphasized were operational and ensured that the company was actually on the right course.

Dell, which had been the source of most of HP’s woes since the mid-1990s, was a sleeping giant during this period. HP had long understood the operational disadvantages it faced with Dell and even knew many of the solutions. As a result of Hurd’s leadership and judgment call to emphasize execution, HP turned the tide. Within three short years, HP and Dell’s fortunes had reversed. HP was a company on the ascendency with a market capitalization twice that of Dell’s.

Meanwhile, by 1997 Michael Dell had forced the resignation of Kevin Rollins, Dell Computer’s CEO and long-time advisor cum executive. How did Dell Computer miss such a profound shift between 2005 and 2007? Rollins was the architect of Dell’s original strategy. His deep operations expertise had led to Dell’s hyper-efficient operating model. There was nothing in his judgment track record to suggest that he had experience making discontinuous strategic shifts when faced with an equally matched operational competitor.

## Developing Good Judgment

So if good judgment comes from experience, how do you develop a CEO? Organizations which develop leaders with good judgment have opportunities for early success and failure. Like an athletic team with a farm league, they have a number of posts which expose leaders to the breadth of profit-and-loss business unit experience. The succession planning process rigorously tests how leaders made judgments, their outcomes, and their ability to learn and adjust.

Creating these opportunities requires deliberate planning. Big manufacturing organizations with large capital investments have a tendency to operate as single P&L businesses. This causes difficult judgments to rise like cream for only the top leaders to address. For example, the big auto companies had few developmental assignments as people grew up in functional silos, and now suffer from a dearth of leaders prepared to handle the breadth of judgments required.

P&G is one company where leaders run multiple businesses as they move up the organization. A.G. Lafley often talks about how he had been developed to make judgment calls during crisis, particularly when running Asia Pacific. Before taking over as CEO, Lafley had lived through natural disasters that included hurricanes and the massive Kobe earthquake of 1995. That 7.2 magnitude earthquake destroyed more than 45,000 homes and killed more than 6,000 people, instantly plunging Japan into crisis. Lafley, immediately ensured that P&G's employees were safe and then began to take stock. The experience taught him the importance of facing reality and planning to ensure a leader uses all available resources in times of crisis. The typical response in a crisis is to react immediately and, indeed, Lafley had pressure coming from his bosses to *do* something.

Instead, Lafley rented an old phone building so he could assemble his Japan team and spent the next week planning. They understood the impact on their employees, customers, distribution channels and manufacturing capabilities before acting. They matched the needs of each with the resources they had available and determined who would lead which response efforts. Lafley had learned a key lesson in making crisis judgments: leaders can use time to their advantage. Not every judgment call needs to be made on-the-spot; in fact, hasty judgments often lead to poor results

Lafley took that experience to the CEO office. Despite his sudden promotion and the surprise removal of his predecessor, before acting Lafley called every major investor, reviewed P&G's technology investments for the prior 5 years, called customers and held employee sessions.

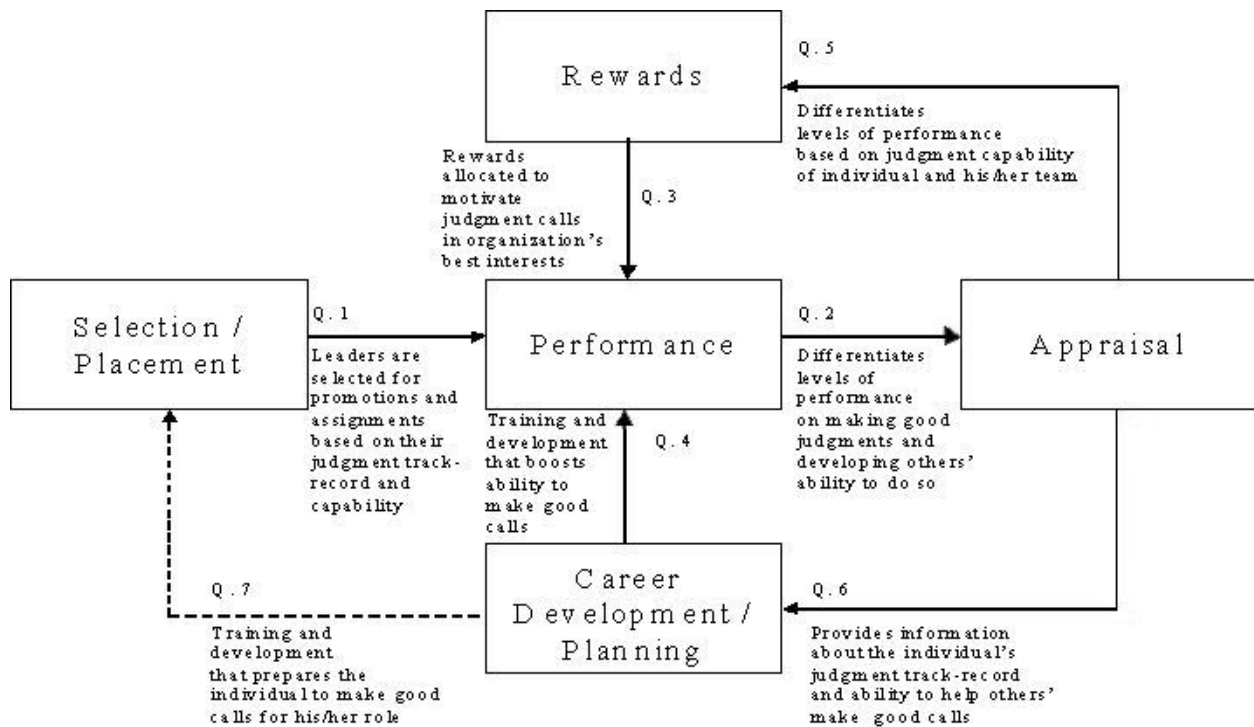
## **Building a CEO Leadership Pipeline Built on Good Judgment**

The cultivation of candidates such as Lafley starts with human resources systems designed to foster the development of leaders at all levels with good judgment. Looking at the state of outside hiring at some of the largest multi-national corporations – think 3M, Boeing, Ford, to name only a few – it is not surprising to find that HR levers in most companies do little to drive this most important leadership capability. Similarly, succession dialogues in most board rooms rarely examine the judgments that leaders have made and the conditions under which they made them.

The pipeline can only be developed by engaging the board and current CEO with human resources to build a multi-generational talent roster. Developing leaders with good judgment takes years, if not decades. Companies that fail to look seriously at the judgment capability of their leaders today will be hard pressed to find CEO candidates able to cope with the complexity of tomorrow's challenges.

(Exhibit 2 will help you assess the extent to which your HR systems aid in the development of leaders with good judgment.)

**Exhibit 2: Using HR Systems to Develop Leadership Judgment**



Q1. Leaders are selected for promotions and assignments based on their judgment track-record and capability

<i>Little Extent</i>	<i>Moderate</i>			<i>Great Extent</i>
1	2	3	4	5

Q2. Performance evaluations differentiate levels of performance on making good judgments and developing others' ability to do so

<i>Little Extent</i>	<i>Moderate</i>			<i>Great Extent</i>
1	2	3	4	5

Q3. Rewards are allocated to motivate judgment calls in the organization's best interests

<i>Little Extent</i>	<i>Moderate</i>			<i>Great Extent</i>
1	2	3	4	5

Q4. There is training and development that boosts the ability to make good judgment calls

<i>Little Extent</i>	<i>Moderate</i>			<i>Great Extent</i>
1	2	3	4	5

Q5. Appraisal differentiates levels of performance based on judgment capability of individual and his/her team

<i>Little Extent</i>	<i>Moderate</i>			<i>Great Extent</i>
1	2	3	4	5

Q6. Career development and planning provides information about the individual's judgment track-record and ability to help others make good calls

<i>Little Extent</i>	<i>Moderate</i>			<i>Great Extent</i>
1	2	3	4	5

Q7. Career development and planning that prepares the individual to make good calls for his/her role

<i>Little Extent</i>	<i>Moderate</i>			<i>Great Extent</i>
1	2	3	4	5

## Conclusion

*In this article we have made the case for judgment as the genome of CEO leadership. The selection of a new CEO is a bet on a leader with great people, strategy and crisis judgment. We have presented a framework for analyzing a leader's past judgment performance and for use as a guide to project future judgment capability. Boards of Directors need to explicitly review CEO candidates' past judgments, carefully discuss future judgment dilemmas CEO candidates may face, and assess how well their experiences have prepared them.*

*In addition to using the framework to assess and predict, there are a set of development and assessment processes the Board and incumbent CEO need to install to develop a CEO pipeline. The first requirement is to provide career opportunities for up and coming leaders to make judgments and be held accountable for them. High-potential candidates must demonstrate what they have learned from the good and bad calls, and how this will impact their future judgment performance. Ultimately, Boards and incumbent CEOs must build human resources systems that take leadership judgment into account in selecting, appraising, rewarding and developing leaders at all levels. Otherwise, there is no CEO pipeline, as HP, 3M, Boeing, Home Depot, Pfizer, Royal Bank of Scotland and many other organizations have shown.*