



# PRINCIPLES AND RULES:

## Part 1: Understanding the difference

### Why does it matter?

How leaders and supervisors choose to direct employee effort and organize resources highly influences an organization's culture. Principles and rules is a mental model that helps us understand (1) how an organization's leadership highly influences the culture of an organization, (2) the implications of various approaches to directing employee effort and organizing resources, and (3) what MBM® organizations strive to do when it comes to supervising.

This 3-part working paper covers the differences between principles and rules, what it means to have principle-based style of management, and what it means to use MBM® principles.

### Principles and Rules – *Compare and Contrast*

Companies use a combination of principles and rules to organize the way employees act in day-to-day business. Companies must choose between principles or rules as the *primary* basis to set expectations for employee behavior. Each approach has positive and negative aspects.

### What happened to “principles vs rules”?

Those who have worked at Koch Companies for several years may have heard this mental model described as “principles vs. rules.” Note that we now call it “principles and rules.” This change was made to help remind us that while we start with principles as a way to organize the business, sometimes we use rules in service of those principles. For instance, specific safety rules are used in service to our Guiding Principle of Value Creation, which describes safety excellence as a way we create value.

As an example, a culture that relies on principles as the main way of interacting with employees can help foster creativity. Yet, employees will likely have to spend more time learning the vision and culture of the organization since they cannot simply follow orders to get their work done. In contrast, a culture that relies on rules as the main way of interacting with employees will find that employees become adept at following rules. This can be beneficial in situations when prescribed steps are necessary (e.g., an assembly line where even the smallest mistake can destroy efficiency).

While most companies rely largely on principles or rules as a way of directing employees, most use a combination of both. The culture of an organization will take shape based on its main approach to doing business.

### Comparing Principles and Rules: An Overview

Principle <sup>1</sup> : <i>A guiding sense of the requirements and obligations of right conduct.</i>	Rule: <i>Prescribed way of doing something or a specific thing to avoid doing.</i>
<b>Management that uses principles as the main way to interact with employees, fosters a culture of:</b>	<b>Management that uses rules as the main way to interact with employees, fosters a culture of:</b>
<ul style="list-style-type: none"> <li>• <i>Flexibility</i> – employees can apply principles in many different ways to many different situations</li> </ul>	<ul style="list-style-type: none"> <li>• <i>Uniformity</i> – employees told what, when and how to do things, which results in things being done the exact same way throughout the business</li> </ul>
<ul style="list-style-type: none"> <li>• <i>Creativity</i> – employees have more chances to find new ways of doing things</li> </ul>	<ul style="list-style-type: none"> <li>• <i>Following orders</i> – employees have a tendency to simply follow orders because that is how they are rewarded/punished</li> </ul>
<ul style="list-style-type: none"> <li>• Coaching to help each employee develop an <i>understanding</i> of the desired state and the ability to apply principles, including <i>acceptable exceptions</i></li> </ul>	<ul style="list-style-type: none"> <li>• Enforcing all employees to <i>obey</i> the rules – and a mindset of “<i>violation</i>” if a rule is broken</li> </ul>
<ul style="list-style-type: none"> <li>• Getting comfortable with ambiguity and dealing with the unexpected (both good and bad)</li> </ul>	<ul style="list-style-type: none"> <li>• The amount of rules tending to grow, and 2<sup>nd</sup> order consequences growing along with them</li> </ul>
<ul style="list-style-type: none"> <li>• Employees focusing on the primary <i>values</i> of the organization</li> </ul>	<ul style="list-style-type: none"> <li>• Employees focusing on which <i>rules</i> to follow and when</li> </ul>
<ul style="list-style-type: none"> <li>• Accountability tends to be primarily with the person doing the work</li> </ul>	<ul style="list-style-type: none"> <li>• Accountability for outcomes when the rules are followed tends to be primarily with the rule-writer or rule-enforcer (others simply follow the rules)</li> </ul>
<ul style="list-style-type: none"> <li>• Advancing the company culture toward one of <i>entrepreneurship and responsibility</i></li> </ul>	<ul style="list-style-type: none"> <li>• Pushing the company culture toward one of <i>bureaucracy and entitlement</i></li> </ul>

### Principles vs. Rules – Understanding the difference

The natures of principles and rules are different.

**Rule:** A prescribed way of doing something or a specific thing to avoid doing. Examples of rules:

- Turn off the light when you leave the room
- Quiet hours are 10pm-8am
- All mailboxes will be painted black

Rules tend to be absolute (without exception) and describe what to do or not do. This is why breaking a rule is often characterized as a “violation.” As the examples above illustrate, rules make it relatively easy to see who is following the rules. Often administration and enforcement of rules is straightforward, and potentially costly or time consuming depending on the complexity. Rules by their nature rarely require anything more than obedience, because there is little ambiguity. This means that people cannot use their judgment to do

<sup>1</sup> The idea of principles and rules applied inside the company was inspired by what is observed in free societies. F. A. Hayek is a primary source for these observations. However, if you choose to read Hayek, he uses different language than we do for a number of reasons (including some translation issues). Hayek tended to use the terms “commands” or “orders” to indicate what we call “rules,” and “rules” to indicate what we call “principles.”

something different than what the rule prescribes, even when it would result in a better outcome. Using the examples above, turning off the light and painting all mailboxes black are specific instructions that do not offer flexibility.

In a business setting, the desire to write and enforce a rule generally comes from the desire to have employees doing something specifically intended or to stop doing something perceived as damaging. In this sense, rules can convey useful information. Take for instance a well-placed stop sign, one that tells cars to stop at an intersection that can be difficult to navigate without stopping. A sign cannot make someone stop, but stating the rule conveys the appropriate knowledge. The sign communicates “come to a complete stop.” This likely creates value because it is simple, conveys appropriate knowledge, and has rare exceptions (e.g., an ambulance getting someone to a hospital). The stop sign stands in contrast with a yield sign. A yield sign defines who has the right of way, and allows the driver to decide what is more appropriate: stopping, slowing down, continuing as is, or increasing speed. In this way, a yield sign is more like a principle because it gives a sense of who has an obligation to look out for whom without giving specific orders.

Removing a written rule can be difficult. Even if a rule is formally removed from the company policies, many people will still follow it. In this sense, rules impact cultural norms. For instance, consider a sales team with a long-standing rule that all new sales leads have to be funneled through a certain person. This rule may have been written for good reason, like giving a senior salesperson a chance to mentor an inexperienced team. Even when the rule is taken away, the cultural habit of informing that person will likely remain unless there is a conscious decision to change. In other words, rules can form powerful mental models because disobeying rules usually have swift and apparent consequences, and mental models can be especially difficult to change when they were formed out of fear of punishment.

Leaders who rely on rules as the main way of instructing and interacting with employees face a particular set of tradeoffs. Below are some things that typically happen over time when a business relies primarily on rules to direct employees:

- Employees will tend to follow the rules without thinking.
- Employees lose the desire and ability to adapt to specific circumstances (they “just follow the rules”).
- Obeying rules can become what is most important, so specific rules and the “just following the rules” attitude become embedded in the culture.
- Rules tend to grow in number. As employees change behaviors, more rules must be written to attempt to cover everything and mitigate unintended consequences.
- Rules tend to require a process of approvals, so what was originally meant to simplify becomes cumbersome.

Honoring rules is important, especially when the rules are necessary to create value and apply our principles. However, as rules become the *dominant* way to supervise employees, the negative aspects start to outweigh the positive benefits. The more a business relies on rules, the more negative these outcomes tend to be. Following rules can prevent catastrophic risks. However, as the number of rules grows, a business may become internally focused on following its own rules instead of what creates value for customers and society. Or even worse, employees start to have so many rules that even the employees who are well-intentioned have trouble keeping track of all of them.

Principles are different in nature than rules.

Principle: A guiding sense of the requirements and obligations of right conduct. Examples of principles:

- Always act with honesty
- Our products will be safe and high quality

- Buy low, sell high

Principles are applicable in many different situations and require a person to think through the specific situation in order to apply them. Since principles are guiding (as opposed to prescriptive), application of principles may take on many forms and will depend upon the circumstances. For instance, “always act with honesty” could be applied in one circumstance by telling every detail and applied in another situation by saying, “I know more than I can tell at this time.” The employee is being honest in both cases, but it still requires judgment to know the circumstances and do what is best.

Often principles have an ethical or moral component to them, like “always act with honesty.” Usually when a principle has no room for exceptions it is due to a moral component or an underlying core value that won’t be compromised. For instance, “our products will be safe and high quality” reflects core values that will not be undermined. Other principles reflect the general nature of things (like scientific principles). “Buy low, sell high” represents the general nature of business – if a profit is to be made, this is how it is done in general. There may be times where there are exceptions to this, but they must be rare (or else this wouldn’t be a principle describing the nature of business).

In a business setting, the desire to articulate principles that convey ethical behavior generally comes from a desire to have a set of values and beliefs all employees embrace. This makes it easier for companies to select employees who have similar values and beliefs. It also makes it easier for prospective employees to decide if they want to work for a company. Sometimes principles can become a part of the culture the way rules become part of a culture, through deliberate action every day. As principles evolve within a culture, the business may choose to articulate them and officially embrace them.

When a business uses principles that make good business sense (in addition to ones that tell right from wrong), generally it comes from a need for flexibility. For instance, many companies in the computer industry give employees a certain amount of time that they can work on whatever they choose, as long as it is connected to what the company does. In essence, this is using a principle to give employees some guidance on how to use their time without being prescriptive. One result is that the employees are able to pursue innovations or react to new customer requests without being hindered by prescriptive policies.

Whereas rules are violated, sometimes there are exceptions to principles that make good business sense, such as selling at a loss because of opportunity cost or a loss-lead strategy. Having a culture based on principles is more likely to create circumstances where discussion and challenge are part of day-to-day business, even when there are strongly held values. For instance, although compliance with the law is not open to debate at Koch Companies, compliance procedures can be subject to challenge. We must continually look for better and more cost-effective ways to comply with the law.

Leaders who rely on principles as the main way of instructing and interacting with employees face a particular set of tradeoffs. Below are some things that can happen with principles that may be positive or negative depending on the specifics of the situation:

- Employees are required to think and take action based on the situation.
- Application of principles can take on many forms based on employee judgment.
- Outcomes will not be as predictable as with rules – the likelihood of positive outcomes increase when a business embraces principles in combination with the right culture.
- Each employee is accountable for his/her individual actions, and their behaviors are measured against the principles of the organization.
- Accountability (reward and punishment) will not be straightforward, requiring managers to think through each situation and have the courage to use their judgment.
- Dealing with ambiguity will become part of the culture.

The more a business relies on principles, the more critical it is that all employees share the business's values and beliefs. Leaders must be more active in day-to-day coaching and working with employees to build up their abilities to apply principles. Employees will need ongoing feedback since applying principles isn't as straightforward as applying rules.

## PRINCIPLES AND RULES: Part 2: Relying primarily on principles as a management style

The way supervisors interact with their direct reports is one of the most influential factors on the culture of an organization. Culture tends to fall into two major categories – bureaucracy and entitlement or entrepreneurialism and responsibility. Culture never stands still, always becoming more bureaucratic or entrepreneurial. To understand how supervisors approach a variety of management activities that affect culture – including decision making, the use of authority and planning – it is critical to understand the difference between principles and rules, the style of principles as the default way of managing, and what it means to apply MBM® principles.

In MBM® organizations, we use a combination of principles and rules. We rely on principles as our essential way of guiding employees. We prefer to use principles for many reasons. First, we've learned from free societies (where laws tend to be principle-based, not rule-based) that principle-based behavior creates an environment where people innovate and can use their judgment to handle a situation instead of being weighed down by bureaucracy. Second, rules are only as good as the rule-writers. When a company has a rule-based approach, it primarily draws knowledge from the people writing the rules (instead of relying on people who have situational knowledge applying a principle). Third, principles are broad and allow people to use their judgment to adapt while staying true to what is important (whereas a rules-based approach often slows down the ability to adapt to the ever-changing world).

An over-reliance on rules can unintentionally work against the broader goals of an organization. For instance, an organization may create a form or database with the intention that it will help employees make career plans. Over time, the helpful job aid turns into an employment requirement, perhaps even part of a computer system that makes it mandatory for every employee to have their 5-year career plan submitted using a form. Imagine employees getting emails about their violation of company policy when they do not have a plan submitted. On the surface, this may not seem to be a bad thing – especially if it means most employees have distinct career plans. However, as a job aid intended to be a guide becomes a rule, it could destroy value primarily by wasting time or creating confusion.

Here are a few examples of how thinking in terms of violations (rules instead of principles with possible exceptions could destroy value in this case:

- An employee close to retirement has to fill out a 5-year plan and it's going through the motions.
- A supervisor fills it out without talking to an employee (or vice versa) to avoid violating the rule, and the form is meaningless.
- Rumors emerge about how the forms are being used and cause distrust (why make it required if it doesn't have some additional purpose?).

- Employees don't take it seriously because it's submitted to a computer instead of having a conversation with a caring supervisor ("it's just paperwork").

By the very nature of using rules as the *primary* way to do career development, a company can inadvertently destroy the very thing it was trying to do (help employees continuously improve and create more value in the future).

While MBM organizations prefer using principles, we recognize the value that rules can add as well. We believe rules create value when they:

- Are required to get the desired result.
- Don't conflict or contradict with our principles.
- Are applied in situations where uniformity or outcomes or consistency of behavior is so important that we are willing to give up creativity and flexibility.
- Are applied in situations where minor deviations have major consequences.
- Are kept to a level and use that does not dilute a culture of entrepreneurship and responsibility.

The following are some **poor** reasons for making a rule:

- To make things easier.
- To overcome a lack of trust in employees to be able to think through situations.
- To cover a belief that it's "too hard for employees to figure out."
- To resolve an issue, you have with a small group of employees instead of handling the situation in a principle-based way.
- To avoid the time/resource cost of building capability in employees.

We are comfortable using rules when they are *required* to get the desired result, while always keeping in mind that being over-prescriptive (using too many rules) often results in people following rules to the detriment of the larger purpose. Here are some common signs that a culture is overly-relying on rules:

- The use of rules start to overwhelm the use of principles, which generally results in being slow to adapt, losing focus on continuous improvement, and becoming internally focused.
- Employees do things to the detriment of the business – even if they don't want to – because they are "just following the rules."
- Rule and policy writing become burdensome and the rules constantly need revisiting.
- Employees have to pick-and-choose which rules to remember because there are so many of them or the rules contradict one another.
- Employees are paralyzed when they face a situation that isn't explicitly covered by the rules.
- When presented with a new problem, leaders default to writing rules versus thinking through the situation using principles. For example, setting up a detailed point system to aid with hiring instead of using principles to build capability in hiring managers.
- Leadership worries more about making and following rules than they do about doing the right thing and what makes good business sense.

A manager who understands the essence of being principle-based will approach situations differently:

- A supervisor will rely on principles when giving an employee a new assignment. Instead of telling the employee how to perform the work, the supervisor gives the employee high-level guidance about what good looks like, some things to look out for while she is deciding how to go about her work, and perhaps a detailed rule or two if there is a compliance issue or something specific she needs to do to create the value desired.

- When faced with an organizational issue, a leader will think about how to apply the principles already in place before considering new rules. For instance, an organization may have problems with compensation not being competitive. To some, it would be tempting to institute a rule to tie compensation to the 50th percentile of market survey data for each position. A leader who understands what it means to rely on principles would be more likely to find alternatives to encourage hiring managers to make pay competitive instead of writing a rule that requires treating all situations the same way.
- In a situation where minor deviations have huge risks – for instance when a customer has certain demands about a product that require exacting specifications – a leader can recognize it, call out the exception to the practice of using principles, and work to use rules appropriately.
- In a situation where we do not have the authority to establish what good looks like – for instance, when laws or regulations define appropriate action – a leader can recognize it, use rules appropriately, and communicate why he chose to use a rule.

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**Often people will ask how we avoid chaos without rules covering all areas of business.**

*We rely on our culture and use the Pay Particular Attention To Your Direct Reports model to apply principles and hold employees accountable. This means that supervisors hold direct reports accountable for their actions and must have the courage necessary to use their judgment to apply principles.*

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**What are some of the main obstacles to having a principle-based organization?**

- *Relying on principles requires a shared set of values and beliefs and a workforce that has the ability and courage to apply judgment. This is why we emphasize values during the selection process.*
- *Supervisors and leaders must have a higher degree of discipline to apply the principles in all that they do, must communicate regularly with employees and commit to building employees' capabilities to use principles. For instance, using principles in our compensation philosophy (instead of a formula), we cannot be sloppy about applying those principles. It must be clear to our employees that we are using certain principles and applying them to all employees. Much of the desire for detailed rules around something like compensation is to eliminate uncertainty or unfairness.*
- *Employees must have a tolerance for ambiguity. Many people crave detailed rules because it takes out the thinking and feels safer than using principles. While this may be true in the short run, in the long run over-reliance on rules actually destroys the abilities of an organization to create value, and the perceived value of rules or formulas is lost.*
- *An existing culture can become dependent on rules. Leaders looking to change from rules to principles should use the Pay Particular Attention To Your Direct Reports model to help each individual build the capability to apply and use principles.*

## PRINCIPLES AND RULES: Part 3: Using MBM® Principles

Using principles as a style of management is only part of what needs to be done in an MBM organization. Supervisors must be diligent about using MBM principles as the default way of doing business. This means

thinking about MBM principles when engaging in day-to-day management activities, facing problems, encountering new opportunities, dealing with supervisory issues, and so forth.

Using MBM principles as a default way of doing business, requires supervisors to internalize MBM principles, hold others accountable for applying the principles, use the MBM language, and adopt a principle-based style of management. In other words, supervisors must deliberately use MBM when making decisions in their day-to-day business. This stands in stark contrast to those who do what they would do without MBM and simply put some MBM language into their documents or presentations – and results usually bear out which path a supervisor is taking.

While the MBM Guiding Principles articulate many of MBM principles, there are others that leaders must apply as well. Studying the MBM Framework (sometimes referred to as the Blue Framework) reveals many MBM principles. The MBM Guiding

Principles and the MBM Framework do not make sense if they are applied as detailed rules. One *must* use judgment when applying these tools. For instance, there is no formula that can describe how to motivate each employee to make the maximum contribution to the long-term value of the company (the purpose of the Incentives Dimension as articulated on the MBM Framework). Trying to come up with a couple of prescriptive rules to do this is impossible. Instead, leaders must use the MBM Framework always keeping in mind it is principle-based: designed to give a guiding sense of the requirements and obligations of right conduct.

General Principles	General principles provide a guiding sense of the requirements and obligations of right conduct. For Example, “buy high, sell low” is a general business principle.
MBM Principles	MBM Principles are the general principles that are part of the MBM philosophy. For example, there is a principle in MBM that guides us to think about capabilities (as opposed to industry or products) when developing a vision or making business investments.
MBM Guiding Principles	10 specific MBM principles that are a concise articulation of the MBM culture. The MBM Guiding Principles are a subset of MBM Principles.

Examples of a supervisor relying on MBM Principles:

- A problem arises, the supervisor asks his leadership team to look at MBM Framework first to see if there are tools and mental models that can help them resolve the situation.
- When an employee makes a mistake, a supervisor will coach with the guiding principles even if the mistake is a rule violation. For instance, if an employee wears a hooded sweatshirt in an area of a facility where they are not allowed by a rule, the supervisor not only references the rule but points out that we pursue safety excellence as called out in the Guiding Principle of Value Creation.
- When an employee does something praiseworthy, the supervisor is sure to connect the specific action to value creation or other MBM principles.
- A supervisor regularly helps each of her employees see if there is an MBM mental model or tool that can help them accomplish their work better, faster, etc.
- Supervisors regularly discuss each employee’s consistency with the MBM Guiding Principles during coaching conversations, performance reviews, granting of individual decision rights, compensation reviews, and career development.
- The workplace looks like the “Indications of Progress” column in the MBM Framework, and employees exemplify the MBM Guiding Principles in all they do.
- The business is getting the desired long-term results.
- When arranging a training program, a supervisor deliberately asks if anything in the training is inconsistent with MBM or may work against the culture we’re trying to create.
- Leaders resist the urge to take shortcuts around using the Pay Particular Attention to Your Direct Reports mental model.

One example of how we use rules and principles in combination, while primarily relying on MBM principles, is our approach to supervision. We use the RR&E process, performance reviews, individual decision rights, compensation reviews, career development, and coaching, which are all based on principles, with an understanding that we always obey the law and uphold our contracts. Over time, if specific rules have arisen around this MBM approach, they should be designed to help us obey laws and meet contractual obligations, which is an example of rules adding value and helping us uphold the MBM Guiding Principles of Integrity and Compliance.

### Principles and Rules – Key Takeaways

The topic of principles and rules has various aspects and organizational implications. Here are the main takeaways:

- How leaders choose to organize, deploy and order resources within the business has a major impact on culture.
- Organizations that want a culture of entrepreneurialism and responsibility need to rely more on principles than rules, while still using a combination of both.
- At MBM organizations, we recognize that we need a combination of principles and rules, but should start with MBM principles before resorting to general business principles or rules.
- At MBM organizations, we prefer a management style of giving instructions, solving problems and directing resources by primarily relying on MBM principles, because they contribute to our culture.
- Sometimes rules can create value. We will use rules when we have to, but must be disciplined to articulate the reason. Rules often create consequences we cannot anticipate.