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Wanted: 100,000 Directors — But Who Is Qualified?

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For most of this country's history, the business community has enjoyed relative obscurity. During the past quarter century, however, business has had to open its doors to the media—from the modern muckrakers of network TV to the austere analysts of *The New York Times*.

The spotlight was first turned on during the late 1950's, focusing on the great entrepreneurs and conglomerateurs of our generation. While Jimmy Ling, H. Ross Perot, and Saul Steinberg may not have had as much recognition as Arnold Palmer or Bob Hope, they certainly did achieve a new level of notoriety for businessmen.

Then, with the collapse of some of their enterprises during the economic downturn of the early seventies, the focus of public attention turned to the professional world: the attorneys and accountants who had been victimized, along with the public, by the hoaxes of Equity Funding, National Student Marketing, and the like.

Although the storms affecting the professions have not abated entirely, the focus of attention now has shifted to the directors of the American business community. What are their qualifications to serve on cor-

porate boards? This article will neither praise nor condemn the people who fill these positions—ample speeches and pages are being devoted to both viewpoints. Rather, it will stress the glaring absence of any institutional framework to assure the business community that the corporate directors it appoints are qualified for office.

Before 1970, American corporate boards of directors operated with the undisturbed tranquility of a private men's club. This calm was rocked, however, by the 1970 collapse of Penn Central. Suddenly, the thought of more Equity Funding/National Student Marketing embarrassments created an almost perverse assumption that clinging to the wings of each business success was a seed of potential failure.

The reaction to these developments was swift. The composition of corporate boards rapidly began to change, as directors assumed greater responsibility and increasing independence. The role of non-management directors also changed. With their new responsibilities came not only demands for a more active involvement in a corporation's affairs,

but also new legal and financial risks of a personal nature.

- The Foreign Corrupt Practices Act introduced a new stratum of civil and criminal liability for individual corporate officers and directors.

- A director's responsibilities were expanded to include social and environmental concerns.

- Enforcement of antitrust laws tightened. More years of prison sentences were imposed for violation of federal antitrust statutes during 1978 than during the prior 89 years of such legislation.

- Numerous seven- and eight-figure judgments were granted and settlements made in civil damage claims, such as in the painful aftermath of the Penn Central collapse.

As if these risks were not enough, the Washington scene is now being bombarded with proposals to enlarge the responsibilities of corporate directors. The American Law Institute, for example, proposes recodification of the federal securities laws, with a broad expansion of the responsibilities and risks of directors.

Although former SEC chairman Francis M. Wheat has noted astutely that "when all is said and done about

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the new corporate governance proposals, more will be said than done," one aspect of the subject requires immediate recognition. In all this ferment, whom may we call upon to serve as the directors of public companies?

The scope of this problem is considerable. The chairman of the SEC recently proposed that public company boards be comprised entirely of outside, independent, non-management directors—except for the chief executive officer. Thus, with five to 20 board positions to be filled for each of the 10,000 or so publically owned companies registered with the SEC, the number of persons required to fill these positions is at least 100,000.

In the pre-seventies, one could serve on numerous boards. However, the current demand for active involvement sharply reduces this possibility. A survey reported by Charles Crumley in the *Journal of Accountancy* last year noted that the average public company board meets eight times a year and that the average director spends more than 95 hours annually on board activities.

Who Has The Skills?

Of concern is not the possible shortage of competent people, however, but the total absence of people fully qualified to fill these positions. At least no one in line for a director's position is fully qualified in the traditional sense, with qualifications such as training, experience, or demonstrable skills.

Training: To the best of my knowledge, no university or business school in the U.S. offers either an undergraduate or graduate level program about the requirements of public company directorships. Of course this reflects the assumption of past generations that the skills required for serving as an independent direc-

tor of a public company were indistinguishable from those required of a chief executive. Revised perceptions now call for directors to scrutinize the activities of management with a skepticism akin to that of the independent auditor; yet no movement exists, even embryonic, to develop those skills through formal training.

Experience: The new responsibilities of the director's chair are barely a decade old. Thus, most experience accumulated to date is of little value in meeting tomorrow's challenges. Who, for example, could claim the kind of experience necessary to evaluate the real difficulties of the Hooker Chemical Company in the Love Canal situation? Similarly, who could claim to have had sufficient on-the-job training in problems of product liability to have offered meaningful guidance to Firestone when it encountered pervasive problems with its primary product line?

Challenges of this sort are difficult enough from the perspective of a director's traditional responsibility to shareholders. The challenges are virtually unmanageable if, as the chairman of the SEC recently has suggested in connection with takeover disputes, public company directors also have a responsibility to "employees, suppliers, and communities." With what skills, for example, does one attempt to balance the competing interests of shareholder profitability and environmental impact?

Skills: The absence of training or experience would be of minimal concern if it were possible to identify the skills that directors need, and if one were able to test how well candidates could satisfy these new standards being established for directors. If the world offered neither training nor practice in the pole vault, one could still determine an Olympic cham-

ion, although the winning height might be considerably less than 18 feet. But we are not so fortunate in the means we possess to measure directors' skills. Traditional expectations have been so skewed by recent events and far-reaching proposals that we truly cannot say we know which direction is up.

In this era of rapid change, one might expect to receive guidance from official sources. In this case, a set of SEC directives regarding standards for measuring the performance of corporate directors at least would provide a starting point and would serve as an incentive for developing job-related skills.

Such a project was undertaken by the commission in the early seventies. After four years of apparently arduous effort, the commission announced that it was abandoning the idea because its staff was so hopelessly deadlocked over fundamental propositions that no meaningful proposal has resulted. Instead, the commission has used its enforcement program to announce standards from time to time. Consequently, a board of directors first may learn that its behavior has failed to meet the standards of the commission during the course of a proceeding in which the commission imposes sanctions upon that board.

Clearly, the resulting fabric of regulation is somewhat porous. Moreover, the rulings that do emanate tend to be inconsistent. The commission, unlike the judicial system, has never been fettered by concern over the consistency of prior pronouncements.

For example, in an amicus brief addressed to the Court of Appeals which decided the case of *Lanza vs. Drexel* 479 F.2d 1277 (2d Cir 1973) the commission declared:

"Directors have the right to rely on

the officers of the corporation to perform their functions in a lawful manner.... Absent circumstances which would put him on notice of a material failure in disclosure by the corporation, a director acting with due care and relying in good faith on officers whom he has no reason to believe are acting improperly, would not incur liability... merely by reason of his having authorized or approved the transaction."

By contrast, the commission issued the following directive in a 1978 enforcement proceeding:

"Moreover, as here, when important events central to the survival of the company are involved, directors have a responsibility affirmatively to keep themselves informed of developments within the company and to seek out the nature of corporate disclosures to determine if adequate disclosures are being made. This is particularly so since... there may be resistance on the part of management to make full and fair disclosure." *Report of investigation in the Matter of National Telephone Co., Inc. Related to Activities of the Outside Directors of National Telephone Inc.* (CCH P. 81 410, p. 88, 880—January 16, 1978).

In the short space of five years, an outside director's reliance on the good faith and honor of management has been transformed into a duty, in special circumstances, to presume the worst about management. In the two years since the National Telephone opinion, the commission has offered little further guidance in determining when those special circumstances exist, or precisely what a director is supposed to do when he thinks they exist.

Given the changing view of what directors should do, how can one determine what is expected of them, or what skills they need to do their

job well? Indeed, how is it possible to write either a job description or a set of performance standards that would aid in the selection of candidates?

Independence

There is an additional, and significant, qualification for service as a public company director. Traditional wisdom once regarded bankers, underwriters, and attorneys, who provided the corporation with professional services, as outside directors. That perception has been under strong attack by the SEC and corporate critics in recent years. The point of their criticism appears to be that an outside director should be truly independent and have no established business or professional relationship with the company. The premise of such thinking is apparently a suspicion that anyone with a fixed interest in the immediate financial success of an enterprise would have too narrow a perspective to offer proper guidance and leadership. While there are laudable aspects to this view, for me it carries the interesting consequence that those deemed best suited to be outside directors are precisely those with no direct interest in the success of the enterprise.

Those who are redefining the criteria for choosing outside directors frequently suggest that board members be selected from diverse social and economic constituencies within the communities served by the corporation. Thus, board positions have been filled increasingly by minority representatives, consumer spokesmen, and representatives of other interests. I suggest that there may be a contradiction at work here: If a banker or underwriter who deals directly with the corporation is not deemed independent, how can a

consumer representative or other representative of a constituency with its own special perspective be deemed qualified? However, that does not appear to be the trend of current thinking.

Although we may assume for present purposes that the U.S. has an ample reservoir of competent persons to serve as corporate directors, the foregoing discussion identifies all our current dilemma. We have created a gulf between the demands and risks imposed on 100,000 directors, on the one hand, and the skills expected of them, on the other. The inevitable consequence is that the most able candidates will be increasingly deterred from accepting key directorial assignments. Moreover, we have failed to develop the measurement tools necessary to distinguish between differing levels of competence and consequently cannot assure ourselves that those chosen are, in fact, qualified.

Three Options

It is not my purpose here to elaborate upon the possible solutions to this dilemma. However, I believe that some lessening of this problem might be achieved through one or more of the following devices.

First, it seems timely for the nation's business schools to consider the development of formal training modules in directorial responsibility. An articulate plea to this effect is contained in an article by Victor M. Earle, III in the July 2, 1979 issue of *Fortune*. A highly desirable by-product of academic thinking in this area might be the more rapid development of a new philosophy of corporate governance.

Second, the SEC should recognize that it has an obligation to develop through its rule-making authority—rather than through a patchwork of

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enforcement pronouncements—a broad set of guidelines for directorial responsibilities. Various commission representatives have suggested that such guidelines would constitute merely a road map for the design of abuses and violations. This is akin to suggesting that the Internal Revenue Code should never have been developed—that we should decide for ourselves how much to pay in taxes, while the IRS is free to prosecute those whose tax payments it deems insufficient. The fact is that a set of corporate directorship guidelines—sufficiently refined to deal with occasional abuses—must be a manageable project. If inconsistent objectives and responsibilities make it impossible for the commission to conclude what is right and wrong in the abstract, how can we expect more from the thousands of directors who are attempting to meet those responsibilities in their daily regimen?

Meaningful guidance in this area is available in the *Corporate Director's Guidebook*, published in 1977 by the Committee on Corporate Laws of the American Bar Association. But this valuable resource falls far short of what the SEC could contribute to resolving this problem.

Third, the development of the committee structure within boards of directors should be increased. The growth of corporate audit committees reflects wise counsel from the accounting profession, the SEC, and the New York Stock Exchange. Other oversight committees, such as the management compensation committee and nominating committee, also have begun to emerge. The New York Stock Exchange and the American Society of Corporate Secretaries conducted a recent survey which noted that although public companies had less than one third as many nominating committees as audit committees

in 1978, the number of nominating committees had nearly tripled since 1975. See the report by the ABA committee on corporate laws which appeared in the July, 1979 issue of *The Business Lawyer*.

The use of special committees does not, of course, resolve the problem of the risks and responsibilities faced by corporate directors. While the laws of most states provide directors with a limited right to rely on the work of such specialized committees, the responsibility of directors is not wholly abrogated. In fact, members of special committees are generally deemed to have a greater exposure because of their greater responsibility and the presumption that they have or will develop special skills in pertinent areas.

On balance, the committee structure seems particularly well designed to take advantage of the special skills available among board members. It also may accelerate the development of specialized experience out of which can emerge a body of standards for corporate governance.

A variety of other solutions have been proposed. For example, it has been suggested that independent outside directors should be provided with a special staff of lawyers, accountants, and advisors separate from those engaged by management. From my perspective, the development of special staffs increases the liability of directors considerably, but offers little opportunity to develop better qualities of judgment. It is also a step that is likely to breed divisiveness among board members and between the board and management. Such divisions are perceived by business leaders as being highly destructive. (See *Harvard Business Review*, September–October 1978).

Others have proposed developing a coterie of professional directors

whose full time energies would be devoted to serving on a variety of boards. Certain individuals might have the ability and the desire to dedicate themselves fully to such service, but I would hesitate to see such a caste system of directors develop. One of the values that a nonprofessional director can bring is the perspective gained from direct managerial responsibility, a factor that would be eroded if the group consisted of retired executives or persons with no managerial experience.

Conclusion

America is blessed with many highly competent people who could serve as corporate directors. The difficulty can be stated simply:

- There are probably fewer competent people than there are positions to fill.

- It is likely that many of these competent persons are dubious about, or wholly unwilling to accept, such positions.

- Those who hold corporate directorships are left with an enormous gulf between the responsibilities and risks they have as directors, and the tools and guidelines available to them to meet board needs.

We have created this condition through a series of whirlwind changes that give no evidence of abating. Since there are no overnight solutions, we now must make a significant effort to evaluate the problem and develop responsive programs.

If a single thought emerges here, it is the need for patience. Patience should temper our response to the fast pace of change, to less than ideal performances, and to all inconsistency. Patience should be our watchword until philosophy and practice catch up with the problems we face and the solutions we need. ▽