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Finding new directors: The Law of supply and demand

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FINDING NEW DIRECTORS

The Law of Supply and Demand

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What kinds of directors will we need in the 1980's and where will they come from? To answer these questions, we must look at where we stand today in developing the kinds of boards which will satisfy public expectations. In fact, determining *whose* public expectations must be satisfied is a major question for the 1980's.

This is not an academic question. The answer will significantly affect the kinds of board structures we will have in 1990 and how directors' responsibilities will be defined. Pressures for change are being exerted continuously—by the federal government, by religious groups and social-action organizations, and by shareholders holding traditional views of the fiduciary responsibility of directors and officers. Groups such as the Business Roundtable, the American Society of Corporate Secretaries, and the American Bar Association also have been heavily involved in the ongoing debate over the direction of change.

Enter the SEC

There is no question, however, that the principal impetus for change has come from the Securities and Exchange Commission. The SEC has been aided and abetted by Congress—particularly in the Foreign Corrupt Practices Act of 1977, a law which most people now agree does considerably less to eliminate overseas bribery than it does to put the SEC into the accounting and auditing departments of every domestic company reporting to the commission.

But the SEC has been active in the courts as well. No one should forget the *Texas Gulf Sulphur* case of the late 1960's, or *BarChris, Stirling Homex*, or *Penn Central*. The commission also has used with considerable effect the power of consent decrees, and it has been able to persuade companies to make substantive changes in the composition, structure, and operations of their boards. In many cases, it has required them to establish audit committees with very specific duties.

In addition, the SEC's corporate governance inquiry, which began in April 1977 and is continuing, has been a major force for change. Two annual rounds of rule changes for proxy statement disclosure have taken place already, and a third-round report is expected from the commission this year.

The State of the Art Today

Under pressure—although voluntarily in many cases, with no hint of pressure—corporations themselves have changed the way their boards work. General Motors, for example, established a nominating committee in 1972, becoming one of the first corporations to do so. Of such committees today, General Motors has one of the most highly developed. In 1968, Texas Instruments adopted a board structure which is now well known. And others, such as Connecticut General Insurance Company, Mead Corporation, and Armco Steel, are continuing to evolve the role of their boards of directors and are establishing suitable committee structures.

But generalizations can be misleading, considering the number and diversity of publicly owned corporations in the U.S. Even within the ranks of the Fortune 500 industrials, practices vary considerably with respect to the size of boards, the proportion of insiders to outsiders, the number and size of committees, the frequency of meetings, and the directors' fees. In observing the great differences between Fortune's company number 1 and those ranked 450 through 500, we can get an idea of how much greater the differences are among the companies too small to make the $410 million sales cutoff for the Fortune list this year

One generalization, however, is safe: Directors of companies most in the eye of the public and the SEC now take their jobs more seriously than they did ten years ago. As a result, the real standards of performance have been raised. Board members in these companies are putting in more time, handling new responsibilities along with the traditional ones. An additional impetus for such performance is the rule adopted by the SEC in late 1978, which requires corporate proxy statements to disclose the functions being performed by three major committees—audit, compensation, and nominating.

But not everyone agrees that such committees are necessary, especially people in smaller companies. The American Stock Exchange, for example, adopted a rule in December which encourages its listed companies to establish audit committees. The SEC's enthusiasm for the new rule has been somewhat restrained, however, inasmuch as it is only a *recommendation*, compared with the mandatory rule applicable to New York Stock Exchange companies since June 30, 1978. A reason cited by the Amex for not adopting a mandatory rule is that unless over-the-counter companies and companies listed on other exchanges also are required to meet these standards, the Amex would be at a competitive disadvantage. In other words, the Amex believes that a noticeable number of its companies would delist rather than comply.

The SEC's displeasure with the Amex's voluntary rule has been underscored by a pointed reference to the Amex's promise to review the policy within a year. The SEC said that the Amex would need to strengthen its rule unless its listed companies without audit committees did comply in one year. Thus, the pressure continues.

Supply and Demand

As standards of performance, personal risk, and time requirements have risen, the supply of potential directors for many companies has diminished. And it will continue to diminish for small companies in particular, just when many of them will be looking to add more independent directors or to find outsiders for the first time. In fact, many of these companies will need to make substantial changes in the way their boards operate in order to attract outsiders who otherwise would not want to take the risk.

The question of balancing risks and rewards has been high in the minds of the directors who have responded thus far to a *Directorship* survey of a small group of directors. The directors have been asked whether they ever had declined an invitation to join a board and, if so, what the principal reason was. Of the 30 men and women answering this question, 23 said that they have refused such invitations. And of these 23, nine (30 percent) stated that the deciding factor was a mistrust of the corporate management.

With traditional sources of supply failing to balance the demand for directors, corporations have begun to search out new sources. Some of these sources are not really so new, however. Women and minorities, even if their numbers are small, are an accepted presence in boardrooms today. Also growing is the number of directors coming from nonprofit sources, including government and military service, which may be related to the fact that more women and minorities can be found at upper management levels of these types of organizations.

According to an analysis by *Directorship* of the 1980 proxy statements of the Fortune 500, fewer than 150 board seats are held by women in the 479 companies included in the analysis. The top 100 companies have 49 women who are directors, or about one-third of all women directors in those 479 companies. But the number drops off significantly among companies in the lower half of the Fortune rankings.

Notable exceptions to this are Harcourt Brace Jovanovich, with four of its 14 directors being women, and the New York Times Company and Scott & Fetzer, with three each. These three companies, which rank 471, 375, and 358, respectively, on Fortune's list, are the only ones of the 479 companies which have more than two women on their boards. Most companies, regardless of size, have only one.

Another favored group for board seats is college and university presidents, as well as deans and professors of business schools with national reputations. Other professors, such as scientists and engineers, also have been sought out for their particular expertise.

Religious groups and activist organizations are not really new to the boardroom scene either. Reverend Leon Sullivan, pastor of Zion Baptist Church of Philadelphia, for example, has been on the board of General Motors since 1971. Sister Jane Scully, president of Carlow

College, joined Gulf Oil's board in 1975. One year earlier, Xerox added Vernon Jordan, president of the National Urban League and a director of five other major corporations. (Also see article on page 28.)

The Union Leader Comes on Strong

New to the boardroom scene are representatives from the labor movement. For the first time in history, stockholders of a major American corporation, Chrysler, have elected to the board the leader of the union which represents its own workers. More recently, Rath Packing Co. anounced that it is meeting with its union to revise the composition of its board of directors to include a majority of union members. Further developments of this type may be in the offing, as indicated by the proposal of the United Auto Workers to include a union representative on the board of American Motors.

These developments raise new questions of conflict of interest, to the extent that such union officials represent a particular interest rather than all shareholders.

Some commentators have pointed out that there always have been special interests represented on boards. Investment bankers and representatives of major shareholders have been cited as examples, suggesting that union leaders are only a variation on the theme. Ignoring the legal issues, such notables as Arthur Burns have stated that there are practical benefits in having people like Douglas Fraser on the board of a corporation. What they've been saying is, "Let him find out what it's all about on the other side of the table."

It is difficult to tell at this time whether union representatives will in fact be chosen for board seats as a matter of routine in the future. Nevertheless, the examples which have arisen in 1980 certainly suggest that, depending on economic conditions and social developments, corporations may be faced with increasing demands for such labor representation on boards of directors.

Comparison by Executive Rank of 311 Outside and Inside Directors of 31 Fortune 500 Companies

Executive Title	Outsiders	Insiders	Combined
Chairman	85	37	122
Vice Chairman	7	4	11
President	34	23	57
Executive Vice President or Senior Vice President	13	55	68
Group Vice President*	6	15	21
Other Vice Presidents	6	26	32
Total	151	160	311

Including officers of subsidiaries

Corporate Executives

At the same time as they have been scouring the nonprofit world for outside directors, corporations have been looking more closely at the executive ranks of other corporations, from which more vice presidents are being recruited than in previous years.

To find out which executive levels new directors are being drawn from, *Directorship* examined the backgrounds of 311 active and retired executives on the boards of 30 Fortune 500 companies. The 30 companies were chosen from three Fortune groupings—companies ranked 1-50, 201-250, and 401-450. The results of that examination are illustrated in the chart above.

Wide differences exist between the largest and smallest companies in our sample. The 10 companies selected from one through 50 have 70 outside directors with business backgrounds. Of these 70, 54 are chairmen of their own companies, 14 are vice chairmen or presidents, and two are vice presidents. These very large corporations, of course, have little difficulty in attracting people of the highest quality and broadest experience to their boards. Within the 10 companies ranked 201 to 250, there are 44 outside directors with business backgrounds, with 18 being chairmen, 16 who are vice chairmen or presidents, and 10 who are vice presidents.

Within the grouping of "smaller" Fortune 500 companies, however, the 10 companies ranked 401 through 450 have only 37 outside directors with business backgrounds. Of these, 13 are chairmen, 11 are vice chairmen or presidents, and 13 are vice presidents. Of the 151 outside directors in this sample, 25 (17 percent) are vice presidents, which compares roughly to the 14 percent found in a 1973 Conference Board study.

Big-Company Boards

In its survey, *Directorship* also asked each participant what types of backgrounds would be desirable for board members of a $400 million industrial company. The question focused on the outside directors.

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Thus far, answers have been received from 30 participants, who cast their votes for the following types of business executives.

Director Background	Preferred by
Officers of the company:	
Current chairman and president	30
Retired chairman	15
Executives of other companies:	
Chairmen	25
Retired chairmen	15
Other current officers	21
Other retired officers	6

Participants in our survey also have been asked this question: "In the future, which corporate vice presidents will be most in demand as outside directors?" Of the 32 responses, 29 have endorsed chief financial officers, 17 have favored marketing directors, and 13 believe that manufacturing executives would be desirable.

Tapping New Sources

How does a company locate a specific individual who will meet its needs? Existing techniques certainly will be used, but with adaptations. The principal techniques involve personal contacts and professional recruitment.

Personal Contacts: These still carry the greatest weight with chairmen, nominating committee members, and other directors. In fact, one of the benefits that chairmen look for from other members of their boards is a broadened circle of acquaintances from which to choose directors. It is reasonable to expect that companies will continue to favor this technique, but on a basis much expanded from the "old boy network." This approach already is being cultivated assiduously by knowledgeable women and will adapt itself to include minorities.

Professional Recruitment: Some corporations use professional recruiters to locate new candidates. The number of new director placements by search firms is still small, but it is growing, according to these firms. This service is not inexpensive, especially when provided by the best equipped, best known executive recruiters or management consultants. These firms, which work with a company to determine its specific needs, usually are knowledgeable about corporate vice presidents, and they appear to be a natural vehicle for tapping this important source.

Some corporations, especially the largest, have well-established search procedures in-house. These companies systematically review the needs of their boards and scan the corporate and nonprofit scenes for candidates.

A recent entry into the recruiting field is the American Stock Exchange. The Amex is accumulating a data bank of information about potential directors for its listed companies, the chairmen of which also are being encouraged to serve on other boards.

Other Sources: Professional accounting firms also may provide services to companies in need of directors, especially in recommending chief financial officers, who will be increasingly in demand. This non-audit service can be especially valuable to smaller companies.

Finally, of course, the role of shareholders in offering suggestions to their corporations should not be overlooked. The 1980 proxy statements contain specific information on how shareholders can make such recommendations.

The Small Companies

Though pressures for change in corporate boards have been felt most keenly by large corporations, the recent Amex audit committee rule is a sign that smaller companies also are being brought into the same system and that their boards will experience significant changes in their operations within the next few years. These changes will be adapted to minimize the cost impact and to avoid unnecessary bureaucracy, but will produce a board role which is more formalized and more independent of the chairman than in the past.

Outsiders on the boards of $40-75 million companies will be involved in matters which would be considered operating management responsibilities in large companies. To such boards, a new director from a large company can bring both the critical analysis and the operating expertise necessary in dealing with such problems. Opportunities to apply their judgments and expertise at the top level of responsibility will be attractive to corporate vice presidents of larger companies, provided that their role is clearly delineated, and can be invaluable in preparing these executives for board seats in their own companies.

In their search for directors, companies are seeing that the law of supply and demand is beginning to show its effects even in the rarified atmosphere of the corporate boardroom. To find the new board members they need, companies may have to look beyond traditional sources of supply and consider executives from somewhat lower levels of corporate hierarchies. In many cases, they also will have to increase the rewards and decrease the risks of board service in order to make their directorship positions attractive and to perpetuate an institution which remains as one of the purest examples left of the market system operating effectively.