OUTSIDE DIRECTORS
The fading appeal of the boardroom

Demand for outside non-executive directors is rising even as the supply of them is shrinking. Time for an increase in their pay?

A DECADE ago, 66% of all directors on American company boards were outsiders; last year that figure had risen to 78%. The California Public Employees Retirement System (CalPERS), the loudest voice in American corporate governance, argues that the only company executive on the board should be the chief executive—ie, given that the average size of the American company board is about 12, 92% of all company directors should be independent non-executives. In the past ten years, the demand for non-executives has increased by almost a fifth, and CalPERS is asking for another big increase.

The picture around the rest of the world is much the same. In Britain, where the proportion of outsiders on company boards is less than in the United States, a study published in January by PricewaterhouseCoopers (pwc), a firm of consultants, found that a majority of company directors would like to have a higher proportion of non-executives on their boards.

The desire to have more independents is even spreading to industrialising countries. And for good reason. Recent research by McKinsey suggests that investors are willing to pay a large premium, of up to 28% in the case of Venezuela and 27% in Indonesia, for the shares of what they consider to be a well-governed company—defined in this case primarily the board’s directors do not have management ties*. The government of South Korea, eager to pull its corporate socks up, has recently passed a law insisting that at least one-quarter of the directors of large companies must come from outside.

A notable exception to all this has been the rash of dotcom start-ups. Korn/Ferry International, a large recruitment consultancy, says that they have tended to do what larger old-economy companies once did. Their boards have become dominated by insiders: a mix of the current management and others with close ties to the company. As these firms mature, however, they will undoubtedly seek to change that balance.

The newly assembled board of AOL Time Warner shows the sort of non-executive team that big companies seek to put together. There is a clutch of current and former chief executives in broadly related businesses: Stephen Bollenbach, for example, who runs Hilton Hotels; and Reuben Mark, the boss of Colgate-Palmolive. Then there are a couple of grand investors, such as Frank Caufield of Kleiner Perkins Caufield & Byers, a venture capitalist, and there is a former public servant, Carla Hills (who fortunately is female and so provides the diversity that is so important in board-building these days).

In short supply
Good independent directors with this sort of background are, however, increasingly hard to come by. Not long ago, the job of an independent director was a delightful perk for important (and, often, self-important) business folk at the end of their professional lives. Corporate bosses would appoint executive directors of other companies on the principle, “You scratch my back, I’ll scratch yours.” This type of non-executive director would typically gather a “portfolio” of companies for his retirement in Britain, these independents were sometimes known as “guinea pigs”—for a guinea (£1.05) and a free lunch they were happy to sleep through any chief executive’s presentation of his corporate plan.

The guinea pigs have gone. “These days we are never asked to find a retired ‘portfolio’ director,” says Barry Dinan of Hanson Green, a British search firm that claims to recruit non-executives for the boards of about a third of the FTSE 250 companies. “Yet ten years ago, that was what people expected.”

But still some names crop up on half a dozen big boards. Lord Marshall, for example, the chairman of BA, is also on the boards of British Telecom, Invensys, HSBC and Inchcape. Dennis Carey of Spencer Stuart, an American search firm, says: “Most people today want CEOs or people who run divisions with significant exposure to profit and loss. But many of these people are already ‘boarded-up’.” To help lure such people on*

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to their boards, companies are increasingly seeking the help of headhunters. According to an annual survey by Kom/Ferry, 73% of the Fortune 1,000 companies used a search firm in 2000 to help them fill their boardrooms, compared with only 52% the previous year. In Britain too, the proportion using search firms is rising. Suitable candidates are becoming harder to find for a number of reasons. Some of the most desirable ones have been made unavailable: Jack Welch, the boss of GE, has made it a rule that his senior managers cannot sit on the boards of other companies. That view is gaining ground. Many big organisations are starting to limit the number of boards that their top brass can sit on as non-executives. Most of them set the limit at one, or at the very most two. If a company is going through a difficult patch, as many more may be over the next couple of years, this trend will continue: “It is hard for a CEO to take on an outside job if his company is in trouble,” says Ted Jadick, head of director search for Heidrick & Struggles in the United States.

Also limiting the supply of non-executive directors are the growing demands placed upon their time. Back in 1992, the Kom/Ferry annual survey found that American directors typically spent 95 hours a year on the business of the board. Last year’s survey found that figure had risen to an average of 173 hours, including preparatory work such as reading board papers and traveling back and forth to meetings. For the 82% extra time spent on the job, the average director received a 23% increase in pay.

Travel time becomes an even bigger issue when boards want to be seen to take a global perspective, as is now fashionable: in such cases, they like to fly their board out to one of the organisation’s more distant operations. Korn/Ferry found that 60% of its sample of American company directors turned down a board invitation during 2000, and a majority of them cited “lack of time” as their prime reason. Mr Carey, whose firm recruited directors for over 200 companies last year, says that ten years ago he would have been turned down by two or three directors he approached for any given board post on a “company of consequence”. Today, he reckons that this has risen to six or seven rejections, and as many as ten in the case of some luckless firms.

The demands on time are rising in particular because sub-committees of the board are being given more to do. Nomination and remuneration committees are increasingly composed mainly or exclusively of non-executives; audit committees, with the key role of monitoring a company’s financial position and its exposure to risk, also need a majority of independent members. In America, for example, the SEC and NYSE stipulate that such committees be independent.

Two roles have grown increasingly important for non-executives: that of contributing to setting corporate strategy, and that of monitoring the executives. “When I first became a corporate director in the 1970s,” says Robert Stobaugh, a Harvard Business School professor and expert on governance issues, “boards intervened in times of crisis and occasionally replaced a CEO. They were never active in oversight or strategy.” An article in the Harvard Business Review in 1980s advocating board involvement got a flood of poison- pen letters from CEOs who did not want boards involved in strategy.

Battling the boss
The study of British boards by PWC suggests that many independents see a conflict between the roles of monitoring and of developing strategy. Too much emphasis on monitoring tends to create a rift between non-executive and executive directors, whereas the more traditional job of forming strategy requires close collaboration.

In both activities, though, independent directors face the same problem: they depend largely on the chief executive and the companies management for information. Chief executives rarely encourage direct contact between independent board members and the company’s managers in the field. Moreover, given the nature of their job, chief executives tend to be tough nuts who have been granted enormous powers. Not surprisingly, that turns a good few of them into megalomaniacs. When things are going well, a board will generally put up with an unco-operative megalomaniac. But the moment things start to turn sour, independents tend to find that their ability to win change is limited. They can remonstrate, or they can fire their nuclear weapon of sacking the boss. Between those two extremes, however, there are few alternatives.

Almost invariably, independent directors postpone dropping the bomb for as long as possible. General Motors floundered for a decade while its board, mainly non-executive, failed to kick out Roger Smith or his successor, Robert Stempel. At Tomkins, a troubled British engineering conglomerate, it was a shareholder and not the board who launched the campaign that eventually persuaded Greg Hutchings, an unsatisfactory chief executive, to resign in October last year.

Such delay is not just the result of a desire to postpone unpleasantness. The moment a crisis arises, the demands on the time of the independent directors explode. As one independent chairman told John Roberts, an academic at Cambridge University who recently did a study for Saxton Bamfylde Heiver, a British executive-search company:

Fire the chief executive and you’re in charge for as long as it takes to get a new squad in place. During that period you’ve worried your suppliers, your banks, your institutions. The press are on to you like hyenas, the analysts are writing you down all over the place, and you’re trying to get management back into some sort of shape to run the business just as you’re discovering that things are worse than you thought.

Spot the difference
Do independent directors make a measurable difference to a company’s results? There are certainly occasions when they make a splash. Warren Buffet, on the board of Coca-Cola, reportedly stopped the relatively new chief executive, Douglas Daft, from buying Quaker Oats in November 2000—although senior Coke managers claim that they would not have gone ahead with the purchase anyway. In any case, the rising number of bosses of American companies who have been booted out in the past few years is testimony to a more active approach by the outside directors on their boards.

In truth, though, there is no decisive evidence that a majority of independent directors produces superior corporate performance. A careful analysis by Sumai Bhagat of the University of Colorado at Boulder and
Bernard Black of the Stanford Law School found that companies where at least half the directors were independent did not seem to perform any better than companies where that was not the case.* Indeed, the authors found some indications that boards with only one or two insiders actually performed worse financially than other firms.

Other research, however, reaches different conclusions. For instance, Ira Millstein, a New York lawyer, and Paul MacAvoy, a professor at the Yale School of Management, argue that the rise of the independent director is too recent for much of the research on the issue to be relevant.** They have devised a test for “active governance” based on characteristics such as the existence of formal rules for the relationship between the board and management, and the presence of a non-executive chairman or lead director. These characteristics, they claim, can be linked to superior corporate performance.

However, the structure of boards varies greatly around the world, and this makes it harder to judge the effect of non-executives. Boards in Britain and Australia, for instance, nearly always contain a mix of executives and non-executives. In Germany, on the other hand, the two sit on separate boards. One board consists entirely of executive directors and is generally the real power base, although it is supposed to be monitored by the supervisory board, which is made up mainly of independents and stakeholders, such as bankers, trade-union officials and employee representatives.

Rolf Carlsson, a Swedish expert on corporate governance, has just published a book in which he reviews board structures in five different economies—Britain, France, Germany, Japan and the United States. (“Ownership and Value Creation: Strategic Corporate Governance in the New Economy”, John Wiley.) In 80% of American companies, Mr Carlsson points out, the roles of chairman and CEO are combined. “How can a board’s independence and ability to carry out its governance role be guaranteed if the chairman, the head of the board, is supposed to govern himself as CEO?” he muses.

Britain’s insistence that boards should contain a mix of executive and non-executive directors strikes him as equally odd. The result is that board business is a jumble of strategy, governance and operational issues. Yet his most striking conclusion is that equally successful—or disastrous—companies in different countries may operate with remarkably different board structures.

If companies do decide to put more independents on their board, where can they look for suitable candidates? One option is to turn to new pools of talent—to younger, less experienced directors, perhaps—and the evidence suggests this is already happening. Another direction to look is to academics and to retired government officials or expopilicians; many a senior Democrat, from Bill Clinton down, has doubtless spent much of the past month or so on the telephone to executive-search firms.

**Enticing**

The other thing that companies might do is to pay their non-executive directors more. PWC’s study found that the median annual fee for non-executives in Britain is £25,000 ($36,500), or a day rate of £1,650. In the United States, the director of a company with revenues of more than $20 billion received on average of just under $60,000 last year, not including shares. Considering what is expected of the outside director today, that is not a great deal of money.

In America, however, shares are an increasingly significant part of an independent’s remuneration. Mr Stobaugh found that 98% of the largest companies in America now compensate their directors at least partially in stock or stock options. A few (including PepsiCo) pay them exclusively in equity. In other countries, however, the equity cult has scarcely begun. PWC found that just 8% of British companies currently pay their non-executive directors in shares, partly or wholly.

Some believe that a director’s financial involvement in the company on whose board he or she sits is closely correlated with performance. A study by Donald Hambrick and Eric Jackson of Columbia University business school, presented at last year’s annual meeting of the Academy of Management, argued that the outside directors of companies that outperform their business sector (in terms of shareholder returns) hold four or five times as much equity as those of companies that underperform their sector.

Hermes, one of Britain’s largest fund managers (with a strong reputation for shareholder activism), is keen on share ownership by outside directors. But it is no in favour of giving stock options, which it feels align a non-executive’s interests too much with those of the management. In the United States, Neil Minow, an American shareholder activist whose web site thecorporatelibrary.com, is a treasure trove of information on directors, agrees: “The single most important requirement” for an effective board, she believes, is “that all directors have a significant personal stake in the company.”

Most of the evidence suggests that a stake is more likely to influence directors’ behaviour if they put up their own money to buy it. Messrs Hambrick and Jackson advocate a stake of about $500,000 and suggest that companies establish a matching fund to help directors to acquire shares at the start of their time on the board. “I’ve been on several boards,” one independent director told them: “I’ve always held small, token amounts. But now I’m on a board where the CEO encouraged us to buy and hold significant shares. I’m in for about half a million dollars, and I can tell you I’m a heck of a lot more attentive to the company’s performance than I have been in the past.” If the company fines a challenge, I lose sleep at night.

That, surely, is what shareholders want of their directors more than anything else: that the fortunes of the company should matter enough to keep them awake at night—as well as during board meetings.

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