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Serving as An Outside Director

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Serving as an Outside Director

by Murray L. Weidenbaum

Serving as an outside director can be an absorbing challenge because it involves balancing three important aspects of the role—representing the interests of the shareholders, making a contribution to the company, and maintaining professional independence. It would be presumptuous of any one person currently serving as a corporate director to state exactly how these three factors should be balanced by each outside director.

The way in which anyone works out the three aspects of the director's role must depend on the nature of the company, the problems and opportunities that it faces, and the composition of the Board itself. Therefore, I will limit this article to my personal experiences, mainly explaining how I view my task in the several Boards that I serve on. Perhaps these thoughts will encourage other directors, with different and broader backgrounds, to present their ideas on the subject.

The Role of the Outside Director

First of all, I believe that it is clear that the directors of a corporation represent its stockholders. That certainly should be true

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of independent outside directors. I am a member of the traditional school who does not believe in constituency directors. Thus, I do not view my position as representing 56-year old male Republican college professors from Missouri—or any other group that I happen to belong to, other than the shareholders of the company.

Ralph Nader has proposed national elections for Board members of major companies.

I would propose as a start electing the members of the rubber-stamp Board of his conglomerate.

Although I do not represent any special interest, I do feel free to contribute the special expertise that I have. In my case, it is economics. But if government wants to regulate companies and influence their behavior, they will have to do it from the outside, and certainly not via this director. I know that Ralph Nader has proposed national elections for Board members of major companies. If he is so enamored of the idea, I would propose as a start electing the members of the rubber-stamp Board of his conglomerate. My candidate is former Interior Secretary, James Watt! But, until then, I suggest that the allegiance of directors to the shareholders who elect them is fundamental.

How do you represent the shareholders at the meetings of the Board? Personally, I try to follow a variation of the Socratic method. I mainly ask questions. Of course, I try to avoid second-guessing the management. A company does not benefit from either a totally compliant Board nor from one that tries to dominate the management. My attitude is that a strong management is cultivated by providing some guidance to it.

If the company has that type of management, asking the right questions may be sufficient.

If the management seems too dense to get your message, the company may have the wrong management—or you may have been too subtle. But if you really get a brush off on something you consider important, speak to the other directors. There is nothing like introducing a well-prepared motion to get the chairman's attention.

In any event, the director needs to exercise discretion in carrying out the role. If you are asking questions on every item on the agenda, you are probably becoming a nuisance and diluting your effectiveness. But, if meeting after meeting goes by and you do not open your mouth—except to second the motion to adopt the minutes—then you probably are not earning your director's fee.

Often, outside directors will be expected to draw on their particular expertise. If an acquisition is being considered, an investment banker—or the Chief Executive Officer of another company—may point out some of the unexpected problems that could arise. A consideration of the sales forecast may benefit from the economist commenting on the business outlook. The review of international activities can be a useful point at which a banker on the Board discusses the foreign exchange situation. None of this should be aimed at replacing the role of the internal management and staff, or to be competitive with them. It is more a matter of providing another or at least broader viewpoint.

Relations with Management

The interactions with the CEO are vital for the outside director. The subtlety of the

relationship arises particularly because of the presence of other members of the senior management on the Board, the "inside" directors. The outside director must remember that the CEO-chairman (assuming that the customary dual title obtains) has to deal on a day-to-day basis with the other inside directors in a leadership fashion.

Thus, I often find it useful to communicate ideas or concerns to the Board chairman in an informal way. He is not put on the spot. (By the way, I am not being sexist; it is just that I have never served on a Board with a female chairwoman.) Of course, if I am not satisfied by the Chairman's response, I feel free to raise the matter at a Board or committee meeting. But, especially on touchy matters such as personnel, at least I have put him on notice.

Much can be written on the limits to the director's role. Though much as it may be tempting, outside directors should refrain from taking on management's responsibilities. One of the more frequent opportunities—which I always decline—is to answer calls from reporters inquiring about some aspect of company policy or operations. In what invariably turns out to be a very short interview, I tell them that in no way will I act as a spokesman for the company or even talk about the organization. Any question about the firm should be directed to the management.

Of course, I am generally available to answer calls about economic trends and other business policy matters unrelated to the specific companies on whose Board I serve. But those calls always come on other occasions.

Serving on Committees

The matter of Board committees is of special importance. Much of the work of the Board is performed in those smaller groups. The Audit Committee is, in effect, the watchdog of the corporation. The Nominating Committee is initially responsible for what may be the Board's most basic function: providing for the succession of top management, and also for naming new directors. The Compensation Committee is concerned with providing proper incentives for performance. In each of these areas, it seems clear that independent outside directors are required, at least in large proportion, for the proper performance of the task. In the case of the Audit Committee, the regulations of the New York Stock Exchange limit membership to independent outside directors.

More balanced mixes of inside and outside directors, on the other hand, may be useful in the case of other committees such as Finance and Public Policy. Especially if it is charged with the review of potential acquisitions and other major investments, the Finance Committee needs the institutional knowledge of key inside directors. A similar situation occurs in the Public Policy Committee. The outside directors may be particularly knowledgeable about the external social and political environment facing

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the company. But the inside directors know the actual interactions with government and public interest groups.

The Executive Committee, in contrast, is generally dominated by inside directors. They have the expertise and also the time, in the case of the executive committees that meet frequently. However, I would caution against the type of Executive Committee that is so dominated by insiders and long-term outsiders that it becomes, in effect, a senior management operating committee, and not an arm of the Board itself. To be sure, in practice each company may have its own variation of the composite or typical committee structure that I have just described. Some Boards may prefer fewer committees while other Boards may desire for their members to be involved in other matters.

The "mixed" Board provides a built-in opportunity to balance the pressures for dividends and retained earnings.

Clearly the corporate Board of Directors, both in plenary sessions and acting through its committees, deals (or at least it should) with the issues that are fundamental to the future of the organization. Perhaps that is the ultimate justification for maintaining a Board with both inside and outside directors. The non-employees bring a detachment (I always hesitate to say objectivity) to the task, while the insiders bring to bear a unique understanding of the firm—its people, internal working relationships, customers and supplier dealings, and often rich institutional knowledge. Also, the outside directors are given an opportunity to meet, work with, and observe in action those members of the senior management who may be considered for the top slot in the future.

Another value of the "mixed" Board is that it provides a built-in opportunity to

balance the pressures for dividends and retained earnings. Often many shareholders emphasize the short-run benefits of increased income, while management is more concerned about investing in the company's future growth. Also, the officers may simply find it easier or at least more satisfactory to use retained earnings rather than going to the credit markets. For the typical business firm, this is not an either-or choice, but a case of balancing two important and basic considerations.

Although I share the prevailing view that the Board should consist primarily of outside directors, I must report an uncomfortable feeling. I know of no comprehensive analysis that demonstrates that the performance of companies with outside-dominated Boards is superior to that of companies relying primarily on management directors. Perhaps that simply reflects the fact that, to my knowledge, nobody has undertaken such a study. In any event, there

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is no shortage of anecdotal information about the shortcomings of specific companies with mainly inside directors—such as paying top management far more generously than other companies in the industry whose performance is superior in terms of sales and profitability.

The Independence of the Outside Director

In any event, it would seem clear that, for the outside director to exercise effectively

the role of objective overseer of corporate activity, he or she truly has to enjoy a position of independence. In judging the quality of independence, I find legal requirements and definitions useful but not ultimately satisfying.

Of course, it is important to avoid technical, i.e., legal conflicts of interest—such as an officer of a major supplier or customer serving on the Board. Yet I find that independence must be broader than that. Thus, I find myself in opposition to the suggestions that are made from time to time to provide such generous fees, and supporting staff, that the director can devote a very substantial portion of his or her total professional time to the role.

I believe that directors should be adequately compensated and should take the task seriously. The economist in me urges awareness of competition, in this case in the market for quality directors. Yet, I oppose those proposals because they would tend to give the director too great a financial stake in holding on to the job. Thus, one of my personal tests of a truly independent outside director is how important is the income from Board service to him or her.

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To be specific, I served on the Board of one company whose key policies I came to disagree with strongly. After raising the issue at Board meetings and not obtaining support from other members, I decided not to run for reelection. Given my preferences in working relationships, it was a very quiet departure. Yet I did so without giving any

thought to the loss of director's fees because remuneration from that Board service was not an important part of my total income.

Nevertheless, I do not believe that a company is an eleemosynary institution. Director's fees should be in alignment with responsibility, time spent, and comparability. But clearly much of the income is psychic or otherwise non-financial. How else do you explain a \$1 million a year CEO serving on a Board of another company?

The New Director

What advice can be given to the new member of a Board of Directors? All I can report is the attitude that I have tried to take when joining a Board—that I will have to learn a lot before hitting my stride. That learning process covers the company's activities and history, its people, and especially the variety of formal and informal interactions with the other members of the Board.

Although it may go against the grain, I try not to assume that the firms that I was previously affiliated with always followed the right approach, and that any departures from that path by this company whose Board I have just joined is wrong or at best merely backward. Easier said than done, of course.

To the new director, I would urge you not to feel obliged to say more than "Hello" and "Thank You" at your first or second Board meeting. You can learn a lot by listening— and looking at the interactions among the various Board members and with the management representatives. To belabor the obvious, that is why teachers like to use the blackboard. The visual aid

reinforces the oral lecture. It is more effective to rely on two senses rather than merely on one. Do not be shy about asking some questions, but avoid those that you can answer yourself by looking up the company's annual report or filings with the Securities and Exchange Commission.

Concluding Thoughts

Finally, I raise the often painful subject of Board turnover. I do not view a directorship as a type of civil service appointment. It should not become a sinecure. To be sure, there are important benefits to the company from having members whose longevity provides a wealth of background and experience with the company—sometimes in excess of that of the current top management. Yet, there may be the danger of long-time directors becoming so accustomed to the existing way of doing business that they viscerally oppose innovation on the oldest bureaucratic grounds: "We have never done it that way." Also, the needs of a company may change—with shifts in its markets, product line, regulatory status, and external environment.

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All this, of course, underscores the need for relying on such eternal values as judgment and balance in the selection and retention of corporate directors. Although this is hardly a startling conclusion, and it may sound pedantic, I have never found good judgment to be in excess supply in any organization that I have been connected with, public or private. In any event, there

is little that can formally be prescribed, other than to be conscious of the need to maintain an environment conducive to the exercise of those key values.