Breaking Step

Corporate Counsel
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Even as more boards fill up with outsiders, some businesses just won't give up their company directors. What do insiders bring to the boardroom that outsiders don't?

Jim Ringler, an independent director on the board of The Dow Chemical Company, the $40 billion chemical manufacturer in Midland, Michigan, says that directors at other companies look at him strangely when the conversation turns to board insiders. Dow has five, on a board of 14. "They look at me like, 'How'd you get away with that?' " Ringler says. He understands their surprise. The other boards he sits on--NCR Corporation; Autoliv, Inc.; and FMC Technologies, Inc., among others--don't have nearly so many insiders. "But it works in Dow's case," he says. When you give insiders some autonomy, "it works damn wonderfully."

United Parcel Service, Inc., the Atlanta-based $36.6 billion package delivery business, has four insiders on its nine-member board, including former chief executive Jim Kelly and three current officers. Independent director Gary MacDougal cites the company's nearly century-old employee ownership ethic as a chief reason, saying the board wants to be "respectful" to UPS's culture.

Last year Burlington Resources Inc., a $5.6 billion oil and gas producer in Houston, actually added two company managers to its 15-member board--the chief operating officer and the chief financial officer. Previously the only insider on the board was the CEO. "No boards I'm aware of see bringing on insiders wholesale as a good thing," says Barbara Alexander, an independent director at Burlington Resources. But adding one or two shouldn't be taboo either, she says.

Burlington Resources, UPS, and Dow are exceptions to the latest trend in corporate governance. Edward Lawler III, who conducts research on boards at the Marshall School of Business at the University of Southern California, says insiders are fast becoming "a disappearing breed." These days, only one insider has a guaranteed seat at the boardroom table: the CEO. The Sarbanes-Oxley Act of 2002 emphasized the role of independent directors by banning nonindependent directors from the audit committees of public companies. Furthermore, the listing requirements of the New York Stock Exchange, Inc., and The Nasdaq Stock Market, Inc., mandate that boards of these companies have a majority of independent directors.

Many businesses have gone even further. According to 2004 proxy research by Shearman & Sterling, 35 percent of Fortune 100 boards have supermajorities of independent directors in which the CEO is the only nonindependent director on the board. Among the S&P 500, the CEO is the only insider on the board at 38 percent of companies, according to executive recruiter Spencer Stuart.

But a significant minority of boards disagree with that model. Almost a quarter of the S&P 500 maintain three or four nonindependent directors on the board [see "A Measure of Independence,"

page 98]. "You can't ignore that insiders can make a contribution," says Harvard Business School professor Jay Lorsch, author of Back to the Drawing Board: Designing Corporate Boards for a Complex World.

What exactly do insiders contribute? "Having executives in addition to the CEO is beneficial for two reasons," says Lucian Bebchuk, director of the Program on Corporate Governance at Harvard Law School. "First, getting to know other executives and interacting with them over a long period of time is potentially beneficial for future succession decisions that the directors will have to make. Second, hearing about the state of the company from more than one person could improve the quality of the picture directors have."

Executives and board members at other companies that hang on to their inside directors echo these reasons--and a few more:

"Ownership" of the business. Some companies subscribe to the Warren Buffett school of thought: Directors ought to be substantial stakeholders. Insiders have often been buying stock for years--and the fact that their livelihood comes from the business is additional incentive to take their duties as a director seriously.

At Berkshire Hathaway Inc., where Buffett is CEO and chairman, four of the 11 directors are insiders: Buffett, his son, vice-chairman Charles Munger, and longtime outside counsel Ronald Olson of Munger, Tolles & Olson. (Buffett's wife, Susan Buffett, was also a director until her death last year.) In Buffett's 2003 letter to shareholders, he noted that the company's 11 directors, combined with their families, each own at least $4 million of Berkshire Hathaway stock. Some have hundreds of millions of dollars worth of company stock. "Charlie and I love such honest-to-God ownership," Buffett wrote. "After all, who ever washes a rental car?"

Buffett could have been describing the UPS culture, where "98 years of management ownership continues today in large part," says Allen Hill, the company's secretary and general counsel. Given that employees, retirees, and the founders' families own almost half of the company and control virtually all of the voting power, the mix of three current executives and a former chief executive on the nine-member board feels right, says governance chair MacDougal. "You have to remember, we only went public five years ago," MacDougal says. (Two years ago, there were six insiders on a 12-member board.)

The three executives on the UPS board at press time--CEO Michael Eskew, senior vice president of human resources Lea Soupata, and senior vice president of U.S. operations Calvin Darden--are also the largest employee shareholders, each owning in the neighborhood of 200,000 class A shares, worth about $15 million at press time. Those shares were amassed over 30-plus years at UPS. Directors and officers as a group own about 2 percent of the outstanding shares. But none of the outside directors can match the insiders' stock holdings.

Most of UPS's independent directors--such as Carol Tomé, the Home Depot, Inc. CFO who joined the UPS board in 2003--were recruited for their expertise in finance, technology, and marketing, but have been on the board for seven years or less. In contrast, the insiders have spent virtually all their working days at UPS. (Only one outsider, MacDougal--a member of UPS's

board since 1973--comes close to their years of service with the company.)

The inside directors play a role that outsiders can't, says MacDougal. That's especially true when it comes to critical decisions such as whether to take the company public. Choosing to do an initial public offering in 1999, MacDougal says, was a "tough, board-debated decision where the answer wasn't clear. Insiders were concerned, correctly, about the culture." In the end, the inside directors took the lead in a major communications program with the 300,000-plus employees prior to the IPO. MacDougal says the insiders "were an important part of the process that gave all of us the comfort level that any negative impact on the private ownership culture would be minimized."

At UPS, the executive directors also represent the company's "management committee," or the approximately 12 most senior executives who run the day-to-day operations, sort of like an oversize office of the CEO. The management-by-consensus approach translates well to the boardroom debate, says UPS GC Hill, a committee member. "It's what we do on a daily basis on the management committee," he says.

In-depthknowledge. Every board is seeking directors with corner-suite credentials. Many independent board members bring executive-level experience from different companies and industries. But insiders impart their encyclopedic knowledge of one company and one industry. At Smith International Inc., a $4.4 billion Houston-based manufacturer in the oil and gas industry, one of the company's seven board seats is filled by Loren Carroll. He is an executive vice president whose depth of industry knowledge and operating experience at the company would be nearly impossible to get from anyone else, says CEO and chairman Doug Rock, the only other insider on the board. Carroll joined the board shortly after Smith International emerged from Chapter 11 bankruptcy proceedings in 1987. Since then, he has helped the board vet many major financial moves, including decisions to make 69 acquisitions over the last decade. Carroll now runs a division that accounts for half the company's sales. "His reputation is so strong, the institutional investors are very glad he's on the board," says Rock.

Ringler, one of nine independents on the Dow Chemical board of 14, says having four insiders besides the CEO has made a difference during crucial moments. In 2002, Ringler says, the board sensed that the company was losing its direction under CEO Michael Parker, but the outsiders couldn't be sure exactly what was transpiring inside Dow. For the inside scoop, Ringler says they consulted with the longtime Dow employees on the board, including 43-year veteran and vice chairman Anthony Carbone, senior adviser Arnold Allemang, and CFO J. Pedro Reinhard.

"They helped confirm our suspicions about what was going on. They [felt strongly] about the direction of the company because it's their life's work," Ringler says. Parker had been CEO for just two years, but faced with flat 2002 sales, the board didn't wait for that year's results to be released before taking action to remove him, citing the "disappointing financial performance of the company over the last eight quarters" in a public statement. Chairman William Stavropoulos, a former CEO, took over as president and CEO. The decision to act rather than wait another six months, Ringler says, was made easier because of the "comfort factor" of having the inside board members' input.

The insiders also helped the board evaluate inside candidates to succeed Stavropoulos as CEO. "They can network back into the company better than independent directors can," says Ringler. The inside directors' candid impressions of Dow president and COO Andrew Liveris helped the board settle on him. Liveris became CEO in 2004. "They knew Andrew in a way we didn't," says Ringler.

In more everyday matters, Ringler says it's also "useful and comforting" to be able to tap the insiders with their vast knowledge of a complex industry that's part commodity and part engineering services. When the board discusses investment opportunities around the world, says Ringler, "such as 'Should we do this joint venture in the Middle East?' " having the insiders is like bringing together the best consultants in the field. "I wouldn't want to give that up," he says.

Ringler credits a special program at Dow for affording insiders "a certain independence of the management team." A track known as "deceleration" eases top executives into new roles at the company five years before they officially retire. "Decelerating managers" perform special functions within Dow but no longer report to the CEO or any line management. Currently, Allemang, Carbone, and chairman Stavropoulos are in deceleration. "They don't feel beholden to the CEO at all--they clearly have their disagreements in the boardroom," says Ringler. And even though theirs is not the sort of independence that would pass the stock exchanges' bright-line test, "they're sure as hell independent in their thinking," Ringler asserts.

Potential CEO material. While boards consider CEO succession their top priority, many admit they're not doing a good job at it. However, one way to groom a potential CEO successor is to put him on the board. Simply bringing top managers in to attend board meetings--without giving them a seat on the board--isn't enough, argues Burlington Resources director Alexander. Managers who pop in to make PowerPoint presentations and answer questions "are not part of the ongoing dialogue in the boardroom," she says. Putting executives on the board allows you "to see their thought processes" and how their confidence grows over time, she explains.

Alexander won't say whether succession planning figured into the decision to add Burlington Resources COO Randy Limbacher and CFO Steven Shapiro to the company's 15-member board in January 2004. But she notes that at two other companies where she serves as a director--Centex Corporation and Harrah's Entertainment, Inc.--in recent years the COO joined the board and went on to become CEO.

"It is not at all uncommon as a succession-planning tool to bring onto the board the one or two likely successors to the CEO," Alexander says. The move doesn't always signal that a senior management change is imminent. Having top executives on the board means that if faced with a situation in which the board must quickly move to choose a successor, "they can select an executive well-known to the board and familiar with its members and its processes," she explains.

A long-term perspective. Even when companies are following the prevailing trend toward fewer inside directors, sometimes there is a good reason to make an exception. Particularly in times of board transition, the right insider can bring stability and a much-needed perspective.

Steve Odland joined AutoZone, Inc., the Memphis-based $5.6 billion auto-parts chain, as chairman and CEO in January 2001. (In March 2005 he moved to Office Depot, Inc., as chairman and CEO.) At the time there were five insiders out of 11 on the board--Odland's immediate predecessor, the CFO, the former CFO, the COO, and the company founder. AutoZone's institutional investors wanted the number of insiders reduced to bring the board closer to today's norm of one or two. The governance committee, chaired by Charles Elson of the John L. Weinberg Center for Corporate Governance at the University of Delaware, carried out the winnowing process in about a year, as some directors retired and others agreed to resign.

Still, the board felt strongly about the value of keeping one particular insider on: former CEO and longtime director J.R. "Pitt" Hyde, the third generation of the company's founding family. Hyde has a knack for communicating the lessons of his experience without being overbearing, Odland says: "He puts the past into perspective. Instead of saying, 'We tried that, and it failed,' he's more likely to say, 'When we tried it, here's why I think it didn't work, so maybe you want to try it this way.' At every board meeting he can relate back to the past." Most of the other AutoZone directors on the eight-member board have served for five years or fewer.

Odland also chairs the governance task force for The Business Roundtable, a Washington, D.C.--based group of 155 prominent CEOs, which issued its own corporate governance guidelines three years ago. The Business Roundtable deliberately stayed away from saying that the CEO should be the only insider on a board. Rather, Odland says, boards should be open-minded: "Every so often, a founder or someone else not considered independent ... is an asset to the board."

Just ask UPS. As the delivery business tries to expand its international operations, the board will need more board members with related experience, says director MacDougal. His immediate task is to find three more independent directors with international credentials. But at the same time, adding another UPS executive to the board is not out of the question. Says MacDougal: "I like the idea of keeping a few more insiders than the average company."