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The next generation: with CEOs accepting fewer directorship slots, who's filling their shoes?

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The Next Generation

With CEOs accepting fewer directorship slots, who's filling their shoes? By Eugene H. Fram and William J. Stevenson

For decades, CEOs were natural candidates for outside directorships and filled the majority of open board positions. Then came Sarbanes-Oxley, which heaped added responsibilities, as well as new liabilities, on board directors. Now CEO candidates are rejecting most new directorship offers in droves. Others are stepping down from many of their current boardroom positions in the face of mounting workloads and increased risks.

Although such a scenario was predictable, and has recently been well documented, little is known about what has happened to boards in the wake of such decisions by corporate leaders. Who is taking their places on boards? In what numbers? What is motivating members of this next generation of board members? Are active CEOs essential to a highly qualified corporate board?

To better understand the shortage surrounding active CEO board candidates and who is stepping into their shoes, we studied the extent to which *Fortune* 500 firms are maintaining a cadre of active outside senior managers from for-profit firms on their boards. The study, completed early this year, specifically looks at board composition the year before SOX (2002) and the years for which information was available (2003 to 2005) following passage of this federal law.

Recently, scandals surrounding corporate stock option backdating have become the latest in what is now a parade of board-related debacles, including the "pre-texting" scandal at Hewlett-Packard, that have strengthened the justification that an active CEO might use in declining a board appointment. The recent backdating scandal at UnitedHealth Group, for example, led to the resignations of the CEO, CFO, and general counsel, who are among at least 30 corporate officers and board members who have resigned or have been forced out at more than a dozen companies as a result of this issue.

CEO Exodus

The trend underscores the huge extent to which active outside directors can become involved in another company's crisis, as cascading disclosures and events heap responsibilities on time-pressed CEOs.

Such time-intensive activities, not to mention the reputational risks, limit the valuable time CEOs who act as outside directors have to focus on their own companies' problems, which is certainly a critical issue for such leaders today. As one analyst recently put it, "Chief executives are on a shorter leash than ever, facing revived boards and restless shareholders. More CEOs are being forced out." No wonder some of the best CEO candidates are now reporting they are too busy managing their own companies or are restricted by employment contracts from serving as outside directors. A 2006 study by Heidrick & Struggles International and the University of Southern California Marshall School of Business found that 53 percent of CEOs are subject to company regulations that limit the number of outside boards on which they are permitted to serve, up from 23 percent in 2001.

While a common concern in the corporate world was whether fewer CEOs on corporate boards would have negative consequences for the business organizations that have come to rely so heavily upon them, we asked whether there were any downsides for a CEO who decides to avoid being an outside director? Clearly, without opportunities to become involved with other boards, a CEO may be in danger of losing touch by limiting him or herself to a secluded information environment, which is not an uncommon problem for top managers who lack outside board experience. The main source of the risk, of course, is that it is not unusual for subordinates to funnel only the positive news up the chain of command.

It's likely that some CEOs have simply concluded that the risk-to-reward ratio for accepting a director position is no longer compelling. There is too much inherent financial and professional risk, they presume. But whether those risks are real or imagined is a subject for debate. In fact, for outside director personal financial risk, assuming a strong D&O policy is in place, the results of extensive research at Stanford University concludes that the risk "is very low, far lower than many commentators and board members believe, notwithstanding the WorldCom and Enron settlements." On the other hand, once a major event has taken place, the D&O policy can be quite unsettling in terms of what might not be covered, irrespective of the geometric increase in time that must be devoted to board activities.

Regardless of why they are taking fewer board positions, the actual numbers show that the exodus is real. Recent research by James Drury Partners in Chicago, which included a count of *Fortune* 500 CEOs back to 1990, shows the active CEO recruitment pool has slipped dramatically. One of that group's recent predictions indicates that by 2016, it is possible that there won't be any *Fortune* 500 CEOs serving on outside boards.

Widening the Talent Pool

Given this prediction, many savvy companies are using alternative means of filling the CEO gap by pursuing other types of senior managers in profit-focused firms. There is also a belief that the shortage of active CEOs is having an impact on the overall size of boards.

We recently studied results for 384 companies over a four year period, and for each year, they had a total of approximately 4,400 directors at year's end. The 384 firms included 77 percent of the businesses on the 2005 list. Some companies were excluded for a variety of reasons. Some firms, especially many at the bottom of the 2005 list, were not *Fortune* 500 firms during all four years under study. The most significant reason was that newly merged firms required their boards to be reconstituted. For example, the Sears Holdings board was excluded because its board was reconstituted after its 2005 combination with Kmart Holdings Corp.

Based on the research, and the 384 eligible firms in the survey, the average number of directors was roughly 11.5 post-SOX, down slightly from 11.7 in 2001. This current average figure tracks well with the results of a different study of S&P 500 firms conducted in 2006 by Spencer Stuart, an executive search firm. The average board size in the search firm's study was 10.7 members, a slight decline from the 2001 figure of 11.1 members. Its report concluded, and we agree, "Practically speaking, it seems unlikely that boards can grow much smaller." In our study of *Fortune* 500 firms, roughly the same number of companies increased the size of their boards as decreased them (73 increased and 65 decreased), while the majority left the number of board positions unchanged. These studies show that SOX had a nominal effect on the overall size of boards.

Nor did SOX negatively impact the portion of active senior managers on *Fortune* 500 boards. However, based on recent studies cited, the composition of the boards (CEO versus other types of active senior managers) did change. Specifically, the Drury CEO-specific study found that during the 2002-2006 time period, the number of outside CEOs on *Fortune* 500 company boards declined by 30 percent. The Spencer Stuart survey of S&P 500 firms, with data supplied by the firms' corporate board secretaries, yielded similar results. It reported, "Only 29 percent of *new* independent directors added to boards in the past year are active CEOs, a slight drop from 32 percent last year [2005], but a significant drop from five years ago, when 47 percent of *new* independent directors were active CEOs."

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Percentage of Active Manager Directors

2001	28.1%
2003	28.9%
2004	28.5%
2005	28.2%

With the number of CEOs serving as outside directors on *Fortune* 500 boards declining precipitously, but with the number of active senior managers remaining stable, there is a clear explanation of how the departing CEOs are being replaced: Other types of outside active senior managers are readily being appointed to the positions being vacated by active CEOs from profit-making firms' boards. These managers include CIOs, CFOs, and CMOs.

The CEO Brain Drain

Are active outside CEOs as essential to providing board guidance as it was previously believed? The answer is probably not. The executives currently replacing CEOs, such as CFOs and division presidents, also head large complex organizations. While CEOs have broader strategic responsibilities, it seems likely that senior managers on management rungs just one or two levels below them deal regularly enough with the top leaders in their firms and company board directors to also be able to develop a broad understandings of the company's operations.

Others have come to the same conclusion that employing active outside CEOs isn't essential for board effectiveness. Board experts Colin Carter and Jay Lorsch argue, "[It's] possible to build a diverse and effective board if companies widen the talent pool and search for directors who will contribute to the mix of abilities that fit the board's need. We believe the often–mentioned shortage of candidates (like committee chairs) is more likely to reflect nominating committees' failure to look beyond the obvious than it is because of a lack of talent."

If CEOs are passing on outside board membership opportunities, why are lower-level executives taking them on? Don't these managers face the same risk-to-reward ratios as CEOs? They often operate large divisions with thousands of employees. Although their responsibilities are not as comprehensive, their work-life situations are likely to be as time-compressed as active CEOs.

In fact, the lure of certain major boards may be too great even for CEOs predisposed to decline such invitations. Samuel J. Palmisano, the chairman, president, and CEO of IBM, has not been at all willing in the recent past to accept outside positions because of the heavy demands of his own job. Early in 2006, however, he agreed to accept an outside directorship position on the ExxonMobil board.

Lower-level ranking senior managers appear to be ready to take more professional risks to assume board positions that active CEOs are vacating. In addition, they appear willing to make substantial time commitments to the outside boards that will certainly negatively impact the work-life balance most executives want to achieve. Assuming these "replacement" active senior managers are successful as outside directors over the coming decade, the current frustrating search for CEOs to serve as outside directors should, in time, subside.

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The logical answer, we believe, is that two things probably motivate these senior executives to be considered as board candidates for outside board positions and to readily accept them when offered. One is that the position is helpful for current advancement or can lead to a CEO position, since outside directorship experience and interpersonal networking can help open new career paths. A second is that ego motivation may be one of the drivers in the decision. Plenty of evidence supports the idea that it is still an "honor" to be asked to join a board, especially one listed on the *Fortune* 500 or the S&P 500.

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