

Directors

and their

Functions

A Preliminary Study



JOHN CALHOUN BAKER

Directors and Their Functions

A PRELIMINARY STUDY

IN RECENT years there has been much controversy over the place of directors in business society. The proper qualifications for directors, the effectiveness of "inside" and "outside" directors, and their responsibilities have been discussed heatedly and at length.

IN THIS book Dr. Baker discusses the duties of directors, with special reference to their management functions. He stresses the need for strong, able directors to meet the dual responsibilities of administration and trusteeship.

THE experiences of four companies, given in detail, present evidence of different types of boards of directors which indicates that no set formula can be given but rather that each corporation must tailor its board to serve its own particular needs. Certain basic functions, however, are outlined by the author.

DR. BAKER is President of Ohio University. He was formerly Associate Dean of Harvard University and Professor of Business Administration at the Harvard Business School.

DIVISION OF RESEARCH
HARVARD BUSINESS SCHOOL

Soldiers Field, Boston 63, Massachusetts

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FUNCTIONS**

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JOHN CALHOUN BAKER

President, Ohio University

Formerly Associate Dean, Harvard University, and

*Professor of Business Administration, Graduate School of Business
Administration, Harvard University*



DIVISION OF RESEARCH
GRADUATE SCHOOL OF BUSINESS ADMINISTRATION
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GRADUATE SCHOOL OF BUSINESS ADMINISTRATION
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DONALD K. DAVID, *Dean*
MELVIN T. COPELAND, *Director of Research*

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Foreword

The directors of American business corporations carry a heavy load of responsibility. They hold key positions in the management of many of our business concerns. Their judgment and resourcefulness in selecting operating executives and their wisdom in approving administrative policies will play a major part in the job-making task which business faces in the years ahead, especially in the years immediately ahead.

Despite the key importance of directors in business management, no comprehensive, constructive study of their functions has been undertaken heretofore. Certain aspects of the duties of directors have been discussed, to be sure, in various publications, but no broad study ever has been made. The subject is one which long has interested members of the Faculty of the Harvard Business School, and in recent years an increasing number of cases on directors have been used for class discussion. Under these circumstances, members of the Faculty have especially welcomed the opportunity to undertake the research study, the first results of which are presented in this volume.

Dr. Baker's interest in this subject developed naturally out of his extensive research on the subject of executive compensation. In this first report on the study of directors, he opens up the subject and not only gives some concrete results of the research already carried on but also presents a vista of the research opportunities ahead.

The costs of this project were met from funds contributed by the Associates of the Harvard Business School.

MELVIN T. COPELAND

Director of Research

Soldiers Field
Boston, Massachusetts
June, 1945

Preface

In the last half century, American corporations have assumed a position of rapidly increasing importance in our economic, social, and political life. They have often been violently attacked and defended. Certain groups have argued that they were a great blessing to mankind and others that they were impersonal, inhuman, legal machines that were destroying individuals and society. The legal characteristics, the growth, success, failure, and many other phases of corporate activity have been studied, explained, and criticized. All too little attention, however, has been paid to corporation directors, although they are legally responsible for management. They, like executives, are faced with the problem of knowing and meeting their responsibilities and of keeping abreast of rapidly changing conditions. This book is an examination of directors and their functioning in the early 1940's based on a broad study of the directors in many corporations as well as specific policies relating to directors in four well-known American corporations.

A decade ago it probably would have been impossible to make an examination of directors such as is now undertaken. Not only are more adequate records available than existed in past years, but the attitude of directors toward their responsibilities has changed; and almost without exception full cooperation was secured from directors in all companies approached. Not only were they willing to express their opinions, but they made available records of directors' meetings and special reports and answered all questions pertaining to the subject. Without such cooperation from many different individuals this book could not have been written. A large number of directors of important corporations made clear their sincere desire to know more about their function as directors. These men were eager to know what their duties were as fiduciaries and were concerned with their responsibilities. They sought to understand the variety of interests to

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whom socially, if not legally, they owed an allegiance in the exercise of the "rule-making" powers. Issues of this character were found to be uppermost in the minds and inquiries of substantially all the scores of directors with whom interviews and often repeated interviews were held.

Directors, corporation executives, and corporation records furnished the basic data for this analysis. There was frequent recourse to government records and documents as well as numerous interviews with members of government commissions, executives of labor organizations, small and large stockholders, and executives who were not directors. Emphasis was placed on securing firsthand information on directors in action, their achievements and records, as well as secondary material such as criticisms and legal cases. One main objective was to understand the substance of how directors functioned rather than simply the form or what the record appeared to be.

Various members of the Securities and Exchange Commission and staff were interviewed, and pertinent records of the commission examined. It should be recognized that over the last decade this commission's influence on directors has been great. Directly and indirectly laws as well as administrative rulings have turned the thoughts of both the public and directors to the latter's corporate duties and responsibilities. The perspective of history may well indicate that important, constructive results were secured in this way from laws and rulings which were attacked as being radical and destructive at the time they were made.

Broad studies of directors were undertaken to provide data on the whole subject of directors and their functions. Questions were investigated ranging all the way from "Who should be directors?" and "Should they have tenure or rotate?" to "Should directors be paid?" and "How far should they enter into the administration of their specific corporations?" This publication is only part of a more extensive research study of corporation directors which the author has been conducting for two years and which grows out of a prolonged study of executive functions and compensation. (*Executive Salaries and Bonus Plans*, 1938). Certain other important aspects of the problem that are being studied further are the

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legal, political, social, and economic environment in which directors must function; the motivation, remuneration, source, selection, and retirement of directors; the use of executive, financial, and advisory committees; analysis of proposed panaceas, such as representation of the public, labor, or consumers on boards of directors; and the ethics or philosophy of directors in relation to American life. These merely indicate certain additional important phases of the whole subject of directors. The role of management, including both directors and executives, in modern life calls for much further study.

It also should be pointed out that most of the directorates studied were those of medium-size and large companies classified as industrial. There was scattered examination of the directors in railroads, public utilities, banks, and insurance companies, but the conclusions in this book have been little influenced by those incidental studies and it should not be inferred that the findings would necessarily apply to any other group than listed American industrial corporations.

It is important to recognize that so far as directors are concerned, there are important differences between publicly owned and privately owned companies. The companies analyzed in this project are publicly owned in the sense that General Motors Corporation is—with its stock listed and with thousands of stockholders. In contrast, the stock of the Ford Motor Company is unlisted and privately owned by a few stockholders.

Because of the excellent cooperation of the executives and directors in many companies, frequent reference is made to the policies of specific corporations. Special acknowledgment is due to the officers and directors of The American Tobacco Company, Climax Molybdenum Company, General Foods Corporation, and Standard Oil Company (New Jersey) for their willingness to make available the material used in preparation of the detailed studies of directors' policies in their specific companies. Each company had a distinct tradition and corporate personality. The companies varied widely in directorates, problems faced, products, size, age, and management. *All, however, were profitable, even though the policies and practices of their directorates varied widely.* These companies were not selected to

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feature them in any way or to expose their policies to criticism. The executives and directors of these companies furnished the information required. They did not concern themselves with nor have they any responsibility for, my choice of data, comparisons, findings, and conclusions.

The four cases indicate something of each company's individuality by references to its history, products, organization, informal human relations and traditions, methods of communication between executives and directors, directors' meetings and minutes, and problems considered, as background for brief outlines of directors in action. Obviously, within the space available, we have been able to give only a thumbnail sketch of each company.

A committee composed of Professors Ralph J. Baker, George E. Bates, Melvin T. Copeland, and myself originally planned this study. All members of the committee had in past years been interested in directors and their functioning. Professor Ralph Baker had given this subject especial attention as a member of the Harvard Law School Faculty. Professor Bates wrote a pioneer article ("The Board of Directors," *Harvard Business Review*, Autumn, 1940) on the subject, and he and Professor Copeland have discussed some of these problems in their course in Administrative Policy in the Harvard Business School.

All the members of the group took an active part in the initial conferences with numerous directors and executives, but their subsequent participation in the study was interfered with by wartime teaching and administrative duties. The responsibility for carrying on this specific study was therefore delegated to me. The assistance which I received from this group, and specifically from Professor Melvin T. Copeland, I appreciate deeply. For the arrangement of this book and its findings and interpretations I am solely responsible and must accept all criticism.

Mr. Andrew R. Towl has assisted me at many stages of the study, from personal interviews to the final draft of the manuscript. He and Miss Marian V. Sears have borne the detailed labor of preparing specific cases and getting much of the material in shape for publishing. Their criticisms and suggestions

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have been invaluable, and to both of them I am deeply grateful. This bare acknowledgment in no way cancels my debt to them. Finally, I want to express my appreciation for the assistance of many businessmen, my colleagues, and others, with whom I have frequently discussed the problems of corporation directors and from whom I have received constructive ideas and criticisms. Without the help of all these individuals to whom acknowledgment is made, this study could never have been completed.

JOHN CALHOUN BAKER

Athens, Ohio
June, 1945

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DIGEST

DIRECTORS AND THEIR FUNCTIONS A PRELIMINARY STUDY

In recent years there has been much controversy over the place of directors in business society. The proper qualifications for directors, the effectiveness of "inside" and "outside" directors, and their responsibilities have been discussed heatedly and at length.

In this book Dr. John Calhoun Baker discusses and illustrates by actual cases the functioning of directors in the light of business and social trends. Although directors in conjunction with executive officers are responsible for the successful operation of our corporations, too little has been known about the duties, the practices, and the contributions of directors as they actually function. To throw light on reality is the purpose of this book.

Dr. Baker is President of Ohio University and was formerly Associate Dean of Harvard University and Professor of Business Administration at the Harvard Business School.

The research into the broad subject of directors and their place in business society, of which this book is the first result, started with management problems that large industrial corporations must meet and the relationship of directors to these management problems. The study is set against the background of three aspects of the business environment: the separation of ownership from management, the growing social significance of corporations, and the emerging concept of trusteeship. Throughout this study two streams of thought recur. One of these has to do with the part directors play in *administration*, that is, in getting things done. The other has to do with the part directors play in *trusteeship*, that is, in keeping a balance among the interests of stockholders, employees, customers, and the public.

The examination of individual boards in detail was found to be necessary to the understanding of relationships among the numerous and intricate problems of directors, their functions

and contributions. Wide variations were found in the practices and policies of directors in many companies. These variations brought out the need for investigation into their causes and their relation to the environment in which the companies and their directorates had developed. With the assistance of their managements, therefore, detailed studies were made of The American Tobacco Company, Climax Molybdenum Company, General Foods Corporation, and Standard Oil Company (New Jersey).

Six major factors and their interaction were studied for each company: the present and historical composition of the stockholder group; the personalities in top management, directors and executives; key problems facing the business; the place of the board in the informal as well as formal organization of the company; the methods of communication between the board and the executives; and the extent of action by the board as a group as well as the action of directors individually.

The investigation revealed great variations among the companies in the way similar problems were handled. Similarities in functioning were limited mainly to fulfilling legal requirements. These differences in four profitable companies suggest that if no formal pattern for directors is forced on corporations by legislation, there is little likelihood of close conformity or little need for it. Careful diagnosis, appraisal, and treatment of each company by those interested in it are far more sound procedures than ingenious remedies prescribed wholesale.

In spite of the wide variations in practice, the following points outline the basic functions of an effective board of directors in discharging their responsibility for prudent management of the whole enterprise:

- a. The board selects the chief executive and senior officers and makes certain that able, young executives are being developed. Also, the board controls executive compensation, pension, and retirement policies.
- b. The board delegates to the chief executive and his subordinate executives authority for administrative action.

c. The board discusses and approves objectives and policies of broad corporate significance, such as pricing, labor relations, expansion, and new products, as well as payment of dividends, changes in capital structure, loans, lines of credit, and public relations.

d. The board checks on the progress of the company not only as to immediate profits but also as to the discharge of its trusteeship responsibilities. Budgets, reports, inspections, and other controls aid directors in carrying out this function. They serve as the basis for the directors' most effective approach, which is to ask discerning questions from an independent, outside point of view. Also, directors arrange for, control, and follow up outside audits and in general maintain vigilance for the welfare of the whole enterprise.

Directors need leadership to become most effective as a board in meeting their responsibility for management. To provide this leadership is the function of the board chairman, whether he is the chief executive or a separate officer. If the chief executive carries the dual responsibility for administration and for critically checking results, or if separate officers lead the board and the executive organization, the position of chairman presents a real challenge in organization and human relations. The chairman can meet the challenge through: (1) bringing before the board questions where conflicts of interest might occur, such as salary payments, pension plans, determination of dividends, review of independent audit reports, complaints of stockholders, and other problems emphasizing trusteeship; (2) supervising the selection and election of directors and executives and passing on skills and experience in management; (3) guiding attention to the policy questions emerging from executives' operating decisions; (4) proposing sound standards of board procedure; (5) drawing from directors their maximum contribution by arranging for consultation and by opening appropriate questions for board discussion and action; (6) preparing agenda that will bring regularly before the board questions and information for appropriate action.

The essential concern of corporation directors, particularly in our large corporations, is not today, nor should it ever have been, merely protection of stockholders and their interests. The problem is the reconciliation of private enterprise with the smooth functioning of a democratic society with justice to all groups: stockholders, executives, employees, creditors, customers, and the public. Such a broad concept of the functions of directors is frequently overlooked. Nevertheless, this should be the contribution of directors to our national life.

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