

DECLASSIFICATION OF CORPORATE DIRECTORS: ADDRESSING THE REAL CONCERNS AFFECTING STOCKHOLDERS

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Introduction

Tucked away in the pages of a Wall Street Journal (WSJ) is an article describing how WCI Communities, Pepco Holdings, and Duke Energy Corporation are following a growing trend to “declassify” company boards of directors - “an move that ends staggered elections of directors in favor of annual ones” (Murti, 06/08/05, p. B2B). Other firms declassifying boards include: BKF (BKF Capital group Adopts Corporate Governance Changes, 06/08/05), Allegheny Energy, Inc. (SEC Filings, 06/15/05), Wisconsin Energy Corporation (PRNewswire-FirstCall, 05/05/05), Honeywell (Honeywell shareholders OK changes, 04/26/05), and Kohl’s (Hajewski, 04/27/05) to name only a few of the firms.

Supplementing the issue of declassification, is the issue of shareholders voting. Here, proposals are seeking a change from a super majority requirement to a simple majority approval for all matters submitted for stockholder approval (SEC, 06/15/05). The expressed desire is the ability of shareholder (and large fund managers) to affect change in the companies owned. Yet, these votes may be non-binding upon the Boards.

Additionally, declassification is sought for a more subtle issue and that is the “poison pills” quality associated with monolithic board membership, which hinders possible corporate acquisition and merger activities (Deane, 2005). Some believe that Board members are currently positioned to exercise poor judgment due to a conflict of interest when the loss of the member’s position and per diems interfere with organizational and business opportunities

The WSJ article (Murti, 06/08/05) offers two opposing views concerning the move toward Board

declassification. First, Patrick McGurn, a senior vice president of Institutional Shareholders Services, indicates that studies and empirical evidence show “pretty conclusively that unlike poison pills, there is no evidence that the boards use (sic)classified structure to enhance shareholder value...In fact, the opposite appears to be true” (p. 2B2). In opposition, Richard Koppes, former general counsel for California Public Employees’ Retirement System states “directors are more likely to ask critical questions in board meetings if they don’t have to face elections every year” (p. B2B).

Not considered as part of declassification, voting, and/or poison pill issues is the impact of these changes to the individual Director’s - and the collective group’s ability to learn, which is the foundation for critical thinking and informed, symmetric decision-making. Today, information moves at an extreme velocity and organizations are in the data business. As a result, learning has replaced capital as a scarce resource (Stewart, 1997; Schwandt, 1995; Marquardt, 2002). This article explores the impact declassification has on the quality of individual and group learning and the decisions made by Boards of Directors. The paper will also offer alternative actions that must be considered if corporate governance is to serve stockholders and offer sound outcomes.

The Debate

Shareholders’ call to raise the level of Director attentiveness and service is unquestioned. Global Crossing, Adelphia, Enron, WorldCom, and such issues related to the New York Stock Exchange (NYSE) CEO bonus package, all raise red flags about the outcomes of the decisions made by Boards. Investors and non-

investors continue to be exposed to a plethora of information about corporate misdeeds. Even the Catholic Church has provided fodder for consideration concerning how the US leadership is handling the interest of the people it serves. Declassification seems to offer little to remedy these events.

One may question if moving the deck chairs on the Titanic is a strategy that will address the greater problem. If shareholders desire knowledgeable, autonomous Directors, then actions to change corporate governance must seek to increase Board learning and Board communication in order to achieve decision-making excellence. Declassifying directors has the potential to increase the frequency of membership change for these part-timers professionals. It offers little to increase collective learning and support the Board as a cohesive learning community.

“Proponents of proposals to declassify the board frame the issue as one of accountability to shareholders: that directors who are up for re-election only every three years are less likely to be attentive to shareholders concerns and are thus more likely to ‘rubber stamp’ management decisions” (§ 27.03[D] The Debate over Classified Boards). However, research supports a couple of interesting behaviors. First, that group members perform in reference to other groups; and, each member of a group works in reference to other members of the group (Barros & Verdejo, 2001999). It could be concluded that changing membership may result in a delayed learning curve as Directors move thought new Director Orientation to become a capable participant.

“Cranton suggests that there are three types of group learning: instrumental (scientific, cause-and-effect information); communicative (mutual understanding and social knowledge); and emancipatory (increased self-awareness and transformation of experience)” (Imel, 1997). Frequent changes in Board membership will slow communicative and emancipatory learning. Even if new members bring instrumental or technical knowledge, new members will require time to gain both a mutual understanding (with other board members) and social knowledge. This reality questions how shareholders will gain attentiveness as new directors will have focus on the acquisition of learning and skills needed in the new environment.

Further, “Group learning that has as its goal the acquisition of instrumental knowledge is called cooperative [learning in groups when] the focus is on the subject matter rather than on the inter-personal process” (Imel, 1997). Further, the term collaborative describes group learning... based on communication (sic) knowledge. Finally, “collaborative learning groups emphasize process and participants exchange [of] ideas, feelings, and information ... arriving at knowledge that is acceptable to each group member (Imel, 1997).

Clearly learning is a delicate balance between individual and group learning needs. Masick and Kasl (1997) challenge “society’s long tradition of valuing individualism (italics added for emphasis) [which] creates habits of [the] mind that makes it difficult to learn how to work and learn collectively” (¶ 1). Declassifying boards is an act in support of individualism. Shareholders can look to the Disney case to see the problems that individualism may create. Clearly, the Delaware court ruled “that company directors adequately looked out for shareholders’ interest in 1995 when they endorsed CEO Michael Eisner’s decision to hire his former pal Michael Ovitz as president - then, 14 months later, approve his firing with a \$130 million severance package” (Lieberman, 08/10/05, p. B1). Though, in the same article, Charles Elson offered the following post-script and stated “Failure to be independent and failure to be circumspect carries a serious threat of liability” (p. B1). Collaborative learning enhances critical thinking (Gokhale, 1995). This occurs when members actively exchange ideas. Full board communication was at issue in this case. Adding new board members every year seems a slim solution to the problem of poor board communication and decision-making.

Declassification changes offer limited solutions to balance rogue members and autonomous committees that act with little regard for collective debate and due process (as witnessed in the Disney case). This disrupts the natural discourse and debate needed to enhance collaborative learning in support of decisions-making excellence in the board room. Declassification changes side-step the issue of absent members, whose knowledge is unavailable as an enhancement to board voting. Finally, declassification has yet to fully address members of Board of Directors who remain inactive. Finally, proponents of board declassification “point out that directors who stand for election annually are, with rare exception, re-elected year after year, and that there are no director term limits at most companies” (Romanek & Young, 2005, fn16). An additional consideration is the disruptions declassification may have on the yearly board agenda: including the audit cycle and CEO valuation. Should new members be seated, these individuals must challenge a steep mountain of background information needed for current decisions, which naturally leads to the utilization of senior Board members advice as a primary source and the basis for decision-making. This does little to infusion new knowledge to inform decisions. At the end of the year, this cycle may now be repetitively disrupting to the long-term knowledge base of the members of the Board -and the loss of Board autonomy must be addressed. The likely outcome will be a complete lack of decision-making symmetry, which will provide support to the

proponents that classification promotes stability and continuity. Cycle disruptions also hamper learning and the creation of social capital, which is defined as "... Building economically and socially viable and sustainable learning communities learning community"... such as professional or group of business" (Kilpatrick et al, 1999, 1).

Researchers address the need to build social capital as a foundation that supports group learning (Kilpatrick, Rowena, Bell & Ian Falk, 1999). Building social capital in the Boardroom is grounded in rigorous Board member debate by fully participating members. Declassification offers a structural change to the current system of corporate governance, but this structural change doesn't little to positively address the need to increase rigorous debate that informs voting at the Board table. Learning informs voting in the boardroom and it should be the focus of future changes in corporate governance.

Beyond the creation of learning communities in the Boardroom, real solutions do exist that will achieve the desires that the declassification changes fail to address, and include: (1) limiting terms, (2) educating directors as a precursor to professional certification or licensing, (3) limiting D&O insurance for individual negligence, and finally (4) making it mandatory to fully declare and abstain from voting when in a perceived or real conflict of interest. Additionally, The Model Business Corporation Act places all powers in the Board. Simply exercising full due process at the Board table will create the setting that allows for fuller, pro-active communication in support of learning and critical thinking. In absence of a meeting, Boards should follow that mandate to use a consent decree requiring signatures by ALL members to enact a vote. New platforms exist to support secure on-line Board discussions, which negates the need for Board officers or an Executive Committee to provide decisions between meetings. Finally, shareholders may affect greater Board member service and attentiveness if the annual report included the individual Board attendance and voting records. Declassification will not provide for these enhancements. The real desires behind declassification are: (1) an increase in stockholder power, (2) an increase in director accountability, (3) a desire to redraft poison pill protections and options, and (4) a greater voice for stockholders. These problems have occurred due to rogue board members, board members in conflict of interest, and board members in slumber. Owners need a powerful board to balance the power of the CEO and senior management and the power of the marketplace. The Model Business Corporation Act vests all powers of the corporation in the Board. Yet, to use that power, Board MUST learn and practice decision-making synergy. Powerful

members or powerless members must be brought into balance or Boards will continue to face such mandates as declassification by shareholders.

Conclusion

The future will provide the lesson about the effects of Board declassification. Yet, without question, declassification does degrade the synergy needed to build learning and decision-making symmetry, and it makes these part-time professionals, a temporary and potentially short-term member of a decision-making community. As a poison pill, this strategy remains questionable. Clearly, the alchemy of providing excellent oversight that generates great business outcomes is not the mandate of declassification. Declassification is a re-structuring strategy only. Real alchemy comes from a great deal of knowledge, and a sprinkle of luck, but remains unlinked to potentially changing the seats in the chairs after each election. Perhaps corporate governance restructuring should begin to address the real problem, which is positioning Directors to be knowledgeable, accountable, and ethical fiduciaries

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