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Is Independence an Extinct Virtue on Boards?

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Nontraditional financial reporting at Enron, excessive executive compensation at Tyco and numerous other questionable practices at public companies have captured news headlines in recent weeks. Debate continues as to why these revelations have emerged now, given that these practices no doubt have been going on for some time. It is not surprising that public confidence has eroded on voluntary disclosure of such actions by corporate boards. Further, has there not been a move afoot for several years to give greater voice to independent directors on a public company’s board?

Exactly, what is an independent board member or director?

Every member of the board of directors of a public company, according to common corporate bylaws, has the fiduciary responsibility of providing impartial and diligent oversight of a company’s operation and management in the interest of all shareholders. However, for quite some time, boards of directors at public companies were often found stacked with employees, investors with large stock holdings, “trophy” or “big name” directors, and “buddies” of the CEO who brought little business expertise, and more importantly, brought no unbiased eye to the board. In response to complaints from shareholders about boards that appeared to be unresponsive to their interests, the Securities and Exchange Commission (SEC), as early as 1940, asked public companies to take on “independent” board members on audit committees. More recently, the SEC issued Rule RIN 3235-AH83, made effective on January 31, 2000, that asked for disclosure via proxy statements from public companies about the independence of directors on audit committees. An independent board member was supposed to be a recognized business executive with knowledge or expertise relevant to the public company business, with no sizable share holdings in the company stock, not an employee, supplier or customer and with no significant affiliation with the company’s management or operations. The expectation was that this “outsider” could review the company’s policy, finances and strategy and cast votes in the best interests of the shareholders at large.

Despite this SEC noble mission, “stacked” boards still appear to be plentiful. The partnerships used for hiding losses at Enron, the lucrative executive compensation or “loan agreements” at Worldcom or Tyco are items that are normally reviewed and approved at the board level. Were the independent board members asleep? Unlikely. What probably happened was that persuasive arguments by more influential “insider” board members drove the approval of the resolutions allowing such reprehensible and unethical acts to occur. The reason we are learning about these actions now is timing. The market has had a severe downturn, significantly affecting the wealth of a great many Americans who had become shareholders in the “boom” nineties. They want answers and in some cases, retribution.
The negative publicity attributed to boards abdicating their fiduciary responsibility could now make it more difficult to get “quality” independent board candidates to join boards. It simply is not worth the aggravation or risk to be a minority member of a board that is already “stacked.” No compensation at the board member level, (normally a few thousand dollars plus some company shares per year is typical), can possibly offset the risk to one’s reputation and career.

The current public outrage, however well justified, at the shenanigans occurring at public companies could very well have an outcome that would make matters worse. Namely, we could witness a deeper entrenchment of insiders on boards along with the reluctance of business leaders with integrity and honesty to join boards of public companies.