The problem of emotion in the boardroom

By Pascal N. Levensohn

BOARD DYNAMICS The problem of emotion in the boardroom Lefl uncheckedy the force of emotion may act to compromise influential directors' abilities to promote the best interests of shareholders when the menu of options facing the board renders the status quo untenable, BY PASCAL N. LEVENSOHN W HEN A COMPANY'S EVOLUTION reaches a crossroads requiring strategic action outside of the scope of normal business activ- ity, directors are invariably called upon to make difficult decisions with far- reaching implications. These decisions often require extraordinary corporate actions, ranging from the removal of the CEO to the sale or financial restruc- turing of the company. Lawyers and investment bankers, the masters of the corporate reorganiza- tion playbook, will swiftly appear on the scene to guide the board through the maze of options and consequences that must be considered. Nonetheless, directors retain ultimate control over both the tactics and strategic direction of the company. They therefore wield great power in charting corporate strategy. It is impossible to deny that emotion Pascal N. Levensohn is the founder and pres- ident of Levensohn Capital Management LLC, which was established in San Francisco in 1996. His professional activities are focused in two areas: investment advisory, providing strategic advice to high net worth families; and direct investing in both public and private technology companies. Mr. Levensohn has worked closely since 1993 with private, fami- ly-owned operating businesses experiencing challenges associated with generation suc- cession. He has been an activist public equity investor since 1990, when he joined the merchant banking firm of Richard C. Blum & Associates. His professional investing career began in 1983 at First Boston Corp., after he spent two years working at Bankers Trust Co. in New York. He has been a director of both estab- lished public and emerging private companies, and is currently a director of TeraLogic Inc., a Mountain View, Calif- based semiconductor design company, and of LiDCO Ltd., a medical products company based in the U.K. plays a role in director deliberations, if only because we are all human. Recognizing this fact, it is im- portant to channel emotion into positive results when possible and to minimize its negative effects through proactive planning when unavoidable. Emotional boardroom behavior manifests it- self in wide-ranging forms, including ego games de- signed to impress friends, actions taken or not taken to save face, self-interested actions, and personal vendettas. Left unchecked, the force of emotion may act to compromise influential directors' abilities to promote the best interests of shareholders when the menu of options facing the board renders the status quo untenable and

change is unwelcome. Several patterns evident in the structure of cer- tain corporate boards make it more difficult for dis- passionate decisions to rule over emotion in de- termining corporate strategy. Proactive structural steps may be taken in advance by corporate boards to minimize the potential for these outcomes. This article compares the constructive and destructive force of emotion in the closely held family com- pany, the private venture, and the public corpora- tion, noting differences particular to each gover- nance structure but focusing on the common role that emotion plays in the boards of all of these com- panies. These observations are based on my direct experience as an activist shareholder in mature pub- lic companies facing demands for fundamental change, as a venture investor and director of private companies experiencing the challenges of rapid growth, and as an independent adviser to closely held private operating companies and family in- vesting organizations. Establishing common ground Whether a company is young or old, large or small, healthy or troubled, the personal dynamics that de- SPRING 1999 25 BOARD DYNAMICS Long-term patterns of behavior rooted in childhood relationships tend to be replayed in the boardroom of family businesses. velop in the boardroom between directors are sim- ilar. Over time, emotional bonds are created, indi- vidual loyalties established, and the locus of power within the board becomes deñned. The culture of the board may become a mirror ofthe culture ofthe company as a whole, or it may develop in such a manner as to have no relation to the company at aU. While this maybe a virtue in some companies (such as management paragon General Electric), it may enshrine dysfunction in others (such as Morrison Knudsen, where personal relationships protected CEO William Agee to an extreme). The composi- tion ofthe hoard and the strength of its ties to the history of a company may come to represent a prob- lem when change — whether internally promoted or the result of outside forces — comes to dominate the corporate governance agenda. The closely held business: Emotion at full sail The governance structure that invites paralysis and the greatest emotional discord in the face of prob- lems demanding action resides in the family board consisting exclusively of family members or in- cluding one or two passive outsiders. The thorniest such issue is that of generation succession. One causal factor having a great impact on suc- cession is the structure ofthe board, particularly when the board and the family are indistinguish- ^^_^^^_^^^^^ able. Emotion lies at the root of this problem. This negative potential is only magnified when the board members cross different generations — for example, parents, chil- dren, grandchildren, relatives by marriage, and cousins who are not close. By their very nature, fami- lies are closed systems and are therefore insular and exclu- sionary. Long-term patterns of behavior rooted in childhood relationships tend to be re- played in the boardroom. Disagreements over sub- stantive business issues are re-enacted outside ofthe business setting or they come out of old family dy-

namics. As a result, they often lead to intractable, emotionally rooted business positions that create deadlocks with disastrous consequences for com- petitive success in a dynamic business environment. When they do look outside the family for advice, families often retain advisers with a view toward preserving congeniality on the family business agen- da or maintaining a convenient scapegoat at their side. Families thus have a tendency to let advisers go on and on instead of holding them accountable for their action or inaction. This extends to the failure of even denning the scope for measuring advisers' accountability. Consequently, strong advisers who can play the important leadership role are not only absent from many family business governance structures, but their development is discouraged by family inertia and the ever present fear of open family confronta- tion or disagreement. Jay Hughes, in his recently published book Eamily Wealth: Keeping It in the Eamily, refers to this negative tendency as a trend toward "entropy" in the family organization and concludes that "it is apathy or outright indifference by individual family members to the excellence of the representatives selected and to participation in their selection that leads first to government stag- nation and ultimately to failure of governance." Absent the enlightened patriarch or matriarch (a credible, authorized family leader) who can skill- fully engineer the delicate path of succession in a family-only environment, the most successful fam- ily boards defuse the family's emotional agenda through the presence of one or a number of trust- ed outside advisers as their elected representatives. The steadying influence of such non-family mem- bers is most effective when one such person can control the agenda and conduct of the board as its chairman, particularly when it is necessary to main- tain an orderly flow of business and obtain timely binding board votes on divisive issues. Nonetheless, the family board is the most vul- nerable to paralysis due to emotion during the con- sideration of issues such as the sale of the compa- ny or the succession of management from one generation to the next. Hidden agendas and sacred cows often dominate individual positions, and it is necessary to get those agendas out in the open be- fore an individual's position becomes emotionally intractable. Diplomacy to build consensus is neces- sary to see such boards succeed in their activities, and this is no easy task. Family business owners should proactively reach out to and empower strong independent directors in order to enhance the final emotional and eco- nomic outcomes for themselves and their extended families. It has been my experience that, when they do, the range of potentially favorable outcomes will increase exponentially. Venture companies: Embracing emotion while rising above it In emerging ventures, the combination of fragile egos and intensely competitive dynamic markets makes for highly emotionally charged board situ- ations. Venture companies, where the fight for sur- vival defines daily existence, require the steady hand of at least two strong, independent directors with sufficient

experience and economic stakes in the company to command both respect and deference from the CEO. This becomes most relevant when major changes in corporate strategy are required and they are not arrived at by initial consensus be- tween management and the board. Most often, the stress of corporate development is exacerbated for these companies when: 1) the most recent business plan projections have not been met; 2) the key players of the management team (head of sales, head of marketing, chief financial officer, chief technology officer, chief executive officer) are not meeting their objectives and must be re-assigned or replaced; and 3) a new financing is necessary (most venture companies are usually about to raise more money or have just closed on a round). Fundamental, wrenching change is more the norm than the exception for young companies, and there- fore time compression in the decisionmaking cycle is a fact of life. Independent directors play a crucial role in defining the success of venture companies — their decision to support or not support the CEO at a cru- cial time may mean the difference between a very suc- cessful investment and a complete write-off. Con- sequently, these directors must walk the fine line between being close confidants of the visionary en- trepreneurs and maintaining their objectivity as the representatives of all of the shareholders. Two interesting developments in the venture cap- ital business over the past three years in particular have been the proliferation of new venture funds backed by large corporations and the bulging pock- ets of the traditional venture funds as they have har- vested phenomenal returns fi^om investments made over the past 10 years. One result of this prosperity, particularly in technology, has been that virtually every good idea now has three or four well-fund- ed start-up companies competing against each other for leadership in their space. Hence, the importance of the independent di- rector/venture capitalist has been magnified, as the consequences of a strategic mistake may mean dis- aster. Of course, every CEO believes in his or her tal- ent and is convinced in the veracity of their own particular solution to a market's needs. The chal- lenge presented to the board of directors is to man- age the conflict between a CEO's emotional com- mitment to his plan and the evolving reality of the marketplace when they do not coincide. Unlike more mature company boards, the skilled venture company director must learn to embrace the emotional agenda of the entrepreneur, particu- larly during the early stages of a company's devel- opment, and, at the same time, be prepared to ele- vate strategic issues that challenge the status quo to a level above emotion. Objective appeals to the best interests of all of the shareholders, depersonaliz- ing well-thought-out criticism of management, and empowering third parties ^^^^^^_^^^^_ (such as organizational devel- opment consultants) to work with the management team in implementing change are among the tools available to independent directors. Main- taining a sense of timing and avoiding organizational stag- nation are critical to the suc- cessful

management of these situations. In many ways, the venture director must blend approaches to the problems faced by the family-business ^^~^^~^^^^^ board with the discipline of the professional pub- lic-company board in order to successfully shepherd such companies to their next stage of development. Public-company boards: Emotion and the force of company insiders Moving into the public sector, as companies raise capital and grow from private origins to public share ownership, the dichotomy between ownership and management is naturally accentuated. Early or ini- tial stakeholders — the founding shareholders, ven- ture capitalists, and managers — are naturally di- luted and, hopefully, come to enjoy a smaller piece of a much larger economic pie. At the same time, as the interests of the owner/manager naturally begin to diverge, they may also conflict. As stewards of value maximization for all of the company's own- ers, the board of directors also experiences natural changes, with active independent directors often ac- counting for a very small piece of the total share- holder economics but playing a dominant role in establishing the balance of power on the board. Outside directors account for the majority of members on the boards of the larger public com- panies. According to a Spencer Stuart survey of the S&P 500 companies, outsiders represent 78% of board members. For smaller companies, the per- centage is much less, A 1998 survey by Grant Thorn- ton and the Segal Co. of 193 small to mid-size com- panies (with median annual sales of $137 million) reports that outsiders comprise only 44% of board members. While various surveys show that any- where from 75% to 90% of all companies now in- clude some stock component in their director com- pensation, the Grant Thornton/Segal study reports In emerging ventures, the combination of fragile egos and intensely competitive dynamic markets makes for emotionally charged board situations.   Public-company directors have a natural tendency to postpone actions acknowl- edging governance failure until absolutely necessary. that smaller-company board members are more heavily invested in the companies they serve than are directors of larger companies: One in four (25%) of the board members in the smaller public company group own at least 3% of the stock in their companies (emulating more their venture board counterparts); in contrast, less than 2% of total board members at large public companies individ- ually own at least 3% of company stock. In the public-company boardroom, another defining feature is lengthy director tenure. To ad- dress what is often an open-ended appointment, the largest U.S. companies are now generally mandat- ing retirement for board members at age 70 or 72, according to a recent Korn/Ferry survey. Another option to address a glacial pace of board turnover would be term limits, but only 8% of the Korn/Ferry surveyed companies have installed term limits for board members. As board members become ensconced and in- creasingly comfortable in their roles, they also be- come proponents of the status quo, much like bu-

reaucracies have a natural tendency toward self-perpetu- ation. This sense of comfort in the boardroom becomes par- ticularly important because these groups are naturally small and exclusionary, similar to families but less burdened by emotional baggage. One of the most serious instances of resistance to change, however, occurs when emotion confiicts with the de- mands of extraordinary corporate events -— such as unwanted takeovers. Public-company directors have a natural tendency to postpone actions acknowl- edging governance failure until absolutely necessary, particularly when faced with the potential of intense media scrutiny and/or shareholder legal actions. Ironically, the opportunity cost of delay is great- est, and most likely to have a negative impact on shareholder value, when a company faces the need to radically change its corporate leadership but de- lays action due to personal friendships, the bonds of years of collegiality, or a wish to respect the dig- nity of a long-time executive's legacy by not accel- erating succession that is clearly overdue. It has been my experience in representing large shareholders of several mature public companies over the last nine years that boards find it difficult to change corporate strategy — even when a CEO's record has clearly not generated shareholder value and has been roundly discredited in the investor community — when the CEO must be removed to make way for change. The presence of former CEOs on the board, or a history of maintaining for- mer CEOs as directors, is a factor farther inhibiting the timeliness of this type of change. It is naturally very difficult to move a CEO aside, have him remain a voting board member, and pro- ceed to undo major projects that this person has pre- viously done with the board's blessing. When more than one former CEO remains on the board, this problem is magnified. Retired senior executives have a natural tendency to glorify their exploits and to treasure past contributions as well as to protect one another and their reputations. It is therefore risky to keep them at the table. This emotional risk is com- pounded when independent directors loyal to those retired executives also remain in positions of power as the chairpersons of key committees, particularly when the balance of power on the board may rest in the hands of the current CEO, former executives, and long-time independent directors. In some cases, the board's natural reluctance to act in a deliberate man- ner can lead to unintended consequences, including the loss of a company's independence. Emotionalism and the battle for AMP Inc. One interesting example is the recent case of AMP Inc., in which delays by the board in replacing CEO WilHam Hudson and Chairman lames Marley to pursue a more aggressive restructuring left the com- pany open to a hostile takeover approach from Al- liedSignal Inc. in early August 1998.1 was person- ally involved with this company for the two-year period prior to these events as the representative of a large branch of the Hixon family, who co-founded the company and was the second-largest AMP share- holder group, having held its shares for over 50 years. As the events of August 1998 unfolded

and led to the company's acquisition offer by Tyco International in November 1998 (and its completion in April 1999), it was apparent that emotion took center stage in this situation early on for a number of important deci- sionmakers at the company. Prior to these events, AMP's board structure was as follows: out of a total of 11 directors, eight were independent. Of the insiders, Harold A. McInnes was a retired chairman and CEO of AMP and a di- rector since 1981; lames E. Marley, who had been an executive at AMP since 1963 and a director since 1986, was the chairman of the board; and CEO William Hudson was also a long-time AMP veter- an, having joined the company in 1961, becoming a director in 1992, and taking over as chief execu- tive in 1993. These three insiders also comprised the executive committee of the board. Another former 28 DIRECTORS & BOARDS BOARD DYNAMICS Chairman and CEO Robert Ripp (lower right) rallying AMP employees during an anti-AlliedSignal takeover rally, Septem- ber 1998. Says author Pascal Levensohn: "In my personal opinion, the collective feeling of frustration and perceived 'dirty opportunism'of AlliedSignal's Larry Bossidy locked the AMP board into its didactic position of rejection." chairman and CEO of AMP, Walter R Raab, had served on the AMP board until the mid-1990s. Among the independent directors, several serve on multiple public-company boards: Ralph De- Nunzio, the longest-tenured AMP director (on the board since 1977), is a former chairman of Kid- der Peabody and serves as a director of Harris Corp., Federal Express Corp. and Nike Inc.; John C. Morley, former CEO of Reliance Electric Co., is a director of Cleveland Cliffs Inc., Eerro Corp., and Lamson êi Sessions Inc.; and Paul G. Schloe- mer, a former CEO of Parker Hannifin Corp., is also a director of Esterline Technologies Corp. and Rubbermaid Inc. Barbara H. Eranklin, a former U.S. Commerce Secretary, is currently a board member of Aetna Inc., Cincinnati Milacron Inc., Dow Chemical Co., and Medlmmune Inc. Joseph M. Hixon III occupied a board seat that had been held by a Hixon family member since the compa- ny was co-founded in 1943 by Robert Hixon. Other former CEOs who had served on the AMP board in the 1990s include the retired chief executives of Air Products and Chemicals Inc., Harsco Corp., and Hershey Foods Corp. Thus, despite a majority of independent direc- tors, the forces of history and loyalty on the board were very strong at AMP. A legacy of lagging performance From its origins in the 1940s as the inventor of the solderless or crimped connector, AMP grew rapid- ly to become the global leader in the manufacture of electronic connectors for industries ranging from auto- motive to personal computers and white goods. By 1989, however, its operating perfor- mance bore the scars of in- creased global competition from both foreign manufac- turers and from a new breed ^^~'^^^~^^^^ of smaller, nimbler U.S.-based competitors. Ana- lysts and investors had roundly criticized AMP management for years as reactive instead of proac- tive in its operating responses to the challenges posed by the marketplace. Emotional boardroom

behavior manifests itself in wide-ranging forms. SPRING 1999 29 BOARD DYNAMICS The board's natural reluctance to act in a deliberate manner can lead to unintended consequences. This lagging operating performance was reflect- ed in the value created for AMP shareholders. From January 1, 1990, through June 30, 1998, AMP ap- preciated at a compound annual rate of 5.2% com- pared to 14.7% for the S&P 500, excluding divi- dends. In a bid to remake itself under Bill Hudson's leadership, the company dedicated a large part of $1.7 billion in capital expenditures from 1994 through 1996 to pursue a diversification strategy aimed at increasing the company's revenue growth rate by entering new busi- nesses outside of its tradi- tional franchise strength in terminals and connectors. By December 1996, AMP began to publicly acknowl- edge operational missteps re- sulting from this strategy. After reducing its 1996 and 1997 earnings estimate guid- anee for Wall Street several times between August and October 1996, in De- cember of that year AMP previewed what would be the first of a series of restructuring announcements over the next 18 months. Late in 1997, AMP man- agement announced that the company was being adversely affected by weakening U.S. markets and by the Asian financial crisis, but AMP's seven-plus years of declining manufacturing margins and con- tinually deteriorating operating profitability be- spoke of longstanding problems that were partic- ular to AMP, not symptomatic of the industry or the global economy. Steps to reverse the decline In January 1998, AMP took steps to strengthen its op- erating management, promoting Robert Ripp from his position as chief financial officer to direct oper- ating responsibility by making him an executive vice president and "head of all Global Business Units." A relative newcomer to AMP, having joined the orga- nization in 1994 from IBM, Ripp was a strong, nat- ural leader in the company but had previously been largely untested outside of the financial arena. On July 24,1998, AMP announced second-quar- ter earnings per share of $.25,28% below an already lowered Wall Street consensus expectation of $.35, and 49% lower than the prior year's comparable quarter earnings of $.49. The gross margin of 27.7% was well below the company's acknowledged 32% minimum acceptable level, and the anemic oper- ating margin of 6.7% placed the company well below its minimum target of 13%. In conjunction with this disheartening earnings report, AMP an- nounced its Profit Improvement Plan, which fea- tured the layoffs of 3,500 employees, later increased to over 4,000. At the meeting, AMP's newest round of one-time restructuring charges totaled $235 mil- lion. The company spoke of generating annual cost savings of $200 million. Meanwhile, the AMP shareholders continued to suffer. From lanuary 1 to July 31,1998, AMP's price declined by 50% versus an S&P 500 rise of 16%. It should have come as no surprise to anyone that somebody, in this case AlliedSignal, took advantage of the halving of AMP'S stock price and struck with a tender offer. It should also have come as no surprise to the AMP board of directors that the shareholders of AMP

would welcome such an overture from any qualified third party. Along the way, while the board certainly deliberated succession issues and felt a sense of some urgency to effect change, the deep commitment to maintaining the basic status quo embodied in the presence on the board of current and former CEOs was not re-thought, even when presented with clear signposts from constituencies ranging from large shareholders to the redoubtable "sell-side." The highly unusual actions taken by the board of replacing Hudson and Marley with Ripp after AlliedSignal's bid and adopting an "indepen- dence at all costs" posture strongly indicate that the AMP board was acting in an emotional state. A board hampered by emotion The evidence is overwhelming that, throughout the period from at least late 1996 until September 1998, the company didn't bite the bullet and make the type of fundamental operating and management changes that were necessary to address a bloated cost structure and ineffective manufacturing processes. Based on our personal experience with this company, we believe that emotion and loyalty hampered the board from making deeper person- nel cuts sooner and redeploying assets overseas more aggressively in order to remain globally com- petitive. Once Hudson and Marley were replaced, the board and the new management team may have believed that they deserved to have a clean slate and could make a fresh start — hence their emotional commitment to the pursuit of independence through a course as flawed as the so-called Penn- sylvania Legislative Initiative (see below). Public comments made by the company revealed that the ascension of Bob Ripp had been under con- sideration by the hoard for at least the past year. Be- cause the board understood AMP's problems better than any other party and felt that they knew how to fix them, the unfortunate timing of AlliedSignal's approach pulled the rug out from under the board. 3O DIRECTORS & BOARDS BOARD DYNAMICS In my personal opinion, the collective feeling of frustration and perceived "dirty opportunism" of AlliedSignal's Larry Bossidy locked the AMP board into its didactic position of rejection. Unfortunate- ly, this state of denial, while meant to allow man- agement and the board the opportunity to now ex- ecute on what everyone knew had to be done, fiew in the face of shareholder reality. The critical judgment error made at AMP was to assume that, with Hudson and Marley held out as scapegoats and removed from their management positions, institutional investors would automati- cally reset the clock and unquestioningly support the company's new direction. However, when the ballots were counted on two separate occasions, over 70% of the AMP shareholders chose to sell to Al- liedSignal. The furor that erupted when AMP's board chose to disregard the shareholders because the directors felt that they "knew better" only raised the emotional stakes and prompted highly unusual public actions by a number of well-respected in- stitutional investors. Even when one considers the impact of the pend- ing Tyco acquisition on AMP's 1998 year-end stock price, AMP'S performance is

disappointing: for the period from January 1990 through December 31, 1998, AMP compounded at a 9.9% rate versus 14.8% for the S&P 500. Looking at AMP fi-om January 1995 through the end of 1998, the results are even more stark: AMP appreciated at an annualized rate of 12.1% over this period compared to 30.4% for the S&P 500 (all of these figures exclude dividends). An indefensible tactic Some may argue that AMP's vehemence was simply a good negotiating strategy. We would agree with this, were it not for AMP's unfortunate excursion into the halls of the Pennsylvania legislature with the so-called AMP Pennsylvania Legislative Initia- tive. The company wanted lawmakers to revoke the ability of shareholders to act by written consent. Had the single-purpose law advocated by AMP been passed by the legislature, AMP truly would have been takeover-proof, a condition that so thorough- ly challenges good corporate governance principles through shareholder disenfranchisement that it is categorically indefensible. Institutions ranging from the College Refirement Equities Fund (CREF) to the University of Cah- fornia denounced AMP's actions, with CREF going so far as to file a friend-of-the-court brief in op- position to AMP, an action taken for only the sec- ond time in this pension fund's almost 50-year his- tory. Even the descendants of the company's co-founders, the majority of whom I represented as strongly indicate that it was acting in an emotional state. their financial adviser, felt compelled to speak out publicly on this attempted subversion of the cor- porate governance process. While AMP'S management and directors no doubt continue to believe that they knew better than their shareholders, the question remains: Are company directors meant to act as enlightened dic- tators between formalistic elections, or are they in- struments of the shareholders charged with the maximization of shareholder value? Happily, the AMP situation resolved itself into a value-maxi- mizing transaction that preserves the upside for the shareholders. How effective AMP's board has been depends on when you start keeping count. In my view, the clock started ticking for AMP back in 1989, when margins started to erode, and the final outcome should have come as no surprise to AMP management, the board, or the shareholders. ' Of course, there are many factors that infiu- The highly unusual actions enced the AMP board in its deliberations, and I have taken by the AMP board no doubt that AMP's di- rectors acted with a view toward promoting the long-term benefit of the shareholders. Nonetheless, the historic and continuing ^^^^^^^^^^—— influence of former CEOs on the AMP board raised the emotional ante at the board level and inhibit- ed necessary change. Under different governance circumstances, the last chapter in AMP's existence as an independent company might not have yet been written. Carefully considered policy Public corporations, as a matter of policy, should carefully consider whether the company's former CEOs and other retired senior executives should serve on the board, and should also consider the self- imposition of term limits on directors as well as the rotation of key committee

heads (finance, compensation, audit, human resources). Walter Wriston, who retired as CEO and as a di- rector of Citicorp in 1984, observed in a 1993 arti- cle in DIRECTORS & BOARDS that "In short, there are a myriad of reasons for the retiring CEO to leave the board, and few if any arguments for the other course,..The human desire to stay on with a com- pany that has been home for many years is strong and understandable, but the world is so full of so many other interesting things to do that the desire to stay should be resisted for one's own sake and for that of the company." , •