FIFTH EDITION

CORPORATE GOVERNANCE

ROBERT A. G. MONKS & NELL MINOW

Corporate Governance

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Robert A. G. Monks and Nell Minow

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BRIEF CONTENTS

Introduction **1**
1. What is a Corporation? **3**
2. Shareholders: Ownership **101**
3. Directors: Monitoring **251**
4. Management: Performance **347**
5. International Corporate Governance **415**
6. Afterword: Final Thoughts and Future Directions **475**

CONTENTS

Cases in Point	**xiii**
Preface	**xvii**
Acknowledgments	**xxvii**
Introduction – How to Use this Book	**1**
1. What is a Corporation?	**3**
Defining the Corporate Structure, Purpose, and Powers	5
Evolution of the Corporate Structure	6
The Purpose of a Corporation	9
Satisfying the human need for ambition, creativity, and meaning	9
Social structure	10
Efficiency and efficacy	10
Ubiquity and flexibility	11
Identity	11
Metaphor 1: The Corporation as a "Person"	12
Metaphor 2: The Corporation as a Complex Adaptive System	12
Are Corporate Decisions "Moral"?	14
Are Corporations Accountable?	16
Three Key External Mechanisms for Directing Corporate Behavior: Law, the Market, and Performance Measurement	18
Government: legislation, regulation, enforcement	18
What Does "Within the Limits of the Law" Mean?	20
When and how do you punish a corporation?	28
Probation of corporations	29
The problem of serial offenders	31
Securities analyst settlement	32
What is the role of shareholders in making this system work?	33
The market: too big to fail	36
The corporation and elections	40
Citizens united	41
The corporation and the law	45
A Market Test: Measuring Performance	47
Long term versus short term	50
Corporate decision making: whose interests does this "person"/adaptive creature serve?	55

Another (failed) market test: NGOs 61
Measuring value enhancement 62
GAAP 62
Market value 69
Earnings per share 70
EVA®: economic value added 71
Human capital: "It's not what you own but what you know" 72
The "value chain" 73
Knowledge capital 74
The value of cash 74
Corporate "externalities" 79
Equilibrium: The Cadbury Paradigm 79
ESG: Environment, Social Governance – A New Way to Analyze Investment Risk and Value 83
Quantifying Nontraditional Assets and Liabilities 87
Future Directions 92
Summary and Discussion Questions 93
Notes 95

2. Shareholders: Ownership 101
Definitions 105
Early Concepts of Ownership 106
Early Concepts of the Corporation 107
A Dual Heritage: Individual and Corporate "Rights" 108
The Reinvention of the Corporation: Eastern Europe in the 1990s 110
The Evolution of the American Corporation 111
The Essential Elements of the Corporate Structure 115
The Mechanics of Shareholder Rights 117
The Separation of Ownership and Control, Part 1: Berle and Means 118
Fractionated Ownership 125
The Separation of Ownership and Control, Part 2: The Takeover Era 129
Waking the Sleeping Giant 134
A Framework for Shareholder Monitoring and Response 140
Ownership and Responsibility 141
No innocent shareholder 141
To Sell or Not to Sell: The Prisoner's Dilemma 143
Who the Institutional Investors Are 144
Bank trusts 145
Mutual funds 146
Insurance companies 149
Universities and foundations 149
Executive pay from the consumer side – a leading indicator of risk 150
Pension plans 154
The Biggest Pool of Money in the World 154
Pension plans as investors 164
Pension plans as owners 166

Public Pension Funds 169
Divestment initiatives 188
Economically targeted investments 189
AFSCME 195
Federal Employees' Retirement System 197
TIAA–CREF 199
Private Pension Funds 201
The Sleeping Giant Awakens: Shareholder Proxy Proposals on Governance Issues 206
Focus on the Board 212
Hedge Funds 220
Synthesis: Hermes 221
Investing in Activism 222
New Models and New Paradigms 223
The "Ideal Owner" 228
Pension Funds as "Ideal Owners" 233
Is the "Ideal Owner" Enough? 234
Summary and Discussion Questions 236
Notes 238

3. Directors: Monitoring 251
A Brief History of Anglo-American Boards 255
Who Are They? 256
Size 256
Term 256
Inside/outside mix 257
Qualifications 261
Who Leads the Board? Splitting the Chairman and CEO and the Rise of the Lead Director 261
Agenda 263
Minutes 263
Diversity 264
Meetings 264
Communicating with Shareholders 264
Special Obligations of Audit Committees 265
Ownership/Compensation 266
Post-Sarbanes–Oxley Changes 266
Board Duties: The Legal Framework 267
The Board's Agenda 281
The Evolution of Board Responsibilities: The Takeover Era 283
The Fiduciary Standard and the Delaware Factor 284
How did boards respond? 287
Greenmail 287
"Poison pills" 288
Other anti-takeover devices 290
The Director's Role in Crisis 291
Limits and Obstacles to Board Oversight of Managers 295

Information Flow 295
Practical Limits: Time and Money 301
The Years of Corporate Scandals – Boards Begin to Ask for More 302
Director Information Checklist 303
Who Runs the Board? 304
Catch 22: The Ex-CEO as Director 306
Director Resignation 308
CEO Succession 308
Director Nomination 309
Limits and Obstacles to Effective Board Oversight by Shareholders 318
Carrots: Director Compensation and Incentives 319
Sticks, Part 1: Can Investors Ensure or Improve Board Independence by Replacing Directors who Perform Badly or Suing Directors who Fail to Act as Fiduciaries? 324
Can Directors be Held Accountable through the Election Process? 324
Staggered boards 327
Confidential voting 328
Sticks, Part 2: Suing for Failure to Protect the Interests of Shareholders – Are the Duties of Care and Loyalty Enforceable? 331
Future Directions 331
Majority voting and proxy access 331
Improving director compensation 333
Increasing the authority of independent directors 333
"A market for independent directors" 335
"Designated director" 336
Board evaluation 336
Executive session meetings 336
Succession planning and strategic planning 337
Making directors genuinely "independent" 337
Involvement by the federal government 338
Involvement by shareholders 339
Summary and Discussion Questions 339
Notes 340

4. Management: Performance 347
Introduction 348
What Do We Want from the CEO? 354
The Biggest Challenge 359
Risk Management 363
Executive Compensation 363
The pay Czar 370
Post-meltdown pay 370
The Council of Institutional Investors 371
Stock Options 374
Restricted Stock 379
Yes, We Have Good Examples 380
Shareholder Concerns: Several Ways to Pay Day 380

The "guaranteed bonus" – the ultimate oxymoron 380
Deliberate obfuscation 381
The Christmas tree 382
Compensation plans that are all upside and no downside 382
Loans 382
Accelerated vesting of options 383
Manipulation of earnings to support bonuses 383
Manipulation of peer groups 384
Huge disparity between CEO and other top executives 384
Imputed years of service 384
Excessive departure packages 384
Backdating, bullet-dodging, and spring-loading options 385
Phony cuts 386
Golden hellos 386
Transaction bonuses 386
Gross-ups and other perquisites 387
Retirement benefits 387
Obstacles to restitution when CEOs are overpaid 387
Future Directions for Executive Compensation 388
CEO Employment Contracts 389
Cause 390
Change of control 391
Half now, half later 391
CEO Succession Planning 391
Sarbanes–Oxley 392
Creation of the Public Company Accounting Oversight Board 392
Section 404 393
Other changes 394
Dodd–Frank 394
Employees: Compensation and Ownership 395
Employee Stock Ownership Plans 399
Mondragón and Symmetry: Integration of Employees, Owners, and Directors 403
Conclusion 409
Summary and Discussion Questions 410
Notes 411

5. International Corporate Governance **415**
The Institutional Investor as Proxy for the Public Interest 429
Norway in the driver's seat 431
The International Corporate Governance Network 433
ICGN: Statement of Principles on Institutional Shareholder Responsibilities 433
The Global Corporate Governance Forum 435
Sweden 435
Canada 437
Singapore 438
Russia 441

Germany 442
China 443
Japan 444
GovernanceMetrics International (GMI) 445
World Bank and G7 Response 458
Azerbaijan 459
Slovakia 460
Jordan 460
Thailand 461
Poland 461
The Global Carbon Project (GCP) 464
A Common Framework for Sustainability Reporting 465
Towards a Common Language 468
Vision 470
Summary And Discussion Questions 471
Notes 473

6. Afterword: Final Thoughts and Future Directions 475
Beyond the Nation State 477
Government as Shareholder: The Institutional Investor as Proxy for the Public Interest 484
Notes 486

Index 489

CASES IN POINT

CHAPTER 1

Shlensky v. Wrigley (1968) 15
Corporate Crime and Punishment 21
A UK Attempt to Redefine Corporate Manslaughter 26
What Happens When You Let Corporations Choose their Own Regulators? Just What You Would Expect 33
Chrysler 36
The Voluntary Restraint Agreement in the Auto Industry 38
Corporate Political Donations in the UK and the US 44
"Delaware Puts Out" 45
The Years of Accounting Dangerously 48
Protection, Pennsylvania Style 52
The "Good," the "Bad," and the Real 55
Green Tree Financial 64
FASB's Treatment of Stock Options 66
The Battle of the Theme Parks 70
Daimler-Benz and the New York Stock Exchange 77
Johnson & Johnson 80
Socially Responsible Investing 84
Price Fixing 88

CHAPTER 2

Mis-Trust: The Mysterious Case of the Hearst Will 103
How Much is a Fiduciary Worth – And Can He Charge More than That? 103
Of Vouchers and Values – Robert A.G. Monks Visits Vaclav Havel 110
Standard Oil and the Arrival of Big Business 112
Partnership versus Corporation 116
Annual Shareholder Meetings 118
The Conflicted Owner 121
When is the Employee Stock Plan Obligated to Step in or Sell? 121

Who Owns Hershey? 122
F&C Advises Its Clients to Vote Against Excessive Compensation – At F&C 123
Junior Invests in Boothbay Harbor 126
One Share, One Vote 134
Refco 140
Hermes 144
R.P. Scherer and Citicorp 146
T. Rowe Price and Texaco 147
Director Resignations 151
Interlocking Directors 152
The Alumni Protest Fees Paid to Managers of the Harvard Endowment 152
The Rose Foundation Takes on Maxxam 153
Reader's Digest 153
Eating the Seed Corn: NY's Pension Fund Borrows from Itself 158
Maine State Retirement System 159
CalPERS and Enron 169
Public Fund Activism 173
CalPERS Invests in Activism 177
Institutional Investors Address Climate Change 183
Shareholder Influence on Standardizing and Integrating Corporate Ethics and Sustainability 184
Myners Shifts the Burden of Proof on Activism 186
The Institutional Shareholders Committee 187
AFSCME's Economically Targeted Investment Policy 191
Can a Fiduciary Invest in Volkswagen? 193
Socially Responsible Investing 194
Campbell Soup Company and General Motors 202
"Universal Widget" 205
Honeywell and Furr's 209
Swib and Cellstar 214
Revolt of the Yahoos: United Companies Financial and Luby's 215
Deutsche Asset Management Changes Its Vote 217
From DuPont to Relationship Investing 223
A&P, Paramount, and K-Mart 230
Hermes 231

CHAPTER 3

Warren Buffet on Boards 254
The Worldwide Frustration of Audit Committees 255
The Corporate Library's Interlock Tool 259
The Walt Disney Company and the Magical Kingdom of Executive Compensation 268
The Disney Decision 270

Illicit Backdating: Trends in Illegal Executive Compensation 271
Upper Deck v. Topps: Getting a Fair Chance 274
The Duty of Loyalty – A Race to the Bottom? 276
Further Exploration of the Requirement of Good Faith 278
Trans Union 285
Unocal and Revlon 286
Compaq Computers 293
RJR Nabisco, Lone Star Industries, Tambrands, and Enron 296
A Director Quits 310
A Director Demands More from the Board 311
Two Directors Depart at Emap 315
Director Pay at Coca-Cola 320
Sears 325
Salomon Inc. 338

CHAPTER 4

Merck Creates a Product No One Can Pay For 351
Tony Hayward and BP's Deepwater Horizon Oil Leak 353
AT&T and NCR 355
Beyond the Balance Sheet 356
More About H-P and Hurd 357
Exxon, AT&T, and General Electric and Creative Destruction – Internal and External 361
Warnaco 367
ICGN on Compensation 373
The Chairman Speaks 376
Borden 378
United Airlines and Employee Ownership 401
The "Temping" of the Workplace 402
Mondragon and "Cooperative Enterpreneurship" or "Cooperation Instead of Competition" 406

CHAPTER 5

Offshore Outsourcing 417
Russia's Hostile Takeover 418
Embraer 419
Capital Flight, Tax Avoidance, and Tax Competition 428

PREFACE

John D. Rockefeller famously sold out of the stock market just before the 1929 crash because of a shoeshine boy. At least according to legend, he knew that when shoeshine boys were giving out stock tips, it was time to sell.

In *The Big Short: Inside the Doomsday Machine*, by Michael Lewis, there are a couple of shoeshine boy moments. In this case, it was not wealthy industrialists or anyone at the heart of the financial world who figured out that there would be a collapse triggered by billion-dollar bets on the subprime mortgages and their derivative securities.

Lewis writes about four outsiders who saw what was coming and bet it would fail while the entire economy was betting the other way. Steve Eisman had a "light bulb" moment when he found out that his former baby nurse had six investment properties. Michael Burry asked if he could buy a security betting a group of the subprime mortgages would fail. He wanted to bet against a group made up entirely of no-doc loans (those where the applicants for the mortgages did not have to submit any documentation to demonstrate their ability to repay). He wanted it to be a group rated A by one of the ratings agencies, the same rating given to groups of mortgages where the applicants had to demonstrate that they could repay. And he got it.

Why were they the only ones who saw that as a problem? And how did that problem get created in the first place?

What went wrong?

In late 2007, the United States economy suffered its worst economic catastrophe since the Great Depression of the 1930s. The American taxpayers found themselves guarantors of the entire financial services industry when almost overnight assets that had been valued at hundreds of billions of dollars turned out to be worth some undetermined amount but much, much less. The entire economy seemed to collapse like a house of cards.

This was not supposed to happen. Just five years before, the most sweeping reform legislation in decades was passed to deal with the then-record-setting scandals of the time. From late 2001 through 2002 spectacular corporate failures at Enron, Global Crossing, Adelphia, WorldCom, and more resulted in the loss of hundreds of billions of dollars and hundreds of thousands of jobs. Front-page news stories were illustrated with photographs of men in suits doing perp walks. CEOs went to prison.

The passage of the Sarbanes–Oxley legislation in 2002 helped to restore confidence in the markets. Perhaps it restored too much confidence because people like Federal Reserve Chairman Alan Greenspan kept insisting that the mushrooming category of derivative securities did not need to be regulated, because he said the efficiency of the market was all that was needed.

He does not think that any more. "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief," he told the House Committee on Oversight and Government Reform in 2008.

So, what happened? The failures that led to this collapse were widespread and the fault extends to every element of the system: corporations, regulators, accountants, ratings agencies, securities analysts, politicians, shareholders, journalists, and more. A lot of blame has been assigned, mostly from those trying to deflect it from themselves. The alleged culprits have included "monetary policy," the government-sponsored entities (Fannie Mae and Freddie Mac), and lax oversight by regulators. Those all played a role, but unquestionably, the primary culprit was a failure of corporate governance.

The proof of that statement will be one of the key themes of this book. The first element of that proof is a sentence that occurs near the end of *The Big Short*. "What's strange and complicated about [the subprime mortgage market], however, is that *pretty much all the important people on both sides of the gamble left the table rich*."[1]

That tells you everything you need to know – except for how that anomalous situation came about, which is what the rest of this book will cover. The point to keep in mind here is that it is not the market that malfunctioned. On the contrary, the market did exactly what it was supposed to do. It responded to risks and incentives in a rational manner. It was the risks and incentives that were distorted. That is what made it possible – in fact, what made it inevitable – that the people on both sides of the table got rich.

However, if both sides made money, someone had to lose it. The problem is that it was not the buyer or seller or counter-party or insurer who was on the other side of the transaction, it was the rest of us. What happened was a massive shift of costs as Wall Street externalized the risk on to just about everyone else. For example, a hedge fund called Magnetar helped create arcane mortgage-based instruments, made them even riskier, and then bet against them, putting their customers on the other side.

We have seen a fairly consistent cycle of boom and scandal in the financial markets since the savings and loan failures of the 1980s, and the one common theme is the ability of one segment of the economy to externalize its risks. In every case, the system was gamed so that the upside gain was diverted in one direction and the downside losses were diverted in another. The market cannot operate efficiently under those circumstances.

Corporate governance is about how public companies are structured and directed. Every strategy, every innovation in product, operations, and marketing, every acquisition and divestiture, every decision about asset allocation, finance, joint ventures, financial reports, systems, compensation, and community relations – every decision and every one of the thousands of decisions within each one – is determined by some part of the system of corporate governance. Every one of those decisions can be made consistent with long-term, sustainable value creation for investors, employees, and the community or for the short-term benefit of one group regardless of the consequences for the others. When corporate governance operates optimally, the three key players – the executives, the board of directors, and the shareholders – provide through a system of checks and balances a system for a transparent and accountable system for promoting objectively determined goals and benchmarks. When it does not, well, take a look at these examples:

- A very successful CEO had something he wanted to ask his board of directors. He wanted an employment contract. This was not the norm but it was hardly unusual. One-third of Fortune 500 CEOs had written contracts, mostly reflecting the negotiations leading to their employment and

spelling out the terms of their compensation packages and how they would be affected by a merger or termination of employment. What was a little bit unusual was that he was asking after three years on the job without a contract. What was very unusual – what was, in fact, unprecedented – was a particular provision of the contract, which stated that conviction of a felony was not grounds for termination for cause, that is, unless the felony was directly and materially injurious to the corporation.

Huh?

You might think that the board of directors, presented with such a proposal, would ask a few questions. One might be, "Why now – why do you need a written contract now when you did not need one before?" Another one might be, "What exactly prompted this language about the felony – is there something you want to tell us?"

But the board did not ask any questions. The CEO was, as noted above, very successful. Everyone was making a lot of money. Some directors were getting substantial side payments from deals with the company. The board of Tyco signed the contract.

- The board of another very successful company listened to a presentation about a new "special purpose entity" that would allow the company to burnish its financial reports by moving some of its debt off the balance sheet. There was one small problem, however. The deal was a violation of the company's conflict of interest rules because it permitted an insider, the company's general counsel, to essentially be on both sides of the transactions. The board was asked to waive the company's conflict of interest rules to permit the transaction.

  Huh?

  You might think that the board of directors, presented with such a proposal, would ask a few questions. "Why can't someone who is not an insider run this thing?" "Is this something that is going to look good on paper or is there some actual benefit?"

  But the board did not ask any questions. The company was, as noted above, very successful. Everyone was making a lot of money. Some directors were getting substantial side payments from deals with the company. The board of Enron agreed to the waiver – three separate times.
- A graduate of the United States Military Academy at West Point, which teaches the ideals of "duty, honor, country," retired from the Army as a general and went to work for a major and very successful corporation. He participated in a tour of the company's operations for securities analysts that included a fake trading floor where secretaries pretended to be negotiating transactions, peering into computer screens that were not connected to anything, and talking on their telephones to each other. He later admitted that he knew the trading floor was a fake. Yet he did not say anything.

  Huh?

  Tom White, the former general, was paid more than $31 million by Enron in that year.
- Angelo Mozillo, founder and CEO of Countrywide, ground zero for subprime mortgages, made $550 million as his company's stock went down 78 percent, taking the entire US economy down with it. When the compensation consultant advising the board suggested that the pay plan he wanted might be too high, he hired another consultant – at company expense. They unsurprisingly agreed with his proposal and the board agreed.
- The Lehmann board's finance and risk management committee, chaired by an 80-year-old director, met only twice in 2007 and twice in 2006. Nine of the company's directors were retired and one had been on the board for 23 years. Four of the directors were over 75 years old. One was an actress, one was a theatrical producer, another a former Navy admiral. Only two

board members had direct experience in the financial-services industry. Until 2008 it had no one on the board who was familiar with the kinds of derivatives that caused the collapse of the 158-year-old firm that year.

- At Indymac, the CEO's pay was as large as CEO salaries at firms exponentially larger and included $260,000 one-time initiation fee to a country club, reimbursement for payment of taxes ($12,650), financial planning ($15,000), and other perks. It became the then-second-largest bank failure in history.
- The compensation committee at Chesapeake Energy not only paid CEO Aubrey McClendon $100 million, a 500 percent increase as the stock dropped 60 percent and the profits went down 50 percent, but spent $4.6 million of the shareholders' money to sponsor a basketball team in which McClendon owned a 19 percent stake, they purchased catering services from a restaurant where he was just under a half-owner, and they took his collection of antique maps off his hands for $12.1 million of the shareholders' money, based on a valuation from the consultant who advised McClendon on assembling the collection. The board justified this by referring to McClendon's having to sell more than $1 billion worth of stock due to margin calls, his having concluded four important deals, and the benefit to employee morale from having the maps on display in the office.
- RBS CEO Fred "the Shred" Goodwin said he would consider reducing his £17 million pension (but as of this writing has not done so). His leadership, which included the disastrous acquisition of the Dutch firm Amro, ended with the company laying off 2,700 people and writing down £240 billion worth of assets, resulting in a £20 billion bailout. The board allowed him to characterize his departure as a resignation rather than termination for cause, doubling the size of his severance and retirement package.
- The WorldCom CEO asked his board for a loan of over $400 million. According to public filings, the loans were to repay debts that were secured by his shares of company stock and the proceeds of these secured loans were to be used for "private business purposes." The board agreed.
- Hollinger CEO Lord Black informed his board that a particular acquisition had been a mistake and offered to take it off the books by buying it for one dollar. The board agreed.
- Linda Wachner told her board she wanted to take a portion of the company private, with herself continuing as CEO of both organizations, being paid separately by each. They agreed. She subsequently offered to sell the private entity back to the public company, taking not only a profit but an investment banking fee. The Warnaco board agreed.
- A CEO made a phone call to a large institutional investor that had voted against her proposed merger, reminding them that her company did significant business with the institutional investor's parent company. Deutsche Asset Management changed their vote.

This is the description of the bailout and the banking industry's response from President Reagan's budget director turned private equity mogul David Stockman:

> *The banking system has become an agent of destruction for the gross domestic product and of impoverishment for the middle class. To be sure, it was lured into these unsavory missions by a truly insane monetary policy under which, most recently, the Federal Reserve purchased $1.5 trillion of longer-dated Treasury bonds and housing agency securities in less than a year. It was an unprecedented exercise in market-rigging with printing-press*

> *money, and it gave a sharp boost to the price of bonds and other securities held by banks, permitting them to book huge revenues from trading and bookkeeping gains. Meanwhile, by fixing short-term interest rates at near zero, the Fed planted its heavy boot squarely in the face of depositors, as it shrank the banks' cost of production – their interest expense on depositor funds – to the vanishing point.*
>
> *The resulting ultrasteep yield curve for banks is heralded, by a certain breed of Wall Street tout, as a financial miracle cure. Soon, it is claimed, a prodigious upwelling of profitability will repair bank balance sheets and bury toxic waste from the last bubble's collapse. But will it?*
>
> *In supplying the banks with free deposit money (effectively, zero-interest loans), the savers of America are taking a $250 billion annual haircut in lost interest income. And the banks, after reaping this ill-deserved windfall, are pleased to pronounce themselves solvent, ignoring the bad loans still on their books. This kind of Robin Hood redistribution in reverse is not sustainable. It requires permanently flooding world markets with cheap dollars – a recipe for the next bubble and financial crisis.*[2]

What is wrong here? How did so many different people in so many different roles make so many bad decisions? How did corporate governance go from being an arcane, almost vestigial topic in scholarly circles to being the source of scandals, headlines, lawsuits, and business school course materials?

The importance of corporate governance became dramatically clear in 2002 as a series of corporate meltdowns, frauds, and other catastrophes led to the destruction of billions of dollars of shareholder wealth, the loss of thousands of jobs, criminal investigation of dozens of executives, and record-breaking bankruptcy filings.

Seven of the twelve largest bankruptcies in American history were filed in 2002 alone. The names Enron, Tyco, Adelphia, WorldCom, and Global Crossing have eclipsed past great scandals like National Student Marketing, Equity Funding, and ZZZZ Best. Part of what made them so arresting was how much money was involved. The six-figure fraud at National Student Marketing seems almost endearingly modest by today's standards. Part was the colorful characters, from those who were already well known like Martha Stewart and Jack Welch, to those who became well known when their businesses collapsed, like Ken Lay at Enron and the Rigas family at Adelphia. Part was the breathtaking hubris – as John Plender says in his 2003 book, *Going off the Rails*, "Bubbles and hubris go hand in hand." Then there were the unforgettable details, from the $6,000 shower curtain the shareholders unknowingly bought for Tyco CEO Dennis Kozlowski to the swap of admission to a tony pre-school in exchange for a favorable analyst recommendation on ATT at Citigroup.

Another reason for the impact of these stories was that they occurred in the context of a falling market, a drop-off from the longest, strongest bull market in US history. In the 1990s, we saw billions of dollars of fraudulently overstated books at Cendant, Livent, Rite Aid, and Waste Management, but those were trivial distractions in a bull market fueled by dot-com companies. Those days were so heady and optimistic that you didn't need to lie. Why create fake earnings when an honest disclosure that you had no idea when you were going to make a profit wouldn't stop the avalanche of investors ready to give Palm a bigger market cap than Apple on the day of its IPO?

However, the most important reason these scandals became the most widely reported domestic story of the year was the sense that every one of the mechanisms set up to provide checks and

balances failed at the same time. All of a sudden, everyone was interested in corporate governance. The term was even mentioned for the first time in the President's annual State of the Union address. Massive new legislation, the Sarbanes–Oxley Act, was quickly passed by Congress and the SEC had its busiest rule-making season in 70 years as it developed the regulations to implement it. The New York Stock Exchange and NASDAQ proposed new listing standards that would require companies to improve their corporate governance or no longer be able to trade their securities. The rating agencies S&P and Moody's, who had failed to issue early warnings on the bankrupt companies, announced that they would factor in governance in their future analyses. Then six years later, things were even worse. Even bigger legislation has been passed and more rule-making is underway – and the ratings agencies are still promising to do better.

Corporate governance is now and forever will be properly understood as an element of risk – risk for investors, whose interests may not be protected by ineffectual or corrupt managers and directors, and risk for employees, communities, lenders, suppliers, taxpayers, and customers as well.

Just as people will always be imaginative and aggressive in creating new ways to make money legally, there will be some who will devote that same talent to doing it illegally, and there will always be people who are naive or avaricious enough to fall for it. Scam artists used to use faxes to entice suckers into Ponzi schemes and Nigerian fortunes. Now, they use email – or, sometimes, they use audited financial reports.

The businesses that grabbed headlines with spectacular failures that led to Sarbanes–Oxley were fewer than a dozen of the thousands of publicly traded companies, and the overwhelming majority of executives, directors, and auditors are honorable and diligent. Yet, even in the post-Sarbanes–Oxley world, the scandals continued. Refco had a highly successful initial public offering in 2005, despite unusual disclosures in its IPO documents about "significant deficiencies" in its financial reporting, pending investigations, and potential conflicts of interest. Just a few months later, in the space of a week, the stock dropped from $29 a share to 69 cents and the company declared bankruptcy. In 2006, widespread undisclosed backdating of stock options at public companies was uncovered not by regulators or prosecutors but through a statistical analysis conducted by an academic. Then came the subprime/too-big-to-fail mess, with an emergency $700 billion infusion of cash from the government. In the midst of that, the government's taking over of most of the automotive industry, once the flagship of American commerce, hardly seemed worth noting.

If the rising tide of a bull market lifts all the boats, then when the tide goes out some of those boats are going to founder on the rocks. That's just the market doing its inexorable job of sorting. Some companies (and their managers and shareholders) get a free ride due to overall market buoyancy in bull markets. If the directors and executives were smart, they recognize what is going on and use the access to capital to fund their next steps. If they were not as smart, they thought they deserved their success. If they were really dumb, they thought it would go on forever – and kept creating more derivative securities based on increasingly fragile subprime mortgages.

One factor that can make the difference between smart and dumb choices is corporate governance. It is not about structure or checklists or best practices. It is about substance and outcomes. Think of it as the defining element in risk management. **In essence, corporate governance is the structure that is intended (1) to make sure that the right questions get asked and (2) that checks and balances are in place to make sure that the answers reflect what is best for the creation of long-term, sustainable, renewable value.** When that structure gets subverted, it becomes too easy to succumb to the temptation to engage in self-dealing.

This book is about managing the risk of that temptation. Corporate governance is our mechanism for addressing the core conundrum of capitalism, the problem of agency costs. This is the problem that persuaded that great advocate of the free market that the corporate structure could not work. Adam Smith wrote, "People of the same trade seldom meet together but the conversation ends in a conspiracy against the public, or in some diversion to raise prices."

Corporate governance is our way of answering these questions:

- How do we make a manager as committed to the creation of long-term shareholder value as he would be if it was his own money?
- How do we manage corporate value creation in a manner that minimizes the externalization of its costs on to society at large?

Good corporate governance requires a complex system of checks and balances. One might say that it takes a village to make it work. In the last decade, we have seen a perfect storm of failures, negligence, and corruption in every single category of principal and gatekeeper: managers, directors, shareholders, securities analysts, lawyers, accountants, compensation consultants, investment bankers, journalists, and politicians. In this book, we will discuss the theory and practice of corporate governance with examples from the good, the bad, and the very, very ugly, with reference to theoretical underpinnings and real-life cases in point, and with some thoughts on options for reform, future directions, and the prospects for some kind of global convergence on governance standards.

Our primary focus will be on the three key actors in the checks and balances of corporate governance: management, directors, and shareholders. We begin with some thoughts about the role of the board from a speech given by one of America's most successful CEOs at a 1999 conference on ethics and corporate boards:

> *[A] strong, independent, and knowledgeable board can make a significant difference in the performance of any company . . . . [O]ur corporate governance guidelines emphasize "the qualities of strength of character, an inquiring and independent mind, practical wisdom and mature judgment . . . ." It is no accident that we put "strength of character" first. Like any successful company, we must have directors who start with what is right, who do not have hidden agendas, and who strive to make judgments about what is best for the company, and not about what is best for themselves or some other constituency . . . .*
>
> *[W]e look first and foremost for principle-centered leaders. That includes principle-centered directors. The second thing we look for are independent and inquiring minds. We are always thinking about the company's business and what we are trying to do . . . . We want board members whose active participation improves the quality of our decisions.*
>
> *Finally, we look for individuals who have mature judgment – individuals who are thoughtful and rigorous in what they say and decide. They should be people whom other directors and management will respect and listen to very carefully, and who can mentor CEOs and other senior managers . . . . The responsibility of our board – a responsibility which I expect them to fulfill – is to ensure legal and ethical conduct by the company and by everyone in the company. That requirement does not exist by happenstance. It is the most important thing we expect from board members . . . .*

> *What a CEO really expects from a board is good advice and counsel, both of which will make the company stronger and more successful; support for those investments and decisions that serve the interests of the company and its stakeholders; and warnings in those cases in which investments and decisions are not beneficial to the company and its stakeholders.*

That speech, "What a CEO Expects From a Board," was delivered by then-Enron CEO, the late Kenneth Lay. The company's code of ethics is similarly impressive. The company got high marks from just about everyone for best corporate governance practices.

The board looked good on paper: the former dean of the Stanford Business School was chairman of the audit committee. Another director was formerly a member of the British House of Lords and House of Commons, as well as Energy Minister. In addition, the board included one of the most prominent business leaders in Hong Kong, the co-founder and former president of Gulf and Western, two sitting CEOs of large US corporations, and the former head of the Commodities Future Corporation who was an Asian woman, with an economics PhD, and married to a prominent Republican Congressman. There was also a former professor of economics and a former head of General Electric's Power Division worldwide, a senior executive of an investment fund with a PhD in mathematics, the former president of Houston Natural Gas, the former head of M.D. Anderson, the former head of a major energy and petroleum company, and a former Deputy Secretary of the Treasury and PhD economist.

That shows the most important point to keep in mind as you consider the challenges of corporate governance: it is easy to achieve the letter of good corporate governance without achieving the spirit or the reality. While it is tempting to engage in checklists of structural indicators, there is no evidence that intuitively appealing provisions like independent outside directors (rather than people whose commercial or social ties might create conflicts of interest) or annual election of directors (rather than staggered terms) have any correlation to the creation of shareholder value or the prevention of self-dealing.

Therefore, keep in mind throughout this book that corporate governance is about making sure that the right questions get asked and the right checks and balances are in place, and not about some superficial or theoretical construct. Every other topic in business school – analysis, strategy, finance, marketing – is developed and executed under a structure that either does or does not address the issues of agency costs and risk management. Strategic planning is overseen by the board who either does or does not have the expertise, information, and authority to make the right decisions. Every incentive program either does or does not link pay to performance. The difference between the does and does not is corporate governance.

William Donaldson, then Chairman of the Securities and Exchange Commission, made this point in a 2003 speech at the Washington Economic Policy Conference:

> *[A] "check the box" approach to good corporate governance will not inspire a true sense of ethical obligation. It could merely lead to an array of inhibiting, "politically correct" dictates. If this was the case, ultimately corporations would not strive to meet higher standards, they would only strain under new costs associated with fulfilling a mandated process that could produce little of the desired effect. They would lose the freedom to make innovative decisions that an ethically sound entrepreneurial culture requires.*

> *As the board properly exercises its power, representing all stakeholders, I would suggest that the board members define the culture of ethics that they expect all aspects of the company to embrace. The philosophy that they articulate must pertain not only to the board's selection of a chief executive officer, but also the spirit and very DNA of the corporate body itself – from top to bottom and from bottom to top. Only after the board meets this fundamental obligation to define the culture and ethics of the corporation – and, for that matter, of the board itself – can it go on and make its own decisions about the implementation of this culture.*

NOTES

1. W.W. Norton & Co., 2010, pp. 256 (emphasis added).
2. David Stockman, "Taxing Wall Street Down to Size," *New York Times*, January 19, 2010.

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INTRODUCTION

HOW TO USE THIS BOOK

Corporate governance is sometimes marginalized by those who claim it is about "best practices" and checklists. However, the corporate failures of the first decade of the twenty-first century have shown us that corporate governance is best understood as a critical element of risk management. Corporate failure, whether caused by accounting fraud or misaligned incentive compensation, is a failure of corporate governance, the essential system of checks and balances that keeps corporations vital, focused, and supple enough to respond to change and come out stronger than before.

In theory, we minimize the agency costs of outside capital through a system of accountability to boards of directors and shareholders. As the examples and case studies in this book show, however, that system has too often been subverted. We begin with an overview about the history of the corporate structure from a governance perspective. We look at the days of a direct connection between the investor and the portfolio company and how companies have become exponentially larger, more complex, and more far-reaching, with global operations. Shareholders have also changed, with well over half of equity securities in the hands of intermediaries like pension funds, some with many layers between the beneficial holder and the person who makes the buy–sell–hold–vote decisions.

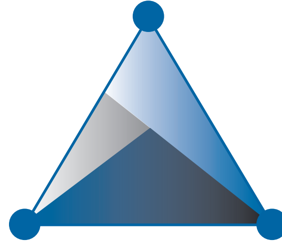
We then go into more depth with chapters on each of the three major players in corporate governance, the shareholders, board of directors, and managers. In each of these chapters, the focus is on one key question: What role does this group play in determining corporate direction and what obstacles interfere with their ability to do so? Our overall guideline is that each decision should be made by those with the best access to information and the fewest conflicts of interest. How can those criteria be applied?

Chapter 5 takes these questions to the global level as we make comparisons between established and emerging economies and put corporate governance in the context of a worldwide competition for capital. Chapter 6 is a brief discussion of some conclusions and thoughts about the future, and Chapter 7 (online only) includes our in-depth case studies, referred to throughout the text but also suitable for stand-alone discussion as illustrations of the successes and failures of corporate governance.

Throughout the rest of the business curricula, you will discuss the ways to evaluate every possible strategic option and risk assessment presented to corporations. Corporate governance is about making sure that the people who will make those decisions have the ability and the incentives to get them right as often as possible.

1

WHAT IS A CORPORATION?



CONTENTS

- Defining the Corporate Structure, Purpose, and Powers 5
- Evolution of the Corporate Structure 6
- The Purpose of a Corporation 9
- Metaphor 1: The Corporation as a "Person" 12
- Metaphor 2: The Corporation as a Complex Adaptive System 12
- Are Corporate Decisions "Moral"? 14
- Are Corporations Accountable? 16
- Three Key External Mechanisms for Directing Corporate Behavior: Law, the Market, and Performance Measurement 18
- What Does "Within the Limits of the Law" Mean? 20
- A Market Test: Measuring Performance 47
- Equilibrium: The Cadbury Paradigm 79
- ESG: Environment, Social Governance – A New Way to Analyze Investment Risk and Value 83
- Quantifying Nontraditional Assets and Liabilities 87
- Future Directions 92
- Summary and Discussion Questions 93
- Notes 95

Henry Ford once said, "A great business is really too big to be human." Indeed, that is the purpose of the corporate structure, to transcend the ability and lifespan of any individual. It is also the challenge of the corporation. The efforts by humans in directing and controlling other humans, whether through democracy or fascism, whether by carrots or sticks, have been notoriously unsuccessful. Efforts by humans to control institutions are an even greater challenge.

The very elements of the corporate structure that have made it so robust – the limitation on liability, the "personhood" that can continue indefinitely – make it very difficult to impose limits to ensure that the corporation acts in a manner consistent with the overall public interest. The corporate structure creates both the motive and the opportunity for externalizing costs to benefit the insiders. As we will see, most of the problems and failures and obstacles we find in looking at corporate functioning from both a micro and macro perspective come from this seemingly intractable element of their existence. In other words, we must make sure that we have created a structure that is not just perpetual, but sustainable.

In this book, we will devote chapters to the three most significant forces governing the direction of corporations and trying to reduce agency costs and maximize sustainable value creation. They are management, shareholders, and boards of directors, all internal and structural. Throughout our examples we will also look at other significant forces like government/law, employees, competitors, suppliers, service providers, and other partners, as well as communities and customers. Key issues include how we establish goals, align incentives for corporate managers to reach those goals, measure performance to see how well they have done, and make whatever adjustments to the goals, the measurement, and the management itself to make sure that the aspirations and operations of the corporation result in sustainable, long-term value creation.

As a beginning we will focus on providing some context by discussing what the corporation is, what the corporate structure was created to accomplish and how those aspirations and structures have evolved. We will discuss the ways in which we do and do not establish, measure, direct, and encourage corporations and the people who govern them to behave in a way that promotes the best interests of society over the long term. We will also talk about the external actors and mechanisms for governing corporations, especially the government, but in this chapter and throughout this book we will also look at accountants, analysts, investment bankers, journalists, and others.

The house-of-cards collapse of every one of the gatekeepers established to provide independent oversight and assessment requires an examination of the ways they were ineffective or complicit in the string of corporate failures and catastrophes that began in 2002 and in the collapse of financial institutions triggered by subprime lending and derivatives in 2007.

We have a tendency to take the corporate structure for granted because it is so pervasive. But in order to understand how it works – and how it should work – we need to take a moment to look at how we got where we are, what it was intended to be, and how that compares with what we have. We will begin with a brief review of what the corporation is. Then, the rest of this chapter will focus on the key issues that put the key questions of corporate governance in context:

- How do we make sure that a corporation or the corporate structure in general adds the maximum value to society? How do we minimize corporations' ability to externalize the costs of their activities on to others? Constraints are generally imposed either by government through application and enforcement of legal standards by efficient application of market forces. Any study of corporate governance has to focus on various forms of oversight and gate-keeping effects of

these constraints, how effective they are, and how well they support the twin goals of market efficiency and public policy.
- When the performance data show that the corporation is not meeting our goals, what is the best way to make the necessary changes and who is responsible for making that happen?

Throughout all business-related studies, we look at the ways we measure corporate performance. We will touch on that question again in this context, asking: What do we want and how do we determine whether we have achieved it? In the first set of twenty-first century corporate scandals, Enron, WorldCom, and others appeared to be outstanding performers due to a combination of accounting dodges and plain old-fashioned lying. Before that, Waste Management and Stone & Webster (see case studies) had massive restatements and "special charges." In the dot.com collapse of the 1990s billions of dollars evaporated and in the financial meltdown of 2008 hundreds of trillions of dollars were "lost." *Where did this money go? Was the value shown on balance sheets ever really there?*

DEFINING THE CORPORATE STRUCTURE, PURPOSE, AND POWERS

The first challenge is defining what we mean by the corporation. There is a legal definition that covers the requirements for obtaining articles of incorporation and the obligations of the resulting entity. However, corporations always seem to have more vitality and more complexity than can be constrained by definitions or laws. They even seem to take on personalities that go far beyond the way we feel about their products. Think of the reputations of Apple, of Enron, of General Motors, of Google, of BP.

The variety of definitions set some parameters but are most useful in what they tell us about the assumptions and aspirations of the people who propose them. They remind us of the blind men who tried to describe an elephant – one feeling the tail and calling it a snake, one feeling the leg and calling it a tree, one feeling the side and calling it a wall, one feeling the tusk and calling it a spear. All definitions of the term *corporation* reflect the perspectives (and the biases) of the people writing the definitions.

Some lawyers and economists neutrally describe the corporation as simply "a nexus (bundle) of contracts," arguing that the corporation is nothing more than the sum of all of the agreements leading to its creation.[1]

Some speak of it with admiration. Ayn Rand wrote, "Capitalism demands the best of every man – his rationality – and rewards him accordingly. It leaves every man free to choose the work he likes, to specialize in it, to trade his product for the products of others, and to go as far on the road of achievement as his ability and ambition will carry him." Historians John Mickelthwait and Adrian Wooldridge lauded the flexibility of the corporate form: "Nowadays, nobody finds it odd that, a century after its foundation, the Minnesota Mining and Manufacturing Company makes Post-it notes, or that the world's biggest mobile-phone company, Nokia, used to be in the paper business."

Some are critical, like Joel Bakan, whose book and movie, *The Corporation*, diagnoses the corporation as pathological by matching its attributes to the standard medical literature's list of symptoms of a lack of moral conscience. In *The Devil's Dictionary*, the acerbic Ambrose Bierce

says that a corporation is "An ingenious device for obtaining individual profit without individual responsibility."

All of these definitions reflect the advantages and the risks from the corporation's key feature – its ability to draw resources from a variety of groups and establish and maintain its own persona separate from all of them. That goes back to the very origins of the word, from "corpus" or body, as in a body of people organized to act as one.

A purely descriptive definition would say that a corporation is a structure established by law to allow different parties to contribute capital, expertise, and labor for the maximum benefit of all of them. The investor gets the chance to participate in the profits of the enterprise without taking responsibility for the operations. The management gets the chance to run the company without taking the responsibility of personally providing the funds. In order to make both of these possible, the shareholders have limited liability and limited involvement in the company's affairs. That involvement includes, at least in theory, the right to elect directors and the fiduciary obligation of directors and management to protect their interests.

This independent entity must relate to a wide variety of "constituents," including its directors, managers, employees, shareholders, customers, creditors, and suppliers, as well as the members of the community and the government. Each of these relationships itself has a variety of constituents, sometimes inherently contradictory. The corporation's obligations to its employees vary, for example, depending on the circumstances: whether it relates to them as members of a union or not, whether they are pension plan participants or not. Each of these relationships affects the direction and focus of the corporation. The study of corporate governance is the study of the connection of those relationships to the corporation and to one another.

EVOLUTION OF THE CORPORATE STRUCTURE

While in law a corporation is, at least for some purposes, considered to be a fictional "person," at its core each corporation is a structure, developed over time to respond to the need for more complex organizations to develop and manufacture and deliver more complex goods and services to a larger and more diverse range of customers. Its current form is the result of evolution through a Darwinian process in which each development made it stronger, more resilient, and more impervious to control by outsiders.

As we examine that evolutionary pattern, it will become clear that every change the corporate form has undergone has been directed toward the corporation's own perpetuation and growth. The advantages and disadvantages of this fact of business life are discussed throughout this book.

In their earliest Anglo-Saxon form, municipal and educational corporations were granted perpetual existence and control over their own functions as a way of insuring independence from the otherwise all-encompassing power of the king. By the seventeenth century, corporations were created by the state for specific purposes, like the settlement of India and the American colonies. Their effectiveness is credited as one of the principal explanations for Europe's half millennium domination of the globe. Limiting investors' liability to the amount they actually invested was a critical factor in attracting the necessary capital for this unprecedented achievement.[2]

Even as recently as 1932, US Supreme Court Justice Louis Brandeis argued for making sure that states conferred the privilege of the corporate structure only in those cases where it was consistent with public policy and welfare.

In the early days, there was a fear of some insidious menace inherent in large aggregations of capital, particularly when held by corporations. "So at first the corporate privilege was granted sparingly; and only when the grant seemed necessary in order to procure for the community some specific benefit otherwise unattainable. The later enactment of general corporation laws does not signify that the apprehension of corporate domination had been overcome."[3]

Brandeis points out that the decision to remove the strict requirements imposed on corporations was not based on the legislators' "conviction that maintenance of these restrictions was undesirable in itself, but to the conviction that it was futile to insist on them; because local restriction would be circumvented by foreign incorporation."[4] In other words, the characteristics of the corporate form were so important to people in business that legislators recognized that they could not beat them, and therefore might as well join them, or at least permit and then tax them.

What made the corporate form so appealing, so essential? According to Dean Robert Clark of Harvard Law School, the four characteristics essential to the vitality and appeal of the corporate form are:

1. limited liability for investors;
2. free transferability of investor interests;
3. legal personality (entity-attributable powers, life span, and purpose); and
4. centralized management.[5]

He adds that three developments, starting in the late nineteenth century, made these attributes particularly important. The first was the need for firms far larger than had previously been the norm. Technological advances led to new economies of scale. For the first time it made sense to have firms of more than a dozen people, and suddenly there were companies employing hundreds, then thousands. The second was the accompanying need for capital from a range of sources broader than in the past, when the only game in town was a small group of wealthy individuals who had previously invested by private negotiation. The third condition was that private ownership of investment property had to be "accepted as a social norm." The concept hardly seems revolutionary now, but it was radical, even a century ago, when it was widely assumed that most property would belong to the state, the church, or a select number of wealthy people. While this tradition was challenged from time to time, as, for example, during the Colonial and Revolutionary period of US history, the idea of widespread private property is essentially a modern one.

Let's look at Clark's four characteristics.

1. Limited liability. The notion of limited liability goes back to at least 2000 BC, when merchants provided the financing for seagoing vessels. The English courts first spelled it out during the fifteenth century. It means that the corporation is separate from its owners and employees; what is owed to the corporation is not owed to the individuals in the group that make up the corporation, and what the group owes is not owed by the individuals that make it up. Hence, if a corporation goes bankrupt and is sued by its creditors for recovery of debts, or is found responsible for some other injury, the individual members of the corporation are not individually liable, as, for example, was the case with the former partners of Arthur Andersen after that partnership collapsed.

This kind of shared liability may work well when the partnership is small enough to enable everyone to keep an eye on everyone else and share in all decisions, and when the personal investment of each partner is big enough to give each one the same incentive for low risk and high returns.[6] However, this oversight and incentive would be impossible in a setting of not just dozens, but

millions of "partners" investing in a company. No one would buy stock in a large corporation if the risk of loss were unlimited. One of the primary advantages of investing in stock is the certainty that whatever happens, the risk of loss is limited to the amount of the investment.

There is a catch here, however. With limited liability comes limited authority. A partner has a co-equal right to run the company with all of the other partners (unless the parties have agreed to another arrangement by contract). It is the partner's high level of control that makes the high level of liability acceptable and it is the shareholder's low level of risk that makes the low level of control acceptable. There is another consideration – what is the responsibility of owners with limited liability? If they know that their risk is limited to the amount of the investment, how do we make them care enough to provide effective oversight? In chapter 2 we will discuss the 89 percent of shareholders who are subject to both a legal (if vestigial) fiduciary obligation and to commercial conflicts of interest, and how that further affects their exercise of ownership rights.

2. Transferability. Just as important as limited liability in achieving an acceptable level of risk is the ability to transfer one's holding freely. A partnership interest is complicated and difficult to value, and there is no stock exchange where partnership interests can be traded. By contrast, stock is almost as liquid as cash. A shareholder who is concerned that the stock may be losing value can sell almost immediately. Note, however, that transferability can be limited. "Poison pills" are characterized by management as a mechanism for ensuring a better price in case of a sale of the company but in reality they impose restrictions on shareholders by not allowing them to determine the price at which they are willing to sell.

Transferability is also a function of limited authority. It is as though the shareholder says, "I will put my money at risk, with little authority to control the enterprise, as long as I can control my own risk by selling out any time I want to."

3. Legal personality. A partnership dies with its partners, or it dies when one partner decides to quit (unless there are explicit contractual provisions to the contrary). Continuing after the death or resignation of the partners can be complicated and expensive. A corporation lives on for as long as it has capital. This is a fairly recent development. Business corporations in the United States during the nineteenth century usually had a life limited to a term of years. As Justice Brandeis wrote in *Liggett v. Lee*, only in the most recent times have people assumed that perpetual existence was a necessary – to say nothing of a desirable – attribute of corporations.

Legal personality has other benefits as well. Actions that would result in a penalty for an individual, perhaps even a jail sentence, have no such result when the individual commits them as part of a corporation. The courts have extended First Amendment protections to corporate managements, allowing them to use investors' money to promote a political agenda with which they may not agree. AT&T claims that it is entitled to an exemption in the Freedom of Information Act that protects "personal privacy." An appeals court agreed, and the case (FCC v. AT&T) is at this writing pending at the Supreme Court.

Another benefit is ownership. It is because corporations are defined as legal persons that they may own property, including real estate, copyrights, and other assets.

This aspect, too, depends on limited authority by investors. To the extent the investors do have authority, they jeopardize the company when they are unavailable to exercise it. Legal personality allows the corporation to act, to own, and to continue past the lifespan of any individual or group.

4. Centralized management. Partnerships are managed by consensus or majority vote (unless partners explicitly agree otherwise). The point is that every partner has, if he wants it, a co-equal say in the affairs of the company. In a corporation, the power to determine the company's overall direction is given to the directors and the power to control its day-to-day operations is given to the managers.

This is another aspect of the limited authority given to investors. In order to allow the company to operate with maximum efficiency, the shareholders give up the right to make decisions on all but the most general issues facing the company. Exactly what those issues are and should be will be a continuing theme throughout this book.

Initially, a corporation was not permitted to engage in any activity unless it was specifically approved by the state in granting its charter. The original rule was based on the state's presumption *against* corporate activity; every undertaking had to be explicitly justified and approved. However, as the corporate form became increasingly popular, the presumption shifted. By the late nineteenth century, business corporations were permitted to organize for any lawful purpose, without requiring the prior approval of the government.

Just as dramatic – and just as important – as this shift in the relationship between the corporation and the government was the shift in the relationship between the corporation and its shareholders. As corporations grew in size and age, their ownership became increasingly fractionated and markets developed to ensure almost total immediate liquidity. This increased their strength and scope, but it reduced their accountability. In the early days, when the directors sat around a real board, they represented the shareholders because they *were* the shareholders. As corporations grew in size and complexity, the law tried to develop a standard of performance for directors that would encourage the same sense of duty and care that they would naturally use when they were representing themselves.

THE PURPOSE OF A CORPORATION

Corporations are such a pervasive element in everyday life that it can be difficult to step back far enough to see them clearly. Corporations do not just determine what goods and services are available in the marketplace, but, more than any other institution, corporations determine the quality of the air we breathe and the water we drink, and even where we live. Their enduring appeal stems in part from the wide range of purposes that corporations serve.

SATISFYING THE HUMAN NEED FOR AMBITION, CREATIVITY, AND MEANING

Business corporations provide an outlet for the satisfaction of essential human drives – quests for fulfillment, success, and security, for creative expression and for the competitive spirit. The corporate structure allows value to be placed on differing contributions that combine together so that the whole is greater than the sum of its parts. Through corporations, skills and experience can be competitively marketed and rewarded according to their contribution to value. Corporations have provided a means for the ambitious to achieve, the enterprising to prosper, and the ingenious to be enriched beyond their fondest expectations – the role played by the church or the military or the crown at

other times and in other cultures. Ideally, money invested buys perpetual ownership in a cornucopia of self-renewing abundance. Only the amount invested is at risk, and, if an investor buys ownership in several companies, that risk can be spread, and a portfolio corporation can be divested at any time to reduce significantly the possibility of loss.

Above all else, creating a structure for the agglomeration of talent and capital has permitted an increasing number of individuals the opportunity to create wealth for themselves and their descendants. Before the creation of the corporate structure, there were few opportunities for individuals to make dramatic changes in status and wealth. However, corporate history is filled with people like Henry Ford, Walt Disney, Bill Gates, Steve Jobs, and Facebook's Mark Zuckerberg, who changed the world and made themselves and their investors rich. The American system has provided opportunity for immigrants from Andrew Carnegie to Google's Sergey Brin to create almost unimaginable wealth.

SOCIAL STRUCTURE

Human beings have created social structures since their cave days, in order to foster cooperation and specialization. For centuries, these structures were devoted to goals that were not (necessarily) financial. For example, during the Dark Ages and the Middle Ages, Western man was organized under the single church. Toward the end of the medieval era, signs of this "church triumphant" system abounded. Under its banner, whole populations committed themselves for decades to Crusades. The gross national product of the continent was devoted to construction of magnificent houses of worship. Then, in a remarkable turn of events aided by religious protest, Henry VIII abruptly asserted the primacy of civil authority. For several centuries, up to the end of World War I, civil order based on hereditary rulers dominated the West.

At about this time, power in the form of ability to create wealth through goods and services desired by a population willing to pay passed to an entirely new type of entity, the huge worldwide corporations (see the Standard Oil case in point). Corporations offer lasting and resilient social structures.

EFFICIENCY AND EFFICACY

Corporations enable people to get things done. The words "businesslike," "professional," and "enterprise" are synonymous with beneficial efficiency and efficacy. The translation of an idea into a product, human ingenuity into bricks, mortar, and equipment, and savings into "growth stocks" has materially enhanced the lives of many people in democratic capitalist societies.

The challenge has been to adapt the corporate form to the needs of society. To this end, the state has maintained the original corporate model, chartering special-purpose corporations to achieve a particular objective. For example, in order to ensure better control by America of its fuel needs, the US Congress created the United States Synthetic Fuels Corporation in 1980 and attempted to use private sector personnel and techniques to solve a public problem. Similarly, organizations such as the Federal National Mortgage Association show the government's recognition that if it is going to compete with Wall Street, it must be through a private, for-profit organization. It also shows the perils of creating such hybrid organizations. As the Fannie Mae case study shows, even with substantial competitive advantages to ensure its financial success and substantial layers of oversight to ensure its compliance with laws and regulations, an organization can get into serious trouble.

This works both ways, of course. It is an understatement to say that the government does not hesitate to regulate corporations for a variety of reasons, some tangential to the corporation's activities. Society can induce or restrain particular corporate activities through tax and regulatory "fine tuning." For example, much New Deal legislation attempted to achieve social goals while pursuing economic ones. The Davis–Bacon Act of 1931 is one of three labor statutes passed in the 1930s to protect workers employed on government contracts. Davis–Bacon provides minimum wage requirements and fringe benefits for government-employed construction workers. More recent examples include laws and regulations designed to promote safety in the workplace and to prohibit discrimination on the basis of age, race, gender, and disability, and laws giving corporations tax incentives to invest in depressed areas.

UBIQUITY AND FLEXIBILITY

Corporations give individuals a greater and more lasting sphere of action. Corporations have no boundaries in time or space. A corporation continues despite the death or retirement of its founder or highest officers.

A corporation that is chartered in Delaware can do business anywhere in the world. Corporations can be moved. They can be transformed by a revision to their legal or financial structure. A corporation's officers and directors can change its place of incorporation, close existing places of business and open new ones virtually without restraint, and reallocate investment capital. American companies change their state of incorporation to receive the benefits of favorable laws or reincorporate offshore for tax reasons. The free trade agreements in Europe and Northern America are creating a "borderless world" in which a company's legal domicile relates to nothing but its own convenience.

An individual may decide to refrain from certain risky actions for several reasons. He may fear blame, shame, liability, even prison, but corporations, though they may be fined, cannot be jailed. This makes the corporate form a way of transferring enterprise liabilities to society as a whole. With their ability to provide jobs, corporations are aggressively courted by competing locations and states and countries, who "race to the bottom," imposing fewer and fewer constraints on profit potential. The state anti-takeover laws, enacted hastily to protect local companies from the prospect of a contest for control, are just one example. This happened in Massachusetts and Pennsylvania on two occasions each, as well as in many other states.

IDENTITY

Corporations have a life, and even citizenship, of their own, with attendant rights and powers. Corporations are "persons" within the meaning of the United States Federal Constitution and Bill of Rights. They are entitled to protection against the taking of their property without due process of law. According to the 2010 Supreme Court decision in *Citizens United*, they are entitled (at least to some extent) to freedom of speech (see Case in Point). They can contribute money to political causes and campaigns and many of the attempts to restrict these contributions were overturned as unconstitutional.

In addition, as the source of jobs, and therefore of the livelihoods for people who vote, they have significant political capital. Corporations, therefore, are powerful participants in the deliberations of our lawmakers. Several of our case studies include examples.

Corporations also decide what products and services will be available. This applies not just to laundry soap and toothpaste but also to medications and safety equipment. They decide investment priorities. They establish workplace conditions. They set prices.

METAPHOR 1: THE CORPORATION AS A "PERSON"

Author and reporter William Greider describes the development of corporate "personalities":

> *The great project of corporate lawyers, extending over generations, has been to establish full citizenship for their business organizations. They argue that their companies are entitled to the same political rights, save voting, that the Constitution guarantees to people. In 1886 the Supreme Court declared, without hearing arguments, that corporations would henceforth be considered "persons" for purposes of the 14th Amendment, the "due process" amendment that was established to protect the newly emancipated black slaves after the Civil War. Fifty years later, justice Hugo Black reviewed the Supreme Court's many decisions applying the 14th Amendment and observed that less than one half of one percent invoked it in protection of the Negro race, and more than 50 percent asked that its benefits be extended to corporations . . . .*
>
> *In the modern era of regulation [corporate lawyers] are invoking the Bill of Rights to protect their organizations from federal laws . . . . Corporations, in other words, claim to be "citizens" of the Republic, not simply for propaganda or good public relations, but in the actual legal sense of claiming constitutional rights and protections . . . . Whatever legal theories may eventually develop around this question, the political implications are profound. If corporations are citizens, then other citizens – the living, breathing kind – necessarily become less important to the processes of self-government.*[7]

METAPHOR 2: THE CORPORATION AS A COMPLEX ADAPTIVE SYSTEM

The corporate structure was designed to be so vital and robust that it is like an "externalizing machine." It is set up to do whatever it can to hang on to its earnings and push its costs off its balance sheet. That is what led to the notorious "special purpose entities" at Enron. The self-perpetuating life force built into the corporate structure fights the systems intended to impose accountability and, through that, legitimacy. This can also be done, for example, through legislation that increases barriers to entry for its competitors or limits its liabilities.

"Externality" is the vocabulary of economics. Another way to think about this is to use the vocabulary of science and call it a "complex adaptive system." Only when one understands that corporations have adaptive characteristics does it become clear that modification of their behavior must come from within the organizations.

For decades, it seemed convenient to ignore the gulf between the theory and reality of corporate accountability. Textbooks and judges spoke cheerfully of the shareholders' ability to provide

oversight by selling the stock, filing a lawsuit, or electing new directors. For example, an article written by Judge Frank H. Easterbrook and law professor Daniel R. Fischel points to mandatory corporate governance provisions to support their argument that these rules provide a solid foundation for real (and informed) freedom of choice for investors. They go on to acknowledge that, "Determined investors and managers can get 'round' many of these rules, but accommodation is a sidelight."[8]

Throughout this book, there are examples of "get(ting) 'round'" these rules. It does not mean much to "forbid perpetual directorships" if management continues to re-nominate the same people and it costs millions of dollars to run a dissident candidate. The Stone & Webster case study includes a director who served on its board for half a century. The General Motors case study reveals that the GM board, in the middle of the company's troubles in 1992, had one member who had been on the board for 20 years and two who had served for 15 years. Requiring the approval of a third of the board or half the shareholders does not mean much if the board is entirely selected by and beholden to management and the shareholders do not have the ability to overcome the obstacle of collective choice to make informed decisions. (See chapters 2 and 3 for further discussion of these issues, as well as the "duty of loyalty," the one share, one vote issue, and the relevance of required disclosures.)

As we will see throughout this book, neither government nor marketplace has consistently succeeded in requiring corporations to conform to society's interests over the long term. Following the 2007 Wall Street financial meltdown and the 2010 BP oil spill, news reports noted that efforts to regulate these companies or charge them with violations of existing regulations were deflected or derailed due to the intervention of politicians who were sympathetic to corporate interests and beneficiaries of corporate contributions.

For example, when then-Chairman of the Commodities Futures Trading Commission Brooksley Born wanted to issue a "concept release" to solicit views about whether derivatives should be regulated, she was shut down immediately. Not only did Federal Reserve Chairman Alan Greenspan opine that government oversight was "wholly unnecessary" but Born got a call from then-Treasury Secretary Larry Summers, who told her, "I have thirteen bankers in my office and they say that if you go forward with this you will cause the worst financial crisis since World War II."[9] She went ahead with the concept release but before any action could be taken Congress intervened with first a delay and then a prohibition of any regulation. In another case in 2008, the Public Employees for Environmental Responsibility filed a complaint alleging that an investigation into a BP oil spill had been prematurely shut down by the Justice Department as a part of a Bush administration practice of undercharging major violators.

Even before the *Citizens United* decision, corporations had a powerful arsenal of weapons to use to shape government policies and actions.

- Large corporations have huge bank accounts to retain the services of the most talented and influential professionals, including the most persuasive lobbyists and lawyers, with very persuasive war chests.
- They even control their own shareholders: the corporations themselves are the largest investors through their pension funds, often the greatest asset and liability even a major corporation has on its balance sheet. For example, according to a *Fortune* magazine article by Carol Loomis: "in 2005, General Motor's pension assets totaled $90 billion, were overfunded by $6 billion, and earned a robust $10.9 billion return, just slightly more than the losses of its operating divisions. One investor joked that General Motors is a pension liability with a car

company attached. (He should have mentioned the healthcare liability, which is underfunded by as much as $61 billion.)" Following the financial meltdown, the pension liability issues became much more severe, as discussed in chapter 2.
- Of course, the mainstream media and journalistic outlets are controlled by corporations as well.

The issue of where and how meaningful accountability can be imposed is the central challenge of governance systems. The rest of this chapter discusses attempts at external mechanisms for limiting the ability of corporate executives to benefit themselves to the detriment of the providers of capital. In economic terms, that would mean to limit their ability to externalize their costs. In public policy or legal terms, we might say, to make them behave in a way that is socially acceptable, even moral.

ARE CORPORATE DECISIONS "MORAL"?

The creation of the modern corporation came about at around the same time as the creation of modern democracies. The concerns about the legitimacy of power that led to the creation of checks and balances in the creation of political systems were evident in some skepticism about the exercise of public power as well. As noted above, originally in the US, every corporate charter had to be voted on separately by the legislature to make sure that its purpose was legitimate.

That did not last very long. The accountability we still seek, however, is that which is most likely to result in corporate choices that best benefit society over the long term. In some sectors, these would be seen as "moral" decisions. This does not mean that we want corporations to set policy. We do not want corporations to decide, for example, emission standards for environmental pollution. That must be left to government agencies accountable through the political process. However, we allow them to make policy indirectly through participation in the political process and through decisions that minimize the costs of their operations by externalizing them on to the community at large.

Can business "do well by doing good"? This is a perennial question. Almost every company proudly points to some evidence of "good citizenship," from participation by employees in extracurricular charitable activities to efforts to minimize environmental degradation. Companies such as The Body Shop and Ben and Jerry's have made social responsibility (or, at least, their view of social responsibility) part of their marketing strategy. Consumers can feel less guilty about buying arguably decadent products like make-up and ice cream if they know that by doing so they are supporting good causes. Can companies thrive, however, when the cost of social responsibility raises prices too high and instead of making the products more marketable, makes them less so? Clearly, there is some point beyond which the company's goods and services will become too expensive to keep the company going.[10]

At one end of the scale are the most basic aspects of social responsibility, like compliance with the law. In the best of all worlds, decisions and priorities that meet social goals also benefit shareholders. A "green" company may save manufacturing costs by creating efficiencies. A company that provides additional benefits and support for its employees and takes care to eliminate discrimination will benefit from a broader and more loyal and motivated staff. At the other end of the scale are activities so unrelated to the goods and services sold that pursuing them is considered by the marketplace to be irrelevant, even detrimental to the company's productivity.

IPO documents nearly always assure prospective investors that management will do everything they can to generate maximum returns,[11] a promise that is intended to respond to the core question of agency costs. Some famous lawsuits raise the question of whether a CEO can decide not to pursue opportunities that will increase revenues in furtherance of some social goal and who should decide how much that is worth. Merck CEO Dr. Roy Vagelos famously committed tens of millions of dollars – without consulting or even informing his board of directors – to the development of a medication for river blindness, knowing that it would be needed only by people living in extreme poverty who would never be able to pay for it. (See the discussion of the Dodge case later in this chapter as well.)

Who should make those trade-offs?

CASE IN POINT *SHLENSKY V. WRIGLEY* (1968)

In 1968, some shareholders of the Wrigley Corporation sued the company and its directors for failing to install lights in Chicago's Wrigley Field. The shareholders claimed that the company's operating losses for four years were the result of its negligence and mismanagement. If the field had lights the Cubs baseball team could play at night, when revenues from attendance, concessions, and radio and television broadcasts were the greatest.

The shareholders argued that the sole reason for failing to install the lights was the personal opinion of William Wrigley, the president of the company, that baseball was a daytime sport, and his concern that night games would lead to a deterioration of the neighborhood. The shareholders said this was not an appropriate basis for decision by management, who were supposed to make the interests of shareholders their top priority.

Nevertheless, the court ruled against the shareholders. As long as the decision was made "without an element of fraud, illegality, or conflict of interest, and if there was no showing of damage *to the corporation*, then such questions of policy and management are within the limits of director discretion as a matter of business judgment," the court ruled (emphasis added).

This decision, which deprived the fans of night games and the investors of a substantial source of revenue, was made on the basis of management's notion of social responsibility.

Is losing money damage to the corporation? How relevant is it that, at the time, William Wrigley had a controlling block of the company's stock?

Later, after the team was sold to the Tribune Company, efforts to install lights met with opposition from fans and the state legislature passed a law prohibiting night

games after midnight except for teams that had been grandfathered. Finally, Major League Baseball threatened to require the Cubs to play in another facility and lights were installed in 1988, 20 years after the lawsuit.

The key question is "Who decides?" That is the theme throughout the study of corporate governance. A CEO can decide that the company's social responsibility is best met by making a substantial charitable donation to his or her alma mater, which then shows its gratitude by giving the CEO an honorary degree and a box at the school's football games. There is also a very happy and congenial member of the board of directors when the university's president is invited to the board. However, is this "social responsibility"?

Who is in the best position to make sure that any expenses not directly associated with identifiable and quantifiable returns are at least related closely enough to have a cost-effective impact on long-term value maximization? Who is in the best position to make sure that the company's definition of social responsibility is an accurate reflection of the definition of the owners? Of the community? ■

ARE CORPORATIONS ACCOUNTABLE?

In policy terms, we want corporate operations to be consistent with the public good. In economic terms, we do not want them to externalize their costs on to the community. How do we make that happen? One way is by establishing a system of accountability. In theory, corporations are held accountable by the "invisible hand" of the market and by government. As the cases in this book show, reality is often something else.

Compare this to the way we grant legitimacy and authority to the exercise of public (government) power through accountability. We are willing to defer to the authority of elected officials because we put them there, and if we do not like what they do, we can replace them. In the US, the checks and balances of the three branches of government add to the credibility and legitimacy of the government. Any of the three branches that goes too far can be curbed by one of the others.

In theory, the legitimacy and authority of corporate power is also based on accountability. Corporate governance also has its checks and balances (including the government). To maintain legitimacy and credibility, corporate management needs to be effectively accountable to some independent, competent, and motivated representative. That is what the board of directors is designed to be.

Corporations exercise vast power in a democratic society. In a thoughtful and enduring essay, "The Corporation; How Much Power? What Scope?," Carl Kaysen outlines the various alternative modes for containing corporate power,[12] asking whether and how corporate power can be "limited or controlled."

> *Broadly, there are three alternative possibilities. The first is limitation of business power through promoting more competitive markets; the second is broader control of business power by agencies external to business; the third, institutionalization within the firm of*

responsibility for the exercise of power. Traditionally, we have purported to place major reliance on the first of these alternatives, in the shape of antitrust policy, without in practice pushing very hard any effort to restrict market power to the maximum feasible extent. I have argued elsewhere that it is in fact possible to move much further than we have in this direction, without either significant loss in the overall effectiveness of business performance or the erection of an elaborate apparatus of control. While this, in my judgment, remains the most desirable path of policy, I do not in fact consider it the one which we will tend to follow. To embark on a determined policy of the reduction of business size and growth in order to limit market power requires a commitment of faith in the desirability of the outcome and the feasibility of the process which I think is not widespread. What I consider more likely is some mixture of the second and third types of control.[13] ”

Kaysen is pessimistic about the prospects for corporate self-regulation. "The development of mechanisms which will change the internal organization of the corporation, and define more closely and represent more presently the interest to which corporate management should respond and the goals toward which they should strive is yet to begin, if it is to come at all."[14]

As the scandals of 2002 and the meltdown of 2008 have shown us again, the theory is often far from the practice. While the details of each of those failures differed, each was above all a failure of accountability, that cornerstone of the markets that permits one group to provide the capital and another to put it to use for the benefit of both – and of all. Therefore, the questions we must answer are:

- How do we make sure that corporate power is exercised in the best interests of society?
- How do we measure corporate performance?
- How should society measure corporate performance?

Those questions are closely related, but their answers are worlds apart. For example, imagine a company that has record-breaking earnings and excellent shareholder returns. This is in part made possible by a rigorous cost-cutting campaign that includes illegal dumping of toxic waste materials, thereby saving the money that had been used to meet environmental standards for disposal. The company's balance sheet and other financials will look very good, but the cost to society, in damage to the health and property of those affected by the illegal dumping, will not be factored in. Neither will the cost of investigating and prosecuting the company, which will be borne by the taxpayers. The cost of defending the company, and any fines imposed, will of course be borne by the shareholders.

Note that this question was central to the Supreme Court's consideration of the *Citizens United* case, which expanded First Amendment rights of corporations. The Court found that the law under consideration could not be justified as a way to protect a shareholder who does not want the corporation to spend money on an election for three reasons. First, it would allow a law to limit the speech of any corporation, including a media corporation, solely to protect the shareholders who disagree with the editorial position of the company. Second, because the electioneering communications ban applied only during certain time periods, it was not an effective way to protect shareholders. Third, it applied to all corporations, including nonprofits and for-profits with a single shareholder.

THREE KEY EXTERNAL MECHANISMS FOR DIRECTING CORPORATE BEHAVIOR: LAW, THE MARKET, AND PERFORMANCE MEASUREMENT

In the following chapters, we will focus on the three major forces that are responsible for determining corporate direction and action: shareholders, directors, and executives. To put them in context, in this chapter we will focus on two external mechanisms that are intended to ensure that corporate behavior is consistent with the best interests of society over the long term. The first is civil and criminal law, which includes the executive, legislative, and judicial branches of state and local government regulation, legislation, and enforcement. The second is external systems of performance measurement, most significantly accounting rules, which are intended to make it possible for the government and other insiders and outsiders to understand a company's priorities, progress, effectiveness, and impact.

First, however, to evaluate the impact of the major players in corporate governance, we have to decide what we are trying to achieve in the largest, most long-term sense. We want jobs that pay a decent wage and goods and services that meet our needs. We want structures and systems that enable us to express our creativity and ingenuity, and when we meet those challenges, we want to have the benefits of the results. We want our workplaces and our environment to be safe. We want a continual sense of progress, opportunity, and growth from our corporations. We want our interest in the company – whether as employee, shareholder, customer, supplier, creditor, or neighbor – to be designed for the long term because all the things we want for ourselves, we also want for our children and grandchildren.

Two connected sets of rules govern the relationships of these constituent groups to the corporation. One is comprised of the laws imposed by the legislature and the other is private law established in agreements between the corporation and its employees, customers, suppliers, investors, and community. Ideally, the public laws would exist only as a kind of floor or backstop to establish minimum standards, permitting maximum flexibility for the corporation and its constituents to devise optimal arrangements between them. In other words, the government should step in only when the system of corporate governance cannot be assured of producing a result that is beneficial to society as a whole. Throughout this book, our starting point for determining who is in the best position to make a particular decision is figuring out who has the best access to information and the fewest conflicts of interest. That is one way to think about when it is appropriate for government or any (or all) of the other parties to play a role in setting the course for the corporation.

GOVERNMENT: LEGISLATION, REGULATION, ENFORCEMENT

Without government, there would be no corporations at all. It is government that grants a corporation the license to operate as long as it can stay in business and limits the liability of its investors and employees. Law also restricts corporate operations. The Securities and Exchange Commission has thousands of pages of rules about what companies must disclose to the public and government agencies like OSHA, EPA, the FTC, and impose requirements to protect the health and safety of employees and the community and the rights of consumers of the company's products. Corporations pay millions of dollars in taxes.

In theory, the government can ensure that corporations act in a manner that benefits society. In practice, however, corporations have influenced government at least as much as government has influenced business. The corporate "citizen," with the right to political speech (and political contributions) has had a powerful impact on the laws that affect it. In theory, corporations support the free market, with as little interference from government as possible. In reality, whenever corporations can persuade the government to protect them from the free market, by legislating barriers to competition or limiting their liability, they do so. Then-Massachusetts Governor (and Presidential candidate) Michael Dukakis not only signed a rush piece of anti-takeover legislation "constituent" company Gillette asked for but he did so at Gillette headquarters.[15]

Many laws are designed to make it possible for corporations to externalize their costs. These laws vary tremendously from state to state and country to country. States that enact laws that corporations do not like run the risk of losing the "race to the bottom" that has states outdoing each other in accommodating business. That term refers to the way that states compete for corporate chartering business through increasingly diluted provisions for oversight, a race that seems definitely won by Delaware.[16] Because managers, not shareholders, select the state of incorporation in the US, most corporations that operate nationwide or even worldwide are incorporated in Delaware, famous for its extensive and management-friendly laws and judicial decisions governing corporations.

In 1978, the Supreme Court issued a unanimous decision in *Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp.* ruling that state anti-usury laws regulating interest rates cannot be enforced against nationally chartered banks based in other states. Thus it freed nationally chartered banks to offer credit cards to anyone in the US they deemed qualified. Two years later, Citibank decided to move its credit card operations, realizing that it could forum-shop to escape New York's interest rate caps, and persuaded Bill Janklow, then governor of South Dakota, to make it possible for them to relocate their operations to his state. South Dakota's agriculture-based economy was under pressure at the time and they were eager for new jobs. The governor persuaded the state's legislature to issue a formal invitation, as required by federal law before a national bank can do business from a state. He then successfully lobbied the legislators to pass a bill drafted by the bank that repealed the state's cap on interest rates. Citibank quickly moved the 300 white-collar jobs in its credit card division to Rapid City, where it was later joined by other credit card operations, including Wells Fargo.[17] What had been a loss leader for banks became one of their most lucrative lines of business. Credit card agreements grew from 700 words to dozens of impenetrable pages. Delaware and other states soon joined the race to the bottom to try to accommodate issuers and get a piece of the action.

Globalization is expanding and accelerating the "race to the bottom." Before it got into the accounting problems and $6000 shower curtain problems that kept it in the news in 2002, Tyco changed its incorporation to Bermuda, which added an additional layer of – depending on your point of view – complication or management protection in the lawsuits over financial reports and self-dealing discussed in the case study. Some day, we may see most of the world's major corporations incorporating in the world equivalent of Delaware, perhaps the Cayman Islands.

If providers of capital were able to communicate their concerns by directing their funds to enterprises governed by more investor-friendly laws or directing their portfolio companies to shareholder-friendly domiciles, competition for capital could turn the race to the bottom into a race to the top.

However, that is far from the case. We will begin with the most extreme exercise of legislative power – criminal law. We look at corporate crime here not as the disease but as the symptom of a corporate governance system that has failed to ensure compliance with the law.

WHAT DOES "WITHIN THE LIMITS OF THE LAW" MEAN?

> Did you ever expect a corporation to have a conscience, when it has no soul to be damned and no body to be kicked?
>
> *Edward, First Baron Thurlow, Lord Chancellor of England*

The American Law Institute says that the objective of a corporation is "the conduct of business activities with a view to enhancing corporate profit and shareholder gain," but that even if doing so would contravene those goals, the corporation has the same obligations as a natural person to act within the law. It may also "take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business" and may devote "a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes."[18]

In practice, however, it has been difficult to apply criminal law to corporations for the reasons so vividly described by the Baron above. By classifying particular conduct as "criminal," government gives its most unequivocal signal that particular activities are intolerable. That seems simple enough when applied to armed robbery or assault, but criminal law and corporate activity seem to exist in different media, like oil and water. Understanding the difficulty that society encounters in trying to communicate absolute standards of conduct to corporations is an essential beginning to the study of governance.

Why do corporations engage in criminal behavior? It has to be because they find that the benefits outweigh the costs, or, to put it another way, the managers who take the risk of criminal behavior decide that the benefits accrue to the corporation, while the costs are borne elsewhere. These costs are enormous. A single price-fixing case involving General Electric and Westinghouse in the early 1960s cost the affected consumers more than all of the robberies in the entire country that year. However, robbers go to jail. Corporate criminals just pay a fine – from the corporate treasury. Shareholders in particular pay the costs on all sides: as members of the community, they pay the costs of the crime itself; as taxpayers, they pay the costs of the prosecution; as shareholders, they pay the costs of the defense and any penalties.

The people who decide to violate the law, however, pay very little. There is a great disparity between the way individual criminal offenders and corporate criminal offenders are treated. One reason for this is society's perception of the crimes. We are more likely to imprison violent offenders than white-collar criminals, despite the fact that the white-collar crime, in absolute terms, is more expensive. The business judgment rule (see the discussion of legal duties in the third chapter) and the limitation on director liability restrict the shareholders' ability to get the courts to order reimbursement for the payment of these expenses or the loss in share value. Corporate managers rarely go to jail; indeed, they seldom even lose their jobs. The company pays the fines, which are seldom high enough to offset any gains, and the company pays the legal fees.

Often the executives and the company enter into deals that involve the payment of a fine without any admission of guilt. *Corporate Crime Reporter* issued a report in 2005 called "Crime Without Conviction: The Rise of Deferred and Non Prosecution Agreements," finding that "prosecutors have entered into twice as many non-prosecution and deferred prosecution agreements with major American corporations in the last four years (23 agreements between 2002 to 2005) than they have in the previous ten years (11 agreements between 1992 to 2001)." Author Russell Mokhiber notes:

> *It could very well be that the rise of these deferred and non prosecution agreement deals represents a victory for the forces of big business who for decades have been seeking to weaken or eliminate corporate criminal liability.*
>
> *The antipathy of business and business lawyers toward corporate criminal liability is deep and far reaching.*
>
> *Many advocates for big business openly advocate for the elimination of corporate criminal liability.*
>
> *One such person is Jeffrey Parker, a Professor of Law at George Mason University.*
>
> *Parker argues that corporate crime simply does not exist and can not exist.*
>
> *'Crime exists only in the mind of an individual,' Parker said in an interview with Corporate Crime Reporter a couple of years ago.*
>
> *'Since a corporation has no mind, it can commit no crime,' Parker said.*
>
> *He argues that since a corporation is not a living breathing human being, it should not be treated as a living breathing human being in the criminal law arena.*[19]

If a corporation is not a person for purposes of the criminal law, then why should it be a person for the purposes of constitutional law, where it is considered a person and is granted protections, including First Amendment guarantees of political speech and commercial speech, Fourth Amendment safeguards against unreasonable searches, Fifth Amendment double jeopardy and liberty rights, and Sixth and Seventh Amendment rights to trial by jury?

CASES IN POINT — CORPORATE CRIME AND PUNISHMENT

In 2002 and 2003, allegations about negligence and abuse from accounting fraud to embezzlement led to a new focus on corporate crime. WorldCom CEO Bernard Ebbers was sentenced to 25 years in prison. Enron executive Kenneth Lay died before sentencing, but Jeffrey Skilling was sentenced to 24 years in prison (later overturned in part by the Supreme Court on technical grounds). HealthSouth CEO Richard Scrushy was acquitted in the trial on accounting and other financial fraud but the court in another suit ruled

that he was not entitled to his bonus and he was convicted at a separate trial for bribing a public official. Adelphia's John Rigas was sentenced to 15 years. Frank Quattrone of Credit Suisse First Boston negotiated the dropping of all charges after the first trial was deadlocked and an appeal of his conviction at the second.

Companies can avoid breaking the law in two ways. They can abide by it or they can get it changed to require them to do just what they want to and no more. The corporate failures of the early part of the first decade of the twenty-first century led to news broadcasts featuring corporate executives in "perp walks," but the Wall Street meltdown of 2007 did not. Thanks to the involvement of the financial services industry in political contributions and $600 million in lobbying expenses, legislation and regulatory provisions were either weakened or eliminated and investigations were short-circuited. The same was true with environmental controls that could have prevented or mitigated the damage from the BP oil spill.

According to *Corporate Crime Reporter*, the top corporate crimes of the 1990s were very different from those we saw in the early twenty-first century. Their list of the top ten corporate criminals from 1990 to 1999 included six antitrust cases, three of financial fraud, and one environmental (the Exxon Valdez oil spill). Fines ranged from $50 to 500 million. In the first decade of the twentieth-first century, while the financial fraud led the headlines, the biggest fines came from health care and violation of the Foreign Corrupt Practices Act.

In 2009, Pfizer and its subsidiary Pharmacia & Upjohn Company Inc. paid $2.3 billion, the largest health care fraud settlement in the history of the Department of Justice, to resolve criminal and civil liability arising from the illegal promotion of pharmaceuticals. Pharmacia & Upjohn Company pled guilty to a felony violation of the Food, Drug and Cosmetic Act for misbranding Bextra with the intent to defraud or mislead. Also in 2009, Eli Lilly & Co. paid $515 million for promoting its drug Zyprexa for uses not approved by the Food and Drug Administration (FDA). This was the largest fine ever in a health care case, and the largest criminal fine for an individual corporation ever imposed in a United States criminal prosecution of any kind. Eli Lilly also agreed to pay up to $800 million in a civil settlement with the federal government and the states. Other enormous settlements were entered into by HCA (formerly Columbia/HCA), $1.7 billion for healthcare fraud, and Schering-Plough, $500 million for repeated failure over the years to fix problems in manufacturing dozens of drugs at four of its factories.

Violations of the Foreign Corrupt Practices Act (FCPA) led to fines and disgorgement for Siemens ($1.6 billion on top of the $285 million paid to German authorities) for a widespread and systematic practice of paying bribes to foreign government officials to obtain business. Siemens created elaborate payment schemes to conceal the nature of its corrupt payments, and the company's inadequate internal controls allowed the conduct to flourish. The misconduct involved employees at all levels, including former

senior management, and revealed what the government's press release called "a corporate culture long at odds with the FCPA." The company made at least 4,283 payments, totaling approximately $1.4 billion to bribe government officials in return for business to Siemens around the world. Halliburton, KBR, and Kellogg Brown & Root LLC paid a fine of $579 million, plus an individual criminal fine from Kellogg Brown & Root LLC of $402 million for violations of the FCPA in connection with a four-company joint venture that bribed Nigerian officials to win construction contracts worth more than $6 billion. Payments involved the former CEO of the predecessor entities; Albert "Jack" Stanley and other executives met with high-ranking Nigerian government officials and their representatives on at least four occasions to arrange the bribe payments. BAE Systems paid a $400 million fine for violations of FCPA and arms export provisions that earned the company more than $200 million. BAES not only lied about setting up control systems to ensure compliance with these laws but it encouraged certain advisors to establish their own offshore shell companies to receive payments from BAES while disguising the origins and recipients of these payments and set up its own company to conceal its marketing advisor relationships.

Companies also paid large fines for violating antitrust laws, including LG Display ($585 million for price fixing of LCD panels) and Air France/KLM ($504 million each for fixing air cargo rates). It is the almost-universal practice to collect fines without requiring an admission of guilt.

Did any of the executives or directors have to pay fines out of their personal accounts? Did any of them lose their positions? When the companies paid these fines, who bore the cost? Does the current system provide an adequate disincentive for breaking the law? If not, what would?

More Examples

KBR. The largest contractor in Iraq is Houston-based KBR, Inc., with fees amounting to more than $37 billion for services that include housing, meals, laundry, and water purification. The company was found partly to blame for the accidental electrocution of a Green Beret, and as a result lost one-quarter's bonus payment, $24.1 million. While the company failed to ground the cables adequately, the death was ruled accidental and there was no finding of criminal negligence. Throughout the rest of 2008, KBR's performance was deemed to have improved enough for the Army to pay it $39.1 million of the $99.7 million available, or about 40 percent, and it was granted a new order worth as much as $568 million. (Note that KBR was also involved in the FCPA violation listed above.)

Goldman Sachs. The SEC charged Goldman Sachs with fraud relating to its failure to make key disclosures in marketing its Abacus derivative securities. Goldman settled for

a record-breaking $550 million. Journalist David Weidner referred to the settlement as the company's "best trade ever."

> *Can Goldman Sachs Group Inc. wheel and deal or what? The bank and brokerage's settlement with the Securities and Exchange Commission on Thursday over the ill-fated Abacus deal may be its best trade ever. At $550 million, it's not terribly expensive. Goldman hasn't agreed to restrict its practices in any meaningful way. And poof! The firm can go back to work with its biggest liability paid.... Goldman's net income last year was $12.1 billion. It could be even higher this year, given the robust first quarter Goldman already has had. The settlement amounts to less than 5% of profits. Maybe Goldman Sachs will even be able to write it off. What's more, Goldman will not suffer any reputational risk from this. Without stronger penalties, without a revealing release of details, cross-examination and court scrutiny, why would any client even consider dumping this firm? If anything, the settlement probably will attract clients who want Goldman to take the same dogged approach to their own investments and trades.*[20]

Alleco. The company's CEO, Morton M. Lapides, was convicted of a price fixing scheme that resulted in record-breaking fines. The judge found the facts of the case so disturbing that he took the unprecedented step of issuing a prison sentence to the corporation. The judge said, "I cannot imagine any company being more tied up with illegal activity." Four of its top managers were directed to spend up to two years in community service. The conviction notwithstanding, Lapides was permitted to take the company private at substantial personal profit.

General Electric. In 1992, GE settled with the government over charges that the company had been falsely billing the federal government for military sales to Israel during the 1980s. Company employees had conspired with an Israeli air force general to divert the money to their own pockets. GE's jet engine division was suspended from bidding for future Pentagon contracts, and the company agreed to pay fines of $69 million. GE's shares dipped $0.87 on the news.[21]

Drexel Burnham Lambert. In December 1988, the securities house pleaded guilty to six felony charges alleging widespread securities fraud and insider dealing. Drexel agreed to pay a fine of $650 million. The following March, the US Attorney's office in New York issued a 98-page indictment charging Michael Milken with similar crimes. Milken had single-handedly made Drexel successful via his aggressive hawking of junk-bonds, a security that financed most of the takeovers of the 1980s. So central was Milken to Drexel's success that the firm paid Milken compensation of as much as $550 million in one year alone. Roiled by the charges of fraud, and damaged by the increasing collapse

of junk-bond financed firms, Drexel filed for bankruptcy protection in February 1990. Just two months later, Milken agreed to plead guilty. In November 1990, he was sentenced to a prison term of ten years. The sentence was later reduced and Milken was eventually released in the summer of 1993. He subsequently taught a finance course at the University of California at Los Angeles.

A.H. Robins. The company marketed an intrauterine contraceptive device, called the Dalkon Shield, despite the fact that the company had over 400 unfavorable reports from physicians. The device was eventually recalled after the deaths of 17 women. By mid-1985, over 14,000 product liability suits had been filed against the company, forcing it into bankruptcy. In 1987, a court ordered the company to set aside $2.4 billion in a trust fund to compensate women injured by the shield. Later, the company also agreed to pay out nearly $7 million to stockholders.[22]

Gitano Group. In December 1993, three Gitano executives pleaded guilty to charges that they had sought to circumvent customs duties on imported clothes. Following the charges, Gitano's largest customer, Wal-Mart Stores, announced that it would cease to do business with Gitano, adhering to strict company standards regarding vendor partners. In January 1994, Gitano's board of directors concluded that it was unlikely that the company could continue to operate without Wal-Mart's support and the board voted to put the company up for sale.

Waste Management. In December 1996, Federal Judge Odell Horton in the Western District of Tennessee issued an opinion ordering a WMI subsidiary to pay a $91.5 million fraud judgment. The judge's ruling held that the officers in Chemical Waste Management had engaged in a scheme to "cheat the plaintiffs out of money" by keeping two sets of books to hide the amount of royalty payments due to the plaintiffs. The judge added, "What is troubling about this case is that fraud, misrepresentation, and dishonesty apparently became part of the operating culture of the Defendant corporation."

PG&E. In 1997, PG&E agreed to pay $333 million dollars to settle claims from 648 residents of Hinkley, California, who had suffered a range of illnesses and injuries from chromium in their groundwater that came from a PG&E plant.

BP. In 2010 BP had to set aside $20 billion for claims stemming from its Deepwater Horizons oil spill. As discussed in chapter 5, the drilling rights were awarded despite past findings of felony-level violations.

See also the price fixing case in point later in this chapter. ■

CASE IN POINT A UK ATTEMPT TO REDEFINE CORPORATE MANSLAUGHTER

In March 1987, a car and passenger ferry called the *Herald of Free Enterprise* departed from the Belgian port of Zeebrugge for Dover. The ferry was owned by P&O European Ferries, a subsidiary of a large and venerable UK shipping line, P&O.

The *Herald of Free Enterprise* cleared the Zeebrugge harbor with its bow doors still open. This was common practice by crews seeking to clear the hold of exhaust fumes. On this occasion, waves flooded the bow doors and the *Herald of Free Enterprise* capsized with the loss of 187 lives. *Who was to blame?*

Clearly, on an immediate level, the disaster was caused by those who failed to close the bow doors and those who instructed the vessel to sail while the doors were still open. However, the judicial inquiry identified deeper causes – a corporate culture at P&O European Ferries that ignored basic safety. The inquiry concluded that: "All concerned in management, from the members of the board of directors down to the junior superintendents, were guilty of fault in that all must be regarded as sharing responsibility for the failure of management. From top to bottom, the body corporate was infected with the disease of sloppiness."

How do you punish the body corporate? As we see throughout these cases, it cannot be put in jail, and any fines will ultimately be paid by those who were not responsible, the shareholders (though they may have unfairly benefited from the behavior before the disaster).

In the UK, corporations may be prosecuted for manslaughter, but, in reality, successful prosecutions are all but impossible to achieve. In English legal history, there have been four prosecutions of corporations for manslaughter and only one conviction.

The problems of securing a conviction were vividly highlighted by the *Herald of Free Enterprise* tragedy. Following the coroner's inquest into the disaster, the jury returned verdicts of unlawful killing in all 187 cases. P&O European Ferries was charged with manslaughter, as were seven high-ranking company officers. However, the judge threw the case out, directing the jury to acquit the company and the five most senior defendants.

The judge gave this direction because English law requires that, to find a company guilty of manslaughter, the illegal acts must be committed by those "identified as the embodiment of the company itself." In a famous passage, Lord Justice Denning said that to convict a company, one must identify as guilty the person who represents "the directing mind" of the corporation.

A company cannot be considered guilty of manslaughter simply because its employees have recklessly caused death. Rather, as one British judge has written, "it is required that manslaughter should be established not against those who acted for or in the name of the

company but against those who were to be identified as the embodiment of the company itself."

In the P&O Ferries example, the judge directed that in order to convict the company of manslaughter "one of the individual defendants who could be 'identified' with the company would have himself to be guilty of manslaughter." There was insufficient evidence against the individuals to meet this standard, hence the direction to acquit.

Yet disasters such as the *Herald of Free Enterprise* give rise to widespread public concern that the law does not do enough to hold companies to account. For this reason, the UK's Law Commission (a government-funded body that studies law reform) proposed a new law of corporate killing to replace the current, inadequate provisions for corporate manslaughter. The Commission argued that "a number of recent cases have evoked demands for the use of the law of manslaughter following public disasters, and there appears to be a widespread feeling among the public that in such cases it would be wrong if the criminal law placed all the blame on junior employees who may be held individually responsible, and also did not fix responsibility in appropriate cases on their employers, who are operating, and profiting from, the service they provide to the public, and may be at least as culpable."

Under the "directing mind" standard, it is all but impossible to convict the large modern corporation of manslaughter. As the Commission wrote, "the more diffuse the company structure and the more devolved the powers that are given to semi-autonomous managers, the easier it will be to avoid liability." The study notes "the increasing tendency of many organisations to decentralise safety services in particular." Indeed, "it is in the interests of shrewd and unscrupulous management to do so."

The inquiry into the *Herald of Free Enterprise* disaster, according to the Commission, found that "no single individual had responsibility for safety matters." The Commission comments that "if responsibility for the development of safety monitoring is not vested in a particular group or individual, it becomes almost impossible to identify the 'directing mind' for whose shortcomings the company can be liable."

The only successful prosecution for corporate manslaughter in English legal history highlights the difficulties. In 1994, a jury convicted the owner-operator of an adventures company, in whose care some children had died while canoeing. The Commission comments: "Since the company was a one-man concern whose 'directing mind' was plainly its managing director, the company's liability was established automatically by his conviction."

The Law Commission thus concluded that the chances of ever convicting a large, complex corporation for manslaughter were minimal, even if, as in the P&O Ferries example, the manslaughter was the result not just of individual errors but of a corporate culture or management failure.

Thus, the Commission proposed a new offence of corporate killing, broadly corresponding to the individual offence of killing by gross carelessness. "For the purposes of

the corporate offence," they wrote, "a death should be regarded as having been caused by the conduct of a corporation if it is caused by a failure in the way in which the corporation's activities are managed or organized." They suggested that "It should be possible for a management failure on the part of a corporation to be a cause of a person's death even if the immediate cause is the act or omission of an individual."[23]

Let us look again at the *Herald of Free Enterprise* example. "If circumstances such as these were to occur again," explained the Law Commission, "we think it would probably be open to a jury to conclude that, even if the immediate cause of the deaths was the conduct of the assistant bosun, the Chief Officer, or both, another of the causes was the failure of the company to devise a safe system for the operation of its ferries; and that that failure fell far below what could reasonably have been expected. In these circumstances the company could be convicted of our proposed new offence."

On conviction, the court would have the power to order the cause of the offence to be remedied. Compare this with the US, where, in just one example, the auto companies successfully prevented the adoption of proposed legislation that would have held them criminally liable for *knowingly* marketing a product that kills or maims.

In 2007, the UK adopted The Corporate Manslaughter and Corporate Homicide Act, making companies and other organizations liable where there has been a gross failing, throughout the organization, in the management of health and safety with fatal consequences. It was watered down from the proposal submitted by the Law Commission, requiring the involvement of senior executives, and many critics said it was too weak to be effective. In 2009, Peter Eaton, the sole director of Cotswold Geotechnical Holdings Ltd, became the first person to appear in court to answer charges under this law, following the death of a geologist in a mudslide while working for the company. ■

All the stakeholders in these companies lost as a result of these actions. Corporations are supposed to be governed by a system of checks and balances to make sure that these disasters do not happen. Who failed? Who paid the price? If it is not the same people, why not? If the system of checks and balances failed, why? Who was in the best position to deter this kind of mistake, and why didn't they do so? What changes would make these mistakes less likely? What changes would catch and address them sooner? Can a company be guilty of a crime? If so, who should pay and how?

WHEN AND HOW DO YOU PUNISH A CORPORATION?

Corporations have limited economic liability, as described above, and at one time this extended to criminal activity. In modern times, at least in theory, corporations do have criminal liability. Originally, the standard for determining that a corporation (and its officers) was liable for criminal activity was *respondent superior*, vicarious liability by the corporation for the acts of its employees, as

long as those acts were (1) within the scope of the employment and (2) with the intent of benefiting the corporation. This required knowledge (willfulness) on the part of the employee. He had to know what he was doing and know that it was illegal.

Recently, however, there has been a trend to criminalize a broader category of behavior, often for political reasons. This began in the health and safety area, and has expanded to include other areas of social policy concern like discrimination and areas of political sensitivity like government contracts. Regulations established a new standard in holding corporations liable for "flagrant indifference," "neglect," or "failure to perceive a substantial risk." Ignorance of the law is no excuse. Courts have held that corporate officers are presumed to know certain things, just because of their position. The knowledge of *any* employee can be attributed to the company as a whole, even if the employee did not inform anyone else.

The primary justifications for penalties are deterrence, incapacitation from further crimes, and rehabilitation. All of these depend on some degree of moral culpability. It is easy enough to apply them to an individual who commits a crime. A thief is sent to jail to deter him (and others) from future crime, to keep him away from society so that he cannot commit further crimes, and to give society a chance to teach him to do better. Some systems also try to incorporate compensation of some kind for the victims as well, though this has been less a priority of the criminal justice system than of the civil justice system; in the criminal system such compensation is more likely to take the form of community service than direct compensation to the individuals who were harmed. As Douglas Ginsburg's example shows below, "community service" is interpreted very broadly.

No one seems to know what to do about it. It almost seems as though a certain level of corporate crime is just assumed as a real-life "cost of doing business."

The failure of our efforts to rein in criminal corporate conduct stems from trying to treat artificial entities as if they were natural persons. Legal scholar John C. Coffee, Jr. of Columbia University has stated the problem succinctly: "At first glance, the problem of corporate punishment seems perversely insoluble: moderate fines do not deter, while severe penalties flow through the corporate shell and fall on the relatively blameless."[24]

PROBATION OF CORPORATIONS

In March 1986, the US government prepared a "sentencing memorandum" recommending "probation" and a fine for the Bank of New England, following the bank's conviction on 31 counts. The crime involved repeated failure to file Currency Transaction Reports (CTRs), a requirement imposed in an effort to track financial transactions that may be related to illegal activities. In this case, although the bank admitted to its failure to file thousands of these forms, the prosecution centered on a bookie named McDonough, whose failure to file CTRs for his dealings with the bank made it impossible for the government to prosecute McDonough for tax and gambling offenses.

The memo pointed out that "the (bank's) misbehavior was truly institutionalized, having been engaged in by numerous employees and officers on repeated occasions over a four-year period.... The failure to file the required CTRs involved not one, but at least ten bank employees.... The failures to file were aggravated by the fact that some of the employees knew McDonough was a bookie and that he was trying to circumvent the CTR law.... The bank's culpability as an institution was compounded...when [the] Branch Manager...was informed of repeated failures to file and

deliberately chose not to file the forms even though she admitted to fully knowing that they were required by law . . . ." Furthermore, said the memo, the bank's internal fraud officer and other senior officials were also made aware of the problems.

The "probation" requested by the government in this case required regular reporting by the bank on its program (including the names of personnel assigned) to comply with CTR requirements.

After emphasizing the law's clear message that failure to file CTRs is a serious crime and that fines should be "severe" enough to have "some real economic impact," the memo recommended a fine that amounted to less than 0.0002 percent of the bank's asset base and 2 percent of its net income. The comparable fine for an individual would approximate to one week's salary, less taxes and expenses.

In 1986 testimony before the US Sentencing Commission, Douglas H. Ginsburg, then Assistant Attorney General for Antitrust (now Chief Judge on the DC Circuit Court of Appeals), bemoaned the inadequate penalties for individuals convicted of price fixing. "There can be no doubt that price fixing is a serious crime. It cannot be inadvertently committed, it causes substantial social harm, and it creates no redeeming social benefits." He noted that the average time served for the small percentage of defendants who actually went to prison was only about 30 days. Fines for individuals averaged less than $16,000. The average fine for a corporation was about $133,000.

The failure of our sentencing system to achieve deterrence is evident from our continuing discovery of significant numbers of price fixing conspiracies each year. The explanation for this is also obvious. Price fixing offers the opportunity to extract huge sums from consumers, and there is a good chance that price fixers will escape detection despite our best efforts. To deter so potentially lucrative an enterprise requires much higher levels of fines and imprisonment than are currently imposed.

> *Before addressing fines and imprisonment, however, I would like to explain why four kinds of alternative sentences or sanctions – community service, probation, debarment, and restitution – are not adequate substitutes for imprisonment and heavy fines. Such alternative sentences or sanctions often impose little hardship on offenders, and their very availability leads all too often to their substitution for more meaningful sentences, thus undermining deterrence.*
>
> *First, many of the community service sentences imposed in recent years were not punishment at all. One defendant's community service involved coordinating an annual rodeo for charity. A defendant in another antitrust proceeding was required to organize a golf tournament fundraiser for the Red Cross. The experience proved so pleasant that he quickly agreed to organize the golf tournament again the next year! In yet another case, the defendant was sentenced to give thirty hours of speeches explaining the economic effects of his criminal activities – punishment that in practice is more likely to frustrate than to advance the purposes of the antitrust laws. Such penalties can do nothing but trivialize the offense in the eyes of the business community and the public.*[25]

Judge Ginsburg went on to explain that probation had little deterrent impact and "implies unwarranted judicial regulation of the defendant's business activities." Debarment (making the company ineligible to sell to the government) was also ineffective. "Ironically, by eliminating competitors,

it can impose on society the same harm as does the crime it is designed to punish. Indeed, there could be situations in which all potential suppliers might be debarred, making the product, at least for a while, totally unavailable."

Many ingenious solutions have been suggested, including the "equity fine,"[26] but all face the same obstacle: cooked books. As John Braithwaite explains in his study of the pharmaceutical industry,

> *... companies have two kinds of records: those designed to allocate guilt (for internal purposes), and those for obscuring guilt (for presentation to the outside world). When companies want clearly defined accountability they can generally get it. Diffused accountability is not always inherent in organizational complexity; it is in considerable measure the result of a desire to protect individuals within the organization by presenting a confused picture to the outside world. One might say that courts should be able to pierce this conspiracy of confusion. Without sympathetic witnesses from inside the corporation who are willing to help, this is difficult.*[27]

Despite various efforts to place corporations "on probation," to require payments to causes that benefit society, and even to jail executives, it is plain that nothing being done at this time is effective and that the problem is becoming more acute. In 1980, *Fortune* magazine surveyed 1,043 large companies and concluded that a "surprising" and "startling" number (about 11 percent) of them had been involved in "blatant illegalities." Two years later, US *News and World Report* conducted a similar survey of America's largest 500 companies and found that, in the preceding decade, 115 had been convicted of at least one major crime.[28] In 1990, the *New York Times* found that 25 out of the 100 largest Pentagon contractors had been found guilty of procurement fraud in the preceding seven years.[29]

After a six-week trial and ten days of deliberations, jurors convicted accounting giant Arthur Andersen for obstructing justice when it destroyed Enron Corp. documents while on notice of a federal investigation. Andersen had claimed that the documents were destroyed as part of its housekeeping duties and not as a ruse to keep Enron documents away from the regulators. (See the case study for more information.) While the jury was unable to agree on more than one employee as "corrupt persuader," the firm as a whole was held responsible. The judgment was a fine and probation, but the effect was to destroy the entire firm, which quickly folded. By the time the Supreme Court reversed the decision in May of 2006, it was too late for any of the Andersen partners, employees, and clients. The original jury decision was, in effect, the death penalty for the 90-year-old firm.

Drexel Burnham declared bankruptcy after its biggest money-maker, Michael Milken, was sentenced to ten years in prison (he served less than two). While he was accused of many violations, the crime of "parking" for which he was actually tried and convicted is one that has rarely, if ever, been prosecuted, and never in such a high-profile case.

THE PROBLEM OF SERIAL OFFENDERS

Look at the Massy and AIG case studies and the discussion of BP in chapter 5 as well as the histories of Fannie Mae and Freddie Mac. What can we do about corporate serial offenders?

SECURITIES ANALYST SETTLEMENT

On December 20, 2002, The SEC, the New York State Attorney General, the National Association of Securities Dealers, North American Securities Administrators Association, the New York Stock Exchange, and state regulators announced a $1.4 billion global settlement with the nation's top investment firms. The settlement provided for:

- The insulation of research analysts from investment banking pressure. Firms will be required to sever the links between research and investment banking, including analyst compensation for equity research, and the practice of analysts accompanying investment banking personnel on pitches and road shows. This will help ensure that stock recommendations are not tainted by efforts to obtain investment banking fees.
- A complete ban on the "spinning" of Initial Public Offerings (IPOs). Brokerage firms will not allocate lucrative IPO shares to corporate executives and directors who are in the position to greatly influence investment banking decisions.
- An obligation to furnish independent research. For a five-year period, each of the brokerage firms will be required to contract with no less than three independent research firms that will provide research to the brokerage firm's customers. An independent consultant ("monitor") for each firm, with final authority to procure independent research from independent providers, will be chosen by regulators. This will ensure that individual investors get access to objective investment advice.
- Disclosure of analyst recommendations. Each firm will make publicly available its ratings and price target forecasts. This will allow for evaluation and comparison of performance of analysts.
- Settled enforcement actions involving significant monetary sanctions.

"This agreement will permanently change the way Wall Street operates," said then-New York Attorney General Eliot Spitzer. "Our objective throughout the investigation and negotiations has been to protect the small investor and restore integrity to the marketplace. We are confident that the rules embodied in this agreement will do so."

Note, however, that the settlement permitted the payment to be characterized as compensation rather than a penalty, so it was tax deductible, making it about a third less in effect than the reported amount. In *Slate Magazine,* Daniel Gross quoted New York University law professor Daniel Shaviro: "The regulators wanted the payment to be big, and the firms wanted it to be tax deductible." Gross concluded, "They both got what they wanted." Another thing the firms wanted was no individual consequences. No one went to jail. No one was made ineligible for future employment on Wall Street.

Should there be such a thing as capital punishment for corporations? In light of the white-collar crime problem, the questions arise: Who is in the best position to define corporate crimes and who should determine their punishment? Who within the corporation is best situated to prevent corporate crime and does that person/group have the authority to do so?

There will always be a need for legal sanctions, but the job of meting out punishment should not belong to the government alone. Indeed, without self-regulation by private industry, government's power to deter crime will decline further. As Braithwaite observes, "[S]ome executives abstain from bribery because they are afraid of being punished. Most abstain from bribery because

they view it as immoral. One reason that they view it as immoral is that executives who bribe are sometimes punished and held to public scorn. Do away with criminal punishment and you do away with much of the sense of morality that makes self-regulation possible. Self-regulation and punitive regulation are, therefore, complementary rather than alternatives."[30]

Self-regulation is the responsibility of all participants in the corporate governance system. Unfortunately, under the current system, the risk of engaging in criminal behavior is evaluated by corporate managers who have very little to lose, even if the company is prosecuted. The criminal justice system has not been able to provide the appropriate level of deterrence, incapacitation, and rehabilitation for white-collar offenders or compensation for their victims.

Corporate crime is not victimless. Those adversely affected include the shareholders, often thousands of them. Long-term shareholders certainly have an interest in making societal and corporate interests compatible, but they are not likely to have the resources to be able to make that interest felt throughout the company, either before or after the fact (see discussion of the collective choice problem, in the "prisoner's dilemma" section of the chapter on shareholders). They can, however, take steps to make sure that the other parties in the corporation have the right incentives and authority. "[T]he firm is better positioned than the state to detect misconduct by its employees. It has an existing monitoring system already focused on them, and it need not conform its use of sanctions to due process standards. Indeed, if the penalties are severe enough, the corporation has both the incentive and, typically, the legal right to dismiss any employee it even suspects of illegal conduct."[31]

CASE IN POINT

WHAT HAPPENS WHEN YOU LET CORPORATIONS CHOOSE THEIR OWN REGULATORS? JUST WHAT YOU WOULD EXPECT

Prior to the meltdown, conglomerate financial institutions could select which of a number of federal regulators they wanted to have jurisdiction over them and the regulatory agencies' budgets were determined by how many of the financial institutions selected them. As anyone who looked at this structure should have been able to predict, the result was a competition between the regulators to see who could entice more business by loosening restrictions and reducing oversight. The result of that was the greatest financial meltdown in 80 years.[32] ■

WHAT IS THE ROLE OF SHAREHOLDERS IN MAKING THIS SYSTEM WORK?

Investors have no interest – much less competency – in developing or prescribing internal corporate procedures. Shareholders expect managers to run their business in a way that will encourage a supportive governmental and societal climate to capitalist enterprise, and that means that the shareholders' concern is to hold management accountable for their conduct of the business "within

the rules." Shareholders share some of the responsibility for failing to make sure that the directors they elect establish mechanisms for preventing and responding to corporate crime. They may have received unjustified returns as a result of the criminal behavior. However, it may be that the shareholders during the time of the gains and the shareholders at the time of the sentencing are two completely different groups.

Shareholders need to find a way within the limited scope of their authority to make it unmistakably clear that continued corporate crime will not be tolerated. However, it is the job of the directors and management to make sure that information flows assure that notice of potentially criminal activity is received at the appropriate level, that the company develops incentive systems to assure that compliance with the law has the clear and undivided attention of appropriate personnel, and that review structures are established to monitor, review, document, and validate compliance with the law. As Judge Ginsburg said,

> "*Shareholders should no more be insulated from the gains and losses of price fixing than from the gains or losses from any other risky management decision. Indeed, it is essential that shareholders have the incentives to institute appropriate safeguards to prevent criminal behavior.*[33]"

Shareholders, along with directors and officers, should be able to see to it that companies have information systems to expose, not cover up, wrongdoing. One way to do this is by setting forth the conditions of eligibility for service on the board of directors. It is the board of directors that has the authority, indeed the responsibility, to promulgate basic corporate policies.

> "*More active stockholder participation might force greater corporate compliance with the law in some areas, although, as we have pointed out, their primary concern is often corporate stock growth and dividends . . . . Far-reaching corporate reform, however, depends on altering the process and structure of corporate decision-making. Traditional legal strategies generally do not affect the internal institutional structure . . . . At present few clear functions are usually specified for corporate boards of directors; they frequently have served as rubber stamps for management. If a functional relationship and responsibility to actual corporate operations were established, directors would be responsible not only for the corporate financial position and stockholder dividends but also for the public interest, which would include the prevention of illegal and unethical activities undertaken in order to increase profits.*[34]"

Directors have the authority to establish policies requiring management to implement obedience to the law as a corporate priority. Shareholders have the authority and the means to make directors do just that. By amending the bylaws to make compliance with the law a condition of eligibility for service on the board, they ensure that the buck will stop somewhere. New developments that strengthen the power of shareholders to remove directors (discussed in chapter 3) will make it easier for shareholders to remove directors for failure to do so. Directors are highly motivated to continue to be eligible to serve as directors of public companies.

One way in which a board can exert its authority is described by long-time consumer advocate Ralph Nader: "[T]he board should designate executives responsible for compliance with these laws and require periodic signed reports describing the effectiveness of compliance procedures."[35] Other reformers recommend that mechanisms to administer spot checks on compliance with the principal statutes should be created. Similar mechanisms, including those required by Sarbanes–Oxley, can insure that corporate "whistleblowers" and nonemployee sources may communicate to the board "in private and without fear of retaliation knowledge of violations of law."

Professor Christopher Stone's *Where the Law Ends*[36] is perhaps the best-known work on corporate criminal liability. He concludes that the suspension of directors is the most effective way of dealing with the problems of corporate criminality. He says,

> *In general, though, I think it would be best if for all but the most serious violations we moved in the opposite direction, relaxing directors' liability by providing that any director adjudged to have committed gross negligence, or to have committed nonfeasance, shall be prohibited for a period of three years from serving as officer, director or consultant of any corporation doing interstate business. Why is this better than what we have now? For one thing, the magnitude of the potential liability today has become so Draconian that when we try to make the law tougher on directors the more likely effects are that corporate lawyers will develop ways to get around it, judges and juries will be disinclined to find liability, and many of the better qualified directors will refuse to get involved and serve. The advantages of the "suspension" provision, by contrast, are that it is not so easy to get around; it is not so severe that, like potential multi-million-dollar personal liability, it would strike courts as unthinkable to impose; but at the same time it would still have some effective bite in it – the suspendees would be removed from the most prestigious and cushy positions ordinarily available to men of their rank, and would, I suspect, be the object of some shame among their peers.*

Do you agree with Judge Ginsburg that imprisonment and heavy fines can deter crimes such as price fixing? Why or why not? Do you share his objections to sentences such as community service, probation, debarment, and restitution? Why or why not? When the top executives of the Beech-Nut company were found to have knowingly sold sugar water as apple juice for infants, the company – and its shareholders – paid their salaries, their attorney's fees, and their fines. Who paid the penalty there? Who should? What could each of the major players in corporate governance do to prevent such crimes in the future?

An alternative model appears to exist in Japan. In 1981, after a series of leakages from a nuclear power station owned and operated by the Japan Atomic Power Company, the chairman and president of the company resigned in the hope that trust in nuclear power stations would be restored under new leadership.[37] Japan Airlines Yasumoto Takagi resigned following the crash of its Flight 123 in 1985.

Can society hope to govern corporations merely by expecting executives of wrongdoing corporations to resign?

The Bush administration announced in 2003 that it had obtained over 250 corporate fraud convictions or guilty pleas, including guilty pleas or convictions of at least 25 former CEOs, and that it had charged 354 defendants with some type of corporate fraud in connection with

169 cases. However, just one high-level corporate executive was sent to jail that year: Sam Waksal, the former ImClone CEO, was sentenced to seven years and three months in prison and ordered to pay about $4.3 million after pleading guilty to insider trading. 2003 was the high-water mark for enforcement actions filed by the SEC, reaching 679. By the third quarter of 2006, Commission estimates were that there would be about 590 for the year. Despite repeated, detailed, and documented complaints from Harry Markopolos, the SEC took no action to investigate Bernard Madoff, who would not be discovered until he turned himself in for the biggest Ponzi scheme fraud in history. Also, despite repeated concerns expressed about the fragility of the subprime and derivative securities, the SEC took no action until after the market collapsed.

According to an article entitled "Multiple Corporate Personality Disorder: The 10 Worst Corporations of 2003" by Russell Mokhiber and Robert Weissman in the December 2003 issue of *The Multinational Monitor,* a 2003 Justice Department memorandum opened a loophole for corporations to get away with criminal behavior without effective criminal sanction, giving prosecutors discretion to grant corporations immunity from prosecution in exchange for cooperation, as they had previously done in minor street crimes. The result is likely to be less accountability for corporate crime.

Post-subprime meltdown, a new administration and a new President promised to do better.

THE MARKET: TOO BIG TO FAIL

Once we enter the arena of civil law, the connection between government and corporation becomes even more complex and murky. The foundation of capitalism is the Darwinian idea that the market will decide whether goods or services or stock should continue to exist. If a company does not adapt to changing times and competition, it will fail. However, corporations do not hesitate to persuade the government that they should be protected or supported by law, regulation, and sometimes a very big check written on the Treasury.

CASE IN POINT CHRYSLER

In 1977, Chrysler was the tenth largest US company and fourteenth largest in the world. Within two years, however, the company was in serious trouble. In 1979, Chrysler's new boss, Lee Iacocca, told the federal government that without huge, federally guaranteed loans the company would almost certainly fold.

Loan guarantees were a familiar element of US economic policy. In 1970, the Penn Central Railroad requested a $200 million loan under the Defense Production Act of 1950, a measure that allowed public corporations to borrow from the Treasury if the national defense was at stake. Congress refused Penn Central's request, and only after the railroad filed for bankruptcy was it granted $125 million in loan guarantees. One year later, Congress narrowly approved (by one vote in the Senate) Lockheed Aircraft's request for $250 million in guaranteed loans. In that instance, New York Senator James

Buckley sonorously warned, “if the inefficient or mismanaged firm is insulated from the free-market pressures that other businesses must face, the result will be that scarce economic and human resources will be squandered on enterprises whose activities do not meet the standards imposed by the marketplace.” Ultimately, however, the prospect of unemployment for Lockheed’s 17,000 workers and the 43,000 employees of supplier companies was enough to see that Lockheed received the loans.

Senator Buckley’s arguments were revived in 1979 when a similar debate broke out over Chrysler. On the one hand was America’s commitment to free markets; on the other, the lives of tens of thousands of Chrysler’s employees. Michael Moritz and Barrett Seaman describe the issue as it faced Congress: “The Corporation’s 4,500 dealers and 19,000 suppliers were another matter. Unlike the company’s, their presence was tangible and their plight immediate. There was a Chrysler dealer or supplier in every congressional district in the country. These were the merchants of the nation, men who had inherited businesses from their fathers and had, in some cases, passed them on to their sons. Family commitments stretched back to the days of Walter Chrysler, and the businesses were located in the small communities of Middle America, like Great Bend in Kansas. These weren’t garish swashbucklers from Detroit, bouncing billions and tweaking communities with the flash of a calculator.” The authors describe how “the company drew up computerized lists outlining contributions in every district and showing congressmen how much local, state, and federal tax was contributed by Chrysler showrooms. Working through the Dealer Councils (the officials elected by the dealers themselves), an average of two hundred dealers a day came to Washington to lobby their representatives. Coached for an hour in the early morning about what they should and should not say, the dealers spent their days roaming corridors, rapping on doors and buttonholing congressmen as well as their administrative and legislative aides. The sight of these independent small businessmen was mighty effective.” As one Chrysler dealer observed: “The very survival of a lot of good people in this country and a lot of small businesses depends upon the whims of the political system.”

Moritz and Seaman sum up as follows: “The underlying precept of a free economy is that unsuccessful corporations do not survive. In recent years in the United States this proposition has been subjected to violent rejection. Not only are companies such as Lockheed, which were arguably essential to national defense, ‘bailed out’ through political action, but such a quintessential consumer giant as Chrysler proved the modern axiom that no large company will be allowed to fail in the United States today. Rarely has the power of a large, if broke, corporation been so effectively and overtly employed as in Chrysler persuading the US government to provide special financial aid to insure its survival.”[38]

When Chrysler came back more successfully than anticipated, the government was entitled to a significant share of the gains, but the company persuaded the government to waive its right and the company kept the money.

In 2009, the government came to the rescue again with less satisfactory results. As a part of a bailout that included rival General Motors (see case study), the US government put $4 billion into Chrysler and became a 10 percent shareholder. In 2010, it appeared the government could lose $1.6 billion of that investment.

CASE IN POINT THE VOLUNTARY RESTRAINT AGREEMENT IN THE AUTO INDUSTRY

Between 1980 and 1982, the "big three" automakers, General Motors, Ford, and Chrysler, lost $8 billion pre-tax, and their domestic market share sank to 71 percent.[39] Of course, in 1955, the big three accounted for 95 percent of the nation's sales.[40] The total market value of GM, Ford, and Chrysler stock was under $14 billion, with GM responsible for over 80 percent of that amount.[41]

Ronald Reagan, elected in 1980, made a voluntary restraint agreement (VRA) with Japan an early priority for his administration. VRAs are devices to limit foreign competitors in favor of domestic industry because, based on the argument that they do not play by the same rules, competition is unfair. The essence of the agreements is that they should be voluntary and temporary, though in reality they are neither. The beauty of it, from the importing government's point of view, is that it shelters domestic industry without appearing protectionist and it does not directly contravene GATT or domestic legislation. Because the arrangements are "informal," the traditional and expected legal protections against monopolistic behavior are simply put into suspense. This agreement limited car and truck imports from 1981 onward. While campaigning in Detroit in 1980, Reagan said, "I think the government has a responsibility that it's shirked so far. And it's a place government can be legitimately involved, and that is to convince Japan that in one way or another, and for their own best interest, the deluge of their cars into the US must be slowed while our industry gets back on its feet."[42]

Within three to four years, there came about such an explosive reversal in fortunes for the big three auto manufacturers that all were reporting record historical profit levels and amassing huge cash reserves. For instance, in 1984 total net income from automotive operations was over $10 billion, cash flow from operating activities exceeded $20 billion, and cash on hand at the end of 1984 was over $16 billion. Market value soared to $37 billion and market share was edging back to 74 percent.[43] In the short term, all of the most affected constituencies benefited. The union workers were locked into their jobs with higher than competitive-level salaries for a few more years; the companies made profit and cash; shareholder values soared. Even the Japanese companies were happy: "[T]he quotas were a boon to the Japanese manufacturers, who did extremely well and greatly strengthened their position in the US market. Thanks

to the artificial hold-down of supply, they boosted their prices and profits. (Buoyed by the profits from price premiums that often exceeded $2,000 per unit, the Japanese companies' US dealer networks got bigger and stronger."[44] There have been a number of studies of the impact of the VRA. One study estimated that the restraints produced an increase in cash flow estimated at some $6 billion, before leakages into other factor suppliers' rents. Accordingly, between 33 and 45 percent of the automobile industry cash flow for 1984–5 may be attributed to the restraints.[45] The premium for consumers has been estimated at between $500 and $2,000 per car and total consumer losses of up to $5.3 billion.[46] One study estimates that "by 1984 the restrictions led to an $8.9 billion increase in US producers' profits, virtually all of the industry's record profits of that year."[47] The VRA produced pricing increases typical of successful cartels. Consumers still purchased imported cars, but paid up to $2,000 more for them. Not surprisingly, having achieved protection from competition, the domestic manufacturers substantially increased the prices of their own cars. Thus profits for the automobile industry in the mid-1980s were really a government-mandated transfer from the American customer to the big three and to the Japanese manufacturers, the unintended beneficiary of the whole exercise.

See the General Motors case study. Did the VRA help Detroit to compete? Should the consumer or the taxpayer or the shareholder bear the cost of an industry's failure to compete? Will the bailouts of the twenty-first century be more or less likely to lead to a robust, competitive US automotive industry than the VRA? Than reorganization in a bankruptcy proceeding?

The next example of "too big to fail" occurred in 1998, when the Federal Reserve organized a rescue of Long-Term Capital Management, a very large and prominent hedge fund on the brink of failure. The Fed intervened because it was concerned about possible dire consequences for world financial markets if it allowed the hedge fund to fail. The founder, John Meriwether, left Salomon Brothers following a scandal over the purchase of US Treasury bonds. The fund's principal shareholders included two eminent experts in the science of risk, Myron Scholes and Robert Merton, who had been awarded the Nobel Prize for economics in 1997 for their work on derivatives, and a dazzling array of professors of finance and PhDs in mathematics and physics. After taking 2 percent for "administrative expenses" and 25 percent of the profits, the fund was able to offer its shareholders returns of 42.8 percent in 1995, 40.8 percent in 1996, and "only" 17.1 percent in 1997 (the year of the Asian crisis). However, in September, after mistakenly gambling on a convergence in interest rates, it found itself on the verge of bankruptcy.

The Federal Reserve denied that it was a bailout, because it did not use public funds and because LTCM and its investors were not made whole, but a government entity did orchestrate the soft landing for LTCM. Note, however, that an effort to orchestrate the same kind of deal for Enron in late 2001 failed, partly because it did not threaten the destruction of a major bank and partly because President George W. Bush's close Texas ties to Enron would have made it a political liability.

Note, too, the examples later in this chapter concerning Defense Secretary Rumsfeld's failed attempt to impose more of a market test on government contractors.

The $700 billion US government bailouts after the collapse of the US automobile industry and the subprime meltdown in 2008–9 show that large corporations do not really face the risk of any meaningful market test.

If an enterprise or sector is "too big to fail," does that mean the government is a guarantor? If that is the case, doesn't that make them utilities, and shouldn't they be regulated and compensated like utilities?

THE CORPORATION AND ELECTIONS

The power of larger corporations to involve themselves in the most critical decision making by citizens has been reaffirmed by the US Supreme Court. In *The Bank of Boston v. Bellotti*, the court upheld corporations' right to enter the arena of political advertising. The Court said that the bank could spend whatever shareholder funds it thought appropriate to influence voting on a referendum matter that was not related to its business.

Efforts to reduce the influence of corporate management on the political process have failed. For example, the Federal Election Campaign Act of 1971 (FECA) prohibits corporations from making any political campaign contributions, with very limited exceptions, like nonpartisan elections. However, corporate management may establish separate segregated funds (commonly referred to as political action committees or PACs) to solicit campaign contributions and make contributions to candidates, subject to a complex set of limitations and reporting requirements.

There have been a number of widely reported violations of these rules. Beulieu of America, a carpet manufacturer, pleaded guilty to five misdemeanor counts, four involving violations of campaign finance rules. Executives of the firm directed 36 employees or spouses to contribute $1,000 each to Lamar Alexander's presidential campaign, and then reimbursed the employees with corporate funds. Juan Ortiz, chief financial officer of Future Tech International (FTI), pleaded guilty to a scheme in which he secretly reimbursed himself and eight other FTI employees with corporate funds for their individual $1,000 contributions at a 1995 Clinton–Gore fundraising event at a Miami hotel. The CEO of FTI, who had been allowed to meet with top government officials, including the President, fled the country while he was under investigation for his involvement.

As *Slate* founder Michael Kinsley says, the crime in campaign finance is not what is illegal; it is what is legal. According to a 2002 Federal Election Commission report, the Republican and Democratic parties reported raising a total of $1.1 billion in hard and soft dollars from January 1, 2001 through November 25, 2002. Post-election reports to the Federal Election Commission (FEC) include the final soft money receipts for national parties (mostly from corporations). Soft money contributions to both parties spiked before November 5, 2002, the cut-off date imposed by the Bipartisan Campaign Reform Act (BCRA). Receipt totals were nearly equal to the party fundraising totals in the 2000 election cycle, which included a competitive presidential campaign, and were 72 percent higher than in 1997–8, the most recent nonpresidential cycle. When compared with 1998, however, Democratic Party hard money receipts were up 43 percent and Republican hard money receipts were 47 percent higher than their 1998 totals. Even with all of the reform legislation, corporations still make large political contributions. Morgan Stanley (through its PAC, its individual members, or employees or owners, and those individuals' immediate families) donated over $600,000 to the Bush campaign, for example. John Kerry's largest corporate contribution was just over $312,000 from Time-Warner – again, indirectly.

The economic power of corporations is dominating the political process. Because those contributions are allocated according to the priorities of the managers, not the shareholders, that power distorts the ability of the marketplace to discipline corporations. In January of 2010, the Supreme Court's ruling in the *Citizens United* case opened the floodgates to unlimited corporate political contributions.

CITIZENS UNITED

The federal Bipartisan Campaign Reform Act of 2002 (known informally as McCain–Feingold) included a provision prohibiting corporations and unions from using their general treasury funds to make independent expenditures for speech that is an "electioneering communication" or for speech that expressly advocates the election or defeat of a candidate. However, that provision was thrown out as an unconstitutional violation of the First Amendment's guarantee of free speech.

A nonprofit group made a film called "Hillary: The Movie" that was highly critical of Hillary Clinton, who was then a candidate for the Democratic nomination for President. Justice Anthony Kennedy, in the majority opinion, wrote "If the First Amendment has any force, it prohibits Congress from fining or jailing citizens, or associations of citizens, for simply engaging in political speech." The Court ruled that since there was no way to distinguish between media and other corporations, these restrictions would allow Congress to suppress political speech in newspapers, books, television, and blogs.

The Court found that the Act's provisions were valid as applied to the movie and the ads promoting it.

Justice John Paul Stevens wrote a 90-page dissent, joined by Justices Ginsburg, Breyer, and Sotomayor. He concurred in the Court's decision to sustain BCRA's disclosure provisions and in Part IV of its opinion, but dissented with the principal holding of the majority opinion. He wrote that the majority decision

> "*. . . threatens to undermine the integrity of elected institutions across the Nation. The path it has taken to reach its outcome will, I fear, do damage to this institution . . . . At bottom, the Court's opinion is thus a rejection of the common sense of the American people, who have recognized a need to prevent corporations from undermining self government since the founding, and who have fought against the distinctive corrupting potential of corporate electioneering since the days of Theodore Roosevelt. It is a strange time to repudiate that common sense. While American democracy is imperfect, few outside the majority of this Court would have thought its flaws included a dearth of corporate money in politics.*"

In the first year after the ruling, some companies announced publicly that they would not make any direct political contributions, including Goldman Sachs. In 2008, GlaxoSmithKline had already announced it would stop making any political contributions. "We continue to believe that it is important for GSK to be engaged in policy debates and the political process. However, we need to ensure that there is no implication whatsoever that corporate political contributions provide us with any special privileges." BP's CEO Lord Browne made a similar commitment in 2002, but, as with many of his policies, this was reversed by his successor, Tony Hayward. During the investigation into the 2010 oil spill, BP's contributions led to allegations of favoritism.[48]

The mechanisms for making political contributions have multiplied and many of them are opaque, making it difficult to determine the source of the funds or how they are paid out. *The Washington Post* reported just before the 2010 elections:

> *A new political weapon known as the 'super PAC' has emerged in recent weeks, allowing independent groups to both raise and spend money at a pace that threatens to eclipse the efforts of political parties. The committees spent $4 million in the last week alone and are registering at the rate of nearly one per day. They are quickly becoming the new model for election spending by interest groups, according to activists, campaign-finance lawyers and disclosure records.*[49]

The Washington Post reported that in the 2010 election, the first since the Citizens United case was decided, special interest contributions were up by 500 percent since 2006, and that in less than half the identities were disclosed, as compared to 90 percent in 2006. "The trends amount to a spending frenzy conducted largely in the shadows. The bulk of the money is being spent by conservatives, who have swamped their Democratic-aligned competition by 7 to 1 in recent weeks."[50]

Columnist/blogger Ezra Klein wrote about the post-Citizens United increase in political spending by corporations, calling it a "gamechanger."

> *[I]t's hard to wave away the news that special interest groups have increased their spending fivefold since the 2006 election, particularly given that fewer than half of them are disclosing their donors. And yes, that money is going pretty much where you'd expect: Democrats have been outspent 7:1 in recent weeks. That's a lot of cash. Gamechanger cash, in fact.*[51]

As usual, the sage of Omaha has the wisest take on this issue. In a 2000 New York Times op-ed, Warren Buffet expressed his concern that corporate political contributions were creating a government "of the moneyed, by the moneyed, and for the moneyed." He quoted a senator who once joked that for a $10 million contribution he could get the colors of the American flag changed. Buffett proposed a "thought experiment" as a path to a solution. "Suppose that a reform bill is introduced, raising the limit on individual contributions from $1000 to, say, $5000, but prohibiting contributions from all other sources, among them corporations and unions." The canny wizard proposed a clever way to get it passed: "just suppose some eccentric billionaire (not me, not me!) made the following offer: if the bill was *defeated* this person – the E.B. – would donate $1 billion in an allowable manner (soft money makes all possible) to the political party that delivered the most votes to getting it *passed*."[52]

In 2010, a foundation that holds shares in News Corp. wrote to the board to object to its political contributions (reportedly $2 million) as an improper use of corporate funds. The Nathan Cummings Foundation charged that the contributions were made to further the political careers of the personal friends of News Corp. CEO Rupert Murdoch and to promote his own political goals and not for the benefit of shareholders. "The apparent lack of a strategic rationale for News Corp. raises very serious

concerns for shareholders as to whether Mr. Murdoch and the rest of the News Corp. Board of Directors are truly taking shareholder interests into account when they approve political payments made with shareholders' assets."[53] The letter expressed concerns about reputational risk, particularly the risk of real or apparent bias in a media company and cited data showing that shareholders discount the value of companies with highly visible political agendas.

What should the obligations of a public company be in disclosing direct and indirect political expenditures or submitting them for shareholder approval?

Dr. Marcy Murninghan, a respected scholar and expert on sustainability issues, wrote this comment about the impact of Citizens United in the fall of 2010:

> *'Oyez, Oyez, Oyez!' the Marshal of the Court called out today, marking the beginning of the Supreme Court's 2010 term. In addition to a new Justice, the Court has a new website with user-friendly features that help keep track of Court information. (We've bookmarked that, as well as the OYEZ Project, which archives audio recordings of Court proceedings, and the American Bar Association's preview of SCOTUS cases.) While this term promises controversial cases on, for example, protests at military funerals, illegal immigration, support for religious schools, violent video games, DNA evidence, and prosecutorial misconduct, none will likely match the impact of last term's blockbuster Citizens United case, which opened the floodgates of corporate money into political campaigns and continues to reverberate throughout public life.*
>
> *Last week, Politico revealed that News Corp. (the parent corporation of Fox News) recently contributed $1 million to the US Chamber of Commerce (which recently joined the Business Roundtable in asking the DC Circuit Court to overturn proxy access) – the latest example of unregulated campaign spending. In late June, News Corp. made a similarly controversial $1 million contribution to the Republican Governor's Association. Next month's midterm elections reveal the political impact of Citizens United, while a less understood area looms in the background: the effect of Citizens United on shareholder value.*
>
> *First, the politics. Thanks to Citizens United, some call it Wild West time in political spending; others such as legal scholar Lawrence Lessig say it's eroded public trust in Congress. On Friday, OpenSecrets.org reported that, with the Gulf of Mexico mess as a backdrop, the oil and gas industry poured more than $17 million this election season into the coffers of congressional candidates and national political committees, "a number on pace to easily exceed that of the most recent midterm election four years ago." OpenSecrets provides a chart listing the top 10 Senate and House candidates who've indirectly benefited from oil and gas industry funding. OpenSecrets also maintains a "Campaign Countdown" widget (you can add it to your website) that provides real-time spending tallies for candidates, parties, and issue groups. (OpenSecrets.org is the website for the Center for Responsive Politics, which tracks, on a nonpartisan basis, the influence of money in politics.)*

The Citizens United ruling triggered a new political weapon known as the "Super PAC". One of the biggest: American Crossroads, a pro-Republican group founded with the help of Karl Rove, which has spent $5.6 million this year on conservative causes (it plans to spend $50 million).

Meanwhile, some beneficiaries of the financial bailout appear to be showing a bit of restraint in political spending. Last Thursday, American International Group (AIG) announced its plan to repay the $182.3 billion bailout by converting the preferred shares owned by the Treasury Department into common stock. AIG joins other recipients that have repaid the (now-expired) Troubled Asset Relief Program (TARP) rescue funds, including JP Morgan Chase, Bank of America, and Goldman Sachs. According to OpenSecrets, AIG has cut 2010 lobbying and campaign donations to zero. Last August, Goldman Sachs pledged to stop spending on political advertising, as did JP Morgan and a number of other firms.

As for shareholder value, a recent paper by Harvard Law School's John Coates published on the Harvard Law School Forum explores the relationship between corporate governance and corporate political activity, and finds strong negative correlations between political activity and firm value. Coates examined existing data from 1998 to 2004 on governance and political activity among S&P 500 companies along with empirical studies of corporate political activity. (He also acknowledges the limits of his analysis, given untold amounts of undisclosed political activity.) Coates supports new laws restoring shareholder protections, such as the DISCLOSE Act (H.R. 5175) – which fell victim last month to a Republican Senate filibuster.

Bottom line: unfettered corporate political activity isn't just bad for America. It's bad for shareholders, too.[54] ■

CASE IN POINT CORPORATE POLITICAL DONATIONS IN THE UK AND THE US

Following the 2010 elections in the UK, questions were raised about substantial political contributions to the Conservative party from the wives of two wealthy Middle Eastern businessmen involved in arms deals, substantial enough to qualify them for private dinners with the candidate who became Prime Minister. Both of their husbands had been connected to political scandals and corruption in the past. The teenage daughter of one of them had made a political contribution two years earlier. After a challenge, it was revised as being from her mother.

After the Citizens United decision, some companies poured money into politics, much of it through intermediary organizations like the national Chamber of Commerce (a very forceful pro-business lobbying organization not to be confused with the local

Chambers). While some companies, like Goldman Sachs, pledged that they would not make any direct political contributions (this explicitly excludes contributions through the Chamber, the Business Roundtable, and other groups), others gave money to candidates, which proved to be a reputational or branding problem. The CEO of Target had to write to employees to apologize for a $150,000 corporate contribution to a candidate with a record of anti-gay policies. A company that had touted its top score from the Human Rights Campaign (HRC) on LGBT issues lost their credibility by supporting a candidate for unrelated reasons without anticipating that they would be seen as supporting all of his positions. The HRC took out a full-page ad criticizing Target and there was a flurry of embarrassing press reports, with high-profile suppliers asked to comment.

Shareholder proposals on increased disclosure of political contributions have become more frequent and are attracting increased levels of support, triple the average of seven years ago.

Corporations are enormously wealthy organizations and "money is the mother's milk of politics." What dangers arise from these two facts? How can companies be held accountable for their involvement in the political process?

Should public companies be prevented from playing a role in the political process? If not, what can we do to ensure that the involvement reflects long-term shareholder interests?

THE CORPORATION AND THE LAW

Not only have corporations succeeded in dominating the executive and legislative branches of state and local government in the United States, but they have also made substantial inroads into the decisions of the judicial branch as well. In the "race to the bottom" for corporate chartering and related legal fees, states compete to be the most attractive to corporate management, and that applies to the courts as well as the legislatures. (See chapter 3 for further discussion.)

Accommodating the interests of corporate management (called "the Delaware factor") is the underlying rationale for many of the decisions of Delaware's Chancery and Supreme Courts.

CASE IN POINT "DELAWARE PUTS OUT"[55]

Although Delaware is one of the smallest states in the union, more companies are incorporated there than any other state. Joseph Nocera explains why: "The degree to which Delaware depends upon its incorporation fees and taxes is really quite extraordinary. It's a $200 million a year business, comprising nearly 20 percent of the state budget."

During the 1980s, when a vigorous market for corporate control developed, management appealed to the Delaware courts for protection. What became apparent was that large corporations would do whatever it took to ensure that the Delaware courts would continue to issue opinions favorable to management. In 1990, a number of pro-shareholder decisions began emerging from the Delaware Chancery court, forcing companies "in play" to entertain hostile bids. These decisions aroused a tough response from Martin Lipton, a corporate lawyer who made his name defending companies from takeover in the 1980s. In Nocera's words: "Marty Lipton went nuts. He lashed out at the [Delaware Chancery] court, sending scathing notes to his very long list of major corporate clients, most of whom were incorporated in Delaware. In one conspicuously leaked memo, he wrote ominously, 'Perhaps it is time to migrate out of Delaware.' Lipton acted the way bullies always act when they know they have someone by the balls: he squeezed."

As every other entity concerned with corporate governance and accountability responded to the post-Enron era with proposals for reform, the courts and legislature of Delaware, the only place with authority over the obligation of directors, was alone in making no response. ■

One study claims that Delaware incorporation is correlated with increased shareholder value. An NYU Law School paper called "Does Delaware Law Improve Firm Value?" by Robert Daines[56] finds that Delaware companies are worth more, using Tobin's Q as a measure and adjusting for other variables. There is no way to adjust, however, for cause and effect. Since an overwhelming majority of public companies are incorporated in Delaware, it seems likely that the incentives to locate there would appeal to the most valuable.

Corporations promote regulations that limit their liability or impose barriers to entry all the time. They fight regulations that impose costs they would rather be borne elsewhere. The auto manufacturers fought the rules requiring the installation of airbags from the original proposed rule for more than 15 years, including a trip to the US Supreme Court. However, nothing so forcefully holds the attention of corporate managers as rules relating to their pay packages. As shown by the example later in this chapter of the fight against the Financial Accounting Standards Board's proposal to require companies to expense stock option grants at the time of award, acknowledging that value had been transferred outside of the company, they can be very effective when their paychecks are at stake.

In 2008, North Dakota adopted the first self-styled "shareholder-friendly" law governing corporations incorporated in the state after 2007, requiring:

- Majority voting in the election of directors. In an uncontested election of directors, shareholders have the right to vote "yes" or "no" on each candidate, and only those candidates receiving a majority of "yes" votes are elected.
- Advisory shareholder votes on compensation reports. The compensation committee of the board of directors must report to the shareholders at each annual meeting of shareholders and the shareholders have an advisory vote on whether they accept the report of the committee.

- Proxy access. The corporation must include in its proxy statement nominees proposed by 5 percent of shareholders who have held their shares for at least two years.
- Reimbursement for successful proxy contests. The corporation must reimburse shareholders who conduct a proxy contest to the extent the shareholders are successful. Thus, if a shareholder conducts a proxy contest to place three directors on a corporation's board and two of the candidates are elected, the shareholder will be entitled to reimbursement of two-thirds of the cost of the proxy contest.
- Separation of roles of the Chair and CEO. The board of directors must have a Chair who is not an executive officer of the corporation.

When managers control the state of incorporation, what is the incentive for them to to be governed by these provisions?

A MARKET TEST: MEASURING PERFORMANCE

To establish a context for the evaluation of a company's performance, it makes sense to define the ultimate purpose of a corporation as long-term value creation. This creates a framework for defining the rights and responsibilities of shareholders and directors and therefore for determining how they should be organized, how they should be motivated, and how they should be evaluated. For example, it does not mean much to set long-term value creation as the goal if we allow the people who have primary responsibility for meeting the goal to be the ones who define it; that would be like allowing students to grade their own exams.

The expressions "long term" and "value" are subject to many interpretations. Anyone who is being evaluated has an incentive to define "long term" as "after I am gone." Anyone who is being evaluated has an incentive to define "value" as "results from whichever financial formula makes us look most appealing this year." While far from perfect, there is an entire spectrum of concepts for measuring economic performance. These traditionally include balance sheets and earnings statements prepared according to Generally Accepted Accounting Principles (GAAP), the availability of cash to meet corporate needs, and the ability to raise new cash from outside sources. Management expert Peter Drucker highlights the problems of evaluating corporate performance:

> *One of the basic problems is that management has no way to judge by what criteria outside shareholders value and appraise performance. The stock market is surely the least reliable judge or, at best, only one judge and one that is subject to so many other influences that it is practically impossible to disentangle what, of the stock market appraisal, reflects the company's performance and what reflects caprice, affects the whims of securities analysts, short-term fashions and the general level of the economy and of the market rather than the performance of a company itself.*[57]

Drucker, along with former New York State Comptroller Ned Regan and others, has advocated periodic "business audits" by expert outside parties to provide perspective in evaluating a company's performance. *But is there such a thing as "independence" in professionals who are hired by the people*

they are supposed to evaluate? Even if they are people of exceptional integrity and insight, by the time they do the study and produce the report, it may be too late.

"Performance measurement" must be a flexible and changing concept. What is suitable for one time or company is wrong for others. Therefore, the single most important structural requirement is that the standard be set by someone other than management. Yet it must be by some group vitally interested in what we have already said was the only legitimate goal: long-term value creation. For that reason, it cannot be the government or the community. They have other priorities they would be happy to have corporations address.

The best entity for establishing goals and evaluating the performance of any corporation is its board of directors, as long as they are genuinely independent and not so beholden to management that they cannot be objective. It is in the "creative tension" between the informed, involved, and empowered monitors – the board of directors in the first instance and the owners ultimately – that the corporation's performance can best be monitored on an ongoing basis.

CASE IN POINT THE YEARS OF ACCOUNTING DANGEROUSLY

Arthur Levitt used his 2002 book, *Take on the Street,* as an opportunity to tell his side of some of the frustrations he faced as the longest-serving chairman of the Securities and Exchange Commission (SEC) during the Clinton administration. No one was singled out for more vituperative recrimination than the accounting industry.

On September 28, 1998, then-chairman of the SEC Levitt expressed his concerns about earnings management in a speech delivered at New York University. He focused on five questionable practices: "big bath" restructuring charges, creative acquisition accounting, "cookie jar reserves," "immaterial" misapplications of accounting principles, and the premature recognition of revenue. He called for a number of studies and reforms, including more effective audit committees, concluding that:

> *…qualified, committed, independent, and tough-minded audit committees represent the most reliable guardians of the public interest. Sadly, stories abound of audit committees whose members lack expertise in the basic principles of financial reporting as well as the mandate to ask probing questions. In fact, I've heard of one audit committee that convenes only twice a year before the regular board meeting for 15 minutes and whose duties are limited to a perfunctory presentation.*

Levitt's book followed stunning revelations of accounting irregularities at companies like Cendant, Livent, Waste Management, and Sunbeam. Cendant Corp. executives fraudulently inflated income before charges by $500 million over three years, in large part by booking fictitious revenues. They ended up paying a $2.8 billion settlement to the shareholders. Livent Inc. allegedly kept two sets of books to mask extravagant expenses. Waste Management announced that it was reducing its estimated value by

three-fifths (see case study). Sunbeam “stuffed” sales, calling inventory sold when it was all but being parked with retailers. America Online (AOL) posted a 900 percent rise in operating profits, to $57 million. At 23 cents per share, earnings would handily beat Wall Street’s estimate of 19 cents. However, the excitement did not last long. The SEC was suspicious. It turned out that the numbers reflected some aggressive accounting. AOL tried to instantly write off much of the value of two companies it had just purchased. By taking a charge for “in-process R&D” under way at the companies, AOL figured it could write off fully $20 million of the $29 million it was paying for NetChannel, an Internet television company, and a “substantial portion” of the $287 million it would pay for Mirabilis, a developer of real-time chat software.

Levitt convened a commission to make recommendations for improving audit committees, but accounting problems continued to make headlines. Staff at MicroStrategy worked until midnight on September 30, 1999, to be able to nail down a deal in time to report it in its third-quarter numbers. The company on the other side of the deal booked it in the fourth quarter, but MicroStrategy booked it in the third, allowing it to claim a fifteenth consecutive quarter of increased revenues. Without the deal, revenues would have decreased by 20 percent. MicroStrategy’s stock went up 72 percent. Its officers sold shares worth more than $82 million. Then, six months later, MicroStrategy restated its financial results. Its annual profit was actually a loss. The stock dropped 62 percent in one day, erasing $11 billion of shareholder value.

Levitt’s book includes descriptions of several different battles with the accountants, including the fight over expensing stock options (discussed later in this chapter). According to Levitt, the accounting profession’s defeat of the Financial Accounting Standards Board (FASB) proposal to expense options provided momentum for them to try to “pull off a hostile takeover of the standard-setting process.” The then-Financial Executives Institute (now called Financial Executives International), made up of the chief financial officers and controllers of major companies, decided that the independent foundation that governed the FASB, which sets accounting standards, was too independent and not supportive enough of business. They proposed limiting the foundation’s ability to control the agenda and initiate new projects. Levitt says, “I smelled a rat. Rather than speed up and improve the standard-setting process, I believed this cabal was looking to place it in the corporate equivalent of leg irons.” He believed that a large part of the incentive to try this takeover was the hope that the FEI could persuade the FASB to allow companies to use derivatives to smooth out their earnings. Levitt succeeded in preventing the watering down of the standards for reporting derivatives, but he had to give up some of what he was trying to accomplish on the oversight of the FASB. Later, after a series of accounting scandals, Levitt convened a Blue Ribbon Commission to come up with recommendations. His description of his failed attempt to prevent firms from providing both audit and the more lucrative consulting services to the same clients is truly tragic, in light of the even more devastating accounting scandals that would be revealed after he left office. (See Arthur Andersen case study.) ■

LONG TERM VERSUS SHORT TERM

At some point, any long-term strategy will seem at odds with the goal of profit maximization. The same is true of any commitment to corporate constituents beyond that required by law. It is impossible to determine whether a new benefit program for employees will be justified by the increased loyalty and enthusiasm it inspires. There are so many opportunities for mistakes and even self-dealing that this area requires oversight and accountability. The way it is handled is a strong indicator of the merits of any corporate governance system.

The key is finding the right system of checks and balances. A board that will approve paying for a $120 million art museum with the shareholders' money is obviously operating without such a system, and so is the CEO who will spend $68 million on developing an (ultimately disastrous) "smokeless" tobacco cigarette before informing his directors. (See the discussions of RJR Nabisco in chapter 3 and Occidental Petroleum in chapter 7.)

A paper company may consider which is an appropriate method of, for example, storing bark or floating logs down a river. If management makes that determination, it is likely to be designed to impose as much of the cost as possible on someone else. The only way to make sure that corporate management cannot merely externalize its costs on to the community is to have government, accountable through the political process, make the ultimate determination when the issue involves a trade-off of corporate profits against social goals. Government regulation is justified in two ways. First, it is the government's responsibility, because the government is – at least in theory – uniquely able to balance all appropriate interests as it is equally beholden (and not beholden) to all of them. Second, if enough of the community objects to the action taken by the government, they can elect new representatives who will do better.

Directors who fail to consider the interests of customers, employees, suppliers, and the community fail in their duty to shareholders; a company that neglects those interests will surely decline, though not until after insiders have had the chance to benefit from the short-term choices. There is danger in allowing corporate managers to make policy trade-offs among these interests. That should be left to those who have a more direct kind of accountability – through the political process. It is the job of elected public officials, not hired corporate officers, to balance the scales of justice.

F. A. Hayek posed the alternatives this way:

> *So long as the management has the one overriding duty of administering the resources under its control as trustees for the shareholders and for their benefit, its hands are largely tied; and it will have no arbitrary power to benefit from this or that particular interest. But once the management of a big enterprise is regarded as not only entitled but even obliged to consider in its decisions whatever is regarded as the public or social interest, or to support good causes and generally to act for the public benefit, it gains indeed an uncontrollable power – a power which could not long be left in the hands of private managers but would inevitably be made the subject of increasing public control.*[58]

There have been long periods in recent American economic history during which large corporation managers have viewed themselves as fiduciaries for society as a whole. Ralph Cordiner,

the long-time CEO of General Electric Company, exemplified this standard. He said that top management was a "trustee," responsible for managing the enterprise "in the best balanced interest of shareholders, customers, employees, suppliers, and plant community cities." This is echoed in the corporate governance credo that emblazoned every copy of *Director's Monthly:* "Effective corporate governance ensures that long-term strategic objectives and plans are established, and that the proper management and management structure are in place to achieve those objectives, while at the same time making sure that the structure functions to maintain the corporation's integrity, reputation, and accountability to its relevant constituencies."[59]

During the takeover era of the 1980s, more than half of the states in the US adopted "stakeholder" laws, which permit (or even require) directors to consider the impact of their actions on constituencies other than shareholders, including the employees, customers, suppliers, and the community.[60] This is in contrast to the traditional model of the publicly held corporation in law and economics, which says that corporate directors serve one constituency – their shareholders. Many people think this is a mistake. James J. Hanks, Jr. of the law firm Ballard, Spahr, Andrews & Ingersoll, has called it "an idea whose time should never have come."

Typically, these statutes "apply generally to decisions by the Board, including decisions with regard to tender offers, mergers, consolidations and other forms of business combinations."[61] Most state laws of this kind do not mandate constituency-based decision-making, and just permit these provisions to be adopted by corporations, with shareholder approval. Most also make it clear that the board's authority to consider other interests is completely discretionary, and that no stakeholder constituency will be entitled to be considered. Thus far at least, corporations have been reluctant to claim protection under these provisions when challenged to justify their decisions.

Do these provisions have any meaning? Do they allow or require directors operating under them to evaluate options any differently? Should they? Evaluate a proposed plant closing or acquisition as though you were a board member operating under such a provision and as though you were not.

Companies cannot afford to ignore the needs of their constituencies. Indeed, in the past, "stakeholder" proposals have been occasionally submitted by shareholders, asking the board to undertake a more comprehensive analysis of proposed actions. We agree with Hanks, however, that "stakeholder" language, in legislation or in corporate charters, can camouflage neglect, whether intentional or unintentional, of the rights of shareholders.

It has always been permissible, even required, for directors and managers to consider the interests of all stakeholders, as long as they do so in the context of the interests of shareholder value. Courts have upheld a corporation's right to donate corporate funds to charities, for example, if it was in the corporation's long-term interests. As the American Bar Association Committee on Corporate Laws pointed out: "[T]he Delaware courts have stated the prevailing corporate common law in this country: directors have fiduciary responsibilities to shareholders which, while allowing directors to give consideration to the interests of others, compel them to find some reasonable relationship to the long-term interests of shareholders."[62] The Committee also noted that the Delaware Supreme Court's decision in the *Unocal* case (see discussion in Directors, chapter 3), which enabled directors to analyze the effects of a potential takeover on a variety of factors, including constituencies, does not suggest "that the court intended to authorize redress of an adverse 'impact' on a nonshareholder constituency at the expense of shareholders."[63] While it is useful (and cost-effective) for boards to consider the best way to meet the admittedly competing needs of the company's diverse constituencies, it is imperative

for them to give shareholders first priority. Only with that as their goal can they serve the other constituencies over the long term.

The Business Roundtable seems to agree. In its 1990 report, "Corporate Governance and American Competitiveness," it contrasts political and "economic" organizations. "Legislative bodies... represent and give expression to a multiplicity of constituent interests. Our political system is designed to create compromises between competing interests, to seek the broad middle ground.... This system of governance would be fatal for an economic enterprise." In later reports, it backed off, suggesting that a stakeholder approach (not coincidentally, a very effective anti-takeover protection) was the better way.

CASE IN POINT PROTECTION, PENNSYLVANIA STYLE

Pennsylvania risked the consequences F. A. Hayek warned about when it adopted the notorious Act 36 of 1990, which went far further than other stakeholder laws in moving beyond the rather benign concept of "consideration" of the interests of others, to a standard with more legal bite: usurpation. Directors may consider "to the extent they deem appropriate" the impact of their decisions on *any* affected interest. They are not required "to regard any corporate interest or the interests of any particular group...as a dominant or controlling interest or factor" as long as the action is in the best interest of the corporation.

The previous version of the law, adopted in 1983, included a stakeholder provision similar to those adopted by many other states, but the new version went further than any other state had, so far, by expanding the list of interests that may be considered and, more important, by establishing that no interest must be controlling (including the interests of shareholders), as long as the directors act in the best interests of the corporation. Other changes to the fiduciary standard include an explicit rejection of the Delaware "heightened scrutiny" test applied to directors' actions in change-of-control situations. Note that this statute was adopted very quickly, with the strong support of a major Pennsylvania company that was then the target of a hostile takeover attempt. The attempt was ultimately unsuccessful, thanks in part to the passage of this law, which included other anti-takeover provisions as well. The Sovereign case study shows the results of this kind of protection.

In the context of a potential or proposed change-of-control transaction, a determination made by disinterested directors (those not current or former employees) will be presumed to satisfy the standard-of-care requirement unless clear and convincing evidence proves that the determination was not made in good faith after reasonable investigation. This means, as a practical matter, that directors cannot be held liable for

what they do, absent some element of self-dealing or fraud. This provision required no shareholder approval; it was immediately applicable to all companies incorporated in Pennsylvania, unless they opted out within 90 days. The anti-shareholder bias of the bill was made clear during the campaign to pass the bill. In December 1989, a "fact sheet" sent to state legislators from the Pennsylvania Chamber of Commerce, which co-sponsored the bill with local unions under the banner of the AFL–CIO, contained the statement that the bill would "reaffirm and make more explicit the time-honored (and current) principle that directors owe their duties to the corporation, rather than to any specific group such as shareholders."

The new law does not say that directors are free to place greater importance on factors other than long-term profit maximization, but to give it any other interpretation would violate the foremost principle of statutory construction and assume that the legislature intended its language to have no effect.

It did have an effect, though perhaps not what the legislature intended. The *Wall Street Journal* called it "an awful piece of legislation," and it soon became apparent that many Pennsylvania companies agreed. By October 15, 1990, 99 companies – nearly 33 percent of the state's publicly traded companies – had opted out of at least some of the provisions of the bill. Over 61 percent of the *Fortune* 500 incorporated in Pennsylvania opted out, as did over 56 percent of those in the S&P 500. So massive was the stampede out of Pennsylvania Act 36 that a *Philadelphia Inquirer* editorial noted: "These business decisions make it all the more clear that the law was crafted not in the best interest of the state's businesses, but to protect Armstrong World Industries Inc. and a few other companies facing takeover attempts." A company spokesman for Franklin Electronics Publishers stated that its board "believes that the Pennsylvania legislation runs counter to basic American principles of corporate democracy and personal property rights."

The market also agreed. Jonathan M. Karpoff and Paul M. Malatesta at the University of Washington School of Business found that from October 12, 1989 (the date of the first national newswire report of the bill) through January 2, 1990 (when the bill was introduced in the Pennsylvania House), the shares of firms incorporated in Pennsylvania underperformed the S&P 500 by an average of 5.8 percent. Another study, by Wilshire Associates, linked enactment of the Pennsylvania anti-takeover law with a 4 percent decline in stock prices of companies incorporated there.[64]

Are the "best interests of the corporation" the same as the "best interests of the shareholders"? When do they differ? Who defines the competing interests? Who decides how to balance them? For what purpose? Consider these questions in the context of the debate about just what a corporation is. How do the answers differ if you think of a corporation as an "imaginary person"? A "bundle of contracts"? ■

Some scholars have developed what they call an "ethical contract." The ethical contract is built on the model of more traditional, operational contracts between the executives and the other stakeholders in the venture. It assumes that any executive's legitimacy can only be sustained by the interaction of these "relationships" with other stakeholders. External legitimacy of the executive and the employees must be sustained and controlled by the personal ethic of the individuals involved as well as by broader corporate and societal ethics. The personal ethic operates through conscience. The corporate and societal ethics work through the internal and external systems of scrutiny, each of which is reinforced by mechanisms for enforcement. Together, these underpin the "corporate contract" between the employee and the firm.[65]

If you were drawing up an "ethical contract" between the corporation and the community, what substantive and procedural provisions would you want to include? What would be your enforcement mechanism? What provisions would you have for amendment?

Professor Carol Adams of the Centre for Business Research at Deakin University in Australia argues that stakeholder laws will minimize externalities by requiring companies to consider the impact of their decisions on the community. However, without a clear and direct and enforceable fiduciary obligation to shareholders, the contract that justifies the corporate structure is irreparably shattered.

It seems to make the most sense to envision a hypothetical long-term shareholder, like the beneficial owner of most institutional investor securities, as the ultimate party of interest. That allows all other interests to be factored in without losing sight of the goal of long-term wealth maximization.

In our view, the arguments advancing a "constituency" or "trustee" role for corporate functioning are miscast. It is difficult enough to determine the success of a company's strategy based on only one goal – shareholder value. It is impossible when we add in other goals. There is no one standard or formula for determining the impact that today's actions will have on tomorrow's value. The only way to evaluate the success of a company's performance is to consult those who have the most direct and wide-reaching interest in the results of that performance – the shareholders. The problem is one of effective accountability (agency costs). Only owners have the motive to inform themselves and to enforce standards that arguably are a proxy for the public interest. As Edward Mason comments:

> *If equity rather than profits is the corporate objective, one of the traditional distinctions between the private and public sectors disappears. If equity is the primary desideratum, it may well be asked why duly constituted public authority is not as good an instrument for dispensing equity as self-perpetuating corporate managements? Then there are those, including the editors of Fortune, who seek the best of both worlds by equating long-run profit maximization with equitable treatment of all parties at issue. But to date no one has succeeded in working out the logic of this modern rehabilitation of the medieval 'just price.'*[66]

With all of the talk of corporations being run for the benefit of shareholders, it is surprising that so little attention has been paid to the past difference and utter incompatibility of interests

of different shareholding groups, ranging from index funds to day traders to highly quantitative computer models. The largest single component is the pension plan participant, and even there we have a range between those in defined benefit versus those in defined contribution plans and those who are just beginning employment, those who are nearing retirement, and those who are retired. Still, as discussed in chapter 2, the hypothetical pension plan participant, with a long-term time horizon and wish to retire into a world with a sound economy and environment, can serve as a worthwhile standard.

CORPORATE DECISION MAKING: WHOSE INTERESTS DOES THIS "PERSON"/ADAPTIVE CREATURE SERVE?

Are we confident of our ability to identify a "good corporation?" How do we reconcile economic and social goals?

CASES IN POINT THE "GOOD," THE "BAD," AND THE REAL

Let us begin with some examples of companies that have made economic decisions with (arguably) adverse social consequences. The first three cases in point are true, as also is the Wiederhorn case. The rest are hypothetical, but adapted from real cases.

- For several decades following World War II, the great inventor Edwin Land, chairman of Polaroid Corp., pioneered project after project to promote the public good – creating work groups to determine job characteristics, banning discrimination in employment, locating new plants in distress areas, and developing new technology. In the late 1960s, it was revealed that one of Polaroid's most versatile products was producing photo identification cards. In most cases, this was a useful technology, but a controversy arose when it was revealed that Polaroid's photo ID machines were the key to enforcement of the apartheid laws in South Africa. *Did Polaroid all of a sudden become a bad company?*
- William Charles Norris was the CEO of Control Data Corporation, at one time one of the most powerful and respected computer companies in the world. He was committed to corporate functioning in aid of societal objectives. Influenced by a seminar for CEOs where Whitney Young, head of the National Urban League, spoke about the social and economic injustices in the lives of young black Americans and race riots in Norris's home town of Minneapolis, he became a champion of moving factories into the inner-cities, providing stable incomes and "high-tech" training to thousands of people who would otherwise have little chance of either. He created two subsidiaries, both dealing with underdevelopment, one for cities and the other rural, bringing

jobs and training to inner cities and disadvantaged communities. When the company faltered, some blamed these programs, and Norris was ousted.

- BP stands for British Petroleum. The company, as a part of its branding as a forward-thinking, environmentally-friendly organization, adopted the slogan "Beyond Petroleum" and emphasized its commitment to solar, wind, and other sources of energy. Under CEO Lord Browne, a pioneer in corporate social responsibility, the company was ranked in the Corporate Knights Global 100 in 2005 and 2006. Browne's successor, Tony Hayward, committed to a better record on safety. However, the 2010 oil spill led critics to say that the company's initials stand for "Big Polluter."
- A chemical company complied with all applicable laws in the disposal of its waste chemicals, burying most of them in state-of-the-art drums in a landfill. Twenty years later, there was a statistically high rate of cancer and birth defects in the housing development located near the landfill. *Is the chemical company a bad company?*
- A small manufacturing company in a very competitive market is advised by its lawyer that it is not meeting federal environmental standards. The cost of bringing the company into compliance would more than wipe out the company's profits for the year and could drive up the cost of the company's products. None of its competitors is undertaking the expenses of meeting the standard. The odds of prosecution are low. The company decides not to comply. *Is this company a bad company?* Let's say that they decide, instead, to give their hazardous materials to a disposal firm that does not comply with environmental standards but is inexpensive. *Is this a better or worse solution than continuing to violate the standards themselves?*
- A newspaper company with a liberal outlook frequently publishes strongly pro-environment editorials. It is printed on paper produced outside the US, which is cheaper than US paper, partly because the producers do not have to comply with US environmental laws. *Is the newspaper a bad company? Is the paper company it buys from a bad company?*

These were companies who made arguably antisocial decisions for economic reasons. Let us look at some examples of companies, like the Wrigley example above, who make uneconomic decisions for social reasons.

- In a landmark 1919 case, *Dodge v. Ford Motor Co.,* a Michigan court ordered Henry Ford to pay dividends to his shareholders.[67] The case arose when Ford ceased paying out a special annual dividend of over $10 million and the Dodge brothers sued. At the time, Henry Ford owned nearly 60 percent of the company and the Dodge brothers owned 10 percent.

Ford Motors was rich in surplus capital and the company would have had no difficulty in paying the dividend. Henry Ford claimed, however, that he needed the money

for expansion (he planned a second plant) and he did not wish the cost of such growth to be borne by the consumer in the form of higher car prices. Indeed, because times were tough, Ford wanted to lower the price of cars. Ford argued that the stockholders had made enough money and it was more important to help the working man through the Depression. (Some suggested that Ford's reasons were not so altruistic: he knew that the Dodge brothers planned to join the auto-making business and he did not want to finance their expansion by paying dividends.)

The Michigan Supreme Court reminded Ford of his duty to the stockholders. Their message was that Ford's generosity was all very proper, but not when he was being generous with other people's money. The court wrote: "There should be no confusion…of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his co-directors owe to protesting, minority stockholders. A business corporation is organized and carried on primarily for the profit of the stockholders." *Was the court right? Compare with the Wrigley decision, about installing lights so the Chicago Cubs could play night games, in the first case in point in this chapter.*

- A chain of restaurants called Chick-fil-A® is closed on Sundays because of the religious beliefs of the management. Clearly, the company (and the shareholders) are foregoing considerable revenue, but the company's mission is not stated in economic terms. It does not even mention profit. It is "To glorify God by being a faithful steward of all that is entrusted to us. To have a positive influence on all who come in contact with Chick-fil-A." *Is this a good company? If it sold shares to the public, would the courts permit management to decide to keep it closed on Sundays because it was the Sabbath?*
- There was a fire in the Malden Mills textile factory in Lawrence, Massachusetts, that destroyed three of the nine buildings just before Christmas in 1995. As described in the thoughtful *Edges of the Field* by Harvard law professor Joseph W. Singer, the next day, the company's founder and owner, Aaron Mordecai Feurstein, spoke to the company's more than 3,000 workers in a high-school gymnasium. They feared the worst. Feurstein was 70 years old. Most local manufacturing jobs had been moved offshore. Would he rebuild? Feurstein told the workers that he would. In addition, he promised to rehire every worker who wanted a job. He also promised they would all get their $275 Christmas bonuses. He did better than that. He paid all of their salaries for several months, until he could not afford it any more. By 1998, almost all of the workers had been rehired. When asked why he did not just lay off the workers, he said, "Because it wouldn't be right." When he attracted a great deal of press attention for his response, he said, "My celebrity is a poor reflection of the values of today." *Would a publicly owned company, watched carefully by analysts and accountable to shareholders, have been able to respond in this way?*

Singer comments, "One might think that a publicly held company might have public obligations. The reality is that such companies are managed by professionals who are obligated under existing law to maximize return to shareholders, whether or not this is in the public interest. Existing law not only does not encourage most employers to act as Feurstein did, but may actually *prohibit* them from responding as he did." Singer suggests that if it had been a public company, shareholders might have sued Feurstein for corporate waste. *Compare this case with Ladish Company, which in 2003 announced that due to an accounting correction it was docking the workers 10 percent of their pay to make up for profit-sharing bonuses they received due to the inflated numbers.*

- A publicly held oil company spends over $100 million to build an art museum for the CEO's collection (see the Occidental Petroleum case study). *In whose interests is this expenditure?*

Sometimes the conflict between economic and social goals is even more complicated.

- An oil company with lucrative operations during the apartheid era in South Africa is scrupulous about imposing the highest standards of equal rights for its employees. It has therefore made jobs and wages available to black South Africans that are not available to them elsewhere. The company is pressured by some of its shareholders and by outside groups to withdraw from South Africa entirely, even though a sale of the division would be uneconomic for the company and would leave the black employees unlikely to do as well with the successor owners.
- A major consumer goods company includes among its many and widely varied charitable contributions a six-figure donation to Planned Parenthood. Employees, shareholders, and consumers who object to abortion protest this contribution, so the company cancels it. The company is then confronted with employees, shareholders, and consumers who object to the cancellation and demand that the company continues to support Planned Parenthood. At annual meetings ranging over a period of several years, more time is given to this issue than any other. *Who should decide?*
- Warren Buffett's Berkshire Hathaway allowed its shareholders to direct its charitable contributions in proportion to their ownership. Over a 20-year period, over $200 million was given away, the majority going to educational institutions and religious organizations. He wrote.

> *Just as I wouldn't want you to implement your personal judgments by writing checks on my bank account for charities of your choice, I feel it inappropriate to write checks on your corporate 'bank account' for charities of my choice.... I am pleased*

that Berkshire donations can become owner-directed. It is ironic, but understandable, that a large and growing number of major corporations have charitable policies pursuant to which they will match gifts made by employees (and – brace yourself for this one – many even match gifts made by directors) but none, to my knowledge, has a plan matching charitable gifts by owners.[68] ”

However, some customers of one of Berkshire's new acquisitions, the Pampered Chef, threatened a boycott because they objected to the proportion of the donations allocated to Planned Parenthood. Buffett shut down the entire program. *Who should decide?*

- In 2005, Fog Cutter Capital Group Inc., a publicly traded company, noted on its web site that its founder and CEO, Andrew Wiederhorn, was on "a leave of absence." In fact, he was in prison, serving an 18-month sentence, after pleading guilty to financial fraud. Another one of his companies defaulted on a $160 million loan that caused the collapse of a pension fund, leaving union pension plan participants with nothing. Wiederhorn had taken $14.5 million of the money loaned to the pension fund to bail himself out of a problem with federal regulators concerning another one of his companies.

  Wiederhorn earned more than $6.5 million in total compensation that year – even though he had spent the last five months of the year in prison. The company's net income before taxes was about $9 million in 2003, compared with $20.2 million in 2002. Net income before taxes in 2004 was a negative $3.9 million. Nevertheless, and despite the fact that he spent five months of 2004 in prison, the board decided to give him by far his highest pay ever, $556,830, in 2004 and bonuses of more than $5.5 million – $3.5 million beyond the $2 million "leave of absence" payment that just happened to be the amount of the fine the court ordered him to pay. The company also awarded Wiederhorn an additional $544,000 worth of company stock. The acting CEO who approved all of this was Wiederhorn's father-in-law. Ultimately, Wiederhorn was reinstated, leading to the stock's being delisted from the NASDAQ. ■

Another example of how difficult it is to use social tests of company performance is Stride Rite Corporation, a company that prided itself on its well-deserved reputation for corporate citizenship. The *Wall Street Journal* noted, "In the past three years alone, Stride Rite has received 14 public service awards, including ones from the National Women's Political Caucus, Northeastern University, the Northeast Human Resources Association, and Harvard University, which praised it for improving the quality of life in its community and the nation."[69] Yet Stride Rite had to move its shoe-making jobs outside of the slum areas of Boston – indeed outside of the United States to foreign countries where employment costs are significantly lower.

Is it socially responsible to move jobs out of depressed areas? Is it socially responsible to stay in these areas if it means going bankrupt?

The former chairman, Arnold Hiatt, wanted Stride Rite to be (and be seen as) a leader in socially responsible capitalism. He passionately espoused a Jeffersonian vision linking corporate and social responsibility. When Stride Rite joined 54 other companies to form Businesses for Social Responsibility, he said, "If you're pro-business, you also have to be concerned about things like jobs in the inner-city and the 38 million Americans living below the poverty line.... To the extent that you can stay in the city, I think you have to...[but] if it's at the expense of your business, I think you can't forget that your primary responsibility is to your stockholders."[70]

For the sake of this argument, let's define "social judgments" as explicit trade-offs of profit maximization in favor of social goals.

To what extent do we want corporate leaders to exercise social judgments? What is their authority to make determinations affecting the public good? Who elected them to what? To whom are they accountable?

Doug Bandow, a former Reagan aide, offers a view from the supply-side:

> *Corporations are specialized institutions created for a specific purpose. They are only one form of enterprise in a very diverse society with lots of different organizations. Churches exist to help people fulfill their responsibilities toward God in community with one another. Governments are instituted most basically to prevent people from violating the rights of others. Philanthropic institutions are created to do good works. Community associations are to promote one or another shared goal. And businesses are established to make a profit by meeting people's needs and wants.*
>
> *Shouldn't business nevertheless 'serve' society? Yes, but the way it best does so is by satisfying people's desires in an efficient manner.... Does this mean that firms have no responsibilities other than making money? Of course not, just as individuals have obligations other than making money. But while firms have a duty to respect the rights of others, they are under no obligation to promote the interests of others. The distinction is important.*[71]

Bandow goes on to say that promoting other goals (giving to charity, exceeding regulatory or industry standards for pollution control, or employee benefits) is permissible if it promotes the firm's financial well-being (all of the above may create loyalty in employees and customers) or if the shareholders know (and presumably therefore approve) of the program. He uses as an example the jeans company Levi Strauss, which informed shareholders when it went public that it intended to continue its generous charitable giving program.

Experienced CEO and director Betsy Atkins argues that it is not the role of the corporation to become involved in "social responsibility."

> *It is absolutely correct to expect that corporations should be 'responsible' by creating quality products and marketing them in an ethical manner, in compliance with laws and regulations and with financials represented in an honest, transparent way*

to shareholders. However, the notion that the corporation should apply its assets for social purposes, rather than for the profit of its owners, the shareholders, is irresponsible . . . . There are practical reasons why corporations should cloak themselves in the politically correct rhetoric of social responsibility. But marketing should not be confused with significant deployments of corporate assets. For example, British Petroleum's marketing campaign, which is all about looking for alternative energy sources, makes the consuming public feel good about purchasing BP products. But if BP had redeployed billions of dollars into environmental investments that yielded no profits, and its stock plummeted, one would certainly expect the investing public to transfer its money to a competitor. [72] ”

" 'I'm personally very much against corporate philanthropy,' [Nestlé CEO Peter] Brabeck said in a television interview in London. 'You shouldn't do good with money which doesn't belong to you. What you do with your own money, this is absolutely fine.' Nestlé's strategy in corporate and social responsibility focuses on areas that are key to its own business strategy and that boost shareholder value as well as helping society, 65-year-old Brabeck said."[73]

The late Congressman Paul Gillmor of Ohio sponsored a legislative proposal that would require companies to disclose their corporate charitable contributions, based on concerns that conflicts of interest led to contributions that might not otherwise be justified as beneficial to shareholders. Douglas L. Foshee, chairman and CEO of Nuevo Energy agreed in a statement to the Federalist Society that: "Three things should be disclosed to the shareholders: the company's giving philosophy, the amount of charitable contributions above some threshold, and a description of any potential conflicts resulting from those charitable contributions." He explained his view that charitable contributions are "a part of our corporate purpose." He said that, "I believe our contributions in these communities help ensure that they remain attractive places for our employees to work, live, and raise their families. I [also] view our corporate contributions as another in a long list of employee benefits. Our employees take pride in knowing that our corporate giving dollars go to causes that are important both to them and to our company."

The corporate conflicts of interest revealed in the scandals of 2002 led to additional legislative proposals for disclosure of charitable contributions to entities affiliated with corporate directors or their spouses, but strong opposition from the nonprofit community prevented it from becoming part of the package of reforms that were ultimately enacted.

ANOTHER (FAILED) MARKET TEST: NGOs

Even the most apparently independent of entities can be susceptible to conflicts of interest when it comes to efforts to hold corporations accountable. Corporations co-opt environmental public interest groups with contributions and partnerships. "[W]hen it was revealed that many of IKEA's dining room sets were made from trees ripped from endangered forests, the World Wildlife Fund (WWF) leapt to the company's defense, saying – wrongly – that IKEA 'can never guarantee' this won't happen. Is it a coincidence that WWF is a 'marketing partner' with IKEA, and takes cash from the company?

Likewise, the Sierra Club was approached in 2008 by the makers of Clorox bleach, who said that if the Club endorsed their new range of 'green' household cleaners, they would give it a percentage of the sales."[74]

MEASURING VALUE ENHANCEMENT

As we have noted throughout this book, the measure of corporate performance must be the creation of value. This is difficult, at best. If it is impossible to determine in the present what the impact of current decisions will be on future value, it is not much easier to determine after the fact what the impact of past decisions has been.

There are many measures of corporate value. While a full discussion of the range of measures could easily fill several books, it is useful to include at this stage a brief description of the pros and cons of some of the most popular measures. To stay within the context of a discussion of corporate governance, we examine these measures by asking two questions:

1. What does each of them contribute to (or how does each interfere with) the ability of the three primary parties to corporate governance to do their part in guiding the corporation?
2. Who is in the best position to decide when to apply which measures?

GAAP

We begin, of course, with the Generally Accepted Accounting Principles (GAAP). Note that the operative term here is "generally accepted," not "certifiably accurate." This is well expressed in a cartoon showing two men in a prison cell, one saying to the other dolefully, "I guess my accounting principles weren't as generally accepted as I thought."

GAAP is a language by which the assets and liabilities of corporations are recorded in balance sheets and their functioning is stated in income statements. Accounting purports to present performance in numbers; by the consistent use of a fixed set of quantitative techniques, accountants can accurately depict the course of a business over long periods of time. Accounting rules are important because the Securities and Exchange Commission (SEC), the New York Stock Exchange (NYSE), and other regulatory bodies require that companies have "certified financial statements." The purpose of these rules is to ensure a consistent (if minimal) level of disclosure. What they measure is (theoretically) measured consistently over time and between companies, and that has some utility.

The gap between GAAP and underlying reality can have profound consequences. For example, during the early stages of the response to the financial meltdown, the government was expecting to take the "tarnished assets" off the banks' hands and books with the $700 billion allocated for that purpose. Then a decision by the Financial Accounting Standards Board (FASB) made it easier for the banks to set their own valuations for those assets (permitting them to use "significant judgment"), and they decided to keep them and accept a direct cash infusion from the government instead. While FASB is an independent enterprise specifically designed to be completely independent of any political interference, this ruling was rushed through in response to pressure from Congress, itself under pressure from the banks.

It is crucial to remember that even without the explicit authorization to use "significant judgment" there is enough flexibility and room for interpretation in the GAAP to permit accounting firms to compete with each other by offering more creative approaches, and there are many clients out there who will hire the firm whose creativity is most in their own favor. Accountancy is a business, indeed, a competitive business, and one of its characteristics is the willingness to find solutions to a client's problems. One accounting firm's charges against earnings are another's "charge offs" to surplus, for example. For this reason, the numbers may not be as "apples and apples" as an outsider evaluating them would wish for.

It is best to view accounting as an invented foreign language like Esperanto, useful enough for communicating across cultures, but really not particularly helpful in day-to-day business dealings. For example, accounting has always had a hard time dealing with inflation. The "nominal" or stated value of an asset departs widely from its market value. Many items that are vitally connected to the profitability of the enterprise are not carried as assets on a balance sheet: the value of a concession to drill for oil, the value of brand names, the "goodwill" associated with a new venture launched by a household name. Accounting standards are based on a time when real property, like machinery, was the most important asset. They do not reflect the value of "human capital."

However, the real problem with accounting standards is that through their general acceptance, appearance becomes reality. New forms of measurement are rarely conceptualized or applied, and existing standards are too often seen as far more objective and meaningful than they are. For example, "earnings" are one of the critical components of value in the marketplace, yet, essentially, earnings are what accountants say they are. Earnings are subject to manipulation. Much of it is legal and some is even appropriate, but some goes far beyond what should be acceptable. The whole concept of "managed earnings" has an oxymoronic sound. Commissioner Norman Johnson of the Securities and Exchange Commission spoke about the pressures to manage earnings in a 1999 speech:

> *Fundamentally, companies may attempt to manage earnings for numerous reasons. Perhaps the single most important cause, however, is the pressure imposed on management to meet analysts' earnings projections. The severity with which the market punishes companies failing to meet analysts' expectations is extraordinary. This factor, combined with the recent increased emphasis on stock options as a key component of executive compensation has also placed greater pressure on management to achieve earnings expectations. The pressure to meet analysts' estimates and compensation benchmarks have both operated to increase the temptation for management to 'fudge' the numbers. Auditors surely want to retain their clients, and are thus under pressure not to stand in the way of companies who have succumbed to these temptations....*
>
> *No one who follows the financial pages could escape awareness of the recent allegations of apparent large-scale financial fraud, often involving hundreds of millions of dollars of manufactured or 'managed earnings,' at many prominent public companies. While the problem is not new, it is happening with alarming frequency. Barely a week goes by without an announcement that another large company is restating its past results. There are a number of dubious practices that companies employ to manage their earnings, including such gems as: 'big bath' restructuring charges, creative acquisition accounting, 'cookie jar reserves,' 'immaterial' misapplications of accounting principles, and the premature recognition of revenue. The names for some of these techniques may be amusing, but in reality they are not amusing at all.*

Take "big bath" accounting as one example. This is the practice when a company decides at the end of the year that it must make a one-time only "restructuring charge." This charge is not assessed against current earnings; it is levied against the accumulated earnings of the venture. This technique is so popular that the SEC's chief accountant reported that in the first quarter of 1998, corporate write-offs, as a percentage of the reported earnings per share of the S&P's Fortune 500 stock index, surged to 11 percent of reported earnings, their highest level in the previous ten years.

Warren Buffett noted in the annual report of Berkshire Hathaway that the 1997 earnings of the Fortune 500 companies totaled $324 billion dollars. He compared this with reports by R.G. Associates of Baltimore that the total charges for items such as asset writedowns, restructurings, and IPR&D charges amounted to a stunning $86.3 billion dollars in 1998.

There is an *Alice in Wonderland* character to this. The numbers make more sense if you keep in mind that accounting earnings are not economic earnings. Imagine a company that has reported over the past five years earnings of $10 a share each year; then in year six, the company decides on a restructuring charge of $75 a share. During all of the six-year period, the company is deemed to be operating profitably from an accounting point of view. Each year has its $10 earnings; the retroactive "restructuring charge" cannot affect the five years of perceptions that have passed. Furthermore, because it is a restructuring charge, it does not alter the reported "earnings from ongoing operations" in year six, which are, let's say, $10 a share. Thus, the company has lost money over a six-year period, and yet each annual component shows a profit at the time of reporting. This trick is especially popular for new CEOs, as it enables them to start with, if not a clean slate, a cleaner one.

Accounting standards are like a maze through which to work one's way. A concept as simple as "costs" can be interpreted a dozen different ways. If the CEO is a veteran who wants to show steady progress, costs may be reported one way. If he or she is going to re-engineer the company and be compensated according to new reported earnings, costs may be calculated another way. And if he or she is top gun of a defense firm that is paid only "cost plus" a percentage, costs will be calculated another way.

Consider the situation of Westinghouse Corporation, which by 1993 had taken six restructuring charges over the previous seven years. It got to the point that the "operating earnings" figures were meaningless; most analysts disregarded the company's figures and developed their own calculation of Westinghouse operations.

In many instances, the accounting conventions have a material impact on the company's decisions. For example, in the late 1980s, Westinghouse decided to expand its real estate financing business very substantially. To motivate the executives, the company devised a compensation package that provided incentive for an improved return on the equity (ROE) invested. The executives were so motivated that they dramatically improved the ROE by the fastest method available: they borrowed. This leverage brought increased earnings (and, hence, compensation) to the bottom line. Everyone was happy, until Westinghouse became overwhelmed by its new debts. When the real estate commitments proved to have been carelessly assumed, the entire company (not just the real estate division) almost went bankrupt – and all because of an accounting formula to create incentives for salespersons.

CASE IN POINT GREEN TREE FINANCIAL

An early subprime mortgage company faced a very different kind of unexpected outcome from the derivatives-fueled meltdown of 2008, but its lessons are still instructive. Green Tree CEO Lawrence Coss was a pioneer in loans to a previously un-served customer base, mobile homes. He had an unusual compensation formula. Instead of tying

his pay to stock price performance or a particular financial goal at the company, which specialized in high-risk mortgages, Coss received a percentage of the company's profits. Perhaps it is not surprising, therefore, that the company used very aggressive accounting techniques in its reporting of profits, booking the returns on loans as though there would be no defaults. Ironically, the problem was not defaults but pre-payments. After several years of astoundingly good results, Coss had to announce in 1997 that earnings would actually be reduced by $190 million and that the company would retroactively cut its 1996 pre-tax earnings by $200 million. Since Coss's 1996 bonus was based on pretax profits, the restatement forced him to give back an estimated $40 million of his then record-setting $102 million payday.

Note that Green Tree's problems were only beginning. After more than $700 million in accounting corrections, the company was acquired by Conseco, an insurance firm. Conseco, with stock trading at under a dime a share, down from a high near $60, filed for bankruptcy in December of 2002. ■

The varying accounting practices in different countries have produced some grotesque consequences. Until recently, in the United States, the "goodwill" arising out of an acquisition – meaning the extent to which the purchase price exceeds the value of the tangible assets – could not be charged off against the ongoing earnings of the enterprise.[75] In the UK, goodwill arising out of acquisitions has been amortizable. Thus, the Blue Arrow scandal involved the acquisition by a small UK company of a much larger American one on terms with which other potential American acquirers could not compete. Blue Arrow was able to take on a level of debt that could be buried in its balance sheet over a period of years; an American firm, by contrast, would have had to take a hit to its profits. As John Jay wrote in *The Sunday Telegraph:* "Thanks to the disparity between United States and British accounting rules over the treatment of goodwill, an American white knight was out of the question and Fromstein [Manpower's CEO] was reduced either to contemplating some kind of poison pill acquisition or suing for peace."[76] Arbitrary accounting rules thus generate uneconomic corporate decisions.

Increasing concerns about "pro forma" reports led to a December 2001 release from the SEC cautioning companies about misleading "pro forma" reports and, a month later, the first SEC enforcement action on pro formas, involving Trump Hotels and Casino Resorts, Inc.

The SEC found that the CEO, CFO, and treasurer of Trump Hotels violated the antifraud provisions of the Securities Exchange Act by issuing an earnings release that was materially misleading. In its third quarter 1999 earnings release, Trump Hotels explained that the reported earnings excluded a one-time charge of $81.4 million. Exclusion of the charge was not in accordance with GAAP; therefore, the reported earnings were pro forma, though not identified as such. By comparing the pro forma earnings to analysts' expectations and to its own prior period results, which were GAAP figures, Trump Hotels suggested that, but for the exclusion, the reported earnings also were in accordance with GAAP.

Most importantly, the SEC found that by specifically describing this exclusion, the company implied that no other significant unusual items were excluded from or included in the pro forma

figures. However, the figures also included an undisclosed one-time gain of $17.2 million that, if excluded, would have effectively turned the quarter's positive operating results into a loss. Company executives compounded the problem by suggesting that the company's operating improvements led to the positive results. Yet, had the one-time gain been excluded, the figures would have shown a negative financial trend in operating results and that the company's earnings failed to meet analysts' expectations. The SEC found the undisclosed one-time gain to be material, particularly because it represented the difference between a positive and negative trend in earnings and revenues – and the difference between meeting and failing to meet analysts' expectations.

On January 16, 2003, the SEC adopted tougher rules on pro forma releases, requiring companies to explain exactly how the pro formas differ from what would be required under GAAP.

The long-time controversy over the best way to value stock options is a good illustration of many of the issues relating to corporate governance, including executive pay and measuring both performance and value, and the relationship of business, shareholders, government, the press, and the community in resolving these questions.

CASE IN POINT FASB'S TREATMENT OF STOCK OPTIONS

A stock option grant is the right to buy a company's stock at a fixed price for a fixed period. That usually means that an executive is granted the right to buy the company's stock at today's trading price for a period of ten years. If the stock goes up over that period, the executive can "cash out" the increase in the stock's trading price.

Stock option grants usually account for the multimillion-dollar executive pay packages. For example, in 1999, Disney CEO Michael Eisner took home $575.6 million, mostly in stock option gains.

Stock options first became popular in the 1960s, as a way to tie an employee's compensation – and motivation – to the shareholders' interest. At that time, an award of 30,000 options was considered generous. Options became much more popular in the 1980s and 1990s, when huge gains in the market as a whole made it possible for corporate executives to increase their pay exponentially while claiming that they were linking pay to performance. Grants in the hundreds of thousands, and even the millions, became the norm. Stock options offered a unique accounting advantage. They were not charged to earnings, and yet were tax deductible. In other words, companies could issue stock options without recording them as an expense on the income statement, while, at the same time, deducting their cost from taxes paid to the federal government.

Therefore, when a company paid a CEO in cash, that payment was treated as an expense: it was deducted from company earnings on the earnings statement, and the

company claimed that expense as a tax deduction. However, when a CEO exercised an option, let's say on 10,000 shares, at $15 a share, and sells the shares at $35 a share, the company generally does not show any expense on its earnings. Yet the company may deduct $200,000 (the difference between $15 and $35 times the 10,000 shares) as a business expense.

When this anomaly attracted the attention of the press, shareholders, and Congress, the logical entity to resolve it was the Financial Accounting Standards Board (FASB), which is responsible for setting accounting standards for US corporations. FASB is not a government organization, but the Securities and Exchange Commission takes its recommendations into account when issuing accounting regulations.

Through FASB, corporate managers and accountants are self-regulating; that is FASB (made up of a board of trustees taken from managerial ranks and the accounting profession) issues accounting rules and the private sector agrees to abide by them. Historically, Congress has never legislated accounting practices because as a policy matter it was committed to having accounting principles determined without being influenced by politics.

However, the issue of accounting for option grants has so far at least twice given rise to a controversy that threatened to destroy this commitment to independence. When FASB tried to address the anomaly and require companies' financial statements to reflect the fact that options have value, two US senators issued conflicting bills that would have put Congress in the position of legislating accounting rules for the first time. The political pressure from the high-tech companies was enormous.

It is undeniably difficult to put a value on options, because the value depends on what is going to happen in the future and all of our evidence is about what has happened in the past. An option grant becomes valuable only if (and to the extent that) the stock goes up. If the stock drops in value over the term of the grant, the option grant is worthless. Thus, if a company issues its CEO an option grant of 100,000 shares, the grant may, in ten years, be worth millions of dollars or it may be worth nothing. The value is determined by the performance of the stock over this term.

This was the conundrum facing FASB: how do you account for something of undetermined value? Obviously, it is impossible to predict precisely the growth or depreciation of stocks over a ten-year period. Just because we do not know what the value is, however, does not mean that it has no value. The right to buy stock at a fixed price in the future clearly has value, and we can make a principled guess at the present value of the option by factoring in various known elements – the stock's historic performance, its volatility, and company earnings estimates – into an option-pricing model. Such a model gives an estimated, though far from guaranteed, idea of what an option is worth. Two widely accepted formulas are the Black–Scholes model, developed by financial economists Fisher Black and Myron Scholes in the early 1970s, and the binomial pricing model.

The question before FASB was whether it should require companies to use an option-pricing model as the basis for charging the cost of the option to earnings. In other words, if a company issues an option grant to its CEO of 100,000 shares, should it produce an estimated value of that option and enter that sum as a liability on the balance sheet?

The issue of accounting for options is not a new one. FASB first proposed that the cost of options be deducted from earnings in 1984. The response from corporate America was so fierce, however, that FASB tabled it indefinitely. Eight years later they found that the debate had turned 180 degrees: FASB was criticized for its inaction.

Once again, the business community opposed possible changes to the accounting rules. Business leaders argued that a balance sheet should record known costs and expenses; it should not cover estimated sums that might or might not be a cost to the company in years to come. Companies that used options widely to compensate thousands of employees complained that they would no longer be able to be so generous with their grants. Startup companies said that options were a vital means of compensating key employees when there was insufficient cash flow to pay regular salaries and bonuses and warned that accounting for options would render them bankrupt. Ultimately, Joseph Lieberman (D-Connecticut) sponsored a bill opposing FASB's rule change, which was passed by a vote of 88 to 9 in May 1994. The key point here is the procedural/jurisdictional one. Congress set up FASB to make sure that political considerations would not corrupt accounting judgments. That worked until the executives' paychecks were at issue, which meant that politicians' campaign contributions were at issue.

FASB faced controversy over stock option accounting again in 1999, when it proposed that companies take an expense for re-pricing options. Perhaps still stinging from its previous fight, FASB made a decision to frame this as an interpretation, rather than an amendment. Once an option is re-priced (i.e., the original exercise price is lowered), that option must be accounted for as a "variable plan," whereby subsequent increases in stock price must be recorded as an earnings charge until the option is exercised. FASB wanted companies to recognize that they were increasing the value to the employees by re-pricing the options. Over many objections from the corporate community, particularly the high-tech community, FASB issued the new ruling in March of 2000.

In his book, *Take on Wall Street*, former SEC chairman Arthur Levitt says that he made a serious mistake in encouraging FASB to give up requiring that stock options be expensed. According to the book, in his first months in office, fully one-third of his time was taken up with people who wanted to object to the proposed rule. Senator Joseph Lieberman's 88:9 vote on a nonbinding resolution on the issue showed that he had the support to impose a legislative override, and Levitt felt he had no choice.

Levitt "worried that if [FASB] continued to push for the stock option rule, disgruntled companies would press Congress to end the FASB's role as standard-setter.... In retrospect, I was wrong. I know the FASB would have stuck to its guns if I had pushed them not to surrender. Out of a misguided belief that I was acting in the FASB's best interests, I failed to support this courageous and beleaguered organization in its time of need and may have opened the door to more meddling by powerful corporations and Congress."

The International Accounting Standards Board now requires that all stock option grants be expensed. When Congress indicated that they would not try to obstruct the rule again, FASB finally moved forward and stock option expensing has finally been required. In the meantime, many companies, including Coca-Cola and the Washington Post Company expensed their options voluntarily (not coincidentally, long-time expensing advocate Warren Buffett served on both boards). On the other hand, a number of companies waited until the last minute and then accelerated the vesting of options to evade application of the rule. ■

MARKET VALUE

Fortune magazine has developed and perfected the concept of annually ranking the nation's (and, in later years, the world's) companies by their size. They calculate size by volume of sales, by net earnings, and – most significantly – by the market value of their equity capitalization. What is the largest company in the world? According to *Fortune*, it is the one that is worth the most. Being considered a "Fortune 100" or "Fortune 500" company has long been considered a badge of honor, but this is changing.

Market value has statistical interest, but to whom is it really meaningful? The public's valuation of a company in the marketplace has unique value, because it is the only judgment that cannot be manipulated, at least not for long. Various notions of value based on concepts like earnings per share, book value, rate of return on reinvested capital, and the like are based on accounting principles that are so highly flexible that they have limited significance. The fact that the market valuation is independent, however, does not make it accurate in absolute terms. Fair market value does not tell you everything about what a company is worth, only what it is perceived to be worth.

We are all familiar with the Dutch tulip bulb mania and "Popular Delusions and the Madness of Crowds." The public can value companies on bases that in retrospect appear idiotic. Examples include conglomerates in the 1960s, the "nifty fifty" in the early 1970s, and high-tech companies with no revenues in the 1990s. The greater the price a company can command for its shares on the market, the greater is its power to raise future capital through equity sales. Even strong current market value provides little insurance against its own future decline. Good planning on all fronts must provide that insurance.

Conglomerates face special obstacles to traditional notions of head-to-head free market competitiveness, as shown by the following case in point.

CASE IN POINT THE BATTLE OF THE THEME PARKS

Six Flags theme park began an aggressive advertising campaign emphasizing what it saw as its primary advantage over Disney World: its geographic convenience. The message of the ads was that people could go to Six Flags and have a wonderful time, and still be home in time to feed the dog. Both theme parks were held by massive conglomerates, Six Flags by Time Warner and Disney World, of course, by Disney. Instead of taking out its own ads responding to Six Flags, by saying, for example, that their park had more attractions, Disney went to parent company Time Warner, pulling its advertising from Time Warner publications and threatening to pull out of a joint venture for video distribution.

What impact does this kind of response have on competitiveness and the efficiency of the market? ■

Ultimately, what is important is the company's continuing ability to obtain the capital necessary for the profitable production of goods and services that can be sold at a profit, and there is no magic monitor of this ability. More important than the worth of a company, which measures (imperfectly) today's value, is the health of a company, which can predict tomorrow's.

EARNINGS PER SHARE

> *Isn't it more important to go from #5 to #4 en route to #1 than to increase EPS by 5 percent or 10 percent this year?*

Cyrus F. Freidheim, Jr., vice-chairman of Booz Allen Hamilton, made a provocative presentation at a conference on corporate governance sponsored by Northwestern University's Kellogg Graduate School of Management.[77] Acknowledging that there are "a number of CEOs who won the compensation battle (by hitting specified performance formulas) but whose companies lost the competitive war," he went on to attack the popular measuring stick, earnings per share (EPS), echoing the critiques of 1980s valuation gurus like Northwestern's Alfred Rappaport (now with LEK/Alcar) and Joel Stern of the New York consulting firm Stern Stewart. Freidheim said EPS has the advantage of simplicity and clarity, but is of questionable value in determining the health of an enterprise because it is too susceptible to manipulation. EPS can be driven up by liquidating the franchise, by restructuring and weakening the balance sheet, by playing "the accounting game with acquisitions, convertible securities, switching conventions. And none of those things would improve the value of the enterprise a wit." Freidheim is similarly skeptical of "the 'Rs' – ROI, ROE, ROCE, ROA, ROS, ROT. They all have a place in managing the business…but each can pay off without performance if followed as *the* measure."

Using stock price as the measure puts too much emphasis on the short term, Freidheim says:

> *Let's stipulate that the return on shareholders' investment is maximized if the enterprise leads its industry in growth, profitability, and competitiveness over the long-term.*
>
> *Let's now reduce that to a framework for evaluating the performance of the CEO and the enterprise. Performance equals:*
>
> *– building the franchise, and*
> *– achieving long-term financial results and strength . . . .*
>
> *The three financial categories that should be measured are:*
>
> *– earnings;*
> *– growth in the financial base;*
> *– financial strength.*
>
> *In measuring earnings, what should we use if not earnings per share? We should pick ones that demonstrate the effectiveness of the CEO in directing all of the companies' capital without the muddying effects of accounting changes . . . and which produce what we want: cash.*
>
> *The best of these could well be cash flow on investment . . . . The second financial measure is simply growth in equity before dividends . . . . The final financial measure focuses on financial strength . . . the balance sheet.*

The late Coca-Cola CEO Roberto Goizuetta had a pillow embroidered, "THE ONE WITH THE HIGHEST CASH FLOW WINS."

EVA®: ECONOMIC VALUE ADDED

A 1993 cover story in *Fortune* magazine, called EVA (economic value added) "today's hottest financial idea and getting hotter." The cover headline said EVA is "the real key to creating wealth . . . and AT&T chief Robert Allen and many others use it to make shareholders rich." Stern Stewart, which *Fortune* calls EVA's "pre-eminent popularizer," says, "quite simply, EVA is an estimate of true 'economic' profit after subtracting the cost of capital." EVA is commonly defined as (ATOP – WACC) × TC (where ATOP is after-tax operating profit, WACC is the weighted average cost of capital, and TC is total capital). It cannot be reduced to a simple formula, however. As Ernst & Young EVA expert David Handlon (based in Washington, DC) advised us in an interview, "the applied meaning of EVA varies tremendously from company to company, so each company should tailor it carefully to fit its own circumstances." For example, according to its brochure,

> *Stern Stewart has identified more than 160 potential adjustments in GAAP earnings and balance sheets in areas such as inventory costing, depreciation, bad debt reserves, restructuring charges, and amortization of goodwill. However, in balancing simplicity with precision, we advise most clients to make only five to fifteen adjustments. In customizing EVA to each client's specific situation, we help identify those adjustments that can meaningfully improve accuracy and, in turn, performance. The basic tests are that*

the change is material, that the data are readily available, that the change is simple to communicate to non-financial managers, and, most important, that making the change can affect decisions in a positive, cost-effective way. ”

Despite EVA's complexity, however, it has become very popular, and is used by companies like Coca-Cola, Premark, Sprint, and Monsanto. *Fortune* noted that stock prices track EVA more closely than earnings per share or operating margins or return on equity. "That's because EVA shows what investors really care about – the net cash return on their capital – rather than some other type of performance viewed through the often distorting lens of accounting rules." By analyzing at the division level, managers can see if they are making more than their cost of capital. Since implementing EVA also includes a compensation plan, managers not only know it, they feel it.

Not everyone is as enthusiastic, however. John Balkcom and Roger Brossy of Sibson & Co. warn of the hidden traps in EVA-based incentives – value increments depend on the cost of capital, which can change materially if interest rates rise or fall or if the company changes its capital structure. Our experience suggests that the combination of EVA, organizational refinement, and customized incentives unlocks value, but no one of these three elements works by itself. Many monolithic companies have introduced EVA without the complementary organizational changes enacted by the likes of AT&T and Quaker, and the result has been a new, more cumbersome "value bureaucracy" that impedes decision making, misallocates capital, and destroys value.[78]

A 1998 Working Paper compares operating income, residual income, and EVA to determine which is more relevant to value. It concludes that all three provide information of value, but that the other two measures were slightly better correlated to explaining results.[79] Another way of thinking about this critique is in corporate governance terms. No matter how valid the method for evaluating the company's performance and direction, it cannot work itself. It must be applied within an organizational structure permitting decisions to be made by those with the best information and the fewest conflicts.

Financial Executives International published a report by Edward J. Lusk, Ruth A. Pagell, and Michael Halperin that reviewed 19 articles on the merits of EVA and the results of the authors' own survey of CFOs. They concluded that EVA was not as valid a measure as earnings in enhancing the organization's relative financial performance. Considering how highly it was rated by CFOs, the authors concluded that it might just be "the Hawthorne effect," the renewed excitement and energy that results from any new program and the renewed dedication that results from any new focus of attention.

HUMAN CAPITAL: "IT'S NOT WHAT YOU OWN BUT WHAT YOU KNOW"

Lawyer and former Darden School of Business professor Richard Crawford, in his book *In the Era of Human Capital*, documents the movement from an industrial society to a "knowledge society." As the economy shifts from "production of standard, tangible things with a split between production and consumption," to an "integrated global economy whose central economic activity is the provision of knowledge services with more fusion of producer and consumer," the primary resource shifts from physical capital to human capital. How does this affect the way we quantify value?

The GAAP still assume that physical capital is the company's most important asset, even though overall investment in human capital has been higher for almost 30 years. Standard accounting rules assign no value to human resources, although they account for about 70 percent of the resources being used by US businesses, according to Crawford. He suggests "putting human capital on the balance sheet," including "off-balance-sheet intangible assets and human capital assets." Support for efforts to account for intangible capital is growing, especially markets, intellectual property, and strategic organizational issues.

A task force of academic and corporate experts that was convened by the Securities and Exchange Commission in 2001 recommended that nonfinancial performance data be released to investors. Similarly, the Financial Accounting Standards Board has called for further review of methods to account for intangible assets. So far, both groups have recommended that disclosure remains voluntary.

In 2001, the Brookings Institution released a report, co-chaired by Margaret M. Blair and Steven M. H. Wallman, called "Unseen Wealth: Report of the Brookings Task Force on Intangibles."

Leif Edvinsson, the world's first corporate director of intellectual capital at Skandia of Stockholm, Sweden, developed a system for visualizing and developing intellectual, intangible, and organizational business assets. In an interview in Juergen Daum's book *Intangible Assets and Value Creation* (John Wiley & Sons Ltd, December 2002), he described those assets in this way:

> “*One is people. The other is what is surrounding people in an organization; that is what I call structural capital – all those intangibles left behind, when people go home, and in that I include internal processes and structures, databases, customer relationships and things like that. With structural capital you enable organizations to make their human capital more productive. It's not that people work harder. It's that people work smarter with structural capital. This is what represents really the value of an organization. Not financial capital, not human capital, but structural capital.*”

THE "VALUE CHAIN"

In another interview in the same book, New York University professor Baruch Lev criticized GAAP for relying too much on transactions to determine values. He says that a better measure is the "value chain."

> “*By value chain, I mean the fundamental economic process of innovation that starts with the discovery of new products, services or processes, proceeds through the development and the implementation phase of these discoveries and establishment of technological feasibility, and culminates in the commercialization of the new products or services. And this innovation process is where economic value is created in today's knowledge-based businesses from nearly all industries. So what I recommend as one important complementing element of a new accounting system is a so called Value Chain Blueprint, a measure based information system for use in both internal decision making and disclosure to investors, that reports in a structured and standardized way about the innovation process.*”

Clearly, the greatest challenge for financial reporting in the twenty-first century will be finding some way to account for the value of intangibles, from patents to PhDs, and from client relationships to risk assessment strategies. As the ratings agencies, including S&P and Moody's, begin to factor in corporate governance into their assessment of companies, even elements like the abilities and independence of the board will become items on a balance sheet.

KNOWLEDGE CAPITAL

The current accounting system was developed at a time when a company's most vital assets were equipment and property. In today's companies, however, "knowledge capital" includes assets like patents, brands, and research and development. Professor Baruch Lev of New York University is one of the leading scholars working on the thorny problem of trying to find a way to reflect the value of a company's "knowledge capital." With patents, for example, he suggests looking at how many times a patent is cited in other applications as a measure of its value. With regard to estimating overall knowledge capital costs, he takes annual normalized earnings and subtracts a number arrived at by multiplying recorded assets by their respective after-tax expected returns. The residual is earnings generated by knowledge assets.

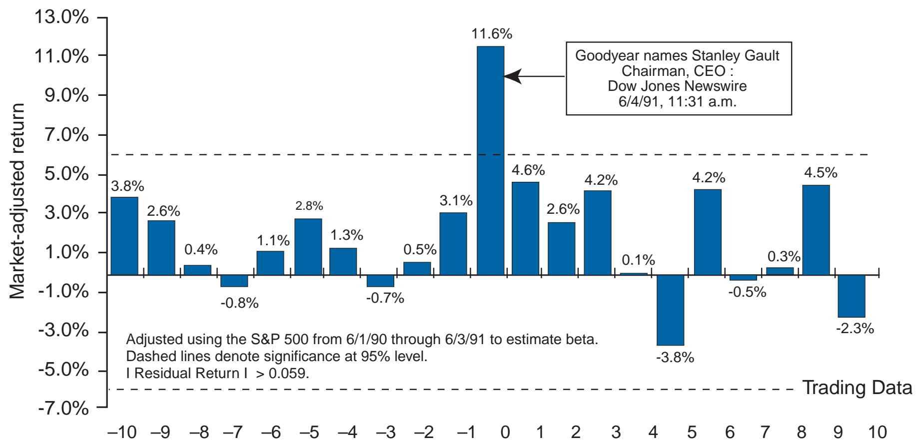
THE VALUE OF CASH

Ultimately, a company is valued because of analysts' conviction that it can generate certain levels of positive cash flow from present and future operations. Any calculation of company value necessarily is based on "guesses" as to what will happen in the future. Some of the guesswork is taken out of the projections by taking into account the strength of its past performance, the quality of its products, the positioning of its niche within its industry, the competitiveness of its technology, its ability to sustain margins, and, most critically, the vision and competence of its management. For example, when an under-performing company replaces its CEO, the market's reaction can be highly positive. See figures 1.1 to 1.4, which show the market's response when Goodyear and Allied Signal replaced poor-performing CEOs with well-regarded outsiders. Similarly, Lord Weinstock's announcement in July 1994 that he was extending GEC's retirement age so that he could stay on for two more years sent the company's value down significantly.

The market's valuation of human capital extends beyond the CEO slot. Eastman Kodak's market value went up $2 billion on the hiring of Christopher Steffen – the highest ranking outsider appointed at Kodak since 1912 – and then lost $1.6 billion on the day that Steffen resigned 12 weeks later. This kind of reaction shows that the market's valuation of a company depends not just on the value of the company's assets but also very much on the market's perception of the management's ability to manage those assets.

A company's capacity to survive and prosper is based on its ability to obtain the capital necessary to conduct its business at a competitive price. No matter how famous a company, no matter how admired its products, ultimately its worth lies in its ability to raise capital at a cost significantly less than the increase in earnings resulting from the new investment. Someone with a lower cost of capital can always buy goods, build plants, and finance sales cheaper than the competition. Business is done on the increment; a new entrant into the business creates a new reality by its cost of capital. This becomes the competitive bogey that the rest of the industry has to meet regardless of actual costs.

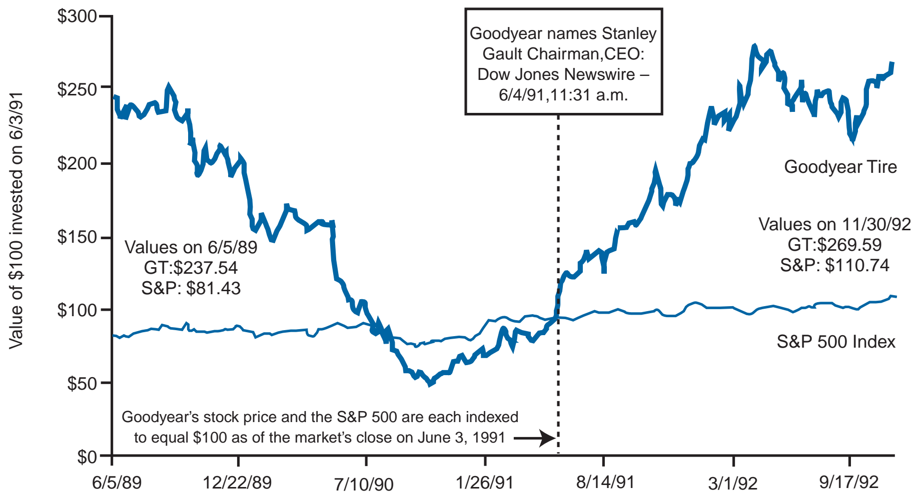
As Michael Jacobs argued persuasively in *Short-Term America*,[80] the international competitiveness of a country – the United States in his account – rests on its ability to provide capital to domestic



Charts from *Barbarians Inside the Gates* by Joseph Grundfest, reproduced with permission of *Stanford Law Review.* (45 Stanford Law Review 857–937 (1993))

Sources: Compuserve and the Center for Research in Securities Prices (CRSP), University of Chicago, daily return tapes.

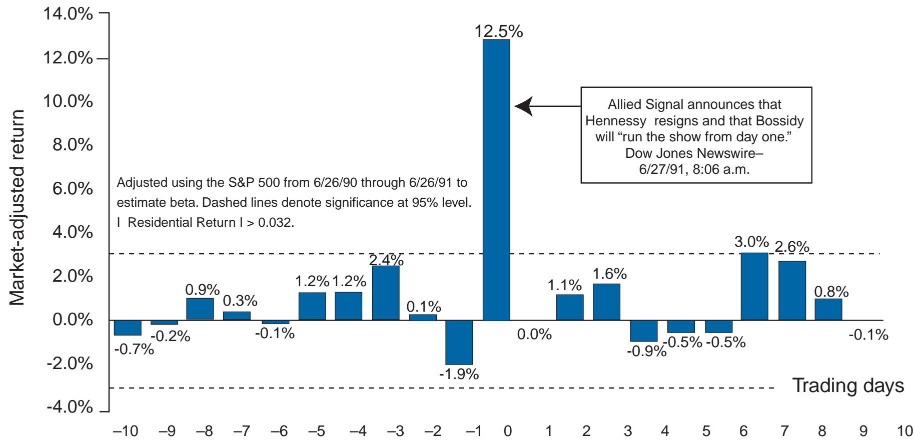
Figure 1.1 Goodyear Tire market-adjusted returns, May 21 to June 18, 1991.



Charts from *Barbarians Inside the Gates* by Joseph Grundfest, reproduced with permission of *Stanford Law Review.*

Sources: Compuserve and the Center for Research in Securities Prices (CRSP), University of Chicago, daily return tapes.

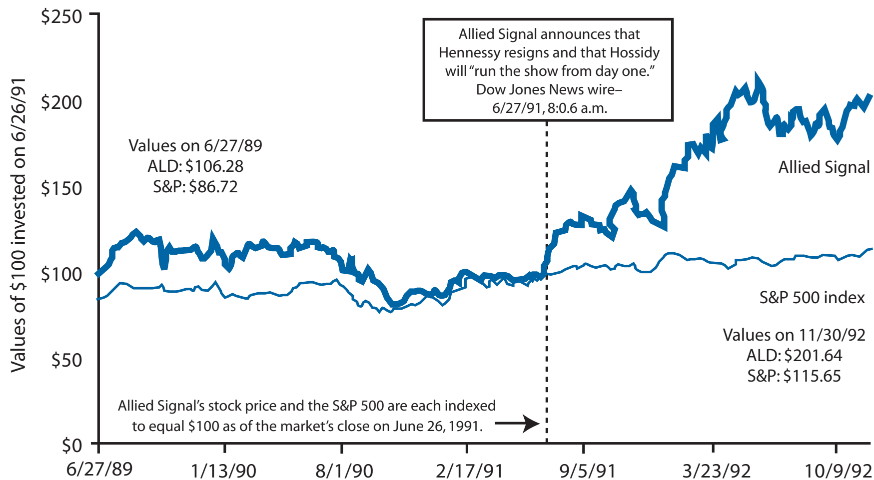
Figure 1.2 Value of $100 invested in Goodyear Tire and the S&P 500 index on June 3, 1991 (June 5, 1989 to November 30, 1992).



Charts from *Barbarians Inside the Gates* by Joseph Grundfest, reproduced with permission of *Stanford Law Review.*

Sources: Compuserve and the Center for Research in Securities Prices (CRSP), University of Chicago, daily return tapes.

Figure 1.3 Allied Signal market-adjusted returns June 13 to July 12, 1991.



Charts from *Barbarians Inside the Gates* by Joseph Grundfest, reproduced with permission of *Stanford Law Review.*

Sources: Compuserve and the Center for Research in Securities Prices (CRSP), University of Chicago, daily return tapes.

Figure 1.4 Value of $100 invested in Allied Signal and the S&P 500 index on June 26, 1991 (June 27, 1989 to November 30, 1992).

companies at a rate that is internationally competitive. The perceived threat that Japanese industry would simply take over the rest of the world in the 1980s was largely based on their having virtually a zero cost of capital. Companies can survive from the earnings generated from operations in excess of depreciation and dividends, but, as even the Japanese have learned, markets change.[81] Debt that was attractive one year suddenly is noncompetitive the next. Even the most financially secure company must continually have access to capital markets in order to assure that it is using the most cost-effective capital at all times.

The definition of a financially successful company might be this: one with the ability to generate returns from new investment in its business that are substantially greater than the cost of obtaining the funds, on a continuing basis.

CASE IN POINT DAIMLER-BENZ AND THE NEW YORK STOCK EXCHANGE[82]

On March 30, 1993, Daimler-Benz announced that it would list its shares on the NYSE, making it the first German company listed on a US exchange. The move was highly significant because it showed that Daimler-Benz was prepared vastly to improve its financial disclosure in return for access to the United States' large and liquid capital markets.

The move was the result of lengthy discussions between Daimler-Benz management, then-NYSE Chairman and CEO William Donaldson, and then-SEC chairman Richard Breeden regarding disclosure requirements for the listing. While the final agreement involved compromise on all sides, it appears that the SEC for the most part held sway over the other two parties.

To list its shares on the NYSE, Daimler-Benz was required to provide greater financial disclosure than is required under German law. For years, the NYSE advocated that the SEC relax some disclosure requirements in order to attract foreign companies but the SEC remained steadfast.

According to the SEC, more than 200 foreign companies had listed on the US exchanges over the previous three and half years; however, no German company had ever done so. Several years earlier, six of Germany's largest listed companies (Daimler-Benz AG, BASF AG, Bayer AG, Hoechst AG, Siemens AG, and Volkswagen AG) approached the SEC as a united front, attempting to forge a compromise whereby German companies would not be subject to the complete SEC disclosure regime. This approach failed and Daimler-Benz decided to "go it alone." In a March 1993 press release, Gerhard Liener, Daimler-Benz's chief financial officer, said: "We were on the way to becoming a global company and I realized that I might have been caught in an anachronistic way of thinking. Just as English has become the language of international business, Anglo-Saxon

accounting has become the accounting language worldwide. I thought it was foolish to go on trying to play Don Quixote tilting at windmills."

The company's financial difficulties at the time might have contributed to a decision to create good news abroad. Net income for the group had fallen from DM1.9 billion ($1.15 billion) in 1991 to DM1.5 billion ($909 million) in 1992. Had the parent company not allocated DM4 billion ($2.42 billion) from hidden reserves in 1992, net income would have been DM703 million ($426 million) compared with DM1.19 billion ($721 million) in 1991. Unfortunately, the outlook for the following year was bleak: in April 1993, the group announced its forecast that income would fall to DM1 billion ($606 million) in 1993.

Factors affecting the German economy as a whole may also have influenced Daimler-Benz's decision. In the March press release cited above, Liener said: "[T]he agreement we have reached with the SEC gives us access to the world's largest and most dynamic stock market." In the 1980s, German companies were not strapped for capital resources since they had enough capital of their own to finance expansion. Furthermore, German companies have enjoyed solid banking relationships, which are strengthened by the fact that many German banks hold substantial, long-term stakes in a wide range of publicly listed companies.

It is absolutely clear that it was the discipline of American accounting standards that made the subsequent merger with Chrysler possible. Thus, the Daimler listing carries implications for corporate governance worldwide. As competition for global capital increases, corporations will be forced to make concessions to the providers of capital.[83]

Daimler, by its NYSE listing, showed that it was willing to make significant governance concessions in the quest for new and cheaper investment sources. However, this was at least in part temporary. Though they promised at the time of the merger to continue to issue US-style proxy statements, in the year following the merger they did not. They had literally the best of both worlds – the increased access to capital and markets as a result of the US presence and the decreased transparency as a result of the European domicile. They had the best of one more world as well – reportedly, the executives appropriated the salary levels of their American counterparts. The benefits of the merger for other constituencies, like investors, employees, and consumers, were harder to see. In early 2007, Daimler announced that it was selling 80.1 percent of its Chrysler unit to US private equity firm Cerberus Capital Management LP. Daimler estimated that it will end up paying out about $650 million to close the deal and that its earnings for 2007 will take a $4 billion to $5.4 billion profit hit because of charges related to the transaction.

Transparency (disclosure) and good governance can produce a lower cost of capital, as equity markets increasingly recognize the value of reduced agency costs. However, it may be a while before that becomes clear.

In 2000, shareholders protested as it became clear that the "merger of equals" was really a takeover. American shareholders found that they had relinquished most of their rights to protest by allowing the merged company to be organized under German law.

> Compare this with the impact of Sarbanes–Oxley, which is popularly considered to be a significant factor in the drop in non-US companies deciding to list on American exchanges. This is a "race to the bottom" on a global scale and should, if markets are truly efficient, result in a premium for companies subject to more stringent disclosure rules, as long as the market considers the information to be relevant. ■

CORPORATE "EXTERNALITIES"

Each business imposes costs that are not usually reflected in its profit and loss statements. Some of this is tradition, some of it reflects the difficulty of valuing intangible elements, and some of it reflects the success of companies in having governments, regulators, and professional auditors make accommodating rules. These are "externalities," costs incurred by business but paid for elsewhere.

One of the co-authors of this book has created the Brightline simulation, a simplified but accurate model of a market economy in which businesses compete against each other for a fixed pool of consumers. Brightline currently models five companies that can be customized by the user. Additionally, the shareowners (owners) of one of the five companies are given the potential to become actively involved in running the company, should the company's performance fall below their expectations. The company assigned to have potentially active shareholders will be called the "Focus" company. Variables that can be used to show different outcomes include: interest rate used for discounting, investment time horizon, customer brand loyalty, shareholder reactivity, government vigilance, supplier selection mode, shareholder anger mode, and company management aggressiveness.

Perhaps the most important factor to keep in mind about accounting principles is the way that executive compensation creates perverse incentives with regard to financial reports and financial reporting creates perverse incentives with regard to compensation. GAAP provides a range of choices. We often see choices made to skew or manage financial reports to support achievement of goals to trigger incentive pay.

> Given existing systems of executive compensation, the more management retains complete discretion over the choice of accounting principles (as it does even after Sarbanes–Oxley), the more further scandals seem inevitable.
>
> *John Coffee*

EQUILIBRIUM: THE CADBURY PARADIGM

Corporations must balance many competing considerations: long- and short-term notions of gain, cash and accounting concepts of value, democracy and authority, and, as we said in the title of our first book, "power and accountability."

The intricate equilibrium of corporations has been particularly well described by Sir Adrian Cadbury, following a tradition that extends for two generations before his birth. Sir Adrian's

grandfather refused to provide Cadbury chocolate to British troops in South Africa in protest against the Boer war.

From his base in the United Kingdom, Sir Adrian has provided world-class leadership and guidance with respect to corporate governance. He has been the notably successful CEO, and then chairman, of Cadbury Schweppes, a non-executive director of IBM Europe and the Bank of England, and chairman of the Cadbury Commission, which in 1992 published governance guidelines for the UK.

In his classic study, *The Company Chairman,* Cadbury identified multiple levels of responsibility in the corporation:

> *In practice, it is possible to distinguish three levels of company responsibility. The primary level comprises the company's responsibilities to meet its material obligations to shareholders, employees, customers, suppliers and creditors, to pay its taxes and to meet its statutory duties. The sanctions against failure to match up to these relatively easily defined and measured responsibilities are provided by competition and the law.*
>
> *The next level of responsibility is concerned with the direct results of the actions of companies in carrying out their primary task and includes making the most of the community's human resources and avoiding damage to the environment . . . . Beyond these two levels, there is a much less well-defined area of responsibility, which takes in the interaction between business and society in a wider sense. How far has business a responsibility to maintain the framework of the society in which it operates and how far should business reflect society's priorities rather than its own commercial ones?*

How do we determine the answer to Cadbury's question? Who should be responsible for answering it?

CASE IN POINT JOHNSON & JOHNSON[84]

How much is the confidence of the marketplace worth? How should a company "invest" in gaining and maintaining that confidence? How does a company respond when confidence has been shaken?

Johnson & Johnson faced two crises with its Tylenol product, the first in 1982 and the second just four years later. The episodes show how a company can respond to an almost instant evaporation of consumer confidence by demonstrating to the public that it is more interested in safety than profits.

In 1982, seven people died after taking tampered Tylenol. One variety of the product was sold in capsule form and the capsules could easily be opened. It was clear that

the poison had been inserted in the capsules after they left Johnson & Johnson. Sales of the product plummeted. Johnson & Johnson recalled all of their Tylenol capsules and introduced new "tamper-resistant" packaging, so that consumers could know if a bottle had been opened prior to purchase. The company was able to regain market share despite the initial drop in sales.

By 1986 Tylenol had regained a 35 percent share of the $1.5 billion nonprescription pain-reliever market, as big a share as the product had achieved before the 1982 crisis. Tylenol was Johnson & Johnson's most profitable single brand, accounting for some $525 million in revenues in 1985. The capsule form accounted for roughly a third of that. When, in February 1986, it became known that a New York woman died of taking cyanide-laced Tylenol, those revived revenues were threatened. The incident became more serious when a second bottle of adulterated capsules was discovered in the same Westchester village.

The questions facing Johnson & Johnson were these. Should the company launch another all-out offensive to calm consumer fears or could the company get by with less drastic damage limitation? Did a pair of contaminated bottles in a New York suburb warrant a nationwide campaign to withdraw the capsules? According to the *New York Times*, chairman James E. Burke's aim was to strike a balance "between what is good for consumers and what is good for Johnson & Johnson."

Johnson & Johnson did indeed withdraw all Tylenol capsules from the nation's shelves and replaced them with new "caplets." These were coated tablets that were safer from contamination. The full withdrawal, which could have cost the company's shareholders $150 million, or one-quarter of Johnson & Johnson's 1985 earnings, was deemed necessary in the light of bans in 14 states on the sale of Tylenol and a drop in sales similar to that following the 1982 crisis.

In an interview with the *New York Times*, James Burke said that the company's decision making was argumentative and aggressive. Discussions were characterized by "yelling and screaming," he said. Some executives pressed for the withdrawal and discontinuation of the capsule product. Others argued that an isolated incident in a small town did not merit a national campaign.

The decision to withdraw the capsules was encouraged by a $4 fall in Johnson & Johnson's stock price in the days following the death of the Westchester woman.

The company launched a massive publicity campaign to defend the Tylenol product, led by James Burke himself. The company held three news conferences and Burke made over a dozen television appearances.

Did Johnson & Johnson act in the interests of the company's customers or shareholders? To what extent are those interests mutually exclusive? To what extent are they inextricably linked? ■

The American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (1994)

Sec. 2.01 The Objective and Conduct of the Corporation

(a) Subject to the provisions of subsection (b) and section 6.02 (Action to Directors That Has the Foreseeable Effect of Blocking Unsolicited Tender Offers), a [business] corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.

(b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:

(1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law;

(2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business;

(3) May devote a reasonable amount of resources to public welfare, humanitarian, educational and philanthropic purposes.

The only qualifications to shareholder primacy and profit maximization are that these aims should be achieved within the boundaries of the law; taking into consideration ethical considerations; ensuring responsible conduct of business; and that a reasonable amount of resources be given to public welfare, humanitarian, educational, and philanthropic purposes. (emphasis added)

Read that last paragraph again. How would you, as director or manager, use that standard to evaluate competing priorities? How would you, as investor, want them to? How is this standard either possible or enforceable? ■

Accountability requires not just a mechanism, but also a standard. That standard is usually described as “maximizing long-term returns for the owners.” (Milton Friedman adds “within the limits of the law,” but we believe that compliance with the law is assumed as a part of value maximization.) The relationship of any particular corporate action to shareholder returns does not have to be immediate or direct. Corporations can give away money, voluntarily increase their workers’ compensation over required, or even competitive, levels, spoil their customers, and act as benefactors in the communities where they function, all to the extent that these activities can be credibly related to increasing the long-term value of the enterprise. To the extent that they drive up costs to make the company’s products and services less competitive, they cannot be credibly related to profit maximization.

The extent to which corporations can pursue objectives that are by definition not related to value generation must be severely limited, both as a matter of legislated and economic rules. Compare the current corporate system with the prevailing Western system of political legitimacy and accountability. We allow the legislature to make economic trade-offs. We give this level of authority to the government, which derives its legitimacy from its accountability through the political process.

When it does not earn that legitimacy, the citizens disregard the laws and create a new government. We have laws allowing a certain level of permissible emissions from factories, despite documented health risks and attendant costs, after determining that those costs are exceeded by the benefits of the factory's products and jobs (and contributions to the tax base). The US has refrained from imposing especially onerous environmental laws like the German law requiring that all materials involved in the production process be recycled. This calculus will shift when additional data about the impact of pollution become both a health and safety and a reputational concern.

As in the political domain, in the corporate domain accountability should be based on a comprehensible standard that is widely understood. It can be argued that employees, customers, suppliers, and the residents of host communities should share with owners the entitlement to hold corporations accountable. Yet to date, no one has developed a language of accountability that would be equally acceptable to all of these constituencies; indeed, no one has succeeded in conceiving of acceptable quantifiable standards. As Milton Friedman said, "Few trends could so thoroughly undermine the foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible."[85]

Friedman is too often cited in a simplistic way. He does not ask us to accept the narrowest definition of immediate profit as defined by accountants as the ultimate rudder for corporate direction, but we should recognize that the size and power of the corporate system tends to dominate the language of accountability.[86]

> *I submit that you cannot abandon emphasis on the view that business corporations exist for the sole purpose of making profits for their shareholders until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else.*[87]

ESG: ENVIRONMENT, SOCIAL GOVERNANCE – A NEW WAY TO ANALYZE INVESTMENT RISK AND VALUE

The nearly 400 signatories to the Principles for Responsible Investment include some of the largest institutional investors in the world, as a part of the United Nations Environment Programme Finance Initiative and the UN Global Compact. The principles they have adopted to promote better disclosure and management of environmental, social responsibility, and governance policies in portfolio companies provide:

> *As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:*

The list includes incorporating ESG issues into investment analysis and decision-making processes, being active owners to promote ESG policies internally and at portfolio companies, pushing companies for better disclosure, and seeking additional support from the investor community. They each also pledge to disclose their own efforts and the results.[88]

It makes sense that ESG would be of interest to investors. Even at its best GAAP is an asset and liability-based system that is not very revealing about potential risk factors. GAAP would tell you that BP is a $134 billion company based on its market capitalization and that it lost $85 billion almost overnight following the oil spill. However, an ESG assessment before the oil spill might have given investors, regulators, employees, and communities a better sense of its investment and liability risks and an ESG assessment afterward might better reflect actual value than the volatility of news-related market swings.

As with GAAP, though, it is easier to know what we would like to understand than it is to figure out what data will be available, accurate, and meaningful. One of the most widely accepted approaches is the Global Reporting Initiative, developed by representatives from 60 countries, which has guidelines for reporting on corporate sustainability.[89] Sample reports are posted on the online supplement for this text.

In *One Report: Integrated Reporting for a Sustainable Strategy*, Harvard Business School professor Robert G. Eccles and Grant Thornton partner Michael P. Krzus describe the opportunities for better, more informative reports made possible through technology. They argue that these benefit both those inside and outside the company in clarifying progress and direction. GAAP is still based in a nineteenth century concept of corporate value and a nineteenth century capability of reporting frequency. Eccles and Krzus advocate "moving from a periodic static document to ongoing reporting, which can only happen if sustainability is embedded in a company's strategy."[90] Like all financial reports, this is not only a way to communicate; it is a discipline. The first of the Dow Jones Industrial Average companies to adopt the One Report system is United Technologies. Their first report included traditional financial indicators like revenues and earnings as well as sustainability-related items like fuel and emission reductions in a new jet engine and a reduction in lost workday incidences, and reduced environmental impact of its operations. The essential information was included on one "at-a-glance" page of bar and pie charts and there were separate reports on each business unit. Furthermore, the company was candid about its successes and failures in achieving previous objectives and about its benchmarks going forward.

Google Finance listings now include a carbon disclosure rating as one of the "key stats and ratios." Companies that do not file the report get a blank space. *What other ESG indicators will show up as "key" in the next ten years?*

CASE IN POINT SOCIALLY RESPONSIBLE INVESTING

A 2002 book by Peter Camejo, *The SRI Advantage: Why Socially Responsible Investing has Outperformed Financially*, documents the way that socially responsible funds (screening out companies that violate environmental and other laws, use child labor or sweatshops, discriminate in hiring, produce products detrimental to society, or engage in objectionable practices) have higher returns and lower risk than funds that do not screen for these

factors. He predicts that "the current conflict between economic forces destroying the natural world to achieve short-term profit gains and the inevitable counter-movement to preserve natural equity and thus our economic well-being for the long term can lead to a multi-decade period of superior performance for SRI funds." He says that socially responsible investing "reveals a link between existing mass social trends and the financial performance of corporations" (emphasis omitted). He argues with Milton Friedman's claim that it is "subversive" for corporate managers to have any goal but making as much money for their stockholders as they possibly can. It may be that their views are not as diametrically opposed as Camejo thinks, however. Indeed, Camejo's use of the vocabulary of investment and economics shows that it is really not an argument about the purpose of capitalism but just an argument about how best to achieve that purpose. The very subtitle of his book makes that clear – after all, it isn't called "Why Socially Responsible Investing Is a Good Thing even if You Don't Make Any Money At It."

In 2010, Walden Asset Management, a "social responsibility" fund manager, submitted a shareholder proposal asking for a sustainability report from Layne Christensen Corporation, which provides drilling and construction services in two principal markets: water infrastructure and mineral exploration, as well as providing unconventional natural gas services for the energy market. The proposal asked the company to measure, evaluate, and disclose environmental, social, and governance factors that could impact long-term business success. It received a 60 percent vote from shareholders. Walden lists the advantages of sustainability reporting:

- Executives in hundreds of companies have noted that the reporting process helps companies better integrate and gain strategic value from existing corporate responsibility efforts, as well as identify gaps and opportunities for improvement.
- Comprehensive ESG reporting helps companies demonstrate that they have in place effective internal controls for anticipating, managing, and reporting on operational, regulatory, and reputational risks and opportunities.
- Finally, increased transparency helps to develop employee satisfaction and loyalty, build community support, and provide a venue for the company to publicize innovative practices.

At this writing, nearly 80 percent of the largest 250 companies worldwide issued corporate responsibility reports, up from about 50 percent in 2005. ■

The quotation from Adrian Cadbury above speaks of a second level of company responsibility: considering the implications of a corporation's operations on the rest of society. Certainly, some corporate operations may have an adverse impact on society. In some cases, corporations pay for this cost; in others, society as a whole absorbs the cost. Examples include the EPA standard setting an acceptable level for the odor of emissions from paper mills and the wrongful death statutes limiting the amount of recovery for human lives in coal mining accidents.

In theory at least, the government is in the best position to decide which aspects of corporate cost should be charged to the enterprise. The two examples in the last paragraph illustrate this point. In the United States, environmental and occupational safety standards are set by the legislature and regulatory agencies. However, many securities rules are set by the "Self-Regulatory Organizations" made up of the regulated community, whose proposals are routinely rubber-stamped by the SEC.

Some companies have made significant, if sporadic, efforts over the past decades to reflect the "real" (in contrast to GAAP) cost of their operation. During the administration of US President Jimmy Carter, Commerce Secretary Juanita Krepps actually proposed a formal methodology for "social accounting." The report declared that "changing public expectations of business" demanded that corporations reveal such information as: "the impacts of day-to-day business activities on the physical environment, on employees, consumers, local communities and other affected interests."[91]

One attempt to design a "social responsibility accounting" proposes the following characteristics of a social report:

1. Each report should include a statement of its objectives which allows (*inter alia*) the assessment of the grounds for data selection and the reasons for the form of presentation chosen.
2. The objective of a social report should be to discharge accountability in the spirit of improved democracy.
3. The information should be directly related to the objectives held for the particular groups to whom it is addressed.
4. The information should be *unmanipulated* and readable by a non-expert. It must be audited.[92]

You should know that the authors themselves acknowledge that there may be some internal inconsistency between these requirements, and indeed some conflicts of interest between the intended readers of such a report. However, the authors conclude that "These are matters outside the model itself. We seek information to discharge accountability, what society does with that information has to be society's concern."[93]

South Africa's Triple Trust Organization set forth its social accounting procedure this way:

- TTO board decision to begin social accounting process.
- Identify facilitators with social accounting expertise.
- Distill social objectives from TTO mission and values.
- Identify key organizational stakeholders.
- Consult stakeholders about social performance indicators.
- Design questionnaires or interviews to measure performance.
- Set a meaningful and manageable sampling frame for each stakeholder group.
- Gather stakeholder feedback through external facilitators and staff.
- Analyze data and write social accounts (report).
- Have external auditor verify the accounts.
- Board and management respond to issues raised in the accounts.
- Publish the accounts.

The broadest-ranging effort to try to account for nontraditional financial measures is that of the Global Reporting Initiative, which states, "GRI's vision is that reporting on economic, environmental, and social performance by all organizations is as routine and comparable as financial

reporting." Its extensive and constantly upgraded reporting guidelines are, at the time of this writing, 94 pages long.

What are the advantages and disadvantages of these approaches? Note that in the first example, the report is to a broad "democracy" rather than to shareholders, directors, employees, the government, or any other specific group. What obstacles do you see to putting this approach into practice? What liability issues does it raise?

A recent study concluded that companies that make a public commitment to social responsibility outperform those that do not.[94] One example of such a public commitment is Johnson & Johnson, which has its statement on its website. It details community services that include $176 million in cash and product contributions, emphasizing programs that assist mothers and children, but including programs in the areas of health, safety, education, employment, the environment, culture, and the arts.

Wisely, Johnson & Johnson does not try to quantify the costs, the benefits, or the net of these endeavors. Attempts to do so have looked like financial economist Ralph Estes's "comprehensive social accounting model,"[95] which is better at listing topics to be covered and constituencies to be considered than in explaining how the items are to be quantified.

QUANTIFYING NONTRADITIONAL ASSETS AND LIABILITIES

When should corporate management pursue objectives that are not directly and immediately correlated with profit maximization?

This is the third level of corporate responsibility mentioned above by Adrian Cadbury: "How far has business a responsibility to maintain the framework of the society in which it operates and how far should business reflect society's priorities rather than its own commercial ones?" Johnson & Johnson's "credo," posted on its website in dozens of languages, explicitly ranks its constituents as follows: consumers, employees, communities, and then shareholders, and concludes, "When we operate according to these principles, the stockholders should realize a fair return."

David Engel has provided a magisterial analysis of the answer to this question.[96] In the earlier discussion of "balancing interests," we considered the limits to the scope of corporate managers' discretion. Nobody elected them to make social decisions. The legitimacy of corporate power requires that it be limited to business and not extend to the trade-offs necessary to balance competing social goals. Engel concludes that there are four general areas where extra value maximization objectives are justifiable.

1. Obey the law. This may appear to be a relativistic command, but Engel argues that it is absolute. In many instances, a corporation can make a cost/benefit calculation and conclude that it is cheaper to break the law than to obey it. This involves weighing the costs of compliance against the probability of getting caught, plus the costs of attorneys' fees, lost time, and damages that would be awarded. Engel argues that corporations, in using such analysis, will ultimately run the risk of subverting the "legitimacy" of the societal base that is, in turn, a necessary precondition for profitable corporate operations.

The "law" underlying the legitimacy of capitalism is the existence of competition. To the extent that markets are not free, prices fixed, or territories divided, the justification for the profit

structure of business disappears. One high-profile crime in the post-World War II era was the electrical price-fixing scandal of the late 1950s, which stole more money from Americans than all of the robbers of that era. It was unusual in its scope, and even more unusual because several executives of General Electric and Westinghouse went to jail.

CASE IN POINT PRICE FIXING

In the years 1959–60, government investigators unraveled the largest price-fixing and market-rigging conspiracy in the 50-year history of antitrust law. The conspiracy aimed to divide up the $17 billion market for power generating equipment and electrical goods. Among the indicted companies were the two giants of the industry, Westinghouse Electric Corp. and General Electric Corp.

In 1959, the Tennessee Valley Authority (TVA), which operated the largest electrical generating capacity in the United States, asked for bids on a hydroelectric turbine generator for its Culbert Steam Plant. General Electric and Westinghouse offered (secret and sealed) bids of over $17.5 million. To the fury of those two companies, TVA awarded the contract to a British firm that bid a little over $12 million. GE and Westinghouse sought to have the award overturned as prejudicial to "national security" since they would be unable to repair foreign equipment in times of national emergency.

TVA explained why it had gone abroad for the contract: "For some time, TVA has been disturbed by the rising prices of turbo generators. There are only three American firms that manufacture large turbo generators. Since 1951, the prices charged by these manufacturers for such equipment have increased by more than 50 percent while the average wholesale price of all commodities has increased only 5 percent."[97] Between 1950 and 1956, GE and Westinghouse had increased prices on power transformers six times, one firm copying the other's price increase within days. Between 1946 and 1957, prices on large turbines had been raised ten times.

The story instantly aroused the interest of Tennessee Senator Estes Kefauver, chairman of the Senate Subcommittee on Antitrust and Monopoly. He quickly announced an investigation into the pattern of identical bidding. An investigation into TVA's records found 24 instances of matched bids in just over three years. Some of these bids were the same down to the nearest hundredth of a cent. These were all secret, sealed bids.

The examination of TVA's records also found:

- *Circuit breakers:* Identical bids of $21,000 were submitted by GE, Westinghouse, Allis-Chalmers and Federal Pacific.
- *Suspension circuit breakers:* Eight identical bids of $11,900.
- *Condenser tubing:* Eight identical bids quoting prices down to the last thousandth of a cent.[98]

TVA was not the only organization to complain. Many local, state, and other federal agencies backed up TVA's complaint, saying they had also received a series of similar bids.

In July 1959, the Justice Department announced that a federal grand jury in Pennsylvania was investigating the bidding for possible antitrust violations. In February 1960, the jury handed down the first seven of what would amount to 20 indictments. By the end of the summer of 1960, 29 electrical manufacturers and 45 of their executives had been indicted. The government alleged that the effect of the conspiracy had been to raise the price of electrical equipment throughout the country to high, fixed, and artificial levels, as price competition was restrained, suppressed, and eliminated.

As antitrust law had developed until this point, corporations generally offered one of two responses to an antitrust indictment. First, they could plead guilty and pay the fine. As one author describes, "Between 1890 and 1959, whenever a fine was imposed, it was paid, almost happily and cheerfully, as a cost of doing illicit business. Prison sentences were seldom imposed and usually suspended. Somehow the violation of the antitrust law never was considered more than a gentleman's misdemeanor – and a gentleman was never sent to jail for violating the antitrust law. Being indicted under the Sherman Act was regarded as nothing more than a bad corporate cold, which could be shaken off by the payment of a nominal number of dollars."[99]

Second, corporations could plead *nolo contendere*, literally, "I do not contest." Because this plea did not admit guilt, any party seeking damages would have to prove wrongdoing. In other words, a *nolo* plea put the burden of proof on the damaged parties. As a result, *nolo* pleas were common in antitrust cases.

Initially, Westinghouse and General Electric did not feel they had too much to worry about – just a "bad corporate cold." They had violated antitrust laws before and would no doubt be accused of doing so in future. As the evidence grew in 1959, however, the giant electric companies began to get worried.

In March 1960, the companies were arraigned on the first seven charges, considered by the government to be the most serious. Westinghouse and GE pleaded not guilty; every other company pleaded *nolo.* The government believed the charges were too severe for a *nolo* settlement and took the unusual step of asking the judge not to accept such pleas. Assistant Attorney General Robert Bicks, head of the antitrust division, told the judge: "The Attorney General states his considered judgment that these indictment charges are as serious instances of bid-rigging and price-fixing as have been charged in the more than half-century life of the Sherman Act."[100] In other words, the government wasn't charging the electric companies with mere technical violations of the Act, as was usually the case. They had evidence of serious and sustained criminal activity.

The judge granted the government's request to throw out the *nolo* pleas, leaving the corporations wondering if they could possibly win at trial. As the number of indictments increased through 1960, the corporations found themselves looking at a series

of trials that could last five years. Allis-Chalmers decided not to fight the battle and pleaded guilty to all charges. This undermined the defenses of the remaining companies. After the nineteenth indictment was handed down, Westinghouse and GE approached the government with a possible settlement. The companies would plead guilty on the most serious charges in exchange for a *nolo* plea in the remaining cases. After long negotiations, the government agreed, but insisted on guilty pleas in the seven most serious charges.

General Electric chairman Ralph Cordiner learned that GE was going to be deeply involved in the scandal in September 1959. The next January, he addressed GE's annual management conference on the subject of Business Ethics in a Competitive Enterprise System. He said: "The system will remain free and competitive only so long as the citizens, and particularly those of us with responsibilities in business life, are capable of the self-discipline required. If we are not capable of self-discipline, the power of the government will be increasingly invoked as a substitute, until the system is no longer free or competitive."[101]

In 1961, GE's stockholders met for their first annual meeting since the indictments. The next day, the *New York Times* editorial page carried the following comment. "Unhappily, little recognition of this responsibility [to inspire public confidence] manifested itself at the annual meeting of GE stockholders.... For a company with nearly half a million share owners, the meeting had too much of a rubber-stamp quality to provide an inspiring demonstration of democracy at work in the corporate field. It merely supplied fresh ammunition for those who doubt the moral underpinnings of our industrial society."[102]

The Westinghouse annual meeting was not so uneventful. A shareholder made a motion from the floor for the company's three top executives to resign. A second proposal called for a committee of directors to determine if management should have known what was going on. The resolutions were defeated by overwhelming margins.

By the end of 1964, GE had settled about 90 percent of its lawsuits, paying out about $200 million. Westinghouse settled about the same for $110 million. The total settlements for the industry were about $500 million.

Note: Compare this with the antitrust lawsuit brought against Microsoft by the Justice Department in 1997, alleging that it violated a 1994 consent decree governing bundling of its products. The Justice Department and 17 state attorneys general asked the court to break the company into two parts: one company to develop and market the Windows operating system and the other to develop Microsoft's other software and internet holdings, including the Microsoft *Office* suite of programs. The court agreed, Microsoft appealed, millions of dollars were spent on legal fees, a new President was elected, and the effort to split the company was abandoned. Compare, too, with the trials of executives of Enron, WorldCom, and HealthSouth. ■

2. Disclose information about social impact beyond the minimum requirements of law that relate to the impact of corporation on society. Full disclosure at the outset may result in fewer sales in the short term, but it will contribute to a society in which the legitimacy of corporate power is more generally conceded than when there are surprises. There are many recent examples of companies that learned the hard way that it is cheaper to disclose negative information than to suppress it: They include Dow Corning's research on the health hazards of its breast implants, A.H. Robins' research on its intrauterine contraceptive device, tobacco companies' research on the harmful effects of tobacco, and Beech-Nut's evidence that it was manufacturing adulterated apple juice.

3. Dramatically reduce corporate involvement in politics. In the past decade, we have witnessed the consequences of incest between the state and its corporations with the virtual collapse of the Italian state and economy and the humiliating defeat of the LDP party in Japanese elections. In the United States, the problem is demonstrated by the level of political action committee campaign contributions, the increase in the expense and use of lobbyists, and the perception that government lacks the will and capacity to deal effectively with large companies. Corporations need to have some say in the government process affecting them, but not so much that they undercut the popular support for government in the process. It should not be so much that they undercut the judgment of government, either. When George W. Bush appointee (and former Congressman) Donald Rumsfeld became the Secretary of Defense, he tried to push through some reforms of the procurement and weapons systems but was stopped by established government contractors and the Congressmen and Senators to whom they gave millions of dollars. Rumsfeld tried to allocate more of his budget to the development of lighter, more maneuverable conventional forces and a rapid expansion of missile defense and military space programs. However, that meant scaling back existing big-ticket programs like Lockheed Martin's F-22 fighter plane and United Defense's Crusader artillery system to make way for next-generation systems. For the major contractors, this would mean giving up lucrative production contracts now for the promise of new projects down the road, a trade-off the industry did not want to make.

Rumsfeld's reform agenda ran into a brick wall on Capitol Hill and in the military services, each of which had their own weapons procurement priorities. Then, following the terrorist attacks of September 11, 2001, the Defense Department was given an enormous budget increase. The biggest beneficiaries, however, are existing systems, many of which were designed during the Cold War and have little or nothing to do with the fight against terrorism. Similarly, the pharmaceutical corporations have 625 registered lobbyists, more than one for each member of Congress, and a combined lobbying and campaign contribution budget in 1999 and 2000 of $197 million, larger than any other industry. Following the terrorist attacks and anthrax scare of 2001, they used those resources to push through additional protections for their industry, including exemption from antitrust regulations, reduction of the timetable for getting new drugs to market for treating the ills of biological warfare, and immunity from lawsuits for any vaccines they develop to combat bioterrorism. Senator John McCain (R-Arizona) condemned this effort as "war-profiteering."

Engel's point is echoed by Andrew B. Schmookler:

> *The protection of that equality, therefore, should be our first priority, even if that requires some sacrifice of other important rights. Two general principles would advance our democracy.*

> *First, access to political speech must not be apportioned according to wealth, at least in the publicly licensed broadcast media. If a corporation like Exxon buys time to broadcast a message with political import, there should be equal time provided (perhaps at Exxon's expense) for an opposing point of view. Defining political speech might not be easy, but it should not be impossible. Our legal system continually solves definitional problems of this nature. The right of free speech is sacred, but there is no reason it should be defined in a way that subverts one of its primary purposes: the protection of democracy. Exxon has the right to be heard. But let us hear also the voices of other people, though they lack Exxon's billions, on the same policy-related questions.*
>
> *Second, our political campaigns need to be completely insulated from private wealth. This is not easily achieved, but this, too, should be possible. Perhaps it could be achieved with some combination of free air time, public financing in proportion to registered voters signing petitions, and automatic public financing. In any event, it is incompatible with the principle of democracy for a candidate to have an advantage over an opponent because the supporters of the one are rich and those of the other are poor.*
>
> *Let us not despair of the possibility of democracy. We have yet fully to try it.*[103] ”

4. *Adhere to the "Kew Gardens" principle.* In the late 1960s, a young woman named Kitty Genovese returned to her apartment in the Kew Gardens section of New York City and was stabbed in broad daylight in the courtyard in full view of her neighbors, none of whom did anything to save her as she slowly bled to death. She became a symbol of the tragic consequences of failing to act. Engel argues that corporations should act when failing to do so would certainly create serious damage for society.

These four "Engel principles" form the critical basis for developing a theory of performance measurement for corporations because they reveal the need to limit corporate power to a known, definable, and limited sphere. With these principles in place, it is time to turn to the people who make and monitor these decisions: managers, shareholders, and the board of directors. First, however, is a brief discussion of global forces.

FUTURE DIRECTIONS

As corporations expand their operations and markets into virtually all parts of the world, we must begin to develop a more consistent and coherent approach. To do that, we must, whenever possible, integrate the most important legislated standards with the realities of the economic laws, so that all incentives promote the priorities we agree on, without perverse incentives or unanticipated consequences. The law should be process oriented, not substantive. It should be focused on results, not structures. Structural requirements can always be subverted and too often even the best-intentioned of them end up impeding innovation. The focus should be on the relationships between the corporation and its constituents, to reduce conflicts of interests (agency costs) and make sure that the right people are making the decisions (or at least are able to monitor the results of the decisions) that affect them most.

One of the problems that is presented by this task is finding some way to balance the need for long-term planning with the need for present-day certainty that whatever is planned for the

long term is indeed likely to happen. Corporations must have as their primary and overriding goal the generation of long-term value. A commitment to the satisfaction of employees, suppliers, customers, and the community is essential for achieving this goal, but calibrating that commitment to achieve maximum value in the long term is a daunting task. No one can predict the future. In the past decade alone we have seen both new and long-established corporations achieve market dominance and extraordinary growth and vitality, only to fall into disaster, sometimes beyond recovery. How do we know that today's commitment to a long-term research and development project is going to produce a Dell instead of an Atari? More important, how can our laws best be designed to increase the likelihood that it will be the former instead of the latter?

The World Bank has an extensive governance program for developing economies that the established economies would do well to follow. Instead of prescriptive structures, the World Bank encourages countries to develop their own systems that meet three key goals: transparency, independent oversight, and accountability. The Global Corporate Governance Forum (www.gcgf.org/), co-sponsored by the World Bank and the OECD, is a new international initiative that brings together the leading bodies engaged with governance reform worldwide – multilateral banks active in developing countries and transition economies, international organizations, country groupings – alongside professional standards setting bodies and the private sector.

The Forum has been established to provide assistance to developing transition economies on corporate governance. It has three functions: to broaden the dialogue on corporate governance; to exchange experience and good practices; and to coordinate activities and identify and fill gaps in provision of technical assistance.

Through other international efforts, from the International Accounting Standards Board to the International Corporate Governance Network, global corporations and investors are working to develop systems that meet the needs of individual cultures and economies while making the best possible use of international capital sources.

SUMMARY AND DISCUSSION QUESTIONS

Chapter 1 sets the stage for the topics ahead by covering the theoretical constructs that led to the modern corporation and the history of its evolution.

What conflicts does the market resolve most efficiently and what requires government intervention?
The chapter is organized around the following major themes:

- How do we make sure that the corporation adds the maximum value to society?
- How do we measure corporate performance? What do we want and how do we determine how far we have achieved it?
- How do we determine the role and the impact of the range of corporate "constituents," including its directors, managers, employees, shareholders, customers, creditors, and suppliers, as well as the members of the community and the government?

We look at the pros and cons of each of the four elements Robert Clark identified as the essential attributes of the corporation:

1. Limited liability for investors;
2. Free transferability of investor interests;
3. Legal personality (entity-attributable powers, life span, and purpose);
4. Centralized management.

The metaphors for the corporate role and structure are reviewed: the corporation as "person," as "complex adaptive system," as "nexus of contracts."

Which is most apt? Which is most complete? What are the overlaps and what are the conflicts?

What we have covered so far addresses the problem of finding the right way to motivate corporations – or, more particularly, their executives, directors, and shareholders – and looks especially at the meaning of the famous quote:

> "Did you ever expect a corporation to have a conscience, when it has no soul to be damned and no body to be kicked?"
>
> *Edward, First Baron Thurlow, Lord Chancellor of England*

Discussions of corporate ethics and morality should be seen as risk management within the context of the corporation's own sustainability (including reputation and brand) and a question of minimizing externalities. (See the case studies on Massey Energy, AIG, GM, Sears, and Lehman Brothers for illustrations of failures of risk management.)

What are the most significant and effective limits on the exercise of corporate power? The market? The government?

The chapter asks:

- How do we make sure that corporate power is exercised in the best interests of society?
- How do we measure corporate performance?
- How should society measure corporate performance?

It focuses on the two key external mechanisms for directing corporate behavior: law and performance.

> *LAW*
>
> *What are the most significant laws imposed on corporations? How can a corporation be punished? Who should pay the penalty? What are some examples of successful and unsuccessful prosecution of corporate offenses?*

PERFORMANCE
Do provisions that encourage boards to consider the interests of stakeholders have any meaning? Do they allow or require directors operating under them to evaluate options any differently? Should they? Evaluate a proposed plant closing or acquisition as though you were a board member operating under such a provision and as though you were not.

Are the "best interests of the corporation" the same as the "best interests of the shareholders"? When do they differ? Who defines the competing interests? Who decides how to balance them? For what purpose? Consider these questions in the context of the debate about just what a corporation is. How do the answers differ if you think of a corporation as an "imaginary person"? A "bundle of contracts"?

Is it socially responsible to move jobs out of depressed areas? Is it socially responsible to stay in these areas if it means going bankrupt?

Discuss the prospects for global convergence of accounting standards and the pros and cons of non-GAAP measures of performance.

NOTES

1. See, for example, Ronald Coase, "The Nature of the Firm," *Economica*, 4 (1937), p. 386; and Frank H. Easterbrook and Daniel R. Fischel, "The Corporate Contract," *Columbia Law Review*, 7 (Nov. 1989), p. 1416. "The corporate structure is a set of contracts through which managers and certain other participants exercise a great deal of discretion that is 'reviewed' by interactions with other self-interested actors" (p. 1418).
2. A 1993 *Wall Street Journal* article noted that a variation on the corporate structure, the limited liability company (LLC), was "arguably the hottest thing in business start-ups today." A hybrid, which offers owners "the liability protections of a traditional corporation and the tax advantages of a partnership," was, at the time of the article, permitted in 35 states, up from only 8 in 1991. A 1988 IRS ruling that permitted LLCs to be treated as partnerships, so that each owner's profits are taxed only on his or her personal returns, and not double taxed, as with corporations, gives LLCs the advantages of partnership and the limited liability provides the advantages of incorporation. This has not been lost on entrepreneurs or on "scam artists." Regulators have claimed that fraudulent communications technologies firms have used the LLC to avoid state and federal securities laws. *Wall Street Journal*, Nov. 8, 1993, p. B1.
3. Opinion in *Louis K. Liggett Co. v. Lee*, 53 S. Ct. 487 (1932).
4. Ibid., p. 493.
5. Robert C. Clark, *Corporate Law* (Little, Brown & Co, Boston, 1986), p. 2.
6. Note, though, the widespread practice today of partners in professional firms (doctors, lawyers, etc.) each individually incorporating as a mechanism for minimizing both liability and taxes.
7. William Greider, *Who Will Tell the People? The Betrayal of American Democracy* (Simon & Schuster, New York, 1992), pp. 348, 349.
8. Frank H. Easterbrook and Daniel R. Fischel, "The Corporate Contract," pp. 1417–18.
9. This anecdote inspired the title of *Thirteen Bankers: The Wall Street Takeover and the Next Financial Meltdown* by Simon Johnson and James Kwak (Pantheon Books, New York, 2010), and is described on p. 9.
10. See, for example, Anne Murphy, "Too Good to be True?," *Inc.*, June 1994, p. 34.

11. A notable exception is the case of energy company AES, which disclosed in its IPO that its first goal was serving God and its second was having fun. Third on the list was creation of shareholder value.
12. Carl Kaysen, "The Corporation; How Much Power? What Scope?," in Edward S. Mason (ed.), *The Corporation in Modern Society* (Harvard University Press, Cambridge, 1959), p. 103.
13. Ibid., pp. 103–4.
14. Ibid., pp. 104–5.
15. Gordon C. McKibben, *The Cutting Edge: Gillette's Journey to Global Leadership* (Harvard Business Press, Boston, MA, 1998), p. 189.
16. Some sources argue that there cannot be a "race to the bottom" because if Delaware, for example, permitted laws that benefited management to the detriment of shareholders, then companies incorporated in Delaware would be at a competitive disadvantage in the capital market, and ultimately in the product market. See Ralph K. Winter, "State Law, Shareholder Protection, and the Theory of the Corporation," *Journal of Legal Studies*, 6 (1977), p. 251. This argument would have more weight if shareholders were able to change the state of incorporation, instead of just refraining from investing in companies incorporated in a particular state, or selling out once the state has adopted unacceptable new legislation.
17. http://www.pbs.org/wgbh/pages/frontline/shows/credit/more/rise.html.
18. "Principles of Corporate Governance: Analysis and Recommendations," American Law Institute (1992), Sec. 2.01.
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21. Martin Dickson, "GE Shares Dip on Fraud Allegation," *Financial Times*, June 3, 1992, p. 17.
22. See John Braithwaite, *Corporate Crime in the Pharmaceutical Industry* (Routledge & Kegan Paul, London, 1984), p. 258; and Marshall B. Clinnard, *Corporate Corruption: The Abuse of Power* (Praeger, New York, 1990), p. 103.
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24. John C. Coffee, Jr., "No Soul to Damn: No Body to Kick: An Unscandalized Inquiry into the Problem of Corporate Punishment," *Michigan Law Review*, 79 (1981), pp. 386, 387.
25. Statement of Douglas H. Ginsburg, Assistant Attorney General, Antitrust Division, before the United States Sentencing Commission, Hearings Concerning Alternatives to Incarceration, July 15, 1986.
26. "When very severe fines need to be imposed on the corporation, they should be imposed not in cash, but in the equity securities of the corporation. The convicted corporation should be required to authorize and issue such number of shares to the state's crime victim compensation fund as would have an expected market value equal to the cash fine necessary to deter illegal activity. The fund should then be able to liquidate the securities in whatever manner maximizes its return." John C. Coffee, Jr., "No Soul to Damn," p. 413, citations omitted.
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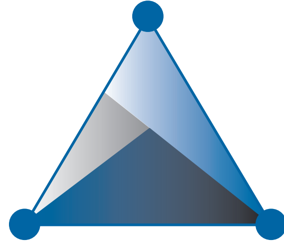
2
SHAREHOLDERS: OWNERSHIP



CONTENTS

- Definitions 105
- Early Concepts of Ownership 106
- Early Concepts of the Corporation 107
- A Dual Heritage: Individual and Corporate "Rights" 108
- The Reinvention of the Corporation: Eastern Europe in the 1990s 110
- The Evolution of the American Corporation 111
- The Essential Elements of the Corporate Structure 115
- The Mechanics of Shareholder Rights 117
- The Separation of Ownership and Control, Part 1: Berle and Means 118
- Fractionated Ownership 125
- The Separation of Ownership and Control, Part 2: The Takeover Era 129
- Waking the Sleeping Giant 134
- A Framework for Shareholder Monitoring and Response 140
- Ownership and Responsibility 141
- To Sell or Not to Sell: The Prisoner's Dilemma 143
- Who the Institutional Investors Are 144
- The Biggest Pool of Money in the World 154
- Public Pension Funds 169
- Private Pension Funds 201
- The Sleeping Giant Awakens: Shareholder Proxy Proposals on Governance Issues 206
- Focus on the Board 212
- Hedge Funds 220
- Synthesis: Hermes 221
- Investing in Activism 222
- New Models and New Paradigms 223
- The "Ideal Owner" 228
- Pension Funds as "Ideal Owners" 233
- Is the "Ideal Owner" Enough? 234
- Summary and Discussion Questions 236
- Notes 238

A scene in *Barbarians at the Gate* frames the problem of accountability of corporate management to investors. Then-RJR Nabisco CEO Ross Johnson, who somewhat impetuously initiated the leveraged buyout of his company, met with bidders Henry Kravis and George Roberts of Kohlberg, Kravis, Roberts, & Co. to discuss what the company would be like if it went private. There was a brief discussion of the business before Johnson's central question came up. "Now, Henry, if you guys get this, you're not going to get into [deleted] stuff about planes and golf courses are you?" Johnson's perquisites included corporate jets, having two domestic staff at his home on the company payroll, and membership fees at 24 country clubs.

Kravis was eager to gloss over this question, but Roberts was more candid. "Well, we don't want you to live a Spartan life. But we like to have things justified. We don't mind people using private airplanes to get places, if there's no ordinary way. It is important that a CEO sets the tone in any deal we do."

Johnson stated his concern more directly. "I guess the deal we're looking for is a bit unusual." Johnson, as it turned out, wanted to keep significant control of the company. Roberts responded even more directly: "We're not going to do any deal where management controls it. We'll work with you. But we have no interest in losing control."

Johnson asked why.

> *We've got the money," Roberts said. "We've got the investors, that's why we have to control the deal." From the look in Johnson's eyes, Roberts could tell it wasn't the message he wanted to hear. "Well, that's interesting," Johnson said. "But frankly, I've got more freedom doing what I do right now.*[1]

Why should debt holders have more control than equity holders?

Shareholders are often referred to as the "owners" of the corporation, but the corporation's "legal personality" raises questions about whether it can be "owned" in any meaningful and effective way. There will always be agency costs in any corporate structure in which someone other than management owns equity. Public companies have managers with agendas different from their owners'; the governance challenge is to make sure that the resolution of conflicts is an open and fair process between entities that are informed, motivated, and empowered. That challenge is primarily addressed by laws, most significantly the imposition of the highest standard of procedural and substantive performance ever developed under our legal system: the fiduciary standard. Fiduciaries have responsibilities based not just on contracts but on honor, integrity, trust, and ethics. In the famous language of future Supreme Court Justice Benjamin Cardozo, "Not honesty alone, but the punctilio of an honor the most sensitive."[2] Interestingly, this standard is imposed on the largest category of shareholders (institutional investors), corporate officers, and directors, even corporate executives.[3] Even more interestingly, there have been many efforts to erode this standard over the past 30 years.[4] Before we get to that, however, we will provide some larger context with a quick look at an even bigger problem with the fiduciary standard. The law often speaks of "enforceable" obligations, meaning those promises and duties that the law considers significant enough that if someone fails to do them, a court will either make sure they get done or require the defaulting party to pay damages. There is another "enforceability" issue – is the fiduciary standard meaningful if the entity with the right to enforce the obligations either cannot or will not do so? To put it another way, all shareholders other than the tiny category of individual

stock-pickers who invest directly rather than through mutual funds or pension funds, have their own parallel set of governance issues. A fiduciary can be like the tree that falls in the forest with no one around to hear.

CASE IN POINT — MIS-TRUST: THE MYSTERIOUS CASE OF THE HEARST WILL

Silver mine heir and press mogul William Randolph Hearst (the inspiration for the title character in *Citizen Kane*) took three years to prepare his last will and testament because he was so intent on making sure that it reflected his wishes for the disposition of one of the country's great fortunes. The document was 125 pages long, a record in California. It provided for stock grants that would give his children $30,000 income and generous salaries as long as they stayed with the company. However, the bulk of the fortune was put in trust, under the direction of fiduciary trustees. This will was designed to avoid taxes and retain control within the company itself, and not the family. The will even had an "in terrorem" clause, which means that anyone attempting to challenge the will would be immediately cut off from any benefit, and yet the trust was broken.[5] There were developments including closing the loophole that had permitted a charitable trust to have a nondiversified portfolio, so that inside control would no longer have been possible. There was also the problem that decades after Hearst's death, who was going to sue if the trustee decided to turn over to the family the very assets he took three years and 125 pages to keep away from them? ■

CASE IN POINT — HOW MUCH IS A FIDUCIARY WORTH – AND CAN HE CHARGE MORE THAN THAT?

Under Section 36(b) of the Investment Company Act of 1940, an investment advisor is subject to a fiduciary duty with respect to the fees it charges the fund for its services. The Act also requires that a board of trustees be appointed to oversee the fund annual review and approve the contract with the advisor as well as the amount of the advisor's compensation from the fund. When an advisor charged the individual investors in the fund fees that were not only in excess of competitors but more than the advisor charged its institutional clients, they filed a rare lawsuit, charging that the excessive

fees were themselves a violation of fiduciary duty. Instead of settling, the fund went to court, arguing that they had a right to any disclosed amount. The appeals court found in their favor, ruling that an investment advisor does not breach its fiduciary duty unless it fails to fully disclose the facts relevant to its fees to the fund's board of trustees. An analysis of the advisor's compensation from the fund is relevant under this ruling only if it is so unusual that it raises an inference that deceit must have occurred or that the fund's board of trustees failed to engage in an arm's-length negotiation of the fees.

The case went to the US Supreme Court, which ruled unanimously in March of 2010 that an investment advisor breaches the advisor's fiduciary duty under the Act if the fee it charges the fund is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining in light of all of the surrounding circumstances.[6] The burden of proof is on the plaintiff to show that the fees are disproportionate. The Court applied a process-oriented standard. The Court returned the case to the lower court for application of this standard.

How can the trustees be arm's-length if they are selected by the fund itself or the company that owns it and there is virtually no opportunity to replace them if investors are unhappy? ■

To put the role of the shareholders into context, we will spend a brief time on the overall issue of "ownership" to provide a context for the important role of the owners of public companies in legitimating private enterprise. We will also discuss their rights and responsibilities for market-based oversight to ensure efficient, sustainable allocation of capital and avoid moral hazard. Then we will explore the structural and practical limitations that interfere with effective oversight and the consequences of failure. These include: law (legislation, regulation, and judicial rulings), conflicts of interest, and the problem most often described as collective choice or the prisoner's dilemma or "rational apathy" – shareholders must pay all of the costs of oversight for only a pro rata share of any returns.

As you read through this brief background, keep the following questions in mind:

What problems with traditional notions of ownership was the corporate form intended to solve?

How was it intended to solve them?

What have been the consequences (intended and unintended) of this corporate model?

How do we determine who is in the best position to make a given decision, and does this person/group have the authority to make it?

DEFINITIONS

Generally, we think of ownership (O) of property (P) as including three elements:

- O has the right to use P as he wishes. If it is food, he can eat it or sell it. If it is land, he can build on it or grow crops on it.
- O has the right to regulate anyone else's use of P. If it is food, he can share it or not, as he pleases. If it is land, he can decide who may step over its boundaries.
- O has the right to transfer rights to P on whatever terms he wishes. If it is a product, he can limit the use of what he sells or loans. For example, he might stipulate that it may not be resold or restrict not just the purchaser but also all future purchasers from using the product for some purpose he does not wish. If it is land, O can keep the land while he gives or sells the right to take a shortcut across it or the right to extract natural gas or oil from it. This means that O's property may be subject to restrictions when he receives it or later, as a result of rights he grants or sells while he owns it. If there are apple trees on his property and he sells to a local farmer all the produce from the trees, he may no longer pick off an apple whenever he is hungry. He may not be able to cut a tree down if it blocks his view or he needs the wood.

There is less general agreement on a fourth component of ownership:

- O is responsible for making sure that his use of P does not damage others. As Supreme Court justice William O. Douglas put it: "My freedom to move my fist must be limited by the proximity of your chin."[7] If P is a dog, O is responsible for taking reasonable precautions for making sure P does not bite anyone. There are often specific statutory requirements limiting the use of property. Zoning laws may provide that O may not operate a business on his property, if it is in a residential district. Other restrictions may mean that he cannot build a structure that will block his neighbor's access to sunlight, play his radio so loudly that it disturbs his neighbors' peace, or create a dangerous "attractive nuisance" that will entice children on to his property. Environmental laws restrict O's ability to dump chemicals in a river that crosses his property. Balancing the right of O to use P with the rights of the rest of O's community has challenged the imagination of lawyers and lawmakers from the earliest notions of property.

Ownership is therefore a combination of rights and responsibilities with respect to a specific property. In some cases those rights and responsibilities are more clearly defined than in others. Much of the complexity that arises from ownership comes from the responsibility side of ownership. There is little ambiguity in owning a dollar bill or a laptop, for example. Neither imputes much in the way of responsibility to the owner (though O is not permitted to use the dollar to buy drugs or hire a hit man and may be expected to give some of it to the Internal Revenue Service and O is not allowed to use the laptop to hit someone or hack into someone else's P).

What does it mean to own part of something? Stockholders, for example, are deemed to "own" the company in which they invest. However, a share of stock does not translate into a specified segment of the company's assets, at least not unless the company dissolves and there is something left over after the creditors get what they are owed.[8] Shareholders have limited liability, limiting their opportunity to direct the affairs of the company and their responsibility to prevent or redress the corporation's wrongs. Limited liability does not extinguish responsibility for shareholders. It is the

shareholders' money that gets paid out when fines or other penalties are assessed. The responsibility of shareholders to participate in the direction of the company and the obstacles to doing so are questions we will explore further.

What does it mean to own a share of stock? What are the rights of share ownership and what are the responsibilities? Human beings relate in a special way to things that they own. Ownership is not only a measure of wealth; it is an element of personal satisfaction. Adam Smith believed that protection of an individual in his quiet enjoyment of property is one of the few legitimate activities of civil government.

> "*Wherever there is great property, there is great inequality. For one very rich man, there must be at least five hundred poor, and the affluence of the few supposes the indigence of the many. The affluence of the rich excites the indignation of the poor, who are often both driven by want and prompted by envy to invade his possessions. It is only under the shelter of the civil magistrate that the owner of that valuable property, which he acquired by the labor of many years, or perhaps of many successive generations, can sleep a single night in security.*[9]"

EARLY CONCEPTS OF OWNERSHIP

Ownership has been at issue since the dawn of human history. Disputes over property appear throughout the Bible, including bitter struggles over Joseph's coat and Jacob's inheritance. The early teachings of the Christian church were intensely hostile to individual ownership of property. The Gospels repeatedly warned that riches were a threat to salvation. "It is easier for a camel to go through the eye of a needle than for a rich man to enter the kingdom of God."[10] These invectives against ownership failed to take hold in the West, where a tradition going back to Aristotle viewed ownership of property and its involvement in the public good as the basis of a durable society.

The later eighteenth-century notion of property involved a direct relationship between the owner and the thing owned; Locke thought of property as legitimate only to the extent that it provided enough for personal sustenance. The right of individual ownership of property was deemed important because it assured that citizens could be protected in their independence from the monarchy and centralized authority.

The central tenet of the Western concept of ownership is that to the extent that individuals own property, they will have the incentive to manage that property in a manner that is compatible with the interests of society as a whole. Adam Smith wrote that even if a businessman "intends only his own gain, he is…led by an invisible hand to promote an end which is not his intention." Indeed, Smith believed, "by pursuing his own interest, he frequently promotes that of society more effectively than when he really intends to promote it."[11] This argument is still the foundation of government policies the world over, including privatization drives in such diverse countries as the United Kingdom and Chile. Former British Prime Minister Margaret Thatcher privatized state-owned UK industries for the same reason that Chilean Labor Minister Jose Pinera privatized Chile's social security system[12] – namely that the best way for a nation to achieve prosperity is to create a society of individual property owners pursuing their own interests.

Some cultures and some political systems are not based on ownership of property by individuals. Ownership has often been criticized throughout history as the expression of inequality

in a world where fair treatment should be the highest priority. Karl Marx's *Communist Manifesto* memorably declares, "The theory of Communism may be summed up in one sentence: Abolish all private property." The French anarchist Pierre-Joseph Proudhon went even further, "Property is theft." However, no one has figured out a way to do that on a country-wide scale without severe deprivation of human rights and an unsustainable economic model.

There are also complex hybrids and variations that can be the best – or the worst – of both worlds. In that latter category, exhibits A and B for the prosecution would be Fannie Mae and Freddie Mac, government sponsored enterprises (GSEs) that made a lot of money for shareholders, an enormous amount of money for executives, and then collapsed with a cost to the taxpayers of as much as $350 billion. These entities sold stock and paid their executives like public companies but had a special advantage over their competitors that essentially amounted to an exclusive and very lucrative competitive advantage. Other good and bad examples include regulated monopolies like the ratings agencies and the 1960s-era ATT, the Thatcher-era privatization of British Airways, British Airports Authority, British Petroleum, British Telecom, and several million units of public housing, tripling the number of British shareholders, state share ownership of public companies in China and Russia, and recent efforts by municipal and state governments by selling off their buildings and privatizing their prisons, parking enforcement, and water. *How do these different structures affect the rights of shareholders and their ability to provide oversight?*

There is a natural tension between freedom and equality. On the one hand, human beings must be free to express their individuality, and in so doing their differences – their inequality. On the other hand is the view that only equality is an acceptable basis for a civilized state. The conflict between these two views produces uncertainty about the value of individual contributions. Should people own according to their ability to pay or according to their need? The extreme at one end is shown by the failure of communism in Eastern Europe. The extreme at the other end is epitomized by Marie Antoinette, who is often quoted as saying that if the poor had no bread, they should eat cake.

EARLY CONCEPTS OF THE CORPORATION

The corporation could not exist without a notion of private property. If everything is owned by the king, it does not matter whether the ownership is direct or indirect, or whether it is possible for many people to share in the ownership of one entity. However, the corporation is a unique subset of the category of ownership, created for unique reasons, and having a unique character. It was created as a way of resolving some of the challenges presented by private ownership; it then created a new set of challenges of its own.

The first corporations were more like municipalities than businesses. They were towns, universities, and monastic orders founded in the Middle Ages. These were collective organizations – sometimes in corporate form – as a protection against the centralized power of autocrats and as a way to create a source of wealth and power that was free from royal domination. The key elements that made them corporations were:

- they existed independently of any particular membership and
- all assets and holdings belonged to the corporation itself, distinguishing them from partnerships.

John J. Clancy, in his thoughtful book about the language we use to talk about business, noted that the development of double-entry bookkeeping in the late Middle Ages "first developed to check

errors in accounts, became a technique to separate a man's business from his private life. The firm could then be seen as a separate entity, with an existence beyond the life of the owner/operator."[13] Sir William Blackstone, the great legal scholar, made his earliest reference to corporations in a judgment that King Charles I could not unilaterally abrogate the charter of the City of London.

The first joint-stock companies emerged in Britain and Holland during the early seventeenth century in response to the rapidly emerging markets of the East Indies and West Indies. In 1602 the Dutch East India Company was granted a royal charter, with permanent capital and shares of unlimited duration. The British East India Company had received its charter from Queen Elizabeth I two years earlier. A little over a century later in response to a speculative crash in the East Indies – known as the South Sea Bubble – the British Parliament passed a law (the Bubbles Act of 1720) which forbade unchartered companies to issue stock. This meant that all commercial enterprises that wished to raise capital from stock issues had to acquire a certificate of incorporation.

Corporate organization thus meant that property could be held subject to rules that transcended royal prerogatives and power. This kind of collective establishment of an entity that could limit interference by the monarch was the basis for the modern corporation. Corporate power – although limited in time, scope, and purpose – was designed to counter the otherwise unlimited centralized authority of government.

This posed a serious threat to government. Through the ownership of corporations, individuals acquired wealth, which gave them an independent source of power. The emergence of a "private sector" threatened not only the hereditary power of princes but also the wealth of the established church. The preponderance of gross national product would no longer automatically be available for the ruler's pet projects, whether the building of great cathedrals or the launching of Crusades.

> *Distrust of the state as organized caused the accumulation of political powers in the hands of minor states, corporations, which excited no apprehensions because they were democratically organized . . . . If the entire state had been formed and organized like the corporation, would not philosophers and political theorists have had to confess that it was an ideal state . . . ?*[14]

Although the independence of the corporate structure was a threat in the short term to a powerful centralized government, ultimately the corporate form became the government's ally. (If it had not, it probably would not have been allowed to continue.) The level of independence the corporate form provided made the government's authority more acceptable. Indeed, it made it more necessary. If the state permits private property, the government must be able to protect citizens in the useful enjoyment of that property. It must provide the "civil magistrates" that Adam Smith said owners must have in order to be able to slumber peacefully.

A DUAL HERITAGE: INDIVIDUAL AND CORPORATE "RIGHTS"

The struggle to hold property free from the demands of the state inspired European migration to the new world of the Americas and helped to inspire the Revolutionary War for independence. The United States Constitution and its Bill of Rights specifically protected property rights. "Property"

replaced the Declaration of Independence's "Pursuit of Happiness" as an "inalienable" (impossible to lose or take away) right that was protected and enforced by the state. The Constitution promised "life, liberty, and property" to every (white male) citizen of the new nation.

Over time, at least a part of this guarantee was extended to corporations as well, despite the fact that while "property" is prominently mentioned in the Constitution, the word "corporation" does not appear. Over the past century, the US Supreme Court has repeatedly ruled that certain Constitutional protections such as "freedom of speech"[15] and the right to the protections of "due process" in the taking of its property extend to corporations (creatures of law) as they do to natural persons. As noted in the opening section of this book, corporations have at least some of the same inalienable rights as people as well as many that people do not have, like perpetual life and limited liability.

Owners of corporations are thus heirs to a twofold tradition: on the one hand, they personally have rights as individuals and as owners of shares in a corporate entity; on the other hand, they receive the benefits of the rights extended to that entity. In this section of the book, we will explore this dual heritage. Alfred Conard points out that the development of this dual tradition has been far from straightforward. "[F]or a hundred years after the Constitution was written, Congress showed little interest in exercising its commerce power. Meanwhile, throughout the nineteenth century, the states built up their idiosyncratic patterns of legislation, their separate bureaucracies for dealing with corporation documents, and their addictions to tax revenues exacted for corporation privileges."[16] In 1819, the US Supreme Court decided the case of *McCullough v. Maryland,* where Chief Justice John Marshall posed the question, "Has Congress power to incorporate a bank?" While the court was more concerned with the issue of federalism and states' rights than with corporate law, the decision has some relevance here. Marshall said:

> *The power of creating a corporation, though appertaining to sovereignty, is not, like the power of making war, or levying taxes, or of regulating commerce, a great substantive and independent power, which cannot be implied as incidental to other powers, or used as a means of executing them. It is never the end for which other powers are exercised, but a means by which other objects are accomplished. No contributions are made to charity for the sake of an incorporation, but a corporation is created to administer the charity; no seminary of learning is instituted in order to be incorporated, but the corporate character is conferred to subserve the purposes of education. No city was ever built with the sole object of being incorporated, but is incorporated as affording the best means of being well governed. The power of creating a corporation is never used for its own sake, but for the purpose of effecting something else. No sufficient reason is, therefore, perceived why it may not pass as incidental to those powers which are expressly given, if it be a direct mode of executing them.*[17]

Ownership in general – and share ownership in particular – is necessary for the organization of talent, money, and other energies critical to technological and industrial progress. Allowing fractionated "ownership" through public offerings of stock enabled the access to capital that funded modern industry. The corporate structure was as important in transforming commerce as the assembly line. Both were based on the same principle, specialization. You didn't need to know how to make a chair to work in a chair factory; all you needed to know was how to put the chair leg into the chair seat. Also, you didn't need to know how to make a chair to invest in a chair company; all you needed to do was buy some stock.

This notion of stock ownership has been indispensable in the extraordinary rise of Western Europe and the United States over the past half millennium. With the opportunity through ownership to achieve wealth and independence, Western man was able successfully to motivate, discipline, and organize himself in competition with other cultures. Before we continue further with the Western model for corporations in modern times, we will take a brief look at the way that the corporate ideal is being reinvented as Eastern Europe tries to build it from scratch.

THE REINVENTION OF THE CORPORATION: EASTERN EUROPE IN THE 1990S

Some argue that the "progress" that made bigger, more complicated organizations possible produced bigger, more complicated problems. This debate is being carried on today in Eastern Europe and the component states of the former USSR. Their approach to property over the past three-quarters of a century was based on the communist ideal, which denied individuals most rights of ownership, leaving nearly all property in the hands of the state. The social, political, and economic failures of this system have presented the new leaders with an historic challenge – to examine the best and worst effects of the Western model of ownership and corporation laws and to devise a new system, improving it.

CASE IN POINT OF VOUCHERS AND VALUES – ROBERT A. G. MONKS VISITS VACLAV HAVEL

I visited Finance Minister Vaclav Havel of the then Czechoslovakia in February 1992 to discuss his program of privatization of the nation's economy. It was an exciting time. People spoke constantly about the details of vouchers and bids, various levels of value setting, and, most important, a complete change in their way of life. They aimed to convert their economy from a system of public ownership of the factories and stores in their traditionally wealthy country to one in which individuals for the first time in over half a century would become stockholders. In the West, the corporate structure evolved over time. The Czechs were starting a capitalist system from scratch. This was a moment truly worthy of the term "revolution."

The obstacles were enormous. All the incumbent bureaucratic managers were opposed; there was no way to set the value of the enterprises; nobody knew whether a particular business was profitable or not.

How could an individual afford to investigate and make the kind of informed decision that markets depend on? They couldn't. Instead, each Czech citizen was issued for a nominal amount a voucher book containing certificates entitling the bearer to an aggregate number of "points." This entitled him to "bid" for ownership in one or more of the

corporations to be privatized. Over a series of bids, values would be determined by the marketplace – supply and demand; the more "bid," the higher the value, and vice versa.

The details were overwhelming. Ultimately, in true free market fashion, a class of "fund managers" developed who would offer to buy the vouchers from individuals for many times their cost; the managers ultimately acquired a substantial portion of all the outstanding vouchers, giving them enormous leverage in the privatization process. All of this became clearer as events unfolded; little was known in advance. By the time of my visit, it was plain that there simply wasn't enough time or wisdom in the world to assure that the privatization process would be both "fairly" and "economically" administered.

I asked Minister Havel: "But how can you assure that the process will be fair?" He replied: "I have had to get beyond fairness. I can only hope that nothing too unfair occurs. What I have to accomplish is to get ownership into the hands of the Czech people within these precious days that my political support remains steadfast. *Once the people have become owners, nothing can stop the democratic revolution.*"

A 1997 study, "Ownership and Corporate Governance: Evidence from the Czech Republic" by Stijn Claessens, Simeon Djankov, and Gerhard Pohl, described the results of Havel's program. They found that mass privatization was effective in improving firm management because of the concentrated ownership structure that resulted. For a cross-section of 706 firms for the period 1992-1995, the more concentrated the firm's ownership, the higher the firm's market valuation and profitability. Large ownership through bank-sponsored investment funds and strategic investors appears to be particularly important in improving corporate governance and turning firms around. On balance, banks that had an (indirect) equity stake in a firm had a positive influence on the firm's corporate governance. Just as ontogeny recapitulates phylogeny, many of the emerging economies found that they could move quickly through the evolutionary stages of capitalism, but they could not skip them. We therefore see the twenty-first century equivalent of both the more benign structures, like the involvement of the banks as midwives to public corporations, as well as the less benign, like the robber baron equivalents of the new Russian economy.[18]

Compare this to the corrupt privatization efforts described as "briberization" by Joseph Stiglitz. ■

THE EVOLUTION OF THE AMERICAN CORPORATION

We need to go back more than 200 years before Havel's revolution to understand the way that the corporate structure evolved. America was born with a profound mistrust of power and an even more profound commitment to making sure that power drew its legitimacy from a system of checks and balances. One initial controversy that arose in the early 1830s concerned the charter of the Bank of the United States. The Bank, as originally chartered, was a private corporation though

it had the power to issue notes of exchange. The Bank was not taxed and Congress was not allowed to charter any similar institution. In return for these favors, the government was allowed to appoint five of the Bank's 25 directors.

The Bank's powers shocked democrats. Roger B. Taney, Congressman and later Chief Justice of the Supreme Court, said: "It is this power concentrated in the hands of a few individuals – exercised in secret and unseen although constantly felt – irresponsible and above the control of the people or the government…that is sufficient to awaken any man in the country if the danger is brought distinctly to his view."[19] This was a typical view of unchecked private power.

In the early days of the United States, corporate charters were granted by special acts of the state legislatures. Applicants for corporate charters had to negotiate with legislators to arrive at specific charter provisions, notes Harvey H. Segal, including "the purpose of the enterprise, the location of its activities, the amount of capital to be raised by stock sales, and the power of its directory."[20] The theory was that the state should separately and specifically approve each new corporation, to guard against improper activity. However, as Segal noted, instead of oversight, this process "invited bribery and corruption." Therefore, in 1811, New York enacted a general incorporation statute (though restricting it to manufacturing enterprises), and other states followed suit, but the state was still deeply involved.

> *Applications had to be approved by the state secretary, or by some other high official, who enforced firm rules such as the requirement that a minimum of capital had to be paid in before an enterprise could be launched and that delinquent shareholders would be held personally liable – up to the unpaid balances on their stock subscriptions – for any corporate debts. High taxes were levied, and there were also severe constraints on the kinds of securities – common stocks, preferred stocks, and bonds – that a corporation could issue.*[21]

After the Civil War, companies began to form "trusts." It was clear that if competitors in the same line of business worked together instead of separately, they could control prices. This was not illegal or even disapproved of at the time. Indeed, the directors of these new entities were called "trustees," a term that still lives on in the nonprofit, banking, and securities sectors. Segal points out that, "In wielding such broad discretionary power, the trustees established important precedents for the control of corporations by professional managers rather than dominant shareholders."[22] The first antitrust laws ended the trusts, but the professional managers were there to stay.

CASE IN POINT — STANDARD OIL AND THE ARRIVAL OF BIG BUSINESS

In the 1870s and 1880s, several companies achieved spectacular size, not by internal growth but by merger. Perhaps the most famous example is the Standard Oil Company. Initially, Standard Oil was less a company than a cartel – a group of smaller, separate

companies under the guidance of the largest refiner of them all, John D. Rockefeller's Standard Oil Company of Ohio.

Rockefeller initially created a trade association of refiners, and became its first president. Ultimately, this association became a massive, vertically integrated, centralized corporation. By 1880, the Standard Oil "group" or "alliance" numbered 40 separate companies. In 1882, the shareholders of these 40 companies exchanged their stock for certificates in the Standard Oil Trust. The trust authorized an office of nine trustees to "exercise general supervision over the affairs of the several Standard Oil companies." Moreover, the trust chartered local subsidiaries to take over Standard's operations in each state. This allowed Standard to avoid taxes owed by "out of state" corporations. The effect of the coordination was to allow Standard Oil to tighten its already vice-like grip on the mushrooming oil industry. By the early 1890s, Standard Oil was extracting 25 percent of the nation's crude.

Though Standard Oil was broken up by a Supreme Court order in 1891, other conglomerates avoided the antitrust axe. The United States Steel Corporation, for example, created by Andrew Carnegie in 1901, created close to 60 percent of the industry's output.[23] ■

The next stage in the evolution of the corporate structure was widespread (and therefore diffuse) ownership. Look at the description of the first public offering of Ford Motor Company stock in David Halberstam's book, *The Reckoning*:

> *It made ordinary citizens believe that buying stock – owning part of a giant company – was a real possibility in their lives. By purchasing stock, they became participants in American capitalism, owners as well as workers, junior partners of Henry Ford II. . . . The news generated excitement rarely seen on Wall Street. Everyone wanted in on the issue . . . . Early in the negotiations the principals had agreed that $50 per share would be satisfactory. But the fever kept building. The actual price turned out to be $64.50. Some ten million shares were sold, and it took 722 underwriters to handle them. At a time when $100 million was considered a handsome result from a public offering, this one brought $640 million – the sheer scale of it was staggering. The fever continued, greatly inflating the stock, but though it briefly surged up near $70 it soon hit a plateau near $50. The Ford family had been joined by some 300,000 new co-owners of their company. It was, said Keith Funston of the New York Stock Exchange, "a landmark in the history of public ownership." It was a landmark in tax avoidance, too; estimates were that Eleanor Clay Ford and her four children saved some $300 million in taxes while keeping control of the company.*
>
> *It also marked the beginning of a historic shift in American capitalism, a major increase in the influence of Wall Street in companies like Ford. The Street was a partner of the family now, and the family had to respond to its norms. In the old days, the Street did not demand too much of the companies whose stock it sold. But the stock market*

was changing now. Before the war only a small number of Americans held stocks, and they were to a large degree of the same class as the owners of the old-line companies. The market was a kind of gentlemen's club, virtually off limits to the rest of the society. People owned stocks because their families had always owned stocks. They invested not so much to gain but to protect . . . . Those who were in the market were generally rich and were in for the long haul[24] ”

This was the high-water mark of the old system. Ford became one of the last of the blue chips, just as blue chip stocks were becoming irrelevant. Instead of a few clubby long-term investors, the postwar era created a world where the New York Stock Exchange vowed to make every American a stockholder and where stockholders could make a lot of money fast by betting on the best of a large group of entrepreneurs. Both sides were hungry and impatient: those raising capital and those who provided it. "No one talked about safe buys; there was too much action for that. Companies like Xerox and Polaroid replaced US Steel and Ford as smart buys, and they in turn were replaced by fried chicken companies and nursing home syndicates."[25]

Mutual funds allowed investors to limit the downside and take advantage of the upside. Gerry Tsai's $250,000 fund at Fidelity reached $200 million three years later. Wall Street was no longer the exclusive enclave of young men from a tiny group of "good families" – it was open to anyone (well, any white males). "Also significant for anyone involved in business – whether the investors, the managers of the companies, or the bright young men coming out of business schools – was the effect of the talent flow. One could make far more money by playing the market on Wall Street – where cleverness was rewarded immediately – than by joining a company and getting in line to do something as mundane as producing something. The effect of this drain on ability away from the companies themselves was incalculable."[26] One result was that companies started thinking that their product was not the product – it was the stock. Halberstam notes that at Ford, "Not only were the top people there mainly from finance, but the bias of the (stock) market invisibly but critically bore on the company's decisions. There was a great deal of talk about the effect of production decisions on the stock."[27]

Meanwhile, a different sort of "trust" was forming in one of the states, as, for corporate charters, tiny Delaware, the second smallest state, won the "race to the bottom" and became "home" to most of America's corporations, at least on paper. In 100 years, America had gone from a country where each corporate charter had to be approved by the state legislature to a country where storefronts along the streets of Delaware's capital city are covered with signs that say "Incorporate While You Wait." Woodrow Wilson, as governor of New Jersey, persuaded the state legislature to pass the nation's first antitrust laws. Once he left to become President, they were repealed.

Legal authority over corporations has always been left to the states. The federal government has very little authority over corporate governance. The theory was that the states would be "laboratories," learning from each other's successes and failures and trying to outdo each other. In reality, all of that did occur; the problem was that instead of trying to outdo each other to do what was best for the economy or the shareholders or even the community, they outdid each other in trying to attract corporations and their tax revenues.

Should the state play a role in approving any aspect of a corporation's purpose or financial structure, or should it be left to the market? If the former, what questions should it ask and what answers should it demand? If the latter, what disclosure should it require to enable informed decision making by the investor community?

THE ESSENTIAL ELEMENTS OF THE CORPORATE STRUCTURE

> *For debt investors and employees, everything (literally) is open to contract; for equity investors, almost everything is open to choice. Why does corporate law allow managers to set the terms under which they will govern corporate assets? Why do courts grant more discretion to self-interested managers than to disinterested regulators? Why do investors entrust such stupendous sums to managers whose acts are essentially unconstrained by legal rules? The answers lie in, and help explain, the economic structure of corporate law. The corporation is a complex set of explicit and implicit contracts, and corporate law enables the participants to select the optimal arrangement for the many different sets of risks and opportunities that are available in a large economy. No one set of terms will be best for all; hence the 'enabling' structure of corporate law.*[28]

What the authors are saying here is that the law gives corporate managers a great deal of flexibility in determining their capital and governance structure, relying on the market for capital to create competition that will allow shareholders to "choose" the one they think is best. In our view, this power of "choice" is hardly worthy of the term, because it all but disappears the moment it is exercised. Shareholders can "choose" which companies to invest in, and companies court them on that basis. Once shareholders have invested, however, their power to influence the company is all but vestigial, as discussed throughout this chapter. The authors of the above quotation seem to admit that, when they argue that managers and investors both "assume their roles with knowledge of the consequences."[29]

Is it fair to assume that shareholders have that knowledge? That they can act on it in a meaningful way? What is the evidence to support your answer?

Individual ownership evolved over time into a variety of models of collective enterprise. In Darwinian terms, the corporate model has prevailed as the legal structure of choice in modern commerce because it was the "fittest." As Dean Clark's description in chapter 1 noted, corporations combine many attractive features: among them, the ability to acquire management and financial resources efficiently, the capacity to transfer holdings easily, and the ability to assert control over an under-performing venture.

Among the special attractions of the corporate form or organization are:

- A high degree of advance certitude about the ground rules of the organization. There simply isn't a lot of law on most of the other forms of doing business. In the case of entities like business trusts, the applicable law is common law – harder to determine, understand, and predict than statute.
- The financial markets have been developed to accommodate easily the mechanics of share issuance and transfer. Partnerships are more cumbersome.
- Those who put up the money can decide on the management and changes in extreme cases. In a partnership, those who put up the money cannot change the general partner.

However, as we explained earlier, perhaps the most attractive component of the corporate model is limited liability – the owner's liability is limited to the amount of his investment (or subscription).

This "limited liability" means that ventures can take very large risks and incur substantial liabilities without threatening the personal resources of their owners. Without this protection, the wealthy would be reluctant to risk their resources in risky ventures. This ability for "investors" (in contrast to active participants) to diversify their risks of investing in any single venture by investing in many is undoubtedly one of the principal reasons that capital has been available for research, innovation, and technical progress during the past two centuries.

Just because the owners have limited liability does not mean that the risk inherent in their investments disappears or that someone else automatically pays the liabilities. The impact of business failures hits many individuals, the community, and the government. This capacity of corporations to "externalize" the costs of their actions is a continuing problem, as explained in chapter 1. The different investment horizons and priorities for different investors, combined with structural and economic barriers to collective action, discussed throughout this book, also make it very difficult to contain the externalization.

CASE IN POINT PARTNERSHIP VERSUS CORPORATION

Let's consider an example of two failed business enterprises, one a solely owned proprietorship (an individual) and one a corporation, both owners and operators of a modern paper mill that becomes bankrupt. Suppose that the working of the mills involved discharges of both liquid and gaseous emissions that violated environmental standards and caused great damage and financial loss to members of the community. The investigators who are responsible for enforcement of the environmental laws institute legal proceedings, and so do members of the community who were damaged.

The individual owner of the mill has no alternative – he must pay the damages up to the point of personal bankruptcy. The corporation's liability is limited to the extent of its assets. If, for example, it is leasing the plant and literally "owns" no assets, then it does not have to pay damages. The benefit of this system is that the shareholders of the corporation are protected against liability; that is they lose what they invested, but are not liable beyond that investment. On the other hand, the individual who owns the failing paper company loses almost all of his personal assets. In both cases, the community, the employees, and the customers, suppliers, and other corporate stakeholders are all damaged, but in just one do they have a chance of some recourse. The corporate form of ownership does not change the cost; it just changes the extent of the owner's responsibility. ◻

As explained in chapter 1, the corporate form limits liability, but it does not limit risk, which extends to many "corporate externalities." Nonetheless, the virtue of limited liability, combined with the benefits of investment diversification and the progress of technological innovations, have made it possible for corporations to grow to huge dimensions. Modern corporations are virtually

unlimited in the scope of their enterprise, the size of their capital, the national reach of their operations, and even the span of their existence. It is not surprising, then, that they have acquired the capacity to influence the circumstances of the societies within which they operate. They have more money than individuals for financing elections (a serious problem in Japan, the US, and most European countries); they have more resources to expend in influencing legislation and the administration of laws; they can hire the best lawyers, lobbyists, and media consultants. All of these costs are simply passed on to the customer – and the shareholder.

Because of this ability to influence the making, interpretation, and enforcement of laws, corporations in our time are able to "externalize" many of the consequences of their operations. In our paper company example, we assume that both the company owned by an individual and the one organized as a corporation face the same marketplace and the same obligations. However, the corporation has another important advantage – it is able to participate more effectively than the individual in the process that sets the legal standards regulating permissible emission levels. It is better able to organize itself and the community to fight suits by those alleging that they have been damaged by its discharge of effluents. Ownership in a large modern corporation has therefore come to be a one-way street – the shareholders and the managers appropriate the profits and, to the extent possible, force the costs on to society as a whole.

THE MECHANICS OF SHAREHOLDER RIGHTS

Shareholders have limited liability and therefore they have limited rights to affect the direction of the company. Essentially, the mechanics of those rights fall into three categories. They have the right to "elect" the board of directors. As we note elsewhere in detail, this right is limited by the managers' ability to control the selection of candidates, power that may be lessened if the "proxy access" provision of the Dodd–Frank legislation, giving shareholders a limited right to put their own candidates on the company's proxy, survives a court challenge. In a very small fraction of the director elections each year, usually well under 1 percent, dissident shareholders mount a very expensive full-scale challenge, nominating an entire slate of opposing candidates. Shareholders also have the right to vote on management-sponsored proxy issues like the approval of the auditors and certain compensation arrangements.

Second, shareholders have the right to submit shareholder proposals to a vote. If they want their proposals to be circulated on the company's proxy card, it must be limited in subject matter (see the SEC's rule 14a-8). It may not pertain to "ordinary business" or to any specific individual matter. It is limited in length to 500 words. In one case, a proposal was excluded because it was one word over. Most important, in virtually all cases it must be nonbinding, so even a 100 percent vote would not require the company to comply. Finally, shareholders have the right to bring a lawsuit against the company or the board for failure to meet their obligations. An entire category of litigation in the US called "derivative" suits are unique because they involve shareholders suing on behalf of the corporation and usually against its own executives, for actions they believe the corporation should have pursued. These lawsuits are frequent in the US but rarely go to trial as nearly all are settled by the company's insurer. In the past, they have been very lucrative for the lawyers but have not provided much benefit to shareholders as the insurance payouts often return to the corporate treasury. More recently, settlements have required specific governance improvements as well as penalties. Derivative suits are far more rare in the UK due to the 1843 decision in

Foss v. Harbottle, which establishes a higher standard for injury to support a claim, usually fraud or acting beyond the scope of granted authority.

These rights, limited as they are, should be viewed as an asset and an opportunity, subject to the same kind of analysis as the decision to buy, hold, or sell.

CASE IN POINT ANNUAL SHAREHOLDER MEETINGS

In the US, corporations are required to hold annual meetings. In the overwhelming majority of cases they are a formality; all of the votes have already been cast. However, management is required to give shareholders an opportunity to ask questions and is required to make public a summary of the meeting and the vote count.

Some companies, especially consumer goods firms and the largest and most widely known, attract larger crowds and often get protesters. In some cases, where management expects controversy, they will try to dodge the shareholders. At one meeting, the CEO announced that the meeting was not the time or place for shareholder questions. At others, no board members attend so they will not have to answer questions. One American company moved its annual meeting to Asia. Another company moved its meeting from Houston to a small, remote Texas town, set the time for 8:30 in the morning, and bought up all of the hotel rooms so that no one could stay there the night before. They did include the traditional, "We look forward to seeing as many of you as possible" in their announcement of the meeting. In 2010, Symantec Corporation announced that it would have a virtual meeting, with no in-person component at all.

In other countries, this event is often called the AGM (annual general meeting). In the UK, 10 percent of shareholders can call a special meeting but in the US that right is optional and very limited. ■

THE SEPARATION OF OWNERSHIP AND CONTROL, PART 1: BERLE AND MEANS

The rights of ownership outlined at the beginning of this chapter are fairly simple when applied to a house, a car, or a herd of cattle, but the "owner" of a fractional share of a corporation has an intangible interest in an intangible entity. While the entity itself may have many tangible assets, the relation of those assets to the "owners" is questionable.

Only one of the ownership rights listed in the beginning of this chapter is unequivocally exercised by the stockholder – the right to transfer the interest. That is fairly simple; indeed, that has been the overwhelming priority in the development of the security markets. A share of stock is, above all, highly transferable, and our system puts a premium (in the most literal terms) on making sure that anyone who wants to sell (or buy) a share of stock can do so, immediately. Note, however, that during the takeover era even this paramount right was limited by corporate management

and state government. Companies adopted "poison pills" (see discussion in chapter 3) and other anti-takeover devices that limited the ability of the shareholders to sell to a willing buyer at a mutually agreed price. In other cases, like the Time Warner deal, corporate management was able to prevent the shareholders from making the choice about which company was a better candidate for a business combination.

In this context, what does it mean to talk about the other two ownership rights listed at the beginning of this chapter? The first was the right to use the property. One does not really "use" a share of stock, beyond cashing the dividend checks or possibly using the stock to secure a loan or giving some or all of it as a gift. The shareholder does not "use" his intangible fraction of the company – even if his proportionate share of the company's assets were worth, for example, the equivalent of one desk and telephone, he cannot take it, sell it, or even use it, much less tell anyone at the company how to use it.

The shareholder-owner does not participate in the activities by which his "property" is managed. He has no relationship with the other owners; their community of interest is limited to the price of the stock. As Davis notes:

> *Corporate association has reference rather more to the corporate property or industry than to the persons associated. The physical element is exaggerated, the human element is depressed. The purchaser of stock considers that he is acquiring an interest in an enterprise, not so much that he is assuming common relations with the numerous other stockholders; for the most part, he does not know them and does not take the pains to learn who they are; if he 'knows the property' and by what directors it is administered he is satisfied. All of this 'is a process which seems to be culminating in our time with a "Cheshire Cat" disappearance of ownership in any meaningful sense of the term.'*[30]

The shareholder has the exclusive control of the stock itself, but as a condition of the shareholder's limited liability, the shareholder gives up the right to control use of the corporation's property by others. That right is delegated to the management of the corporation. Indeed, it is one of the benefits of the corporate organization to the investor; he can entrust his money to people who have expertise and time that he does not. However, it is also one of the drawbacks. Thus, it is this separation between ownership and control that has been the focus of the struggles over corporate governance.

What the owner of a corporation "owns" is a certificate representing entitlement to a proportional share of the corporation. The only thing he has is the stock certificate; the corporation itself (or maybe its subsidiary) is the owner of its own property. However, the certificate entitles him to particular rights and obligations, some set by federal law, some set by the state in which the corporation is incorporated. The rights of a shareholder are classically defined as (1) the right to sell the stock, (2) the right to vote the proxy, (3) the right to bring suit for damages if the corporation's directors or managers fail to meet their obligations, (4) the right to certain information from the company, and (5) certain residual rights following the company's liquidation (or its filing for reorganization under bankruptcy laws), once creditors and other claimants are paid off.[31]

> *But in the modern corporation, these two attributes of ownership [control and economic rights] no longer attach to the same individual or group. The stockholder has surrendered*

control over his wealth. He has become a supplier of capital, a risk taker pure and simple, while ultimate responsibility and authority of ownership is attached to stock ownership; the other attribute is attached to corporate control. Must we not, therefore, recognize that we are no longer dealing with property in the old sense? Does the traditional logic of property still apply? Because an owner who also exercises control over his wealth is protected in the full receipt of the advantages derived from it, must it necessarily follow that an owner who has surrendered control of his wealth should likewise be protected to the full?[32] ”

Corporations today are larger and more far-reaching than anyone could have dreamed, even half a century ago. In those days, industrialists such as John D. Rockefeller, Cornelius Vanderbilt, Andrew Mellon, and Andrew Carnegie ruled empires that rivaled whole countries in their size and scope – and power. The companies had public shareholders, but the men who built them held huge stakes to back their stewardship. Today, with rare exceptions like Bill Gates of Microsoft and the late Sam Walton of Wal-Mart, large companies are led by men whose stakes in the company are dwarfed by the holdings of institutional investors. The shareholders who "own" the company are so diverse and so widely dispersed that it is difficult to characterize their relationship to the venture in the terms of a traditional owner.

Most people begin the study of ownership in the context of public corporations with Columbia University professors Adolf A. Berle and Gardiner C. Means, who first recognized the separation of ownership and control in the large modern corporation.

“ *This dissolution of the atom of property destroys the very foundation on which the economic order of the past three centuries has rested. Private enterprise, which has molded economic life since the close of the Middle Ages, has been rooted in the institution of private property. Under the feudal system, its predecessor, economic organization grew out of mutual obligations and privileges derived by various individuals from their relation to property which no one of them owned. Private enterprise, on the other hand, has assumed an owner of the instruments of production with complete property rights over those instruments. Whereas the organization of feudal economic life rested upon an elaborate system of binding customs, the organization under the system of private enterprise has rested upon the self-interest of the property owner – a self-interest held in check only by competition and the conditions of supply and demand. Such self-interest has long been regarded as the best guarantee of economic efficiency. It has been assumed that, if the individual is protected in the right both to use his own property as he sees fit and to receive the full fruits of its use, his desire for personal gain, for profits, can be relied upon as effective incentive to his efficient use of any industrial property he may possess.*[33] ”

We must remember that it is not as though anyone ever made a decision that companies would work better if they separated ownership and control. There was no conscious choice in favor of treating shares of stock as though they were betting slips for races that were over at the end of each day. The wedge driven between ownership and control of American corporations was the unintended

consequence of what was then thought of as progress – the technological and procedural changes made in order to meet the needs of a rapidly expanding economy. To make that economy work, and in order to keep it expanding, the market placed a premium on liquidity and privacy. It was not until decades later that it became clear that those priorities would create a system as shortsighted as a cat chasing its own tail.

CASE IN POINT — THE CONFLICTED OWNER

A pension fund spread its assets among six to ten different money managers at any given time, in an effort to protect itself through diversification. Each had its own formula and assumptions. On any given day, half were buying United Widget stock and the other half were selling it to them. At the end of most days, the pension fund had the same number of shares of United Widget, but was out the transaction costs. Once a year, the three to five money managers who held the stock on behalf of the pension fund on the record date received proxies. In the year when United Widget was the target of a hostile takeover attempt by International Products, some of them voted with management and some voted with the acquirer.

Is it consistent with fiduciary obligation for the pension manager to permit this activity? Is it relevant that the fund's assets also included stock in International Products that was likely to decline after the acquisition? That it was also a bondholder? How does a fiduciary examine the proposed transaction when it is a stockholder in both United Widget and International Products? ▪

CASE IN POINT — WHEN IS THE EMPLOYEE STOCK PLAN OBLIGATED TO STEP IN OR SELL?

In theory, an ESOP or other employee stock ownership plan will make employees feel like owners, and that will be good for them, for the company, and for the nonemployee shareholders. However, what happens when things go wrong? As discussed in the Stone & Webster and Carter Hawley Hale case studies, when the employer company gets into difficulties, this can put the trustee (who is the employer or someone selected by the employer) into a very difficult situation. We can agree that theoretically at some point a significant block holder who is a fiduciary for the employees must either sell the stock (though at that point the stock is by definition depressed, so the transaction costs are

significant) or step in to make changes in management or the board. The hard part is knowing when that should happen and the hardest part is finding a trustee who is willing and able to do so. In early 2003, as United Airlines struggled in bankruptcy, a group of employees filed suit against the employee stock plan, which held 55 percent of the company's stock. They alleged their investment managers cost them billions by holding on to United stock as it plummeted. "Employee stock ownership does have the capability to align shareholder and employee interests under the proper conditions. However, ESOPs lack independence from managerial influence and are much less likely than outside institutional investors to monitor management decision-making and pressure management to adopt strategies that incorporate greater risk and an opportunity for greater returns."[34]

The suit is reminiscent of the famous line from the Pogo comic strip: "We have met the enemy and he is us." The complaint alleges the plan's all-employee committee "was not objective in its decision" to keep the plan exclusively invested in United stock as it went into decline.

Note. In a culture where trust law is respected and where trustees are accustomed to uphold its standards, a different result obtains. Sir Roger Gibbs, as Chairman of the Trustees of the Wellcome Trust, determined that a sale of its sole asset was necessary in order to enable the trust to carry out its purpose. He therefore took it on himself to effect a merger with Glaxo and to change utterly the nature of the Wellcome company, over the objections of some of its management. ■

CASE IN POINT WHO OWNS HERSHEY?

Hershey Candy was begun by a benevolent man named Milton Hershey, whose progressive views kept all of the employees on the payroll throughout the Depression. Hershey and his company practiced "welfare capitalism." The company was a pioneer in fields like occupational safety and employee benefits. The town of Hershey, Pennsylvania, with its chocolate kiss-shaped street lamps is a reflection of his values. Hershey was deeply committed to helping orphans, and he established a school for them in Hershey. He gave the foundation that runs the school $60 million in 1918. With that as a foundation, the school expanded and became very successful, making tuition-free education and support services available to orphan boys, and then later on to poor children of both genders.

In 2002, the school's endowment was $5.9 billion, about 58.6 percent in Hershey's stock. The trustees, recognizing that their fiduciary duty was not to Hershey Candy

company but to the school and its students, decided that they needed more diversification. While this was an entirely prudent, perhaps even overdue, conclusion, the announcement caused an uproar. If the foundation wanted to diversify, control would be outside of sympathetic private hands for the first time. The company could end up being sold to the highest bidder, perhaps even a non-US company like Nestlé. The impact on the town of Hershey, where most of the residents work for the company or affiliated entities, would be devastating.

The State of Pennsylvania went to court to stop the sale and got a preliminary favorable ruling. The foundation chose not to appeal. According to *Slate* magazine's Daniel Gross, "because Pennsylvania officials, acting on the behest of local politicians, substituted their own judgment for that of shareholders and executives, the deal is off. As a result, Hershey's stock fell today and closed at about 65. The poor kids who attend the Hershey School just lost $24 per share, or about $1 billion."[35]

Compare the involvement of similar foundations established by founders of major corporations, like the Hewlett and Packard Foundations' opposition to the HP-Compaq merger and the foundation that controlled *Reader's Digest*. How do the conflicts these relationships raise compare with the block holdings of employee stock plan and pension fund investments in employer stock? ■

CASE IN POINT F&C ADVISES ITS CLIENTS TO VOTE AGAINST EXCESSIVE COMPENSATION – AT F&C

George Dallas had two options and neither was appealing. He was director of the corporate governance unit at F&C, a division that handles corporate governance and global engagement for more than £83 billion of funds. F&C's own executive compensation did not meet the standard it applies to all other portfolio companies. Thus, he could either be consistent and recommend a vote against his own company or he could find some way to justify making an exception. "It is a difficult situation when we are voting shares in our own company," he said. "In the case of F&C, you're damned if you do and damned if you don't."[36] ■

The dispersion of ownership began to reverse in the second half of the twentieth century with the creation of huge mutual funds, pension funds, and other institutional investors, which will be covered later in this chapter. Observers like Jonathan Charkham and Anne Simpson have called on

these institutions to act as involved owners. Their suggested "obligation of significant ownership" is based on public policy, a sort of economic good citizenship.

> *It is because the good working of the market-based system demands it for economic, social and political reasons. The economic reason is that there needs to be a mechanism for controlling boards that do not work well so as to prevent unnecessary waste of resources; the social reason is that listed companies are a crucial and integral part of the fabric of a modern society and their success reduces alienation; the political reason is that the limited liability company has achieved its far-sighted originators' aims beyond their wildest dreams, producing concentrations of power and resources, and that those who exercise these powers must be effectively accountable for the way they do. The power and influence of the leaders of companies in domestic politics – and indeed internationally – are considerable.*[37]

This is all very well as an ethical statement, but as a legal matter it underestimates the posture of an individual shareholder with limited liability. The critical point is that we are now talking about "fiduciary" duties.

Every "improvement" in the system for owning stock was designed to make it easier to trade. No one seemed to notice or care that each of these "improvements" also made it harder to exercise classic ownership rights. These rights had once been thought of as equal to the right to buy and sell freely in the "invisible hand" that kept the marketplace operating efficiently.

Shareholders' ability to perform what James Willard Hurst has called "their legendary function" of monitoring has been substantially eroded. There are two primary reasons for this. First, as noted by Berle and Means, sheer numbers rob shareholders of power. Management has every incentive to increase the number of holders.[38] It increases available capital and helps transferability by keeping the prices of individual shares comparatively low.[39]

Second, increasing the number of shares has another significant advantage for corporate management; it reduces the incentive and ability of each shareholder to gather information and monitor effectively. Even the $363 million investment in Apple by the largest equity investor in the United States, the California Public Employees' Retirement System (CalPERS), is not of much significance in a company with a market value of more than $266 billion. When the number of shareholders is in the hundreds of thousands – even the millions – and each of those holds stock in a number of companies, no single shareholder can monitor effectively. How much monitoring is worth the effort when your investment (and liability) is limited and when even if you did understand the issues, there was nothing you could do about them? The result is palpable. The greater the dispersal of ownership, the more likelihood of weak links between pay and performance and lower investment in research and development.

Professor Melvin Aron Eisenberg writes of the "limits of shareholder consent,"[40] noting that "under current law and practice, shareholder consent to rules proposed by top managers in publicly held corporations may be either nominal, tainted by a conflict of interest, coerced, or impoverished."[41] In Eisenberg's view, shareholder consent is "nominal" when (as permitted under proxy rules) the shareholder does not vote at all and management votes on his behalf, or shares held by the broker or broker's depository are voted with no direction from the beneficial owner. Shareholder consent is "tainted" by a conflict of interest when an institutional investor is pressured to vote in favor of a management proposal it would otherwise oppose, due to commercial ties to the company management (see the cases in point on Boothbay Harbor, R.P. Scherer and Citicorp, and Deutsche Asset Management).

Shareholder consent is "coerced" when, for example, management ties an action that is attractive to shareholders, like a special dividend, to passage of a provision that may be contrary to their interests. For instance, in 1989, shareholders of Ramada Inc. were asked to approve a package of anti-takeover measures, bundled with a generous cash payment.[42] Shareholder consent is also "impoverished" when its choices are limited by self-interested managers. "[F]or example, shareholders may vote for a rule proposed by management even though they would prefer a different rule, because the proposed rule is better than the rule it replaces and management's control over the agenda effectively limits the shareholders' choice to the existing rule or the proposed rule."[43] This is a reflection of management's vastly superior access to the proxy, both procedurally (in terms of resources) and substantively (in terms of appropriate subject matter). Eisenberg has described shareholders as "disenfranchised."

The disenfranchisement of the modern shareholder has been developing for over a century, but it took the events of the past two decades to bring it to public attention. In the 1980s, the takeover era itself was a symptom of the problems created by the failure to link ownership and control. As we describe below in more detail, the abuses of shareholders by both managers and raiders made it clear that there was not enough accountability to shareholders and that this lack of accountability was detrimental to the competitiveness and vitality of American companies. However, as noted above, the fact that the disconnect was inadvertent was irrelevant to one important fact – it was convenient, even ideal, for those whom it most benefited. When efforts to reconnect ownership and control began in the mid-1980s, shareholders found that the very problem of their inability to act made it all but impossible to regain their ability to hold corporate management accountable, especially when corporate management had no interest in changing a system that was working very well from their perspective. The terms "synthetic ownership" and "empty votes" have been used lately, sometimes to refer to the pernicious decoupling of economic interest and voting rights but also by those opposing more engagement by institutional shareholders.[44]

Harvard Professor Michael Jensen predicted in *The End of the Public Corporation* that the "ownerless" modern venture without the discipline of accountability would inevitably be unable to compete. He saw the leveraged buyouts that had reconnected management and ownership at the end of the 1980s as the model for the future.

Henry Kravis put it this way in a speech to The Private Equity Conference in New York City on September 22, 2004: "If you examine all the major corporate scandals of the past 25 years, none of them occurred where a private equity firm was involved.[45] Businesses have failed under our ownership and that happens. But to my knowledge there has been no systematic fraud or management abuse in our industry. Why? Because I believe that as genuine partners we are vigilant in our role as owners and we protect shareholder value." He still feels the way he did when he told Ross Johnson why he'd be flying commercial after the LBO.

FRACTIONATED OWNERSHIP

In addition to the separation of ownership and control, there are several other respects in which share ownership in the modern corporation differs from traditional notions of ownership.

- *Numerical.* There are so many owners of the largest American corporations that it makes little sense to consider any one of them an "owner" in the sense of an individual with an economic interest in being informed about and involved in corporate affairs.

- *Legal*. The splitting of ownership between a legal title holder (the trustee) and beneficial owners (trust beneficiaries of all kinds, including pensioners and mutual fund participants) has created a welter of separate interests. The relationships between fiduciary and beneficiary are usually stipulated by a specific governing law. Trustees can be individuals or special purpose corporations; beneficiaries can be individuals, or classes of individuals, whose identities may not be known for many years.
- *Functional*. "It has often been said that the owner of a horse is responsible. If the horse lives he must feed it. If the horse dies he must bury it. No such responsibility attaches to a share of stock."[47] A corporate shareholder owns a share certificate, but this piece of paper does not accord him the rights and responsibilities traditionally associated with ownership. Berle and Means observe that, "Most important of all, the position of ownership has changed from that of an active to that of a passive agent. In place of actual physical properties over which the owner could exercise direction and for which he was responsible, the owner now holds a piece of paper representing a set of rights and expectation with respect to an enterprise. But over the enterprise and over the physical property – the instruments of production – in which he has an interest, the owner has little control. At the same time, he bears no responsibility with respect to the enterprise or its physical property."[47]
- *Personal*. "The spiritual values that formerly went with ownership have been separated from it. Physical property capable of being shaped by its *owner* could bring to him direct satisfaction apart from the income it yielded in more concrete form. It represented an extension of his own personality."[48]

CASE IN POINT JUNIOR INVESTS IN BOOTHBAY HARBOR

The traditional relationship between entitlement to receive the benefits from a venture and responsibility for its impact on society was charmingly put at the beginning of the century, as a father advises his son in *Main Street and Wall Street*, written in 1926:

> *Now, Junior, before you go to college I want to give you my investment in the Boothbay Harbor Electric Light Co. This concern serves our old neighbors and friends, and I want you to feel a continuing interest in, and a responsibility for, our share in this local enterprise. If properly managed it should be a benefit to this community; and it will yield you an income to be applied to your education through the next few years. But you must never forget that you are partly responsible for this undertaking. Our family had a hand in starting it. That responsibility is an inseparable part of your ownership. I read something the other day, in an opinion by Justice Brandeis of the US Supreme Court, which bears this out: 'There is no such thing to my mind... as an innocent stockholder. He may be innocent in fact, but socially he cannot be held innocent. He accepts the benefits of the system. It is his business and his obligation to see that those who represent him carry out a policy which is consistent with*

the public welfare.' He is right in that. This accountability for wealth underlies and justifies the whole institution of private property upon which the government of our great country is founded.[49] ”

Contrast Junior and his father with today's shareholder, who will be represented by Junior's son Trip, now an employee of Widget Co., a mid-sized manufacturing company with a "defined-benefit" pension plan. That means that no matter what he puts in before he retires, once he does, he is guaranteed a set retirement check every month. Let's say that Trip has been with the company for 20 years, with about another 15 to go before retirement, keeping in mind that his office mates, one who just started work and one who is five years from retirement, might have very different sets of priorities. Trip and his colleagues are a far cry from Junior, who had a "sense of responsibility" for the companies he invests in; indeed, Trip could not tell you what stocks he holds – they were bought by several investment managers who are hired by the named fiduciary designated by the corporate chairman. Trip "owns" a minuscule fraction of perhaps thousands of publicly traded companies. He has not only no say about which securities are purchased on his behalf, but also he doesn't even find out until after the fact, sometimes not even then. Between Junior and Boothbay there was a reliable system of communication. Between Trip and Boothbay there is an investment manager, a custodian, a trustee, a named fiduciary, and the CEO of Trip's employer, Widget Co.

Meanwhile, Trip and the other employees whose pension money is invested really have no legally enforceable interest with respect to a particular holding of the plan. Their only right is to be paid the promised benefits. Whether that comes from stocks, bonds, or gold bullion is irrelevant to them. Trip's only right is to require that the trustee act loyally and competently in his interest. That could be complicated. The trustee, usually a bank, may have business relationships that create uncomfortable conflicts, putting him in a situation quite different from Junior's. For example, the trustee will be voting stock in the same companies it makes loans to or handles payrolls for. There have been a number of reports of cases where a trustee attempting to vote against corporate management was stopped by his own management.[50] Why fight it? After all, the shareholder has no economic interest whatsoever in the quality of his voting decision, beyond avoiding liability. No enforcement action has ever been brought and no damages have ever been awarded for breach of duty in voting proxies. Trustees earn no incentive compensation, no matter how much energy and skill they devote to ownership responsibilities.[51] Crucially, the corporation knows how he votes, while Trip has no idea. The trustee has nothing to lose, and everything to gain, from routine votes with management. Even if the trustee wanted to view his ownership responsibility more energetically, it would be all but impossible as a practical matter due to further inhibitions to shareholder activism arising out of the problems of "collective action" and "free riding," the pervasive problem of conflict of interest by institutional trustees, the legal obstacles imposed

by the federal "proxy rules" and state law, and state court acquiescence to management entrenchment – all described later in substantial detail.

At the top of the chain, the CEO's interest in the investment in Boothbay is also quite different from Trip's or Junior's. His interest is, first and foremost, being able to pay Trip his "defined benefit" when he retires, with a minimum of contribution by Widget Co. and, probably, a minimum involvement of his own time – after all, pension benefits don't have much to do with the products or sales of the company. So the CEO will push the investment managers to provide results (while he decries the "short-term perspective" of investors with other CEOs). If he is involved, he is faced with what has been called "ERISA's Fundamental Contradiction."[52] On one hand, as a corporate manager, he would tend to favor provisions that, on the other hand, as a shareholder or director, he might find unduly protective of management.

In the 1920s, Trip's father, Junior, and his grandfather, who spoke of Boothbay Harbor with such proprietary interest, felt a real connection to the company they invested in. In the 1990s, the trustee, the custodian, the investment managers, and the CEO stand between Boothbay and Trip.

Do any of these people "feel a continuing interest in, and a responsibility for, our share in this local enterprise"? Are any of them equipped, able, or even interested in the right or responsibility of providing overall direction for the company? What happens when Trip's son works for a company with a defined contribution plan?

Given the changed nature of stock ownership today, are shareholders "failed owners"? If so, are they entitled to the benefit of having their property protected by the government? (See the quotation from Adam Smith about the "invisible hand" at the beginning of this chapter.) ■

We need to keep in mind that fractionalization of ownership characteristics, although not requested by owners, has possibly served to enrich them by decreasing their accountability for corporate externalities. This may be accounted for in the value placed on the company by the marketplace – there may be a "bad governance" discount.[53] For example, in the middle of the 2006 "pretexting" scandal at Hewlett-Packard over their allegedly illegal activities in investigating a leak by a board member, the stock declined in value significantly, even though there was no change in the viability of its products or the prospect of returns on its research and development. If there is a "governance discount" and a "governance premium," this creates the basis for an obligation for fiduciary shareholders to pull together the fractions of ownership and restore value for their beneficiaries.

Perhaps instead of speaking of "failed owners," we should speak of "vestigial owners," or even "nonowners." It is important to consider the implications of corporations without owners. Bayless Manning, former dean of Yale Law School, describes the consequences:

> *Assume a large modern corporation similar to its typical commercial counterpart in all respects but two. First, the model abandons the a priori legal conclusion that the*

> *shareholders 'own the corporation' and substitutes the more restricted conception that the only thing they 'own' is their shares of stock. Second, the shareholder in this model corporation has no voting rights. His position would be quite similar to that of a voting trust certificate-holder with all economic rights in the deposited stock but no power to elect or replace the trustees by vote . . . . [A]s a broad generalization for use in thinking about the problems of power distribution within the publicly held corporation, the suggested model offers a much better guide than the unarticulated model we have been following – the homespun Jeffersonian image of the small business owned and operated by sturdy freeholders. Accepted as a valid working tool, the model points to the likely course of tomorrow's law governing control of the big corporation. The four areas of legal change suggested by it and outlined earlier combine to form a unified general pattern: franker acceptance that centralized managerial control is necessary, a fact, and here to stay; less wishful pretense that the shareholders' vote is or can be an effective restraint; emphasis upon disclosure, free exit and transfer as the shareholder's principal protection; and development of new and extrinsic mechanics to supervise management dealings in corporate funds for non-business purposes and for itself.*[54] ”

More than 50 years later, Manning's description seems to be an accurate description of today's corporations. Without accountability to shareholders/owners, there is no settled notion of "new and extrinsic" mechanics to assure the accountability of management either to shareholders or to society as a whole. There is a fair measure of agreement that ownership is necessary, but there has been little consensus on how to make it meaningful or indeed how to pinpoint it.

Where are the owners?

THE SEPARATION OF OWNERSHIP AND CONTROL, PART 2: THE TAKEOVER ERA

As explained above, one of the essential rights of ownership is the right to transfer ownership to someone else. Indeed, in making transferability a priority, owners of common stock were willing, for most of this century, to relinquish some of the other rights of ownership. In order for the stock to be freely transferable, shareholders had to have limited liability and shares had to trade at a fairly low rate. Both conditions loosened the connection between ownership and control. To have limited liability, shareholders had to give up control over any but the most basic corporate decisions. To keep trading prices low enough to ensure liquidity, shareholders had to allow their companies to issue millions of shares of stock, making it almost impossible for any one investor to hold a meaningful stake. The result was the "Wall Street Rule." Recognizing that transferability was the only real right the shareholder had, this approach provided that investors should "vote with management or sell the shares." The theory was that shareholders could send a powerful message to a company's management by selling out, ideally in enough of a block to depress the share value. Ultimately, the theory continues, the stock price would fall enough to make the company an

attractive takeover target. This risk would then keep management acting in the interest of shareholders.[55] As Edward Jay Epstein points out:

> *[T]his economic theory requires more than a shareholder being free to sell his holdings to another investor. Merely selling shares is analogous to political refugees leaving a dictatorship by 'voting with their feet.' While it may solve their personal problem, it does not end, or necessarily even weaken, the dictatorship – though it might weaken the economy. Similarly, just the exchange of one powerless shareholder for another in a corporation, while it may lessen the market price of shares, will not dislodge management – or even threaten it. On the contrary, if dissident shareholders leave, it may even bring about further entrenchment of management – especially if management can pass new bylaws in the interim.*
>
> *This theory works if, and only if, shareholders can sell their shares eventually to an investor who has the power to take over the company – and fire the ruling board of directors.*[56]

A society of sheep must in time beget a government of wolves.

Bertrand de Jouvenel

In the 1980s, the seismic impact of takeovers, junk bonds, and the growth of institutional investors jolted every aspect of the corporate structure, down to its tectonic plates. Perhaps the most unexpected shift was the way the musty, academic question of "corporate governance" became the focus of intense debate. Once exclusively the province of scholars and theorists, the arcane vocabulary of governance was re-forged as each of the corporation's component groups blew cobwebs off the antique terminology and employed it to redefine its role and that of the corporation.

One reason the debate had become so tangential to the reality of politics and business was that most of the theories about corporate governance bore little relation to the reality. Indeed, the Panglossian theories assumed the status, and the role, of myth – and myth has both advantages and disadvantages as the basis for debate. The theory was that corporations were managed by officers, under a system of checks and balances provided by the board of directors and the shareholders. All three groups, acting in their self-interest, would maximize profit within the confines of the legal system, and all three groups would benefit, as would society as a whole, including the groups now termed "stakeholders" – employees, customers, suppliers, and the community. The reality was that there was no system of checks. Corporate governance had become completely out of balance.

That lack of balance was revealed by the collision of two developments of the 1980s, both the collateral and unanticipated results of another set of priorities. The first was the rise of the institutional investor. Even those who worked hardest for the passage of the Employee Retirement Income Security Act (ERISA) of 1974 never anticipated that in less than 20 years the funds subject to its standards would hold a third of the stock of American companies. Institutional holdings mushroomed in the 1970s and 1980s, creating a category of investor that was big, smart, and obligated as a fiduciary to exercise shareholder ownership rights if it was "prudent" and "for the exclusive purpose" of protecting the interests of pension plan participants to do so.

Meanwhile, the takeover era was giving shareholders plenty to react to. Both raiders and management took advantage of shareholder disenfranchisement and there were extraordinary abuses, which we will discuss below. All of a sudden proxy cards asked for more than approval of the auditors and the management slate of directors. The value of ownership rights became clear just as for the first time there emerged a group of owners sophisticated enough to understand them, obligated enough as fiduciaries to exercise them, and big enough so that when they did exercise them, they made a real difference. However, it took them a while to do so, and during that time corporate boards and managers were able to diminish further the value of share ownership. We will come back to this issue when we discuss the role of the board as fiduciary in the next chapter, but will discuss its impact on ownership here.

As mentioned above, most of the technology and systems developed for the stock market were designed with liquidity and transferability as the primary goals. Transferability has been so important, in fact, that the market has willingly, if inadvertently, relinquished many of the other rights of ownership in order to preserve it. In early days, stock certificates were like checks or like other kinds of property; you transferred stock by giving someone the actual certificate. As recently as the early 1950s, at least five documents were necessary for each transfer of stock, all pinned together with great ceremony by a man who worked behind a cage in the front of the office. This system worked, briefly. In the summer of 1950, for example, the market never traded over 750,000 shares in a day.

The system, however, was inadequate for the volume that would come. It was cumbersome and too invasive of shareholder privacy. In the late 1980s, as policy-makers debated "circuit breakers" to slow down or even stop trading (as a way of preventing a stock market crash like the 500-point drop in October of 1987), the New York Stock Exchange (NYSE) was trading upwards of 290 million shares a day. In 2010, it was 4.7 billion shares a day, and circuit breakers are now in place to halt trading on the NYSE in the event of declines greater than 10, 20, or 30 percent, depending on the time of day.[57]

On May 6, 2010, the NYSE fell almost 1,000 points in an hour-long "flash crash."[58] The collapse was caused principally by worries about European economic stability, a $4.1 billion trade rapidly executed by a single "high frequency" trading (HFT) firm, and the resultant withdrawal of several other HFT firms from the trading markets.[59] The series of events led the SEC to approve additional circuit breakers for certain "ETFs" (Exchange Traded Funds), as well as the S&P 500 and Russell 1000 equity indices, should any of their constituent stocks decline more than 10 percent within five minutes.[60]

Universal transferability also critically changed the nature of the shareholders' relationship to the corporate structure. As an investor, the stockholder had to look to corporate performance for protection and enhancement of his investment; he had to consider the efficacy of capital investments and he was directly influenced by how the corporation conducted itself and how society perceived that conduct. In the absence of readily available "exit," or sale, the traditional shareholder used "voice," or ownership rights.[61] "[T]he corporation with transferable shares converted the underlying long-term risk of a very large amount of capital into a short-term risk of small amounts of capital. Because marketable corporate shares were readily salable at prices quoted daily (or more often), their owners were not tied to the enterprise for the life of its capital equipment, but could pocket their gains or cut their losses whenever they judged it advisable. *Marketable shares converted the proprietor's long-term risk to the investor's short-term risk . . . .*"[62] The increased number of shares and ease of transferability acted as a vicious circle because the inability to use "voice" to influence corporate activity made "exit" the only option.

Note that the courts do take interest in ensuring that the economic and control aspects of stock remain integrated. The Delaware courts especially examine those "transactions that create a misalignment between the voting interest and the economic interest of shares." In its 2010 decision *Crown Emak Partners LLC v. Kurz*,[63] the Delaware Supreme Court continued to uphold this tenet, reiterating the lower court's mantra that "[w]hat legitimizes the stockholder vote as a decision-making mechanism is the premise that stockholders with economic ownership are expressing their collective view as to whether a particular course of action serves the corporate goal of stockholder wealth maximization." In this particular case, the appellate court affirmed the lower court's ruling that so long as *both* the economic and voting interests remained with the purchaser of the stock, the fact that the "bare legal title" remained with the seller of the shares did not invalidate the purchaser's right to exercise the voting power of its shares.[64] Note, however, that hedge fund manager Richard C. Perry and others were able to borrow Mylan shares briefly over the record date to vote them in support of a short position King Pharmaceuticals during Carl Icahn's efforts to get Mylan to acquire King.

It is virtually impossible to argue that effective monitoring is cost-effective for investors whose profit is principally derived from buying and selling in the short term. The prospect of buying low and selling high is so beguiling that a lucrative industry of "active money management" has flourished, notwithstanding the reality that institutional investors are the market and, therefore, cannot hope to beat its performance. As Charles D. Ellis, one-time President of the Institute of Chartered Financial Analysts, noted: "Investment management, as traditionally practiced, is based on a single basic belief: professional investment managers *can* beat the market. That premise appears to be false, particularly for the very large institutions that manage most of the assets of most trusts, pension funds, and endowments, because their institutions have effectively become the market."[65] William Fouse, chairman of Mellon Capital Management, says that pension fund management is "like monkeys trading bananas in trees." As he observed in an interview with *Forbes* writer Dyan Machan, "The money managers end up with a lot of the bananas."[66] The efforts by pension fund fiduciaries to find active money managers who can beat the market over time have been unsuccessful. Most pension funds give their money to whichever manager did well the previous year and, given the statistical "regression to the mean," the odds are that that manager will not do as well in the future. Turning to the revenue side, Vanguard founder Jack Bogle tells us: "During 1997–2002 alone, the total revenues paid by investors to investment banking and brokerage firms exceeded $1 trillion and payments to mutual funds exceeded $275 billion."[67]

An alternative strategy is "indexing," in which a fund buys every stock in a given index, such as the S&P 500. The holdings are held, not traded, so the fund neither beats the market nor underperforms it – but replicates it. A *Forbes* headline summed up the simplicity of such a strategy: "Don't Just Do Something, Sit There."[68]

For example, the S&P 500 Index beat 89.9 percent of all US stock funds in 1997 and that number goes over 99 percent when you measure the performance over several years.

Investment decisions are often based on recommendations by consultants, but consultants rarely recommend indexing. "[I]t would put them out of business if everyone did it. Pension funds pay consultants for objective advice on which funds to hire, but the same consultants charge managers fees for measuring the managers' performance.... There are plenty of stories about managers who are recommended by the consultants on the grounds that the managers pay the consultants the biggest fees."[69] A rare contrarian exception is the General Mills pension fund, which has dared to "break entirely out of the cycle.... Instead of firing the stock picker who happens to be performing below the mean in a given year, General Mills gives him more money, taking from the highest ranked

performer." As a result, General Mills produced one of the best long-term records, with 17 percent annualized equity return over the 15 years ending in 1992.[70] It is therefore not surprising that a study of 135 funds, with $700 billion in assets, concluded that "There was no positive correlation between performance and money spent on staff, managers, and other high-priced advice to get it."[71] Of course every investor, whether individual or institutional, hopes that it can be the exception and can beat the averages. This is reminiscent of the joke about the poker player's comment: "If we all play well, we can all make money." This hope, rather than any statistical evidence, accounts in part for the change in the way shareholders see themselves today: no longer as owners but as speculators.

Of course another of the incentives for a minimal sense of ownership by money managers is short-term self-interest. Active trading produces immediate transaction costs. Monitoring involves the commitment of resources for gains that are not immediately quantifiable, with the possible exception of shareholders who are large enough and aggressive enough to underwrite contests for control. In the longer term, this has involved a high price for the business system as a whole.

Unfortunately, the compensation structure of executives, bankers, and many other financial service professionals often gives rise to an issue known as "moral hazard." The phrase describes the economic situation confronting managers who bear none of the long-term risk but can reap the reward of short-term (yet perhaps insubstantial) gains. The professional is thus incentivized to earn higher, yet ultimately riskier and less-certain, "paper" profits now at the ultimate risk and expense of the institution, its shareholders, and, as the financial crisis has borne out, society.

Moral hazard is particularly exacerbated in the financial services sector, as the pay of most of its professionals is tied to benchmarks, typically the individual's annual performance. Though bankers may claim (however facetiously) that they are doing "God's work," they still require effective oversight and control to combat what may be an overwhelming incentive to "cheat"; it is certainly imprudent to leave the foxes guarding the henhouse. While news reports tend to focus on the aggregate amount realized by chief executives in a given year, with the multitudinous services offered by modern financial institutions and their corresponding employees, no general compensation structure set by regulators will effectively rein in all the relevant parties. Analysts focusing on the municipal bond markets may examine debt markets with 30-year outlooks and be satisfied with $100,000 paychecks, while high-volatility energy traders may walk away from $25 million and hundreds of thousands of stock options to join a hedge fund.

Accordingly, some market experts suggest that to accommodate the needs of both institutions and financial services workers involved in the short- and long-term markets, it is necessary to "link compensation, risk, and capital at both the institutional and micro levels."[72] This can be done by ensuring appropriate levels of compensation linked to salary, stock options indexed and restricted for long periods of time, and clawback provisions (now mandatory for some executives with the Dodd–Frank Act) to recoup unwarranted compensation. Such an approach, if effectively employed, is the best available method to ensure that the interests of the financial institution, its shareholders, and employees align, and may have the side-effect of better matching social preferences as well.

Additionally, to improve the likelihood of pay based on actual performance, compensation should further be determined by realized profit and loss, and those profits gained from socially deleterious practices such as high-frequency trading or predatory lending should be heavily taxed (if not out of existence). So long as central bank practices maintain interest rates near zero that keep cash abundant and cheap, it is government policy that remains the pillar of financial profits, not any particular skill of some of the sector's workers.[73]

We cannot understand governance or the operation of the capital markets without keeping in mind the implications of 40 percent of the market being indexed – 10 percent openly and 30 percent in effect, with the same results. Thus, 40 percent of the holdings of institutions are essentially permanent. Scholars and those who argue for management supremacy often base their arguments on claims that there are no share owners, only "renters," based on turnover rates that can exceed 100 percent in a year. A solid core of permanent ownership would go a long way to rebut these claims as well as providing a stable infrastructure of committed owners.

WAKING THE SLEEPING GIANT

Transferability has had consequences for corporations as well. It means that the interests of shareholders and managers are based on incompatible premises. The investor will want to sell at the first sign that the stock may have reached its trading peak whereas the manager wants stable, long-term investors. The American corporate system was initially based on the permanence of investor capital. However, while the capital may have remained in place, the owners kept changing. Unintentionally, the growth of the institutional investors may have served to reintroduce stability in stock ownership. That could not happen until the institutional investors were shocked into activism by the abuses of the takeover era.

An essential part of the theoretical underpinning for the market was the notion that shareholders should sell to each other and as often as possible keep the markets "efficient." During the takeover era, it became clear that, though the system was designed to promote transferability above all, there was one kind of transfer that the system would not tolerate: the transfer of power from one group to another. Despite a strong theoretical commitment to "the market for corporate control," as soon as the means to create a genuine market were developed, corporations, lawyers, and legislators, even judges, worked quickly to obliterate it.

One unjustifiable practice was called a "two-tier tender offer." A two-tier offer was used to accomplish what was then the largest non-oil takeover in history, R. J. Reynolds's $4.5 billion acquisition of Nabisco in 1985. In such a deal, a buyer would offer, for example, $10 per share over the market price to everyone who tendered until 51 percent had been received. The last 49 percent to line up would be left, like Oliver Twist, asking for more. What they would get would be thinner than Oliver's gruel – such as notes for the tender not payable for 15 years. For reasons that will become clear later in this chapter, institutional investors were invariably at the front of the line in such offers – as fiduciaries, they couldn't refuse an offer of $10 now rather than $10 in 15 years.

CASE IN POINT ONE SHARE, ONE VOTE

One of the most important (and valuable) aspects of stock ownership is the right to vote in proportion to one's ownership. The holder of 100 shares has ten times as much to say about the issues put to a vote of the shareholders as the holder of ten shares. In the mid-1980s, during the takeover era, when it seemed that every company had a permanent

"for sale" sign, this system was seen as dangerous to managements trying to protect themselves (and, in some cases, their shareholders). They therefore decided to change the rules to make it easier for them to take away voting rights through an "exchange offer" that was something like the offer in Aladdin to trade new lamps for old. In that story, the magic in the old lamp was a genie; in this story the magic in the old stock certificate was the vote. This story is important because it raises two questions relating to ownership.

How valuable is a vote that can be bought back (for less than its true value) by the management whose accountability the vote is supposed to ensure? How meaningful is the accountability of management when management can change the rules of accountability themselves?

In 1986, the New York Stock Exchange (NYSE) asked the Securities and Exchange Commission (SEC) for permission to drop its long-time requirement that companies listed on the NYSE have stock that gave each shareholder one vote per share.[74] One share, one vote is a shorthand reference to a form of capitalization in which the amount of investment and the amount of voting power are exactly proportional. In a dual or multiple class system, by contrast, they are not. Holders of less than 1 percent of the invested capital can, none the less, attain, through their specially classified shares, over 50 percent of the voting authority.

Under the unique system governing the securities markets, the NYSE, like the other exchanges, is a "self-regulatory organization."[75] This means that it has the authority to issue its own rules, subject to the approval of the SEC. Once they get that approval, the rules have the force of law. The SEC had always approved the exchanges' submissions as a matter of routine, mostly because the rules were routine, but this one was different.

In testimony before Congress just months before proposing to rescind the one share, one vote rule, then-NYSE chairman John J. Phelan said, "We have consistently stated – and we repeat now – that the NYSE continues to favor the standard which we alone applied over the past 60 years: the standard of 'one share, one vote'." Phelan also admitted, in earlier testimony presented shortly before the NYSE first asked for permission to rescind the rule, that the one share, one vote rule was "good for its listed companies, good for their shareholders, and good for this country.... In an ideal world, most people would probably want it to be retained." *Then why were they trying to get rid of it?* The other exchanges allowed companies to issue stock with less than one vote per share, though each had its own rules prescribing how it could be done. However, most companies had only one class of stock. Traditionally, dual-class voting structures were only for companies that were family run, like Wang, Ford Motor, and *The Washington Post.* These companies wanted access to capital without relinquishing control and they went public with dual classes of voting stock. Investors bought in, knowing what they were getting and paying a price that reflected their reduced voting power.

Growing concerns about institutional shareholder involvement and the prospect of real accountability led corporate management to seek ways to disenfranchise shareholders, and dual-class stock given to shareholders through a coercive exchange offer seemed like the perfect answer. The NYSE was concerned that its rule imposed a competitive disadvantage and that its listed companies would flee to the other exchanges, which had more liberal rules. The pressure to rescind the rule came from companies who wanted to prevent takeovers by essentially taking their companies private without having to pay the full price. Chairman Phelan described the problem in his testimony: "In response to hostile takeovers, a small but growing number of listed companies have asked their shareholders to approve changes in voting rights that would, directly or indirectly, give management greater control. In some instances, this has involved creating a second class of common stock having multiple votes per share. . . ."[76] The SEC was unsuccessful in trying to get all of the exchanges to agree to a consistent standard. Thus, despite its own misgivings, the NYSE asked the SEC to approve its abandonment of the one share, one vote rule. All that was needed was for the SEC to do what it has always done, approve without question the NYSE proposal.

Instead, in 1987, the SEC decided to use for the first time the authority granted to it by Congress in 1975 to impose a standard on the exchanges. This was successfully challenged in court by the Business Roundtable in the DC Circuit Court of Appeals. While the court never questioned the SEC's finding that exchange offers were coercive, it found that the rule-making exceeded the SEC's authority. The NYSE, though, voluntarily adopted the rule, and it has been in place ever since. The Business Roundtable had won the battle, but lost the war.[77]

The issue was not really whether companies could issue stock with disparate voting rights. Limited voting stock was never prohibited – preferred stock, for example, is often issued without voting rights. The issue was how that limited voting stock could be offered. What made the NYSE proposal controversial was that it allowed "exchange offers," where the company asked a shareholder to exchange stock with full voting rights for stock with lesser voting rights, usually with a "sweetener," such as a higher premium. Extensive testimony presented to the SEC in 1986–7 showed that these offers are coercive, meaning that the benefits to the individual will make it impossible to refuse the offer, even though the group as a whole will suffer. (See discussion of the prisoner's dilemma and of two-tier offers below.)

In other words, the offer could be framed in such a way that shareholders would accept, even though it was contrary to their interests. The debate over the one share, one vote proposal was therefore really about what procedural protections must be in place to ensure that limited voting stock is offered to shareholders in a way that enables them to make a fair and economically sound choice.

The shareholders argued that corporate efficiency and legitimacy depends on the managers who are, in effect, the agents of shareholder-principals. To the extent that the agency costs of managers increase, productivity and innovation will decline.

In an important analysis published in the *Journal of Law and Economics*, for example, Frank Easterbrook and Daniel Fischel argued that the separation of residual claims from voting power will always create agency costs that contribute to substantial inefficiencies in corporate oversight. They found that the one share, one vote rule ensures that no unnecessary agency costs will be created.[78] They also presented testimony that said that as the shareholder loses even the theoretical ability to control corporations by holding their managers to account, those corporations will cease to pay attention to the need to maximize profits. Companies will become bloated and inefficient, causing dislocation in supply and demand, and performance will drop. Furthermore, if managers cannot be held responsible for meeting clear, public standards of performance such as profits, sales, or growth, then their focus of attention will shift from outside to inside the corporation. Managers will place a higher value on maintaining good relations with employees, suppliers, or local communities than on increasing market share through improved products or services. Inevitably, the primary goal of the corporation will become self-perpetuation, and the result will be a stifling level of bureaucracy.

The SEC was persuaded that the process by which shareholders are presented with a proposal for re-capitalization into dual classes of voting stock is inherently coercive. Apparent efforts to provide equal value for each choice backfire, in fact, increasing the coercive character of the re-capitalization. Easterbrook and Fischel envision the possibility of a market in votes: "The collective choice problem would exert a strong influence over the market price of votes. Because no voter expects to influence the outcome of the election, he would sell the vote (which to him is unimportant) for less than the expected dilution of his equity interest. He would reason that if he did not sell, others would: he would then lose on the equity side but get nothing for the vote.... Thus, the legal rules tying votes to shares increase the efficiency of corporate organization." By enacting provisions that skew the voting power of different classes of stock and thereby protect directors and officers from removal, management tends to make itself self-perpetuating at the expense of shareholders.

Giving any shareholders the opportunity to dilute or relinquish their votes puts them on the horns of a dilemma. Harvard Business School professor Richard Ruback has demonstrated that "[t]he terms of the dual-class re-capitalization can be structured to compel individual outside shareholders to exchange even though the outside shareholders, acting *collectively*, would choose not to exchange...." Therefore, he reasons that "the rational choices by individual outside shareholders lead to an outcome that harms the outside shareholders" (emphasis in original). In other words, when the issue of limited voting rights is presented to shareholders, a rational, fiscally optimal choice made by an individual may, when made by enough individuals to carry the resolution, result in significant reduction in value of the holdings of all of them.

This was not the first time the one share, one vote issue caused controversy. This topic has played a colorful and dramatic role in American financial history. On October 28, 1925, William Z. Ripley, a Harvard University professor of political economy, warned:

"[T]he new stock, thus sold, is entirely bereft of any voting powers, except in case of actual or impending bankruptcy. General stockholders, to be sure, have always been inert, delegating most of their powers of election. But at worst they might always be stimulated to assist themselves, and, in any event, they all fared alike as respects profits or losses." In his book, *Main Street and Wall Street*, Ripley described particularly outrageous examples of abusive practices. In one, Industrial Rayon issued 600,000 shares of common stock. Only 2,000 carried voting rights. The attention Ripley drew to this kind of disparity touched off a firestorm in the public consciousness and one share, one vote became standard capitalization for the most prominent American industrial companies.[79] Disastrous experience in the 1920s with public utility companies and investment companies who consolidated control in a few voting shares, held by managers, led to the enactment of legislation to impose the one share, one vote rule on those companies.[80] The Public Utility Holding Company Act was a response to a 78-volume report prepared by the Federal Trade Commission (FTC). In the report, the FTC noted:

> *Instead of the corporation on one side and the public, on whom it will depend for trade and revenue, on the other, as was the case originally, we have a third party of minority ownership but with management and control which may be likened to absentee landlordism. Obviously, whenever this managerial group becomes swayed with lust for power and greed for excessive profits, the many other stockholders are treated as having few, if any, rights. In many instances, such managerial groups have failed to act as trustees for their corporations and other stockholders, as in equity they are supposed to do.*

The Investment Company Act of 1940 is also especially relevant here. The legislative history shows that it was enacted in response to three factors: the large proportion of investors involved (one in ten investors was a participant in an investment company, according to the SEC staff report to Congress), the serious discrepancy between equity interest and voting rights, and the consequent conflicts of interests between the senior and junior shareholders. The SEC, using its 1940 Act rule-making and enforcement authority, found that multiple classes of stock with divergent voting rights were a major factor in the corruption and abuse prevalent in the investment industry in the 1940s. Section 18 of the Act, applying one share, one vote to investment companies, was adopted in response. As Arthur Levitt, then chairman of the American Stock Exchange and, from 1993 to 2001, the chairman of the Securities and Exchange Commission, noted in 1987:

> *One of the historical sources of the New York Stock Exchange rule against non-voting stock lay in the use of such shares in the public utility industry in the 1920s: non-voting stock was a key device that underlay the pyramiding of personal control in that industry and that ultimately led to collapse, to a tragic loss of public confidence in our capital markets, and to direct federal regulation in the form of the Public Utility Holding Company Act.*[81]

These laws were based on the policy that management must be made accountable to shareholders who can vote them out. The one share, one vote standard was based on compelling evidence of the evils of pyramiding and otherwise separating management from the need to account to ownership. It was considered useful and efficient until the takeover era raised the specter that shareholders might be able to insist on meaningful accountability. Then the NYSE was quick to jettison it; or at least to try to.

It is important to recognize the distinction between public offerings of stock with varied voting rights and exchange offers, which are inherently coercive. There is clearly a premium for voting power, but one that varies according to circumstances, and some limited voting stock offerings are very popular. The 2004 public offering from Google was of A shares with one vote each, while the B shares retained by insiders had ten votes each. A 2003 paper, "Incentives vs. Control: An Analysis of U.S. Dual-Class Companies," by Paul Gompers and Joy Ishii of Harvard and Andrew Metrick of Wharton found that insiders with a great deal of voting clout "are reluctant to raise cash by selling additional shares, which would dilute their influence. As a result, they tend to skimp on capital expenditures and other spending that can improve results. They sacrifice some performance to maintain control. The super shares provided such an effective barrier to hostile takeovers that dual-class firms tended to employ poison pills and other takeover defenses less than other firms." The researchers also found that "dual-class companies tended to have more debt than single-class companies," according to an interview with Knowledge@Wharton. The study concludes that:

A potential explanation for dual-class firms' heavier reliance on debt financing is that investors may be reluctant to purchase the inferior voting stock of these firms, and they may therefore have to rely more heavily on debt financing. The most plausible explanation [for the study's findings] is that some firms adopt dual-class structures when their original owners are reluctant to cede control; later, these firms are less likely to tap capital markets (so as to avoid diluting control) and thus invest less, grow slower, and are valued lower.

The one share, one vote issue continues to be controversial. In 2004, the Toronto Stock Exchange was urged to adopt a one share, one vote requirement following the complaints by nonvoting shares of a broadcasting firm called CHUM over the controlling family's refusal of an attractive takeover offer. In 2006, David Beatty, managing director of the Canadian Coalition for Good Governance, was sharply criticized for serving on the boards of two companies with dual classes of stock. It is an issue in emerging economies as well. A 2003 study by Alexander Muravyev documented a significant premium for the voting stock of Russian companies compared with the nonvoting shares. See the discussion of Swedish corporate governance in Chapter 5. Note also that Hollinger, Adelphia, and Martha Stewart Omnimedia all had dual class voting structures and all had crises relating to failure of oversight. ■

CASE IN POINT REFCO

Refco, a futures-trading firm, went public in August of 2005. Two months later, CEO Phillip R. Bennett was arrested for trying to keep as much as $545 million in bad debts off the company's books, inflating earnings and bolstering Refco's stock price. The scandal took the stock down to one dollar a share, losing over $1 billion in (previously inflated) shareholder value, and Bennett was convicted of fraud and sentenced to 16 years in prison. This was clearly a failure of the gatekeepers who brought the company public, including public accounting firm Grant Thornton LLP, private equity firm Thomas H. Lee Partners, and Wall Street investment banks Goldman Sachs (later retained to help bail them out), Credit Suisse First Boston, and Bank of America Securities LLC.

However, it was also clearly a failure of the shareholders who lined up to invest even though the IPO documents had plenty of red flags. In the IPO document, Refco disclosed that it was under investigation and that its auditor, Grant Thornton, had identified "two significant deficiencies" in the firm's internal controls: it devoted inadequate personnel and resources to producing SEC-compliant financial statements on a timely basis and it did not have formal procedures for closing its books each quarter. Refco also acknowledged it typically does not charge off delinquent customer receivables, as required when a debt becomes uncollectable.

What is the responsibility of fiduciary investors who ignore such warnings? How will the system work if they fail to provide a rational market response?

A FRAMEWORK FOR SHAREHOLDER MONITORING AND RESPONSE

The regulatory framework governing the issuance and trading of public securities and the functioning of exchanges was almost entirely set up by two landmark statutes of the New Deal era. Congress passed the 1933 Securities Act and the 1934 Securities and Exchange Act after exhaustive debate and in response to overwhelming evidence of mismanagement, deception, and outright fraud during the stock market boom of the late 1920s. In the Public Utility Holding Company Act of 1935 and the Investment Company Act of 1940, multiple classes of common stock with differing voting characteristics were flatly prohibited for the affected companies. Rather than attempt with industrial companies to remedy specific mistakes or abuses, lawmakers attempted a far more difficult task; they tried to set up a process of corporate accountability – an impartial set of rules preserving the widest possible latitude for shareholders to protect their financial interests. In searching for a reliable and familiar model, they turned to America's own traditions of political accountability.

Shareholders were seen as voters, boards of directors as elected representatives, proxy solicitations as election campaigns, corporate charters and bylaws as constitutions and amendments. Just

as political democracy acted to guarantee the legitimacy of governmental or public power, the theory went, so corporate democracy would control – and therefore legitimate – the otherwise uncontrollable growth of power in the hands of private individuals. Underpinning that corporate democracy, as universal franchise underpinned its political counterpart, was the principle of one share, one vote.

OWNERSHIP AND RESPONSIBILITY

What is the accountability of the shareholders themselves? Shareholders reap the rewards from corporate performance. What about the risks? While one of the fundamental attributes of common stock is limited liability, shouldn't they bear some responsibility for a corporation's impact on society? In other words, how limited should the liability be?

NO INNOCENT SHAREHOLDER

Supreme Court Justice Louis D. Brandeis, who had a distinguished legal career defending both individual and public rights in large corporations, wrote passionately about the moral aspects of ownership of shares. His comments, quoted in part in the Boothbay Harbor case above, are a poignant reminder of how far modern stock ownership has strayed from its origins. They are as true today as when written almost a century ago.

> *To my mind there is no such thing as an innocent purchaser of stocks. It is entirely contrary, not only to our laws but to what ought to be our whole attitude toward investments, that the person who has a chance of profit by going into an enterprise, or the chance of getting a larger return than he could get on a perfectly safe mortgage or bond – that he should have the chance of gain without any responsibility. The idea of such persons being innocent in the sense of not letting them take the consequences of their acts is, to my mind, highly immoral and is bound to work out, if pursued, in very evil results to the community. When a person buys stock in any of those organizations of doubtful validity and of doubtful practices, he is not innocent; he is guilty constructively by law and should be deemed so by the community and held up to a responsibility; precisely to the same responsibility that the English owners of Irish estates have been held up, although it was their bailiffs who were guilty of nearly every oppression that attended the absentee landlordism of Ireland.*
>
> *He may be innocent in fact, but socially he cannot be held innocent. He accepts the benefits of a system. It is his business and his obligation to see that those who represent him carry out a policy which is consistent with the public welfare. If he fails in that, so far as a stockholder fails in producing a result, that stockholder must be held absolutely responsible, except so far as it shall affirmatively appear that the stockholder endeavored to produce different results and was overridden by a majority. Stockholders cannot be innocent merely by reason of the fact that they have not personally had anything to do with the decision of questions arising in the conduct of the business. That they have personally selected gentlemen, or given their proxies to select gentlemen of high standing in the community, is not sufficient to relieve them from responsibility.*

From the standpoint of the community, the welfare of the community, and the welfare of the workers in the company, what is called a democratization in the ownership through the distribution of stock is positively harmful. Such a wide distribution of the stock dissipates altogether the responsibility of stockholders, particularly of those with five shares, ten shares, or fifty shares. They recognize that they have no influence in a corporation of hundreds of millions of dollars' capital. Consequently they consider it immaterial whatever they do, or omit to do. The net result is that the men who are in control of it become almost impossible to dislodge, unless there should be such a scandal in the corporation as to make it clearly necessary for the people on the outside to combine for self-protection. Probably even that necessity would not be sufficient to ensure a new management. That comes rarely except when those in control withdraw because they have been found guilty of reprehensible practices resulting in financial failure.

The wide distribution of stock, instead of being a blessing, constitutes, to my mind, one of the gravest dangers to the community. It is absentee landlordism of the worst kind. It is more dangerous, far more dangerous than the landlordism from which Ireland suffered. There, at all events, control was centered in a few individuals. By the distribution of nominal control among ten thousand or a hundred thousand stockholders, there is developed a sense of absolute irresponsibility on the part of the person who holds the stock. The few men that are in position continue absolute control without any responsibility except that to their stockholders of continuing and possibly increasing the dividends.

That responsibility, while proper enough in a way, may lead to action directly contrary to the public interest.

Everyone should know that the denial of minority representation on boards of directors has resulted in the domination of most corporations by one or two men; and in practically banishing all criticism of the dominant power. And even where the board is not so dominated, there is too often that "harmonious co-operation" among directors which secures for each, in his own line, a due share of the corporation's favors.

Minority stockholders rarely have the knowledge of the facts which is essential to an effective appeal, whether it be made to the directors, to the whole body of stockholders, or to the courts. Besides, the financial burden and the risks incident to any attempt of individual stockholders to interfere with an existing management is ordinarily prohibitive. Proceedings to avoid contracts with directors are, therefore, seldom brought, except after a radical change in the membership of the board. And radical changes in a board's membership are rare.

Protection to minority stockholders demands that corporations be prohibited absolutely from making contracts in which a director has a private interest, and that all such contracts be declared not voidable merely, but absolutely void.[82] ”

And what of the institutional shareholders? The extra overlay of fiduciary obligation requires institutional shareholders to act if it appears reasonably cost-effective to do so. While an individual is free to ignore both Justice Brandeis's concern and his own wallet by ignoring his rights and responsibilities as corporation owner, institutions, as trustees, enjoy no such liberty. They are legally obligated to manage *all* trust assets prudently, including those relating to ownership. Institutional investors, individually and collectively, are so large that it will be increasingly clear that oversight is not only cost-effective but a more reliable investment than many of the alternatives, including active trading.[83]

Yet it is indisputable that shareholders have largely been unable to exercise the responsibilities of ownership of American corporations. In some respects, this "ownership failure" is due to the difference between tangible and intangible property.

> *The capitalist process, by substituting a mere parcel of shares for the walls and the machines in a factory, takes the life out of the idea of property. It loosens the grip that once was so strong – the grip in the sense of the legal right and actual ability to do as one pleases with one's own; the grip also in the sense that the holder of the title loses the will to fight, economically, physically, politically, for 'his' factory and his control over it, to die if necessary on its steps. And this evaporation of what we may term the material substance of property – its visible and touchable reality – affects not only the attitude of the holders but also that of the workmen and the public in general. Dematerialized, defunctionalized and absentee ownership does not impress and call forth moral allegiance as the vital form of property did. Eventually, there will be nobody left who really cares to stand for it – nobody within and nobody without the precincts of the big concerns.*[84]

As discussed above, the liquidity of share ownership has diluted the notions of ownership and responsibility and created obstacles to their exercise.

> *The owner of non-liquid property is, in a sense, married to it. It contributes certain factors to his life, and enters into the fixed perspective of his landscape .... At the same time, the quality of responsibility is always present. It is never possible, save with the irresponsible, the spendthrift, or the disabled, to decline decisions .... So long, then, as a property requires contribution by its owner in order to yield service it will tend to be immobile. For property to be easily passed from hand to hand, the individual relation of the owner to it must necessarily play little part .... Thus if property is to become a liquid it must not only be separated from responsibility but it must become impersonal, like Iago's purse: 'Twas mine, 'tis his, and has been slave to thousands.'*[85]

TO SELL OR NOT TO SELL: THE PRISONER'S DILEMMA

The incentives driving shareholder actions can be compared to the famous logical problem about collective choice called "the prisoner's dilemma." Two co-conspirators are captured and placed in separate cells by the police. They are each told that if neither confesses, they will both go to jail for five years. If one confesses, he will go free but the other will be sentenced to ten years. If both confess, both go to jail for eight years. Each must sit, unable to communicate with the other, and decide what to do. The dilemma is that an action that may benefit the individual making the choice (whether silence or confession) may have adverse consequences for the group (prison), whereas an action that benefits the group (silence) may have adverse consequences for the individual (prison, if the other confesses). This is also referred to as the problem of "collective

choice" and the "free rider" problem. Any shareholder who wants to exercise ownership rights to influence a company must undertake all of the expenses for only a pro rata share of the gains, if there are any. This problem has also produced one of this field's better oxymorons, by giving rise to the term for shareholders who deem it uneconomic to become involved in governance: "rational ignorance." This leads to votes against the investor's own interest in dual-class exchange offers and sales against the investor's own interest in two-tier offers.

CASE IN POINT **HERMES**

"Returns to Shareholder Activism, Evidence from a Clinical Study of the Hermes UK Focus Fund" found that British institutional investor Hermes "frequently seeks significant changes in portfolio companies' strategy, including large asset sales, divestments, reductions in capital expenditure and changes to payout policy. Hermes also seeks and achieves major changes to executive management, including the replacement of the CEO or chairmen." The study of individual engagement initiatives found "the fund substantially outperforms benchmarks and estimate that the abnormal returns are largely associated with engagements rather than stock picking."[86] ■

WHO THE INSTITUTIONAL INVESTORS ARE

The largest groups of institutional shareholders had the following US equity holdings in fall 2010.[87]

	$ billion
Private pension funds[88]	1,673.9
State/local pension funds	1,453.4
Mutual funds	3,814.5
Insurance companies	1,451.5
Household sector	6,767.9[89]

The increase in institutional funds has been extraordinarily rapid. In 1970, institutional assets stood at $672 billion. Over the next decade, that figure grew to $1.9 trillion. From 1980 to 1990, the value of institutional assets tripled, to $6.3 trillion. According to Carolyn Kay Brancato of The Conference Board, US institutional investor assets increased more than 144 percent from 1990 to 1998, reaching $15 trillion. With as much as 26.5 percent of these assets in equities,[90] which as of March 31, 2010 measured $9.3 trillion held in the United States alone,[91] institutions represent a powerful stockholding force. Indeed, by 2002, institutions owned more than 60 percent of equity of most large, multinational companies.[92] At this writing, institutions held 69 percent of Microsoft, 55 percent of General Electric, 70 percent of Intel, 80 percent of Cisco Systems, and more

than 90 percent of some publicly traded companies.[93] Clearly, concerns of institutional investors should be of the utmost importance to corporate management.

These institutions have one very significant thing in common. All are subject to the highest standard of care and prudence our legal system has developed, the fiduciary standard. In Justice Benjamin Cardozo's classic terms, they must be "above the morals of the marketplace." Beyond this guiding standard, however, the groups of institutions have little in common with each other. As one observer noted, "institutional investors are by no means a monolithic group."[94]

As you read through the descriptions of the structures, incentives, and obstacles facing each category of institutional investors, ask how that affects their ability to monitor the directors and managers of the companies in which they invest. Look for consistent themes and for individual variations, and try to determine the impact of both. Think carefully about the governance issues within the institutional investors themselves. As you do with corporate governance, ask who has the best information and the fewest conflicts of interest to make such decisions as defined benefit versus defined contribution, passive versus active fund management and other fund allocation issues, whether to sell stock in a company whose performance has been disappointing, or undertake some kind of shareholder initiative, etc.

One consistent theme is the problem of collective choice, as described in the "prisoner's dilemma" above. Another is the problem of agency costs. All institutional investors, by definition, are acting on behalf of others, whether pension plan participants, insurance policy holders, trust beneficiaries, or the less well-defined beneficiaries of charities and endowments.

As you read the descriptions below, look carefully at this issue in particular. One way to begin is to ask which party has which information. For example, until 2003, the beneficial owner of stock managed by an institutional investor had no idea how the proxies for that stock are voted. On the other hand, despite the growing popularity of "confidential voting," the corporation issuing the stock did know how the proxies are voted, and by whom. The Boothbay Harbor and Deutsche Asset Management examples illustrate this point.

BANK TRUSTS

Banks make up one large category of institutional investor, as trustees for everyone from pension plans to private estates. Trust administration is dominated by the complexities of federal income, gift, and estate taxes. Like other institutions, trusts have different classes of beneficiaries who have different kinds of interests.

In most instances, trusts are irrevocable, and, unless there is fraud, which is almost impossible to discover or prove, the bank can expect to continue to serve and collect fees as trustee, regardless of its investment performance. The security of the trust business may well be the reason for the traditional poor investment performance by banks. After all, in quite literal terms, they – unlike the beneficiaries – have nothing to lose. The trust contains "other people's money." *What does that mean for the way that the bank trustee votes proxies?*

Banks generally get the most profitable, and certainly the most interesting, portion of their business from prominent local corporations. The smaller the community in which the bank is located, the more completely its tone is apt to be dominated by the locally based businesses. Banks, especially trust departments, do not encourage innovation, especially positions that are contrary to corporate management's recommendations on proxies.

CASES IN POINT R.P. SCHERER AND CITICORP

R.P. Scherer. A rare lawsuit exposed the conflicts of interest that can occur in these situations. In the late 1980s, Karla Scherer watched the company her father founded, R.P. Scherer Corporation, seem to lose its way under the direction of its CEO, her then husband. As a major shareholder and board member, Ms Scherer soon realized that the inefficiently run company was more valuable to shareholders if it was sold. However, the board repeatedly refused to consider this option, forcing her to take the matter to shareholders directly in the form of a proxy fight for board seats. She filed a lawsuit, challenging the way her trust shares were being voted. Scherer recalls the most devastating blow to the ultimately successful campaign to force a sale was when she had to deal with her own trustees. "Manufacturers National Bank, the trustee of trusts created by my father for my brother and me, indicated it would vote all 470,400 shares for management, in direct opposition to our wishes. Remember the bank's chairman sat on our board and collected director's fees as well as more than half a million dollars in interest on loans to Scherer. During the trial, the then head of the bank's trust department admitted under oath that he did not know what the 'prudent man' rule was. He also stated that he had arrived at his decision to vote the stock for management in less than 10 minutes, without conferring with us and after affording management an opportunity to plead its case over lunch in a private dining room at the Detroit Club." The court initially ordered the appointment of an independent voting trustee, but the ruling was reversed.

Citicorp. The officer of Citicorp responsible for voting proxies determined that a proxy proposal made by Boeing management in 1987 was contrary to the interests of the shareholders, so she voted against it. She was summoned to the office of the chief executive officer to be reminded that Boeing was an important customer of the bank and expected their support. *How can a fiduciary vote proxies with prudence and diligence when there are always going to be conflicts of interest with the institution's commercial relationships?* ■

MUTUAL FUNDS

According to the industry's "Investment Company Fact Book," mutual funds hold about 24 percent of all US companies. Mutual funds are trusts, according to the terms of the Investment Company Act of 1940, which governs them. Otherwise, they bear little resemblance to the other institutional investors because of one important difference: they are designed for total liquidity. The "one-night stands" of institutional investment, they are designed for investors who come in and out on a daily basis, or at least those who want the flexibility to do so.

The investors are entitled to take their money out at any time, at whatever the price is that day. The investment manager has no control over what he will have to pay out or when he will be forced to liquidate a holding. He therefore views his investments as collateral; they are simply there to make good on the promise to shareholders to redeem their shares at any time. This is not the kind of relationship to encourage a long-term attitude toward any particular company the fund happens to invest in, and if there is a tender offer at any premium over the trading price, mutual fund investment managers have to grab it.

In the face of the real need to attract new money and to retain the investors he has in a world of perpetual and precise competition, the mutual fund manager cannot concern himself with the long term, because his investors may all show up today and he must be prepared to stand and deliver.

CASE IN POINT T. ROWE PRICE AND TEXACO

Investment firm T. Rowe Price held substantial Texaco stock in various accounts during Carl Icahn's proxy contest for that company in 1988. Its investment managers voted the stock in one account for Icahn and the stock in another account for incumbent Texaco management. Their justification was that one fund was explicitly short term in orientation while the other was long term, and that this was no different from having one fund buy the stock while the other was selling it.

Is this adequate justification? Does an investment management firm have an obligation to recognize the net impact of its proxy votes?

A 2007 report from The Corporate Library showed that in one family of funds managed by AIM, 14 voted against shareholder resolutions calling for an advisory vote on CEO compensation and 12 voted for them. ■

Mutual funds became embroiled in their own corporate governance scandal in 2003 when it was revealed that many of them were trading for their own benefit ahead of their clients. Fund manager Gary Pilgrim actually bet against his own fund with an independent investment through another vehicle he established. Commentator Alan Sloan observed, "It's as if a captain ran his ship into an iceberg, however inadvertently, then jumped into a private lifeboat and collected on his passengers' life-insurance policies."

A number of funds were charged with "late trading" (executing trades after the close of business at that day's stock price instead of the next day's, as regulations require) and "market timing" (allowing some clients to get beneficial treatment in the timing of their trades). Almost all of the cases brought resulted in settlements, without an admission of guilt, consistent with the discussion of corporate crime in chapter 1. The widespread problems did lead to some reforms in mutual fund governance, but they were overturned in litigation brought by the Chamber of Commerce

due to procedural insufficiencies. At this writing, it remains unclear whether the SEC will try to issue them again.

Our primary concern in this section is not the governance of mutual funds but their role in the governance of their portfolio companies. In 2004, following the controversy over the last-minute vote switch by Deutsche Asset Management for the Hewlett-Packard/Compaq merger (see case in point), the SEC issued rules that for the first time required mutual funds and money managers to disclose their proxy voting policies and any votes inconsistent with those policies. The industry objected, claiming that it would be very expensive, but record comments in favor of the proposal led to its approval by all but one of the SEC commissioners.

A 2006 study co-authored by the American Federation of State, County, and Municipal Employees and The Corporate Library called mutual fund managers "enablers of excess." The study noted that, "With a few exceptions, the largest mutual fund families are complicit in runaway executive compensation because they have not used their voting power in ways that would constrain pay by tying it more closely to individual company performance. In the aggregate, the mutual funds voted to support management recommendations on compensation issues – both recommendations to vote in favor of management compensation proposals and recommendations to vote against shareholder proposals seeking executive pay reform – 73.9 percent of the time and rejected the management position only 23.7 percent of the time. The specifics of individual pay plans did not seem to affect the votes cast – those generally seen as excessive were as likely to get "yes" votes as those more closely tied to performance. Perhaps it is not surprising that the fund identified as being the greatest "enabler" of excessive pay, Morgan Stanley, was also at the top of a recent list of overpaid executives from proxy advisory firm Glass-Lewis.

A 2010 update showed that:

- Funds supported 84 percent of management-sponsored proposals in 2009 on average, unchanged from 2008.
- Federated and Fidelity were the fund families least likely to support management-sponsored resolutions, with average support of 55 percent. Barclays, Northern, State Street, and Vanguard had the highest levels of support for management resolutions, with average support greater than 94 percent.
- Support for management's director nominees remains middling, averaging 50 percent support by the 25 fund families included in this study, with six fund families voting with 100 percent support for management's nominees and six fund families voting for none of the management's director nominees.
- Funds voted in favor of 56 percent of shareholder-sponsored resolutions, on average. Governance-related resolutions, which comprised 76 percent of all shareholder-sponsored resolutions published in proxies in 2006, received 44 percent support from funds. This figure has increased over the three years spanned by this study for 14 of the largest fund families, up from 37 percent in 2004.
- Fidelity and Federated were the fund families least likely to support corporate governance shareholder resolutions, with an average 12 percent and 20 percent support, respectively. The fund families most likely to support these resolutions were Schwab, which supported 83 percent of governance shareholder resolutions, and T. Rowe, with 72 percent support.
- Among shareholder resolutions, those proposing increased information on conflicts of interest of compensation committee consultants received the highest level of fund support – 63 percent, on average – in the 2009 proxy season. The largest category of shareholder resolution, those urging

majority affirmative support for uncontested director elections, achieved 60 percent support from funds, on average – up significantly over the past three years.[95]

INSURANCE COMPANIES

Insurance is the only major industry that has successfully avoided any significant federal regulation, although "special accounts" and subsidiary manager investments are subject to ERISA and other federal rules. Life and casualty insurance companies prefer to deal with state legislatures, with whom they have historically had a close relationship.

State law has until most recent times severely circumscribed the extent to which insurers are allowed to invest their own funds in equities. Even today, only 14 percent of insurance fund assets are invested in common stocks. The current limit on stock is 20 percent of a life insurer's assets, or one-half of its surplus. However, insurers still may not take influential blocks: life insurers may not put more than 2 percent of the insurance company's assets into the stock of any single insurer, and property and casualty insurers may not control a noninsurance company.[96]

Insurance companies, perhaps more than any other class of institutional investor, have a symbiosis with the companies in which they invest. First, they are usually holders of debt securities of any company in which they have an equity investment; debt instruments are very compatible with their needs because they have a reliable, set payout. Second, they typically have – or would like to have – a commercial relationship with the company by providing insurance or a product to meet the company's pension obligations. Third, like most other institutional shareholders, they are under no obligation to report to their customers on their proxy voting (but the companies whose proxies they vote – and with whom they do business – do know). Finally, like all other shareholders, the collective choice problem makes any form of activism uneconomic. Therefore, it is not surprising that the insurance industry consistently votes with management, regardless of the impact on share value. For example, one Midwestern insurance company wrote that its policy "is to support management positions on normal corporate policy and matters falling within the conduct of a company's ordinary business operations."[97]

UNIVERSITIES AND FOUNDATIONS

Universities and foundations are institutional shareholders because they are funded through endowments. People contribute to a fund, and the interest that fund generates is used for whatever charitable or educational purpose the endowment permits. In 2010, the Harvard endowment was $27.4 billion and the Ford Foundation had $10 billion. In 2006, Warren Buffett announced he was donating $30 billion over time to the Gates Foundation, adding to the $25 billion contributed by Bill and Melinda Gates. This money is put into widely diversified investments, including common stock. Although these organizations have "not for profit" status under US tax laws, they seek returns as rigorously as any other investor. However, they have not been rigorous in the exercise of their stock ownership rights or responsibilities.

Foundations and universities are no less subject to commercial pressures than banks and insurance companies. After all, their money comes from alumni, who are often business executives, and from businesses themselves. One study reported that in 1985 corporate contributions to American universities and colleges "surpassed donations from alumni for the first time."[98] Indeed, nonprofits are "selling" a much less tangible product, so they must be especially diplomatic. Foundation

and university trustees are usually drawn from the business community. The trustees of the Ford Foundation, of Harvard, of the New York Public Library, or of any public museum or symphony are drawn from the same list as the directors of the largest corporations. Many corporate boards include members of the academic community, whose programs and schools receive large contributions from the grateful companies. This makes it difficult for these investors to provide meaningful oversight or feedback to portfolio companies. A typically diplomatic – and vague – policy can be found on Harvard's website: "Harvard encourages corporations whose securities it owns to provide the information stockholders need to make informed decisions on proxy votes, and Harvard considers carefully how to vote each and every proxy."

Harvard has the largest school endowment in the nation, second in all endowments after the Gates Foundation. It supplies roughly $1 billion, or 38 percent of the university's annual $3.8 billion budget. The biggest chunk of the endowment funding goes for financial aid. In fiscal 2005, head manager Jack Meyer earned $6 million and two other managers earned about $17 million each, triggering sharp criticism from alumni and others. Some of its best money managers, including Meyer and his successor Mohammed El-Erian, left to go to other financial services companies or to start their own firms, where their pay is not disclosed (but certainly much higher). Harvard invests in their new companies and retains their services, which are less visible and therefore not upsetting to the monitoring constituencies.

EXECUTIVE PAY FROM THE CONSUMER SIDE – A LEADING INDICATOR OF RISK

Stephen Schwarzman, CEO of the Blackstone Group, described to the board of a nonprofit organization the struggle between the Obama Administration and the business community regarding increasing taxes on the compensation structure of private equity fund managers. "It's a war…[i]t's like when Hitler invaded Poland in 1939."[99] If that statement seems hyperbolic, well, so is CEO pay. Consider how that relates to the incentive and ability of institutional investors to monitor the pay at portfolio companies. Compensation and the link between pay and performance comes up in every chapter in this book. Here we look at it from the point of view of the ultimate consumer – the shareholders, the role it plays (and should play) in evaluating investment risk and the role shareholders play (or should play) in providing market feedback to ensure that it aligns managements' interests with theirs.

The pay of corporate executives, particularly of CEOs, continues to dwarf that of the average company employee. In 2009, the Institute for Policy Studies reported the average CEO of a major US corporation was paid 263 times the salary of the average American worker, down from a high of 319 times the average worker in 2008.[100] Compare this disparity to 1965, when the average CEO of a major American corporation earned 24 times more than the typical worker.[101] There is growing evidence that the commonly propounded theories of executive compensation have not achieved their intended results, and that the pay of top executives is inflated and counterproductive. Furthermore, the negative publicity, the animus within the company generated by such compensation, and the concerns of investors to rein in such payments through "Say-on-Pay" reform (now required at least every three years by means of the Dodd–Frank Act) means executive compensation presents some of the greatest challenges to boards and their general counsel today.

Compensation committees typically cite the necessity to "retain talent" or "remain competitive" in justifying the massive "compensation structures" provided to their corporation's chief executive. Typically employing a combination of annual salaries, performance bonuses, stock

options, and long-term restricted stock, boards employ compensation consultants (either firms or individuals, such as Graef Crystal in the *Disney* case, formerly of the leading executive compensation firm Towers Perrin, which is now Towers Watson[102]) to design pay packages to keep their company's leaders interested in the both the short- and long-term success of the company to best ensure positive business results, and to keep them happy enough to not jump ship when a better offer comes along as well.

However, recent studies have shown that in designing executive pay packages, boards inordinately select highly paid peers to use to compare to their own executives' pay,[103] inflating their compensation in a manner that assumes, as one reporter noted,[104] that the executives hail from Garrison Keillor's fictitious Lake Wobegon, where "all the children are above average." Further studies[105] examining the "entrenchment," "learning," "career concerns," and "dynamic contracting"[106] hypotheses of increasing CEO pay over time have shown evidence that well-governed firms tend to return better compensation results, with particular evidence of the career concerns and dynamic contracting theories of compensation.

Ann Yerger, an Executive Director of the Council of Institutional Investors, notes that the CII has developed a list of ten "red flags" to help its member institutions examine the pay policies of the companies they invest in. These include:

- policies that require executives to own and retain stock for the long term, with vesting requirements that do not unnecessarily shield the executive against downside risk;
- meaningful "clawback" provisions that can recapture bonuses later found to be unearned;
- a larger portion of compensation controlled by performance-based metrics and goals determined by and dispensed with board oversight;
- curtailment and control of post-employment and separation benefits commonly known as "golden parachutes";
- an open, goal-oriented and straightforward compensation policy, prepared with the help of independent compensation advisors.[107]

Ultimately, directors are best advised to take careful, deliberate consideration in not only the selection and compensation of their company's management but also in monitoring and continually evaluating their performance. With the increased scrutiny of the government, shareholders, and the general public, the potential fallout of a poorly conceived payment plan can be immense. In January–May of 2011, the first proxy season after Dodd-Frank imposed a "say on pay" requirement, fifteen pay plans failed to get a majority of shareholders to vote yes. All were at companies with a high proportion of institutional investors.

CASE IN POINT DIRECTOR RESIGNATIONS

Note that the resignation of one of a company's "outside" directors (a director not controlled by the company in the same sense as an employment relationship, and similarly not standing to make personal financial gain from a transaction) frequently portends negative events for the company, such as a federal class action securities fraud lawsuit, earnings restatement, or a general downturn for the company. Some researchers have noted that

this may be because the outside directors want to escape the reputational damage caused by such events.[108] What does the surprise resignation of a director before their company releases its latest compensation figures say about the future of the company?

CASE IN POINT INTERLOCKING DIRECTORS

The dean of a university served as head of the compensation committee of the company headed by the chairman of his university's board. The CEO and his company were both large contributors and the company funded a good deal of the university's research (see charts in chapter 3).

If you were the dean, and you had to vote on the CEO's pay plan, what steps, if any, could you take to make sure that you were objective? (Of course, the same question applies to the CEO voting on the dean's pay plan, but in that case it is not a question of corporate governance but university governance.)

CASE IN POINT THE ALUMNI PROTEST FEES PAID TO MANAGERS OF THE HARVARD ENDOWMENT

In 2006, a group of Harvard alumni protested the fees paid to the in-house managers of the Harvard endowment. The total paid to six investment staff in 2003 was $107.5 million. The top two, Maurice Samuels, who oversees foreign fixed-income securities, and David R. Mittelman, a US bond investor, split just under $70 million. The alumni argued that this was not appropriate for a nonprofit educational institution. The University argued that if they wanted the kind of results that top Wall Street firms got – or better – they had to be willing to pay competitive compensation. Furthermore, the Harvard fund managers have "clawbacks" so that if they do not reach their targets they must pay the university back. It is therefore hard to complain that it is not fair or – since in the past they have had to return some of the money – that it does not work.

Compare this with Fannie Mae (see case study) and the NYSE, where hybrid organizations that were part-government, part-private (structured very differently) justified enormous executive compensation packages by comparing their CEOs to the heads of public companies.

CASE IN POINT THE ROSE FOUNDATION TAKES ON MAXXAM

The Rose Foundation for Communities and the Environment is a rare foundation that puts the ownership rights of its endowment money where its programs are. Concerned about Maxxam's environmental and labor policies, Rose and its allies ran dissident candidates for the board in 1999 and 2000. Although they knew from the beginning that they had no chance of success, because Maxxam CEO Hurwitz had majority control of the voting shares, they believed that their campaign, which included a full-page ad calling the board a "rubber stamp," would put pressure on the Maxxam board to address their concerns. ■

CASE IN POINT *READER'S DIGEST*

The 46th largest private foundation in the United States is the Wallace Foundation, established by the founders of *Reader's Digest*, DeWitt and Lila Acheson Wallace. It is the successor organization to a group of "family philanthropies" that has donated over $2 billion since the 1950s. Its assets in 2008 amounted to $1.1 billion. Until 2003, it was the primary shareholder of *Reader's Digest* stock, with the overwhelming majority of its voting shares. Almost all of the shares issued to the public were nonvoting. The intentions behind this structure were benign, but the result was the worst of both worlds for both the foundation and the publicly held company, which shared overlapping directors.

A philanthropic foundation's tolerance for risk in its endowment investments is not compatible with the kind of risk tolerance required for a public company. As a result, the company became set in its ways, forgoing innovation or even changes that responded to changing times and tastes. The foundation's assets were also shrinking as a result of the stock's decline. Both the foundation and the company recognized (with some outside pressure from shareholders) that keeping that structure would have locked the entities in a death spiral.

In March of 2007, an investor group led by Ripplewood Holdings LLC completed a $2.4 billion acquisition of the company. However, that purchase saddled *Reader's Digest* with over $2 billion in debt, forcing the company to file for Chapter 11 bankruptcy in 2011. Ripplewood was out as owner of the company and its lenders swapped their debt for equity in the post-bankruptcy *Reader's Digest.*

Some of the same issues are presented by the unexpected role of pension funds as significant, even majority, holders of public companies. Like trust fiduciaries, pension fiduciaries are more risk-averse than the theoretical investor anticipated by Adam Smith. This may lead to over-investment in blue chips and under-investment in emerging companies. It may also lead to an overly conservative approach to the exercise of shareholder ownership rights and oversight powers. ■

PENSION PLANS

In the heady days before the financial crisis, pension funds rode high. "We own the economy now," said Carol O'Cleireacain, then New York City finance commissioner and trustee of four city employee pension funds with nearly $50 billion of assets.[109] David Ball, then director of the Pension and Welfare Benefits Administration that oversees billions of dollars in pension assets, said that institutions could accurately borrow a phrase from the comic strip Pogo: "We have met the marketplace and they is us."[110] At one point, the California Public Employees' Retirement System (CalPERS) grew about $1 billion every two months – "in a year more than four times the median market value of a *Fortune* 500 industrial company; in a year, enough to buy all the common stock of General Motors, with enough left to buy five tankfuls of gasoline for each vehicle it makes."[111]

Since then, the fortunes of pension plans – particularly public state and local funds – have suffered. States face unfunded liabilities (the difference between the amount the state is legally obligated to pay pension fund members and the amount available to pay out) of between $1 and $3 *trillion* dollars. The largest fund, CalPERS, valued at over $250 billion in 2007, dipped as low as $160 billion in March 2009, though it has since regained some value to settle near $210 billion. More state pension funds face massive shortfalls, with projections forecasting that as many as 31 states will be unable to meet their pension obligations by 2030.[112] As these states are unlikely to approach the 8 percent investment returns necessary to avoid insolvency, and with government leaders unlikely to attempt to reduce state benefits (note the riots and general unrest throughout Europe in 2010 and the protests in Wisconsin in 2011), a federal bailout may be necessary to avoid the complete collapse of many of the nation's public employee retirement funds.[113]

THE BIGGEST POOL OF MONEY IN THE WORLD

The largest institutional investors, the group that includes the largest collection of investment capital in the world, are the pension funds. An understanding of this group is one of the most important elements to understanding the current state of corporate governance, as well as its future direction and potential.

Although they are very diverse in many ways, pension funds share several important characteristics. As we examine their impact not just on corporate governance but also on competitiveness and productivity, we need to understand the impact of the most important characteristic they have in common: they are all trustees. A money manager who does not perform may lose clients. A trustee who does not perform may pay a fine, be permanently prohibited from managing pension

money, even go to jail. This is certainly a good way to protect the pension funds, but it is almost as certainly not a good way to move markets. The problem is that no one ever realized that the pension system would quickly take over the market, for rather Gresham-like reasons.[114]

After World War II, the US government provided generous tax incentives to encourage individuals and employers to make provision for retirement income. The program was subsidized three ways:

- the employer's payments to the plan were deductible for federal income tax purposes;
- all transactions by the plan – buying, selling, collecting income – were exempt from tax; and
- the recipient is allowed to stagger the receipt of payments to fall into the most advantageous year from a tax point of view.

This huge federal subsidy transferred national savings from savings banks to pension systems as individuals responded to the tax incentives. They preferred to save 100-cent dollars in retirement plans rather than 50-cent dollars in the savings bank. Thus, over 30 percent of all the equity investments in the country are held in public and private pension plans. This means that the largest accumulation of investment capital in the world was the responsibility of trustees, who have a perspective (and set of incentives) very different from the strictly economic "invisible hand" of the capital markets.

The "invisible hand" is now the hand of these trustees of public (state, municipal, federal) and private (corporate and union) pension plans. Peter Drucker called this "The Unseen Revolution" in 1976, noting that "If 'Socialism' is defined as 'ownership of the means of production by the workers' – and this is both the orthodox and the only rigorous definition – then the United States is the first truly 'Socialist' country."[115] Drucker forgot one important fact, however. The trustee of the employee pension plans did not work for the beneficial holders; it was the other way around. Despite the requirement in the ERISA legislation that the funds be managed "for the exclusive benefit of plan participants," the investment and share ownership choices often benefit corporate managers.

> *Shortly before the year 2000, there will be more workers in companies that are more than 15 percent employee held than in the entire US trade union movement. The property rights of workers will dwarf labor laws as an option for influence in corporations. For the first time since the 1930s, America will see a new wave of employee activism – one more likely to be low key and business oriented than the early trade union movement. But this time unions will be joined by company-wide employee associations – ad hoc and coordinated – asking for a say because they are either the dominant shareholder or the second major shareholder in the firm.*[116]

Drucker was right about the pension funds becoming the dominant owner of the securities of publicly held corporations, but he was wrong that the result would mean a kind of socialism, with the workers controlling their companies. The sole substantive requirement of the Employee Retirement Income Security Act (ERISA) is diversification. As a result, the pension funds hold a small fraction of just about everything instead of most of something, seldom enough to support any form of activism, especially in light of the other obstacles discussed in detail below.

Is this "invisible hand" capable of managing the economy's rudder? While in theory the trustees are vitally committed to earning the highest possible rate of return, in reality there is little incentive for most of them to perform better than the actuarially defined return necessary to meet an actuarially defined payout (for a defined-benefit plan) or a market rate of return (for a defined-contribution plan).

A defined-benefit pension plan specifies the level of benefits it will pay, or the method of determining those benefits, but not the amount of company contributions. Contributions are determined actuarially on the basis of the benefits expected to become payable. A defined-contribution plan specifies the amount of contributions, but not the level of benefits. The size of the pension is determined by how much (or how little) is in the account at the time the plan participant retires. Over the last 20 years of the twentieth century, defined benefit plans (with a guaranteed payout, regardless of how well the investments do, putting the risk on the company), once prevalent, all but disappeared from the corporate side as pensions were converted to the more manageable and predictable defined contribution (with a payout that varies depending on investment return, with the risk borne by the employee).

Defined-benefit plans with cost of living adjustments (COLAs) are an effort to insulate a particular class of citizens from the economic vagaries of the world by guaranteeing them a set level of buying power, no matter what the rate of inflation. This is a very expensive commitment, and companies and states are increasingly reluctant to assume it. The total number of defined-benefit plans increased from 103,000 in 1975 to 175,000 in 1983, and then declined precipitously to 83,600 in 1993. As of 2009, the AFL–CIO determined that only 49,000 defined-benefit plans remained, covering a mere 20 percent of private-sector workers, down from 38 percent in 1980.[117] In contrast to the fall in defined-benefit plans, the total number of private defined-contribution plans rose steadily from 208,000 in 1975 to 618,500 in 1993. Over the past 20 years there has been a huge shift from defined-benefit plans, in which the employer bears the risk, to defined-contribution plans, in which the employee bears the risk, and 2006 legislation, called The Pension Protection Act of 2006, will accelerate this trend. One article called the new law "Ice Age for the Defined Benefit Dinosaur."

Defined-contribution plans are the alternative. Because the amount that the employer and the employee pay in is fixed, the employee has a certain control over the investment of the funds. The funds are entirely his (subject to restricted use for statutorily permitted purposes, like the purchase of a residence or for education costs), and so is the risk of gain and loss. The employer ceases to play a buffering role either with respect to the performance of plan investments or with respect to inflation in the outside world.

It may appear that employees have lost financial ground in the trend toward defined-contribution plans, because of the loss of security. It is only in defined-benefit plans that the employer acts as guarantor of a set level of purchasing power after retirement. However, defined-contribution plans have advantages for the plan participant as well, including portability, the ability to change jobs and to take the benefits along. The ultimate problem lies in investment policy. As we have pointed out above, the trustee of the entire defined-benefit pool has the luxury of making the optimum long-term investment in stocks. On the other hand, the individual acting as his own "trustee" for a defined-contribution plan, worried on a day-to-day basis about preserving his retirement fund, is apt to invest in bonds. He will be satisfied with losing only a little bit as long as he avoids running the risk of losing a lot. Thus, the assets committed to an individual under a defined-contribution scheme are apt to be invested less profitably, and the aggregate will have a massive long-term impact on what funds are actually available in retirement.

As public funds gradually evolve from defined benefit to defined contribution, plan participants will have the potential for increasing involvement – and increased risk. The primary purpose of the pension system in the first place was to make it possible for employees to have their retirement secured through management by professionals. In defined contribution plans, although the trustee will manage plan assets and retain ownership responsibilities with respect to plan stocks, plan participants exercise more choice in selecting investment categories (stocks or bonds), as in the Federal Employees' Retirement System Act (FERSA) example below. President George W. Bush tried to convert Social Security to a defined contribution plan. While the idea lost a lot of its appeal after the stock market volatility of the early twenty-first century, it continues to be debated as a way to forestall a crisis when the unfunded obligations of the system get out of control.

The assets in a public plan are assumed by the actuaries to earn a particular rate of return. It was typically 9 percent in 1999, but many plans exceeded that level for the several years of the century-end bull market. This created a condition where most of the largest plans in 2000 were substantially over-funded. Clearly, if the plan can earn a consistently higher rate of return than the one assumed, the amount of money required to be paid in by the state from taxes can be reduced. In the case of private pension systems, this translates into higher earnings for the corporation and, presumably, bonuses for the pension manager. With public plans and civil service salaries, however, there are no bonuses, though in some cases there may be political benefits. Compare this pre-crisis standard to the present situation, where CalPERS needs to meet a 7.75 percent rate of return to satisfy its payment obligations, and its losses during the financial crisis pushed its 20-year average annual rate of return to 7.9 percent.[118]

In general, though, the individual responsible for the investment of public plan funds has no incentive to achieve beyond the mandated averages. As Edward V. Regan, former Comptroller of the State of New York, said: "Nobody ever got elected to anything by beating the S&P 500. On the other hand, for one bad investment, they'll throw you out." It is not surprising that Regan responded by investing in an "index." This meant that the state pension fund performed exactly as well as the Standard & Poor's 500; in essence it *was* the S&P 500.[119] Indeed, given the inability of actively managed funds to beat the indexes, this may be the very definition of prudence, but that means that we must consider the implications of these huge passive investments. *How can the market be efficient if such a large chunk of it cannot respond to good or bad performance by trading?*

Some states have already raised the eligibility age, capped benefits, or made other cuts, but most of them are making accounting adjustments now to pay for cuts that will not begin for years. "Despite its pension reform, Illinois is still in deep trouble. That vaunted $300 million in immediate savings? The state produced it by giving itself credit now for the much smaller checks it will send retirees many years in the future – people who must first be hired and then, for full benefits, work until age 67. By recognizing those far-off savings right away, Illinois is letting itself put less money into its pension fund now, starting with $300 million this year. That saves the state money, but it also weakens the pension fund, actually a family of funds, raising the risk of a collapse long before the real savings start to materialize."[120]

New Jersey pension trustee Orin Kramer wrote an op-ed for the New York Times that explained why the public pension system is in much worse shape than reported due to an accounting "mirage."

> *[P]rivate corporations, in measuring the value of the assets in their pension systems, are required to use real portfolio market prices. Government accounting standards, in*

contrast, allow public pension systems to measure their assets based on average values looking back over a period of years. In most instances those average values add up to a figure that is much higher than the amount of money the pension plan actually has. Public pension funds are also allowed to make assumptions about future investment returns that many of us would regard as overly optimistic. And since those assumed returns are incorporated into measurements of the fund's status, as if they had already been realized, states that come up with the most rosy market forecasts look, on paper, to be better financed. This government accounting mirage adds up to an enormous national problem. If you use the most recent data from government accounting standards, the collective shortfall for state and local governments nationwide appears to be about $1 trillion. If you use corporate accounting standards to estimate the value of those public pensions, however, you come up with a shortfall two and a half times as large – about $2.5 trillion. Employing a third approach that assumes, as economists generally do, that even corporate accounting standards in this area are too lenient, public pension underfunding is about $3.5 trillion, or one-quarter of gross domestic product. To make matters worse for state budgets, hidden underfunding of public employees' health retirement costs is even greater than that of their pensions.[121] ”

State pension funds may be facing as much as a $78 billion shortfall and have nowhere to go for help but a federal bailout. Kramer recommends immediate recognition of the real liabilities embedded in the public pension system, but acknowledges that this will force states to make immediate cuts in state programs and will likely lead to increased privatization of parking meters, roads, and other public services. Unsurprisingly, no politicians have been willing to take that on.

CASE IN POINT EATING THE SEED CORN: NY'S PENSION FUND BORROWS FROM ITSELF

In 2010, New York governor David A. Paterson and the state legislature tentatively agreed "to allow the state and municipalities to borrow nearly $6 billion to help them make their required annual payments to the state pension fund. And, in classic budgetary sleight-of-hand, they will borrow the money to make the payments to the pension fund – from the same pension fund.... Another oddity of the plan is that the pension fund, which assumes its assets will earn 8 percent a year, would accept interest payments from the state that would probably be 4.5 percent to 5.5 percent."[122]

How does that work? What is the obligation of a fiduciary in making that determination? ■

CASE IN POINT MAINE STATE RETIREMENT SYSTEM[123]

The Maine Public Employees Retirement System (MePERS) has a typical defined-benefit plan. Like most public pension plans in the United States, it offers participants "defined benefits" on retirement. The employee is paid an amount based on the cost of living as well as other factors. The formula takes into account expected raises, inflation, and differing retirement ages. The formula is the number of years of service times 1/50 times the average of the final three years' pay. This produces an ideal result for a "typical" career state employee: after 35 years of service, an individual can retire at age 62 with a pension calculated as 70 percent of "final pay."

Public plans generally provide for a level of "inflation protection" for payments. In Maine, there is a cap of up to 4 percent per year. The state is required to pay into the plan every year an amount calculated by actuaries to be sufficient, if invested according to the assumed returns, to produce an adequate amount of capital to pay the system's commitments as they mature.

Maine's promise to make "defined-benefit" payments to participants is enforceable whether or not there are assets in the pension plan. If the plan does not have enough, it will have to come out of tax revenues. The purpose of the plan (and the basis of the actuaries' calculations of the amount of annual payments) is to match pension payments with the benefits from the service of the participant. Like social security, it is something of a Ponzi scheme. Today's workers pay in money that is immediately sent out to today's retirees.

To make the system work, then, today's taxpayers must pay in as well. The portion of their taxes allotted to the pension system must be enough, when invested, to provide today's public employees with a suitable pension when they actually do retire. The amounts in the pension plan serve two purposes. They serve intergenerational fairness by assuring that those who receive the benefits (i.e., current citizens) pay the full costs. They also act as a buffer (if not a complete guarantee) against the changing politics and priorities of the state budgetary process. While a state can (and does) break some promises, the legislature makes it a little more difficult by segregating pension assets in an independent trust (difficult, but not impossible – see the discussion of economically targeted investments (ETIs) later in this chapter).

The dynamics of a defined-benefit system are skewed heavily in favor of an individual who works until the end of the anticipated term of service. In the state of Maine system, a hypothetical defined-benefit participant only begins to get a portion of the state's contribution during the last third of his term. After that, his interest soars.

What this is doing is to "lock in" state employees for their full working lives. Neither the state nor the employee can afford flexibility. Is this what the system intends?

The liability assumptions have been subject to great change over the past half dozen years:

- In 1987, there was an increase of about $0.5 billion to reflect a change in assumptions as to the retirement age.
- In 1992, assumptions were changed by $0.45 billion to reflect the level of pay increases at career end (and to reflect vacation and sick pay).

States are trying a variety of means to lower their OPEB liability, with some taking money from their general funds, others issuing bonds, and others cutting benefits or extending the time required for an employee to be vested. Maine Governor John Baldacci has proposed establishing a trust at the Retirement System that would fully fund the healthcare benefit for state retirees over the next 30 years. However, it calls for an initial $80 million contribution and then annual payments of needed contributions plus 10 percent more to catch up to the needed level of funding. As with the pension system, these figures could change over the years. There are a lot of variables, all of which seem to be escalating, from the cost of healthcare and number of participants to the rate of return – to say nothing of future state legislators' willingness to continue to make the necessary contributions when other short-term needs seem more politically appealing.

State employee compensation is bargained, but pension obligations are legislated. This means that lobbying is the mode of employee involvement. In 1992, in an effort to reduce state expenditures, the legislature modified benefits for all employees with fewer than seven years' creditable service. They excluded from the definition of "earnable compensation" payments received for unused sick leave or vacation; raised the minimum age for retirement with full benefits by two years to 62; and increased the penalty for retirement before the minimum age. The state employees went to court, arguing that as soon as they accepted employment they had in effect accepted a contract providing that the state would provide them with the benefits at that time and that they could not be reduced. Other states, like California, have ruled in favor of the employees in these challenges. The lower court in Maine also did so, but it was reversed by the state supreme court, which ruled that only benefits actually due could not be changed; those merely anticipated could be. The state employees also attempted to challenge the 1992 amendments in the federal courts, but were similarly unsuccessful.

Two important developments came out of the 1992 amendments and the challenges to those amendments. In 1995, the Maine Constitution was amended (a) to require the unfunded liability to be retired (paid down) in 31 years, (b) to prohibit the creation of any future unfunded liabilities (i.e., future benefit increases must either be prospective only or must be paid for upon enactment), and (c) to mandate that any experience losses (i.e., costs in excess of projections or investment shortfalls) must be paid off over a period no greater than ten years. These constitutional changes make it very costly

and difficult to improve pension benefits within the system (and they have had the unintended consequence of "locking in" the 1992 benefit reductions).

The MePERS Trustees were able to meet the 31-year constitutional paydown requirement for the first 15 years of its existence due to favorable investment returns and actuarial reserves. The negative stock market returns from 2001 to 2010, however, finally hit the system hard when it had to present the constitutionally mandated actuarial bill to the Administration for the 2011–13 premium. The mandated cost increased from $630 million for the 2009–11 biennium to $920 million for the next biennium, a 46 percent increase. The new Governor and Legislature will have no choice but to pay this 46 percent increase despite a nearly $1.0 billion "structural deficit" in other line items of the budget. This result is mandated by the 1995 Constitutional Amendments and will put an increasing burden on the State's finances over the next 10 years (with increases to nearly $2 billion per biennium, 300 percent higher than the 2010 level, depending on investment returns).

The second significant development occurred in 1999 when the Maine legislature, the administration, and the employee unions agreed to resolve the pension contract issue by passing a statute making certain portions of the Retirement System "solemn contractual commitments of the State protected under the contract clauses of the Constitution of Maine…and the United States Constitution" (5 MRSA, para.17801). This enactment covers the current benefit levels and benefit structure, and ensures that benefit reductions of the type passed in 1992 could not be done in the future.

The "conventional wisdom" is that defined-benefit plans are "cheaper" than defined-contribution plans in the sense that less benefit is actually received under the former system. The reason is that so few defined-benefit plan participants actually serve the optimal period of time; the others are losers. Younger, shorter-service employees are absolute losers under the current Maine system since their own contributions, plus earnings, exceed the value of the pension promise being made to them. Most of these employees will receive no (zero) benefit from state contributions at all. Someone who leaves before five years is not vested; 25 or more years of employment are essential for a reasonable benefit. Employees hired at older ages (e.g., over 50 years of age) receive substantially greater benefits from employer contributions than employees hired in their twenties and thirties.

A Task Force was empanelled in 2009 to evaluate the possibility of having the State join the Federal Social Security plan. The Task Force determined that the State of Maine is one of the winners under the current pension design. Since most State employees and teachers never reach 25 years of service (only 27 percent of State employees and 13 percent of Maine teachers), and further since most participants elect to take distributions of their own employee contributions upon termination (thereby losing the Maine State contributions), the net employer cost (after participant forfeitures) is only 5.5 percent of payroll, as compared to 6.2 percent for Social Security. Therefore, it would cost the State of Maine

millions of dollars of additional employer funds to join Social Security due to this forfeiture provision. This transition to Social Security is therefore unlikely to occur.

The defined-benefit system creates winners and losers. Every employee hopes that he or she will win. Importantly, for the political process, the losers are usually not available to testify, litigate, or lobby. Thus, the impression prevails that all is well, when less than 30 percent of those entering the system ultimately receive their full rewards. A defined-contribution system is transparent; you can see what is yours and what you see is what you get (and complain about).

Many employers are considering cash balance plans as replacement for traditional defined-benefit plans. The Internal Revenue Service has recently published detailed regulations outlining the permissible scope for plans that will be eligible for favorable tax treatment. Great flexibility is encouraged, but the dominant pattern of cash balance plans involves rather larger build-ups of cash balances for employees during their early years of service than under the traditional defined-benefit arrangement. A cash benefit plan will be more expensive for an employer wishing to provide his employees with a traditional benefit expressed as a percentage of higher pay, because the plan, as a whole, will have been diminished by those employees who terminate their employment at a younger age. Companies have explained the change from defined-benefit arrangements to their employees as a reflection of the employment realities of the times – namely that very few employees will end their working careers with the same employer as they began. Therefore, the build-up of transferable larger cash balances is very much in their interest. Cash balance plans are easy to explain to employees, but no one should fail to note that they really are not "pensions" in the sense of guaranteeing a financial result. They are savings plans with substantial risk transferred from the company (and the US Pension Benefit Guarantee Corporation) to the employee.

A public pension system enjoys special status within governmental institutions:

- it has substantial money;
- the state can decline to make requisite payments for a sustained period of time and there is no immediate adverse impact; and
- the impact is sufficiently complex, long range, and diffused that no one seems to be hurt by deficiencies.

Governments are increasingly being driven to extremes in efforts to balance their budgets. Roughly speaking there are three alternatives:

1. Raise taxes, which can be political suicide.
2. Cut back programs, which can also be politically disastrous.
3. Postpone, reduce, eliminate, but – above all else – decline to pay timely the actuarially determined amounts into the pension system.

Clearly, the pension system is the easiest target. Only the raging "bull" market has obscured the extent of political profligacy over the past decade. In recent years, the percentage of equity holdings has gradually increased, so that now about 70 percent of Maine's investments are in stocks. A rising market covers all manner of sins, or has so far. Note that the Maine legislature increased the employee contribution from 6.5 percent to 7.65 percent in the 1990s. This contribution, however, is exempt from federal income taxes, making the net cost to the participants lower than private sector employees who contribute to Social Security with after-tax dollars. According to a newsletter published by the National Association of Public Pension Attorneys, "No sound actuarial reason was given for this increase. It is reported that the State Legislature did it simply to reduce the employer contribution so as to solve state budget problems unrelated to the retirement fund." In a bear market, however, the underlying problems are exposed and increased. The MePERS was briefly 100 percent funded in 2001 (on an accrued or termination basis), but the State is back on the hook for a significant proportion of its liabilities again. ■

The efficacy of the defined-benefit system, where no one really has a sense of owning something specific, depends ultimately on the level of discipline in the political system. Indeed, there have been challenges to the cost of living increases granted to defined-benefit plan participants, on the grounds that these increases should be considered "gifts." In one such suit, the challengers argued that the money belongs to the government, and not the retirees, because the government administers the plans and the government determines when or if cost of living increases are payable.

If one has no confidence in the capacity of government to be held to its commitments, a defined-benefit system is less desirable than a defined-contribution system, where an individual has a continual sense of ownership with respect to the specific assets in his retirement account, bolstered by regular reports of its status. It seems likely that tens of thousands of participants in a defined-contribution system would be better motivated, informed, and able than defined-benefit plan participants to compel government to make the promised payments into the plan and to prevent it from wasting the assets already in the plan.

A fascinating study of the public and private pension fund cultures was described in the 1992 book *Fortune and Folly*[124] by anthropologist William M. O'Barr and law professor John M. Conley. They approached the pension fund world just as they might an unusual tribal culture. "[T]o fit better into the native environment, we exchanged our academic tweeds for field clothes – in this case, blue suits from Brooks Brothers rather than khakis from an army surplus store – and set out to live with the natives and observe their ways of life."[125] Perhaps the most interesting part of the book is its description of the cultural differences between the private and public pension funds. For example: "Private fund officials often talk about their accountability to the sponsoring corporation's bottom line, or at least to the sponsor's corporate notion of successful management. Their public counterparts talk instead about the press and the ballot box as the instruments of day-to-day accountability."[126] The result, according to the authors, is that public funds' primary goal is to avoid poor performance, while private funds try to achieve superior performance – a fine, but very important, distinction that is both the cause and the result of the differing incentives (pay and otherwise) of the two systems.

This distinction stems in part from what the authors call, in classic anthropological terms, "creation myths." These "oral histories" about the origins of the pension system reveal, in their differing emphasis on particular aspects, what each system's assumptions and goals are. "The creation myths we heard at private funds tended to be centered around important individuals and to convey the teller's sense of the corporation's culture and personality."[127] In these stories, "cultural influences predominate over economic ones."[128] Private fund "creation myths" tend to emphasize a visionary leader who created the pension fund to provide for loyal employees and their dependants. Interestingly, these myths focus on the origins of the pension fund at the particular company and not on the establishment of the overall structure of private pension funds under ERISA, which was enacted in 1974.

O'Barr and Conley found that public fund "creation myths," too, focus on "history and politics, but the history was scandalous and the politics was external. (Ironically, much of the impetus for ERISA came from widespread corruption in the *public* pension system, which ERISA left untouched.) Once again, financial analysis was not a primary determinant of structures and strategies."[129] In contrast to the private fund managers, who see themselves as living up to the "creator's" vision of economic security for fellow workers, the public fund managers see themselves as protecting their fellow workers from those who would try to benefit themselves, politically or financially, to the detriment of the workers. While both are fiduciaries – operating under the strictest standard for integrity and loyalty imposed by our legal system – the "creation myths" reveal an important difference in the way each sees their obligations and goals.

The authors found that there was one point on which public and private pension funds were alike – their efforts to avoid accountability for the consequences of their investment decisions. This is understandable in a field where even the most capable professionals have so little ability to control or even predict what the market will do. The 20-year effort of the federal government to gain control over the Teamsters' Union and the "looting" of the New York City plans created a generation of risk-averse fiduciaries.

Perhaps *Fortune and Folly*'s most important conclusion is:

> *In every interview we conducted, fund executives talked at length about assuming, assigning, or avoiding responsibility. As we listened to them, it often seemed as if the funds had been designed for the purpose of shifting responsibility away from identifiable individuals. They described four specific mechanisms for displacing responsibility and avoiding blame: burying decisions in the bureaucracy, blaming someone else, blaming the market, or claiming their hands were tied by the law.*[130]

PENSION PLANS AS INVESTORS

Before we consider the question of pension funds as owners (as participants in the corporate governance system), we must take a brief look at the bigger question of pension funds as buyers and sellers. The fiduciary standard for prudent investment works well in the situation for which it was designed, protecting the assets of a trust beneficiary, like a minor inheriting property. It does not work when it is applied to a pot of money that constitutes the largest single collection of investment capital. There are simply not enough "prudent" investments around to sustain all of that money. What you therefore get is over-investment in large-capital blue chip stocks and not enough

in everything else. The concept of the investor as *homo economicus*, or the perfectly rational value-maximizing individual, has been overtaken.

This is what happens when a horde of "prudent experts" go to the marketplace to look for diversified and seasoned investments. It is inevitable when they are faced with a choice between rational (in economic terms) or prudent (in legal terms) investments. The problem is that we need a system that invests to encourage risk, and we have a system that invests to discourage it.

The data show that pension money has not, by and large, provided needed new capital or new employment. During the decade of the 1980s, the S&P 500 corporations typically *reduced* their capital by buying back stock. In 2006, *Business Week* reported that, "According to Standard & Poor's, companies in the S&P 500 index repurchased a record $115 billion of their own shares in the second quarter, up 43 percent from 2005 and 175 percent from 2004," [131] suggesting that the goal was to increase earnings per share. In 2009, Cisco Systems repurchased $7.8 billion of its own shares. The company purchased a total of $37.4 billion over five fiscal years ending in 2010.

This (over)investment in the largest companies fails to create new products or jobs. Artificial inflation of investment in large-capitalization companies has had no meaningful benefits either to those companies or to the pension beneficiary investors, and of course it has provided no special benefits to participants in the pension plan, the employees, and retirees. With all of the pension managers grouped together in the S&P 500, it is not surprising that none of them, over time, beats the market and that so many of them have taken the savings available by eliminating the transaction costs in active trading and investing in "index funds" that replicate the market.

Can that essentially permanent holding give the market the feedback that it needs?

A 2006 speech by former SEC attorney-turned pension investment fraud investigator Edward Siedle at Florida Atlantic University identified the problems he believes create an environment for pension funds that encourages exploitation and outright corruption and theft.

> 1. *The money management and pension management industries are neither rational nor moral. There is far more money to be made from giving pensions bad advice than good;*
> 2. *Much of the behavior in these industries is guided by financial incentives experts hide from their clients and pensions they do not fully understand;*
> 3. *Expert advice is frequently subject to undisclosed conflicts of interest that result in substantial, quantifiable harm to pensions;*
> 4. *As a result conventional wisdom, the advice pensions and investors hear repeatedly from experts, is frequently corrupt and wrong;*
> 5. *Confusion regarding what to measure and how to measure performance and other important factors distracts attention from mismanagement, fraud and critical reforms;*
> 6. *The causes of underperformance or failure to achieve investment objectives, especially in the pension context, are generally so distant and subtle that they are virtually never fully exposed.*
>
> *In summary, the problem is that there's a lot more money to be made from misleading pensions than from prudent guidance and ferreting out wrongdoing.*

Siedle points out that the Pension Benefit Guarantee Corporation (PBGC), the government-sponsored insurance safety net for more than 30,000 defined-benefit plans, has taken over 4,000 failed pension funds and never once conducted a forensic investigation to find out what went wrong or who was responsible. Indeed, the PBGC itself has come under significant scrutiny in recent years, with a criminal investigation of its former chief executive, reports of poor data management and privacy safeguards, and a ballooning deficit ($21.9 billion in 2009) as it takes on an increasing number of collapsed pension plans.[132]

Since the financial crisis, many pension plans have shed enormous amounts of their value, with no clear way to fund their deficiencies. Using California's CalPERS as an example again,[133] the high-risk/high-return investments (principally real estate and private equity) that contributed to CalPERS' fantastic performance in the early 2000s were among the investments that led to the plan's massive loss in value, owing to their illiquidity and uncertain future value. With a looming $19 billion budget deficit, California has little room to maneuver as it simultaneously attempts to pay its pension obligations, continue to employ the largest number of state employees in the country, and overcome a lingering recession. "It's a ticking time bomb," Arizona House Speaker Kirk Adams said of his state's pension systems.

While some states, including Illinois, have issued bonds to pay their current pension obligations,[134] New York, whose plan is underfunded by (potentially tens of) billions of dollars, is borrowing $6 billion from the pension fund itself to make its required annual payments, a plan that will ultimately cost the state an additional $1.85 billion in interest payments over time.[135] States, desperate to solve their budget crises, are slashing once untouchable benefits, by raising minimum retirement ages, decreasing total annual amounts of public pensions, reducing payment increases to pensioners, and are even attempting to sell long-held state properties for "fire-sale" prices[136] (such as the attempt to sell the Del Mar Fairgrounds in California, whose value had been estimated at $1 billion, for a mere $120 million). Though many argue these drastic measures are the only way to correct enormous current deficits, they nevertheless remain politically sensitive issues, will be endlessly (and expensively) disputed in the courts and at the ballot box, and will ultimately be borne by future generations as well.

PENSION PLANS AS OWNERS

The paradoxical result of passive investing should be active owning. Says James Dowling, chairman of Burson-Marsteller, the public relations firm that established a corporate governance practice to advise CEOs and boards on how to operate in the changed environment: "The public funds have so much money that they find it's harder to find new companies to invest in than to try to turn around poorly performing ones." Says Jennifer Morales, executive director of the Houston Firemen's Relief Retirement Fund: "We don't want to sell. If a company can be improved, why should we be the ones to leave?"[137]

Public and private pension funds are the second largest component of equity ownership, behind mutual funds, as of early 2010.[138] According to The Conference Board:

> *Latest available year-end 2005 data show that U.S. institutional investors – defined as pension funds, investment companies, insurance companies, banks, and foundations – suffered a brief hiatus in the trend of steadily increasing ownership during the market break*

of 2000–2002, but have since rebounded robustly to control $24.1 trillion in assets in 2005, up from a low of $17.3 trillion in 2002. Institutional assets thus grew 19.0 % in the 2002 to 2003 time period, another 11.7 % from 2003 to 2004, and yet another 5.1 % from 2004 to 2005.

Institutional investor ownership of U.S. corporations also rebounded during the post-2002 market break period and in 2005 institutional investors held a record 61.2 % of total 2005 U.S. equities, up from 51.4 % in 2000. Institutional ownership of the largest 1,000 U.S. corporations has increased from 61.4 % in 2000 to a peak of 69.4 % in 2004, and dropped just slightly to 67.9 % in 2005, but still in record historic territory. Within the categories of institutional investors, the "activist" state and local pension funds have increased their percentage share of U.S. equity markets (from 2.9 % in 1980 to 9.8 % in 2005) while private trusteed corporate funds who rarely participate in corporate governance activism have declined in their percentage share of U.S. equity markets (from 15.1 % in 1980 to 12.3 % in 2005).[139] ”

With an average of 30 years from the time money comes in to the time it has to be paid out, they are the ultimate long-term holder. For that reason, we need to understand their impact on the capital markets and on corporate performance. They bring significant advantages and disadvantages over the old system of highly fractionated individual investment.

Advantages

- Their size and expertise minimizes the collective choice problem discussed above. They are sophisticated enough to understand when activism is necessary and large enough to make it effective (and cost-effective) to do so. The holdings of pension funds are large enough to alleviate the free rider problem that makes shareholder information and action economically nonrational (and therefore imprudent for fiduciaries).
- They are widely held – almost 100 million Americans have interests in employee benefit plans – so their pension trustees are good proxies for the public interest. It is virtually inconceivable that something would be in the interest of pensioners that is not in the interest of society at large.
- Pension plans are less restricted by commercial conflicts of interest than are other institutional investors, like banks, insurance companies, mutual funds, and other classes of institutional investors. Note, however, that there are still significant commercial conflicts of interest, as shown by the Citicorp example above. Note as well that while pension fund trustees are less conflicted, ERISA has created a mechanism for them to delegate full authority and responsibility to investment managers. Trustees are responsible only for their prudence in selecting them. The investment managers themselves have vast conflicts of interest, notwithstanding the trustees' personal independence.
- For political and investment reasons, pension plans are becoming increasingly "indexed" in their equity holdings. This makes them both universal and permanent shareholders. Their holdings are so diversified that they have the incentive to represent the ownership sector (and the economy) generally rather than any specific industries or companies. This endows them with a breadth of concern that naturally aligns with the public interest. For example, pension funds can be concerned with vocational education, pollution, and retraining, whereas an owner with a perspective limited to a particular company or industry would consider these to be unacceptable

expenses because of competitiveness problems. Robert Reich, then Secretary of Labor, urged institutional investors against the short-term view that cutting payrolls boosted the immediate bottom line. Instead, he told institutions to adopt a long-term perspective, arguing that retraining programs and heightened employee security can enhance productivity. Reich said: "You should be aware of the full consequences of the signals you send and the positions you take, not just in the current round of play, but in the next, and the next. Stewardship of the future, after all, is the essence of your profession."[140]

- The private pension system is administered under ERISA, an existing federal law that preempts state involvement. The administration of this law in its definition of the scope of fiduciary responsibilities by the Pension and Welfare Benefits Administration (PWBA) of the US Department of Labor has succeeded in creating a standard that has been widely followed by the states in the operation of public pension systems. The essential legal structure needed to govern these investors is already in place.

Disadvantages

The disadvantages are in general a function of what we do not know, and they can best be stated as questions.

- Who watches the watchers? Who should watch them? Who can?
- What are the qualifications of the trustees? What should they be?
- Are the trustees genuinely accountable to their own beneficiaries or are we simply substituting one unaccountable bureaucracy for another? How do we identify and then minimize the inevitable conflicts of interest of what Professor John Langbein calls "the non-neutral fiduciary"?
- The system has evolved so that fiduciary obligation is essentially outsourced to consultants. By creating a trust standard, government requires that fiduciaries inform and protect themselves; this in turn leads to consultants, who sell compliance products rather than value-adding ones. Because the consultants ultimately get to be "gatekeepers" for particular products and funds, they tend to overreach and get themselves into the business of providing product, leading to a culture of imitative investing.

One way to address these questions is to make the qualifications of the trustees (like the qualifications for members of boards of directors) explicit and public. However, there is another disadvantage that is more subtle and complex: *What is the impact on the capital markets of having such a high percentage of the available capital invested by fiduciaries who must by law be more risk-averse than the typical investor contemplated by Adam Smith?*

More than $3 trillion is now under the control of laws that effectively relegate pension assets to permanent yet docile holdings in large, established companies. The result is "excess diversification and insufficient innovation."[141] This means over-investment in large companies and under-investment in emerging opportunities. By nature and by law the objectives of fiduciaries are low risk. This can hamper market efficiency, because for the first time a significant portion of the investment is managed for some goal other than maximum returns. Both public and private pension funds have thus been criticized for being under-inclusive in their investment strategy – for failing to recognize the opportunities that may be higher risk but may also be higher return. They have been encouraged to behave more like venture capitalists.

CASE IN POINT CALPERS AND ENRON

The first of Enron's "special purpose entities" that allowed it to hide the seriousness of its financial condition was established when Enron and CalPERS established the Joint Energy Development Investment LP (JEDI) investment partnership. Enron was the general partner of JEDI and contributed $250 million worth of Enron stock. CalPERS was the limited partner, but it exerted substantial control over the partnership and also contributed $250 million in cash. Four years later, Enron wanted to create a new and larger investment partnership, JEDI II, capitalized at $1 billion. Enron proposed to redeem CalPERS' interest in JEDI, freeing CalPERS to invest in JEDI II. Enron therefore created an "independent" entity called CHEWCO to buy CalPERS' stake in JEDI. (The names were an intentional *Star Wars* "tribute.") CalPERS invested $250 million and redeemed $383 million.[142] Meanwhile, CalPERS was also an investor in Enron equity (three million shares, almost entirely through its index holdings) and debt securities. Its losses when the company went bankrupt amounted to $105.2 million or one-tenth of a percent of its assets.

How does an organization like CalPERS sort through its various relationships and attendant rights when it has debt, equity, and private equity investments with the same company?

Pension funds have also been criticized for being over-inclusive, for making investments for reasons other than returns – and for failing to do so. Social investing (or economically targeted investing) falls into this category, as well as some of the attempts to fund corporate pension funds with the corporation's own stock. Both are described in more detail in the following section. It is useful to apply the same overlay of questions in connection with the management of pension funds that we do with corporations: *Who has the best information and the fewest conflicts of interest? Who is in the best position to make the decisions, and does that person have authority to do so?*

PUBLIC PENSION FUNDS

A small group of public pension funds have been the most visible of the institutional investors with regard to governance issues. They include pension funds for state and municipal employees, ranging from teachers and civic workers to fire fighters and police, and they oversee nearly a trillion dollars. It is important to note that of the very large group of public plans, only a handful have been actively involved in governance initiatives. One of these activists noted:

> *There might be lots of noise and action, and there might be talk about all the new, awakened shareholders and institutional investors, but there's really not much more than a dozen public pension funds involved. And they call the tune. In fact if you took the*

CalPERS and the New York City pension fund and TIAA-CREF out of the equation along with our fund [New York state] and Wisconsin, Pennsylvania and to some extent Florida, you might have very little activism at all.[143] ”

In terms of their own governance, the public plans are all organized differently. Some are directed by bureaucrats, some by politically appointed officials, and some by elected officials. The more than $200 billion California Public Employees' Retirement System (CalPERS), for example, is overseen by trustees appointed through a variety of mechanisms, who are intimately involved, whereas the New York State employees' fund is overseen by a single trustee, one of only four statewide elected officials. However, both pension funds have seen significant scandals develop in the last decade, as described below.

The people who oversee the public pension funds come from a wider variety of backgrounds than the money managers who are responsible for other kinds of institutional investments. The CalPERS board, for example, includes union officials and political appointees who oversee the staff (both inside and outside the civil service) and both professional money managers and staff with other kinds of expertise – quite a governance challenge of its own:

- *Six elected members:* two elected by and from all CalPERS members; one elected by and from all active state members; one elected by and from all active CalPERS school members; one elected by and from all active CalPERS public agency members (employed by contracting public agencies); one elected by and from the retired members of CalPERS.
- *Three appointed members:* two appointed by the governor (an elected official of a local government and an official of a life insurer); one public representative appointed jointly by the Speaker of the Assembly and the Senate Rules Committee.
- *Four Ex Officio members:* the State Treasurer; the State Controller; the Director of the Department of Personnel Administration; a designee of the State Personnel Board.

Public pension funds cannot compete salary-wise with other institutional investors for the top investment professionals, though, ironically, they may end up employing those same professionals by retaining their companies to manage their assets. This is because, with rare exceptions, the public plan pay schemes are designed for political, not economic, reasons. As one public pension CEO said, "If I do a good job, I get $100,000. If I do a great job, I get $100,000." Job tenure depends on the same measure of performance. Several senior officials lost their jobs in the Washington state pension fund when their very lucrative investments with LBO fund KKR became perceived as a political liability.

Actuaries can tell any defined-benefit plan exactly what its liquidity needs will be and how much cash it will need over the next ten years to meet retirees' entitlements. The balance of the fund really is "permanent." All of the long-term analyses of rates of return to be derived from different classes of investment prove that returns from common stocks beat the returns from bonds or money market funds – or any other investment medium for that matter. This means that it is all but impossible to justify any investment for the public plans (except for a small percentage of Treasury Bills to meet their liquidity needs) other than common equity.

Thus the conservative approach described by Regan prevails. The "prudent man" degenerated into a "lowest common denominator" approach. There is no incentive to do better than others and every incentive to be safely in the middle of the pack.

In this context, let's examine the role of the public funds in corporate governance. We have already established that they are not strictly motivated by economic returns and it is all but tautological to say that they are motivated by political concerns. To the extent that the public plans do become involved with corporate governance, they raise the very real specter of "back door" socialism.

What is the role of the state when it becomes a major shareholder – even the major shareholder – of American business? To what extent do we really want elected officials overseeing the managers of American business?

The incentives, expertise, and goals of business and government are so different, at such fundamental levels, that this is a complicated – and crucial – question. The trustees of public plans act on behalf of a very diverse group, including current employees (from those hired this morning to those approaching retirement) and retirees. The trustees themselves are a diverse group, including employees, retirees, and others, like political appointees, elected officials, and a wide range of experts – investors, bankers, actuaries, insurance professionals. Usually they are paid just a nominal per diem fee for their work. While this attracts people with a high level of public spiritedness, there is a certain impracticality in trying to manage the operations of a truly mammoth investment and retirement system under the direction of people whose expertise is often in other areas, and who are not paid enough to be able to devote a substantial amount of time to this task – or to attract and motivate the kind of top-caliber Wall Street types they are competing against. There is also a substantial political impediment to hiring people outside the government – especially at the prices that the market demands for people who manage money. This is a significant disadvantage. (See the case in point about the fees paid to the managers of the Harvard endowment in this chapter.)

The public fund board of trustees must reach a perilous equilibrium between plan participant representatives and political appointees. There are frequent disagreements on questions of funding and investment. The plan participants' top priority is safety of the fund and the politicians are interested in politics – on the budget side and on the investment side.

There are often controversies about, for example, the role of the board in making individual investment decisions. In 2002, an Associated Press story reported that CalPERS trustees were criticized for having personal holdings in the same companies held by the then $149 billion fund. Trustees had to disclose their stock holdings and a very rough estimate of their value, but were not required to report the timing or size of their trades, and so – while there was no allegation or evidence that any of them could or did profit from knowledge of the timing of CalPERS investments – the apparent potential conflict of interests was a concern.

Since a 2009 placement agent scandal, CalPERS has adopted new disclosure and regulatory measures to improve the accountability of the investment decision process. The first issue was CalPERS' rules permitting portfolio companies to contribute to the campaigns of candidates for the CalPERS board. For example, three members of the CalPERS board received campaign contributions from supermarket magnate Ron Burkle, his wife, or his companies. All three later voted to invest hundreds of millions with Burkle's Yucaipa Co., though one of them abstained from one of the votes.[144] Some also received campaign contributions from service providers to CalPERS. CalPERS put $100 million into Premier Pacific Vineyards Inc. The co-CEO of that firm, Richard Wollack, was a major fundraiser for then-California Governor Gray Davis, who had authority to name three CalPERS board members. Another scandal arose in October 2009 when former CalPERS board member and then placement agent Alfred Villalobos was accused of facilitating a "pay-to-play" scheme through his connections with the CalPERS board. Several investment funds, seeking the opportunity to earn fees through investment advising and managing portions

of CalPERS' assets, allegedly paid more than $70 million to placement agent firms managed by Villalobos in exchange for Villalobos using his connections, illegal gifts, and unreported financial dealings (in violation of CalPERS and California disclosure laws) with CalPERS' then-current board to direct CalPERS' assets to those funds.[145] CalPERS colleagues CalSTRS (the state teachers' retirement system) has limited its contractors' campaign donations to any board member or gubernatorial candidates at $250.

CalPERS' success as an activist shareholder is based on a realistic assessment of the limits of its practical ability to force issues. "We have a strong predisposition to accommodation," CalPERS' former CEO Dale Hanson explained in a lecture to the Harvard Business School.[146] The political realities (both internally, in Hanson's relationship with his own board and his fiduciary obligation to plan participants, and externally, as a government agency reporting to the governor) placed a premium on compromise. The economic realities ("rational ignorance") may place an even larger premium on compromise. Perhaps the public pension funds' most significant contribution has been to make the world an uncomfortable place for a director of an under-performing company.[147] In 2010, CalPERS began to develop a database of board candidates in an effort that echoed the British ProNED search firm of the 1980s. It announced a refinement of its "focus list" process for selecting portfolio companies for shareholder initiatives including meetings, shareholder proposals, and possible suggestion of board candidates. CalPERS will concentrate on companies where the fund has a larger ownership position. Specifically, that means changing the screening universe from the Russell 1000 to the fund's top 500 domestic equity holdings. Its selection process for the list will be more reactive to market developments, including examination of one-year stock returns. The process already takes into account three- and five-year returns, which will continue to have a greater weighting.

They will exclude corporate governance factors from the initial screen for the list. Where the current screen combines total stock returns, governance, and financial performance, the staff proposes considering financial returns first and governance issues in a secondary analysis. The current approach "tends to diminish the emphasis of underperformance in the selection process and allows 'check the box' governance to mask opportunities for improvement," the agenda says. However, there would also be more attention paid to directors. It is unclear from the agenda whether board characteristics will fall into this second screening, but the staff recommends "a greater emphasis on board quality, skill sets and diversity."

Many public funds, as well as many union funds and corporate funds, belong to the Council of Institutional Investors (CII). It now includes public, labor, and corporate pension funds with assets exceeding $3 trillion. The Washington-based group acts as a resource for its members, holding conferences, providing information and acting as a clearing-house, occasionally issuing policy papers, filing amicus briefs, and testifying or commenting on proposed legislation and regulation.

The public pension plans differ in their perspectives, their policies, and their politics, but they are all fiduciaries, obligated by law to protect the interests of their plan beneficiaries, the public employees. They all have a high degree of independence because they are not dependent on commercial relationships with those in whom they invest. This makes it easier for them to become involved in governance issues. Some state funds have taken the lead in litigation over fraudulent accounting and other shareholder abuses. The Maine State Retirement System has successfully brought suit against Travelers' Insurance Company to recover a portion of an investment negligently managed.

Public institutions have relationships too, and like their private counterparts, those relationships can affect investment strategies, proxy votes, and other governance activity. They are subject to political considerations, as the cases below demonstrate.

CASES IN POINT PUBLIC FUND ACTIVISM

- When the Wisconsin state pension fund wanted to object to General Motors' $742.8 million forced greenmail payment to Ross Perot, it was stopped by the governor, who was trying to get General Motors to build some plants in his state.
- When Shearson Lehman Hutton (as it was then called) assisted in the takeover of a Pennsylvania company called Koppers, many local residents (and politicians) were concerned about possible job losses. Shearson was not only acting as investment banker for the acquiring firm but also as a participant. Shearson had loaned $500 million of its own funds to the acquirer and had agreed to purchase 46 percent of Koppers for itself if the takeover was successful. The state held some Koppers stock in its pension fund. It was not enough to stop the takeover, but it was enough to slow the effort down. The state treasurer suspended all state business, including bond business, with Shearson and its subsidiaries. Three Shearson subsidiaries were eliminated from consideration for management of state pension fund assets. The takeover was ultimately completed in a manner that satisfied the state's concerns about jobs and the suspension was removed.
- The New York State United Teachers Fund sold its investment in the Tribune Company when employees of the Tribune's *New York Daily News* went on strike in 1991. The fund stated that, "our policy is not to invest in any project, corporation, or stock that is anti-union."
- Several police pension funds used the pension fund's proxies in Time Warner, parent company of Ice-T's record label, to protest the Ice-T "Cop Killer" record.
- Dr. David Bronner, manager of the Alabama State Pension Fund, invested $120 million to build the "Robert Trent Jones Golf Trail," seven huge golf complexes across the state. He has built so many office towers and parking garages in downtown Montgomery that he is the most active developer in that city. "Officially just the bureaucrat who manages money for teachers and state employees, Dr. Bronner has come to view himself as the personal guardian of Alabama's future."[148] He emphasizes the economic benefits to the state of his investments, arguing that the golf courses will increase tourism.
- In 2002, New York State Comptroller H. Carl McCall, North Carolina Treasurer Richard Moore, New York State Attorney General Eliot Spitzer, and California State Treasurer Philip Angelides announced the launching of a major initiative to protect state taxpayer funds and public pension funds from the risks of conflicts of interest. Investment banking firms that do business with New York, North Carolina, and California were asked to adopt the conflict of interest principles set forth in the agreement that Attorney General Spitzer reached with Merrill Lynch on May 21, 2002. In addition, the North Carolina Public Employees' Retirement Systems and the New York State Common

Retirement Fund imposed the following requirements on investment banking and money management firms that do business with the pension funds:

- money management firms must make disclosures regarding: (a) portfolio manager and analyst compensation; (b) the firms' use of broker dealers that have adopted the Merrill Lynch principles; and (c) potential conflicts of interest arising from client and corporate parent relationships;
- money management firms must adopt safeguards to ensure that potential conflicts of interest do not influence investment decisions made on behalf of the pension funds; and
- money management firms must scrutinize more closely the auditing and corporate governance practices of companies in which pension fund moneys are invested.

- In 2010, several pension funds divested from oil giant BP for a combination of obvious financial, environmental, and political reasons. In addition to the massive loss of value (BP fell from a 52-week high of $62.38/share to a low of $26.75 during the spill, a market capitalization loss of over $110 billion), the fallout from the devastating environmental impact of the spill and continued public blundering of the company and its former CEO Tony Hayward was incalculable. Many investors filed class-action lawsuits in light of the failure to disclose the company's allegedly poor safety practices, including one suit seeking recovery for some BP employees, whose retirement accounts were funded by nearly 30 percent BP stock.[149]
- The New Jersey state pension fund, required by state law to disinvest all holdings in companies doing business with South Africa, ended up selling out of two New Jersey pharmaceutical companies whose only dealing with South Africa was the sale of medicine used exclusively by black South Africans. The *Wall Street Journal* estimated that the disinvestment policy has cost the plan between $330 and $515 million in two years.[150]

How is this different from taking as much as $515 million out of the state budget and spending it? How do you evaluate the success of this program on moral grounds? On political grounds? On fiscal grounds? Is there any reason not to treat this as an expenditure, subject to the same procedural protections and deliberations as other expenditures of public funds?

- Note that New York City's pension fund was able to adopt a more flexible policy on South Africa. It began by writing letters to express its concerns, then sponsored and supported a number of shareholder resolutions, calling for companies to adopt the Sullivan Principles making a commitment to providing equal opportunity in their South African facilities. They sold out of a limited number of companies that they determined had business dealings like those who do business with the police and military there. Regan, of the New York State pension fund, took a different approach. Facing annual legislative proposals along the inflexible lines enacted in New Jersey, Regan used the

fund's shares to commence a massive program of shareholder resolutions calling for disinvestment from South Africa, instead of divesting. Regan's view was that mandated sale of stocks (for any reason) would impose unreasonable financial costs on the portfolio and force higher contributions from the taxpayers. By use of the shareholder franchise, he negotiated results with the companies, arguing that he met the objectives of divestment legislation without incurring the significant financial losses.

The California Public Employees' Retirement System "believes that constructive engagement is the most powerful tool investors can use to effect change at those portfolio companies whose corporate governance, social, or environmental practices could lead to value destruction. Divestment is a tool that must be used sparingly; nonetheless divestment remains an option."[151]

- In 1991, California Governor Pete Wilson initiated what some observers called a "hostile takeover" of the state's pension funds to reduce the budget deficit and gain more control over the trustees. In 2006, California Governor Arnold Schwarzenegger proposed switching the entire fund to a defined-contribution plan, essentially giving state employees 401-Ks instead of a guaranteed payment. The governor later dropped his proposal, but continued to push for viable pension reform.
- New York State Comptroller Regan voted the state pension fund's proxies in favor of management in the Texaco proxy contest. In a series of newspaper articles in 1990 he was accused of basing this vote on the campaign contributions of the dissident candidate Carl Icahn. Icahn was a contributor to Regan's political opponent. Regan was subjected to a grand jury investigation.
- Both California State Treasurer Phil Angelides and Controller Steve Westly decided to run for the Democratic nomination for governor in 2006. Both had taken big campaign donations from firms with contracts with the California state teacher's pension fund, which they oversaw.
- In 2004, the SEC investigated a series of alleged "pay to play" arrangements in which money managers were said to have paid consultants to recommend them to pension fund clients, and introduced further measures to combat these arrangements in 2010.[152]
- Lawyer Charles B. Spadoni was convicted of giving a $2 million bribe to Paul J. Silvester, former Connecticut State Treasurer, in exchange for a contract for his company to manage Connecticut's pension fund. Silvester was sentenced to four years in prison after admitting that he arranged a scheme to collect kickbacks in the form of campaign donations for himself and jobs for his mistress at the time, Lisa A. Thiesfield, and his associate Christopher A. Stack in exchange for contracts to manage pieces of the state's $20 billion pension fund.

- The Inspector General of the state of Massachusetts issued a report finding that state pension fund officials had hired outside financial advisers based on friendships and political relationships rather than by competitive bidding, then created phony, back-dated documents to conceal the fact that they had not adequately researched the firms' performance in advance.
- Sean Harrigan, the regional executive director of the United Food and Commercial Workers Union, was removed as chairman of CalPERS after what reporter Nicole Gelinas called "a hopeless fiduciary tangle in 2004 when the fund mounted a corporate proxy fight against the Safeway supermarket chain right after Safeway resolved a four-month strike by Harrigan's union at its California supermarkets." Harrigan supporters pointed to the poor stock price performance at Safeway, arguing that it was a legitimate target for shareholder initiatives, but the coincidence/overlap of union and shareholder concerns made it impossible for him to continue as chairman.
- In Minnesota, former state pension fund employees pled guilty to charges of embezzlement.
- Pension funds for Harvey, Illinois' police officers and firefighters are running so short of money the pension holders are considering a suit against the city for financial mismanagement, including the question of what happened to the $400,000 the city claims it paid into the pension funds in 2004 but the pension fund reports it never received.
- In 2005, the SEC, the US Attorney's Office, and the FBI announced an investigation into possible securities violations and corruption involving the San Diego employees' pension system, which has a deficit of at least $1.4 billion. The case ultimately settled in 2006, with the SEC finding the city had committed securities fraud in its sale of over $250 million dollars of municipal bonds in 2002 and 2003, and actively took steps to conceal an anticipated future $2.2 billion shortfall. As part of the settlement, the city neither admitted nor denied any wrongdoing.[153]
- Federal investigators examined the pension fund of the Commonwealth of Virginia, following the governor's (unsuccessful) attempt to use some of the pension fund's real estate for a new football stadium for the Washington Redskins. The state legislature also hired an investment firm to examine the state fund's operations, including its investment policies and procedures.
- In 2010, New Jersey became the first state to ever be charged with violating the federal securities laws. The SEC charged that the state sold $26 billion worth of municipal bonds between 2001 and 2007 while maintaining the false pretense that the state's Teacher's Pension and Annuity Fund (TPAF) and Public Employee Retirement System (PERS) remained adequately funded. The SEC's order alleged further that the state's material misrepresentations and omissions of financial information caused investors to be unaware of the true nature of New Jersey's financial situation while making their investment decision. New Jersey settled the case, neither admitting nor denying the SEC's charges.[154]

- Additionally in 2010, former New York State Comptroller Alan Hevesi pleaded guilty to charges of corruption in discharging his office. He admitted to directing New York's $125 billion pension fund to invest $250 million in the California fund Markstone Investment Partners in exchange for more than $1 million in assorted benefits, including political contributions and vacations for himself and his family.[155] ■

There continue to be investigations of state and city pension funds and the way they make their investment decisions, focusing on corruption, political conflicts of interest, and on policy and new rules to increase transparency and reduce conflicts of interest. In 2006, in response to complaints about "pay for play" (vendors who make campaign contributions in order to get state business), the California State Teachers Retirement System (CalSTRS) placed a $1,000 limit on vendor contributions to board members, as well as the governor and gubernatorial candidates. The board also capped gifts and meals at $360 a year and charitable contributions at $250 annually and prohibited trustees from deciding issues involving campaign contributors for 12 months and insisted on enhanced disclosures about placement agents and their fees from firms seeking to do business with the state. Firms that violate these rules face a fine of $10,000 or more and a two-year ban on doing new business with CalSTRS.

CASE IN POINT CALPERS INVESTS IN ACTIVISM

In 2006, finance professor Brad M. Barber of the University of California at Davis published his assessment of the CalPERS shareholder activism program and concluded that CalPERS has "generally pursued reforms at focus list firms that would increase shareholder rights." His analysis showed:

> "*…small, but reliably positive, market reactions of 23 basis points (bps) on the date focus list firms are publicly announced. This translates into a total wealth creation of $3.1 billion ($224 million annually) over the 14 year period that I analyze. My long-run analysis yields intriguing, but inconclusive results. Portfolios of focus list firms earn annualized abnormal returns ranging from 2.4 to 4.8 percentage points annually at holding periods ranging from 6 months to 5 years. If these abnormal returns are causally linked to the activism of CalPERS, the wealth creation is enormous – as much as 20 times greater than the short-run benefits and as large as $89.5 billion through December 2005.*"

He cautions, however, that long-run volatility makes it impossible to tie extraordinary returns to activism. However, "without exception, the CalPERS proposals increase

shareholder rights. Empirical research establishes a strong link between shareholder rights and firm value and provides strong support for prudence of CalPERS' initiatives designed to improve shareholder rights."

CalPERS notes that as of June 30, 2010, its Corporate Governance Investment Program[156] outperformed its benchmark since inception by 9.19 percent.

The CalPERS program, with more than $4.8 billion invested, currently consists of the following:

1. Secondary involvement through investment in 21 external "activist" funds that maintain "a highly concentrated portfolio where the portfolio managers of the fund actively engage the portfolio companies to unlock value through governance, operational, strategic, and/or management changes." They were an early and significant supporter of Relational Investors, now arguably the leader in this category.
2. Direct involvement through selection of portfolio companies for its "focus" and "monitoring" lists, based on quantitative and qualitative screens and "an engagement process…designed to identify and positively reform undervalued companies in the internal portfolio that produce the lowest long-term value relative to peers and lack good governance practices."

The engagement process ranges from letters and meetings with managers and directors to shareholder proposals and litigation. Most of the focus is on governance and performance-related matters, but, like other large institutional investors, CalPERS is also beginning to focus on climate change and other environmental issues as a factor in investment risk. Many companies voluntarily adopt reforms following CalPERS' suggestions, including board evaluation, director and managerial changes, and tighter ties of pay to performance. In 2010, CalPERS' board voted to remove the fund's limit on the number of shareholder proposals it may annually propose to the companies it invests in. A sampling of shareholder proposals from 2005 to 2010 follows.

CalPERS' shareholder proposals filed: 2005–2010.[157]

Season	Company	Description or proposal	Voting results (votes cast)
2010			
	La-Z-Boy Incorporated	Amend the Company's bylaws to reorganize the Board of Directors, in accordance with applicable state law, into one class by amending and restating Section 2 of Article IV, Directors, as follows:	For: 64.89 % Against: 21.29 % Abstain: 0.02% Broker nonvotes: 13.52 %[158]

Season	Company	Description or proposal	Voting results (votes cast)
		Section 2. Classification and Term of Office. The Board of Directors shall consist of one class each serving a term of one year. The initial declassification of the Directors after adoption of this bylaw may be effected in a manner that does not affect the unexpired terms of directors previously elected.	
2009			
	JetBlue Airways Corporation	Resolved, that the shareowners of JetBlue Airways Corporation ("Company") hereby request that the Board of Directors initiate the appropriate process to amend the Company's articles of incorporation and/or bylaws to provide that director nominees shall be elected by the affirmative vote of the majority of votes cast at an annual meeting of shareholders, with a plurality vote standard retained for contested director elections, that is when the number of director nominees exceeds the number of board seats.	For: 42.45 % Against: 37.90 % Abstain: 0.13 % Broker nonvotes: 19.52 %
	Hospitality Properties Trust	Resolved, that the shareowners of Hospitality Properties Trust ("Company") ask that the Company, in compliance with applicable law, take the steps necessary to reorganize the Board of Trustees into one class subject to election each year. The implementation of this proposal should not affect the unexpired terms of directors elected to the board at or prior to the 2009 annual meeting.	For: 59.44 % Against: 19.40 % Abstain: 1.69 % Broker nonvotes: 21.80 %[159]
2008			
	Eli Lilly & Company	Resolved, that the shareowners of Eli Lilly & Company ("Company") urge the Company to take all steps necessary, in compliance with applicable law, to allow its shareowners to amend the Company's bylaws by a simple majority vote	For: 44.42 % Against: 45.51 % Abstain: 0.41 % Broker nonvotes: 9.66 %

Season	Company	Description or proposal	Voting results (votes cast)
	Interpublic Group of Companies, Inc.	Resolved, that shareowners of The Interpublic Group of Companies, Inc. (the "Company" urge the board of directors to adopt a policy that Company shareowners be given the opportunity at each annual meeting of shareowners to vote on an advisory resolution, to be proposed by the Company's management, to ratify the compensation of the named executive officers ("NEOs") set forth in the proxy statement's Summary Compensation Table (the "SCT") and the accompanying narrative disclosure of material factors provided to understand the SCT (but not the Compensation Discussion and Analysis). The proposal submitted to shareowners should make clear that the vote is nonbinding and would not affect any compensation paid or awarded to any NEO	For: 31.06 % Against: 59.16 % Abstain: 3.38 % Broker nonvotes: 6.39 %
2007			
	Dollar Tree Stores, Inc.	Resolved, that the shareowners of the Dollar Tree Stores, Inc. ("Company") urge the Company to take all steps necessary, in compliance with applicable law, to remove the supermajority vote requirements in its Articles of Incorporation and Bylaws, including, but not limited to, the supermajority vote requirements necessary to declassify the board of directors, remove a director for cause, or allow shareowners to call a special meeting.	For: 69.48 % Against: 20.17 % Abstain: 0.29 % Broker nonvotes: 10.06 %
	Sara Lee Corporation	Resolved, that the shareowners of Sara Lee Corporation ("Company") urge the Company to take all steps necessary, in compliance with applicable law, to allow its shareowners to amend the Company's bylaws by a majority vote. Currently, the Company does not allow shareowners to amend the Company's bylaws.	For: 64.03 % Against: 15.42 % Abstain: 1.56 % Broker nonvotes: 18.96 %

Season	Company	Description or proposal	Voting results (votes cast)
2006			
	Mellon Financial Corporation	Amend the Company's bylaws, in compliance with applicable law, to delete Article II Section 16, which requires a 75 percent of outstanding shares supermajority vote to change certain provisions of Article II of the Company's bylaws relating to directors including Section 2 (relating to the number of directors); Section 3 (relating to the classified board structure); Section 4 (relating to board of director nominations); Section 5 (relating to the filling of board vacancies); Section 6 (relating to the removal of directors); Section 7 (relating to directors elected by preferred class of stocks); and Section 16 itself (relating to supermajority voting requirements for certain bylaw amendments)	For: 73.50 % Against: 26.50 %
	Brocade Communications	Delete Article VIII of its Certificate of Incorporation in order to eliminate Article VIII's supermajority voting requirements to alter, amend, or repeal (1) Article VII, which creates a classified board structure, and (2) Article VIII itself.	For: 91.60 % Against: 8.40 %
	Cardinal Health, Inc.	Require that the Board of Directors ("Board") seek shareowner ratification of any Severance Agreement with any Officer that provides Severance Benefits with a total present value exceeding 2.99 times the sum of the Officer's base salary plus target bonus. "Severance Agreement" means any agreement that dictates what an Officer will be compensated when the Company terminates employment without cause or when there is a termination of employment following a finally approved and implemented change of control. "Severance Benefits" means the value of	For: 59 % Against: 41 %

Season	Company	Description or proposal	Voting results (votes cast)
		all cash and noncash benefits, including, but not limited to, the following: (i) cash benefits; (ii) perquisites, (iii) consulting fees, (iv) equity and the accelerated vesting of equity, (v) the value of "gross up" payments, i.e., payments to offset taxes, and (vi) the value of additional service credit or other special additional benefits under the Company's retirement system. "Officer" means any senior executive officer. If the Board determines that it is not practicable to obtain shareowner approval of the Severance Agreement in advance, the Board may seek approval of the shareowners after the material terms of the Severance Agreement have been agreed upon. This amendment shall take effect upon adoption and apply only to Severance Agreements adopted, extended or modified after that date.	
2005			
	Weyerhaeuser Co.	Reorganize the Board of Directors into one class subject to election each year.	For: 73.80 % Against: 26.20 %
	AT&T Corp.	Amend the Company's bylaws, to require that the Board of Directors ("Board") (1) limit Severance Agreements to instances where a senior executive officer ("Officer") is actually terminated and (2) seek shareholder ratification of any Severance Agreement with any Officer that provides Severance Benefits with a total present value exceeding 2.99 times the sum of the Officer's base salary plus target bonus.	For: 66.60 % Against: 33.40 %
	Novell Inc.	Amend Company's bylaws that at least 50 % of future equity compensation be performance-based and disclose a reasonable level of detail of the performance metrics.	For: 31.17 % Against: 68.15 % Abstain: 0.68 %

CalPERS has a program for monitoring shareholder litigation and in some instances takes a lead role. In 2007, they recovered $117.7 million in a settlement of a securities lawsuit against Time Warner Inc. concerning accounting issues arising from the merger with AOL. In 2008, CalPERS recovered a further $30 million in a settlement with the former CEO of UnitedHealth Group (UNH), following a securities fraud investigation and settlement with the SEC stemming from the CEO's involvement in UNH's options backdating scandal in 2006. ■

CASE IN POINT INSTITUTIONAL INVESTORS ADDRESS CLIMATE CHANGE

In March of 2007, investors representing $4 trillion signed a statement coordinated by Ceres – a national network of investors, environmental organizations, and other public interest groups working with companies and investors to address sustainability challenges such as global warming – and the Investor Network on Climate Risk, calling for measures to help them address the long-term investment risks of climate change. The 65 signers included institutional investors and asset managers such as Merrill Lynch and the California Public Employees' Retirement System, as well as leading corporations such as BP America, Allianz, PG&E, DuPont, Alcoa, Sun Microsystems, and National Grid.

- Leadership and action by the US government to achieve sizable, sensible long-term reductions of greenhouse gas (GHG) emissions in accordance with the 60–90 percent reductions below 1990 levels by 2050 that scientists and climate models suggest are urgently needed to avoid dangerous climate change.
- Wherever possible, the national policy should include mandatory market-based solutions, such as a cap-and-trade system, that establish an economy-wide carbon price, allow for flexibility, and encourage innovation.
- A realignment of national energy and transportation policies to stimulate research, development, and deployment of new and existing clean technologies at the scale necessary to achieve GHG reduction goals.
- The Securities and Exchange Commission (SEC) to clarify what companies should disclose to investors on climate change in their regular financial reporting.

The next decade may see groups like this working together to promote initiatives at individual portfolio companies as well. ■

CASE IN POINT SHAREHOLDER INFLUENCE ON STANDARDIZING AND INTEGRATING CORPORATE ETHICS AND SUSTAINABILITY

As the global sustainability initiative slowly grows while the damage to our planet continues to destroy homes, habitats, and biospheres alike, so too has the network of sustainability-supporting institutions and the desire of those institutions and companies to portray themselves as environmentally, socially, and governance (ESG) conscious. With consumers, investors, and governments increasingly making their choices not only on the quality of the products, services, or investments they are purchasing but their understanding of the providing corporation's environmental policies as well, companies have begun to mail out "Corporate Social Responsibility" (CSR), "Sustainability," or, in the case of BMW AG, the "Sustainable *Value* Report" (emphasis added). With companies devoting significant advertising expenditures to broadcast their environmentally friendly credentials at every turn, such as Pepsi delivery trucks in vibrant "hybrid" livery or BP's (ultimately ironic) attempt to rebrand itself as "Beyond Petroleum," corporations are in a rush to the "green," responsible, and alternative investment markets.

It's no wonder. Strong records of social responsibility and environmental credentials increasingly resonate with the public, and many companies recognize this will lead to increased brand awareness, higher customer satisfaction, and ultimately greater shareholder value – many companies seem to view their relationships with environmental conservation groups as a form of "reputation insurance" in the event they perpetrate some incredible environmental disaster.[160] Furthermore, as energy costs will likely continue to increase and competition for scarce natural resources grows more intense (see Japan and China's 2010 dispute over rare earth minerals), a policy of developing an environmentally sustainable corporation will almost certainly reap substantial rewards. Also, the growing appetite of Islamic communities for financial investment has led to an explosion in the Sharia-compliant (Islamic law) investment field. To communicate their social resume effectively to investors, many experts are proposing integration and standardization efforts to recognize the impact these efforts and needs have on the corporation as a whole, and to give management, companies, investors, and the public at large a common yardstick to compare their various sustainability initiatives.

In an effort to develop a practice they hope will become as common as annual reporting for public companies in the US, some experts[161] have proposed a framework that examines a company's "ESGFQ" factors: Environmental, Social, Governance, Financial, and Quality. A company's Environmental score would relay its eco-friendly (and unfriendly) activities and provide information about the risk to the environment (and investors) inherent in the company. Such a score may have been particularly useful for

the shareholders of BP. The Social score examines the company's human rights, labor, charitable, and product safety record (e.g., note the US Army's decision to deny all of a $24 million bonus to KBR, Inc. following the accidental electrocution death of a Green Beret in Iraq, as well as the ongoing wrongful death lawsuit in that matter[162]), an insight into a company's "soul," and perhaps evidence of its long-term commitment to a region, business, or workforce. Companies with particular religious or ethical rules on investment, such as Sharia-compliant firms (presently holding $1.5 trillion under management), which traditionally prohibits investment in pork, gambling, speculation, and alcohol producing businesses,[163] would have their particular credo noted and benefit from such a system. The Governance rating examines the issues of this book: moral hazard, conflicts of interest, and the like, and their resulting impact on risk and shareholder value. The Financial score would cover the traditional forms of business analysis: EBITDA, net income, total assets, and the like, but now in a format where they can be analyzed in conjunction with those things that impact them most. Finally, the Quality score measures the quality of the management behind the business: the human touch behind the corporate veneer that provides the ideas, determination, and judgment to direct a sound business.

Companies, including three-quarters of the Global Fortune 250, and the institutions that invest in them (such as CalSTRS and investment firms like Walden Asset Management, an ESG-centered fund) continue to develop and submit shareholder proposals calling for commitments to combat climate change and adopt ESG-sensitive business plans.[164] Note that for these firms sustainability is not a profitless pastime – the Social Investment Forum reported that the US had $2.71 trillion dollars invested in ethical and socially responsible methods in 2007, and 650 global institutional investors managing over $20 trillion support the United Nations' "Principles for Responsible Investing," an effort to expand ESG reporting worldwide.[165] Also note that companies that fail to live up to their sustainability goals (or to those of their competitors) are starting to feel the pinch as well: the NASDAQ removed Microsoft, Cisco, and Oracle, three companies renowned for their ingenuity and innovation, from its Global Sustainability Index on October 31, 2009 for failure to live up to the index's disclosure requirements, in spite of the companies' efforts to promote their corporate citizenship and environmental sustainability programs.[166] There is also evidence of "capture" and abuse of the corporate/environmental conservation group relationship as well, with environmental concerns and scientific truths falling victim to political squabbling and fiscal realities, which can be relieved by corporate donations of lobbying and economic largesse.[167]

Of course, companies do not have to develop specialized programs removed from their main area of business to be good corporate (and world) citizens: while Nestle SA's CEO Peter Brabeck-Letmathe, citing the depth and complexity of worldwide social issues, personally believes corporate philanthropy is a misappropriation of shareholders'

money, he and his company promote coordination between government, business, and civic groups to promote social welfare that also develops its business, such as providing microfinance to agricultural producers in areas it sees as emerging markets.[168] "You don't have to be bad to make a buck." ■

CASE IN POINT MYNERS SHIFTS THE BURDEN OF PROOF ON ACTIVISM

A commission in the UK led by Paul Myners addressed "distortions" in institutional investment. The central proposal of the review, closely modeled on the approach taken on corporate governance by the Cadbury (and subsequent) Codes, is a short set of clear principles of investment decision-making. These would apply to pension funds and, in due course, other institutional investors. As with the Cadbury Code, they would not be mandatory, but where a pension fund chose not to comply with them, it would have to explain to its members why not. One of the most important of those provisions was:

> *Incorporation of the US ERISA principle on shareholder activism into UK law, making intervention in companies, where it is in shareholders' interests, a duty for fund managers.*

Paul Myners said:

> *The principles may seem little more than common sense. In a way they are – yet they certainly do not describe the status quo. Following them would require substantial change in decision-making behavior and structures.*

The review asked the investment industry to adopt the principles voluntarily, but warned that if necessary the government would require disclosure of the extent to which firms complied with these goals.

Recently however, some have expressed reservations about whether an increased level of shareholder oversight will prevent a future failure of corporate governance.[169] Indeed, it is unclear that shareholders-as-owners or other stakeholders in financial institutions and other organizations would have been able to halt the pending financial crisis even if better governance rules had been in place. Indeed, a recent study in the *Journal of Finance* demonstrated that whistleblower employees rewarded with financial considerations were best at revealing corporate fraud, performing better than external auditors, US regulators, or the news media.[170] (See also the discussion of David Walker and the UK's "engagement" principles in chapter 5.) ■

CASE IN POINT — THE INSTITUTIONAL SHAREHOLDERS COMMITTEE

The Institutional Shareholders Committee of the UK, made up of the Association of British Insurers, the Association of Investment Companies, the National Association of Pension Funds, and the Investment Management Association, adopted a statement of responsibilities and principles setting out their policy on how they will discharge their responsibilities. This includes:

- clarifying the priorities attached to particular issues and when they will take action;
- monitoring the performance of, and establishing, where necessary, a regular dialogue with portfolio companies;
- intervening where necessary;
- evaluating the impact of their activism; and
- reporting back to clients/beneficial owners.

In the discussion of the obligation to intervene when necessary, the report says:

> *Institutional shareholders' primary duty is to those on whose behalf they invest, for example, the beneficiaries of a pension scheme or the policyholders in an insurance company, and they must act in their best financial interests. Similarly, agents must act in the best interests of their clients. Effective monitoring will enable institutional shareholders and/or agents to exercise their votes and, where necessary, intervene objectively and in an informed way. Where it would make intervention more effective, they should seek to engage with other shareholders.*
>
> *Many issues could give rise to concerns about shareholder value. Institutional shareholders and/or agents should set out the circumstances when they will actively intervene and how they propose to measure the effectiveness of doing so. Intervention should be considered by institutional shareholders and/or agents regardless of whether an active or passive investment policy is followed. In addition, being underweight is not, of itself, a reason for not intervening. Instances when institutional shareholders and/or agents may want to intervene include when they have concerns about:*
>
> - *the company's strategy;*
> - *the company's operational performance;*
> - *the company's acquisition/disposal strategy;*
> - *independent directors failing to hold executive management properly to account;*
> - *internal controls failing;*
> - *inadequate succession planning;*
> - *an unjustifiable failure to comply with the Combined Code;*
> - *inappropriate remuneration levels/incentive packages/severance packages; and*
> - *the company's approach to corporate social responsibility.*

If boards do not respond constructively when institutional shareholders and/or agents intervene, then institutional shareholders and/or agents will consider on a case-by-case basis whether to escalate their action, for example, by:

- *holding additional meetings with management specifically to discuss concerns;*
- *expressing concern through the company's advisers;*
- *meeting with the chairman, senior independent director, or with all independent directors;*
- *intervening jointly with other institutions on particular issues;*
- *making a public statement in advance of the AGM or an EGM;*
- *submitting resolutions at shareholders' meetings; and*
- *requisitioning an EGM, possibly to change the board.*

Institutional shareholders and/or agents should vote all shares held directly or on behalf of clients wherever practicable to do so. They will not automatically support the board; if they have been unable to reach a satisfactory outcome through active dialogue then they will register an abstention or vote against the resolution. In both instances it is good practice to inform the company in advance of their intention and the reasons why. ”

DIVESTMENT INITIATIVES

Activists have called on institutional investors to divest on political or social grounds ranging from involvement in Vietnam, infant formula, apartheid, tobacco, and many others. Most recently, California, Illinois, Maine, New Jersey, and Oregon have enacted statutes to divest state pension funds from companies that do business with the government of Sudan. New Jersey's divestment law, adopted in July 2005, requires all state pensions and annuity funds to phase out investments in companies that directly or indirectly support the Sudanese government – with the exception of companies that provide humanitarian aid. The law affects about $2.16 billion in investments and required all divestment to be completed by July 2008. Connecticut, Ohio, and Vermont have passed nonbinding resolutions that encourage divestment from Sudan.

In 2007, the United States Congress passed and President Bush signed the "Sudan Accountability and Divestment Act of 2007," which allowed state and local governments to more easily divest from Sudan, and required companies seeking federal contracts to certify they had no business ongoing in Sudan. Note that while America continues to level economic sanctions against Sudan, American investment funds are not barred from investing in other companies that have business in that country. Accordingly, some retirement funds have seen fit to change their investment manager relationships in protest, such as the Unitarian Universalist Association's move of its $178 million retirement fund from Fidelity Investments to TIAA-CREF in 2010.[171] In 2010, The Unitarian Universalist Association said it will replace Fidelity Investments as recordkeeper on

its retirement plan, citing "disappointment" with the Boston mutual fund company's record on human rights. Fidelity responded that it could do more by staying invested than by selling out of the stock; however, it has not been public about any efforts to pursue human rights protections in portfolio companies.

ECONOMICALLY TARGETED INVESTMENTS

A number of states are experimenting with "social investing" (sometimes called "economically targeted investments" or ETIs), which is the investment of state pension funds in local companies, programs, or securities that may not meet traditional standards for risk and return. A Commission convened by New York Governor Mario Cuomo released a report in 1989 called "Our Money's Worth," recommending that the state pension fund consider the impact of its investments on the state economy as one aspect of its investment strategy. It also recommended the creation of a state agency to act as a clearing-house to find these investments, and this agency was in fact created the following year.

In May 2001, the CalPERS Investment Committee established the California Initiative Program, making $475 million of commitments to ten private equity funds and earmarked for investment in "traditionally underserved markets primarily, but not exclusively, located in California." The three "ancillary benefits" criteria are:

1. Providing capital to areas of California and the United States that have historically had limited access to institutional equity capital. The Investment Committee notes that "Over 30 % of all venture capital investment made globally between 2000 and mid-2005 was concentrated in 100 postal code geographies."
2. Employing workers living in economically disadvantaged areas, defined as "Companies where at least 25 % of employees who reside in California live in a zip code designated economically disadvantaged."
3. Supporting women and minority entrepreneurs and managers. This consists of companies where at least one officer or owner is female or of an ethnic/racial minority.

The *Wall Street Journal* reported in 2002 that while CalPERS set an aggressive 15 percent return benchmark, the returns on its alternative investments were negative, though in 2007 CalPERS announced the Program realized a 5.6 percent one-year net return, in addition to helping increase employment by 13 percent at the companies where it had investment relationships.[172]

Professor Emerita D. Jeanne Patterson of Indiana University published a thoughtful analysis of the ETI programs of the public pension funds in the Great Lakes States (Michigan, Illinois, Ohio, Wisconsin, Indiana) in 1992. She found that the "targeted investments" averaged about four percentage points below the S&P 500 stock index over a five-year period and about two percentage points below the Wilshire 5,000 index during the same period. Citing Harvard professor E. Merrick Dodd's well-known argument that "It is not for the trustee to be public-spirited with his beneficiary's property," she concludes that "there will be continuing pressure for federal controls because of the excesses of a few systems."[173] She adds that "we must remember that the use of [public employee retirement system funds] to *subsidize* economic development efforts is inappropriate," citing Regan's view that "the greatest good a [state pension fund] can do for its state is to maximize return on investments and reduce the contributions necessary from taxpayers." Table 2.1 provides an overview of state targeted investment programs.

Table 2.1 State pension system targeted investment programs.

State	Housing debt financing				Economic development debt financing		Equity financing		
	Multi-family	Single family	Rehab.	Construction	Small business	Industrial/ commercial	Real estate	Venture	
								Indust.	Env.
Alabama		•					•	•	
Alaska		•			•	•			•
Arkansas					•				
California		•			•	•	•	•	
Colorado							•		
Connecticut		•		•		•		•	
Hawaii		•							
Illinois (Chicago)	•								
Massachusetts	•	•			•			•	
Michigan					•		•		•

Prepared by: Center for Policy Alternatives, 1875 Connecticut Ave., NW, Suite 710 Washington, DC 20009

The CalPERS report on its California Initiative Program says that its goal is "ancillary benefits" along with "attractive risk-adjusted returns commensurate with their asset class." It issued an "ancillary benefits" report outlining the job creation and other nonfinancial returns resulting from the program but explicitly did not reveal whether the "attractive risk-adjusted returns" were achieved. [174]

Look at the discussion of the private pension funds' version of ETIs – generally propping up their own financial health – in this chapter. Compare this with claims made in a lawsuit by a group of ministers and lay employees charging that their pension funds' environmental and political investment restrictions resulted in inferior financial performance. Predictably, their complaint provoked references to the necessity of choosing between God and mammon, but it also showed the difficulty in pinpointing which is which.

CASE IN POINT — AFSCME'S ECONOMICALLY TARGETED INVESTMENT POLICY

The American Federation of State, County, and Municipal Employees sets forth its policy on economically targeted investments:

> *The General Definition: An investment which has collateral intent to assist in the improvement of both national and regional economies, and the economic well being of the state, its localities and residents while producing a market rate of return by filling capital needs in underserved markets where investments have a competitive advantage.*
>
> *Purpose of ETIs: To mobilize the powerful instrument of financial capital in new and innovative ways, consistent with the highest fiduciary standards, to respond to the challenges of widening economic disparity. Successful ETI programs are designed to harness the public sector to invest capital in a way which meets two objectives: achieving successful investment results, and broadening economic opportunity in at-risk communities.*

Why should public funds make ETIs? Public funds are stakeholders. Public funds have a stake in the continued economic strength of their states, given the interlocking relationship among:

- the fiscal health of the state;
- revenues generated by the economy;
- public sector costs to mitigate social and economic dysfunction, and
- the reliance of public funds on state and local government contributions to maintain viability.

Note that investing in capital gaps can produce outsized returns.

The challenge of ETIs for public funds. Finding ways to invest public assets and capital in a manner that is fully consistent with the highest fiduciary standards and which yield competitive market returns and to deploy assets and capital that broaden economic opportunity and contribute to long-term economic success in the state.

Fiduciary duty. Trustees must fulfill their fiduciary duty through due diligence in making their investment decisions, and keeping and maintaining records that reflect this diligence.

Diligence and prudence. Trustees are not considered legally liable for the outcome of their investment decisions, but for the diligence and prudence of the decision-making process.

System target investment for ETIs. ETIs should not be treated as a separate asset class; instead, funds can set targets within each of their asset classes, equaling across the full spectrum of classes, roughly 2 percent of a fund's total portfolio.

Demand for capital not being met

- Minority businesses are growing even faster than the population in terms of both numbers of new firms and revenues.
- This is an "emerging" and largely untapped domestic market.
- This rapid growth is a catch-up phenomenon for a historically under-served business market and is being constrained by inadequate capital access.
- The total minority business community capital demands measured $144 billion in 1999. Only a small portion of these capital demands is being met.

The US private equity market does not meet the standards for market efficiency. Underserved markets, or capital gaps, represent real investment opportunities.

Examples mentioned include: a New York City pension fund's $234.5 million investment in "improving and creating low- and moderate-income housing, revitalizing neighborhoods, returning property to the tax rolls and creating construction and small business employment" and a California Urban Real Estate (CURE) investment by CalPERS that announced in 2005 it had earned annual returns of 22.2 percent from its California Urban Real Estate partnerships since the program's inception in 2001. ■

What are the risks and benefits of ETI programs? How do you ensure that these investments are not "concessionary"? Compare the efforts to expand (or "weaken," depending on who is describing it) the fiduciary standard of pension trustees and members of boards of directors, both at least ostensibly to factor in the concerns

of a broader community. This is a key issue. How would you structure an ETI program to avoid both the risks of "over-investment" in enormous, mature companies and the risks of reduced economic returns from investment on the basis of noneconomic goals like public housing or protecting jobs?

CASE IN POINT CAN A FIDUCIARY INVEST IN VOLKSWAGEN?

Volkswagen has a widely known and respected brand name. Its design and product qualities are at the top of the automobile industry. Innovest, the Toronto-based strategic value advising firm, concludes that Volkswagen will outperform the industry. Its June 2001 rating was: "Volkswagen received a rating of AA, ranking 3 out of 14 Automobile companies in this sector." This suggests that Volkswagen would be an attractive investment – but it is not the whole story.

The largest shareholder in Volkswagen is the government of Lower Saxony, with a little less than 20 percent (18.6 percent), which has been adequate to maintain control. Government officials have typically been on the Supervisory Board – Federal Chancellor Schroeder used to be chairman, when he was the chief state officer – and it is clear that the company is run in large measure for the benefit of the state. Five out of its seven manufacturing plants are located there, notwithstanding a productivity of 46 cars per worker per year in contrast to 101 cars for the Japanese plants in northern England. Volkswagen stock is at approximately the same level – $45/share – as it was in 1997, even though it rose 40 percent in 2000, representing the effect of a $2 billion stock buyback. Using conventional investment ratios, VW is valued by the market at about half the level of its competitors – seven to eight times projected 2002 earnings as against an average of 13–14 and DaimlerChrysler at 16. VW's market capitalization, at $17.6 billion, is 20 percent less than that of BMW although it has twice the revenue.

Volkswagen appears to have two disadvantages from an investment point of view. Its earnings are reduced by needlessly high operating costs dictated by noncommercial considerations and the multiple that the market applies to even these reduced earnings is drastically lower than the industry average, representing lack of confidence that there is commitment to earnings growth. Lower Saxony as the controlling shareholder receives additional benefits of (i) subsidy of noncompetitive wages and (ii) subsidized tax revenues, the subsidy being extracted from the other shareholders. Like many large companies, VW has been able to finance its operations from internal sources and is, as a practical matter, not subject to the cost of capital discipline of the marketplace. It would be interesting to know the extent to which the compensation of the principal officers of VW depends on the stock price.

How can a global investor justify acquiring VW common stock? In the short term, it is always possible to "buy low and sell high," but that is not a responsible investment policy

for fiduciaries. A long-term investment decision would have to be based on the conclusion that the level of political and social harmony achieved through subsidies to Lower Saxony compares favorably with the costs of competitors in achieving comparable conditions in other locations. Otherwise, the holder of VW is faced with the prospect of never being able to generate free cash, either for distribution or reinvestment, at the level of others in the industry. The global investor must evaluate the extent to which attention to nonprofit-oriented values decreases the risk of continuing earnings and profits. When these values are unique to a major shareholder – like Lower Saxony in the case of Volkswagen – it would be difficult to conclude that spillover benefits are competitive for the global investor.[175] ■

CASE IN POINT SOCIALLY RESPONSIBLE INVESTING

Peter Camejo's 2002 book, *The SRI Advantage: Why Socially Responsible Investing Has Outperformed Financially*, asks why pension trustees fail to consider socially responsible investing, despite the fact that it has higher returns and less risk than a portfolio that does not screen for issues like compliance with environmental and labor laws. He says that the pressure for money managers hired by pension trustees to rely on short-term benchmarks leads to a kind of lowest common denominator investment strategy.

However, *The Dangers of Socially Responsible Investing*, edited by John Entine in 2005, concludes:

> *Certainly, as part of their fiduciary mandate to maximize investment returns for their beneficiaries, pension-fund trustees have a duty to press for changes in corporate behavior that could result in better returns for their pension holders. But judging by the actions of many activists now running multi-billion dollar pension funds, using social investing under the guise of increasing 'shareholder value' threatens to undermine the financial security of retirees who have no say in these highly politicized investment decisions. The authors argue that social investing, by both the political left and right, frequently ends up hurting the very people – particularly the economically disadvantaged – that it is supposed to help.*

It is important to note that what begins as "social investing" often evolves – or is redefined – as a refinement of risk assessment. Tobacco and environmental concerns were initially dismissed as "touchy-feely" but are now seen as economic issues positioning litigation, liability, and reputational risk. ■

AFSCME

AFSCME, the American Federation of State, County, and Municipal Employees, is the largest union for workers in the public service, with 1.4 million members nationwide. In the past few years, they have been particularly innovative and effective in pursuing shareholder concerns on behalf of their pension fund participants. They adopted the following resolution in 2010:

WHEREAS:
AFSCME's 1.6 million active and retired members have more than $1 trillion in retirement assets invested in more than 150 public pension systems across the country. The magnitude of these assets can make us a major force in the financial markets; and

WHEREAS:
To ensure that plan participants have a voice, AFSCME and its affiliates work to identify and take advantage of opportunities for members, retirees, and allies to be appointed or elected as trustees; and

WHEREAS:
AFSCME works to ensure our members' financial security and to give those members who serve as trustees on public retirement systems the tools to be effective in those positions. To fulfill their mission, trustees and staff of public pension systems in the United States must invest billions of dollars prudently, ensure sufficient funds will be available to pay retirement benefits many years into the future, and make certain systems are in place to pay retirement benefits in a timely and accurate manner; and

WHEREAS:
The current financial crisis was brought about by a stock market focused on the short-term approach to corporate returns and fueled by excessive executive compensation, poor corporate governance, including poor risk management practices at companies, and lax oversight of capital markets; and

WHEREAS:
Many studies have demonstrated the positive correlation between good corporate governance practices and corporate performance; and

WHEREAS:
AFSCME's program of trustee education and activism and its efforts to improve corporate governance in the companies owned by worker pension funds have made our union a recognized leader in this area.

THEREFORE BE IT RESOLVED:
AFSCME will continue to work to ensure that retirement money is invested wisely so that the retirement benefits promised to public employees are safe and secure; and

BE IT FURTHER RESOLVED:
AFSCME and its affiliates will continue and expand efforts to get AFSCME members, retirees, and allies elected or appointed to public pension boards; and

BE IT FINALLY RESOLVED:
AFSCME will support our members, retirees and allies who are trustees of public pension funds to exercise their fiduciary duty by providing them with materials, training, and technical assistance to ensure that the funds vote their proxies in the companies in which they own stock in accordance with best practices.

In 2006, AFSCME played a key role by winning a lawsuit against AIG, which had sought to exclude its shareholder proposal about proxy access for shareholder nominees to the board from the company's proxy statement. The court reversed the SEC's finding and directed the company to put the proposal to a shareholder vote.

AFSCME's 2007 program included 27 shareholder proxy proposals that included proxy access for shareholder-nominated board candidates, a binding majority vote standard in director elections, advisory shareholder votes on executive compensation, a system for recouping expenses in proxy contests that do not seek board control, more effective executive compensation programs, and annual board elections. AFSCME President Gerald W. McEntee, who chairs the Employees' Pension Plan, said, "Our proposals are designed to give shareholders the tools to make boards listen."

Its 2010 proposals – some in concert with other investors – and its willingness to pursue litigation represent the current state of the art in institutional investor activism. The proposals cover:

- *Anti gross-ups policy* (refiled at CVS/Caremark, and first-time proposals at Alcoa and Regions Financial). Tax gross-ups are reimbursements for senior executives, paid by the company, to cover executives' tax liability on perks and other benefits that can potentially cost shareholders millions. This proposal asks for a policy where executives are not provided any tax gross-up payments that are not available to other managers.
- *Bonus banking* (refiled at Charles Schwab and JPMorgan Chase, and first time proposals at Bank of America, Goldman Sachs, Wells Fargo, and XTO Energy). Bonuses are paid out for results that are based on short-term results, results that can ultimately prove to be illusory. This proposal is designed to align long-term value creation and bonus incentives by placing a portion of bonuses in escrow accounts to be paid in installments based upon sustained corporate performance, and adjusting the unpaid portion to account for performance during that period.
- *Golden coffins* (refiled at Safeway). Some executives receive provisions entitling them to payouts even after they die. These provisions known as "golden coffins" commit companies to pay significant compensation after the death of a CEO. This proposal asks companies not to provide golden coffin benefits if they are not available to other managers.
- *Independent chair* (filed at Abercrombie & Fitch, Aetna, BB&T, Fifth Third Bancorp, IBM, Nabors, and SunTrust). The role of a board is to monitor management and the chair runs the board. However, if the board is led by a chair who is also the CEO, then the CEO effectively becomes his or her own boss. Separating the chair and CEO positions avoids that fundamental conflict of interest.
- *Holding equity shares until two years past retirement*. Most corporations provide their executives with equity as part of compensation packages, but do not require their executives to hold on to any meaningful portion of this equity. To bolster the alignment of management and shareholder interests, this proposal asks that companies require executives to retain a significant percentage of shares acquired through equity compensation programs for two years past their termination of employment. Proposals have been refiled at Dow Chemical and Valero Energy, and first-time proposals have been filed at American Express, Capital One Financial, Eli Lilly, and Mylan.

- *Reincorporation from Indiana to Delaware* (filed at WellPoint and Lincoln Financial National). Indiana Corporate Statutes adopted in 2009 diminish key basic rights of shareowners by weakening standards of care for directors and strengthening anti-takeover provisions through default classified boards. Reincorporation to Delaware, with fewer anti-takeover measures and an established standard of care for directors, would restore these key shareowner rights.
- *Say on pay* (refiled at Allstate and Raytheon). In 2006, the AFSCME Plan was for the original investor to file proposals asking for annual shareholder approval of executive compensation in US markets.
- *Solicitation expenses* (filed at Anadarko Petroleum, Citigroup, Dell, Hartford Financial Services Group, Omnicom Group, and Pulte Homes). Currently, in a proxy contest, management can use the company treasury to campaign in support of a candidate nominated by the incumbent board, while shareholders who nominate a candidate must bear the cost of a solicitation themselves, even if their candidate wins. This resolution proposes that shareholders who nominate candidates for fewer than half of the seats on the board and win be reimbursed for their expenses. In the absence of a final Securities and Exchange Commission proxy access rule, solicitation expense reimbursement lowers the cost barriers to entry for short slates contesting less than a majority of board seats in noncontrol elections.

See the Massey Energy case study for an example of union pension fund activism from Change to Win.

FEDERAL EMPLOYEES' RETIREMENT SYSTEM

In 1986, the US government established what recently became the largest institutional investor in the world, the Federal Employees' Retirement System (FERS). Up to that point, the federal employees had operated outside of the Social Security system. Like Social Security, the federal retirement system had no "fund" – money paid in by today's workers was immediately sent out to retirees. FERS was created in large part to help bail out Social Security by adding the federal employees to the pot and by making their part of the pot a growing one. The Federal Employees' Retirement System Act of 1986 (FERSA) made it possible for the first time for federal employees to create "defined-contribution plans" that employees could invest in a variety of securities of their choice, including equities.

Congress wanted to allow federal employees the benefits of being allowed to invest their retirement funds in equity securities (which, as noted elsewhere in this book, according to all of the long-term analyses, have the best rate of return of all classes of available investment). The creation of FERS was not a simple matter of politics or policy, however. It raised a number of troubling issues, many of which were discussed in congressional hearings. As we have noted, widespread private ownership is viewed as an essential ingredient of democratic government and free enterprise, but the federal government already exerts enormous power over the private sector. *What would the impact be if we made Uncle Sam the country's largest shareholder as well?* Congress was reluctant to give an agency of government – the trustees of the pension fund – power over the private economy. When President John F. Kennedy became angry with the steel companies, he mobilized the government's purchasing power to force them to retract a price increase. *What could he have done if the US was also the steel industry's largest shareholder?* (For a suggested scenario, see the Koppers example in the "Public Fund Activism" case in point above.) Note that at least one study has concluded that a higher rate of departure by federal employees may be due to the portability of the retirement benefits under FERSA.

No one wanted to create a system in which federal officials could through purchase or sale of the securities of a particular industry – or even, in an extreme case, a particular company – compel corporate America to comply with or even support the policies of a particular government. No one wanted federal employees with regulatory and enforcement authority over industries and companies to be able to buy and sell and vote proxies in these companies through their pension funds. Would an employee of the Environmental Protection Agency go short on a company he knew was soon to be the target of an enforcement effort? Would an employee of the Food and Drug Administration buy stock in the company whose experimental medication he was testing? Would an employee of the Occupational Safety and Health Administration over- or under-regulate a particular industry depending on what was in his portfolio? The possibilities for abuse were almost endless.

FERSA solved that problem by limiting the options for investment. The law required that equity investments be in an "index" that reflected the economy as a whole.[176] The trustees selected the S&P 500 and appointed Wells Fargo to administer the equity fund. Wells Fargo then became part of Barclays Global, so for a time a non-US investment firm managed the pension fund of the employees of the US government. In 2009, the US investment firm BlackRock acquired Barclays Global, leaving the management of the fund in American hands once again.

That solved the issue of buying and selling, but it left the issue of voting and other corporate governance opportunities. At the legislative hearings on FERSA, the issue was raised explicitly. The late Republican Senator Ted Stevens from Alaska and former Social Security Commissioner Stan Ross engaged in an illuminating dialogue. It shows that everyone wished to avoid "back door socialism." As a result, FERSA provides simply that: "The Board, other government agencies, the Executive Director, an employee, a member, a former employee, and a former member may not exercise voting rights associated with the ownership of securities by the Thrift Savings Fund." The trustees were made responsible for management of FERS's assets and yet were prohibited from being involved in the "ownership" portion of the security. They delegated voting power to the money manager.

The story of the federal retirement system's ownership of equity securities illustrates the fractionalization of ownership. The layers of ownership exemplify the evolution from the individual shareholder to the institutional shareholder.

- Trustees appointed by the President with the consent of the Senate are the legal owner of the interest in an S&P 500 Index Fund.
- The trustees of the index fund are the legal owners of the portfolio equity securities.
- The federal employee – the beneficial owner – has no right to make a decision about whether to buy or sell stock in a particular company. Indeed, he hasn't even chosen a particular equity index (the FERS trustees did that); he has only elected to invest a portion of his retirement plan in the equity mode.
- Neither the federal plan trustees nor the federal employee are legally permitted to exercise their ownership rights respecting shares of common stock.
- Ownership responsibilities are dumped on to the investment manager. An index fund is committed to market returns. It cannot compete with other index funds on returns. Although there is some competition between various indexes, the major basis for competition is on fees. In this case, the investment manager won the contract by giving negative basis points; the fund is a loss leader for the opportunity to engage in the lucrative business of stock lending.
- Index funds save money because they do not have to hire analysts to follow companies and make investment decisions. Whatever resources the investment manager commits to getting information

to be able to monitor its portfolio companies effectively make it less competitive both with other index funds and other modes of equity investment. In addition, it faces the "collective choice" and "free rider" problems mentioned in the discussion of the prisoner's dilemma.
- Like some corporate pension funds, the FERS fund has made significant investment in its own enterprise – it holds $775 billion of Special Issue Treasury securities, as much of the United States' paper as the Chinese and the Federal Reserve.

It is impossible to consider an individual federal employee as the owner of portfolio companies. His interest is fractionalized among 500 companies and he is forbidden by law to make any decision with respect to the shares of a particular company. Those who are entrusted with "ownership" responsibility have a pervasive economic disincentive to discharge them in a substantively meaningful way.

Who is the real "owner" of these companies (or even of these equity securities)? Who is best equipped to take on the responsibilities and make the most of the opportunities that accompany share ownership?

Furthermore, the federal government has not confronted its own massive under-funding problems. "If the government were forced to adhere to the same accounting standards [as private funds], retirement programs for civilian and military employees would be underfunded by more than $1 trillion. What's more, if Uncle Sam were required to reserve for pensions as they are accrued by workers – the way corporations are – the federal budget deficit would be roughly one-third higher.... Thanks to aging baby boomers within the civil service, the funds needed to cover annual benefit payments by 2010 are expected to nearly triple, to $160 billion."[177]

In 2010, the cash paid out from FERS was $70 billion while the cash paid in was only $4 billion.[178] It currently has a larger and more immediate impact on debt held by the public and total debt than Social Security.

TIAA–CREF

The Teachers Insurance and Annuity Association–College Retirement Equities Fund (TIAA–CREF) is in a category of its own – a pension fund that is neither quite public nor quite private. The $125 billion fund manages pension money for 1.5 million teachers and other employees of tax-exempt organizations. It has $425 billion total, including over $100 billion in equities. In 2001, TIAA–CREF was among the top one hundred in *Fortune* magazine's listing of the five hundred largest US corporations. Its size and its unique position have given it unusual freedom from commercial or political restrictions on involvement with corporate governance. It is therefore not surprising that it has often been first, if not most visible, with shareholder initiatives. Its 1986 proposal to put International Paper's poison pill to a shareholder vote was the first such proposal by an institutional investor to be voted on. It pioneered the "preferred placement" initiatives, asking companies not to offer preferred equities to "white squires" without shareholder approval.

In 1993, the fund announced a broader program and released a detailed list of its corporate governance policies, saying "TIAA–CREF acknowledges a responsibility to be an advocate for improved corporate governance and performance discipline."[179] The policies provided the basis on which TIAA–CREF said it intended to pursue all of its portfolio companies. "The significance is not the three or four laggards you catch – it's that you get the herd to run," said Chairman John Biggs. "We need to scare all the animals."[180] The policy statement also gave considerable space to

a discussion of executive compensation issues – specifically, determining what constitutes "excessive" compensation, evaluating the soundness of policies and criteria for setting compensation, and deciding what constitutes adequate disclosure. There is some irony in the fact that CREF's own 1993 proxy statement, issued to its plan participant/shareholders, included a shareholder resolution concerning the executive compensation at CREF itself, complaining about the CEO's salary of over $1 million a year.

The primary focus of TIAA–CREF's policy statement was on the board of directors. They encouraged boards to have a majority of outside independent directors and said that key board committees should be made up exclusively of independents. Moreover, TIAA–CREF did not believe that directors who have other business dealings with the corporation (as a legal representative, for instance) should be considered independent. Biggs said that the fund would be willing to withhold votes for directors "where companies don't have an effective, independent board challenging the CEO."[181] TIAA–CREF's website explains its current views on corporate governance:

> *TIAA–CREF believes that its policies on corporate governance should be shaped and allowed to evolve in collaboration with the companies in which it invests. Accordingly, we will continue to take the following steps, which have proven valuable in the past: a) provide copies of this Policy Statement and subsequent editions to companies in which we invest and suggest that the companies distribute the Statement to all executive officers and directors; b) periodically seek suggestions from companies and knowledgeable observers for ways to improve our guidelines and to make them more useful to directors and senior management; c) arrange for occasional informal opportunities for company directors, managers, and TIAA–CREF managers to review the guidelines in the Policy Statement; and d) send copies of the Policy Statement to other large institutional investors and appropriate organizations, make them available upon request, and publish them for TIAA–CREF participants and participating institutions to review and offer suggestions for change.*
>
> *We also communicate directly with companies where we perceive shortcomings in governance structure or policies. We engage in confidential discussions with board members and senior executives of the companies to explain our concerns and gain insights to their company. Our aim is to resolve privately any differences we may have. When these discussions fail to persuade us that management is responsive to shareholder interests, we may file shareholder proposals to build support for necessary change.*

In 2002, TIAA–CREF was on the other end of shareholder activism as its own annual meeting was picketed by social justice advocacy groups, asking it to make some disclosure and corporate governance changes: revealing its proxy votes; reporting on how it takes into account social issues in its investing; and splitting the positions of chair and CEO. The groups also asked TIAA–CREF to (1) take action on Unocal and Singapore Technologies, two companies in its stock portfolio that are invested in Burma, a country with one of the world's worst human rights records; (2) sell its stock in Philip Morris, the world's largest tobacco corporation; (3) remove Nike from the fund's portfolio, due to the company's notorious sweatshop abuses; and (4) divest holdings in British Petroleum because of this company's involvement in egregious human rights violations associated with gas extraction in Chinese-occupied Tibet.

PRIVATE PENSION FUNDS

The largest category of institutional investors is pension funds managed for the benefit of employees of private companies. ERISA, the law that governs private pension funds, was intended to encourage private companies to create pension plans and to protect the money in those plans once they were created. The statute was designed to resolve questions of conflict of interest and liability that had left the private pension system uncertain, even chaotic. The two public interest problems it was designed to solve were under-funded pensions and unvested pensions. "These are the institutions then that create the distinctive ERISA problems: funding, with managerial direction of the funds, and under-funding, with government guarantees of performance."[182]

ERISA funds are most often handled by outside money managers who range from one extreme to the other in their focus on proxy voting. A recent trend, endorsed by the Business Roundtable, is for plan sponsors to leave other aspects of the fund management outside, but to take the proxy voting in-house. Given the natural pro-management outlook of people who are, after all, part of management, this can be expected to result in more consistently pro-management votes. In all cases, however, whether the money is managed in-house or outside, "The brute fact that managers control their own firms' pensions is central. Few managers want their pension more active in the corporate governance of other companies than they would want their own stockholders to be active in the firm . . . Although arising from other intentions, [ERISA's] doctrines fit well with managerial goals of shareholder passivity."[183] Despite their size, ERISA funds face the same problem of "collective choice" and "free riders" that all shareholders do: *Can it be prudent for them to expend resources, knowing that, without the ability to communicate with other shareholders, any positive results are unlikely?* Even if the results are positive, any returns to the active shareholder will only be proportionate to its holdings, all of the other shareholders getting a free ride.

For private pension funds, perhaps, this problem is presented most sharply. To the extent that a company's pension department adopts an activist posture with respect to portfolio companies, it risks retribution: retaliation in the marketplace and invitation to other pension professionals to take an equally aggressive view of their own functioning. All the more reason, then, to do nothing, to try to maximize value by trading, despite the fact that all evidence indicates that the majority of those who do so fail to outperform the market.

ERISA fiduciaries must meet all of the obligations of prudence and diligence that any trustee must meet under common law. The ERISA statute starts with that standard and then imposes obligations beyond those of traditional trust law. One reason for the additional obligation is that ERISA permits a "non-neutral fiduciary,"[184] which would not be allowed under the common law of trusts. Under traditional trust law, the first requirement for a trustee is that he or she must be "neutral," and must have no conflicts of interest that would interfere with the ability to administer the trust assets in the sole interest of the trust beneficiary. However, it is a fact of ERISA that in pension plans, unlike traditional trusts, there is an inevitable and inherent conflict of interest. Employers and employees are both settlors (the party that provides the pension) and beneficiaries (the party that receives the pension). The plan sponsor is the party at risk of having to make up the difference if the plan is poorly run, even if there is no negligence – a level of risk that a "neutral" trustee does not have to face.

Thus, for example, while it would normally be considered a conflict of interests of a fiduciary to purchase shares of its own company for beneficiaries, this is allowed under ERISA. For instance, employers can make their contributions to 401-K accounts entirely in company stock. There is a strong incentive to do this because when employers make their contribution in stock, it is a cash-positive transaction for the company as there is no cash cost to the employer and the employer is able to take a tax deduction for the contribution.

ERISA requires that a "named fiduciary"[185] with responsibility for the plan be designated by the company, called a "plan sponsor."[186] Typically, a major corporation designates a committee of the board of directors as the "named fiduciary." ERISA recognizes that these people are too busy and important to watch over the pension fund money, so it permits them to delegate authority (and responsibility and potential liability) to an investment manager. So long as the selection of the investment manager is prudent and the plan sponsor monitors its performance, the plan sponsor company will not be liable for the investment manager's mistakes. The standard is utterly process oriented. As long as there is a reasonable process, and it is followed, the Department of Labor (DOL) will not second-guess the results. This applies to all investment decisions, whether buy–sell decisions or decisions on the exercise of proxy voting and other governance rights.

The passage of ERISA in 1974 shook up trustees of private systems. There was almost as much of an impact on the public systems, which usually *de facto* hold themselves to the ERISA standard, at least in terms of process. With liability avoidance as the primary goal, the trustees developed the practice of hiring consultants of all kinds and shapes to advise the trustees. By and large, these consultants have succeeded in placing a floor beneath which the trustees feel they cannot go. The stress is on "process." The "process" is simple: "Walk slowly and cover your tracks." (This is reflected in the conclusions of O'Barr and Conley, *Fortune and Folly*, cited earlier.) This is the basic message of consultants' elegant presentations, often in exotic locales, to which pension fiduciaries are invited, all designed to shield the trustees from liability no matter what actually happens with their investments.[187] ERISA funds have not been noticeably active in exercising ownership rights. The issues of pension fund management (and the small subset of issues that come up for a vote on proxies) are remote from whatever goods or services the plan sponsor company produces, so it is easier to file the pension fund away under "human resources."[188] As we have seen in the case of the public pension funds, meaningful exercise of the ownership rights of private pension assets is thankless. No investment manager, in-house or outside, ever got paid extra for voting proxies well, because that would mean a number of votes against management recommendations. For that reason, the ERISA funds have been among the least visible of institutional shareholders.

There is some evidence of change, however. In 1991, departing from their usual pro-management line, the ERISA funds sharply distinguished themselves from at least some traditional management positions in the letter to the SEC from the Committee on Investment of Employee Benefit Assets (CIEBA).[189] CIEBA's members are corporate benefit plan sponsors, representing $600 billion in collective assets managed on behalf of eight million plan participants. The letter gave guarded backing for proxy rule changes that were often opposed by top company managements. For instance, CIEBA said that any changes to the proxy process should include giving shareholders a vote when companies want to adopt a "poison pill" or other anti-takeover defenses. CIEBA has not been visible, much less outspoken, in any matter of corporate governance or shareholder activism since then.

CASES IN POINT CAMPBELL SOUP COMPANY AND GENERAL MOTORS

Campbell Soup Company. In July of 1993, Campbell Soup Company's $1 billion pension fund became the first major ERISA plan to make a commitment to "investing"

in shareholder activism. Until that point, institutional shareholder activism had been largely the province of public pension funds. Proud of its own corporate governance structure and record, Campbell's pension fund announced that it would direct the firms managing their pension fund's equity investments to vote their proxies against companies that elect more than three inside directors or re-price stock options after falling stock prices leave them with little value. Campbell's also said it would direct its money managers to vote their proxies to emphasize linking executive pay to performance.

General Motors. In late 1993, General Motors announced that it hoped to reduce its massive ($17 billion) pension under-funding by contributing $5.7 billion of newly issued shares of GM Class E stock (which are linked to the earnings of the EDS subsidiary) to its pension plan. The pension fund would then hold 38 percent of the EDS shares. This would require special legislation granting the company relief from tax penalties and special rulings by the Internal Revenue Service and the Labor Department. GM at that time had the most under-funded private plan in the country, meaning the largest gap between its assets and its expected payout.

At around the same time, PPG Industries announced that it would contribute 1.5 million of its shares to its pension fund and Tenneco, Inc. announced that, having already contributed 225,000 of its own shares, it would next contribute the 3.2 million shares it owns in Cummins Engine, Inc., a joint venture partner. A Tenneco spokeswoman said, "It was a way to achieve two things: to bring pension funding closer to where it needs to be, and to do so without using cash."[190] IBM planned to put up to 15 million shares into its pension fund. Chrysler contributed 30 million shares to its pension plans in 1991, when the stock was trading at around $10 a share, about one-fifth of what it was three years later. A Chrysler executive supports this approach: "The beauty of contributing stock to your pension fund is that the act of contributing increases the equity base of the company, and if, in fact, the stock appreciates in value, the benefit goes to the pension fund."[191] An executive at another company noted that his company saved time and investment banking fees by contributing stock to the pension fund instead of presenting it to the public equity market.

Who is benefiting here? Is it consistent with the fiduciary obligation of a pension fiduciary to contribute an asset to the plan when he appears unsure, if not indifferent, as to whether it will appreciate in value?

The strongest bull market in American history led to a huge additional boost to corporate earnings as the corporate pension plans, invested heavily in equities, performed extremely well, contributing the surplus to the companies' earnings. However, as the market softened, pension assumptions had to be recalibrated, and the bottom

line at many companies took a hit. In John Plender's 2003 book, *Going off the Rails,* he coins the term "pension fund glasnost," because:

> *. . . the bear market had an impact not unlike that of glasnost in the Soviet Union. It exposed an economic reality that people had previously been no more than faintly aware of. . . . This creates enormous corporate vulnerability to the gyrations of equity prices, especially in the more mature sectors of the economy where defined benefit schemes predominate. . . . British Airways, for example, could reasonably be characterized as a hedge fund with a sideline in air transport. Its viability is even more dependent on the mood swings of the equity market than on the fortunes of the airline business.*

Because accounting rules count the predicted rather than actual increase in pension assets and allow the surplus to be blended in with operating earnings, the assumptions can have a critical impact on a company's balance sheet. No one wants to give that up, which accounts for some of the rosy predictions for pension returns that seem to bear no connection to the market's performance. According to Deepa Babington's article called "Wild Optimism Rides High in Pension Accounting" in a February 3, 2003 issue of *Forbes:* "Of the first 45 S&P 100 companies to report fourth-quarter earnings [in early 2003], the 22 that spelled out their new assumptions have cut them to an average of about 8.7 percent from 9.6 percent, according to an analysis by Reuters. But the cuts in the crucial expected rate of return on pension assets may not be enough to keep pace with stock market declines. . . . By contrast, investor advocate Warren Buffett, who frequently attacks high pension fund assumptions, uses a 6.5 percent rate for his company, Berkshire Hathaway Inc."

California State Controller Kathleen O'Connell has called upon the state pension funds to limit or withdraw investments from companies that take advantage of what she calls an "accounting gimmick." Analyst David Zion recommends carrying the pension fund at its actual fair market value, to minimize distortion and remove incentives for financial engineering, and S&P developed a "core earnings" calculation that removes the distortion of the pension assumptions from the balance sheet. ■

Westinghouse contributed 22 million shares trading at $16.50 in 1991, about three dollars a share more than the stock price in 1994, when the company contributed a further 16 million shares. On the other hand, Xerox guidelines prohibit such donations. "We feel there is enough exposure on the part of the employees to the fortunes of Xerox, and there ought not to be additional exposure through the pension fund," said Myra Drucker, then assistant treasurer.[192]

Examine the finances and the policy of contributing the issuers' own stock to the pension fund, both from the perspective of the company and the employees. Is Myra Drucker right?

This is a good example of the problems of the "non-neutral fiduciary," because what is best from the perspective of the corporation's financial structure (forced sale of company stock to the longest term and friendliest possible hands) may not be best from the perspective of the plan beneficiaries, whose pension money is tied up in stock that may not be the best possible investment.

CASE IN POINT "UNIVERSAL WIDGET"

Universal Widget's pension plan holds the largest block of the company's stock. Universal's performance has been very poor over the past ten years, following a series of disastrous acquisitions and declining market share. The plan trustee is a major bank that also handles Universal's commercial accounts. It routinely votes the proxies in the pension fund for management.

Under what circumstances do "prudence" and "diligence" require action on the part of the trustee, either shareholder proposals, withholding votes for the board, or more aggressive initiatives? In other words, how bad does it have to get? (See also the Carter Hawley Hale and Stone & Webster case studies in chapter 7.)

Many observers are concerned that the pension system may require a bailout that will make the savings and loan crisis look small. Private pension funds may be currently under-funded by as much as $300 billion. As stock prices have fallen, an aging but longer-lived workforce has increased the expected liabilities.

Given that trustees hold a majority of the ownership of the major US companies, this collective ownership is large enough to mitigate significantly the "free rider" problem. Should the courts and the government monitoring agencies enforce the fiduciary obligation of trustees to their beneficiaries by requiring some kind of active monitoring? Collective action?

If fiduciaries are genuinely "required" to vote independently, it will be all but impossible for commercial conflicts to interfere. Columbia professor Mark Roe says, "ERISA's key fiduciary restraint is *not* to force passivity but to *reinforce* whatever the prevailing practice is. ERISA mandates imitation." In "The Modern Corporation and Private Pensions" (41 UCLA Law Review 75, 1993–4), he recommends consideration of four possible changes to ERISA doctrine to enable more effective shareholder monitoring: a safe harbor specifying that an ERISA fiduciary could meet its diversification goals with "say, 20 or 50 stocks in different industries," "netting" for big block investments (absent wrongdoing), limiting the liability of pension funds to the business judgment rule for boardroom actions, and scrutinizing pension managers more carefully when they have conflicts of interest stemming from their position as corporate managers.

ERISA funds are also subject to the pressure for "economically targeted investments." On September 2, 1993, Olena Berg, Assistant Secretary of Labor for Pension and Welfare Benefits, delivered a speech to the AFL–CIO Asset Managers Conference. While emphasizing that she was in no way recommending or even countenancing "concessionary" investments (accepting a lower

return in order to support some social goal), she asked pension trustees to recognize that: "Investments that promote a more productive, healthier economy over the long run serve the best interests of plan participants. These two objectives, of maximizing pension fund performance and investing pension fund assets in a manner that strengthens the American economy, need not be, and, indeed, are not, inconsistent."[193] She urged the audience to consider "underutilized indicators" of long-term corporate performance, like "the ability to develop and retain a highly trained, high-performance workplace." There has been virtually no discussion of this issue during the George W. Bush administration.

THE SLEEPING GIANT AWAKENS: SHAREHOLDER PROXY PROPOSALS ON GOVERNANCE ISSUES

As noted above, some institutional shareholders became more active in exercising the rights of share ownership in the late 1980s. Initially a reaction to the abuses of the takeover era, this activism gained a life of its own as it focused on performance – and on boards of directors as the place to go when performance was unsatisfactory.

The reach and power of this trend can be seen in the number of shareholder proposals and the number of votes in favor of them. For many years these proposals were the exclusive province of legendary corporate "gadflies" like Wilma Soss and Evelyn Y. Davis, still filing dozens of proposals each year, and the late Gilbert brothers. Soss inspired the delightful play (later a movie) *The Solid Gold Cadillac*, which is still remarkably relevant to current corporate governance issues.

This small group, cheered on by a few, ridiculed by more, and dreaded by corporate management, really created the field of shareholder activism. In 1932, Lewis Gilbert attended the annual meeting of New York City's Consolidated Gas Co. Gilbert was unhappy with the chairman's refusal to recognize shareholder questions from the floor. He and his brother John Gilbert began buying stock (their investment policy was "never sell") and attending meetings. Their actions led to the SEC adopting rule 14a-8 in 1942, giving shareholders the right to have their proposals included in the company's proxy statements. The early gadflies began submitting shareholder resolutions on corporate governance topics like executive compensation, cumulative voting, and the location of the annual meeting.

Public interest advocates were inspired by this approach in the 1960s, and the range of topics for shareholder proposals expanded beyond the governance realm into social activism. Public pension funds, union pension funds, and church groups sponsored shareholder resolutions on "social policy" issues like investment in South Africa or the sale of infant formula. The vote of less than 3 percent for Ralph Nader's 1970 "Campaign GM" shareholder proposals was hailed as a victory of unprecedented levels for a shareholder initiative. These groups have continued to submit social policy proposals, which have received votes of 20 percent and higher. Some of these proposals have become something of a hybrid, combining elements of social policy and corporate governance. These include proposals regarding tobacco, defense manufacturing, environmental issues, South Africa, and Northern Ireland. Members of the Interfaith Center on Corporate Responsibility, an organization that promotes corporate social accountability, sponsored many of these resolutions.

All indications are that this area will expand. The Parents Television Council, which had urged its members to write to the sponsors of offensive television programs, began to suggest that members who own stock in those companies submit shareholder proposals, and included sample language in

their newsletter. A 2000 report from Amnesty International, titled "Human Rights – Is it Any of Your Business?," warns that advocacy groups will challenge the reputation of multinational corporations that fail to make a public commitment to fair and safe labor practices. It advises corporate board members that they cannot afford to be ignorant or neglectful on labor and environmental matters. "Companies have a direct self-interest in using their legitimate influence to protect and promote the human rights of their employees and of the community in which they are investing and/or operating," the report says. In 1993, US District Court judge Kimba Wood overturned the SEC's determination that Wal-Mart did not have to include a shareholder resolution asking the company to issue a report on its affirmative action and equal employment opportunity programs. The resolution was sponsored by the Amalgamated Clothing and Textile Workers Union and several church groups.[194] The SEC found that the proposal concerned "ordinary business," which, as the exclusive province of corporate managers, was not appropriate for shareholder initiatives. This was a reversal of the SEC's policy before 1991, when they viewed employment issues as raising important policy questions. Judge Wood agreed with the earlier view.[195] Similarly, in 1993, the New York City Employees' Retirement System (NYCERS) sued the SEC after the agency allowed Cracker Barrel Old Country Store Inc. to exclude NYCERS' resolution asking the company to rescind its policy prohibiting gay employees. The SEC agreed with Cracker Barrel that the issue came under the heading of "ordinary business" and was thus not suitable for shareholder comment. NYCERS argued that the issue had broader economic implications: "Limiting the available talent pool from which a company can choose employees and managers puts that company at a disadvantage in the labor marketplace," said NYCERS chairwoman Carol O'Cleireacain.

In 1998, the Commission reversed its position and decided to permit proposals on issues of employment discrimination. Cracker Barrel, meanwhile, had rescinded its anti-gay policy.

In 2002, then-SEC Chairman Harvey Pitt recommended that the "ordinary business" exception be rescinded, so that shareholders could file proposals on any topic that they wanted. This seemed to make sense, as shareholder proposals are precatory so that even a 100 percent vote in favor would not require a company to adopt a proposal, except for the tiny fraction of binding proposals framed as bylaw amendments. After he left, the proposal was dropped. The SEC has expanded the appropriate subjects for shareholder proposals in light of the corporate failures of the early twenty-first century, allowing proposals relating to risk oversight if "the underlying subject matter transcends the day-to-day business matters of the company and raises policy issues so significant that it would be appropriate for a shareholder vote" and there is a sufficient nexus between the subject of the proposal and the company and relating to CEO succession planning.

In 2009 and 2010, more than half of the 100 largest companies had at least one shareholder proposal relating to corporate governance. A majority of shareholders supported 271 of them, including proposals to declassify board terms, put pay to a shareholder vote, and require directors to get at least 50 percent of the vote in order to serve.[196]

Compare this with the Wrigley Field example in chapter 1 and describe an optimal "ordinary business" standard.

The United Shareholders Association (USA), founded in 1986 by T. Boone Pickens, had thousands of members in all 50 states and became a powerful force for activism by individual investors, providing information about companies, issues, and the mechanics of filing. USA members filed a large proportion of the shareholder resolutions each year, and USA was instrumental in persuading the SEC to amend the proxy rules and was a prominent commentator on executive pay issues.

It closed down in 1993 following the SEC's successful overhaul of the shareholder communication rules. Until those amendments, any material circulated to more than ten other shareholders in support of a proxy proposal had to be reviewed and edited by the SEC before it could be sent out. This astonishing example of government intervention, even censorship, prior to publication, all but unheard of in any other subject area under the US system without the most severe national security implications, is evidence of the strong sense of protection the system provides for the management of public corporations.

By the late 1980s, many major companies, particularly poorly performing companies, routinely had at least one shareholder resolution – sometimes as many as five or six – submitted by individuals, union pension funds, church groups, and public pension funds. Even though virtually all shareholder resolutions are precatory only, companies have increasingly responded to them, often negotiating with proponents so that the proposals are not voted on at the annual meeting. USA found, in its last year, that 29 of 50 resolutions were withdrawn after successful negotiation. CalPERS found that 11 of the 12 companies they targeted that year were prepared to make concessions.

As institutional investors began to use governance resolutions to fight disenfranchising anti-takeover devices corporate management installed to protect themselves from changes in control, the levels of support grew. Forty years after Campaign GM, shareholder resolutions routinely get votes ranging from 20 to 40 percent, and some receive majority support.

In 1987, the first corporate governance resolutions from institutional investors (mostly relating to poison pills) were submitted at 34 companies, with votes in favor ranging from about 20 to 30 percent. A year later, two of these resolutions got majority votes, one concerning a poison pill, one prohibiting payment of greenmail. Both were at companies where proxy contests for control provided a good deal of visibility (and engendered a good deal of shareholder support). The more significant development that year, though, was the "Avon letter," issued by the DOL on February 23. It was the first formal ruling by the agency with jurisdiction over the ERISA funds that the right to vote proxies was a "plan asset" and thus must be managed according to fiduciary principles. Money managers across the country began to establish procedures and policies for voting proxies.

In 1988, TIAA–CREF became the first institutional investor to run a dissident slate of candidates for the board – and the first to succeed. The following year, in 1989, there was the first proxy contest that was not over director candidates, but over corporate governance.

The Los Angeles Times reported in 2010 that shareholder activists Ken Steiner and John Chevedden, following in the tradition of the Gilbert brothers, were gaining enough support for their shareholder proposals that they were having an increasing impact on companies. Chevedden's "say on pay" proposal at Edison Electric got majority support from the other shareholders. Even though that vote was not legally binding, the company decided to comply and put its compensation to a shareholder vote. "Riding a populist wave set off by the financial crisis[,]" the two had fought with corporate boards for years, typically through correspondence and book research,[197] but are now aided by the provisions of the Dodd–Frank Act that require a "say on pay" at least once every three years and clawback provisions for undeserved executive pay. Sometimes thought of as the pesky gnats that can get even the most stubborn bull moving, these activists have helped keep important compensation and governance issues in the public eye, and are being rewarded with victories as the pendulum of public opinion swings against management. Though the struggle for adequate corporate governance remains unfinished, they intend to keep stinging.

CASES IN POINT HONEYWELL AND FURR'S

A large individual shareholder of Honeywell joined with two public pension funds and Institutional Shareholder Services, Inc.[198] to prevent management from adopting two of management's proposed changes. The company wanted to stagger the election of directors and to eliminate the right of the shareholders to act by written consent, instead of waiting for the annual meeting. The ad hoc coalition circulated its own proxy card and was successful at preventing management from getting the necessary level of support. Over the three-month period of the initiative, Honeywell common stock rose 22 percent, with each stage of the contest sparking a favorable market reaction. While takeover rumors played a role, the market clearly recognized the value of active shareholder involvement in an under-performing company. The individual investor who paid the costs of the solicitation got a substantial return on his investment in activism – as did the other Honeywell shareholders. Figures 2.1 and 2.2 demonstrate the impact of this effort on trading volume.

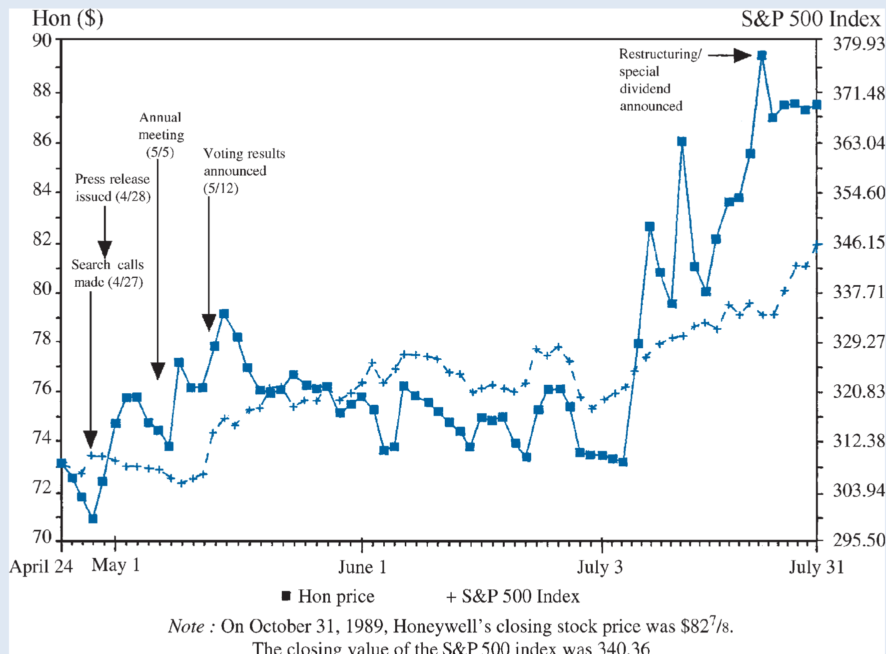


Figure 2.1 Honeywell versus S&P 500 daily trading volume.

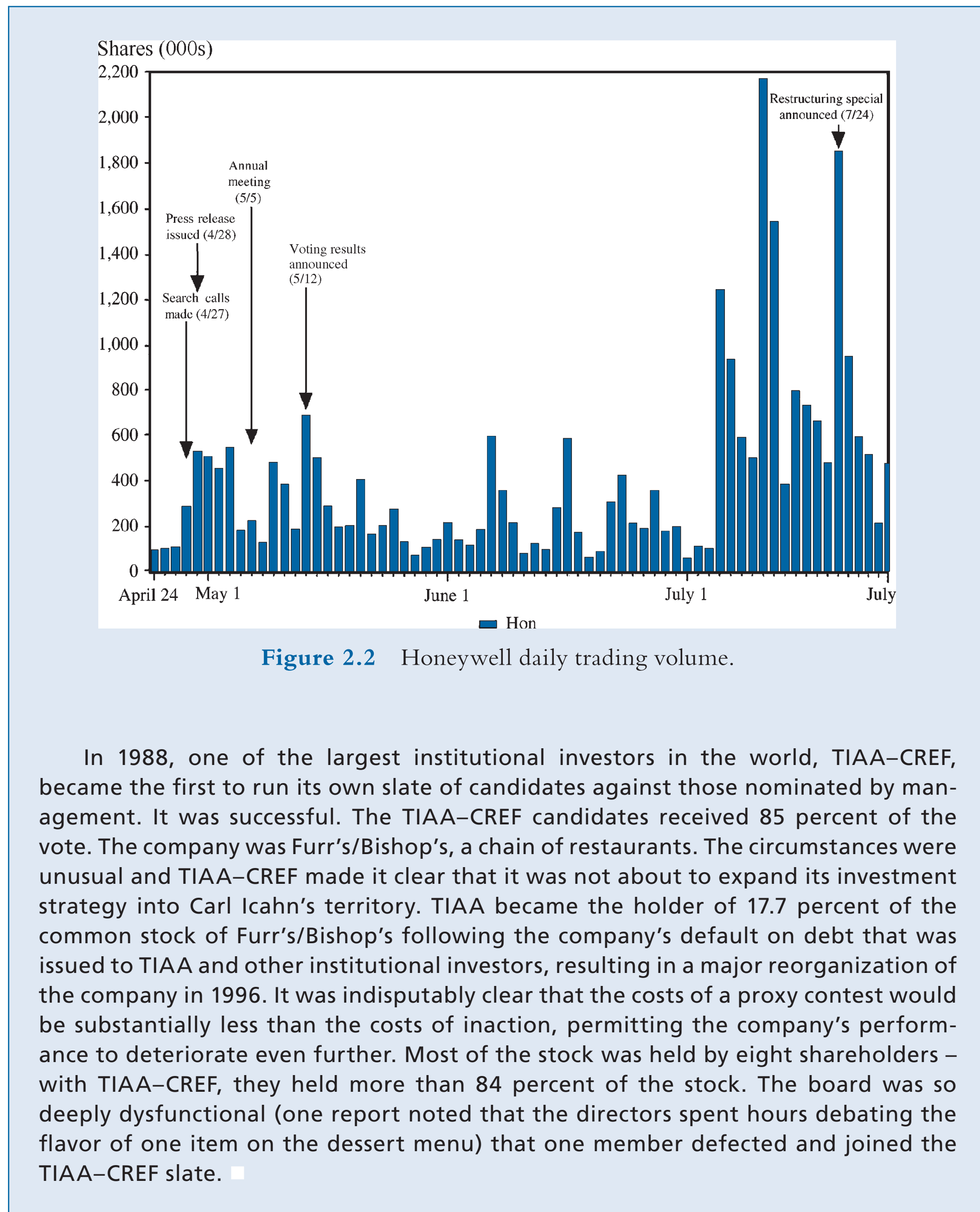


Figure 2.2 Honeywell daily trading volume.

In 1988, one of the largest institutional investors in the world, TIAA–CREF, became the first to run its own slate of candidates against those nominated by management. It was successful. The TIAA–CREF candidates received 85 percent of the vote. The company was Furr's/Bishop's, a chain of restaurants. The circumstances were unusual and TIAA–CREF made it clear that it was not about to expand its investment strategy into Carl Icahn's territory. TIAA became the holder of 17.7 percent of the common stock of Furr's/Bishop's following the company's default on debt that was issued to TIAA and other institutional investors, resulting in a major reorganization of the company in 1996. It was indisputably clear that the costs of a proxy contest would be substantially less than the costs of inaction, permitting the company's performance to deteriorate even further. Most of the stock was held by eight shareholders – with TIAA–CREF, they held more than 84 percent of the stock. The board was so deeply dysfunctional (one report noted that the directors spent hours debating the flavor of one item on the dessert menu) that one member defected and joined the TIAA–CREF slate. ■

In 1990, shareholder resolutions on governance, mostly from public pension funds, continued to receive growing support. Two resolutions got majority votes, the first majority votes without a formal proxy solicitation. The most important corporate governance issue of the year was the battle over Pennsylvania's controversial new anti-takeover law. Like most states, Pennsylvania had adopted new laws to protect local companies from takeovers, but it went further, with a second set of amendments, when local company Armstrong World became a takeover target. The 1990 amendment was objected to so strongly by shareholders that nearly one-third of the state's companies (including over 60 percent of the Fortune 500 companies located in the state) opted out of at least one of its provisions (see "Protection, Pennsylvania Style" case in point in chapter 1).

In 1991, there was an unprecedented level of cooperation and negotiation between shareholders and management. Many of the shareholder resolutions submitted by institutional investors were withdrawn following discussions with management and agreed-upon changes. Representatives of the shareholder and corporate community negotiated a "Compact Between Owners and Directors" that was published in *Harvard Business Review.*

Significant as the Compact was, however, the 1991 proxy season demonstrated that management and investors were more theoretical than real. One of the top governance stories of the year was Robert Monks' proxy contest for one board seat at Sears, Roebuck (see Sears case study).

In the same year, for the first time, a corporate governance issue exploded, leaving the business pages to land on the front pages, the editorial pages, even the comic pages. The issue was, of course, executive compensation (see discussions in chapter 4), which has remained a core issue for investors and press and policy-makers. It was in 1991 that even the business press first used terms like "obscene" and "out of control" in describing the level of pay received by some top executives. Politicians and the mass media made it a central issue, and it has continued to be controversial, with pay packages that made those of this era seem paltry.

Shareholders came full circle in the early 1990s, with shareholder proposals reminiscent of the ones filed by the Gilbert brothers half a century earlier. In 1991, ITT CEO Rand Araskog's pay increased by 103 percent to more than $11 million, in a year when ITT's shareholders watched the value of their stock decline 18 percent. Pressure from shareholder groups led the company to overhaul its compensation scheme for the top 500 employees, with very positive effects on the company's stock price. Also in 1991, the SEC reversed its long-term policy and allowed shareholder resolutions about pay. It gave the go-ahead to ten resolutions, all submitted by individual shareholders.

These resolutions were presented at annual meetings in the spring of 1992. While none got a majority vote, they all received substantial support, and one got 44 percent. Overall, though, the volume of shareholder proposals was down in 1992, largely because both shareholders and management were more interested in trying to find common ground through less confrontational methods. Many individual and institutional investors withdrew their proposals after successful negotiations.

CalPERS, long in the vanguard of institutional shareholder activism, announced it would be, in the words of George H. W. Bush, "kinder and gentler," and it did not submit any shareholder resolutions that year. Instead it targeted a dozen under-performing companies, many with compensation schemes that had several of their widely distributed list of "danger signals" developed for them by compensation guru Graef Crystal. Although some companies stonewalled CalPERS (until their failure to respond was reported in the press), many of the companies were willing to meet and negotiate.

Boards of directors did respond to the increased levels of shareholder activism, and not just in making concessions to avoid shareholder resolutions. In just over twelve months – between October

1992 and December 1993 – the CEOs of six major companies, including IBM, American Express, and General Motors, were pressured to resign in light of the long-term under-performance of the companies they managed.

These resignations represented nothing less than a seismic change in American governance. Boards of directors were finally holding management accountable for poor performance. Soon after, CEOs were dismissed from Mattel, Scott Paper, Quaker, Sunbeam (the same CEO who was brought in to replace the one who was fired at Scott Paper), Waste Management (two), Compaq, AT&T, Apple, Coca-Cola, and many others. In the post-Enron era, boards have become even more hair-trigger when it comes to replacing CEOs. Search firm Spencer Stuart estimates that CEO job tenure now averages less than two years. As we discuss further in chapter 3, the "Pharaonic" CEO has given way to the fired CEO, in large part due to the insistence of shareholders.

Read the Eastman Kodak and General Motors case studies. Is pushing out the CEO a solution or just a first step in revitalizing a company? Is it just a dramatic gesture that doesn't address underlying problems with the company's operation? What are the problems associated with letting a company continue to under-perform to such a point that it is necessary to replace the CEO? What less drastic steps can be taken earlier to ensure that the CEO need not be forced to resign? See also the discussion of "dinosaur" companies in chapter 3 for a look at those companies that remain successful for decades.

FOCUS ON THE BOARD

After the early 1990s, shareholder focus turned from anti-takeover abuses and CEO pay/performance disparities to the perpetrators of those failures of oversight, the boards of directors. Shareholders increasingly looked to boards to provide a more independent review of corporate performance, direction, and strategy. Then-CalPERS CEO Dale Hanson told a group of corporate managers, "We are no longer into CEO-bashing. We are now into director-bashing."

From the shareholder perspective, the "just vote no" strategy became an increasingly important mechanism for sending a vote of no confidence. The 1 percent "withhold" vote at ITT in 1991 was overtaken in 1992 by 2 percent withhold votes at Dial and GM, 3 percent withhold votes at American Express, 4 percent at Westinghouse, Unisys, and Occidental Petroleum, 6 percent at Sears and Travelers, and a stunning 9 percent at Champion International.

In the post-Enron era, withhold vote campaigns ramped up considerably. Aided by a furious (in both senses of the word) campaign by Roy Disney to oust Disney CEO Michael Eisner in 2004, the withhold vote amounted to 43 percent. As a result, Eisner stepped down as board chairman and accelerated his departure as CEO. In 2007, Laborers' International Union of North America urged shareholders to withhold their vote from Carl B. Marbach, the director who chairs the board's compensation committee, arguing that the CEO was overpaid. Two proxy advisory firms, Institutional Shareholder Services and Proxy Governance Inc., supported the Union's position, and one-quarter of the shareholders withheld their support. The Union did not have anywhere near the $50 million spent by Roy Disney, but its good timing and well-chosen target produced very impressive results.

Further concerns about the board have been reflected in shareholder resolutions calling for separate individuals to serve as chairman and CEO, compensation and nominating committees to be entirely made up of independent outside directors, and an overall majority of independent outside directors on the board as a whole. However, the two most powerful initiatives had to do

with the process for selecting directors, based on the view that as long as insiders controlled the process of deciding who served on the board, directors would be beholden to management and unable to provide genuinely independent oversight. Those initiatives are: (1) majority vote (making ineligible for board service any director who does not receive a majority of the votes cast) and (2) proxy access (giving shareholders the right to nominate director candidates whose names would appear on the same proxy card as the management-sponsored candidates). A proxy access proposal at Hewlett-Packard sponsored by the American Federation of State, County, and Municipal Employees received a 39 percent vote in 2007. While it would have needed a two-thirds vote to have been binding, this was still a very significant showing.

These ideas had their roots in a proposal from then-New York State Comptroller Edward V. Regan to permit large shareholders access to the company's proxy statement for brief evaluations of the performance of the board and in a 1992 proposal submitted to Exxon by Robert Monks that would permit the creation of a Shareholder Advisory Committee, a group of shareholders, elected by shareholders, to meet (at company expense). As with Regan's proposal, this group would be permitted to include its comments on the company in the corporate proxy statement. The California Public Employees' Retirement System negotiated the creation of such a committee with Ryder, and discussed similar committees with other companies.[199]

Following the corporate scandals of 2002, the focus on the board became even more intense. Director and officer liability insurers, rating agencies, and even traditional investment analysts increasingly looked at the board as an element of investment risk.

The new rules made possible more effective shareholder oversight. Managers, directors, and shareholders must keep in mind that just as shareholders' liability is limited, so is their agenda. The rules governing the appropriate topics for shareholder resolutions did not change, and a brief effort to do so failed. Shareholders do not have the expertise, the resources, or the right to get involved in matters of day-to-day management and should not become involved in second-guessing "ordinary business." Indeed, such involvement is currently prohibited by sections of the proxy rules that are not under consideration for change.

The financial crisis of 2008 resulted in the most significant of changes to financial regulation since the Great Depression, principally through the Dodd–Frank Act, which continued to focus on the board of directors and executive management. Shareholders have gained powerful new rights and methods to pursue them. These include removing "ordinary business" restraints on shareholder proposals about the CEO succession process; heightened disclosure requirements of companies, requiring them to explain why they combined the CEO and chairman of the board positions; increased shareholders access and control over risk and executive compensation (a chance to have a "say on pay" at least every three years); the increased access of shareholders to the proxy for board nominees; and, finally, the broker voting provisions described earlier in the chapter that change the election of directors to nonroutine matters and make it likelier a dissident slate of directors may be elected as brokers may no longer vote for shares for which they have received no instructions.[200]

As Benjamin Graham and David L. Dodd argued over a half century ago, shareholders do have the right and responsibility to focus their attention on matters where "the interest of the officers and the stockholders may be in conflict," including executive compensation.[201] Developments since the time of Graham and Dodd have shown that shareholders must also be vigilant about preserving the full integrity – and value – of their stock ownership rights. For example, their right to vote may be diluted by a classified board or by dual-class capitalization, and their right to transfer stock to a willing buyer at a mutually agreeable price may be abrogated by the adoption of a

"poison pill." (For a discussion of "poison pills" and other devices adopted during the takeover era that encroached on the rights of shareholders, see chapter 3.) These kinds of issues present conflicts of interest not contemplated at the time of Graham and Dodd's first edition, as shareholders are interested in accountability and officers and directors are interested in protecting themselves.

Even if poison pills are good, isn't there a conflict of interests between shareholders and management in the design and timing of a pill? Who is in the best position to determine the optimal design and timing? Should pills be submitted to a shareholder vote?

Of course, the shareholders' most important function as monitors concerns their election of the directors. As noted above, the "just vote no" strategy is an increasingly important way for shareholders to send a message of concern about the performance of a company or its board of directors. Company proxy statements reveal information about whether individual directors attend 75 percent of the meetings, how much stock they own, which committees they serve on, and whether they have other financial connections to the company. Shareholders can withhold votes for directors who do not attend meetings, who hold no stock, who serve on committees that approve bad compensation schemes, or who have conflicts of interest. While even a majority of "withhold" votes cannot keep an unopposed director candidate off the board, it can send an effective message to the board, to management, and maybe even to members of the financial community who may be considering running a dissident slate. It can also capture the attention of the press. A 1997 13 percent "withhold" vote at Disney, supported by CalPERS, helped win the board the "worst board" designation from *Business Week* that year.

Investors continued to focus on the key issues of executive compensation and board compensation and composition. In the late 1990s, accounting scandals at Waste Management, Cendant, Livent, and Sunbeam led to increased focus on the independence and competence of the audit committee.

Another important change was the passage in 1995 of legislation[202] changing the rules for shareholder lawsuits. It was intended to provide a "safe harbor" for forward-looking statements, to encourage corporate representatives to speak openly about the companies' prospects without worrying about being sued if every comment they made was considered an enforceable commitment, and to give large institutional shareholders a better opportunity to represent the class of investors than the "professional plaintiffs" used by the "Delaware regular" law firms. These are firms who file dozens of lawsuits on behalf of professional plaintiffs, so they can settle quickly and move to the next case. The impact of that legislation is still being evaluated. Preliminary studies show that it has had little effect on the number of lawsuits filed, but that it has affected the jurisdiction (more filed now in state court than federal court) and the charges (more fraud based). In a few cases, institutional investors have been able to take control of the lawsuits away from the "Delaware regulars" with good results.

CASE IN POINT SWIB AND CELLSTAR

The State of Wisconsin Investment Board (SWIB) made one of the earliest attempts to be appointed as the lead plaintiff under the new law, in a case filed against CellStar. This

was a matter of the gravest concern to the usual plaintiff's counsel, who had been accustomed to controlling the cases and taking large fees, so they objected to SWIB's filing. They were forced to concede that SWIB met the statutory standard as "presumptively most adequate plaintiff" due to the size of their investment (over 20 percent of the stock), the promptness of their filing, and their initial showing of "typicality and adequacy," as required by the law. However, the law firm challenged them anyway, on the grounds that they were not as "typical" and "adequate" as they appeared; in other words that they were not good representatives of the class of shareholders in CellStar. Why? Because they were too big and sophisticated and would thus not be able to represent the interests of small and ignorant investors. The judge found this claim to be unfounded. ■

Institutional investors are transforming the world of corporate governance. The issues they must consider in voting proxies are becoming more complicated and diverse, with economic and fiduciary consequences to consider and evaluate. The priorities of the institutional investor community are evolving quickly, past the secondary (and reactive) issues of poison pills and staggered boards and toward the central (and active) concerns of board composition, independence, and effectiveness, with executive compensation as a primary indicator.

It is not only the shareholder community that has changed in the past two decades. The corporate community has also changed, in response to the increased ownership focus of shareholders, even in cases where shareholders have not taken any overt action.

Many companies are restructuring their boards of directors in response to governance concerns raised by the shareholder, financial, and legal communities. More significant than the percentage of directors who meet some "independence" standard as defined by the SEC or the stock exchanges is the rise in the number of "lead directors," a position all but unknown just a few years ago. Now 94 percent of S&P 500 boards have a lead director, compared with 85 percent in 2005; only 36 percent had this board position in 2003.

Both institutional and individual investors are taking advantage of the new technology to become more effective in overseeing corporate managers and directors. This next case in point may turn out to be the most significant development since Lewis Gilbert persuaded the SEC to require companies to publish shareholder proposals in their proxy statements.

CASES IN POINT — REVOLT OF THE YAHOOS: UNITED COMPANIES FINANCIAL AND LUBY'S

United Companies Financial. UC was founded in 1946 and engaged in various businesses relating to lending money to "subprime" borrowers [people whose credit profile is unacceptable to major lenders]. In 1992 it began securitizing subprime residential mortgages.

That business grew very rapidly, but CEO and chairman Terrell Brown was unwilling to control operating costs and unable to come up with a long-term plan that did not depend on unlimited access to cheap capital. The stock price fell from $36 to $12 over the second half of 1997. The company put itself up for sale, and the price rebounded to $26. However, there were no takers and reversals at the company brought the price down to $4 and then to under a dollar. Two professors who were significant shareholders, Aaron Brown and Martin Stoller, attempted to get in touch with management. Stoller posted some of his concerns on the Yahoo! message board assigned to the company. When he saw that other shareholders shared his concern, especially after the company filed for bankruptcy, he asked them to reveal how much stock they had. It turned out that 40 percent of the stock was represented by the participants in the Yahoo message board.

The Yahoo message board turned out to be an ideal mechanism for doing what had previously been impossible – finding and communicating with other shareholders. With the support of the other shareholders, they were able to play a role in the bankruptcy proceeding. Brown described what he learned as follows:

> *I believe the internet played a crucial role at three points in this story:*
>
> 1. *I do not think we could have gotten an Equity Committee without the large number of shares and people represented on the internet. The message board got us the SEC and newspaper interest that, in my opinion, forced the US Bankruptcy Trustee to appoint a committee. Without an Equity Committee composed of aggressive shareholders, I believe UC would have been liquidated in May 1999 with no value for shareholders.*
> 2. *The internet message board helped me find a buyer for UC in several ways. First, it got me the meeting with UC. Second, it provided detailed financial and management information that were essential to designing a plan. Finally, I found that all the potential buyers were following the message board with a combination of amusement and awe. I got in the door of several places where I had no prior relationship, as a sort-of celebrity.*
> 3. *The message board, and the attention it generated from the SEC and newspapers, may have caused some parties to be somewhat more solicitous of shareholder interests. It had no discernable effect on UC management, however. On the other hand, the internet postings may have caused some problems. Some of the postings were arguably illegal as stolen information, inside information, libel, or invasion of privacy. There was not a lot of false information; most of that was obvious and some of it I suspect came from employees. Certainly many employees did post, most of them without revealing their status.*

Although the outcome was not entirely successful as a financial matter, Brown and Stoller took what they learned and created a fund designed to use the internet to force change at under-performing companies.[203]

Luby's. In 2001, Les Greenburg organized the shareholders of Luby's, a chain of Texas restaurants, primarily through an online message board. He ran a slate of four dissident directors and attracted so much support from shareholders who were unhappy about the stock's declining value that the unpopular CEO departed. The dissidents ended up with only 25 percent of the vote because many shareholders felt that the board was responding to their concerns. However, the proxy contest would have been prohibitively expensive if not for the presence of a critical mass of shareholders on the message board and Greenburg's ability to do his own legal work. Despite the directors' protestations to the contrary, it is unlikely that they would have replaced the CEO without the pressure of the contested election. The stock has continued to decline in value, but the message board has yet to try again. ■

The separation between ownership and control and the collective choice/prisoner's dilemma problems that inhibit shareholder oversight rest primarily on the inability of shareholders to locate each other and communicate with each other inexpensively. The best prospect for changing that is the internet. The Luby's and UC examples demonstrate the possibilities. They have been followed by more organized approaches from sites like Moxy Vote, Proxy Democracy, and the Shareholders Education Network (the last funded in part from the settlement of shareholder litigation), all designed to act as hubs for providing guidance and information to shareholders on voting proxies. Large institutional investors like CalSTRS post their proxy votes (often voting against more than half of the compensation proposals), permitting anyone who is interested to mirror their votes. Unlike buy–sell decisions, there is no benefit in exclusivity of information and free riders are welcome.

A second major factor affecting shareholder votes is the increased transparency. As the SEC promulgated the most extensive regulatory changes in 60 years following the corporate scandals of 2002, the only major initiative not prompted by the Sarbanes–Oxley legislation was a requirement that money managers and mutual funds disclose their proxy voting policies and any votes inconsistent with those policies. This was a reflection of SEC concerns that institutional investors had too often been either negligent or corrupt in proxy voting and that the disconnect allowed the issuer company to know how the shareholders voted while the beneficial holders did not create perverse incentives. The tipping point may have been the decision by Deutsche Asset Management to switch votes in the hotly contested merger of Hewlett-Packard and Compaq (see case in point below).

CASE IN POINT DEUTSCHE ASSET MANAGEMENT CHANGES ITS VOTE

In the fall of 2001, the boards of Hewlett-Packard and Compaq voted unanimously to merge the two companies, but then one of HP's directors, Walter Hewlett, the son of one of HP's founders, decided to oppose the deal. He was joined by David Packard, son of the other co-founder.

It was front-page news for weeks as Hewlett and the board, of which he was still a member, spent as much as $100 million dollars (Hewlett spent $40 million) on lawyers, proxy solicitors, and publicity to battle each other for the support of the shareholders. HP sent out a letter to shareholders calling Hewlett "a musician and an academic.... [whose] motivations and investment decisions are likely to be very different from your own." In the previous year's proxy statement, they had characterized him very differently: "Mr. Hewlett has been an independent software developer involved with computer applications in the humanities for more than five years."

In *Backfire: Carly Fiorina's High Stakes Battle for the Soul of Hewlett-Packard* (John Wiley & Sons, 2003), author Peter Burrows describes what happened next.

> *The foundations established by the two founders of HP voted against the merger. That made getting the support of other significant shareholders essential if the deal was going to go through. Money manager Deutsche Asset Management, a subsidiary of Deutsche Bank, had 20 million votes, 1.3 percent of the stock. They originally voted against the merger. This came as a shock to HP, which had been so confident of their support that they had not even called to lobby them. They were paying Deutsche a million dollar fee to support them in getting shareholder support – with another million dollars as a bonus if the merger was approved. Furthermore, Deutsche Vice-Chairman Benjamin H. Griswold had promised that Deutsche would follow the recommendation of proxy advisor ISS, who came out in favor of the deal.*

Then Deutsche decided to vote against the merger. When HP CEO Carly Fiorina got the news, she left a voicemail for HP's CFO that was later leaked and played repeatedly on the national news. She said, "Call the guy at Deutsche Bank again first thing in the morning. You need a definite answer from the vice-chairman, and if it's the wrong one, we have to swing into action. See what we can get, but we may have to do something extraordinary to bring them over the line here."

After a call from the investment banking side of Deutsche Bank and a talk with Fiorina just hours before the votes were to be counted, in which she said their support was "of great importance to our ongoing relationship," the American side of Deutsche switched its vote. When the German side balked, Deutsche's chief investment officer pushed hard, saying that "I'm not trying to put you under any undue pressure, but make sure that you have a very strong documented rationale for why you voted this way as it relates to this merger," and concluding that the deal was "extremely sensitive" to Deutsche's CEO, Josef Ackerman. The German side switched, too. Later, Fiorina called to thank Griswold for his support, and said, "I'm looking forward to doing business with you in the future."

The vote was so close that the final tally was not known for several more weeks. Ultimately, the merger won by 3 percent of the vote.

Hewlett challenged the vote in the Delaware courts and won a preliminary ruling. Ultimately, however, the chancery court found that Hewlett had not been able to demonstrate that the vote by Deutsche Asset Management was made for any reasons that were not legitimate.

A Deutsche Bank investment banker – the banker who oversaw the Deutsche Bank/Hewlett-Packard relationship – then organized a call between Fiorina and the asset managers and participated in it. Walter Hewlett received the same privileges to discuss his side in a separate call.

Not surprisingly, the Hewlett-Packard executives did not openly threaten Deutsche Bank with a loss of business, and only discussed the merits of the transaction during the call. Nor did the Deutsche Bank asset managers make any express reference to the overall business relationship when, after the call, they decided to switch their vote to approve the merger.

The subtext, however, was very clear: the Hewlett-Packard/Deutsche Bank relationship would go dramatically south if the asset managers voted against the merger. If there were any doubt, the presence of the relationship banker on the call would have made the implicit threat clear to them.

Nevertheless, in evaluating the evidence, Chancellor Chandler made every inference in favor of management's justification for the merger. He accepted Fiorina's explanation that to do "something extraordinary" was merely to make every effort to explain Hewlett-Packard's pro-merger position to the Deutsche Bank asset managers.

He also accepted the Deutsche Bank investment bankers' story that the call had not occurred to implicitly threaten the asset managers so that they would switch their vote. Rather, they said, the call was arranged because they were embarrassed at having misled Fiorina into thinking that the managers would vote for the merger.

In the end, having essentially required Hewlett to prove the threat with a "smoking gun," and seeing no smoking gun, Chancellor Chandler dismissed the vote-buying claim. A thoughtful commentary by James Fanto, "The Recent Decision on the Hewlett-Packard/Compaq Mega-Merger: How the Court Ignored the Psychological Reality of Over-Optimistic CEOs" (Findlaw.com), concludes that the court completely missed the implicit threat of retribution, and calls it "naïve" to insist on "a smoking gun" to prove coercion in a voting situation.

> *Chancellor Chandler missed the psychological realities of the situation. Hewlett-Packard executives did not have to communicate openly, whether inside or outside the call, any threats to Deutsche Bank about the loss of future business. It would have been clear to everyone involved what would have happened had Deutsche Bank failed to change its vote. (It had similarly been clear to Hewlett-Packard, following Walter Hewlett's declared opposition to the merger, that it had to compensate Deutsche Bank for its support and votes by hiring it as an advisor.)*

> *It is not at all surprising that there was no express threat. One would expect that the conversation, both during the call and among the asset managers following it, would deal only with the merits of the transaction.*
>
> *Indeed, the managers might not even have realized they had capitulated to an implicit threat. Rather, under the influence of the groupthink mentality, the asset managers would naturally rationalize, to themselves and others, that they had made the vote switch only because of their own independent assessment of the merger. Certainly they would not have liked to think they had cravenly switched their honest opinion in order to prevent Deutsche Bank from losing business.* ”

HEDGE FUNDS

One of the most notable developments in corporate governance in the past five years is the rise of activist hedge funds. In 1990, there were 610 hedge funds with about $39 billion in assets. By 2005, that had grown to nearly 8,000 funds with a total asset base topping $1 trillion, according to Hedge Fund Research Inc. As of early 2010, that number had swelled to $1.5 trillion, but was down from its all-time high of nearly $2 trillion in late 2007.

The term "hedge fund" has no precise legal or universally accepted definition; it is generally described by what it is not. Generally, a hedge fund is one of several categories of investment vehicle that holds a pool of securities and perhaps other assets and that does not register its securities offerings under the Securities Act and is not registered as an investment company under the Investment Company Act. The areas of greatest difference between the hedge funds and those that must be registered are: fees, leveraging practices, pricing and liquidity, degree of regulatory oversight, and investor characteristics.

The fee structure compensates the adviser based on a percentage of the hedge fund's capital gains and capital appreciation. Hedge funds were originally designed to invest in equity securities and use leverage and short selling to "hedge" the portfolio's exposure to movements of the equity markets, but now include a very wide range of investments and strategies. There are no limits on the fees, which are privately negotiated with investors. *Institutional Investor*'s list of the top hedge-fund earners showed that the man at the bottom of the list made $65 million. As *New York Magazine* noted, that is more than the combined pay of the CEOs of Goldman Sachs, Morgan Stanley, and JPMorgan. The incentives to create these funds are obvious.

However, so are the challenges. Hedge funds often make use of leveraging and other higher risk investment strategies. For example, in late 2006, the once-successful Amaranth Advisors Fund suffered an $8 billion loss within weeks and announced that it was liquidating what was left, and Tontine Associates LLC, managers of over $7 billion, unwound two of their largest stock hedge funds in late 2008.

Mutual funds are required to "mark-to-market," that is to value their portfolios and price their securities daily, based on market quotations that are readily available at market value and others at fair value, as determined in good faith by the board of directors. Moreover, mutual funds are required by law to allow shareholders to redeem their shares at any time. There are no specific rules governing hedge fund pricing. Hedge fund investors may be unable to determine the value of their investment at any given time.

Anyone with the minimum (typically around $1,000) can invest in a mutual fund, but hedge funds are often limited to those who can invest $1 million or who have at least $5 million in assets, in recognition of the higher risk and lower liquidity.

The rise in activist hedge funds reflects the confluence of two trends. The first is the recognition by long-time activists that hedge funds provide an appealing vehicle for the same kinds of activities they were already doing, in part because they enabled them to use other people's money and collect a hefty management fee. One-time "raiders" Carl Icahn and Kirk Kirkorian both turned to hedge funds. Icahn said he resisted for a while because he believed that outside investors would not be willing to join in his hostile efforts, including proxy contests. However, that turned out not to be a problem, even though he charges more than the already-hefty norm for management fees, 2.5 percent of assets under management and 25 percent of the gains. Icahn used his hedge fund to gain a seat on the board of Blockbuster (see chapter 4) and to persuade Kerr–McGee to divest some assets. In 2006, he took a large position in Time Warner and presented management with a 343-page paper commissioned from an investment banking firm detailing how to break up the company to release about $40 billion in shareholder value. Shortly afterward, Icahn and management announced that they had come to an agreement. Kirk Kirkorian pressured General Motors by acquiring as much as 10 percent of the company, urging them to work with other car manufacturers.

The second trend is the recognition by more traditional fund managers that activism is an attractive investment strategy. Like a classic value approach, it relies on a fundamental analysis showing that a company's inherent value is greater than the trading price of the stock. This adds another component; instead of waiting for the market to recognize the value, the investors themselves push for the changes to close the gap. As hedge funds mushroomed, it became more difficult for managers to distinguish themselves and find returns in excess of the market. As the success of activist funds like the $6.7 billion Relational Investors and the increased awareness of "governance risk" post-Enron changed the calculus for undertaking activist strategies, hedge fund managers increasingly saw activism as a good bet.

That does not mean that it always worked. In 2005, hedge fund manager Bill Ackman tried to undertake an activist strategy at McDonald's. In a presentation at the Value Investing Congress held in New York's Time Warner Center, Ackman, the managing partner of Pershing Square Capital Management, spelled out his belief that the constituent parts of McDonald's were worth more than the whole. However, the short-term nature of his proposals, based on spinning off a 65 percent stake in the roughly 8,000 restaurants the company owns, failed to attract much support from other investors. Those who predicted that investors would jump to support any activist who promised a quick bump in the stock price were in some measure reassured by the cool reaction to Ackman's proposals. McDonald's did make and accelerate some changes, including an increase in its dividend, possibly in response to the pressure and scrutiny Ackman's efforts produced. Activist hedge fund Pirate Capital, a $1.8 billion fund once earning 32 percent returns, announced in September of 2006 that it was shedding half of its investment team and being investigated by the SEC. Finally, New York City's pension funds fired Shamrock Capital Advisors, run by a team that includes Roy Disney, after the fund returned losses across its funds ranging from 10 to 22 percent.

SYNTHESIS: HERMES

Hermes is a UK independent fund manager investing approximately £22.8 billion on behalf of over 440 clients, including pension funds, insurance companies, government entities, and financial institutions. Originally an in-house pension fund of British Telecom, its continuing affiliation with that group "gives its investment management perspective a unique insight and close alignment with the

needs of other long-term investors and pension funds," according to its report *Corporate Governance and Shareholder Engagement Overview.*

Hermes manages money on an index/specialist approach. One of its many unique attributes, though, is its commitment to "Focus Funds" intended to "tackle the 'anxieties' brought on from owning stocks in the index." Because of its long-term holdings in index stocks, it is "therefore necessarily exposed to under-performing assets." In addition to exercising the ownership rights of these indexed securities to ensure that the clients' interests are upheld, Hermes is the first major investment institution in the world to establish "shareholder engagement funds." They invest in "underperforming companies which are fundamentally sound but poorly managed, where Hermes believes that its intervention and involvement as long-term shareholders can release the latent value that exists within the company." (See the Premier Oil and Trinity Mirror case studies in chapter 7.)

Hermes prefers the term "engagement" to activism. Engagement occurs at the end of a series of steps that begin with communication, through telephone, letters, meetings, and visits, of any concerns and efforts at private, cooperative negotiation to "help resolve issues that are hindering the company's performance." This can include executive compensation along with a broad range of other issues. Hermes will consult with and involve company advisers and other shareholders as well. Focus companies are selected based on two criteria – the underlying investment value and the probability of or susceptibility to change. Because engagement is resource-intensive, a limited number of companies are held at any one time in the Focus Fund portfolios. The idea is that engagement will produce superior returns in that portfolio and in the securities held in the portfolio company through the indexed investments as well.

INVESTING IN ACTIVISM

This gap between governance forms and the reality they confront is not new. In 1960, Harvard law professor Abram Chayes wrote that "Ownership fragmented into shares was ownership diluted. It no longer corresponded to effective control over company operations." He found that there were no "institutional arrangements" that could "make it possible for many scattered individuals to concert their suffrages on issues sufficiently defined to warrant meaningful conclusions about an expression of their will."[204]

Those arrangements now exist. In addition to the hedge funds noted above and the "focus funds" managed by Hermes, there is Relational Investors, Hermes' affiliate in the United States. Relational, a registered investment adviser, is a privately owned asset management firm founded in 1996 that invests $6.3 billion in large-capitalization US-listed companies. "Relational believes that proper shareholder stewardship requires active involvement with the companies in which it invests. Through intense and focused research, Relational develops a strategic plan to unlock latent value of its portfolio companies. Relational actively engages the management, boards of directors, and shareholders of its portfolio companies in a productive dialogue designed to build a consensus for positive change to improve share value." It has consistently and materially outperformed its benchmark, the S&P 500 cumulative Total Return Index.

Relational invests in eight to twelve companies at a time. *Business Week* said, "They buy a chunk of an ailing company, say Mattel or J.C. Penney or Waste Management, then politely tell the board it should be doing a much better job before prodding, cajoling, and twisting arms to get their way." Sometimes it is not polite. In 2005–6, Relational's investment in 6.5 percent of Sovereign Bank

was very contentious, involving litigation and a threatened proxy contest. Sovereign tried to protect itself from Relationship by announcing the sale of 24.9 percent to one of the world's biggest banks, Banco Santander Central Hispano SA of Spain. Most significantly, the deal with Santander did not have to be put to a shareholder vote. Normally, acquisitions of 20 percent or more must be approved by shareholders, but Sovereign managed to keep it away from shareholders by selling Santander a combination of new shares and treasury shares, which aren't counted by the NYSE for the purposes of the 20 percent rule. Ultimately, Relational and Sovereign agreed to a settlement of all outstanding claims and Relational's Ralph Whitworth was added to the Sovereign board.

The $25 million Lawndale Capital Management is a similar fund on a smaller scale. It invests smaller amounts in smaller-cap companies. Like Relational, Lawndale takes a position and then makes some friendly suggestions to management. If necessary, it pushes harder: CEOs and board members of portfolio companies have been replaced. Like Relational, it has had consistent above-market returns.

In early 1992, Wilshire Associates' Steve Nesbitt analyzed several years of CalPERS' shareholder initiatives and concluded that the effort was highly profitable to the system; a program costing $500,000 resulted in $137 million extraordinary (above the S&P 500) returns. Significantly, the initiatives did not have to be "successful" (gain majority support) to produce those returns.[205] To the extent that it becomes part of the "conventional wisdom" that a corporation with informed and effectively involved owners is worth more in the marketplace than one without them, a burden is placed on pension fund trustees – who are, after all, the majority owners of American corporations – to develop the ability to act as owners.

Prospects for more investing in activism are promising. A McKinsey report in 2000 found that UK and US investors would be willing to pay as much as an 18 percent premium for what they perceived as good corporate governance. Investors in developing economies would be willing to pay as much as 28 percent, reflecting the discount they attribute to less rigorous governance requirements imposed by legislation. The willingness of Daimler-Benz to make governance changes to accommodate the requirements of the New York Stock Exchange and Rupert Murdoch's rejection from the Australian Exchange are real-life examples. Perhaps the most telling indicator of the institutionalization of this investment strategy is the creation of an investment newsletter dedicated to tracking the investments and predicting the initiatives of the activist shareholders, *The Turnaround Tactician*.

NEW MODELS AND NEW PARADIGMS

In the absence of effective mechanisms for channeling shareholder power, some individuals and institutions have sought a way to hold management accountable – often by joining it.

CASES IN POINT — FROM DUPONT TO RELATIONSHIP INVESTING

Du Pont at General Motors. In an article in *Harvard Business Review*, William Taylor held out Pierre S. du Pont (the first in the distinguished industrial lineage) as a large

shareholder and chairman of a troubled General Motors corporation. Du Pont was both the substantial owner and the chief executive of the DuPont Company, which in turn owned a substantial stake in General Motors. Acting as an owner, much along the lines Brandeis contemplated for "Junior's" father at Boothbay Harbor, du Pont was able to provide the focus and energy to ensure that General Motors emerged as the dominant force in the world automotive industry for a half century. However, du Pont's very effectiveness raised questions. In 1957, in the context of the trust-busting concerns of that era, the United States Supreme Court ordered the DuPont company to divest itself of its holdings of General Motors on the grounds that the relationship violated the nation's laws against restraint on competition (see the case study in chapter 7).

Warren Buffett. Some people think that a modern version of the ideal owner is Warren Buffett, the only person to reach the *Forbes* list of the country's wealthiest people through investments alone. Buffett is chief investment officer and principal owner (with a holding of 44 percent) of Berkshire Hathaway. Shareholders applauded Buffett's willingness to assume the position of chief executive officer in the disgraced banking firm Salomon Brothers (now part of Citigroup). He served without salary. This signaled his dedication. He took the challenge out of pride, in the best sense of that word; he wanted to demonstrate that a little straight thinking at the top could justify his original decision to invest in Salomon Brothers. Even with a 30 percent equity position, Buffett's involvement has given a "free ride" – or at least a discounted ride – to the rest of the shareholders.

But the ride is not always free, even with Buffett. It shouldn't be. In many corporate investments, Berkshire Hathaway insists on the purchase of a special class of convertible preferred stock, which guarantees a better return than ordinary common stock. In effect, Buffett is reducing the free rider problem by charging a fee for his perceived – and, in the case of Salomon, proven – ability to add value to the company. This may be the ultimate example of the modern-day owner – big enough to make a difference, smart enough to make a valuable difference, and valuable enough to be paid for at least some portion of the difference that his contribution makes.

Buffett is one of the rare examples of a shareholder who is willing and able to intervene on behalf of the whole class of owners in return for some approximation of the value he confers on other shareholders. In his incarnation as holder of convertible preferred stock, Buffett is one model of an ideal modern owner. In July 1989, Buffett rescued Gillette Co. from a hostile takeover bid by Coniston Partners. Buffett paid $600 million for preferred shares paying a guaranteed dividend of 8.75 percent. In 1991, Buffett performed similar rescue missions at possible takeover candidates USAir and Champion International. He restored the reputation and re-established the viability of Salomon after trading illegalities brought it to the brink of disaster.

On the other hand, this kind of convertible preferred investment can be viewed as (or used as) an opportunistic entrenchment of existing management, as some of the "white knight" or "white squire" investors were in the 1980s.

At the time of this writing, one share of Berkshire's A stock trades at almost $125,000.

Sunbeam. CEO Al Dunlap was the most enthusiastic advocate director stock ownership ever had. He was brought into the company by its two largest shareholders, and he made sure that all of the directors held a significant amount of stock. However, he was hoist by his own petard when his directors, spurred by their vital interest in the stock price, pressed him for more information about upcoming figures, and then, when he could not answer to their satisfaction, fired him. The stock had fallen from a high of 52 in early March to a low of $8\frac{13}{16}$ on June 22. Sunbeam declared bankruptcy. Dunlap later paid $500,000 and agreed not to serve as an executive in another public company to settle fraud charges brought by the SEC and $15 million to settle lawsuits brought by shareholders. Under his direction, Sunbeam had engaged in accounting practices like "cookie jar reserves" to increase Sunbeam's reported loss for 1996 and inflate income by $60 million in 1997, "contributing to the false picture of a rapid turnaround in Sunbeam's financial performance," the SEC said.

Relationship investing. As discussed in greater detail in chapter 5, in other countries, "relationship investors" provide monitoring that many observers credit for making a substantial contribution to industrial competitiveness. The German Hausbank, with capacity to provide all manner of financing, places its own executives on the supervisory boards of corporations. The bank benefits from this relationship through the payment of fees; otherwise the Japanese members of a *keiretsu* are financiers, customers, suppliers, and owners of each other. The ownership interest is an entrée to a more profound commercial relationship. Monitoring is not so much a function of ownership, but rather one of preserving a valuable commercial relationship.

The hedge fund and Relational Investors experiences described above show that selecting firms with intrinsic value and pressing for changes in corporate governance to ensure that directors and managers had the appropriate ability and incentives can produce reliable above-market returns.

What conflicts of interest do these owners have? How might the owners in the examples in this section, du Pont, Buffett, and the German and Japanese block holder, have at least a theoretical conflict of interest in their roles as officers of their principal employer and as "active owners" of a portfolio investment? Why did the courts stop Pierre du Pont's involvement in GM? If they had not, could GM have stopped him? In the case of Warren Buffett, will his obligation to his own shareholders at Berkshire Hathaway always align with his priorities as CEO of Salomon Brothers? Are these interests reconcilable? (One obvious conflict is which one gets his primary time and attention.) In Germany and Japan, is the interest of the bank consistent with the interest of the entity in whom it invests and with whom it does business?

For this kind of involvement by owners to work, the owner's stake in the enterprise must align his interest with the interest of the shareholder more than his other organizational interests create conflicts.

How can the relationship be structured to make sure this is the case? What are the alternatives for shareholders (or managers or boards of directors) if the alignment is insufficient? Are the inevitable conflicts preferable to the problems these relationships are designed to solve?

How can we encourage more activist owners? How can we make sure their activism will be appropriate and effective? Even the legendary Buffett is only human and cannot be expected to guide more than a dozen corporations at a time. Where do we find others who can play that role?

The role of activist investor is unlikely to be assumed by any of the categories of institutional investor outlined in this chapter, because each of them faces commercial or political restrictions. Financial institutions are all subject to constraints against owning sufficiently large percentages of the outstanding stock of particular companies. With commercial banks, there is the prohibition of Glass–Steagall (though substantially rescinded in 1999); mutual fund holdings are limited by the Investment Company Act of 1940; insurance companies are limited by state law; private pension plans are required by ERISA to diversify as widely as possible; the federal system under FERSA is limited to equity investment through index funds. These provisions, enacted independently, have a cumulative impact of preventing the financial sector executives from being able to exercise control over commercial sector executives – to keep Main Street independent of Wall Street.

Like many barriers, the wall between Main Street and Wall Street was constructed out of mistrust and misunderstanding. It is probably based on what Columbia professor Mark Roe chronicled as the pervasive American distrust of centralized "money trust" power.[206] This attitude may be based more in myth than reality. The reality is that Main Street needs Wall Street more than ever – and not just its money. Unless finance executives can monitor portfolio companies, it is unlikely that a meaningful system of accountability based on institutional investors will be established.

Look at the chief executive of the largest institutional investor, CalPERS. No one, inside CalPERS or inside corporate management, has ever suggested that it would be useful or even appropriate for the CEO of CalPERS to take a role in a portfolio company comparable to that taken by Buffett in Salomon Brothers. It is a question not of expertise but of culture. With public plan officials, one can only ask: *Is it possible to make an owner out of a bureaucrat?*

An employee of a public pension system appears to have none of the characteristics of an owner. Although there is now some incentive compensation, the CEO bears none of the risk of loss if the value of the investment declines; his own career progress is only tangentially related to the performance of a particular company. He is unlikely to be invited to serve as a director of a portfolio company. Even if he is, and his trustees approve, he is likely to find the restrictions on insider transactions a practical obstacle that is insurmountable.

Despite this nonowner mindset, public plan officials, even those who preside over index funds, can be credible candidates for some kinds of investor activism. For one thing, they can be counted on to do their duty, in this case their fiduciary duty. To what extent is that duty compatible with the kind of focus and expertise required for meaningful monitoring of corporate performance? As we consider different models of shareholder involvement, we must keep in mind the strengths and the limits of the different categories of investor. Public plan *officials* face a set of conflicts and a set of impediments to obtaining information different from other institutional investors. This is, in a way, their greatest strength. Their inherent limitations may be what is needed to assure an elementary

level of monitoring while protecting against undue interference. A public *official*, acting as trustee, can insist that a portfolio company perform at or above the level of its peer group. He can insist on a governance structure that will enable the board to do the closer monitoring that is beyond the capability of the shareholders. Indeed, that is what CalPERS and some of the other public pension funds have done over the past few years and – with the additional opportunities made available to them through the revised SEC shareholder communication rules and the increased oversight of pay/performance linkages – what they can be expected to do in the future.

But is that enough, not from their perspective, or even their plan participants' perspective, but from the perspective of the economy as a whole?

It is interesting to note that although CalPERS had an early and visible role in raising issues of concern with James Robinson of American Express, they did not play a significant role in resolving the issues. The institutional shareholders who pushed Robinson to leave the company were not the public pension plans but the white-shoe Wall Street funds like Alliance Capital and J.P. Morgan. Two very different kinds of shareholders played two very different kinds of roles, each one the other could not play (see the case study in chapter 7).

CalPERS could play a public role in identifying the problems, but could not follow through with something as specific, and even as radical, as insisting that the CEO step down. This is because CalPERS' equity portfolio is almost entirely indexed, even with limited experimental forays into "relationship investing." In essence, indexed funds replicate the market. Their investment is not based on any particularized knowledge about the individual companies. If they select a target, based on poor performance, they must then invest the time and resources in trying to understand the company and its problems. When CalPERS' representatives speak with any CEO about their holdings in the company he heads (and this is rare, no more than a dozen or so each year of the more than 6,000 companies whose securities they hold), they recognize that they also own stock in all of that company's competitors, suppliers, corporate customers, potential takeover targets, or acquirers. Given these broad holdings, public pension funds cannot be sufficiently informed about their holdings to make recommendations about strategic issues (assuming they could do so without violating insider trading restrictions, triggering concerns about "pension fund socialism," or exceeding the limits of the legitimate shareholder agenda).

For these reasons, public pension plans can be visible, but they cannot be very specific. They therefore focus on issues of process – confidential voting, annual election of directors, executive pay, the independence of the directors on key committees, and similar issues.

The Wall Street investment firms are at the other end of the spectrum. They are stock-pickers. They buy into the company because of what they know about it, not because it happens to be on the index. Their "investment" in learning about the company is made already; it's a sunk cost. These institutional investors were not willing to take the commercial risks of making public statements or filing shareholder resolutions, but they were willing and able to meet with the new CEO of American Express to insist that James Robinson had to leave. They were rumored to be involved in the departures of CEOs at Borden, W.R. Grace, Home Depot, and Motorola. This will increasingly be the pattern. After all, these same firms are very used to negotiating what are in essence governance issues on the bond side of the business. As governance is more demonstrably translated into value, negotiations will become a part of the equity side as well.

There are a range of institutional investors with a range of perspectives, obligations, and goals, but all of them are acting as fiduciaries and all of them are long-term participants in the

capital markets. That combination can and should provide a balancing energy to management autocracy. Some can afford the cost (financial and reputational) of active engagement, but there is a role for those who cannot but who can call attention to problems, raise general consciousness, and alert the potentially effective activists. Ideally, they work effectively together. Of course, this raises the "who watches the watchers?" question; the internal governance of the institutions themselves presents all of the same issues of accountability and potential conflicts of interest that are raised throughout this book.

On all parts of the institutional investor spectrum, there are potential plausible candidates for at least some forms of active monitoring. However, the "carrot" of increased shareholder value is not enough to make it happen in a world where the collective choice problem and political and economic reprisals present overwhelming obstacles. Neither the public pension funds nor the money managers will be willing or able to act as quickly, as publicly, or as meaningfully as is necessary for optimal monitoring. If ownership must provide more than the primary level of assuring honesty and minimal competency, both will have to follow. Others will have to lead.

THE "IDEAL OWNER"

In the search for the ideal owner, it is useful to start with Harvard Business School professor Michael Porter's statement:

> *Perhaps the most basic weakness in the American system is transient ownership, in which institutional agents are drawn to current earnings, unwilling to invest in understanding the fundamental prospects of companies, and unable and unwilling to work with companies to build long-term earning power. . . . The natural instinct of many managers is to seek fragmented ownership to preserve their independence from owners in decision making. . . .* The long-term interests of companies would be better served by having a smaller number of long-term or near permanent owners, whose goals are better aligned with those of the corporation. . . . *Ideally, the controlling stake would be in the hands of a relatively few long-term owners. . . . these long-term owners would commit to maintaining ownership for an extended period, and to becoming fully informed about the company. In return for a long-term ownership commitment, however, must come a restructuring of the role of owners in governance. Long-term owners must have insider status, full access to information, influence with management and seats on the board. . . . Under the new structure, management will be judged on the basis of its ability to build long-term competitive position and earning power, not current earnings of stock price.*[207]

Where are the "smaller number of long-term or near-permanent owners, whose goals are better aligned with those of the corporation"? Locating the ideal owner (or its closest approximation in our system) does not permit us to lose sight of the limits of ownership involvement. No one is suggesting that shareholders should second-guess corporate managers on "ordinary business" decisions. The contract between shareholders and the companies they invest in provides, in essence, that in exchange for limited liability shareholders will have a limited scope of authority and a limited

agenda. Shareholders are not there to tell corporations how to run their business; they should be there, and they are beginning to be there, to tell corporations that they need to do a better job.

The ideal owner must be someone who has the information, the ability, and the alignment of interests with other corporate constituencies to provide the optimal level of monitoring. It is important to keep in mind, though, that the optimal level of monitoring is in part a function of the narrow range of appropriate issues for shareholder involvement.

The shareholder agenda should focus only on assuring that the interests of directors and management are aligned with those of the shareholder and that when a conflict of interest is presented, the shareholders make the decisions. As Ira Millstein, noted governance authority and adviser to outside directors, has said:

> *Where there is a 'problem' company, an institution can ask for meetings with the board, pose the problem, and determine whether the board is dealing with it or ignoring it . . . . In our system, if the shareholder satisfies itself that the board is knowledgeable, diligent, aware of the problems and attempting to deal with them, generally this should suffice.*[208]

To make this possible, shareholders must be able to act when necessary to preserve the full integrity – and value – of ownership rights themselves. Any ideal shareholder must be vigilant about preventing dilution of the right to vote (by a classified board or by dual-class capitalization, for example) and preserving the right to transfer the stock to a willing buyer at a mutually agreeable price (which could be abrogated by the adoption of a poison pill).

If any institutional investor is to be the ideal owner, the trustees must exercise their ownership rights with the "care, skill, prudence, and diligence" and "for the exclusive benefit" of the retirement plan participants (the employees), the people who are, after all, the real owners. That is the standard for ERISA fiduciaries (very similar to the common law and statutory standards applicable to other fiduciaries as well). This means that the "real owners" have their own obligation to monitor; they must not only delegate to their elected representatives (directors or trustees) the responsibility of safeguarding share value, they must also assume part of it themselves. The trustees responsible for monitoring the accountability of corporate managers must themselves be genuinely accountable to their beneficiaries, whether they are elected officials, civil servants, or hired fund managers.

The system of accountability for those who manage institutional funds is not perfect. There are often efforts to dilute the accountability further, as with economically targeted investments. In general, however, it has worked well. New York State's Comptroller is sole fiduciary for the state fund. He is not only accountable as a fiduciary, he is accountable through the electoral process. The State Comptroller is one of four state-wide elected officials. While he does not have trustees, he has advisory councils made up of the representatives of beneficiaries and other groups. The CalPERS CEO meets with his trustees (some of whom are elected by the beneficiaries directly while some are appointed by state elected officials) for one week out of each month.

Former New York State Comptroller Edward V. Regan is not so sure that the present state is satisfactory. "This leaves us then exactly where we started. Shareholders, directors and the public react only after the economic damage has been done, to the detriment of the company and the nation. It leaves us with the activist pension systems presumably without the ability (and maybe the will) to stand up and oppose a company whose performance is deteriorating (not deteriorated), to force that company to turn around by attempting to fire, in a public manner, a prestigious board of directors."[209]

CASES IN POINT A&P, PARAMOUNT, AND K-MART

A&P. Regan announced in February of 1993 that his fund had selected an under-performing company to target with a shareholder initiative. He said his fund would solicit shareholders to withhold votes for the re-election of the board at his target company, A&P. This was a symbolic gesture only. Even if the target was not controlled by a single 52 percent shareholder, as this one is, it is impossible, as a matter of law, to prevent the election of a management-sponsored candidate unless someone is running against him.[210]

Paramount. Similarly, the Wisconsin Investment Board announced that it would urge other Paramount shareholders to join it in withholding votes for director candidates. The *Wall Street Journal* noted, "The effort by the pension fund, which owns 100,000 shares of Paramount's 118 million outstanding, is mainly designed to send a message to the movie and publishing company's management that it is unhappy with the company's stock performance rather than to remove the four directors, since there are no alternate candidates for the board and the fund isn't putting up its own slate of directors." In 2000, the New York City pension fund had a similar initiative at Great Lakes Chemical, with a record breaking 30 percent withhold vote.

What kind of a message did that send? How effective is this approach?

K-Mart. In 1994 the Wisconsin state pension fund successfully blocked a proposed restructuring at K-Mart by conducting a campaign to solicit proxy votes against the management's proposal.

How much say should shareholders have in major strategic decisions?

What shareholders like the New York and Wisconsin funds can do is put the pressure of publicity on the board. The board may very well react (as did the boards of IBM, GM, Westinghouse, and American Express). As Mr. Regan said, "The point is to alert board members that a significant number of shareholders do not believe they are doing their job." Perhaps the shareholder movement's most significant contribution is to make the world an uncomfortable place for a director of an under-performing company. As co-author of this book Nell Minow has said, "Boards of directors are like sub-atomic particles. They behave differently when they are observed."

Sometimes activism comes from less likely places. Gordon Crawford, the chief media stock-picker for Los Angeles-based money-management firm Capital Research & Management Co., had a large holding in AOL-Time Warner, which had lost $750 billion in value. He was reportedly a major factor in the decision of AOL founder Steve Case to resign as chairman of the board in early 2003. Another of his holdings, Disney, was also a disappointment. However, there Crawford took the more traditional "Wall Street walk," and just sold his shares.

What might have been the factors that led to different decisions about activism versus selling the stake in these holdings?

CASE IN POINT HERMES

From the website of Hermes, a pioneer in institutional investor activism:

Hermes' corporate governance and responsible investment programme is founded on a fundamental belief that companies with interested and involved shareholders are more likely to achieve superior long-term financial performance than those without.

Hermes places great emphasis on exercising its clients' ownership rights and responsibilities at all the companies in which they invest, with the objective of adding long-term value to their shareholdings. As a significant portion of our clients' investments are in index-tracking portfolios, they are necessarily shareowners in under-performing companies. In our engagement, voting and public policy work, we aim to ensure that companies are run by managers and directors in the best interests of their long-term investors. A pioneer in corporate governance and shareholder engagement, Hermes is a leader of the debate in the UK and abroad.

Furthermore, Hermes has taken its corporate governance and responsible investment programme to the next level by advising and acting for other institutional investors through its Equity Ownership Service and being the first major investment institution to establish shareholder engagement funds. These Focus Funds invest in under-performing companies which are fundamentally sound but are undervalued due to a variety of strategic, financial or governance issues.

Hermes believes that good stewardship contributes to superior corporate performance. Its vigilance and involvement as a long-term shareholder is thus intended to enhance returns on its clients' assets.

. . .

The first corporate governance issue on which Hermes took a public stance was that of three-year rolling contracts for directors of UK companies, which were commonplace at that time. Hermes' then-chief executive Alastair Ross Goobey headed a highly successful initiative to have the notice period in executives' contracts reduced to two years. The issue was subsequently picked up by the Greenbury committee, which recommended contracts be reduced over time to one year.

Following the publication of the Myners report and the Institutional Shareholders Committee's statement on shareholder responsibilities, all UK institutional investors are expected to take an active role in voting, monitoring company performance, and, where appropriate, engaging with companies to improve performance. Hermes responded to this by developing its Equity Ownership Service, which can undertake this activity on behalf of institutional investors, such as pension funds, whether or not Hermes is the fund manager. Hermes has led or been involved in a considerable number of successful shareholder engagements at individual companies. We differentiate our programmes from those of the 'raider activist' by adopting a relational approach on behalf of all shareholders and we are particularly critical of activist programmes involving greenmail or micro-management of companies. Hermes'

programmes are generally conducted in private and have not therefore been widely publicised.

Other issues that Hermes promotes actively, both publicly and in private with companies, are the maintenance of pre-emption rights, remuneration policies that align directors' and shareholders' interests and the universal introduction of electronic voting. Hermes places great emphasis on the calibre of non-executive or outside directors and on the importance of having a clear balance of independence in the boardroom. As a result, we have supported the development of education programmes for non-executive directors and participate in seminars and workshops offered by such organisations as Cranfield School of Management, Henley Management College and the UK Institute of Directors. We host regular lunches for non-executive directors to hear their views and share perspectives. We also hold an annual Stewardship and Performance seminar for clients and speak on corporate governance, responsible investment and shareholder engagement issues at conferences worldwide.

The experience of running active shareholder programmes at companies prompted Hermes to establish the Hermes Focus Funds. These invest in companies which are part of our indexed portfolios, which have under-performed their peers and where we believe shareholder involvement will help to release the higher intrinsic value of the company. The shareholder programmes run at these companies bear long-term benefits for the index portfolios, as well as medium-term returns for the Focus Funds' clients. Hermes, which is 100 per cent owned by the BT (British Telecom) Pension Scheme, the UK's largest pension fund, was the first major investing institution to manage funds of this type.

Public policy submissions

As part of its involvement in promoting continuing improvement in corporate governance practice Hermes makes submissions to committees and government agencies around the world undertaking public consultations. Several of our policies were incorporated into the Greenbury and Hampel Committees' reports, and the subsequent UK Combined Code. Hermes has also been actively involved in consultations with the US Securities and Exchange Commission, European Parliament and the UK Government amongst many others.

Examples include our submissions to the International Accounting Standards Board on the issue of accounting for share-based payment and our evidence to the enquiry into vote execution conducted by the National Association of Pension Funds (NAPF). We were involved in the recent revision of the takeover panel rules on when investors will be deemed to be acting in concert and the Financial Services Authority's review of the UK Listing Rules. Internationally, we have made submissions to the New York Stock Exchange as part of their consultation on directors' share option plans and to the European Commission on the Prospectus Directive. We also participated in a process to establish corporate governance guidelines for companies in emerging markets run by the UN Committee on Trade and Development. ”

Notes: former Hermes fund managers Peter Butler and Steve Brown began their own fund called Governance for Owners in 2005, an independent partnership between major financial institutions, shareowners and executives dedicated to adding long-term value for clients by exercising owners' rights. There are two main product offerings. The GO European Focus Fund invests in European public companies where value can be added through making use of ownership rights. The GO Stewardship Services offers a voting and underlying engagement service covering 700 European and 500 US quoted equities combined with a more intensive program of enhanced-value engagement on a conceptual "portfolio" of clients' investments. One of the co-authors of this book is affiliated with the venture. ■

PENSION FUNDS AS "IDEAL OWNERS"

The Economist sees the ideal owner in activist institutions, ranging from pension funds to brokerage firms:

> *So everything now depends on financial institutions pressing even harder for reforms to make boards of directors behave more like overseers, and less like the chief executives' collection of puppets . . . . Financial institutions must also fight to restore their rights as shareholders, lobbying for the dismantling of state takeover restrictions which have provided no protection to workers, only to top managers. Institutions should also demand that shareholder democracy be allowed to operate . . . . But there is more to be done. In the age of the computer, access to shareholder lists should be cheap and simple, not jealously guarded by the boss; that would make it easier to solicit support from other shareholders. Institutions would then be able to use their clout in big firms to elect directors, who would be obliged to represent only their collective interest as owners. Chief executives would still run their firms; but, like any other employee, they would also have a boss. And when they failed at their jobs, they would face the sack.*[211]

Public and private pension funds have many of the qualities necessary to play this kind of role. Their ownership, by virtue of their size and their time horizons, is as close to permanent as possible. Because of this near-permanent stake, their interest is far-sighted enough to incorporate the long-term interests of the corporation and (as an essential element of those interests) the interests of the employees, customers, suppliers, and the community.

Leadership cannot come only from the public plans. It must also come from the private (ERISA) plans. In addition to the benefits of size and long-term time horizons they share with public pension plans, they have the additional advantage of greater familiarity with business needs and the financial expertise of professionals whose qualifications price them out of the public plan market. In order for them to serve this role, the "non-neutral fiduciaries" who administer the pension fund must recognize that involved ownership is essential to the healthy continuance of the capitalist

system – and that it will make them money. They must also be willing to create and support a system with the resources and the insulation from reprisals to do the job.

Exercising ownership rights with regard to a limited agenda, and meeting the requirements of a strict fiduciary standard, means that a trustee voting proxies does not have to know how to make widgets, or even how to improve an under-performing company's widget manufacturing operation or marketing strategy. The trustee must only be able to identify an under-performing company and determine, within the limited options available to the shareholder, which one is appropriate. A meeting with management? A nonbinding shareholder resolution? A vote against a compensation plan that does not provide the right incentives? A "withhold" vote for a board that is not doing its job? A push to divest noncore assets? Suggested nominees for the board?

Limiting shareholders to a narrow range of substantive concerns and to a narrow range of procedural options is an important protection against abuse. There is another important protection to limit any possible damage from a trustee who is wrong (whether through inaccuracy or political motivation) in identifying an under-performing company or in selecting a particular mechanism for making changes. Unless the trustee can persuade enough of the other shareholders to support the initiative, nothing will happen and management will continue to move in the same direction, enhanced by the demonstration of support by a majority of the shareholders.

IS THE "IDEAL OWNER" ENOUGH?

If we assume something more is needed, some entity that can initiate more than symbolic involvement, what model is appropriate?

One that shows great promise is the International Corporate Governance Network (www.icgn.org). It is an association of institutional investors from around the world with assets under management totaling over $10 trillion. Its goals are:

- to provide an investor-led network for the exchange of views and information about corporate governance issues internationally;
- to examine corporate governance principles and practices;
- to develop and encourage adherence to corporate governance standards and guidelines; and
- to generally promote good corporate governance.

A particular focus has been executive compensation/remuneration. They have also developed policies on matters like stock lending, accounting, and shareholder rights in different jurisdictions. Other international associations and alliances began to develop as offshoots and supplements.

Given the limits on even the most likely candidates for active monitoring, additional structures may be necessary. For example, new classes of special purpose securities can encourage more effective involvement by investors or groups of investors. The kind of preferred shares issued for Warren Buffett in many of the companies in which he invests can also give institutional shareholders the incentives (and compensation) necessary to reduce the free rider problem and make active monitoring worthwhile. Pension funds can take advantage of their size and their limited need for liquidity by insisting that the market present them with specialized instruments to meet their situation.

Another possibility is adding the "stick" of enforcement to the "carrot" of increased value. In 2002, at the direction of the late Senator Edward Kennedy, the General Accounting Office undertook an

investigation into the Labor Department's past failure to bring a single enforcement action relating to the exercise (or lack of exercise) of share ownership rights. In addition to enforcement actions for those who do not, the Department of Labor could issue new regulations requiring ERISA trustees to demonstrate that they have acted "for the exclusive benefit of plan participants" in their voting and governance actions, including consideration of (and participation in) more active involvement in corporate governance. This would reduce the collective choice problem because many of any company's largest shareholders would be required to consider shareholder initiatives as an alternative to selling out. Furthermore, it would spread to other institutional investors as well. Once a fiduciary standard is created and rigorously enforced for ERISA fiduciaries, other institutional investors tend to follow.[212] In addition to voluntary action and forced action from regulatory impetus, there are some options available to shareholders who want to strengthen their ability to respond to under-performing management and boards.

The challenge is to develop a structure to bridge the gap created by the collective choice and free rider problems – the gap between the level of activism that is optimal for individual shareholders (even large ones) and that which is optimal for maximum corporate performance.

One option is a new kind of institutional investor, one designed to be the "ideal owner," in partnership with the existing institutions. This would be a partnership organized for the purpose of capturing the profits available due to inefficiencies in the marketplace relating to governance. The partnership would buy shares in undervalued companies, push for governance reforms, and benefit from the value of those reforms. It is what Michael Porter described when he recommended that institutional investors increase the size of their stakes and create special funds to test these new (governance-based) investment approaches. The authors had such a partnership structure, named Lens. Some of those efforts, at Sears and Eastman Kodak, are described in chapter 7. In recent years, hedge fund managers and 1980s raiders like Carl Icahn have created structures to allow outsiders to invest in activism.

The United Companies Financial example in this chapter provides one promising opportunity for effective shareholder oversight. The internet allows shareholders to locate and communicate with each other at almost no expense. It may open up a whole new range of activist opportunities for shareholder monitoring, especially as changes in transparency (the 2006 revisions to the executive compensation disclosure requirements), law (the increasing independence of boards as a result of Sarbanes–Oxley and exchange listing standards), and culture (increasing skepticism of investors, press, analysts, and regulators) make activist initiatives more accessible and appealing.

Much of the focus of this chapter has been on the incentives, disincentives, and impediments that shareholders have in fulfilling their "legendary monitoring role." To understand that issue more fully, however, we need to examine it from another perspective, the perspective of those who are "elected" by shareholders and owe the duties of care and loyalty to shareholders. In chapter 3, we turn to the board of directors. We will revisit the idea of an "ideal owner" in chapter 5.

The issue is summarized with a quote used in a speech given to the Columbia University School of Business by the founder of The Vanguard Group, Jack Bogle:

> *When the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters' . . . yet those who serve nominally as . . . trustees but relieved by clever legal devices, from the*

obligation to protect those whose interests they purport to represent . . . corporate officers and directors who award to themselves huge bonuses from corporate funds without the assent or even knowledge of their stockholders . . . the loss and suffering inflicted on individuals, the harm done to the social order founded upon a business base and dependent upon its integrity are incalculable.[213] ”

Though it may appear that Bogle ripped these words from recent headlines, he was in fact quoting a speech describing the roots of the Great Depression given by the United States Supreme Court Justice Harlan Fiske Stone in 1934.

SUMMARY AND DISCUSSION QUESTIONS

This chapter introduces the role and responsibilities of the shareholder – legal, theoretical, practical, actual, philosophical, and even cultural/anthropological. The discussion begins with these questions:

- What problems with traditional notions of ownership was the corporate form intended to solve?
- How was it intended to solve them?
- What have been the consequences (intended and unintended) of this corporate model?
- How do we determine who is in the best position to make a given decision, and does this person/group have the authority to make it?

One of the most critical elements in understanding corporate governance is recognizing the various inhibitions and obstacles to the theoretical elements of shareholder oversight that legitimize the corporate structure.

“ *What are the consequences of our making liquidity/transferability and privacy the top priorities of stock ownership?*

What are the consequences of giving control of huge blocks of stock, often majority holdings, to intermediary fiduciaries whose risk tolerance may be incompatible with market efficiency?

Do any of these people 'feel a continuing interest in, and a responsibility for, our share in this local enterprise'? Are any of them equipped, able, or even interested in the right or responsibility of providing overall direction for the company? ”

Analysis of recent proxies issued by public companies and proxy voting policies published by institutional investors can be instructive.

The chapter also discusses the traditional "Wall Street rule" – "vote with management or sell the shares." The theory was that shareholders could send a powerful message to a company's management by selling out, ideally in enough of a block to depress the share value. Ultimately, the theory continues, the stock price would fall enough to make the company an attractive takeover target. This risk would then keep management acting in the interest of shareholders.

The takeover era of the 1980s, when the seismic impact of junk bonds and the growth of institutional investors jolted every aspect of the corporate structure, is comparable to the increasing appeal and power of private equity in today's markets. This is part of a cyclical corrective force in the markets; the nomenclature and vehicles may change (raiders become hedge fund managers) but the incentives and consequences are the same, as the forces push companies to combine, break up, and recapitalize. The lawyers and investment bankers make money no matter what.

A key theme of this chapter is how investors can make possible the kind of effective oversight and market check that is the foundation of both the credibility and the viability of the capitalist system despite the collective choice problem, the separation of ownership and control, the impediments that make it almost impossible for shareholders to locate and communicate with each other, and the economic conflicts of interest that affect institutional investors.

> *What is the impact on the capital markets when a majority of shareholders are risk-averse fiduciaries? The underlying premise of the capitalist system is that investors' risk tolerance will ensure that capital flows efficiently. When a majority of the money in the marketplace is handled by intermediaries who by law and culture are risk averse and by size are de jure or de facto indexed, how does that affect capital flows and the ability of the markets to correct themselves?*
>
> *In what way does indexing increase and decrease the incentives to monitor through the exercise of shareholder rights? What are the factors that go into an institutional investor's evaluation of the pros and cons of making use of shareholder rights?*
>
> *What is the accountability of the shareholders themselves? Shareholders reap the rewards from corporate performance. What about the risks? While one of the fundamental attributes of common stock is limited liability, shouldn't they bear some responsibility for a corporation's impact on society? In other words, how limited should the liability be?*

The issue of one share, one vote is a way of exploring the larger issue of shareholder rights. It comes up when, for example, Google made an investment in a biotech company founded by the wife of Google's co-founder. *Would this have happened in a single-class stock company?* It also came up in public debates about the dual-class structure of Dow Jones and the New York Times Company in 2007, as unhappy shareholders tried to influence or even get control of the companies and insiders argued that the dual-class structure was essential for the integrity and brand of the companies' core business.

Like the issue of dual-class stock, the issue of social investing is significant both on its own and as an example of the kinds of issues presented to institutional investors.

> *How is the New Jersey retirement system's divestment from South Africa different from taking as much as $515 million out of the state budget and spending it? How do you evaluate the success of this program on moral grounds? On political grounds? On fiscal grounds? Is there any reason not to treat this as an expenditure, subject to the same procedural protections and deliberations as other expenditures of public funds? New Jersey essentially 'spent' $515 million – what did they get for it?*

NOTES

1. Bryan Burrough and John Helyar, *Barbarians at the Gate* (Harper & Row, New York, 1989), p. 255. The book also notes that "Johnson's two maids were on the company payroll."
2. *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928).
3. *See Ryan v. Gifford*, 935 A.2d 258, 269 Del. (2007) ("[t]he fiduciary duties an officer owes to the corporation have been assumed to be identical to those of directors"); see also *McPadden v. Sidhu*, 964 A.2d 1262, 1275 Del. (2008).
4. See, for example, the discussion of the business judgment rule and stakeholder statutes in chapter 3 and the Carter Hawley Hale and Stone and Webster case studies.
5. Lindsay Chaney and Michael Cieply, *The Hearsts: Family and Empire The Later Years* (Simon & Schuster, 1981), p. 279. Many thanks to the authors for providing additional background information on this case.
6. *Jones v. Harris Associates* (March 30, 2010). See Stephen Tate, "The Role of Independent Directors in Mutual Fund Governance," Student Paper, 2000.
7. Quoted in Milton Friedman, *Capitalism and Freedom* (University of Chicago Press, Chicago, IL, 1962), p. 26.
8. "The holder of shares owns no part of the corporate property as such.... He has, however, an equitable interest in the property, the extent of which interest is determined by the number of shares held." Arthur L. Helliwell, *Stock and Stockholders* (Keefe-Davidson, St Paul, MN, 1903), p. 3 (citations omitted). "It is incorporeal and intangible. The interest, thus being abstract, cannot, during the life of the corporation, be reduced to possession" (ibid., pp. 6-7, citations omitted).
9. Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (eds Campbell and Skinner, 1976), p. 709.
10. Mark 10:24.
11. Adam Smith, *Wealth of Nations* (Modern Library Edition, New York, 1937), p. 423.
12. For a discussion of Chile's privatization policies, see Rita Koselka, "A Better Way To Do It," *Forbes*, Oct. 28, 1991.
13. John J. Clancy, *The Invisible Powers: The Language of Business* (Lexington Books, Lexington, MA, 1989), p. 10.
14. John P. Davis, *Corporations: A Study of the Origin and Development of Great Business Combinations and of Their Relation to the Authority of the State* (Capricorn Edition, New York, 1961), p. 266.
15. See the discussion of the *Citizens United* decision later in this chapter.
16. Alfred F. Conard, *Corporations in Perspective* (Foundation Press, New York, 1976), p. 7.
17. 17 US 316.
18. Nobel prize-winning economist Joseph Stiglitz has been critical of other privatization efforts that he says have been co-opted by first world bankers, with the cooperation of their governments. See "The Globaliser Who Came In From the Cold: The IMF's Four Steps to Economic Damnation" http://www.skeptically.org/wto/id6.html.
19. Arthur M. Schlesinger, Jr., *The Age of Jackson* (Little, Brown, Boston, 1945), p. 75.
20. Harvey H. Segal, *Corporate Makeover: The Reshaping of the American Economy* (Viking, New York, 1989), pp. 5-6.
21. Ibid., p. 6.
22. Ibid., p. 7.
23. All information for this case in point was taken from Alfred D. Chandler, *The Visible Hand: The Managerial Revolution in American Business* (Harvard University Press, Cambridge, MA, 1977).

24. David Halberstam, *The Reckoning* (William Morrow, New York, 1986), pp. 227–8 (emphasis in the original).
25. Ibid., p. 232.
26. Ibid., pp. 232–3.
27. Ibid., p. 234.
28. Frank H. Easterbrook and Daniel R. Fischel, "The Corporate Contract," *Columbia Law Review*, 89, 7 (Nov. 1989), pp. 1416–48.
29. Ibid., p. 1419.
30. John P. Davis, *Corporations* (Capricorn Edition, New York, 1961), at p. 273, quoting A. J. Chayes.
31. See Edward J. Epstein, "Who Owns the Corporation?," a Twentieth Century Fund Paper (Priority Press Publications, New York, 1986).
32. Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (Transaction Publishers, 1991 edn), p. 297.
33. Ibid., p. 8.
34. Zahid Iqbal, Shaikh Abdul Hamid, and Jan Tin, "Stock Price and Operating Performance of ESOP Firms: A Time-Series Analysis," *Quarterly Journal of Business and Economics*, June 22, 2000.
35. At this writing, the stock was $56 a share and had slightly underperformed the S&P since 2006.
36. Helia Ebrahimi, "F&C Told Clients to Vote Against Its Pay Plans," *The Telegraph*, November 18, 2010.
37. Jonathan Charkham and Anne Simpson, *Fair Shares: The Future of Shareholder Power and Responsibility* (Oxford University Press, 1999), p. 224.
38. The effects of increasing the number of shares, and thus holders, have become increasingly limited due to the rise of institutional investors.
39. Ease of transferability is not a priority for Warren Buffett, whose Berkshire Hathaway stock trades in six figures per share, but he is a rare exception – most companies split their stock before it reaches $100 a share.
40. Melvin Aron Eisenberg, "The Structure of Corporation Law," *Columbia Law Review*, 89, 7 (Nov. 1989), p. 1461.
41. Ibid., p. 1474.
42. Marlene Givant Star, "Paying for Approval," *Pension and Investment Age*, July 24, 1989, p. 1.
43. Eisenberg, "The Structure of Corporation Law," p. 1477.
44. See Commissioner Paul Atkins, "Remarks at the Corporate Directors Forum 2007" (January 22, 2007), http://www.sec.gov/news/speech/2007/spch012207psa.htm, and Theodore Mirvis, "Delaware Addresses Vote Buying and Synthetic Ownership," *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, Identifying the Legal Contours of the Separation of Economic Rights and Voting Rights in Publicly Held Corporations, IRRC Institute and Rock Center for Corporate Governance (October 2010), "Borrowed Proxy Abuse: Real or Not?" (concluding that loan volume did not spike over record dates), Center for the Study of Financial Market Evolution (October 2010) , and http://blogs.law.harvard.edu/corpgov/2010/05/03/delaware-addresses-vote-buying-and-synthetic-ownership/#more-9067, May 3, 2010.
45. However, note that in the Bernard Madoff Investment Securities scandal of 2008–9, several private equity funds were remotely involved with and invested in the collapsed fund.

46. Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (Transaction Publishers, 1991 edn), p. 64.
47. Ibid.
48. Ibid.
49. William Z. Ripley, *Main Street and Wall Street* (Scholars Book Company, Kansas, 1972; reissue of original edition of 1926), pp. 78–9. The quotation from Brandeis is not from his opinions on the Supreme Court, but rather from testimony before the Commission on Industrial Relations, Jan. 23, 1913, p. 7660.
50. See the R. P. Scherer case in point.
51. The Department of Labor in 1985 issued a release permitting incentive compensation in limited cases.
52. Daniel Fischel and John H. Langbein, "ERISA's Fundamental Contradiction: The Exclusive Benefit Rule," *University of Chicago Law Review*, 55, 4 (Sept. 1988), pp. 1105–60.
53. See Lilli A. Gordon and John Pound, "Governance Matters: An Empirical Study of the Relationship Between Corporate Governance and Corporate Performance," The Corporate Voting Research Project, John F. Kennedy School of Government, Harvard University, June 1991; Stephen L. Nesbitt, "Study Links Shareholder Proposals and Improved Stock Performance," Wilshire Associates, Feb. 13, 1992; Stephen L. Nesbitt, "Long Term Rewards from Corporate Governance," Wilshire Associates, Jan. 5, 1994; Robert F. Felton, Alec Hudnut, and Jennifer van Heeckeren, "Putting a Value on Board Governance" (McKinsey & Co., 1996); Paul Coombes and Mark Watson, "Three Surveys on Corporate Governance," *McKinsey Quarterly*, 4 (2000).
54. Bayless Manning, review of "The American Stockholder" by J. A. Livingston, Y*ale Law Review*, 67 (1958), p. 1477.
55. See Henry G. Manne, "Some Theoretical Aspects of Share Voting," *Columbia Law Review*, 64, 8 (1964), pp. 1430–45, and also Andrei Shleifer and Robert W. Vishny, "Large Shareholders and Corporate Control," *Journal of Political Economy*, 94, 31 (1986), pp. 461–88.
56. Edward J. Epstein, "Who Owns the Corporation?" (Priority Press Publications, New York, 1986), pp. 24–5.
57. New York Stock Exchange, "Circuit Breaker Levels for Fourth Quarter 2010" (2010), available at http://www.nyse.com/press/circuit_breakers.html.
58. Nelson Schwartz and Louise Story, "Surge of Computer Selling after Apparent Glitch Sends Stocks Plunging," *New York Times*, May 6, 2010, p. B7.
59. Tom Lauricella, Kara Scannell, and Jenny Strasburg, "How a Trading Algorithm Went Awry," *Wall Street Journal*, Oct. 2, 2010, available at http://online.wsj.com/article/ SB10001 424052748704029304575526390131916792.html.
60. Securities and Exchange Commission, "Investor Bulletin: New Stock-by-Stock Circuit Breakers," 2010, available at http://www.sec.gov/investor/alerts/circuitbreakers.htm.
61. Albert O. Hirschman noted that deterioration in performance of an institution produces two options for its members and consumers: exit, "some customers stop buying the firm's products or some members leave the organization," and voice, "the firm's customers or the organization's members express their dissatisfaction directly to management or to some other authority to which management is subordinate or through general protest addressed to anyone who cares to listen." See *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Harvard University Press, Cambridge, MA, 1970), p. 4.

62. Nathan Rosenberg and L. E. Birdsall, Jr., *How the West Grew Rich: The Economic Transformation of the Industrial World* (Basic Books, New York, 1986), at p. 229 (emphasis added).
63. *Crown Emak Partners LLC v. Kurz*, 992 A.2d 377 (Del. 2010).
64. See also Theodore Mirvis (note 45).
65. Charles D. Ellis, *Investment Policy* (Dow Jones-Irwin, Homewood, IL, 1989), p. 5.
66. Dyan Machan, "Monkey Business," *Forbes*, Oct. 25, 1993, p. 184.
67. Jack Bogle, *The Battle for the Soul of Capitalism* (Yale University Press, 2006).
68. Jonathon Clements, "Don't Just Do Something, Sit There," *Forbes*, Dec. 26, 1988, p. 142. See also Warren Buffett's reference to his million dollar bet against hedge fund managers: "Over a ten-year period commencing on January 1, 2008, and ending on December 31, 2017, the S&P 500 will outperform a portfolio of funds of hedge funds, when performance is measured on a basis net of fees, costs and expenses." http://www.longbets.org/362.
69. Dyan Machan, "Monkey Business," p. 190.
70. Ibid., p. 188.
71. Ibid., p. 190.
72. Shumeet Banerji, "Solving Moral Hazard in Banking," *strategy+business*, June 7, 2010, available at http://www.strategy-business.com/article/00036?gko=731ad. Mr. Banerji is the CEO of the global management consulting firm Booz & Co.
73. Ibid.; see also David Stockman, "Taxing Wall Street Down to Size," *New York Times*, Jan. 20, 2010, p. A21.
74. The NYSE's one share, one vote rule was not made formal until 1940, and the sanction for violating the rule, delisting from the NYSE, was not added until 1957. In truth, the traditional requirement is not correctly termed one share, one vote, as there is nothing prohibiting some inequality in the voting rights allocated among security holders. What the rule did was limit the amount of voting power that could be attached to any class of stock. There was a flat prohibition on the listing of nonvoting shares of common stock and a prohibition against any noncommon class of security holding more than 18.5 percent of all outstanding voting rights.
75. Sec. 3 (a) (26) of the Exchange Act.
76. Testimony of John J. Phelan, Jr., Hearings before Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce of the House of Representatives, One Hundredth Congress, First Session, on H.R. 2172 (Serial No. 10065), July 29, 1987, at pp. 538, 543, 544.
77. The American Stock Exchange (AMEX) later submitted a proposal permitting exchange offers with a vote by two-thirds of the outstanding shares or a majority of the shares unaffiliated with management or the controlling group. A multiple class company would have to have at least one-third of its board composed of independent directors, or provide that holders of the lesser voting class be entitled to elect at least 25 percent of the directors. The NYSE then came back with a second proposal that would allow companies to issue shares with disparate voting rights, or to change relative voting rights, if: (1) the decision is approved by a majority of a committee of independent directors and a majority of the board as a whole; (2) in those cases following the implementation of the decision, management or a control group would have a majority of the voting power, the majority of the board being made up of independent directors; and (3) the transaction is approved by a majority of the outstanding shares and a majority of the affected class of shareholders, not including the vote of any "interested shareholder."

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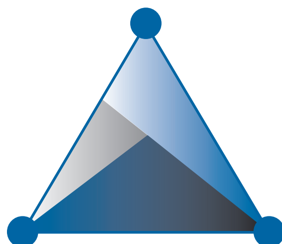
3
DIRECTORS: MONITORING



CONTENTS

- A Brief History of Anglo-American Boards 255
- Who Are They? 256
- Who Leads the Board? Splitting the Chairman and CEO and the Rise of the Lead Director 261
- Diversity 264
- Meetings 264
- Communicating with Shareholders 264
- Special Obligations of Audit Committees 265
- Ownership Compensation 266
- Post-Sarbanes–Oxley Changes 266
- Board Duties: The Legal Framework 267
- The Board's Agenda 281
- The Evolution of Board Responsibilities: The Takeover Era 283
- The Fiduciary Standard and the Delaware Factor 284
- The Director's Role in Crisis 291
- Limits and Obstacles to Board Oversight of Managers 295
- Information Flow 295
- Practical Limits: Time and Money 301
- The Years of Corporate Scandals – Boards Begin to Ask for More 302
- Director Information Checklist 303
- Who Runs the Board? 304
- Catch 22: The Ex-CEO as Director 306
- Director Resignation 308
- CEO Succession 308
- Director Nomination 309
- Limits and Obstacles to Effective Board Oversight by Shareholders 318
- Carrots: Director Compensation and Incentives 319
- Sticks, Part 1: Can Investors Ensure or Improve Board Independence by Replacing Directors who Perform Badly or Suing Directors who Fail to Act as Fiduciaries? 324
- Can Directors be Held Accountable through the Election Process? 324
- Sticks, Part 2: Suing for Failure to Protect the Interests of Shareholders – Are the Duties of Care and Loyalty Enforceable? 331
- Future Directions 331
- Summary and Discussion Questions 339
- Notes 340

> Coote got me in as a director of something or other. Very good business for me – nothing to do except go down into the City once or twice a year to one of those hotel places – Cannon Street or Liverpool Street – and sit around a table where they have some very nice new blotting paper. Then Coote or some clever Johnny makes a speech simply bristling with figures, but fortunately you needn't listen to it – and I can tell you, you often get a jolly good lunch out of it.

The blotting paper has vanished, but to judge by the crop of catastrophes rocking the American and world economies in the twenty-first century, little else about life in the boardroom has changed since Agatha Christie wrote *The Seven Dials Mystery* in 1929.

Lord Boothby, the former Tory MP, described his experience with board service. "No effort of any kind is called for. You go to a meeting once a month, in a car supplied by the company. You look grave and sage. If you have five of them, it is total heaven, like having a permanent hot bath."

This is not a new problem. In 1872, Anthony Trollope wrote in *The Way We Behave*: "The chairman of the Great South Central Pacific and Mexican Railway Company would never sit for more than half an hour. [The chairman] himself would speak a few slow words always indicative of triumph, everybody would agree to everything, somebody would sign something, and the board meeting would be over."

There has been no aspect of corporate governance in which we find a bigger disparity between what is said to be the case and what is true as a practical matter than in our idea of boards – what they do, whose interests they represent, and how effectively they oversee management to ensure that the corporation is run in a manner consistent with sustainable creation of shareholder value.

In theory, the board acts as a fulcrum between the owners and controllers of a corporation. They are the middlemen (and a few middlewomen) who provide balance and mediate the conflicts of interest between a small group of key managers based in corporate headquarters and a vast group of shareholders spread all over the world. In theory, at least, the law imposes on the board a strict and absolute fiduciary duty to ensure that a company is run in the long-term interests of the owners, the shareholders who provide the capital. The reality, as we will see later in this chapter, is a little less certain.

Boards of directors are a crucial part of the corporate structure. They are the link between the people who provide capital (the shareholders) and the people who use that capital to create value (the managers). This means that boards are the overlap between the small, powerful group that runs the company and a huge, diffuse, and relatively powerless group that simply wishes to see the company run well.

The strength – and indeed the survival – of any corporation depend on a balance of two distinct powers: the power of those who own the corporation and the power of those who run it. A corporation depends on shareholders for capital, but reserves the day-to-day running of the enterprise for management. This creates opportunities for efficiencies far beyond what any one owner/manager, or even a group of owner/managers, could accomplish. It also creates opportunities for abuse.

This was the conundrum that almost stopped corporations before they began. Karl Marx and Adam Smith did not agree on much, but they both thought that the corporate form of organization was unworkable, and for remarkably similar reasons. They questioned whether it is possible to create a structure that will operate efficiently and fairly, despite the fact that there is a separation between

ownership and control. Adam Smith criticized both those who invested in joint-stock companies and those who managed them. Of the investors, he wrote that they "seldom pretend to understand anything of the business of the company," and of the directors, he said: "Being the managers of other people's money rather than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own."[1]

Put another way, is there any system or structure of incentive compensation to make a manager care as much about the company's performance as a shareholder does?

Corporations cannot be run by consensus or referendum. Managers must be given the power to make decisions quickly and to take reasonable risks. If every managerial decision had to be communicated to the company's owners, much less ratified by them, industrial progress would be paralyzed, and everyone would lose.

Yet while shareholders delegate substantial powers to management, they need assurance that power will not be abused. *How do shareholders know that the assets they own are not being mismanaged, or even embezzled?*

The single major challenge addressed by corporate governance is how to grant managers enormous discretionary power over the conduct of the business while holding them accountable for the use of that power. The daunting task for directors is to find a way to balance independence and consensus-building, to challenge without second-guessing, to focus on the forest of strategy and risk management and not the trees of operations, execution, and compliance, and to make decisions that promote and protect the interests of millions of people they will never meet over those who are sitting in front of them, looking them in the eye, and deciding whether they will continue to serve on the board.

Shareholders cannot possibly oversee the managers they hire. A company's owners may number in the tens of thousands, diffused worldwide. Therefore directors are their representatives to oversee the management of the company on their behalf. Directors are representatives of owners (or, in closely held companies, the owners themselves), whose purpose under law is to safeguard the assets of the corporation and promote long-term, sustainable growth. The board's primary role is to monitor management on behalf of the shareholders, to keep it going in the right direction and, when that fails, to make the necessary repairs and replacements. They are there to hire, evaluate, incentivize, and replace the top managers, to make sure that the financial reports are appropriate and accurate, to oversee the overall strategy and direction, to manage risk, and to set the "tone at the top" to ensure the integrity of the company's operations and employees.

In theory, these duties are enforced through the shareholders' right to elect directors, to sue them for failure to perform their duties, and their right to nominate and run their own candidates if they do not like the job the management-sponsored directors are doing and, if enough of the other shareholders agree, to replace them. As with so much in the world of corporate governance, the reality does not match the theory. Over and over, we see that boards seem to work adequately only when crises occur; they don't seem to be able to prevent or even mitigate them. In this chapter, we will discuss the theoretical and real mechanisms and structures used to keep managers accountable to the board as well as the mechanisms and structures used to keep the directors accountable to the shareholders.

CASE IN POINT WARREN BUFFETT ON BOARDS

In his 2002 report to Berkshire Hathaway shareholders, the most successful investor of all time (and a director of several companies, including Coca-Cola and *The Washington Post*) wrote about the failures of corporate boards:

> *In theory, corporate boards should have prevented this deterioration of conduct.... [In 1993] I said that directors 'should behave as if there was a single absentee owner, whose long-term interest they should try to further in all proper ways.' This means that directors must get rid of a manager who is mediocre or worse, no matter how likable he may be. Directors must react as did the chorus-girl bride of an 85-year-old multimillionaire when he asked whether she would love him if he lost his money. 'Of course,' the young beauty replied, 'I would miss you, but I would still love you.'...*
>
> *Why have intelligent and decent directors failed so miserably? The answer lies not in inadequate laws – it's always been clear that directors are obligated to represent the interests of shareholders – but rather in what I'd call 'boardroom atmosphere.'*
>
> *Over a span of 40 years, I have been on 19 public-company boards (excluding Berkshire's) and have interacted with perhaps 250 directors. Most of them were 'independent' as defined by today's rules. But the great majority of these directors lacked at least one of the three qualities I value. As a result, their contribution to shareholder well-being was minimal at best and, too often, negative. These people, decent and intelligent though they were, simply did not know enough about business and/or care enough about shareholders to question foolish acquisitions or egregious compensation. My own behavior, I must ruefully add, frequently fell short as well: Too often I was silent when management made proposals that I judged to be counter to the interests of shareholders. In those cases, collegiality trumped independence.*

He had more to say in his 2006 report, where he described what he looks for in a director.

> *In selecting a new director, we were guided by our long-standing criteria, which are that board members be owner-oriented, business-savvy, interested and truly independent. I say 'truly' because many directors who are now deemed independent by various authorities and observers are far from that, relying heavily – as they do – on directors' fees to maintain their standards of living.... Charlie and I believe our four criteria are essential if directors are to do their job – which, by law, is to faithfully represent owners. Yet these criteria are usually ignored. Instead, consultants and CEOs seeking board candidates...it sometimes sounds as if the mission is to stock Noah's ark. Over the years I've been queried many times about potential directors and have yet to hear anyone ask, 'Does he think like an intelligent owner?'* ■

CASE IN POINT **THE WORLDWIDE FRUSTRATION OF AUDIT COMMITTEES**

A 2010 survey of audit committee members in 34 countries by accounting firm KPMG found that, regardless of country, they believed that they were not getting the information they needed or looking at the benchmarks that were optimal. While 76 percent rated their committees as effective, they saw room for improvement. They wanted to spend less time on checklists and more on information flow and a better understanding of strategy and risks. Only 55 percent said they looked and that they examined key performance indicators. Only 40 percent said their company's risk management was "robust and mature." *Who is in a position to improve this?* US directors rated their audit committees higher than the rest.[2] (Read the case studies on GM, Lehman Brothers, AIG, Fannie Mae, and Massey Energy to consider the board's effectiveness in risk management.) ■

A BRIEF HISTORY OF ANGLO-AMERICAN BOARDS

US boards carry on a tradition that began with the earliest form of corporate organization, the joint stock companies. In the British colonies, as in Great Britain itself, the group of people who oversaw the company would meet regularly. Fine furniture was expensive in those days, and few people in trade had enough for the meeting, so the men sat on stools, around a long board placed across two sawhorses. The group was named "the board," after the makeshift table they worked at. The leader of the group, who did not have to sit on a stool, by reason of his prestigious perch, was named the "chair-man."

The first commerce in America was conducted by two British enterprises, operating under royal charter: the Virginia Company of London and the Virginia Company of Plymouth. Two bodies governed these companies. The first was a local council, a management board of colonists responsible for day-to-day operations in the new land. This council was accountable to a second, more powerful, body in London. This "supervisory board" was answerable to the sovereign and responsible for more general matters of policy and strategy.

Following the American Revolution, the new republic had to devise its own forms of governance. An early leader was one of the joint authors of the *Federalist Papers*, and the nation's first Secretary of the Treasury, Alexander Hamilton. In November 1791, the New Jersey Legislature passed a bill authorizing Hamilton's "Society for Establishing Useful Manufactures" (or SUM, as it was known). The society was allowed to produce goods ranging from sailcloth to women's shoes.

The governance of Hamilton's corporation was remarkably similar to that of today's largest companies. The Society's prospectus declared: "The affairs of the company [are] to be under the management of thirteen directors." Hamilton also created an early audit committee. He devised a committee of inspectors, separate from the board of directors, made up of five shareholders. They were generally chosen from among defeated directorship candidates, though shareholders could

elect any five of their fellow stockholders. These inspectors were granted access to the company's books, and given power of review over all the company's affairs.[3]

WHO ARE THEY?

Hamilton would have no trouble recognizing the corporate board of today. The structure and composition of boardrooms have changed surprisingly little in more than 200 years. Average board size has remained at about 15, give or take a director or two. Audit committees remain an important force in board life. Most of today's directors come from the same segment of the population as the directors of SUM, the commercial elite. One observer described the typical public company board as "the CEO, ten of his white, male, corporate friends, and one member who is some combination of female/minority/academic/former government official." Boards have consistently tended to be made up of current or former CEOs (more than 40 percent), other corporate executives (21 percent), lawyers, bankers, consultants, other finance experts, executives from nonprofits and professors/administrators, and accountants.[4] They are usually in their late 50s–60s and the average and mean ages have been going up over the past few years, possibly because the additional time requirements make retired executives more appealing.

Nonetheless, organizations that have tracked shifts in board size, composition, compensation, structure, and focus see some changes worth noting. In Korn/Ferry's first survey in 1973, the words "corporate governance" did not appear in either the questionnaire sent to directors or the report that analyzed the results. "How times have changed!" they said in 1998 – and how things were about to change even more as the first years of the new century would bring the biggest corporate upheavals and the most comprehensive legislative changes since the Great Depression. More recently we have seen boards looking abroad for directors, reflecting the importance of the global markets for goods and capital.

SIZE

Boards of directors "have made great strides in paring back to a more workable size," reported executive search firm Spencer Stuart in 1998. Spencer Stuart's 13th annual survey of board practices in large US companies found that average board size had shrunk from 15 in 1988 to 10.9 in 2002, and that has remained steady. As boards have grown smaller, there has been a net reduction in inside directors. The Board Analyst database showed 17 companies with only four directors at the time of this writing. The largest is CME (Chicago Mercantile Exchange) with 34.

TERM

Most shareholders prefer the entire board to be accountable on an annual basis and that was the norm in the US until the takeover era of the 1980s, when many companies switched to staggered terms, with a three-year term, one-third of the board up for election at a time. Companies claimed that this promoted "continuity"; shareholders argued that it promoted entrenchment. Many companies switched back due to shareholder pressure in the post-Enron era. In 2011, thirteen companies agreed to switch from three-year to one-year terms for directors in response to shareholder proposals from the Nathan Cummings Foundation and the Florida Pension Fund. The UK's revised Combined Code of the Financial Reporting Council required all FTSE 350 directors to be elected on an annual basis.

INSIDE/OUTSIDE MIX

Central to the issue of corporate governance is the issue of independent directors. We all agree that independence is important; there is not much agreement about how to define or recognize it. One trend that has characterized boards of directors over the past 35 years has been the rise of the "independent" outside director.

While definitions of "independence" vary, most agree that the first criterion is that a director must have no connection to the company other than the seat on the board. This excludes not just full-time employees of the company, but also family members of employees and the company's lawyer, banker, and consultant. Some include people with connections to the company's suppliers, customers, debtors or creditors, or interlocking directors. Some definitions include direct or indirect recipients of corporate charitable donations, like the heads of universities or foundations. In its report on the relationship between independent directors and corporate performance, then-proxy adviser Faulk & Co. considered any director was not independent who held 5 percent or more of the stock – a most unusual restriction, and one that, according to most lights, utterly skewed the results. Some definitions are so restrictive that they all but require that the CEO has never met the candidate. The theory is that if the director is a friend of the CEO, it is just as difficult for him to be objective as it would be if he were an employee.

In addition to the increasing focus by regulators and investors on making sure there is a majority of directors who do not have other direct connections to the company, the role of outside directors is being expanded. The post-Enron reforms imposed by the stock exchanges require regular "executive session" meetings of the board without management present. However, the issue of "independence" remains a troubling one.

If the job of the board is to oversee management then it is clear the directors must be independent. However, that is easier said than done.

We will start with the "said." "Twenty years ago, the median number of inside directors (full-time employees of the company) for that group of 100 [companies covered in the 1986 report] was four. Today, the median for the S&P 500 boards is two and nearly 40 percent have only one non-independent director – the CEO – up from 12 percent in 2000," according to Spencer Stuart's 2005 edition. By 2009, they found "Half of all boards have only one insider, the CEO, up from 44 percent last year. And 37 percent split the chairman and CEO roles, versus 20 percent a decade ago."

Then here comes the "done." It is important to remember that "independence" as determined by connections that meet the disclosure requirements of the Securities and Exchange Commission or the exchanges does not always mean absence of professional or personal connections that could impair independence of judgment.

There is a big difference between "resume independence" and independence of judgment and courage. At Juno Lighting, the board consisted of the CEO, the CFO, the company's investment banker, the company's lawyer, and an "independent director." While his connections to the company made him de jure independent, de facto he was not. First, he played in the CEO's jazz band each weekend. Second, as the make-up of the rest of the board showed, based on the decisions they made, the CEO made sure no one was going to question him. Similarly, at Disney during the later years of Michael Eisner's tenure as CEO (the era that included the lawsuits discussed above), the "independent" directors included educators, but the educators were affiliated with the schools Eisner's children attended. The other directors included Eisner's architect and his lawyer, and the decisions they made showed that any "independence" was severely compromised (see the Disney/Ovitz case in point later in this chapter). In 2011, Huntsman Corporation issued a press

release about its new "independent" director – the head of a charitable organization funded by the corporation's founder, who is also its chairman and the father of the CEO.

As these examples show, even "resume independence" or lack thereof is not always revealed by the required disclosures. A 2006 study by The Corporate Library's Jackie Cook of the interlocks and network links between corporate directors found increased board size for smaller companies (due to independence requirements and requirements for more specialized expertise on boards and committees), more independent outsiders serving on compensation committees, and a reduction in the average number of directorships held by the busiest directors and by active CEOs serving as outside directors. The impact on the corporate board network (the network of relationships among boards of public companies established by shared directors) has been a reduction in the average number of other boards that each board is linked to, a reduction in the number of multiple interlock relationships among boards (particularly those considered to compromise the independence of directors involved), lower "density" of links in the board network, and a slightly longer average distance between any two pairs of boards that are part of the board network. Interestingly, the report found that shedding of multiple directorships and the reduction in the number of links among boards had not led to a fragmentation or unraveling of the corporate board network. A larger number of the 1,500-odd boards of S&P 500, MidCap 400, and SmallCap 600 companies were now linked to at least one other board in the group and the "principal component"[5] of the corporate board network, i.e., the largest connected portion of the network where each board is connected to every other board via one or more degrees of separation, has grown consistently over the period 2002 to 2005. This component of the corporate board network now linked more directors to each other (by varying degrees of separation) than it did in any of the previous years of the study.

Key objectives of the Sarbanes–Oxley Act have been to increase board independence, both in terms of the proportion of independent directors serving on US public company boards and in terms of the definition of what constitutes "independence" of a director, and to improve board oversight by clearly defining the responsibilities of boards and their committees. The effect has been an increase in board size for smaller companies yet a reduction in the average number of directorships held by the busiest directors and by active CEOs serving as outside directors on other boards. Because there are more individuals, there has been a reduction in the number of multiple interlock relationships among boards, a reduction in the average number of other boards that each board is linked to via shared directors, lower "density" of links in the board network, and a slightly longer average distance between any two pairs of boards that are part of the board network.

The most popular type of director is a top executive of another company. It was not long ago that interlocks were common. In 1993, the *New York Times* found five pairs of companies where executives sat on each other's compensation committees.[6] The CEOs of Cummins Engine and Inland Steel chaired each other's compensation committees. In the words of Justice Louis Brandeis, "The practice of interlocking directorships is the root of many evils."[7] See, for example, the American Express case study for its discussion of the company's board members. CEO James Robinson relied particularly on the support of Drew Lewis, CEO of Union Pacific. Robinson sat not just on the board of that company but also on the compensation committee. The case study describes a host of other relationships that helped to undermine the independence of Amex's outside directors. See also the Carter Hawley Hale case study, which shows how Philip Hawley relied on the Bank of America for support in arranging a voting scheme for employee stock in the face of a takeover. Hawley sat on the executive committee of the Bank of America's board and chaired its compensation committee. With a few exceptions, these kinds of obvious conflicts have almost entirely disappeared. When founder-CEO Andrew Wiederhorn of Fog Cutter went to jail for financial fraud in 2004, the chairman of the board that awarded him record compensation during what they termed his "leave of absence" was his father-in-law.

However, according to Cook, "the shedding of multiple directorships and the reduction in the number of links among boards has not led to a fragmentation or unraveling of the corporate board network." As noted already, more and more companies are now linked to at least one other board in the group and the principal component of the corporate board network – i.e., the largest connected portion of the network where each board is connected to every other board via one or more degrees of separation – grew consistently over the period between 2002 and 2005. This component of the network now links more directors to each other than it did before. Another Corporate Library study in 2006 applied this analysis to the list of companies currently listed, either due to investigations or litigation, as documented or potential option-backdaters. The study found a statistically significant number of directors showed up repeatedly as directors or officers of these companies, suggesting a "viral" spread. Many of them were also linked to one prominent law firm that had strong ties to the high-tech community.

They meet the formal standards for "independence," but a particularly close and enduring relationship has existed between the boards of Anheuser-Busch, Emerson Electric, and SBC Communications, now AT&T, for a number of years. In 2006, Anheuser-Busch shared four directors with Emerson Electric and four with AT&T. Emerson and AT&T in turn shared two directors. Six directors were involved in this close three-way relationship.

Imagine for a moment a director who meets the strictest standards of independence – selected by the nominating committee with the assistance of a search firm, someone with no previous connection to the company or any of its executives. Assuming that despite management's control over the agenda and information, there comes a moment of disagreement. *What happens if "independence" has a result the CEO doesn't like?* According to the best book about boards we have seen, director Shirley Young was kicked off the Bank of America board for asking a single question: Could the CEO's enormous compensation package coming at the same time as a deteriorating performance and 12,000 lay-offs, possibly be a public relations problem? She found out she was off the board when she did not receive the materials for the next meeting.[8]

In 2010, the British online grocery retailer Ocado announced that it would not meet the non-binding standard that at least half of the board be made up of independent directors when it went public. "We recognise that we don't comply with the Code but we've made strides in bringing non-execs on board and will continue to do." *How should the market consider this information in valuing the stock?*

The issue of independence is a complicated one and we will discuss it in further detail later in this chapter. Perhaps the best approach is that taken by the UK's Combined Code of the Financial Reporting Council, which requires an independent assessment of the board every three years.

CASE IN POINT THE CORPORATE LIBRARY'S INTERLOCK TOOL

In 2002, The Corporate Library (now GovernanceMetrics International) developed a tool for the graphic display of interlocking relationships between directors – not just corporate relationships, but also charitable organizations, trade associations, and even the notorious all-male Augusta Golf Club. Figures 3.1 and 3.2 are two examples of highly connected directors.

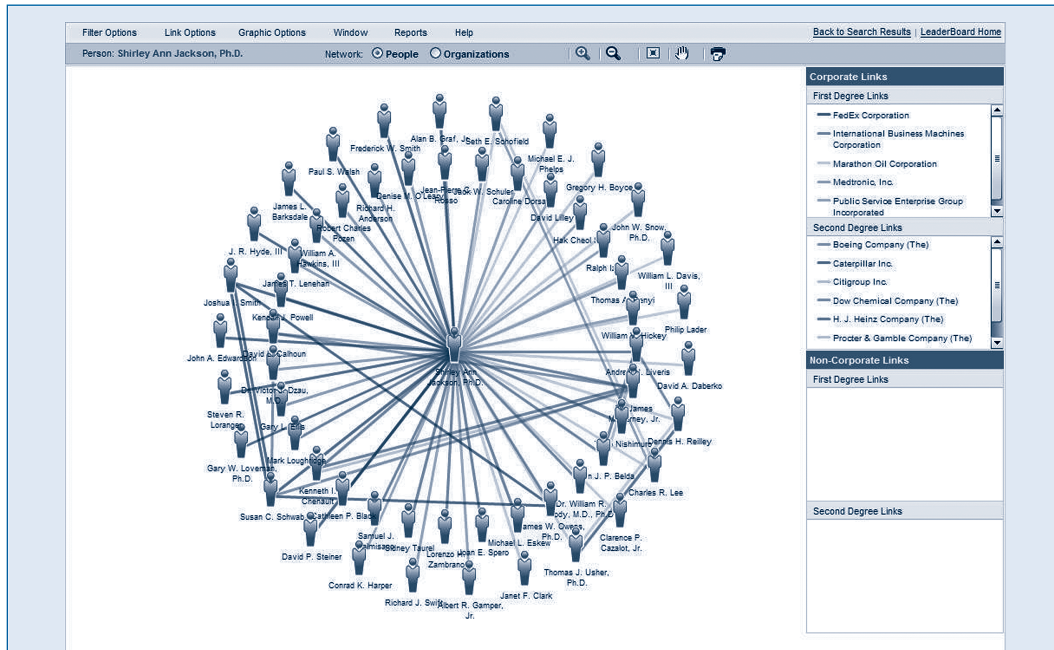


Figure 3.1 Interlocks: Shirley Ann Jackson.

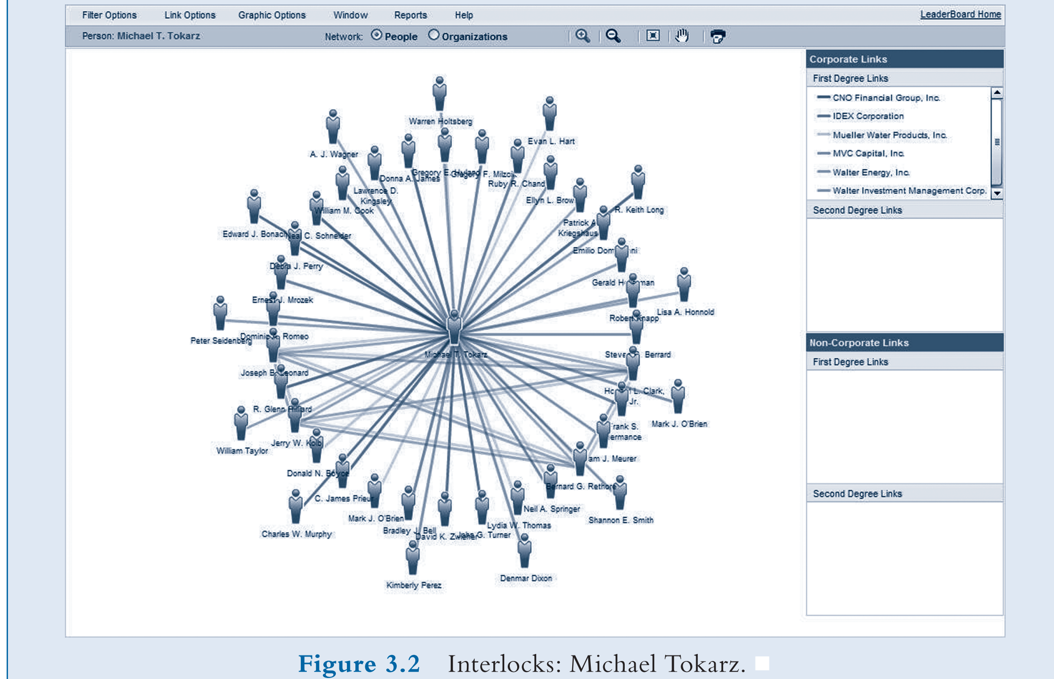


Figure 3.2 Interlocks: Michael Tokarz.

QUALIFICATIONS

Most board members are current or retired executives. Many others are academics, leaders of non-profits, and former government officials or military leaders. We expect to see a range of perspectives and skills in the boardroom, but everyone on a public company board should have a thorough understanding of financial reports and filing obligations. As a whole, the board should reflect a diverse knowledge of the industry and of markets, of the product and of sales and consumers, of compliance and risk management, and of leadership challenges. Individually, every director should demonstrate independence, energy, curiosity, collegiality, and commitment.

Not every director has to come from a business background but every one has to be willing to learn what is necessary. Most presidents of major research universities serve on boards, but in the post-meltdown era, many raised questions about whether a physicist (Shirley Jackson of Rensselaer Polytechnic) and a specialist in romance literature (Ruth Simmons of Brown) could be effective board members at companies like the New York Stock Exchange and Goldman Sachs. There is also a concern about compromised independence when corporations and their executives donate money to the universities.[9]

All new board members should have a thorough briefing on the current issues facing the company and board members should have frequent interaction with upper management and operations. Boards should have meaningful evaluation of their own effectiveness and the contributions of individual members to provide helpful feedback and replace board members who are not able to make the necessary commitment of time and attention. The willingness to replace under-performing directors is just as important as the ability to nominate qualified candidates.

WHO LEADS THE BOARD? SPLITTING THE CHAIRMAN AND CEO AND THE RISE OF THE LEAD DIRECTOR

One of the key challenges for boards (and one significant indicator of genuine independence) is control of the information and agenda. If the CEO is responsible for both, it is all but impossible for the outside board members to provide meaningful oversight. The shift in board leadership structures is intended to address that concern.

In the UK, splitting the chairman and CEO roles went from highly unusual to all-but-universal from 1992 to 2000 as a way of ensuring more independent oversight, but in the US it is still rare. Spencer Stuart's 2009 board index shows that 37 percent of S&P 500 boards split the chairman/CEO role, up from 23 percent seven years ago. However, since a substantial number of those chairmen are not independent outsiders (either former CEOs or otherwise affiliated with the company), in reality only "16 percent of boards (81 out of 491) have a truly independent chair, the same as last year."

As the gap between appearance and reality in chairman/CEO split positions shows, these structural indicators of "independence" can be misleading. The relatively recent notion of a "presiding" or "lead director," something between a chairman and a liaison for the outside directors, has been widely adopted. The role of the person acting in that capacity still varies a great deal from board to board and situation to situation.

Martin Lipton and Jay Lorsch first proposed the "lead director" idea in a 1992 *Business Lawyer* article called "A Modest Proposal for Improved Corporate Governance." They described their ideas as modest, not because they were unambitious in scope, but because their implementation would not require the involvement of Congress, the SEC, or the stock exchanges.

> *What this person is called is not important, but his or her duties are important. We believe that the CEO/chairman should consult with this lead director on the following matters: the selection of board committee members and chairpersons; the board's meeting agendas; the adequacy of information directors receive; and the effectiveness of the board meeting process.*

Lipton and Lorsch argued that a board with a designated lead director would be able to establish a better system of CEO evaluation, and thus deal more effectively with the possibility that the only person to judge the CEO's performance would be the CEO himself. While arguing that specific rules cannot suit every company, the authors produced detailed guidelines for evaluating the CEO.

1. The assessment should be based on company performance, and the progress the CEO has made toward his or her personal long- and short-range goals. Such personal goals would constitute the major extraordinary initiatives the CEO wanted to achieve, e.g., developing and selecting a successor; expanding into markets internationally; making a major acquisition; creating a significant joint venture. We contemplate that short-term goals will be agreed upon annually among the CEO and the independent directors. The longer-term goals might have a three- to five-year horizon, but would be reviewed annually and changed as necessary.
2. Each director would make an individual assessment of the CEO's performance. These assessments then would be synthesized to reveal the tendency, as well as any range of views. This synthesis could be done by the lead director or by a small group or committee of independent directors.
3. The CEO would receive this synthesized feedback in a confidential manner in which both he or she and the independent directors were comfortable.
4. After the CEO had time to reflect on it and to develop a response, he or she would then discuss his or her reactions to the assessment with all the independent directors. This discussion also should focus on any changes in goals for the company or the CEO that seem appropriate.

The "modest proposal" did not get very far until the post-Enron reforms, when it seemed to be a good compromise between the status quo and the UK approach of independent outside chairmen.

A study published in 2010 by PriceWaterhouseCoopers (PWC) called *Lead Directors: A Study of Their Growing Influence and Importance* found that "a lead director is particularly helpful in focusing the board's talent and wisdom when difficult situations arise: management performance and succession, risk management, mergers and acquisitions, and a host of other internal and external matters." The lead directors surveyed said that the most significant contributions of the role were:

- taking responsibility for improving board performance,
- building a productive relationship with the CEO, and
- providing leadership in crisis situations.

They have also taken on the delicate task of dealing with "difficult or underperforming directors. Rather than letting these situations fester until annual board self-evaluations or nominations, lead directors can proactively and diplomatically address them. The lead director also can take an active role in an often-overlooked issue, board succession." The report also predicts that lead directors may take on more responsibilities including "an active and substantive role in managing a crisis."

Lead directors in the LDN (lead director network) also foresee a growing role for board leadership in communications with shareholders. Ironically, these areas where lead directors are making the most valuable contributions are not among those officially mandated for the role as originally envisioned by the NYSE.

In the PWC report, long-time board counsel John Olson of Gibson, Dunn & Crutcher says the job of the lead director is to "keep the board focused and the CEO informed." Former Del Monte foods lead director Nina Henderson, who contributed to the report, said, "Lead director success is all about how one approaches the job. If one views themselves as a proactive enabler for the board, individual directors, the CEO and his/her management, one will be effective and deliver."

AGENDA

One of the board's biggest challenges is deciding what to focus on. If the agenda is set by insiders, oversight is circumscribed. If all of the information is provided by people inside the company, it is difficult to evaluate the options.

One of the most important tasks of the executive session meetings is reviewing the agenda to make sure everything the board wants to discuss will be included, but the board must also make sure that its focus is on the forest, not the trees. Corporate Board Member magazine once reported that the board of Furr's Bishops nearly came to blows over the dessert menu, as described in Chapter 2. "In truth, the humble agenda constitutes the single most important tool for either empowering or emasculating the board. Simply stated, whoever controls the agenda controls the board's ability to do meaningful work."[10]

Once a year, perhaps at a strategic retreat, the board should map out the agenda for the year. Then each executive session meeting should review and revise the agenda for the following meeting. Boards should also make sure they give due consideration to the work of the committees without delegating too much authority to them. Topics for every board to consider on a regular basis are: CEO and board evaluation, the pay–performance link at the CEO level and overall, how the company makes money, and whether it is doing everything it can to separate itself from its competition, whether each division is beating its cost of capital, turnover rates, employee satisfaction, and development, and the effectiveness of the company's risk management and compliance systems. The board should also evaluate on a regular basis the executives' frankness and candor in communications with the board itself.

MINUTES

Boards must keep minutes of their meetings and under Delaware law those minutes must be provided to shareholders on request. For that reason, most corporate counsel advise boards to keep minutes to the bare bones of the topics addressed and the votes taken.

DIVERSITY

Most corporate directors are still middle-aged white males. In 1973, just 11 percent of boards featured a single woman and 9 percent had a director from an ethnic minority.[11] In 1998, Spencer Stuart offered the bold headline: "Boards Eager to Recruit More Women." They found that 16 percent of new outside directors were women (an improvement on the status quo, given that only 12 percent of all directors were women at that time). In 2005, the increase had plateaued. "Women continue to make up 15 percent of all independent directors. 88 percent of boards have at least one female director, and nearly half have two. Of the 58 companies with no women on the board, 43 percent are technology companies." The 2009 Spencer Stuart report found that 16 percent of the directors in its board index were women, holding fairly steady since 2004, with 11 percent still all male. A scholarly study of the 1,000 largest firms ranked by sales showed that the distribution of women on boards was uneven.[12] Larger firms, firms with significant female employees and firms tied to other firms with female directors were all more likely to have women on the board. The Board Analyst data show that 779 boards have at least one woman, but only 226 have more than two and only seven have more than four.

Norway now requires corporate boards to have at least 40 percent women members and France is considering applying the same requirement at the time of this writing.

There is little progress in the recruitment of directors from ethnic minorities. While 85 percent of boards have at least one minority director, the percentage has not increased since 2005, holding at 15 percent. Of course, some of these directors are both female and minority and some in either and both categories are over-represented by serving on more than the average number of boards.

There is also an increasing interest in non-US citizens on boards: "35 percent of survey respondents have a non-US citizen on the board." Directors from the UK are the most prevalent, followed by directors from Mexico, Canada, and Germany.

MEETINGS

Full board meeting frequency has increased from seven to nine since 2000, and there is also an increased reliance on committees, which meet separately. Most companies have four or five committees. The three required committees are audit, compensation, and nominating. Popular other committees are finance, executive (declining as advances in technology make it easier to convene the entire board through conference calls), and a small but increasing number of committees devoted to environmental, science and technology, and legal/compliance issues. The "risk" committee is attracting some support. There are also ad hoc special committees convened for CEO succession, business combinations, investigation of potential problems, and other issues.

COMMUNICATING WITH SHAREHOLDERS

Traditionally, all communications with shareholders were handled by the company. Increasingly, shareholders want to have a direct relationship with the people who are supposed to represent

them. The post-Enron era reforms included an NYSE requirement that companies disclose to shareholders a mechanism for contacting the board. The National Association of Corporate Directors and the Council of Institutional Investors co-sponsored a 2004 report recommending, "Boards should take an active role in developing and adhering to communications policies" and establish a clear list of which topics are appropriate for executives to handle and which should be addressed by the board.

One way for directors to communicate with shareholders is to attend the annual meeting and be prepared to answer questions about the procedures followed by the audit, compensation, and nominating committees. The report includes examples of company disclosures.

SPECIAL OBLIGATIONS OF AUDIT COMMITTEES

The SEC proclaimed 1999 "the year of the accountant," following audit scandals at Cendant, Green Tree, Mercury Finance, Waste Management, and Sunbeam. The Cendant proxy issued just before the fraud was uncovered revealed that, in the previous year, the audit committee had met twice, while the compensation committee met eight times. There were reports of audit committees whose meetings were brief and whose duties consisted of signing the signature block of documents they had not reviewed. There were also reports of CEOs who put their least experienced or financially literate directors on the audit committee as a way of keeping them from asking too many questions. For example, Infinity Broadcasting had a two-person audit committee, neither of whom had a background in accounting and one of whom was O. J. Simpson. Several reports issued that year from groups including the National Association of Corporate Directors and the SEC set forth new guidelines for audit committees.

Another new set of obligations was imposed by Sarbanes–Oxley. Audit committees must disclose whether any of their members meet the very strict five-part definition of a "financial expert." The qualifications include an understanding of financial statements and generally accepted accounting principles and the ability to assess the general application of GAAP in connection with the accounting for estimates, accruals, and reserves as well as experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the company's financial statements, or experience actively supervising one or more persons engaged in such activities.

Furthermore, Sarbanes–Oxley requires the company's audit firm to assess the efficacy of the audit committee and to report on its assessment. In addition to the new requirements imposed by Sarbanes–Oxley, the SEC, and the exchanges, most audit committees comply with the "best practices" recommendations of other sources, like the National Association of Corporate Directors. In addition to being responsible for the financial reports and SEC filings, the audit committee must review earnings press releases and guidance provided to NYSE rating agencies, monitor internal controls and systems for legal and regulatory compliance and risk management, oversee the system for compliance with ethical codes, and retain, monitor, and evaluate auditors. They must have authority to investigate any matter and report annually on whether the committee has fulfilled its responsibilities under the charter. The audit committee should meet individually with internal and external auditors and with management on a regular basis.

OWNERSHIP/COMPENSATION

In 1993, Spencer Stuart concluded that the idea of paying outside directors wholly in stock was a "non factor" in its board analysis. Five years later, their survey found that a small but significant body of 25 companies (just 5 percent of the S&P 500) were paying their directors wholly in stock. Director stock ownership is increasingly becoming an element of governance credibility. Korn/Ferry's 2008 survey of directors found that in North America "the prevalence of ownership guidelines has increased to 80 percent, up from approximately 50 percent in 2002."

The Corporate Library's 2008 report on director pay found that median total compensation for individual directors of S&P 500 companies was just under $200,000, with median total compensation on or just under $120,000 for the whole sample. Scott G. McNealy of Sun Microsystems, Inc., John J. Burns of Alleghany Corporation, and John R. Huff of Oceaneering International, Inc. received payments in stock and option awards, cash bonuses, pension earnings, and all other compensation which, combined together, were worth more than $23.3 million, making them the highest paid nonexecutive directors in the survey. Signficantly, the report showed that almost 2,000 more directors were paid in stock rather than stock options that year, in retrospect a pretty reliable leading indicator of an upcoming market decline. The Corporate Library (now GovernanceMetrics International) designates particular elements of director compensation as "red flags," indicators of inadequate linkage between pay and performance and possible perverse incentives. These include use of the corporate jet (not coincidentally, directors at Chesapeake Energy, with the excessive compensation described in the introduction, had this perk), and director retirement plans, golden parachutes, and consulting contracts.

In 2009, Spencer Stuart found that average compensation for S&P 500 directors is $212,750. "The median annual retainer remains at $60,000. Five years ago it was $40,000; 10 years ago it was $30,000. The three companies with the highest retainers ($260,000 to $280,000) pay partly in equity and none pay meeting fees. 18 percent of boards pay $100,000 or more; just 1 percent did so in 1999."

They noted that 58 percent of director compensation is paid in equity, with stock awards accounting for 39 percent and option grants for 19 percent. "Within the equity component, we have seen a continued shift from stock option programs to stock grants over the past five to 10 years. Nearly 80 percent of companies award shares to directors, up from half in 2004. Meanwhile, just 37 percent of companies offer stock options, down from 68 percent five years ago."

As with executive compensation, this shift to a less variable form of stock-related compensation is a response to market volatility and a way to lessen the pay–performance link. The Board Analyst database shows nearly 6,000 directors who do not own a single share of stock. *What should that tell you about their commitment? About their alignment of interests with shareholders?*

POST-SARBANES–OXLEY CHANGES

Thanks to new listing standards from the exchanges, the once-rare practice of "executive sessions," meetings of outside directors without any representatives of management present, is now close to universal. Many directors report that this has been the single most beneficial of all of the post-Enron reforms. A significant role is involvement in setting the agenda. No matter what the structure and policies, if management controls the agenda and the quantity, quality, and timing

of the information provided to the board, it cannot be effective. Presiding and lead directors also often coordinate the increasing number of board effectiveness evaluations.

Initial compliance costs for Sarbanes–Oxley have been estimated as high as $5 million per company. However, those costs fell as systems were in place and technology performed more of the functions. The cost of compliance with Section 404 of the Sarbanes–Oxley Act (SOX), requiring companies to report on the effectiveness of their internal controls, declined by 23 percent in fiscal 2006 even with accounting fees holding steady, according to a survey by Financial Executives International. These costs must at least in part be assessed as preventative. It may be expensive to assess internal controls; it is certainly expensive not to. Since the enactment of Sarbanes–Oxley, there have been no further Enron-style scandals.

Korn/Ferry reported in 2006 that: "The percentage of the American respondents declining board invitations due to increased liability has doubled since Sarbanes–Oxley became law, from 13 percent in 2002 to 29 percent this year. Almost one-third (31 percent) of directors of German boards refused a directorship invitation on this basis, nearly triple the 11 percent who did so last year." This is due in part to the pressure on "over-boarded" directors. In the past, many directors served on as many as ten boards and former Secretary of Defense Frank Carlucci famously served on 30 (though not all were public companies). Stern Stuart's 2010 report found that "In recognition of the time and commitment required for effective service, two-thirds of S&P 500 companies now restrict the number of outside corporate boards their directors may join. As recently as 2006, only 27 percent did so. Of the 164 boards that do not have numerical restrictions, 65 (40 percent) ask that directors notify the chairman in advance of accepting an invitation to join another company board and/or they encourage directors to 'reasonably limit' their other board service."

The 34th Korn/Ferry report finds that directors are working longer hours but feeling greater satisfaction. "Directors surveyed in North America reported spending 16 hours per month on the work of one board, compared to 9.5 hours spent 20 years ago.... Probable factors in the increased workload include a significant increase in executive sessions (meetings at which no company employee is present) and the rising profiles – and responsibilities – of committees." They note, however, that directors in the UK and Australasia reported higher figures. GovernanceMetrics International estimates that director responsibilities take a minimum of 20 hours a month if everything is going well. If there is a problem, it can quickly become a full-time job.

BOARD DUTIES: THE LEGAL FRAMEWORK

The responsibility of today's boards of directors is little different from what it was in Hamilton's day. Compare Hamilton's statement of the role of the board with today's General Corporation Law of the State of Delaware, which reads: "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors."[13] Of course, since Hamilton's day, the legal implications of such statements have been examined and developed in enormous depth. Today, an enormously complex, ever-changing body of law governs the role of the corporate board of directors. For a complicated range of reasons, including the "Delaware factor" discussed in this book, there is a big difference between the obligations imposed on directors in theory and the ability of anyone – investors, regulators, courts, or anyone else – to enforce them.

Legally, most jurisdictions describe the director as having two duties, the duty of care and the duty of loyalty.

- *Duty of loyalty* means that a director must demonstrate unyielding and undivided loyalty to the company's shareholders. Thus, if a director sat on the boards of two companies with conflicting interests (both trying to buy a third business, for example), he would be forced to resign from one board because clearly he could not demonstrate loyalty to the shareholders of both companies at the same time.
- *Duty of care* means that a director must exercise due diligence in making decisions. She must discover as much information as possible on the question at issue and be able to show that, in reaching a decision, she has considered all reasonable alternatives.

These duties are assessed, however, within the context of the "business judgment rule."

When directors can demonstrate that they have acted with all due loyalty and exercised all possible care, the courts will not second-guess their decision. In other words, the court will defer to their *business judgment*. Unless a decision made by directors and managers is clearly self-dealing or negligent, the court will not challenge it, whether or not it was a "good" decision in light of subsequent developments. Keep in mind that the justification for this rule is that shareholders selected the directors and can replace them if they are not happy. As this chapter shows, both assumptions are invalid.

In practice, the business judgment rule means that judicial review following a challenge by shareholders is based on an examination of the process that led to the decision rather than the substance or the outcome. We do not want directors to become so worried about liability that they are too risk-averse. As long as they show care and loyalty, they will not be second-guessed. Under the business judgment rule, the courts will uphold almost any decision that is: (1) made by an independent board of directors acting disinterestedly (duty of loyalty); (2) made after careful and informed deliberation (duty of care); and (3) as reflected in the meeting minutes (proof of steps taken to ensure care). As noted in the Disney–Ovitz decision (discussed further below), "Fiduciaries who act faithfully and honestly on behalf of those whose interests they represent are indeed granted wide latitude in their efforts to maximize shareholders' investment." Times may change, but fiduciary duties do not. While courts play the most important role in defining the standard, other institutions may develop, pronounce, and urge adherence to ideals of corporate best practices. As in other areas of the law, courts will consider industry best practices in refining the notion of fiduciary obligation.

CASE IN POINT — THE WALT DISNEY COMPANY AND THE MAGICAL KINGDOM OF EXECUTIVE COMPENSATION

In 2006, the Supreme Court of Delaware examined the depth of a board of directors' fiduciary duties of good faith oversight in a case involving one of America's best-loved companies and an executive compensation agreement that resulted in an "only-in-Hollywood"

spectacular payout. Putting to rest a nearly decade-long dispute, the court ruled that the board of directors of the Walt Disney Company neither violated its fiduciary duties nor committed corporate waste in approving a compensation package that ultimately awarded nearly $130 million in severance payments to Michael Ovitz. Ovitz served only 14 months as the company's president and presumptive heir to then-Disney CEO Michael Eisner. Though the directors and officers were ultimately off the hook for charges of gross negligence and breach of their fiduciary duties because they had not "intentionally derelicted their duties or consciously disregarded their responsibilities," the case demonstrated the necessity of thorough examination of high-value compensation contracts and how even long-term friendships may not survive the stresses of the executive suites of the corporate world.

In 1994, Disney stood at the height of its animation renaissance, fuelled by a string of critically and commercially successful films such as *Beauty and the Beast* and *The Lion King*. However, Disney's President and COO, Frank Wells, died in a helicopter crash and Disney's CEO Eisner was diagnosed with heart disease and underwent quadruple-bypass surgery. In an unexpected leadership crunch, the board began seeking an executive of Eisner's caliber to succeed him as CEO. At Eisner's strong direction, a group of the board pursued Ovitz, Eisner's friend and the well-respected co-founder and head of one of Hollywood's premier talent houses, Creative Artists Agency (CAA). Luring Ovitz away from his position at CAA proved difficult, however, where he earned between $20 and $25 million per year. While the final employment agreement (EA) had "extraordinary" terms, the day Ovitz' hiring was publicly announced, the price of Disney shares rose 4.4 percent, a market capitalization increase of more than $1 billion. Estimated to pay nearly $24 million per year if fully completed, the EA granted Ovitz as many as 5 million options on Disney stock, a large annual salary, and discretionary bonus, and, should he be fired other than for cause, a "Non-Fault Termination" agreement (NFT) that consisted of his remaining salary, $7.5 million a year for any unaccrued bonuses, the immediate vesting of a first tranche of 3 million options, and a $10 million cash-out payment for the second tranche of options. Notably, the EA was largely negotiated by a group consisting of Eisner, two members of Disney's compensation committee, and an outside compensation consultant, without the knowledge of the rest of the board. It was finally circulated to and unanimously approved by the compensation committee in a one-hour meeting, after which an executive session of the board unanimously elected Ovitz President.

Ovitz's tenure was short and tumultuous. Ovitz frequently clashed with Eisner and other officers, apparently failing to adequately transition from the private company nature of CAA to the public company spotlight of Disney. As Ovitz continued to struggle in his new position, Eisner attempted to convince him to resign and seek employment elsewhere, making back-channel efforts to persuade him he was no longer welcome. That failing, Eisner and the board investigated the possibility of firing Ovitz for cause

in order to avoid paying the NFT. They decided that Ovitz's performance did not legally constitute "malfeasance" or "gross negligence" in the performance of his duties and that to attempt to fire him for cause may subject Disney to an even costlier wrongful-termination suit. Thus, they elected to pay the terms of the NFT. ■

CASE IN POINT THE DISNEY DECISION

The most significant corporate governance litigation of the post-Enron period was *In re The Walt Disney Co. Derivative Litigation*, the lawsuit about the $140 million compensation paid to Michael Ovitz for his short and stormy 14-month tenure as Disney's president. There was a 37-day trial, which generated 9,360 pages of testimony from 24 witnesses and 1,033 exhibits. The plaintiffs charged that the process that resulted in the hiring and firing of Ovitz was sloppy (a violation of the duty of care) and conflicted (a violation of the duty of loyalty).

In retrospect, the decision to hire Ovitz looks almost impossible to justify. The structure of his compensation package, which guaranteed him the $140 million whether he stayed or left, seemed to encourage failure. However, Ovitz, an agent always referred to in the trade press as "the most powerful man in Hollywood," was talking to a competitor, so failing to get him to join Disney appeared to be an enormous risk. His financial interest in his own firm was worth a great deal, so the opportunity costs were large. All of this was relevant in determining that the offer was within the bounds of the business judgment rule. The court was critical of CEO Michael Eisner's "having enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom," and noted that he had many "lapses," which included his failing to keep any directors outside a small circle of confidants informed during the negotiation process, stretching the boundaries of his authority, and prematurely issuing a press release that placed significant pressure on the board to approve his decision. His board included his lawyer, his architect, and two people in the administrations of the schools his children attended. However, this all still fell within the boundaries of "business judgment."

Filing a shareholders' derivative lawsuit against Eisner, Ovitz, and the remaining members of the board, the plaintiff Disney shareholders alleged the board committed corporate waste and violated its fiduciary duties to act in good faith and with due care by approving the original EA, its NFT provisions, and the massive severance payment. In its opinion dismissing the plaintiffs' claims, the court defined the duty of due care to require that directors of a Delaware corporation "use that amount of care which ordinarily careful and prudent men would use in similar circumstances," and to "consider all material information reasonably available" in making business decisions. The court maintained deficiencies in the directors' process are actionable "only if they represent bad faith

actions or conduct"; to be so, the directors' actions must be either "grossly negligent, an intentional dereliction of duty, or a conscious disregard for one's responsibilities."

Further, the court refused to conflate the duty of care with the duty to act in good faith, finding that such an approach would nullify the legislative intent to exculpate and indemnify directors from breaches of the duty of care provided in sections 102(b)(7) and 145 of the Delaware General Corporate Law. Finding that though it may have been foolish and "far from a best practices" approach for the board to give minimal oversight and for the compensation committee to approve the EA in the manner it did, under Delaware law the board and committee adequately informed themselves of the particulars of the agreement with all reasonably available material. Namely, the board and committee had knowledge, whether first or third-hand, of the spreadsheets prepared by the compensation consultant, and the baseline compensation packages provided to Eisner and Wells for comparison. Therefore, they reasonably should have known the possible magnitude of the payout. While declining to define bad faith, the court held that even if the court decided the board had committed gross negligence, such an action could not constitute bad faith. Finally, by holding that the decision to approve the EA with its NFT provision served a rational business purpose satisfying the business judgment rule, the court also dismissed the corporate waste claim.[14]

What is most important about the decision is the way it signaled that the protection it granted to the Disney board would not be available for future directors. The judge seemed to draw a line indicating that the court had reached the high-water mark for the extension of the business judgment rule and that what had been permitted under the pre-Sarbanes–Oxley era would not be permitted again. The judge warned future boards:

> *Recognizing the protean nature of ideal corporate governance practices, particularly over an era that has included the Enron and WorldCom debacles, and the resulting legislative focus on corporate governance, it is perhaps worth pointing out that the actions (and the failures to act) of the Disney board that gave rise to this lawsuit took place ten years ago, and that applying 21st century notions of best practices in analyzing whether those decisions were actionable would be misplaced.* ■

CASE IN POINT ILLICIT BACKDATING: TRENDS IN ILLEGAL EXECUTIVE COMPENSATION

Options "backdating" is a compensation device employed by boards of directors to issue stock options to employees via a form of postdating: the grant price of the options is based on a past market price of the underlying stock. It is beneficial for the recipient to have the options backdated to a date when the market price was relatively low so that,

when granted, the options are already "in the money," meaning above their "strike" price, the price it would cost to exercise the options. Exercising the backdated options then presents an instant, riskless profit opportunity for the recipient. While backdating options is not in and of itself an illegal practice if properly disclosed, accounted for, and consistent with a company's stock option plan, it would be much simpler to grant options at a price lower than the strike: the backdating provides an opportunity to cheat.

Backdating took center-stage in 2007 when the *Wall Street Journal* published a series of articles discussing a research paper by Professor Erik Lie that demonstrated stock prices tended to decrease before option grants and rise shortly afterwards. The pattern was remarkably pronounced and showed apparent systemic unreported options backdating by a large number of companies. This suggested boards of directors and officers were fraudulently employing backdating to illicitly increase their compensation. Responding to the reports, many financial services companies conducted their own studies of stock option grants to determine the possibility of liability for possible tax, securities law, and reporting violations; one such report by Merrill Lynch named Maxim Integrated Products, Inc. (Maxim), a developer of microprocessor technology, as one of several possible perpetrators of the practice. Following this revelation, plaintiff shareholders of Maxim filed derivative claims against the company and its board of directors alleging violations of their duties of due care and loyalty in approving the options, and simultaneously federal claims alleging violations of Rules 10b-5, 14a-9, and Section 13 of the Securities Exchange Act, alleging employment of fraud and false or misleading statements in the sale of securities, the promulgation of false company proxy statements, and false periodic reports with the SEC.

The plaintiffs' complaint alleged Maxim's board of directors and compensation committee granted millions of illegally backdated stock options to John Gifford, Maxim's founder, CEO, and chairman of the board on nine occasions from 1998 to 2002. Pursuant to Maxim's stockholder-approved stock option plans, on file with the Securities and Exchange Commission, the board contracted that the exercise price of all stock options granted would be no less than the fair market value of the company's common stock as determined by the publicly traded closing price on the date of the specific grants. The plaintiffs, relying on the Merrill Lynch report, based their fraud claims on the fact that all nine of the option grants were on unusually low trading days of the four years, and earned on average an annualized return of 243 percent, ten times higher than the 29 percent annualized market returns during the same time frame. Maxim and subsequently its shareholders were harmed by the lower price paid by Gifford to the company for the shares: as the options were for shares authorized but either held by the company as treasury stock or were otherwise unissued, in selling the shares to Gifford, Maxim received less money than the shares were intrinsically worth. Furthermore, under both IRS tax and SEC accounting rules, Maxim's annual and quarterly financial reports would have to be adjusted: the company in fact suffered lower earnings and overstated

profits than stated as a result of the backdated options, and the company would now also probably have to pay substantial penalties. Notably, the court permitted the case to proceed standing only upon the statistical analysis demonstrating the uncanny timing and extreme profitability of the option grants, holding the "timing [of the grants] seems too fortuitous to be mere coincidence," smacking of impropriety and sufficiently alleged to survive the defendants' motion to dismiss.

In rejecting the defendants' procedural and choice of forum defenses, the court further considered the defendants' substantive legal arguments in their motion to dismiss and rejected those as well. The board principally contended that the plaintiffs failed to make "demand" upon the board to investigate the alleged grievance and otherwise failed to prove that such demand would in any event be futile. Demand, a tool to prevent "myriad individual shareholders from bringing potentially frivolous lawsuits on behalf of the corporation" via derivative actions, is a requirement of Delaware law forcing shareholders to demonstrate that the board of directors was given sufficient opportunity or notice ("demand") to investigate alleged wrongdoing, and failed to do so. However, the capability of the board to make independent, disinterested judgment is sometimes not presumed and demand excused ("futile") when a plaintiff demonstrates that the majority of the directors are either (A) interested in the transaction or (B) the challenged acts were not the product of the board's valid exercise of business judgment.

Though Maxim's compensation committee approved the option grants, a subset of the board and not the full set of directors, the court held that because one-half of the current board was composed of directors serving on the compensation committee and therefore implicated in the challenged transactions, demand was futile and excused under *Aronson* as a majority of the board was compromised by the decisions to backdate the option grants. The court further found that, in any event, demand would remain futile under *Rales* as backdating option grants is "one of those rare cases [in which] a transaction [is] so egregious on its face [and] cannot meet the test of business judgment," and therefore the culpability for the transaction could be imputed to the entire board.

Finally, the defendants did not have the benefit of the broad protections of the business judgment rule, as the court was "unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures… is anything but an act of bad faith." The court's ruling illustrated the continued importance for directors not only faithfully to fulfil their substantive fiduciary duties of due care and loyalty but also not to make knowing and intentional misrepresentations. Such conduct, including the fraudulent awarding of backdated stock options, violates the directors' duty of loyalty, and therefore could expose them to liability for the challenged transactions as Delaware law exempts actions taken in bad faith from the indemnification and exculpation clauses of the DGCL.[15] ■

CASE IN POINT — UPPER DECK v. TOPPS: GETTING A FAIR CHANCE

For generations, Topps Company (Topps) trading cards and candies were a staple of nearly every American household. Primarily a purveyor of major league baseball and "Pokémon" trading cards, the company is also famous for its "Bazooka Joe" bubble gum and Ring Pops. Topps, though publicly owned, could be considered a family-run (if not dominated) business: Arthur Shorin ("Shorin"), its CEO and Chairman of the board, had worked for Topps for more than 50 years, taking over from his father Joseph, who had founded the company. However, years of declining market performance, takeover attempts, and proxy contests took their toll; after a proxy contest in which Shorin and the incumbent directors were forced to seat a slate of "insurgent" directors (i.e. directors opposed to the strategy of the incumbent Topps management), Topps began negotiations to go private in 2007. Michael Eisner (yes, the same one), leading a coalition of private equity firms, Madison Dearborn Partners and The Tornante Company (for simplicity, as in the court's opinion, "Eisner"), offered to "be helpful" to Shorin and to buy out the company's existing shareholders. Part of this deal included Eisner's assurances to retain Shorin and many members of Topps' present management in their original positions or as consultants.

The insurgent directors balked at Eisner's offer. They preferred a public selling process, believing they could extract a higher value per share from another bidder. However, after several previous attempts, no serious buyer had yet materialized. Before Topps' deal with Eisner could be finalized, Topps received a higher bid from its perennial arch rival, cardmaker The Upper Deck Company. In a decision effectively enjoining the merger between Topps and Eisner, the Delaware Chancery Court opinion examined the requirements of *Revlon* duties and the legality of modern deal-making provisions known as "go-shops" and "standstill" agreements in a modern takeover contest.

Topps' original merger agreement with Eisner (the "Eisner Proposal") provided that Eisner would purchase Topps for $9.75/share, nearly $385 million dollars in total. Its first problematic term, known as a "go-shop" provision, entitled Topps to spend 40 days freely shopping for offers "like Paris Hilton" from other parties interested in acquiring the company. If a bidder met certain qualifications, Topps was allowed to either accept the new offer subject to Eisner's right to match it or to continue in negotiations with the company past the expiration of the go-shop period; otherwise, negotiations with the other company were required to cease. Should Topps abandon the Eisner Proposal, it would have to pay a "termination fee," escalating depending on whether or not the go-shop period had ended.

Perhaps unfortunately for Topps, the only serious bidder to emerge during the go-shop process was Upper Deck. Upper Deck ultimately desired to submit a proposal

to purchase Topps via a tender offer directly to its shareholders for $10.75/share, or $416 million dollars: a $31 million dollar premium over the Eisner Proposal. However, the course of business between Upper Deck and Topps was anything but cordial and a second issue emerged: the legality of Topps continuing to enforce the "standstill" provision it had agreed to with Upper Deck as part of a confidentiality agreement signed when they entered negotiations. The standstill provision required Topps to make available to Upper Deck certain information concerning the business and financial condition of Topps solely for the purpose of enabling Upper Deck to evaluate a possible takeover of the company and, in exchange for that information, Upper Deck agreed not to publicly disclose that it had entered into the standstill agreement or make any other disclosure regarding the possible sale of Topps to Upper Deck. Third, Upper Deck agreed not to attempt to take control of Topps via acquisition of any of Topps' stock through purchase in the open market, tender offer, or otherwise without Topps' consent, or to solicit proxies or seek to control Topps in any manner.

Rejecting Upper Deck's proposal and effectively ending the go-shop period in Eisner's favor, Topps' directors cited their fears that Upper Deck failed to prove an ability to finance the transaction, antitrust concerns, and the small reverse termination fee Upper Deck would be obligated to pay in the event they chose not to complete the acquisition. Upper Deck alleged that in ending the go-shop period, by enforcing the provisions of the standstill agreement prohibiting Upper Deck from telling its side of the story, and recommending in their proxy statement that the shareholders accept the Eisner Proposal, Topps' directors illegally prevented Upper Deck from making a stronger proposal and violated their duty to provide their stockholders with the material facts relevant to making an informed decision on the merger vote.

In granting Upper Deck's motion for a preliminary injunction of the merger vote, the Delaware Court agreed with Upper Deck's contentions regarding the entrenched nature of Topps management and the unfairness of the standstill agreement, but deemed the go-shop provision acceptable. The *Revlon* fiduciary duties require that when directors propose to sell a company or engage in a change of control transaction, they must take reasonable measures to ensure that the company's stockholders receive the highest value reasonably attainable. Due to the Shorin family's intimate relationship with Topps and Eisner's assurances to incumbent management, this standard was particularly implicated as any favoritism Topps' directors displayed towards a particular bidder had to be justified solely by reference to the objective of maximizing price. Any bias to unfairly tilt the process toward the bidder more likely to perpetuate the current management would constitute a breach of fiduciary duty.

The Court found particularly egregious Topps' failure to disclose in the proxy statement Eisner's assurances to incumbent management that their jobs would be secure in a post-merger company and the management's failure to reveal discounted cash flow valuations of Topps' future revenues presented by Lehman Brothers. Those valuations

pegged Topps' value in a range anywhere from $8.76/share (the most moderate case) to $12.57/share (the most aggressive), depending on the discount rate. However, the court found Topps revised the initial numbers to present a value range in the proxy statement of $8.76 to $10.16 per share in order to make the Eisner Proposal more attractive to shareholders. Third, the Court held that Topps had made materially misleading statements in its representations of Upper Deck's proposal, finding Topps cited illusory concerns regarding financing and antitrust issues, and failing to note that the termination fees required of Upper Deck should the deal evaporate were substantially similar to those required of Eisner. However, the Court found the features of the go-shop provision to be substantially in line with *Revlon* requirements, refusing to find the advantages given to Eisner as unreasonable. Finding Eisner had the right to protect his Proposal, the Court noted that while deal protections like Eisner's negotiated termination fees may deter potential bidders at $10/share when a deal is in place for $9.75, a bird in the hand is often worth two in the bush and such protections cannot be seen as unreasonable.[16] ■

CASE IN POINT THE DUTY OF LOYALTY – A RACE TO THE BOTTOM?

In 2004, AmSouth Bancorporation (AmSouth) paid $50 million in fines and civil penalties to settle government investigations regarding AmSouth's employees' systematic failure to file "Suspicious Activity Reports," required by various federal banking and anti-money-laundering regulations. The fines arose from the aftermath of a Ponzi scheme (run by a lawyer and a registered investment advisor). The two criminals created a fictitious business venture in which victims could invest their money in custodial trust accounts set up with AmSouth to supposedly finance the construction of medical clinics overseas. In actuality, the investors' money was unbeknownst to them invested in high-return promissory notes subject to correspondingly high levels of risk. The scheme failed and the fraud was discovered; while the two men pled guilty, officials continued to investigate AmSouth's compliance with reporting obligations under various banking laws including the federal Bank Secrecy Act (BSA), and AmSouth ultimately acquiesced to multiple agreements with various federal and state agencies. These included a Deferred Prosecution Agreement (DPA) with the United States Attorney's Office and a Cease and Desist Order with the Federal Reserve, in which AmSouth agreed to pay the $50 million in fines, improve its BSA compliance and anti-money-laundering programs, and implement new policies and procedures to prevent future bank crime. Though the Financial

Crimes Enforcement Network (FinCEN) found AmSouth "violated the [activity reporting and anti-money-laundering program] requirements" of the BSA and specifically concluded AmSouth's board and management failed to adequately oversee the company's compliance programs, nowhere did AmSouth itself attribute any fault, wrongdoing, or failure of oversight to its board or any director, and neither admitted nor denied any of FinCEN's determinations in any forum.

Plaintiff AmSouth shareholders filed a derivative suit alleging the directors breached their duty of oversight, and further that the directors' actions demonstrated an "utter failure" to act in good faith to put into place policies and procedures to ensure compliance with the violated regulations. The viability of their claim depended on whether demand upon the board to sue itself could be excused; for demand on the board to be excused, the plaintiff must create a reasonable doubt that as of the time the complaint was *filed*, the board of directors could not have properly exercised its independent and disinterested judgment in responding to a demand. The plaintiffs alleged that as the directors faced a substantial likelihood of liability for their failure to oversee AmSouth's BSA and anti-money-laundering programs, they are personally interested in the outcome of such a complaint and therefore demand should be excused.

If *In re Disney* can be seen to set the rules for what does NOT constitute bad faith director **conduct**, *Stone v. Ritter* can be seen as the new standard for what does NOT constitute bad faith director **oversight**. As noted in *Disney*, the standard of director liability had traditionally been set by the influential *Caremark* case, in which the Delaware Court held "where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a sustained or systematic failure of the board to exercise oversight – such as an 'utter failure' to attempt to assure a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition to liability." Otherwise, as explained in *Disney* and *Gifford*, such claims escape director liability via Delaware's director exculpation clause, section 102(b)(7). *Caremark* established what has been referred to as a "red flag" test, finding the "duty to act in good faith [does not] require directors to possess detailed information about running the enterprise," but merely a way to ensure things are not running particularly amuck.

Dismissing the plaintiff's complaint, the Delaware Court found that the plaintiffs failed to show that demand should be excused. Examining its previous ruling in *Disney* and holding *Caremark* articulated the prerequisites for director liability, the Court differentiated the two as types here as either (1) the directors utterly failed to implement **any** reporting or information system or controls or (2) having implemented such a system of controls, but consciously failed to oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention. Most importantly, the Court required a showing that the directors **knew** that they were not discharging their fiduciary obligations, making what had previously been considered in the *Caremark* line

of cases as a violation of the duty of care as something requiring a violation of the duty of loyalty.[17] Finding that a reasonable reporting system existed to satisfy *Caremark's* requirements, the Court cited accounting and auditing firm KPMG's report evaluating the components of AmSouth's compliance program. That report noted that the compliance program did in fact have BSA, anti-money-laundering, and suspicious activity officers, departments, and committees, whose job descriptions included investigating and reporting to the board on compliance issues. AmSouth's board's Audit Committee oversaw these compliance programs on a quarterly basis, and some of them reported directly to the board, thus discharging the directors of their duty to establish an information and reporting system. Thus, Delaware Courts continued their push even further towards **knowing and complete dereliction of the duty of oversight** arising to a breach of the duty of loyalty before an action to incur director liability can be maintained. ■

CASE IN POINT FURTHER EXPLORATION OF THE REQUIREMENT OF GOOD FAITH

The Delaware Chancery Court's 2008 ruling in *McPadden v. Sidhu*[18] continued to distinguish the fine boundary between the independent duties of loyalty and of due care. Following a questionable management buyout and quick-flip by an interested corporate officer of the defendant corporation, the court excused demand upon the board of directors as futile, but failed to find the defendant corporation's board of directors liable for breaches of their duties of loyalty or due care. Nevertheless, the court found actions for breach of loyalty and unjust enrichment could proceed against the interested corporate officer defendant.

In 2001, defendant i2 Technologies, Inc. (i2), a Delaware corporation based in Texas, purchased Trade Services Corporation (TSC) and a related company for $100 million. At the time, defendant Anthony Dubreville ("Dubreville") was President and CEO of TSC. Dubreville carried on his leadership role within i2 as Vice President in charge of the Content and Data Services Division (CDSD), which included the wholly-owned TSC subsidiary. Shortly after TSC's purchase by i2, rival company and target of previous TSC litigation Vision InfoSoft/MaterialExpress.com (VIS/ME) offered to purchase TSC for $25 million in 2003. While i2's board initially declined, by early 2005 the board had decided to sell off TSC, and placed Dubreville in charge of the sale. The court found this arrangement intractably problematic, as Dubreville had previously indicated to members of i2's board his desire to lead a buyout of TSC, had intimate knowledge of TSC's financial situation, and was further alleged by the plaintiffs to have manipulated TSC's

earnings through expensive frivolous lawsuits and unnecessary expenditures to make TSC appear less valuable than it actually was.

In any event, Dubreville only managed to attract two nonrelated bids for TSC. Failing to contact VIS/ME, though aware of its previous interest, the other bidding groups were an independent company that offered an extremely low price for i2's entire (and not for sale) CDSD division, and the second group offered $1.8 million, notably led by Dubreville's former boss at TSC. While Dubreville had previously presented reports in 2004 predicting TSC's FY2005 revenues at $16 million, in preparing for the sale i2's investment banker Sonenshine Partners submitted two updated projections that valued the company between $3 and $7 million, significantly less. With less than a week passing between the receipt of the Sonenshine's presentation of the fairness opinion, the review of the company's financial outlook, and the board's decision, a group led by Dubreville named Trade Service Holdings LLC (TSH) in a sale arranged by himself won the bidding with a $3 million agreement that included very favorable terms towards TSH. Less than a year later, Dubreville led a sale of TSC to VIS/ME for more than $25 million.

Finding demand on the i2's board was excused because the plaintiff shareholders had pleaded a duty of care violation sufficient to create reasonable doubt the sale was a valid exercise of business judgment, the Court took the defendant board directors to task for the "egregious" misjudgment of putting the obviously interested Dubreville in charge of the TSC sale. Further, holding that the Sonenshine valuation of between $3 and $7 million should have put the board on notice to investigate whether Dubreville's offer was sufficient, the Court decided the directors were grossly negligent in their decision to sell TSC. The court nevertheless found that the plaintiffs had failed to state a claim against i2's directors because section 102(b)(7) of the Delaware General Corporate Law and the provision in i2's charter exculpated and indemnified the company's directors from personal liability for breaches of the duty of due care. As even negligence as gross as this cannot cross the boundary into a violation of the duty of good faith and therefore loyalty, the Court had no choice but to dismiss the case as to i2's board of directors. However, the Court found Dubreville unprotected by 102(b)(7) by virtue of his capacity as an officer and not a director of the corporation, and permitted the claims of breach of the duty of loyalty and unjust enrichment to proceed as to him alone. ■

Of course, laws offer only a general definition of the director's role. The law, after all, must be sufficiently flexible to cope with ever-changing business developments that are forever challenging directors with new issues and questions to resolve. As we shall see later, the takeover era of the 1980s and the scandals and meltdown of the early 2000s caused a fundamental re-evaluation of these concepts.

Many people have tried to step beyond the legal definitions of a board's duties and develop more specific descriptions of the responsibilities of the directors. Director Betsy Atkins recommends "the duty of curiosity." The Business Roundtable, representing the largest US corporations, describes the duties of the board as follows:

> *First, the paramount duty of the board of directors of a public corporation is to select a chief executive officer and to oversee the CEO and senior management in the competent and ethical operation of the corporation on a day-to-day basis.*
>
> *Second, it is the responsibility of management to operate the corporation in an effective and ethical manner to produce value for shareholders. Senior management is expected to know how the corporation earns its income and what risks the corporation is undertaking in the course of carrying out its business. The CEO and board of directors should set a 'tone at the top' that establishes a culture of legal compliance and integrity. Management and directors should never put personal interests ahead of or in conflict with the interests of the corporation.*
>
> *Third, it is the responsibility of management, under the oversight of the audit committee and the board, to produce financial statements that fairly present the financial condition and results of operations of the corporation and to make the timely disclosures investors need to assess the financial and business soundness and risks of the corporation.*
>
> *Fourth, it is the responsibility of the board, through its audit committee, to engage an independent accounting firm to audit the financial statements prepared by management, issue an opinion that those statements are fairly stated in accordance with Generally Accepted Accounting Principles and oversee the corporation's relationship with the outside auditor.*
>
> *Fifth, it is the responsibility of the board, through its corporate governance committee, to play a leadership role in shaping the corporate governance of the corporation. The corporate governance committee also should select and recommend to the board qualified director candidates for election by the corporation's shareholders.*
>
> *Sixth, it is the responsibility of the board, through its compensation committee, to adopt and oversee the implementation of compensation policies, establish goals for performance-based compensation, and determine the compensation of the CEO and senior management.*
>
> *Seventh, it is the responsibility of the board to respond appropriately to shareholders' concerns. Eighth, it is the responsibility of the corporation to deal with its employees, customers, suppliers and other constituencies in a fair and equitable manner.*[19]

Other groups have developed similar lists. The following, for instance, is the guide developed by the American Law Institute about the responsibilities of the board:

1. Select, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives.
2. Oversee the conduct of the corporation's business to evaluate whether the business is being properly managed.

3. Review and, where appropriate, approve the corporation's financial objectives and major corporate plans and actions.
4. Review and, where appropriate, approve major changes in, and determinations of other major questions of choice respecting, the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements.
5. Perform such other functions as are prescribed by law, or assigned to the board under a standard of the corporation.[20]

The American Law Institute also adds that the board has other powers, including the power to initiate and adopt corporate plans, commitments, and actions, initiate and adopt changes in accounting principles and practices, provide advice and counsel to senior executives, instruct any committee or other appropriate person or group to review the actions of any committee, principal senior executive, or other officer, make recommendations to shareholders, and act on all other corporate matters not requiring shareholder approval.

These lists, though they differ in emphasis, sum up the generally accepted duties of the board. Beneath such umbrella definitions stand the myriad details that the board might attend to: quarterly results and management's projections for the next quarter, the company's long-term strategic goals, its capital structure, debt financing, asset allocation, the need to buy or sell assets, dividend policy, CEO succession planning and compensation, assessing the board's own effectiveness, regulatory compliance, research and development projects, the status of the corporation's competitors, and the company's global prospects.

Most commentators agree, however, that umbrella definitions do not adequately describe a job that has lofty – and nebulous – responsibilities. The difficulty lies in the fact that although boards of directors are burdened with the responsibility of ensuring that management runs the enterprise efficiently, they are not permitted (as a practical or legal matter) to become intimately involved in the running of the company. The board is there to evaluate performance and to respond promptly if it is not satisfactory. They are there for the perspective-restoring forest, as the managers focus on the trees, leaves, and bark.

The board is not sufficiently involved in the day-to-day decisions of the company to determine how the company should be managed – that is the job of the executives. As one academic comments: "Outside directors likely have the most difficult job of all – not running the store, but making sure that the individuals running the store run the store as well as possible."[21] As a result, many believe that the primary responsibility of directors is to see that they have the best management talent available – the best people to run the store – to align incentive compensation with long-term, sustainable, value creation, and to replace managers promptly if performance slips.[22] Directors are responsible for the overall picture, not the daily business decisions, or, as one long-time observer likes to say, a director's position should be NIFO – "nose in, fingers out."

THE BOARD'S AGENDA

A *Corporate Board Member*/FTI Consulting survey found that the top ten concerns of public company directors are:

1. Executive compensation
2. Governance and compliance

3. Mergers and acquisitions
4. Investor relations
5. Operational risk
6. Liquidity
7. Internal controls
8. Managing media and company reputation
9. Managing outside legal fees
10. Proxy and director election issues[23]

Is anything missing? What is the best way to organize the board and committee meetings to address these issues?

In the past, the Delaware courts have bent over backwards to defer to the "business judgment" of the directors. Without compelling evidence of self-dealing, the court will not interfere with the board's decision. Occasionally, though, the courts will provide a warning. In the 1996 case *In re Caremark International Inc. Derivative Litigation*, Chancellor William T. Allen of the Delaware Chancery Court addressed the circumstances under which corporate directors may be held liable for breaching their duty of care by failing to adequately supervise the conduct of corporate employees accused of causing the corporation to violate the law. The case arose out of the 1994 indictment of Caremark International Inc., a provider of patient and managed healthcare services, and two of its officers and several mid-level employees for violations of federal healthcare reimbursement regulations under the Anti-Referral Payments Law (ARPL), prohibiting healthcare providers from paying any form of remuneration to induce the referral of Medicare or Medicaid patients.

Following the indictments, shareholder derivative complaints were filed in the Delaware Chancery Court. Those complaints alleged that Caremark's directors breached their fiduciary duty of care by failing to monitor activities of the company's employees or to institute corrective measures that may have prevented the unlawful conduct, thereby exposing Caremark to substantial liability. No senior officers or directors were charged with wrongdoing in either the indictments or the government settlement agreements. Caremark and its directors then entered into a settlement with the shareholder plaintiffs. As part of this settlement, Caremark agreed, among other things, to establish a new compliance and ethics committee of the board of directors to monitor business segment compliance with the ARPL and report to the entire board semi-annually concerning compliance by each business segment.

The court, in ruling on a settlement agreement, addressed the issue of the standard to be applied. Because there was no evidence that the directors knew of the violations, the question was whether they should have known.

> "*A director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system . . . exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by noncompliance with applicable legal standards . . . only a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition to liability.*"

Other descriptions of a board's responsibility are more general in their approach. Sir John Harvey Jones, the highly successful chief executive of Imperial Chemical Industries in the UK during the 1970s and 1980s, sums up the difficulty of defining the director's role:

> *Management consultants are there for every conceivable part of the manager's job. But you try getting advice, guidance, a course, or a specialist book on the skills of being a good director of a company, and you will find almost nothing except a great deal of mystique.*
>
> *The job of the board is all to do with creating momentum, movement, improvement and direction. If the board is not taking the company purposely in the future, who is? It is because of boards' failure to create tomorrow's company out of today's that so many famous names in industry continue to disappear.*[24]

From this description, one commentator who has served on many boards describes his role as "creating tomorrow's corporation out of today's."[25]

To put the current situation and prospects for change into context, we will examine its first significant modern-day challenge: the takeover era.

THE EVOLUTION OF BOARD RESPONSIBILITIES: THE TAKEOVER ERA

In the 1950s, corporate lawyers felt that their job had been done – they had no questions left to answer! As academic Bayless Manning put it in 1962: "Corporation law, as a field of intellectual effort, is dead in the United States."[26]

However, a number of high-profile corporate crimes in the 1970s prompted a fresh look at the role of directors. The Watergate scandal shed light on the problem of illegal campaign contributions. On the international front, sleazy tales emerged of corporations bribing foreign officials to keep out competition, leading to the passage of the Foreign Corrupt Practices Act in 1977. The failure of the boards of directors, whose job it was to prevent such transgressions, was blamed at least in part on a lack of independence.

Academics, investors, and others began to put more emphasis on the importance of independent directors – directors not primarily employed by the company. In theory, outsiders are not dependent on the chief executive for promotion, or for legal or consulting business. Thus, they are relatively free from conflicts of interest and better able to protect the owners' interests. This philosophy prompted companies to raise the number of outside directors in America's boardrooms, and, more importantly, the ratio of outsiders to insiders on the typical board. Corporate apologists preferred this approach to additional government regulation and oversight. Corporate critics agreed, at least in theory, that if "outsiders" command a powerful majority in the boardroom, they will be better able to check any tendency of those in top management to abuse their positions of power.[27] True or not, the notion of raising the ratio of outsiders to insiders on corporate boards proved extremely popular. Over the past three decades, America's boardrooms have witnessed a remarkable growth in the power of independent outside directors – in 1973, insiders occupied 38 percent of the seats in the average boardroom; today that ratio has dropped to 20 percent.[28]

However, "independence" can also mean "indifference." It certainly does not guarantee courage or focus. More recent efforts have been directed not just at making sure that boards have independent directors but also at giving them a structure that makes it possible for them to monitor more effectively.

One early reform that had an enormous impact on the importance of the independent directors was a requirement by the New York Stock Exchange in 1978 that every listed company had to have an audit committee made up of a majority of outside directors. This forced companies to have at least two outsiders on their board. According to a Spencer Stuart boardroom survey in 1990: "The ratio of outside to inside directorships, which climbed steadily during the 1980s, reached a new high in 1990."

This increase has continued, as many corporate governance experts recommend that, other than the CEO, the board be made up entirely of independent outside directors. There are other indications that outside directors have become an increasingly dominant force on corporate boards. The number of "affiliated outsiders," those with some form of "related party transactions" or other relationship to the company, has also declined.

Twenty-five years later, the takeover era turned Manning's statement on its head. The creation of financial instruments to finance takeovers of any company, of virtually any size, presented directors with the most demanding challenges in corporate history.

Justifying decisions in terms of benefits to shareholders is one thing when the issues relate to marketing or research and development, and quite another when they relate to whether the entity will continue in its current state or be swallowed up by another company. Making a decision that affects the job security of the CEO who brought you on the board (to say nothing of your own job security as a director) is also of necessity less dispassionate than making a decision about ordinary business.

The early takeovers (and efforts to block takeovers) challenged in court produced judicial decisions reflecting concerns about the difficulty directors would have in acting on behalf of the shareholders when the interests of management, and perhaps the directors' own interests, could be in conflict.

The early challenges to takeover defenses produced case law that reflected traditional notions of the director's duty, and traditional concerns that corporate managers and directors would have a natural tendency to protect their own interests to the detriment of the shareholders'. In the most important of the early cases, *Trans Union* (see *Smith v. Van Gorkom* discussed in the case in point below), the court ruled against directors for agreeing to a sale of the company in a manner that seemed almost impetuous. Since the board had not taken enough steps to ensure that they were getting the best price, ruled the court, they had not met their duty as fiduciaries. In *Trans Union*, the board gave in too easily.

In the next wave of cases, the courts objected when the boards did not give in easily enough. Those cases, including *Revlon* and *Unocal*, concerned efforts by boards to block takeovers. When shareholders sued, the courts had to decide whether there was any limit to the defensive maneuvers a board could undertake in the face of an offer to buy the company.

THE FIDUCIARY STANDARD AND THE DELAWARE FACTOR

The Delaware courts have decided most of the cases relating to takeovers, because most big companies are incorporated there. Some other courts have addressed the business judgment rule. The New York court ruled, for example, that issuing a block of stock to an ESOP and a wholly controlled

subsidiary, just to avoid a takeover, violated the duty of loyalty.[29] In general, however, Delaware has a lock on the Fortune 500, and when it seemed that decisions limiting the protection of the business judgment rule might lead companies to incorporate elsewhere, the Delaware courts began to back off (see "Delaware puts out," chapter 1).

CASE IN POINT TRANS UNION

In the landmark case of *Smith v. Van Gorkom*,[30] directors were found to have violated their fiduciary duty over the sale of Trans Union. The CEO of Trans Union, Jerome William Van Gorkom, suggested to potential buyer Jay Pritzker that $55 per share would be a good offer for his company, without consulting anyone on his board. When the board did meet to discuss the deal, Van Gorkom did not tell them that it was he who had suggested that figure to Pritzker, and he did not tell them how he had arrived at it. He did not ask the board whether it was the best price, just whether it was a fair price.

After about two hours, the board approved the deal, subject to two conditions: first, the company could accept (though not solicit) another offer during a "market test" period and, second, to facilitate other offers, that the company could share proprietary information with other potential bidders.

The market test was a brief one. With the permission of his board, Van Gorkom signed the merger agreement that evening, although, the court found, at the time the agreement was executed neither Van Gorkom nor any director had read it.[31] Trans Union issued a press release announcing a "definitive" merger agreement, "subject to approval by stockholders."

The shareholders did approve the deal, but one shareholder sued. The lower court upheld the actions of the directors, but the Delaware Supreme Court reversed that finding, ruling that the Trans Union directors were "grossly negligent" in failing to make an independent determination of whether Van Gorkom did a complete job of evaluating the price and negotiating the terms of the merger agreement and in failing to understand the transaction themselves.

The issue was not the substance of the decision; the court never said whether $55 per share was too low or too high. Instead, the issue was one of process. The court ruled that the directors had not taken adequate steps to be able to evaluate the offer. The substantial premium over the market price, the "market test" period for entertaining other offers, the advice of counsel that they might be violating their duty as fiduciaries if they failed to approve the merger, and the shareholder vote were not sufficient to make up for the board's failure to evaluate the deal independently. It should be noted that this was a close case – two justices dissented, finding the directors' actions reasonable. Controversy notwithstanding, however, *Van Gorkom* became the litmus test for directors' duty. ■

The primary impact of the *Van Gorkom* case has been on the process for arriving at decisions, not on the substance of the decisions themselves. Courts have been very careful not to substitute their business judgment for that of boards. As long as a process is followed, the courts will defer to it. But the processes themselves have little substantive meaning. Law firms present boards with routine checklists of options that are then "considered" just to make a strong record in case of a challenge in court, rather than for any substantive purpose. And, sometimes, the record does not even need to be very strong, as in the Time Warner case study, where all the steps taken to establish due care and deliberation were taken in consideration of a deal that was different in every major respect (except management compensation) than the deal that went through.

CASE IN POINT UNOCAL AND REVLON

In *Unocal*,[32] the court expressed its concern with the "omnipresent specter" that a board would act to protect its own interests when faced with a takeover offer. For that reason, any action to protect the company from a contest for control would be reviewed with special care by a court reviewing a challenge, based on the assumption that the board and the top managers had a conflict of interests between what was best for them and what was best for the shareholders.

While the courts normally give directors' "business judgment" great deference, in takeover cases (as in other cases of possible conflicts of interest), directors have what the law calls a "burden of proof" and therefore have to show "good faith and reasonable investigation" before the courts will defer to their decision. They also have to show that, unlike the actions of the Trans Union directors, their decisions were "informed." Directors' decisions must also meet another test: they must be "reasonably related to the threats posed."[33] Directors are not supposed to use an atom bomb to fight a squirt gun; if they do, it must be assumed that their primary interest is their own job security.

When Revlon adopted a poison pill[34] in reaction to Pantry Pride's offer of $45 a share, that was "reasonable in relation to the threat posed."[35] However, when Pantry Pride increased its offer to $53, the defensive measures were no longer reasonable. At that point, according to the court, "it became apparent to all that the break-up of the company was inevitable" and "the directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." The court lambasted the directors' decision to grant favorable treatment to a white knight whose offer was only $1 per share more than Pantry Pride's, even though its offer provided more protection to note-holders. "[T]he directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions. Market forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity."[36] The court decided that once a company was "for

sale," the only factor to be considered was the best price for shareholders; any other interest was a breach of the directors' fiduciary duty of loyalty.

The court specifically addressed the issue of "stakeholders." As discussed in chapter 2, the nonshareholder constituencies also have an interest in the company and have sought to advance these interests at the board level. The court said that although boards may consider other interests, "there are fundamental limitations on that prerogative. A board may have regard for various constituencies in discharging its responsibilities, provided that there are rationally related benefits accruing to the stockholders.... However, such concern for nonstockholder interests is inappropriate when an auction among active bidders is in progress, and the object is no longer to protect or maintain the corporate enterprise but to sell it to the highest bidder." ■

HOW DID BOARDS RESPOND?

The takeover era of the 1980s demonstrated that the market for corporate control was more theoretical than real. Boards of directors and management joined to protect their companies from the threat of a hostile raid, but, ironically, they only distanced themselves from their own shareholders. By the end of the 1980s, most large companies bristled with a host of "anti-takeover" devices – collectively known as "shark repellents" – that only served to render management and the board still *less* accountable than they had been before. As we saw in chapter 2, these protective devices were one of the main reasons for the emergence of shareholder activists, and the dismantling of such devices was one of their main early aims.

GREENMAIL

Possibly the most unconscionable way of avoiding takeover, greenmail forced shareholders to bear the cost of management's incumbency. There is a reason "greenmail" sounds a lot like "blackmail," though it is really more like extortion. Someone buys a large stake in the company and begins to make his presence known, perhaps by making noises about trying to take over the company. Management does not want him, so they offer to buy him out, at a substantial bonus over the market price of the stock. Raiders achieve huge profits without even having to make a bid for the company; managers are able to keep their jobs. All other shareholders, however, are left with the market trading price, which often went down as a result of a large cash payment being made to silence a potential dissenting voice.

One of the earliest payments of greenmail was in 1984. The Bass brothers had acquired 9.9 percent of Texaco and were known to be interested in purchasing the other 90.1 percent. Instead, Texaco's management paid the Bass brothers $1.3 billion for the stock, a $137 million premium over the market price. In other terms, the Bass brothers were able to sell their stock for $55 per share, while the vast majority of shareholders could only get $35. The payment so infuriated the then-Treasurer of California, Jesse Unruh, that he formed the highly influential Council of Institutional Investors to lobby for improved shareholder rights.

Greenmail is evidence of board neglect. Directors should not permit managers to pay huge sums of shareholders' money merely to avoid possible loss of control. In all likelihood it was not in Texaco's interest to be taken over by the Bass brothers, but that is something for the market to decide. Moreover, the majority of shareholders should have been allowed to decide if selling their shares to the Basses was in their best interests. The Texaco board should have let the company's shareholders make that choice. A few years later, when Carl Icahn went after Texaco, then with very little credibility following not just the greenmail payment to the Bass brothers but an ugly lawsuit that led to bankruptcy, the shareholders were still able to determine that Texaco's highly credible new CEO, Jim Kinnear, presented a better prospect for the creation of shareholder value than a serial corporate raider.

"POISON PILLS"

In November 1985, in *Moran v. Household International, Inc.*, the Delaware Supreme Court upheld a company's right to adopt "shareholder rights plans," or "poison pills" as they are called by everyone apart from corporate management. Moreover, the Delaware court allowed a pill to be created without shareholder approval. The plans usually take the form of rights or warrants issued to shareholders that are worthless unless triggered by a hostile acquisition attempt. If triggered, pills give shareholders the ability to purchase shares from, or sell shares back to, the target company (the "flip-in" pill) and/or the potential acquirer (the "flip-over" pill). While a pill has the effect of entrenching a company from an unsolicited takeover, it also protects shareholders from such coercive practices as two-tier offers.

The widely used flip-over plan gives target shareholders the right to purchase shares of the potential acquirer's common stock at a steep discount, usually 50 percent, should the acquirer attempt a second-stage merger not approved by the target's board. Since the built-in discount would encourage all of the target shareholders to exercise their rights and purchase shares from the acquirer, and since the potential acquirer's shareholders would be prevented from participating, the result would be that the acquirer's pre-existing shareholders would find their own equity interests substantially diluted once the pill was triggered and the rights exercised. This is the "poison" in the pill.

The flip-in plan is often combined with a flip-over plan. On the triggering event, rights in a flip-in plan allow target shareholders to purchase shares of their own company at a steep discount, again usually 50 percent. The right is discriminatory in that the potential acquirer is excluded from participating if the pill is triggered by an action not approved by the target's board.

The pill is a "doomsday device" with such potent wealth-destroying characteristics that no bidder has ever dared proceed to the point of causing a pill actually to become operative.

A poison pill gives the board veto power over any bid for the company, no matter how beneficial to the shareholders. If the board opposes the bid, it can sit back and wait for the pill to be triggered – usually when an acquirer has purchased 15 or 20 percent. If the board is in favor of an acquisition, it can simply redeem the pill. The board can both create and redeem the pill without shareholder approval. Thus, while we have stated that shareholders have a basic right to sell their stock to whomever they please, "poison pills" showed that shareholders could only sell to people pre-approved by the board.

By the end of the 1980s, over 1,000 companies had implemented a poison pill. Meanwhile, academics studied the effects on shareholder value. The evidence has been inconclusive. One type of

study has examined the price movement of company stock following the adoption of a pill. Some have suggested that adoption of a pill increases share value; some say the opposite. Another set of studies has focused on how pills are used in practice. Some of these suggest that companies with pills generally receive higher takeover premiums than companies without pills; others disagree.[37] Evidence of higher takeover premiums reflects only those deals that are consummated. If the pills prevented certain deals from going through, there are premiums that were never realized, and there is no way to calculate those losses and subtract them from the premiums from the deals that were successful.

As the takeover market has declined in recent years, so the need for protective devices such as pills lessened.[38] As described in chapter 2, shareholders have consistently sponsored resolutions calling for the redemption of pills, with considerable success. At Hartmarx, a majority of shareholders voted to redeem a poison pill two years in a row, but the company still refused to do so. There is some evidence that firms that abandon their pill experience short-term positive gains, as the market recognizes that the company has become more susceptible to the discipline of the takeover market.[39] Some companies, rather than canceling the pill outright, have modified the plan to create a "chewable" pill, considered a best practice by most shareholders because it gives a board some breathing room to negotiate the best deal without giving them too much authority to reject a deal shareholders want. This pill is not a "doomsday device" triggered by hostile interest, but a pill that sets certain conditions on an unsolicited bid. Thus, if a bid is fully financed and is made for all shares, then a "chewable" pill generally won't be triggered. It ensures that any bid made for the company is a fair one.

Other companies found ways to add more poison to the pill. Mentor Graphics Corporation launched a hostile cash tender offer for all the stock of Quickturn Design Systems, Inc. in August of 1998. At the same time, Mentor announced that it would solicit proxies to replace all of the members of Quickturn's board at a special meeting of shareholders. Mentor proposed to solicit approvals from Quickturn's shareholders to call the special meeting under a provision in Quickturn's bylaws that allowed shareholders holding at least 10 percent of the outstanding shares to call a special meeting.

The Quickturn board soon decided that Mentor's offer was inadequate and adopted two defensive measures in response. First, the board amended Quickturn's bylaws to provide, among other things, that special meetings called by shareholders must take place not less than 90 days nor more than 100 days after the request has been received by Quickturn and determined to be valid. Second, Quickturn adopted the strongest pill defense it could create. Their pill had a "dead hand" provision, meaning that it could not be amended or redeemed by anyone but the current board or directors they approved.

The practical effect of such a provision is that, even if an unwanted bidder succeeds in ousting a majority of the target's incumbent board members at an annual or special meeting or through action by consent, the newly elected board would be unable to redeem or amend the poison pill to allow the proposed acquisition to proceed. After the Delaware court invalidated the "dead hand" pill in another case, Quickturn amended the pill to a "no-hand" or "slow-hand" provision. The rights plan could not be redeemed or amended for a specified period of time after a change in a majority of the directors or other similar event. While such a provision would not completely prevent a hostile acquisition, the delay might discourage would-be hostile bidders and might also allow additional time for alternatives to develop.

Mentor Graphics took Quickturn to court. The court invalidated the pill, on the grounds that it was disproportionate to the threat posed by Mentor.

OTHER ANTI-TAKEOVER DEVICES

There are other takeover defenses that also seek to prevent shareholders being coerced by such bids as two-tier offers. For instance, a "fair price provision" requires an acquirer to pay the same price for all shares bought, rather than only paying a premium for a sufficient number of shares to gain control.

Another popular strategy was the "white knight" defense. A "white knight" is a friendly third party who agrees to buy a significant portion of stock to keep it out of the acquirer's hands. This strategy was used successfully at Polaroid, Carter Hawley Hale, and Sovereign Bank (see the case studies in chapter 7). A similar strategy involves creating a new class of shareholder with unequal voting rights. Shares may be issued to friendly shareholders (usually management) with greater voting power than that which applies to common stock. Thus, friendly interests may control few of the shares but many of the votes (see the "One Share, One Vote" case in point in chapter 2).

Other takeover defenses are less shareholder friendly and give the impression that the target management would rather destroy the company than let it be taken over. For instance, a "crown jewel" strategy could result in a target company divesting itself of its most valuable assets. In this defense, the target company would sell or otherwise "lock up" the company's most valuable assets – its core business, for instance. Thus, the acquirer would be faced with undertaking an expensive takeover bid for a far less valuable company. Of course, this strategy only averts a takeover at the cost of the dismemberment of the target company.

Still more risky was the "PacMan" defense, in which the target company made a bid for the acquirer. This "I'll-eat-you-before-you-eat-me" strategy was used most famously in the takeover battle between Bendix and Martin Marietta. In 1982, Bendix announced its intention to purchase Marietta; Marietta responded by making a tender offer for Bendix shares. Months later, United Technologies joined the battle by proposing to buy Bendix at a higher price than Marietta was offering. Ultimately, both companies were bought by Allied Corporation.

Perhaps the most bizarre strategy ever adopted was the so-called "Jewish dentist" defense, pioneered by the late leading takeover lawyer Joe Flom, in 1975. Sterndent, a manufacturer of dental equipment, was under attack from Magus Corp., a foreign-based conglomerate. Flom found that 10 percent of Magus was owned by the Kuwait Investment Company. Since Sterndent sold most of its products to dentists, many of whom were Jewish, Flom argued that an Arab-financed takeover would negatively affect Sterndent's operations as its customers would shop elsewhere. Flom was also able to find a white knight for Sterndent and Magus backed off.[40]

The causes and effects of takeovers, and whether management is justified in opposing a takeover without recourse to a shareholder vote, is still a matter of raging debate. Takeover lawyer Martin Lipton believes that the takeover era was disastrous for corporate America and that such devices as poison pills are necessary to allow managers to run their companies without continually looking over their shoulders for a possible hostile bid. By contrast, raiders such as T. Boone Pickens, like Michael Douglas's Gordon Gekko character in *Wall Street*, believe the takeover era restored market accountability by exposing poorly performing companies to the threat of correction. In many ways the debate has been rendered irrelevant by history – with the collapse of junk-bond financing in 1989, large-scale hostile takeovers are now few and far between, a notable exception being the contest for Paramount Communications discussed in the Time Warner case study. However, the years of increased takeover activity did raise a host of new questions regarding the role and responsibilities of the board. As some of the raiders of the 1980s return as

managers of activist hedge funds, these questions remain as pertinent today as they did during the go-go takeover years.

Should a board have the right to "just say no" to a hostile bid without offering shareholders any alternative transaction? Should shareholders have the right to sell their shares to a raider under any circumstances? Did the increasing use of more sophisticated and more bizarre anti-takeover devices render managers more or less accountable? Should a board let a company be either dismembered or destroyed rather than let it be taken over? Is it right for a board of directors to entrench a company against a possible hostile bid? Read the Carter Hawley Hale and Polaroid case studies in chapter 7. Should the directors of those companies allow themselves to be taken over? Should the shareholders of those companies have been allowed to choose for themselves?

In a 2001 paper, "Corporate Governance and Equity Prices," Paul Gompers, Joy L. Ishii, and Andrew Metrick reviewed the performance of 1,500 firms with single classes of stock from 1990 to 1999 and found that the firms with fewer than five anti-takeover provisions significantly outperformed the ones with 14 or more. More work needs to be done on this data – for example, the authors gave all of the provisions they looked at equal weight, and they acknowledge that there are some cause and effect questions about the way adoption of entrenching provisions reflects management's level of comfort with risk. However, even this preliminary work suggests that fiduciary shareholders should look carefully at this information when making investment or proxy voting decisions.

Senator Carl Levin, as Chairman of the Permanent Subcommittee on Investigations, provided perhaps the most authentic view into the nature of US boards at a hearing with the five most senior directors of then-recently bankrupt Enron. These individuals are the ultimate example of America's director culture: they each had served for 17 years; they chaired the most important committees (executive, finance, compensation, and audit); three had earned doctorates; all were paid a minimum of $350,000 a year. They appeared voluntarily and at substantial personal inconvenience and legal hazard in order to articulate plainly and repeatedly that individually and collectively as members of a board they were not responsible *in any way* for the collapse of Enron or for the loss of investments, pensions, and jobs.

Chairman Levin issued a formal report in which he concluded that blame lay at the feet of the board. *Is the experience of the Enron directors confirming Peter Drucker's conclusion: "You can count on the board except when it is really needed?" Is there a way to fix that?*

THE DIRECTOR'S ROLE IN CRISIS

Normally, directors receive attention outside the boardroom only when faced with a crisis – scandal, disastrous performance, or a hostile bid. Too often, it has seemed that they only pay attention when there is a crisis. They almost always do well when disaster strikes (and they have consulted with their lawyers). They do not do as well at preventing crisis or acting quickly to mitigate damages when one occurs. This appears to be one problem that directors' concern with their own reputation does not address; a survey of directors in 1989 showed that they themselves regarded the boards of IBM and General Motors as the most prestigious on which to serve. Both companies suffered precipitous decline with no apparent reaction by the board.

When boards do pay attention, they can go from one extreme of over-deference to the CEO to the other extreme of blame and acting too quickly. They too often fall prey to the "Queen of Hearts" syndrome and shout "off with his head!" to get rid of the CEO, without looking at the underlying problems – including an ineffective board – that created or contributed to the crisis.

The shelf-life of a CEO is shrinking quickly. There seems to be a domino effect, and firings come in groups. The first modern-era flurry of CEO departures was in the period from September 1992 through December 1993, when it seemed to be open season on chief executives. The CEOs of General Motors, Westinghouse, American Express, IBM, Eastman Kodak, Scott Paper, and Borden were all pressured to resign in the face of their companies' long-term under-performance. These moves were heralded in the media as a breakthrough in boardroom activism.[41] Yet in all these instances the board took the necessary drastic action years too late, and in none of the cases was there an official "termination for cause," meaning that all of the CEOs left with huge compensation packages easing the way. At IBM, Akers resigned only after the company's market value had halved in six months, following a $5 billion loss in 1992. At American Express, Robinson was allowed to pursue a course of reckless financial expansion for 17 years. Boards allowed the CEOs of Mattel, Waste Management, Occidental Petroleum, Hewlett-Packard, and Quaker Oats to stay on too long despite persistent poor results and gave them multimillion dollar departure packages when they left.

CEO tenure continues to shorten. As a result, CEOs increasingly insist on downside protection in their contract negotiations, which means that the pay–performance link continues to weaken.

Why does it take boards so long to respond to deep-seated competitive problems? If one of the leading responsibilities of directors is to evaluate the performance of the CEO, why do boards wait too long for proof of managerial incompetence before making a move? What can boards do to insist on downside risk in CEO employment contracts and what can shareholders do to encourage them to insist on it?

Judge William T. Allen, Chancellor of the Delaware court and leading expert on the judicial implications of corporate governance, described the "fire alarm" problem in a 1991 speech: "The view of the responsibilities of membership of the board of directors of public companies is, in my opinion, badly deficient. It ignores a most basic responsibility: the duty to monitor the performance of senior management in an informed way. Outside directors should function as active monitors of corporate management, not just in crisis, but continually." Wise words, but seldom reflected in the decisions of the Delaware courts.

One of the most important reasons that boards have failed to fulfill their role as monitors is also the most intangible – the culture of the boardroom. By "culture" we refer to the psychology, even the anthropology, of belonging to a board – the collegiate atmosphere that prevents any one member speaking out against the prevailing view. It is the existence of this culture that leads to boards being accused of being "old boys' clubs."

The problem is that it is difficult to speak out against management when the CEO controls the board's agenda, information, compensation, and composition – and its membership. In the "director's departure" case in point earlier in this chapter, assume that some of the other outside directors were concerned about the CEO's decision to pursue the unsuccessful acquisition and cancel the board meetings. Once they saw their colleague removed from the board for raising these issues, they understood that they could not challenge the CEO on these or other matters without risking dismissal from the board. This works both ways – the board picks the new CEO when the time comes and they therefore may be reluctant to find him incapable of performing.

A 1989 survey in the United Kingdom found that one-third of directors agreed that "don't rock the boat" was the unspoken credo of most boardrooms. The same survey reported that virtually all boardroom votes are unanimous. As one CEO said, "I often say my directors can come in and vote one of two ways – either 'yes' or 'I resign.'"[42] The problem has been well summarized by New York lawyer Ira Millstein and former lawyer Winthrop Knowlton:

> *[Directors] appear, in theory, to have immense power and flexibility. They can help shape their corporations' missions in a great variety of ways, provided only that they create plausible evidence that they have taken their primary obligation to shareholders adequately into account. They can (and do) stimulate CEOs to formulate long-range plans. They can dismiss the CEO if they do not like these plans or the way he carries them out. They can urge management on to higher standards of performance through an arsenal of sophisticated incentives: salary increases, bonuses, options and a variety of grants. And yet, the gut feeling in their stomach is that their role is an exceedingly limited one. They feel they do not have time enough to know the company's products well and to know, especially, how truly competitive these products are. They do not have time enough to tour company plants, talk to middle managers, hear alternative points of view. While they can, in theory, criticize CEOs, punish them, and even remove them, there is immense reluctance to do so. This is an individual they themselves have selected. This is an individual who has far more information at his fingertips than they do, who is (surprising as it may seem to many corporate critics) usually devoting every waking hour to the firm's affairs, and who is in need of every bit of support the board can give. A number of outside directors who have managed or may still be managing companies of their own are particularly sensitive to this.*[43]

Millstein and Knowlton comment further:

> *Whether [the board's] activities here take on an active or a passive coloration, whether boards respond only to crisis or to specific kinds of issues and the rest of the time restrict their activities to formal, even ritualistic review, depends in large measure on the kinds of people the directors are, the personality and operating style of the CEO, past board practice, and the challenges that the particular corporation faces.*

CASE IN POINT COMPAQ COMPUTERS

Ben Rosen, a venture capitalist with a significant stake in Compaq, served as the nonexecutive chairman of the company's board. After the stock price of the company plummeted, matched by Compaq's first ever quarterly loss, a major disagreement developed between management and the board as to how the company should address

the crisis. The board believed the company needed a fundamental shift in strategy, and the company's founder and CEO, Rod Canion, was forced to resign. The result was vastly increased earnings over the next year and a doubling of the stock price. In testimony to the House of Representatives, Rosen described the criteria for a strong board:

> *(1) An outside, independent chairman; all directors, with the exception of the CEO, should be outsiders. (2) Board members who all have meaningful ownership in the company, making them natural allies of the shareholder owners. (3) Key committees that exclude the CEO. (4) Boards that are relatively small, to increase their effectiveness. In addition, reciprocal directorships should be discouraged, if not eliminated.*

Compaq had such a board, which was vital as the company faced a difficult period:

> *Compaq Computer, after a period of meteoric and profitable growth, ran into serious difficulties engendered by fundamental shifts in the marketplace. Our historical recipe for success was out of tune with the new needs of customers. For the first time, the board and management differed on the fundamental direction of the company. Because the board was composed of all-outside directors (except the CEO), had a non-CEO chairman, and was small (seven members), it was able to act dispassionately and entirely in the interests of the corporation. The board moved promptly, and the rest, as they say, is history.*[44]

Ten years later, Compaq faced the same problem and came up with the same solution – replacing the CEO. Is that evidence that the board is successful? Or is it evidence that they made mistakes in allowing the problems to get to that point? What happened to Compaq and is that considered a success? ■

The same can be said for Sunbeam, where the board acted very promptly as soon as they discovered that there was a problem with the company's financial reporting.

Would those companies have suffered so badly for so long if the boards had followed Rosen's guidelines? What might have happened at those three companies if every director had a significant ownership stake, as Rosen did at Compaq?

At Sunbeam, CEO Al Dunlap insisted that his directors hold a lot of stock. In the end, it worked just as he intended – the alignment of their interests with the interests of the shareholders led them to act quickly and decisively to throw him out. See the online Eastman Kodak, General Motors, and Sears, Roebuck case studies.

See also the American Express, Carter Hawley Hale, Waste Management, and Polaroid online case studies in chapter 7 for further examples of these concerns.

LIMITS AND OBSTACLES TO BOARD OVERSIGHT OF MANAGERS

The existence of boards is based on the premise that they oversee management, select executives who will do the best job, and fire them when they don't. In theory, management serves at the pleasure of the board. The reality is too often the opposite. While boards increasingly remove (with generous severance packages) CEOs who are not performing and some boards are permitting their nominating committees greater leeway in the selection process, in the overwhelming majority of cases directors are beholden to management for nomination, compensation, and information. Moreover, as a practical matter, many directors are unable or unwilling to devote the time or energy necessary to oversee the operation of the company or to make a financial commitment to its success.

As management guru Peter Drucker puts it, "Whenever an institution malfunctions as consistently as boards of directors have in nearly every major fiasco of the last 40 or 50 years, it is futile to blame men. It is the institution that malfunctions."[45] Allowing so many CEOs to receive gargantuan compensation for mediocre returns (as discussed in chapter 4) is just one symptom of the ineffectuality of boards over the past decade. At the end of 2006, for example, the CEOs of Home Depot and Pfizer, both fired for poor performance, were given $200 million departure packages. In 2010, Hewlett-Packard CEO Mark Hurd was fired for submitting false expense accounts in connection with a contractor who later filed a sexual harassment complaint against him. However, this was not considered "termination for cause" and his departure package was valued at $25–50 million. It was reduced in a settlement after he went to work for an HP competitor.

What is wrong with the institution? Why do boards fail so often?

We will use examples to show how various aspects of board organization can work against the interests of shareholders. As you read through this discussion, take a look at the Enron case study in the context of these issues.

INFORMATION FLOW

Directors can never know as much about the operation of the company as management, so they are dependent on the CEO for being supplied with accurate, timely, and material information. The CEO, however, who also acts as chairman of the board in the overwhelming majority of American companies, has a powerful incentive to organize the board meeting agenda and underlying information to emphasize his successes and avoid discussion of anything else. One sign of an ineffective board is a chairman who provides the wrong kind of information – too much, too little, or too late. At Enron, for example, the board voted on three separate times to waive the company's conflict of interest policy so they could permit the CFO to enter into a conflicted transaction that was designed to hide significant liabilities from the balance sheet. The directors signed the waivers contingent on certain controls being in place (which they were not) and certain updates being provided (which they were not). The issue never came up on the agenda again and no one ever asked about it.

CEOs almost always play the dominant role in selecting and inviting board members (see the discussion of nominating committees later in this chapter). CEOs always say they are looking for

"consensus-builders," and that is understandable – no one wants directors to be throwing things at each other or fighting for the chance to speak. However, when you put eleven consensus-builders into a room with one visionary, dynamic leader who is used to being the boss, there is a real problem in making sure that the directors get the information they need to address the issues for which they are responsible.

Sarah A. B. Teslik, then-Executive Director of the Council of Institutional Investors, an association now representing $3 trillion in investment capital, described the problems a director might face in a 1993 newsletter to the Council of Institutional Investors (CII) members, in the midst of the record-setting bull market and almost a decade before the string of corporate meltdowns that led to the passage of Sarbanes–Oxley.

> *What if some very clever record-keeping is occurring to mask problems that may or may not be detectable by auditors? Or what if a few big customers are angry about problems that could be fixed but haven't yet dropped their accounts (and the leader either doesn't know or doesn't want to reveal this)? Since the outside world can, by and large, detect many of the bigger, or later-stage problems without your help, it is presumably these kinds of nascent or potential problems that you [the director] are mostly there to detect, prevent or remedy.*
>
> *But how do you do this if the source of virtually all your information is the leader? The fact is, in too many cases, you don't. Because you can't. Because, under the circumstances, no one can.*
>
> *There isn't much point in fussing over the definition of an independent director, or the existence or makeup of board committees, or the procedures for electing directors if the information they get is inadequate. What can even the most brilliant and properly motivated director do if he or she lacks needed, accurate, or timely information?*[46]

Unfortunately, the corporate history books are full of boards who knew too little too late. This was a problem long before Enron, WorldCom, Adelphia, HealthSouth, Tyco, Ahold, Parmalat, Hollinger, Bear Stearns, Lehman Brothers, and the rest.

CASE IN POINT RJR NABISCO, LONE STAR INDUSTRIES, TAMBRANDS, AND ENRON

RJR Nabisco. CEO Tylee Wilson spent $68 million developing an ultimately disastrous "smokeless" cigarette without telling the board. As chronicled in *Barbarians at the Gate*, even in an epic of corporate excess, Wilson's directors were livid that he had far exceeded his spending limits without board approval.

> *"Why didn't you tell us about this sooner?" Juanita Krepps demanded. "You trust hundreds of company people working on this project; you trust dozens of people at*

an ad agency you're working with; you trust outside suppliers and scientists – but you don't trust us," she said. "I, for one, absolutely resent that."[47] ”

Wilson's successor, F. Ross Johnson, behaved similarly. He handled his board with a combination of lavish perquisites and meager information. He arranged for his directors to rub shoulders with celebrities, use corporate planes and apartments, and he even endowed chairs at their alma maters with corporate funds. All this made it hard for directors to push him on tough questions.

Two *Wall Street Journal* reporters described the life of an RJR Nabisco board member: "A seat on RJR Nabisco's board was almost like Easy Street: lucrative directors' fees, fat consulting contracts and the constant loving care of the company's president and chief executive officer, F. Ross Johnson. 'I sometimes feel like the director of transportation' he once remarked, after ordering up a corporate jet for a board member. 'But if I'm there for them, they'll be there for me.'"[48] While he was dazzling his handpicked directors, who could expect them to complain about his jets and country clubs?

Lone Star Industries. The Lone Star board ordered a special inquiry into the expenses of CEO James Stewart, following a *Business Week* article that criticized his lifestyle at a time of company cutbacks. The inquiry alleged that Stewart billed the company $1.1 million for "purely personal expenses," including taking his personal music teacher on Lone Star trips to three continents. The nine-man board, including such luminaries as Robert L. Strauss, later Ambassador to Russia, never scrutinized Stewart's expenses. "You make an assumption that the CEO is honest and prudent," said David Wallace, an outsider who succeeded Mr. Stewart. "We didn't know what he was doing." In 1990, Lone Star filed for bankruptcy protection.[49]

Tambrands Inc. On June 1, 1993, Martin F. C. Emmett was fired as the CEO of Tambrands Inc., the manufacturer of feminine hygiene products. Seemingly, his ouster was a routine affair, given the increasingly troubled operations of the company. Market share for Tampax, the company's leading product, had dropped 8 percent since mid-1992, and share value had declined by a third in less than six months. The board apparently fired Emmett after he failed to outline a satisfactory recovery strategy.

Ten weeks after the firing, the *Wall Street Journal* reported that Emmett's departure had opened a walk-in closet full of skeletons. The story demonstrates the extent to which an executive can keep his board in the dark. The *Wall Street Journal* commented that the story raises "murky ethical issues hinged on friendships, business relationships, and ultimately a board's role in policing corporate operations."[50] The scandal was based on Emmett's unusually close relationship with two principals in a consulting firm called Personnel Corp. of North America (PCA) – the firm that had originally landed Emmett his job at Tambrands. Immediately after Emmett's departure, Tambrands ended

most of its contacts with PCA. PCA's two principals were long-time friends of Emmett's. During his tenure, he steered contracts worth $2 million to PCA, including compensation, pension administration, and outplacement. Not only did he retain the firm, but the two principals were placed on individual retainers that exceeded the salaries of most of Tambrands' officers.

Emmett's relationship with the PCA executives dated back to the mid-1970s, when PCA principals David R. Meredith and Jack L. Lederer conducted a compensation study for Standard Brands Inc., where Emmett was then an executive. When Standard Brands merged with Nabisco in 1981, Emmett referred PCA to Nabisco, and PCA was awarded a contract. When Emmett left Nabisco to chair the investment banking subsidiary of Security Pacific in New York, PCA followed also.

Even in those days, Emmett enjoyed the trappings of executive privilege. Emmett's boss in the Standard Brands' days was the same F. Ross Johnson described above, who went on from Standard Brands to be CEO of both Nabisco and, following the merger with R.J. Reynolds, RJR Nabisco. *Barbarians at the Gate* describes Emmett's career at Standard Brands: "Johnson lavished gifts on Emmett, including a luxurious corporate apartment and an unlimited expense account." When Emmett was being hunted to head Tambrands, at least one executive search firm report commented on Emmett's apparent taste for the high life.

Lynn Salvage, a director who left the board in 1991, told the *Wall Street Journal* that once PCA had been retained, the two partners "did everything in their power to get [Emmett] the most lucrative compensation scheme they could."[51] Pearl Meyer, a compensation consultant with her own firm, described the PCA consultants as "very capable and energetic advocates on [Emmett's] behalf."[52] Mr. Emmett's stock options and benefits were more appropriate for a company twice Tambrands' size. He received options to buy nearly 600,000 Tambrands shares over the years: in December of 1992 he exercised options for 150,000 shares, which he sold at a profit of over $5 million.[53] PCA also argued that the board was underpaid. Following this advice, the board voted to increase its annual retainer from $13,000 to $20,000, and to award themselves options on 1,100 shares annually.

After his ouster, Emmett still had ten years to exercise his remaining 450,000 stock options – a severance package negotiated by PCA in 1992. Following his departure, he continued to work in an office provided by PCA in their Connecticut headquarters.

Warnaco. "Hard-driving corporate leader Linda Wachner is an example of what happens when lack of self-discipline and arrogance converge in a leader. Rising quickly from department store buyer to be CEO of clothing manufacturer Warnaco, she led a leveraged buyout of the company in 1986. Like Alexander she proved she could put together an empire but couldn't make it last."[54] In 1992, Warnaco's Linda Wachner was the only woman CEO in the Fortune 500. Once the lingerie company's first female vice president,

she became CEO by working with a group of investors on a hostile takeover in 1986. She took the company public and led it to $1.95 billion in sales in 1998. She was one of the country's highest-paid CEOs, receiving some $158 million from 1993 to 1999, but she made a number of mistakes. She was also distracted by serving as CEO of a second company. The compliant Warnaco board not only allowed her to spin it off but paid her the investment banking fee for brokering the transaction when they bought it back. The company went into bankruptcy in 2000 and Wachner went to court to insist on her $25 million severance package.

Hollinger. Former SEC Chairman Richard Breeden coined the term "corporate kleptocracy" in his report on the failures of oversight at Hollinger. He said,

> *[T]his story is about how Hollinger was systematically manipulated and used by its controlling shareholders for their sole benefit, and in a manner that violated every concept of fiduciary duty. Not once or twice, but on dozens of occasions, Hollinger was victimized by its controlling shareholders as they transferred to themselves and their affiliates more than $400 million in the last seven years. The aggregate cash taken by Hollinger's former CEO Conrad M. Black and its former COO F. David Radler and their associates represented 95.2 percent of Hollinger's entire adjusted net income during 1997–2003. . . . Hollinger went from being an expanding business to becoming a company whose sole preoccupation was generating current cash for the controlling shareholders, with no concern for building future enterprise value or wealth for all shareholders. Behind a constant stream of bombast regarding their accomplishments as self-described 'proprietors,' Black and Radler made it their business to line their pockets at the expense of Hollinger almost every day, in almost every way they could devise. The Special Committee knows of few parallels to Black and Radler's brand of self-righteous and aggressive looting of Hollinger to the exclusion of all other concerns or interests, and irrespective of whether their actions were remotely fair to shareholders.*

Enron. The Powers Report on Enron was produced under the direction of William Powers, Jr., Dean of the University of Texas Law School, who took a leave of absence to join the Enron board and, with the help of the SEC, uncover what went wrong:

> *Beyond the financial statement consequences, the Chewco transaction raises substantial corporate governance and management oversight issues. Under Enron's Code of Conduct of Business Affairs, Kopper was prohibited from having a financial or managerial role in Chewco unless the Chairman and CEO determined that his participation 'does not adversely affect the best interests of the Company.' Notwithstanding this requirement, we have seen no evidence that his participation was ever disclosed to, or approved by, either Kenneth Lay (who was Chairman and CEO) or the Board of Directors. . . .*

The Board approved Fastow's participation in the LJM partnerships with full knowledge and discussion of the obvious conflict of interest that would result. The Board apparently believed that the conflict, and the substantial risks associated with it, could be mitigated through certain controls (involving oversight by both the Board and Senior Management) to ensure that transactions were done on terms fair to Enron. In taking this step, the Board thought that the LJM partnerships would offer business benefits to Enron that would outweigh the potential costs. The principal reason advanced by Management in favor of the relationship, in the case of LJM1, was that it would permit Enron to accomplish a particular transaction it could not otherwise accomplish. In the case of LJM2, Management advocated that it would provide Enron with an additional potential buyer of assets that Enron wanted to sell, and that Fastow's familiarity with the Company and the assets to be sold would permit Enron to move more quickly and incur fewer transaction costs. . . .

These controls as designed were not rigorous enough, and their implementation and oversight was inadequate at both the Management and Board levels. No one in Management accepted primary responsibility for oversight; the controls were not executed properly; and there were structural defects in those controls that became apparent over time. For instance, while neither the Chief Accounting Officer, Causey, nor the Chief Risk Officer, Buy, ignored his responsibilities, they interpreted their roles very narrowly and did not give the transactions the degree of review the Board believed was occurring. Skilling appears to have been almost entirely uninvolved in the process, notwithstanding representations made to the Board that he had undertaken a significant role. No one in Management stepped forward to address the issues as they arose, or to bring the apparent problems to the Board's attention. ”

Note also that the Enron board had a number of consulting fees and other related transactions involving directors, including charitable and political donations. Herbert S. Winokur, Jr., who was on the committee that approved the special purpose entities, was chairman of a water company set up with a $3 billion investment by Enron and whose board was made up of Enron directors. After it went public, Enron bought back the shares at more than double the market price. Furthermore, he was also a director of another company that did over $370,000 in business with Enron in 2000. ■

Of course, not many executives try to push the limits as far as the CEOs of RJR Nabisco, Lone Star, Tambrands, Warnaco, Hollinger, or Enron. There are few examples of managers actively trying to mislead the board, and not many boards allow themselves to be kept in the dark for so long. However, it is inevitable that executives will be more fully informed than the board, so there is inevitably an obvious problem deciding what information should be shared. For instance, see the Polaroid case study in chapter 7. In that case, the board was unaware that employee groups opposed swapping various compensation benefits for an enlarged employee stock ownership plan (ESOP). Though a court ultimately determined that this information was immaterial, the example shows the kinds of conflicts of interest present in management–board relationships. (See also the Occidental Petroleum, WorldCom, and Adelphia case studies.)

Technology has made additional sources of information more accessible than ever before. Online discussions like Motley Fool, Yahoo Finance, have candid discussions about corporations and investments that provide a different perspective than the business press, analysts, and insiders. Director Lucy P. Marcus recommends that boards take advantage of social networking online and check Twitter for updates on corporate governance.

> *Reading newspapers, the trade press, and getting reports from the accounting firms and law firms all have a role to play, but over the past several months I found that Twitter offers an equally if not more effective way to do this in real time. Following people on Twitter who have similar interests and mind sets about corporate governance literally feeds me the information that is on the cutting edge – the issues that are on people's minds about anything that impacts our roles, and what other non-exec board directors make of them, ensuring I am better equipped for the challenges that all of us have to deal with on a regular basis.*[55]

PRACTICAL LIMITS: TIME AND MONEY

Directors' ability to oversee management is further undermined by the fact that many directors are unable to devote sufficient time or resources to the job. The following comment was made by two of America's most astute observers of corporate boardrooms, Martin Lipton of Wachtell, Lipton, Rosen & Katz in New York and Jay Lorsch, Senior Associate Dean of the Harvard Business School:

> *Based on our experience, the most widely shared problem directors have is a lack of time to carry out their duties. The typical board meets less than eight times annually. Even with committee meetings and informal gatherings before or after the formal board meeting, directors rarely spend as much as a working day together in and around each meeting. Further, in many boardrooms too much of this limited time is occupied with reports from management and various formalities. In essence, the limited time outside directors have together is not used in a meaningful exchange of ideas among themselves or with management/inside directors.*[56]

Lipton and Lorsch said that for a director to do his job properly, he/she needs to devote at least 100 hours annually on the job. More recent analyses suggest that directors must be able to devote at least 250 hours a year to each board of a company that has no significant problems. When there is a crisis, that number can quickly increase to full time. However, because so many directors serve on more than one board, in addition to a full-time job, their time and attention are limited.

In the post-Enron era, even the busiest directors are now serving on fewer boards. In 2002, former Congressman William Gray held nine directorships at S&P 500 companies. By 2010 he held only four, with the maximum number of S&P 500 directorships held by any single director being six. Yet, in 2010, 11 directors on boards of S&P 500 companies still served on six boards.[57]

Aside from the issue of time commitments, many directors are unable or unwilling to commit money and buy stock. If directors are to be the representatives of shareholders then it is not too

much to demand that they be shareholders. Yet all too often, outside directors hold, at best, only small proportions of their net worth, and merely token holdings at worst. Even those with significant holdings seldom make the same commitment shareholders do; most director stock is provided by the company as a part of their fees. According to the Board Analyst director database at GovernanceMetrics International, about one-sixth of public company directors have no stock at all in the companies on whose boards they serve.[58]

Is this a sufficient contribution – of time or money – for a director to make? Who is in the best position to determine what a sufficient contribution is, and how can that determination be made effective?

In cases like these, despite concerns about reputation and personal pride, directors may not have enough incentive to be aggressive in evaluating and overseeing management. A 1989 polling of Fortune 1000 directors found that 69 percent of respondents agreed that "directors are likely to have the same commitment to representing shareholders' interests regardless of their equity holdings."[59] In some other countries, holding stock is considered a conflict of interest. However, evidence of a strong connection between significant (relative to net worth) director investment and better board and company performance[60] and shareholder pressure has resulted in changes. Now it is widely, if not universally, considered inappropriate in the United States for a director not to hold stock. Equilar found that 84 percent of Fortune 250 companies have stock ownership guidelines for directors, often based on a multiple of the retainer.

THE YEARS OF CORPORATE SCANDALS – BOARDS BEGIN TO ASK FOR MORE

Behind each of the corporate scandals of 2002 and thereafter and each of the companies involved in the sub-prime and derivative-fueled financial meltdown of 2008 was a board that complained that they had not been told what was going on. The outside directors of Adelphia and Tyco said that they had no idea that the executives were using corporate funds for personal expenses. The outside directors of Enron said they did not know that the special purpose entities created to hide losses were based on fraudulent information. The directors of the Wall Street companies said that they thought the derivatives were calculated to remove risk, not to increase it.

If directors have a duty of care and a duty of loyalty, how do they meet the duty of care in making sure that they get the information they need? When, if ever, is an "I didn't know" defense sufficient for a director?

> *"Who has the ultimate responsibility for the corporation? Who is genuinely responsible for a company? And who should have control – management or the board? Legally, the answer is clear; in the final analysis the board has the responsibility for the company and is, therefore, the ultimate fountain of power. It is in practice, not in law, that the problems arise. Management has the expertise, infrastructure, and time to run and control the company. Given this degree of management domination, how can a board still exercise its responsibility? Can an entrepreneurial, energetic management run the*

company and at the same time reserve the ultimate control for the board? How do the board and management determine who should wear the "crown"? We believe the board carries more than de jure responsibility for the corporation. The paradox is how to allow both bodies to retain effective control without diminishing the initiative and motivation of either. The paradox creates tensions that are vexing for many corporations, causing friction at the top and considerable loss of energy . . . . The complexity of the responsibility for corporate governance requires that management and the board find a comfortable, dynamic, balance of power between them. There will always be tension, but the tension that exists is not altogether bad. Like stress, a certain amount enhances creativity and productivity.[61] ”

DIRECTOR INFORMATION CHECKLIST

What information should the board have? One veteran board member produced the following list.[62]

- Operating statements, balance sheets, and statements of cash flow that compare current period and year-to-date results to plan and last year. Management comments about the foregoing that explain the reasons for variations from plan and provide a revised forecast of results for the remainder of the year.
- Share of market information.
- Minutes of management committee meetings.
- Key media articles on the company and competition.
- Financial analysts' reports for the company and major competitors, plus consumer preference surveys.
- Employee attitude surveys.

The executive session meetings now required by the exchanges are a good opportunity for the directors to discuss the quantity, quality, and timeliness of the information provided to them. It is also important for them to have direct access to top corporate officers and managers, without having to go through the CEO. Access to prompt and significant information should be an element of the performance evaluation of both the CEO and the chairman.

Robert K. Mueller, former outside chairman of A.D. Little and a veteran director, summed it up in his ninth book on boards of directors: "Ignorance is no excuse."[63] The duties of care and loyalty have to mean an obligation to be informed.

There are ways to encourage directors to be well informed. Home Depot, Inc., for instance, requires its directors to spend at least one full day a month at one of its stores, and to visit eight to ten stores a quarter, both in and out of the areas in which they live. Bernard Marcus, then-CEO of Home Depot, described the process:

“ *They go in as a customer first, then they announce themselves and make themselves available to the employees of the company . . . . It's a very, very good way for the board members to get a different feel for what's happening in the company. Typically, on a board, everything is filtered through the Chairman; everything you want the directors*

> *to know comes from him. Here we tell our board members to get out in the field. When they do this, they come back with recommendations. It's been very valuable for both sides – from our side as operators and for the board members for their knowledge of the company.*[64] ”

WHO RUNS THE BOARD?

In most American boards, the CEO is also the Chairman and thus is responsible for critical issues like committee assignments, setting the agenda, and the quantity, quality and timing of the information provided to the board. Even in those US companies with separate chairmen and CEOs, only about half of those chairmen are independent outsiders. The others are former CEOs, founders, former CEOs of acquired companies, or otherwise connected to the company beyond their service on the board. Most UK companies have independent outsiders as chairmen, but UK boards have a higher percentage of inside directors.

What are the advantages and disadvantages of separating these two positions? Who is in the best position to determine whether it is worthwhile for a particular board? Does that person or group of people have the authority to impose that structure?

These questions serve as a good way to look at the overall conflict between giving corporate management enough authority to do the job while maintaining sufficient accountability to make sure that the job is done for the benefit of shareholders.

We discussed earlier how the very existence of the board is based on the need for accountability. The board exists to keep management accountable for the vast discretionary power it wields. Thus, when the chairman of the board is also the CEO, it makes management accountable to a body led by management. It can mean that the CEO is put in the position of evaluating his own performance. For the same reason that we do not allow students to grade their own exams, that presents conflicts of interests in the corporate context as well.

According to Harold Geneen, former CEO and chairman of ITT Corp.:

> “ *If the board of directors is really there to represent the interests of the stockholders, what is the chief executive doing on the board? Doesn't he have a conflict of interest? He's the professional manager. He cannot represent the shareholders and impartially sit in judgment of himself.*[65] ”

The thinking on this issue has changed since a 1992 survey of company directors by Korn/Ferry found that just under 20 percent believed that separating the CEO and chairman positions would have a "very negative impact" on boardroom performance. A little more than 20 percent thought it would have a "very positive impact" and not quite 60 percent thought the impact of separating the roles would be neutral. Those who thought separating the roles would have a negative impact thought it important that a company should be led by one person. "You've got to have one boss," said one respondent to the Korn/Ferry survey. "Don't second guess him." Another said, "The

CEO and the chairman need to be intimately involved in the business, so I believe they should be the same person. If they are not, the chairman would be a figurehead or would usurp the role of the CEO."

Those who were in favor of separating the roles believed it would lead to more objective evaluation of the CEO, and create an environment of greater accountability. One outside director commented that when the CEO is also the chairman there is "too great a temptation to 'tilt' things toward protecting CEO career interests."

The majority who believed that splitting the jobs was an unimportant issue typically commented that the chairman was simply the one who chaired the meetings, and that this was merely an argument about titles. While there has not been much empirical work done on this issue, at least one study found that companies with separate CEOs and chairmen consistently outperform those companies that combine the roles.[66] That may be, but resistance is predictably high. Combining the two positions does not mean that a CEO who is also chairman will inevitably manipulate his board, but it does give him that opportunity. Look at the American Express case study. It shows that board chairmanship can mean much more than parliamentary procedure. In the hands of a skilled power broker, the CEO–chairman can shift the locus of power to management and away from the board. Hugh Parker comments in his book, *The Company Chairman*:[67]

> "*In the final analysis a board of directors can only be as effective as its chairman wants it to be. It is the chairman who, over time, is the main architect of the board – i.e. of its composition, agendas, priorities and procedures. The chairman chooses the directors he wants and uses them (or not) as he wishes. A chairman who wants a strong, independent and effective board will in time have such a board. But the reverse is equally true: a chairman who wants a passive and uninvolved board to rubber-stamp his own decisions can in time also achieve such a board.*"

The National Association of Corporate Directors also recommends that boards that combine the two roles perform separate performance evaluations, as a way of keeping the goals and assessments clear and clearly communicated.

The corporate scandals of 2002 inspired a new look at this issue. While it was not unusual to hear the shareholder side call for splitting the two jobs, it was a surprise to hear the idea gain so much support on the business side. In January of 2003, a report called *The Conference Board Commission on Public Trust and Private Enterprise Findings and Recommendations* was released by The Conference Board, the most highly regarded private think-tank on business issues. A prestigious group that included Intel CEO Andrew Grove, CSX CEO (later Treasury Secretary) John Snow, TIAA–CREF CEO John Biggs, former SEC Chairman Arthur Levitt, former Senator Warren Rudman, and former Secretary of Commerce Peter Peterson wrote the report.

They had a thoughtful discussion of the potential conflicts that could arise from having the CEO serve as chairman of the board and concluded that boards had three options for addressing the issue. First, they could split the two functions, with an independent outside director serving as the chairman, or they could have a lead director or a presiding director. A lead director serves as the liaison for the outside directors and conducts the executive session meetings. A presiding director is a lead director with some responsibilities for conducting meetings. Both would be expected to work with the chairman to "finalize information flow, meeting agendas, and meeting

schedules." The group recommends that companies electing none of these options explain their reasoning to the shareholders. This report was very important in promoting the idea of lead and presiding directors and played a significant role in the widespread acceptance of this idea.

The financial meltdown of 2008 led to further support for separating the two positions. The Corporate Library found 38 shareholder proposals calling for independent chairmen filed for the 2010 proxy season, filed by individuals, pension funds, and the Central Bank of Norway.

CATCH 22: THE EX-CEO AS DIRECTOR

In 1991, Institutional Shareholder Services (ISS), a proxy advisory firm that advises institutional investors on corporate governance issues, found that 27 percent of S&P 500 companies had a former CEO of the company as a board member.[68] Six companies even had two former CEOs on the board. In 2010, the Corporate Library's database showed 238 former CEOs serving as chairmen.

Why might you object to an outgoing CEO remaining on the board?

> *They could dominate the board agenda and decisions . . . many, if not all, inside directors may owe their jobs to the retiring CEO, and would be reluctant to contradict his views out of a sense of loyalty and/or fear: CEOs often continue to exercise enormous power even after their retirement. The same combination of fear and loyalty can appear to the non-executive directors recruited by the retiring CEO.*[69]

But one then-current Fortune 500 CEO and chairman told ISS that most retired CEOs recognize the problem posed by their continuing presence and, to give the new CEO a chance to assert his own leadership, they stay silent on major policy questions.

What do you think of this response? Is it enough? If they stay silent, are they doing their job? If they do not stay silent, do they risk improper interference? What kind of chilling effect might their presence have on boardroom discussions?

The author of the ISS report, Howard D. Sherman, concluded, "In short, it is a Catch 22 for a retired CEO. Retired CEOs who care about their successor may not be effective directors. Retired CEOs who want to dominate the board should not be on the board at all."

However, the ex-CEO has vast experience, and probably has more knowledge of the company than anyone else. How can shareholders make the best use of that knowledge? ISS recommended that the company should keep the CEO off the board, but keep him on as a consultant.

What disadvantages does this pose? Look at the news reports surrounding CEO departures to determine how many are kept on as "consultants" and see if you can tell how often this is a bribe to get them to leave.

Examples that appear to fit this category include Paul Lego at Westinghouse. Lego was forced by the board to resign as CEO and chairman of Westinghouse in January 1993. Despite the fact that

Lego was, to all intents and purposes, fired, he received a two-year consulting contract at $600,000 a year (marginally less than the $700,000 salary he received as CEO). This was in addition to a severance payment of $800,000 and a lifetime annual pension of $910,000. If Lego's services were still useful to the company, why was he removed from his CEO post; and if he was fired for poor performance, why *were* the shareholders paying for his consulting services? The same analysis applies to the departures of Dean Buntrock from Waste Management (see the case study in chapter 7) and Robert Annunziata (and his two immediate predecessors) at Global Crossing.

Interestingly, some CEOs told ISS that too much emphasis was put on keeping the ex-CEO around. Sir Adrian Cadbury, the esteemed former chairman of Cadbury Schweppes plc, said, "I personally favor CEOs making a clean break with their companies on retirement. I would like to see this become the accepted practice with the possibility of a consultancy as an exception.... I am skeptical of the real value to a company of past experience, however vast."

Walter Wriston, ex-CEO of Citicorp and member of numerous boards as an outside director, made much the same point as Cadbury:

> *One reason for mandatory retirement is to assure the corporation of fresh leadership to meet changing conditions. If the new leadership wants to consult the old, no corporate structure is necessary; if consultation is not desired, no corporate arrangement will assure it. On the other hand, if the new CEO wants to get moving with his or her agenda, a board seat occupied by the retired CEO may be seen as an impediment to getting on with the job, particularly if new management feels that radical measures are called for.*

One CEO who asked that he and his company remain anonymous said his company gave its outgoing chiefs an informal role:

> *We strongly feel that 'one should not look over the shoulder of a successor,' for it could inhibit and restrict his freedom of action. We have always been fortunate that the retiring and incoming CEOs have had close and supportive relationships and that they could hold informal conversations on significant issues. Thus the new CEO could have the benefit of the counsel of the departed CEO if he sought it. The important consideration here is that the initiative in seeking such counsel must come from the new CEO. The retired CEO does not call or visit the incumbent CEO to offer advice unless it is requested.*

The 2006 Korn/Ferry annual board of directors study reported that 63 percent of directors believe that the ex-CEO should not be on the board and a draft of an EU standard would require the ex-CEO to wait five years before returning to the board. The increasing emphasis on independence has made keeping the ex-CEO on the board less popular, but it is still seen as a transitional benefit by many boards and as a mechanism for easing out a reluctant leader by others. A study in *Strategy + Business* found that having the former CEO stay on as chairman is becoming increasingly prevalent in the US and Europe even though "this 'apprentice' model does not produce consistently superior returns."[70]

DIRECTOR RESIGNATION

The increased emphasis on "independent" outside directors means that companies are turning more often to directors who do not have previous ties to the company and who have prestigious reputations to bring added contacts and credibility to the boardroom. However, that is a double-edged sword. Absence of previous ties and presence of reputational fragility can make these directors more inclined to resign if they see a problem.[71] Unexpected director resignations are correlated with an increase in the probability of litigation. If directors are more concerned with protecting their own reputation than that of the company, it can create greater risk for shareholders.

CEO SUCCESSION

The biggest challenge for a board is often CEO succession planning, because it is there that the CEO/chairman's control of the agenda, information, and access to senior staff can provide an impenetrable barrier to independent oversight. In a 1988 book called *The Hero's Farewell*, Yale's Jeffrey Sonnenfeld brilliantly documents the various strategies CEOs have for conducting – and often undermining – the CEO succession planning process. He categorizes them as: Monarchs, who choose not to leave voluntarily but either die in office or are overthrown; Generals, who leave reluctantly and spend their retirement planning a comeback; Ambassadors, who retain close ties with their former firms; and Governors, who willingly serve a limited term and leave to pursue new interests.

A 2002 book by Harvard's Rakesh Khurana exploded the popular 1990s myth of the superstar CEO, who justifies his high pay by comparing himself with Michael Jordan (the basketball star, not the former CEO of Westinghouse) or Harrison Ford. Khurana's book title says it all: *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs*. Khurana studied the hiring and firing of CEOs at over 850 of America's largest companies and found that while boards tend to hire (and pay superstar salaries to) charismatic CEOs, they do not usually get what they (and the shareholders) pay for. He documents the changes to CEO searches over the past 20 years, particularly the increased tendency to retain a search firm and go outside the company. Khurana concludes that this is not evidence of a robust and efficient market for CEO talent but is "because of the rise of investor capitalism and changing cultural conceptions of the role of the CEO." Boards tend to look for "leadership" and "vision" when they should be looking for strategic, political, and managerial skills – the ability to execute.

Boards of directors must understand that CEO succession planning is their responsibility, not the CEO's, and that it is a perpetual responsibility that begins right after the party celebrating a new hire for the top position. Boards must make sure they always have a name ready in case their CEO is suddenly incapacitated, makes a huge mistake, or takes another job. They should always be familiar enough with the senior staff to get a perspective on the CEO's performance and a sense of who should be cultivated as a candidate for the CEO position. They should always have a sense of when they will be starting up the full-scale search and how it will be conducted.

Yet, too often, that is not the case. The 2009 Spencer Stuart board report found that "while 88 percent of our survey respondents now claim to have an emergency succession plan in place, up from 75 percent in 2007, nearly a third still do not have a long-term plan."

A Conference Board report by Edward Ferris and Justus O'Brien discussed the increased transparency of CEO succession plans.[72]

> *In an October 2009 release, the United States Securities and Exchange Commission effectively removed the ordinary business exclusion defense used by companies reluctant to disclose their CEO succession process to shareholders. The policy change allows for a new wave of corporate governance scrutiny, as regulators and shareholders increasingly focus on CEO succession practices.... The change indicates that regulators have reframed CEO succession as a risk management issue and placed its responsibility firmly in the boardroom.*

The report lists the significant factors of CEO succession planning from a shareholder perspective. Poor planning can lead to disruption and turnover. It can also mean having to go outside the organization, which can result in excessive and misaligned pay packages. The authors conclude that the usual boilerplate or omission will no longer be adequate. Shareholders will insist on a specific, credible description of an independent and engaged process. They cite the Council of Institutional Investors:

> *Poor CEO succession planning and inadequate internal development of managerial talent could result in a panicked board vastly overpaying a replacement chief executive. Shareowners would be able to assess the strength and appropriateness of CEO succession plans if the essential features of such policies were publicly disclosed.*[73]

A study published in *Strategy + Business*[74] by Ken Favaro, Per-Ola Karlsson, and Gary L. Neilson found that the last decade was one of "compression." CEOs have more to prove in less time. CEO succession planning is an almost-perpetual priority for boards.

DIRECTOR NOMINATION

The greatest barrier to meaningful independence in the boardroom is insider control of the nomination process. The fact that we speak of directors as "representing" or being "elected" by shareholders when the shareholders play no role in their nomination is evidence of the challenge we face in trying to understand corporate governance. Almost every public company has a nominating committee responsible for proposing candidates to the board. In many cases, however, the nominating committee receives the names from the CEO. One CEO told the authors of this book, "My nominating committee is very independent. Sometimes they turn down the names I send them." However, when challenged to think of a time that the committee came up with its own names, he could not recall a single one.

Once the nominating committee has decided on a candidate, they bring the name to the full board for its approval. Director candidates are usually interviewed by the full board (including the CEO) and then "elected" (actually ratified, since they almost always run unopposed) by a shareholder vote.

In theory, this structure permits the board to evaluate director nominees independently and to protect against management packing the board with its own allies. However, Korn/Ferry found in 1991 that 82 percent of board vacancies were filled via recommendations from the chairman.

"Nominating committees all too often are a sham, pure and simple," said Dale Hanson, then-CEO of the California Public Employees' Retirement System, before a House of Representatives Subcommittee.[75] In England, a 1992 PRO NED survey found that 86 percent of directors were "dissatisfied with the amateur approach adopted by companies of appointing non-executive directors." Things are improving. In 1997, Korn/Ferry found that 42 percent of outside directors thought that the CEO did not play the dominant role in selecting new directors and over 40 percent agreed that the nominating committee was taking over more of the responsibility. Many nominating committees are now turning to search firms and limiting the involvement of the CEO to improve the independence and reach of the director nominating process. Recently amended SEC disclosures provide more information about the directors and the director search process – and about the reasons for director departures.[76]

CASE IN POINT A DIRECTOR QUITS

A food service company made an ill-advised acquisition attempt for a restaurant group. The acquisition ended up costing the company over $680,000 – a large sum for a small-capitalization firm. One of the directors worried that the aborted acquisition might leave the company's directors liable for damages in a shareholder lawsuit charging that the directors had not acted with sufficient care or loyalty. He was particularly concerned because the CEO had canceled all board meetings for several months while he negotiated the ultimately unsuccessful deal.

After the CEO refused to schedule a board meeting, the director suggested to some of his fellow outside directors that they meet, separately from the insiders, to discuss their potential liability. For instance, he thought they should consider whether it might be wise for them to hire independent counsel.

None of the other outsiders accepted his invitation. Rather, they informed the CEO (who also served as chairman) of his suggestion. The director received a letter from the company's outside counsel accusing him of attempting to set up "clandestine" meetings. At the next full meeting of the board, the first held in over five months, the director was informed that he would not be re-nominated as a director at the company's next annual meeting. In other words, he was fired.

The director sent a letter to the CEO/chairman, requesting that his "resignation" be fully explained in the company proxy statement. He wrote:

> *I believe that the number of board of directors' meetings has not been sufficient to keep the board members as informed as I feel they should be about the activities of the company....*

I am opposed to your having increased the compensation of officers of the company without having come to the board first. Not only was it contrary to the bylaws, but it reflects our differences in philosophy as regards your view of the board's functions. . . .

I thought the fact that my name was not set forth to be nominated as a director and to be voted upon at the next annual meeting because of 'philosophical differences' with you was not in the company's or its shareholders' best interest. Although I may have views that are contrary to yours, even you have, in the past, indicated that it was good for the company. This action (albeit with the concurrence of the rest of the board) once again reflects your desire to have control over the board . . . .

I feel that an independent compensation committee should be appointed and that it set up performance standards, evaluate achievements and judge corporate results.

I would recommend that the positions of Board Chairman and Chief Executive Officer be separated, as you presently have too much control. ”

The company did not take his advice, and he no longer serves on that board.

What is the basis on which a director should not be re-nominated? What information should the shareholders have in the event of such a decision? What do you think of the director's actions in this case? What, if anything, would you have done differently? What do you think of the result? What, if anything, would improve it?

CASE IN POINT A DIRECTOR DEMANDS MORE FROM THE BOARD

A director at another company wrote this letter to a CEO who had been in place for about two years:

“ *I have been thinking about the issues facing [our company], and I have become convinced that we have to come to grips with the mission and performance of the board. Everyone will agree that the board is responsible for strategic direction and management succession. But in my view, there is no single model of optimal board/management interrelationship. What this means, then, is that the board must constantly re-evaluate itself to make sure that it has the best possible structure for the company's present needs. The best results will obtain from recognition that change is always needed, that directors and management need to be committed to an*

ongoing process of self-examination and criticism, and that the balance will constantly be in flux. Until we have adopted an explicit 'mission' for the board, we cannot adequately monitor our performance fairly, and if we cannot monitor ourselves, we cannot monitor the performance of the company or of you as CEO.

You inherited a board that was used to reacting to what was presented to us, and not used to asking for more. As a matter of personality and style, John [the former CEO] had little use for a board. For a long time the board acquiesced, as John produced superior results. During this period, the board was essentially limited to a consultative and oversight role (I refer to this later as a 'watchdog' board). I believe that during at least part of this period, you served for him the role that a board often serves, providing feedback, support, and analysis.

The board has changed little, but the company you inherited is a very different one from the [company] of John's heyday. And you do not have a number two officer playing the same role for you as you played for John. In other words, the players are different, the challenges are different, and it is time for the board to be different, too. To go back to the two primary responsibilities of the board:

Strategic direction

We have already established a goal: $5 of earnings per share within five (now three and a half) years; and $10/share within ten years. With our core business in worldwide recession, simply maintaining our position – approximately $100 million per year in cash flow – is a substantial accomplishment.

It should not, however, permit us to lose sight of our longer-term objectives. Do we have an industrial strategy as to how we are going to achieve these earnings targets? Is it going to be from internal growth? Or by acquisition? In what industrial sectors?

Do we have a financial strategy? If we are going to achieve our growth targets we will need substantial additional capital. My own sense is that the 'cost' of equity capital is low. Our year-end closing price of 51 5/8 indicates a price/earnings multiple of 31. Have we decided to wait for a time when we can demonstrate an actual need for new capital or will we be opportunistic and go to the marketplace when capital is available on an historically attractive basis? These are the questions that the board should be considering right now. If we do not, I fear that we may be allowing a uniquely attractive time for raising additional capital to pass without adequate consideration.

CEO selection, evaluation, succession

You have urged the board to evaluate your performance annually, and it is encouraging that we actually started this process in 1993. I find this to be a very constructive process.

But I am concerned about the issue of succession. When John was CEO, we knew we could turn to you. But I do not think any of the directors have a clear idea as to

whom we would turn in the event that you were no longer able to serve. We need to make sure that you have a back-up. Any company is only as strong as its officer cadre. At present we are very 'thin on the ground.' The board must turn to this issue promptly.

These are the two most important responsibilities of a board of directors. It seems clear to me that our board needs to do more with regard to both. The fact that we have not done well enough in either of these areas demonstrates the importance of devoting time to examining ourselves to determine how we can improve our structure and composition to ensure that we function more effectively in the future.

It is very difficult – but absolutely essential – for our board to redefine itself to address our changing needs. This company needs a strong board.

Somebody needs to get this process started. I think it makes the most sense for you to take the initiative, to make sure that we develop a structure that accords with your sense of the company's needs today.

I found it useful to think of the possible roles of a board by keeping two matrices in mind. The first is a vertical matrix that illustrates a range of involvement – from a primarily reactive 'watchdog' role on one end to a role as a fully participating partner with management to active participation, as boards often play in crisis situations like the board of General Motors a year ago or the board of Paramount right now. Second is a horizontal matrix that is a spectrum of modes of activity – ranging from exclusive focus on the strategic and succession issues that are always the core of the board's responsibility to setting policy, substantively analyzing tactical options, implementation, monitoring, and evaluation.

As far as I am concerned, a board could perfectly properly decide to locate itself anywhere on the graph emanating from these matrices. At the risk of redundancy, there is no 'right' answer, but there is a 'wrong' one. What is wrong is to have no defined role, no mission, no explicit benchmarks against which performance of the board can be evaluated. That is what I worry about here. In particular, I worry about the time we spend reviewing operating results instead of looking at the larger picture. None of us on the board have the time, the expertise, or the wish to become deeply enough involved in the day-to-day affairs of the company to evaluate these results in any meaningful way; even if that was an appropriate role for the board to play, this is not the group of people to play it.

In order to make sure that the board addresses the right issues, based on the right information, I think it might make sense for us to appoint an outside director as part-time chairman of the board. If that does not seem right to you, perhaps we could follow the advice of Marty Lipton and Jay Lorsch and appoint a 'lead director' to help focus the outside directors on the agenda and other governance concerns. We should also have regular meetings of the outside directors in executive session at least twice a year. This is in no way a reflection on you and in no way intended to go behind your back. It is just the best way to make sure that the directors can talk to each other about what kinds of questions they want to ask. This is often mentioned by critics of boards as a key element in improving their performance.

Our board has really not 'jelled.' I think that is because we have not agreed on an explicit set of goals. Certainly, it is not lack of personal financial investment or personal commitment. What I am looking for is a shared sense of commitment, a sense that $5 per share within five years is more than just a slogan; that it represents a commitment by all of us to an extremely challenging and rewarding task; that we are each deeply personally committed to its achievement; that we discuss alternatives; that we see ourselves as successful or failures in terms of achieving the objective. I think having regular meetings of the outside directors would help a great deal.

In the absence of having a strong back-up within the company, it seems to me that you can make very good use of increased board involvement. I would like the board to be more of a resource for you than the rubber stamp with a micro perspective I feel that we have been. I am asking you to give you all that we can."

How effective is this letter likely to be? What are the director's alternatives if the CEO does not accept his recommendations? Once the structure has been created, what is the agenda?

In this case, the director resigned. What message does that send? How should shareholders respond to a director departure? Does it change your answers to know that this memorandum was written to Dennis Kozlowski, then the spectacularly successful CEO of Tyco, still a couple of years away from his even more spectacular fall?

No one is suggesting that all or even most director elections should be contested. The management-led system does avoid the potential chaos of noncollegial boards. However, nonexecutives cannot fulfill their clear external accountability responsibilities if disagreement with CEOs or even a board majority is considered disloyal. In a rare case that became public, Sotheby's West Coast chief Andrea Van de Kamp wrote an explosive memo to her fellow Disney directors after she was told that she would not be re-nominated to the board. In it, she said that her ouster "gives the appearance that rubber-stamping [CEO] Michael [Eisner]'s decisions is an unwritten prerequisite for continued board membership." According to an article that appeared in *USA Today*, Van de Kamp accused Eisner of "threatening and bullying" her in the January 20 meeting at which he told her that she was out. She says he indicated that "he had a file on me" documenting how she had "demonstrated inappropriate behavior" on the board and that he offered her a seat on the Disney Foundation board if she would make it seem that it was her idea to leave. In January of 2006, an unhappy director's insistence that the reason for his resignation be made public led to a scandal over the use of illegal tactics to identify a leaker on the board of Hewlett-Packard.

Note that Sarbanes–Oxley requires disclosure of the reason for a director's departure. If this letter had been sent after that law was enacted, this letter might have made it into the SEC filings in its entirety. Post-financial meltdown reforms include new or enhanced disclosures regarding director and nominee qualifications and legal proceedings and the board of directors' leadership structure and role in risk oversight.

CASE IN POINT TWO DIRECTORS DEPART AT Emap

Boards of directors, like cabinet governments, operate on the basis of collective responsibility. If an individual director disagrees with the majority decision of the board, he should of course express his views and seek to convince his colleagues by force of argument. In the end, however, majority opinion must prevail.

What happens if collective responsibility breaks down? What if a significant minority of directors, say two or three, strongly disagrees with a decision? What if they believe the chairman has an overbearing influence on the rest of the board? And what if they believe that the decision is so fundamental to the well-being of the company that they cannot be bound by the overall decision?

The only choice, of course, is to resign. But does this benefit the shareholders? To the extent that the chairman is likely to replace the resigning directors with his own (more amenable) candidates, resignation merely reinforces the power at the head of the company.

These were some of the questions faced by shareholders of Emap, a rapidly growing UK broadcasting, magazines, and communications company. Emap shareholders, reading their 1996 annual report, were asked to approve a series of amendments to the company's articles of incorporation. (Articles of incorporation are the UK equivalent of a US company's bylaws.)

Two amendments were controversial. The first, if approved, deleted a provision in the articles that mandated a minimum number of nonexecutive directors. The second gave the board power to vote fellow directors off the board, given a 75 percent majority.

Emap shareholders were surprised to read in the annual report that these proposals were opposed by two outside directors – Professor Ken Simmonds and Joe Cooke. Collective responsibility had broken down.

The company argued that the amendments were "housekeeping" measures. The minimum outside director rule, it argued, didn't offer the flexibility that such a fast-growing company as Emap required. It was also argued that several large UK companies had provisions for the board to rid itself of a troublesome minority (although, as research by UK governance watchdog PIRC showed, most companies had no such provision).

The dissidents, in return, argued that the provisions were an important safeguard at a time of succession uncertainty and management tensions. The company's chief executive, Robin Miller, and his deputy, David Arculus, the group managing director, were known to have been at loggerheads for years. A boardroom memo of five years previously had identified difficulties between the pair.

According to press reports, the company chairman Sir John Hoskyns sought to designate Mr. Miller as his provisional successor as chairman, while forcing Mr. Arculus into early retirement. Emap denied that any such succession plan was made. The dissidents

argued that it was a mistake to weaken the company's provisions for a strong and independent nonexecutive presence at a time when just such a presence was needed to oversee fractious management. As became clear, Messrs Simmonds and Cooke suspected Sir John Hoskyns of trying to "roll" the board and ensure that his preferred succession plan was carried out.

For the meantime, however, the debate took place in an amicable fashion. At the annual shareholders' meeting which followed three weeks later, the company chairman, Sir John Hoskyns, assured shareholders that the new articles were "a last resort and will not be used to restructure the board." He said, "there are no difficulties on the board."

In return, the dissidents were given the opportunity to put their side of the case. Professor Simmonds said he was opposed to the changes in principle and he criticized the way that the board had put the proposal together, claiming that a "committee of two, namely the chief executive and chairman," had met to decide on the new articles and that they were presented to a board meeting without sufficient notice or time to debate the full implications.

He asked the chairman to address the simple question: "How is it in shareholders' interests to reduce the number of non-executives on the board and why should they relinquish the right to remove directors?" He argued that the current rules protect shareholders and removing them was akin to "removing the bolt from the door on the argument that we have never had a burglary and some others in the neighbourhood don't have bolts on their doors either."

Eighteen percent of shareholders voted against the changes, a significant signal of concern. However, good governance seemed to have been observed: the nonexecutive directors had had their say, the issue had been debated openly by shareholders, the vote was cast.

Of course, the battle was far from over.

Having voiced their dissent, Messrs Simmonds and Cooke were now personae non grata on the board. Some of their colleagues took great exception to the way the pair had washed the board's dirty linen in public. The rest of the board felt that Simmonds and Cooke had given shareholders a false impression at the AGM, incorrectly suggesting that the chairman had behaved unethically and misled shareholders, and that the rest of the board had ignored their duties. More than one director demanded the dissidents' removal.

At the company's next board meeting, Simmonds and Cooke met in a separate room to the rest of the board, while David Arculus shuttled between the two groups trying to broker a deal.

The two dissidents offered to resign, if Sir John Hoskyns and Robin Miller resigned likewise. Professor Simmonds told one newspaper: "The dispute stems from the chairman's behaviour. I cannot stand down unless I am first assured he would be standing down as well – without that I would not be discharging my responsibility to shareholders."

Ultimately, no deal could be reached, but Sir John had given assurances to shareholders at the annual meeting that the powers to remove directors enshrined in the freshly amended articles would not be used to oust Simmonds and Cooke. Ironically, the board couldn't use its new powers to dismiss the two directors who had opposed the introduction of those powers.

Instead, the company called an extraordinary general meeting – a nonroutine meeting of all shareholders, usually called to consider a single issue. In this instance, that issue was the removal of Simmonds and Cooke from the board. In the end, therefore, the question of the pair's continued board service would be put to the people they represented – the shareholders. The UK governance consultancy, PIRC, advised shareholders to oppose the measures. The US-based proxy advisors, Institutional Shareholder Services, did likewise.

At the EGM the company secured the support of nearly 90 percent of shareholders for the directors' removal, although several large institutions were said to have given support on certain conditions – that the nonexecutive directors be replaced and that the list of possible successors to the chairmanship not be limited to the current chief executive.

The EGM, however, provided a platform for the two dissidents to make a defense of good governance. Professor Simmonds explained to the meeting why he had not retired quietly when it was clear he no longer had the support of his colleagues: "All we could have delivered to shareholders by quiet retirement was complete capitulation." He said that he had acted to protect Emap's future value, telling shareholders: "You need to make sure that the board . . . does not fall under the effective control of any one person, and that internal self-policing is adequately provided for. . . . The articles on corporate governance which we were keen to protect had been included specifically because of problems this company had experienced in the past when managing changes in board composition and responsibilities."

Professor Simmonds said that boards should actively encourage argument and minority views from nonexecutive directors, but that "to remove a minority for trying to ensure shareholders are fully informed is dangerous. . . . It should not be viewed as a crime to inform shareholders properly. Non-executive directors have an overriding responsibility to speak out to shareholders when it is in the shareholders' and the company's interest."

He concluded by offering a number of suggestions for protecting Emap's future value:

- Confront the succession issue speedily.
- Limit the board's power to remove directors to a 100 percent vote.
- Reinstate the article to have at least five nonexecutive directors.
- Expect full and clear reasons for all governance changes.

- Reject any private commitment to a subgroup of shareholders.
- Welcome minority statements in good faith. They are not a crime.
- Appoint some nonexecutive directors who are not also executives elsewhere.

The *Financial Times's* influential Lex column wrote that the vote was "a slap in the face to two courageous men" and that the EGM result sent "an unfortunate message to other companies tempted to ride roughshod over non-executives."

Update: corporate governance concerns continue at Emap. In 2007, a group of shareholders asked CEO Alun Cathcart to allow former managing director Sir David Arculus to return to the company. When he left, the stock was trading at £15 a share. It had fallen to 875 p. Arculus seemed sanguine. "'I think Emap always had a pretty dysfunctional board,' says the man now attempting his own boardroom coup."[77] The company has since been broken up, its pieces sold to other firms. ■

The Emap dispute highlights the tensions inherent in a unitary board structure in which non-executives have a monitoring function. To keep that tension creative rather than destructive is the challenge for all sides.

Is collegiality an essential boardroom virtue? More so than independence? How can the two virtues be reconciled?

What options does a nonexecutive have if he vehemently disagrees with the majority? What good does he do by resigning quietly? But does he harm the company by speaking out? (Bear in mind that by forcing Emap to call an EGM to remove them, the dissidents imposed considerable costs on the company, borne by shareholders.) Should directors be sacked for opposing in good faith moves they consider not to be in shareholders' interests? Would a company be hurt if a minority of nonexecutive directors spoke out publicly but amicably? Do nonexecutive directors serve at shareholders' pleasure or management's?

Is the Emap episode actually a good advertisement for corporate democracy? After all, the final decision was left to shareholders.

Political democracies have devised systems (such as the US Bill of Rights) to protect minority interests from the will of the majority. Can a board operate according to a similar constitution? If a company is indeed run by a tyrannous majority, is there any way of stopping it?

LIMITS AND OBSTACLES TO EFFECTIVE BOARD OVERSIGHT BY SHAREHOLDERS

In part because the obstacles to effective oversight of directors have been so insurmountable, shareholders for decades adopted the "Wall Street rule" – vote with management or sell the shares. Selling the shares, however, is an ineffective and self-destructive policy in an era where as

much as 70 percent of the stock is held by institutional investors, many of which are indexed. If director and management error has depressed the value of the stock, it is likely to be more cost-effective to replace the board than to bear the transaction and opportunity costs of selling the stock. If O. J. Simpson is on the audit committee, that should be a signal to investors that management does not want a very close look at its auditors. If Lehman Brothers has on its board an actress, an admiral, and a theatrical producer, but not one person with any expertise in the kinds of derivative instruments there were, then perhaps the investors should see that as an indicator of a problem.

Good corporate governance should be a part of the buy/sell/hold decision of a portfolio security because it is an element of investment risk. Corporate governance risk should be as essential a part of securities analysis as the cash flow and earnings, and the decisions to vote proxies, submit shareholder proposals, and run dissident candidates for the board should be evaluated as carefully as the buy/sell/hold decisions. Shareholders should focus on the board of directors – its composition, effectiveness, responsiveness, and agenda.

The job of effectively involved shareholders can be simply described as ensuring that the board of directors does its job. This means making sure that the right people are on the board, that they are focusing on the right issues, and that they operate under a structure that enables them to ask the right questions and reach the right answers. This is the answer to the agency costs issues, the most effective way for the ownership to exercise the appropriate level of control.

While the culture and law have improved director effectiveness, there are still significant barriers to prevent shareholders from holding board members accountable when they fail to hold managers accountable. We will examine the range of carrots and sticks to see how effective they are before we look at future directions.

CARROTS: DIRECTOR COMPENSATION AND INCENTIVES

The board is responsible for aligning the interests of managers and shareholders and one of its most important tools is executive compensation. Who is responsible for doing the same for the board? Whether director pay is designed by management (who signs the checks) or the board members themselves (who cash the checks), the agency cost risks are significant.

Increasing demands on directors are resulting in increasing pay. The Corporate Library's 2006 director pay survey found that the median year-on-year increase in board pay was 19.62 percent. Four of the five highest paid single board positions are occupied by independent chairmen – one a chairman emeritus. The highest paid non-chairman director was William Snow, a director at Movie Gallery, who received a very substantial stock option award along with a more modest cash retainer to total almost $2.5 million. "Professional" directors James Johnson, Ann Korologos, and Thomas Kean had pay from six board positions each. These three directors each earned between $1.35 million and $2 million from their multiple directorships. CEOs are in demand. John Snow, then CEO of CSX and later Treasury Secretary, served on seven outside boards. Increasingly, however, boards are limiting the outside activities of their CEOs, making it difficult to find CEO candidates who can serve as directors.

A 2005 Spencer Stuart report found that: "more of directors' compensation is coming from annual retainers, which continue to rise. The average annual retainer is now $56,550, up 14 percent

for the second year in a row and 64 percent from five years ago. Although retainers are usually payable in cash, more boards are including stock grants as part of this amount." The highest retainers in their report were $250,000 at General Electric and $200,000 at Archer Daniels Midland, Electronic Data Systems, Ford Motor, General Motors, and Hewlett-Packard. Outright stock grants beyond the retainer were up (60 percent in 2005 versus 45 percent in 2000) and stock option grants were down (56 percent in 2005 versus 66 percent in 2000).

CASE IN POINT DIRECTOR PAY AT COCA-COLA

Commentary from Paul Hodgson of The Corporate Library on April 10, 2006:

"*[At Coca-Cola, not only are] directors' stock unit awards dependent on meeting a compound earnings per share target, so too is CEO Neville Isdell's latest stock unit award.*

The new compensation plan for directors is described in an 8-K filing, very simply:

> *The Compensation Plan grants directors equity share units each year equal to a flat fee of $175,000 payable only upon the attainment of pre-defined performance targets. When the performance target is met at the end of the performance period, the share units will be payable in cash. Should the performance target not be met, all share units and hypothetical dividends would be forfeited in their entirety.... For 2006, the Board of Directors set an initial three-year performance target of 8 percent compounded annual growth in earnings per share. The Company will use its 2005 earnings per share of $2.17 (after considering items impacting comparability) as the base for this percentage growth calculation.*

So, the directors are being held to an earnings target. What metric, then, is applied to executive management at the company? While the 2006 proxy statement description of Coca-Cola's annual incentive targets is a masterpiece of gobbledegook, long on "shareholder value" references and short on any kind of detail, an earlier 8-K filing is very plain about the performance target attached to the grant of performance share units for the CEO worth a potential $3.4MM at today's prices, considerably more than is at stake for the directors. There are no prizes for guessing that the target is... compound annual growth in earnings per share.

I am already on record as saying that I am not philosophically opposed to incentive plans for directors, and we can, at least, be grateful to Coca-Cola for opening up the debate. There is no reason why a well-designed incentive plan could not be put into operation for the board of directors which would provide additional rewards for successful completion of long-term strategic plans. Unfortunately, we are not dealing with such a plan here. The choice of earnings – the measure most often associated with financial misstatements – is one of the major flaws in the plan, but it is not the only one. Firstly, earnings is an operational target, not only best measured over the short-term, but also a financial target that should be within the purview of the CEO

and other strategically motivated senior officers, but should not be their primary focus. Earnings targets are the responsibility of divisional, departmental and executive vice presidents. The board, and the CEO at the very least, should be focused on metrics of far greater long-term value. It is not being suggested that Coca-Cola's directors will manipulate earnings in order to receive their compensation, but the board should never have put itself in a position where this was even a suspicion. This would be less of a problem, had not the SEC accused the company of manipulating earnings between 1997 and 1999. It is simply common sense to say that no director should be placed in the position of assessing whether management has manipulated earnings if that director's compensation is entirely dependent on the successful outcome of such manipulation. Nor is it being suggested that the CEO and the board will collude to manipulate earnings, but why even raise the prospect of such a picture. Added to which, whether the company has met its earnings targets must be confirmed by... the audit committee, themselves eligible for payments from the plan.

This merely reminds commentators of the situation at Sovereign Bancorp (SOV). In October 2005, I wrote:

> *Pursuant to the Non-Employee Director's Bonus Award Program, now discontinued, 'an award earned hereunder with respect to a relevant year shall not be paid unless an award with respect to the same year has been earned under the terms of the Sovereign Bancorp, Inc. Senior Officers Bonus Award Program.' In other words, as long as senior officers got a bonus by meeting their annual target, the directors would get a bonus too. This provision presented a pretty clear potential conflict of interest: incentivizing directors to make sure that senior officers received a bonus so that they would get theirs. In addition, the condition that if senior officers didn't receive a bonus then nor would directors defeated the purpose of having a director's incentive plan in the first place. Potentially, such a plan, in order to assure that directors would receive a bonus, could encourage directors to make sure the target is set at a level that management will achieve or encourage them to manipulate performance figures or use specially constructed pro forma figures to ensure that an award is made. Furthermore, the Committee that determined whether the directors received a bonus consisted of the directors, and was the same Committee that determined whether the officers received a bonus.*
>
> *Incentive plans for directors do not necessarily have unfavorable implications. However, guidelines should be set in place in order to prevent possible conflicts of interest regardless of the amounts of money involved:*
>
> - *The plan should be administered by someone other than the directors being awarded.*
> - *Short-term operational targets, such as earnings, are not appropriate for a board that should be focused on long-term value.*
> - *There should be no conditional link to officers' receipt of bonuses at all.*

This all sounds very familiar, but Sovereign has since abandoned this plan. As I said earlier, we should be grateful to Coca-Cola for at least initiating the debate. Incentive plans for directors, properly designed, are not necessarily a bad thing. It is not anyone else's responsibility to suggest a more appropriate metric for use. The CEO and the directors, one would have thought, are in a much better position to understand what the long-term strategy is at Coca-Cola and what metrics might best measure the success of that long-term strategy. Directors should be placed in a position where they are free and incentivized to make decisions that will lead to long-term value growth for the people they represent – the stockholders. If such decisions can potentially lead to a short-term fall in earnings, an act that would result in them forfeiting their compensation, it would seem obvious that the choice of such a metric is mistaken, for the directors and the CEO."

What happened at Coca-Cola? Hodgson posted an update on December 14, 2009:

"*Coke's ditched the plan now, but the first time it is due to be paid out there are doubts that it will be. Agenda reports that a poor fourth quarter could jeopardize the plan payments, unless 'one-time items are excluded when calculating' EPS.*

Guess who is going to make the decision about including those one-time items? The CEO? His bonus depends on it. The board? Their pay depends on it. The audit committee? Their pay depends on it." ■

The increased demands on committee chairmen and on audit committee members are also resulting in higher compensation. Sarbanes–Oxley requires companies to disclose whether there is anyone on the committee who qualifies as a "financial expert," meeting a strict five-part test, so candidates who meet this standard are in demand. According to Spencer Stuart: "The average retainer for audit committee chairmen is 86 percent higher than the average retainer paid to chairmen of other committees; for compensation committee chairmen, the differential is 51 percent. The highest audit committee chairman retainer is paid by Monster Worldwide: $8,000 monthly or $96,000 annually. The next highest audit committee chair retainer is $50,000 per year (paid by two companies); another four companies pay $35,000. The highest compensation committee chairman retainer, $50,000 per year, is paid by PG&E. The next highest is $25,000 and is paid by five companies."

In addition to the retainers, meeting fees, chairmanship fees, and stock or option grants, most companies also give directors huge discounts on whatever they produce – not much value if they make ball-bearings, but invaluable if it is an airline. Retail company directors get free merchandise or discounts. (See the General Motors case study: at that company, directors received a new car every 90 days.) There are often other perquisites, like use of the corporate jet and charitable contributions to pet causes. Some companies, particularly those in turnaround situations, are beginning to pay their directors entirely in stock. Those companies include Apple Computer, Rite Aid, Campbell's Soup, Traveler's, ITT, Tribune, and Colgate–Palmolive.

For a job that seldom demands more than two weeks a year, the compensation is generous, especially for those who serve on several boards in addition to having full-time jobs. President Clinton's transition team chief, Vernon Jordan, earned $504,000 in fees from nine of the boards

on which he served in 1992, and if he'd retired from all his board positions in 1993, he would have received $160,000 annually in retirement fees. In the past, directors often got business from the companies for their law, consulting, or investment banking firms as well, but new "independence" restrictions have discouraged these relationships.

These pay schemes rarely relate to the performance of the company – or, of course, to the performance of the director. A director will receive his retainer and fees, no matter what. If a cash retainer is the largest portion of the compensation, it will not rise in good years or fall in bad. Such a scheme provides no incentive. The stock component in some directors' compensation packages is rarely significant enough to make the company's performance an issue. Thus, not only do most directors not hold a significant portion of their worth in the company's stock, but traditionally their pay has not been designed to align their interests with shareholders.

There have been two major changes in director compensation over the past two decades, both in response to shareholder concerns. First, more directors are paid in stock or stock options, to more closely align their interests with the interests of the shareholders. Second, director retirement plans, which more than doubled from 1986 to 1991, have all but disappeared, thanks, in large part, to the efforts of a single shareholder, William Steiner, who targeted these plans with a barrage of shareholder proposals. A 1995 National Association of Corporate Directors report recommended that boards set a target for substantial stock ownership by directors and pay directors solely in stock (or stock options) and cash, dismantle benefit programs, eliminate any side payments (consulting, legal fees) paid to directors, and make comprehensive disclosure of the process and content of director compensation. Companies are slowly moving in that direction.

It is important to make sure, though, that directors' stock is not a gift or a substitute for some other perquisite like a pension. Otherwise, stock awards would merely be a way of exchanging one marginal compensation supplement for another. Programs "to facilitate share acquisition" are not meaningful unless the value of the incentives is directly and explicitly set off against current compensation levels. As Graef Crystal writes:

> *Giving the directors more stock is not a bad idea per se. But I strongly suspect that the critics who were pushing for more stock had in mind some form of capital contribution by the directors, perhaps cutting the cash compensation of the outside directors and then substituting shares of stock with an equivalent economic value. I even more strongly suspect that the critics didn't have in mind letting the outside directors continue to receive their usual cash compensation and then giving them free shares of stock and stock options on top of that.*[78]

Unless carefully designed, stock-related compensation (in the form of stock options and/or outright grants) for directors could encourage measures that attempt to engineer a short-term increase in the stock price at the expense of long-term viability for the company (for example, drastically reducing R&D). This can be addressed by the use of awards of restricted stock vesting 12 to 36 months after the director retires from the board. A growing trend is deferral or conversion of retainer and fees for up to a 50 percent discount of the current stock price; however, these programs should be designed so that they do not interfere with the board's ability to limit the terms of directors they do not want to keep on the board. The most important goal here is for directors to have enough of their own financial future at risk to think like shareholders. Lawrence Tucker of Brown

Brothers Harriman was a director on one board in which the other outside directors' average investment in the company was nearly $1 million apiece. He said: "Believe me, that is a board that pays attention.... I've never seen the pocket calculators come out so quickly in my life."[79]

Director compensation is one of the most sensitive and complex tasks facing the board and the company, because, by definition, no member of the board can view the issue without conflicts. For that reason, many observers, including the National Association of Corporate Directors' Blue Ribbon Commissions on Executive Compensation and on Performance Evaluation of Chief Executive Officers, Boards, and Directors, recommend that boards should impose procedural safeguards to ensure credibility, including enhanced disclosure, review, and greater reliance on stock-based pay. Options for implementing these safeguards include full disclosure of director compensation in the proxy statement, with supporting data justifying the approach, and submitting the director compensation plan to a review by an independent expert (not the company's or the board's compensation consultants) from time to time, publishing a summary of that review in the proxy statement. The 2006 amendments to the compensation disclosure rules include significant additional requirements for providing information about director pay. However, even that will not be enough unless shareholders review director pay disclosures carefully and respond by withholding votes for directors who approve poor pay plans and by submitting resolutions to make sure that director pay plans are designed to align the interests of directors with shareholders.

How can these improvements be achieved? What initiatives can shareholders, managers, or directors themselves take to align director pay better with corporate performance? With director performance?

STICKS, PART 1: CAN INVESTORS ENSURE OR IMPROVE BOARD INDEPENDENCE BY REPLACING DIRECTORS WHO PERFORM BADLY OR SUING DIRECTORS WHO FAIL TO ACT AS FIDUCIARIES?

Although there is much theory and some data to recommend outside directors, their impact is still difficult to quantify, and research on this subject remains limited.[80] That is because independence is impossible to measure when management decides who serves on the board, how the board is paid, and who will serve on which committees. If shareholders cannot replace directors, can they be independent in any meaningful way?

CAN DIRECTORS BE HELD ACCOUNTABLE THROUGH THE ELECTION PROCESS?

One of the most contentious elements of the Dodd–Frank financial reform bill was a provision giving shareholders "proxy access," the opportunity to put their own candidates on management's proxy card. Congress decided to keep the provision but turn it over to the SEC to set the details for eligibility and implementation. Granting the right does not guarantee that shareholders will

exercise it, for the reasons discussed in chapter 2. The British investment institutions have so far not taken advantage of their ability to play a role in nominating directors, despite the strong recommendation of the Cadbury Report.

Increasingly, the board's nominating committee is playing a more active role than the past rubber-stamping of management's candidates, and increasingly they are relying on search firms to help them locate candidates who are qualified and not connected with management. However, the critical appointment offer and any renewal decision depends on approval of the chairman/CEO, a process that falls far short of true independence. Nonexecutive directorships are prestigious, well paid, banners of achievement, and unsurpassed networking opportunities. It is understandable that people of achievement covet them and do not want to lose them. It is also understandable that the system makes it difficult for those who want directorships to restrain or focus a CEO who will decide whether they get to stay in that very exclusive club.

The "majority vote" provision in earlier versions of Dodd–Frank did not make it into the final version, so that legally a director who is running unopposed needs only a single vote to be elected. Most public corporations recognize that if shareholders do not want someone on the board, that person should not serve. More than 500 have adopted explicit policies along those lines. However, at the other end of the spectrum, The Corporate Library has identified six directors who received less than one-third of the vote from shareholders, one of them as little as 20 percent, Edward C. Nafus, director and former CEO of CSG Systems International, Inc., who continues to serve on the board.

What is needed for an "independent" director under pressure to act independently when required?

Shareholder responsibility for board nominations is very clear in Britain. It is the obligation to ensure the services of an appropriate board of directors on a continuing basis, an obligation that is routinely delegated to chairmen/CEOs. However, shareholders retain a powerful reserve power. The Companies Act permits the removal of directors by shareholders at a specially convened EGM. In America, while the theoretical obligation is the same, implementation is more difficult, particularly because of the chilling effect of disclosure requirements that are triggered by as few as 5 percent of the shareholders working together to influence management.

However, in 2010, the board of Liverpool Football Club's parent company decided to sell the Club against the vigorous objections of its ultimate controlling shareholders, the American businessmen Tom Hicks and George Gillett. They were not able to replace the board, even though they had the majority of the stock. After two separate trips to the English High Court, the directors and the Club's principal creditor, RBS, were upheld, and the sale of the Club went forward. Hicks and Gillett ran into two snags. First, they had already ceded certain authority to the board to provide assurances to RBS and could not take it back. Second, they did not follow the required procedures for replacing directors.

CASE IN POINT SEARS

The "independence" of independent directors selected by management was put into focus when Robert A. G. Monks, co-author of this book, ran a campaign to be an independent director of Sears in 1991. At Sears, where the CEO also served as chairman of

the board, CEO of the largest operating division, and head of the board's nominating committee, and four directors were insiders, outside directors not selected by management were so threatening that Sears budgeted $5.5 million (22 times Monks' budget) to defeat his candidacy. (See the case study in chapter 7.)

In 1971, a Harvard Business School professor named Myles Mace conducted a landmark study of boards, and concluded that directors were "ornaments on a corporate Christmas tree." His description echoed U.S. Steel chairman Irving S. Olds who once described directors as "the parsley on the fish – decorative but useless."[81] Since Mace's day, things have improved markedly, but directors still have a long way to go before they exercise their power on behalf of shareholders' interests.

Boards of directors, despite the much-ballyhooed rise of the independent outside director, have seldom succeeded in effectively overseeing management. Rather, the CEO/chairman wields the power in the boardroom, and directors mostly serve at his pleasure. This is not to say that directors do nothing, or that they cannot check managerial abuse. But it is true that boards are mostly reactive, not proactive.

Millstein and Knowlton put it this way:

> *Directors are forced to spend a great deal of their time – in our view, most of it – going by 'the numbers' and by 'the book,' endlessly reviewing financial results, making sure their tracks are covered, and helping their companies mostly, we feel, by the exercise of negative virtues: reducing risks, preventing egregious mistakes, making sure things are 'in order.'*[82]

Not all boards fail in their duty to oversee management. Directors who are meaningfully invested in the company (and that usually means financially) are usually effective monitors and make sure that managers act in the shareholders' interests through a combination of incentives, strategic oversight, and prompt response to potential problems. In almost every case, crisis inspires directors to do the right thing for shareholders.

We have seen in the previous section how the boardroom system conspires against genuine representation of owners' interests.

What can the shareholders do about it? What happens if the board fails to represent the owners? Who watches the watchers?

In theory, directors, like politicians, are elected by their constituents. This system, like representative democracy, is predicated on the assumption that if shareholders don't approve of their representatives, they will "throw the bums out."

As noted above, however, most observers will agree that the electoral process has not been an effective mechanism for ensuring that directors represent the interests of the shareholders. Edward J. Epstein says that shareholder elections "are procedurally much more akin to the elections held by the Communist party of North Korea than those held in Western democracies."[83] The reality backs

him up. Management picks the slate of candidates, no one runs against them, and management counts the votes. Managers even know how shareholders vote. As soon as the votes come in, they can call and try to persuade (or pressure) those who vote against them. Of course, management also has access to the corporate treasury to finance its search for candidates and solicit support for their election, while anyone running against them must put up their own money. (Successful dissident slates often get reimbursed, however, once they are in office.) Management has access to the shareholder list; a dissident shareholder still faces significant obstacles (see the Sears case study), including millions of dollars for lawyers, ads, mailings, etc., though a few of the regulatory restrictions were eliminated in 1992 SEC rule changes.

In this section, we will look at how the electoral system can be manipulated to reduce the efficacy of shareholder voting rights. As mentioned above, in reality, it is more a ratification than an election, because in more than 99 percent of the votes, the management candidates run without opposition. The "election" is really just a formality. Except for the rare case of a proxy contest, where those trying for control of the company nominate (and finance) a competing slate of directors, there is no chance of the nominees not being elected. Shareholders cannot vote "no" to unopposed directors. They can only abstain by withholding their support, and their abstentions currently carry little weight; it only takes one yes vote from a single shareholder to get a slate of unopposed candidates elected, no matter how many shareholders refuse to support them. Note that this is an area of rapid change – see the discussion of majority vote and proxy access proposals at the end of the chapter.

Corporate managers often seek to limit shareholders' voting rights. They argue, correctly, that corporations cannot be run by referenda. However, there is a difference between governing a company as a "town hall" and allowing shareholders a voice in the governance of the corporation they own.

How should we define this difference? Who should define it?

The Dodd–Frank financial reform legislation of 2010 gave the SEC the authority to issue a rule granting shareholders "proxy access" to nominate their own candidates for the board. Along with the increase in voluntarily adopted "majority vote" provisions requiring that a director receive a majority of the votes cast in order to be qualified to serve, these developments may bring about the most meaningful shift in board "independence" since the development of the public company structure. Representatives of corporate managers challenged this provision in court with a suit that has delayed its implementation.

The anti-takeover measures described earlier in this chapter protect management from corporate raiders but they also "protect" management from market-driven shareholder initiatives.

STAGGERED BOARDS

Until the mid- to late-1980s, it was the all but universal practice for all directors to be elected at each annual meeting of shareholders. Thus, a director would serve a succession of yearly terms either until retirement or until the nominating committee decided not to propose him for re-election.

The takeover era, however, raised the possibility of raiders being able to take over a company by nominating a separate slate of directors and seeking votes from shareholders to vote for the dissident's slate over management's.

As a protective device, companies began to nominate directors for three staggered sets of three-year terms. Thus, the board would be divided into three sets, or classes, of directors who would each be nominated for re-election every three years. In this way, an acquirer would have to run a dissident slate three years running to replace the board – an impossibly long time to maintain a hostile bid.

This practice became especially popular in the late 1980s. By 1991, 51 percent of sample companies elected directors to three-year terms, up from 33 percent in 1986.[84] The Commonwealth of Massachusetts enacted a law *requiring* all companies incorporated there to adopt a staggered board structure, just to protect one local company from a prospective hostile acquirer.

In adopting a staggered (or classified) board structure, management argued that it assured the "continuity" of board service. This ignored the fact that it should be up to the shareholders whether they wish their directors to continue representing them or not. When Carl Icahn won a proxy contest for a minority number of seats (because the board was staggered) at Blockbuster, he knocked the CEO off the board. The other directors promptly voted to create a new board seat and put the CEO into it, explaining that it was necessary for "continuity," even though the shareholders, by electing someone else, made it as clear as they possibly could that continuity was exactly what they did not want.

Studies performed by Securities and Exchange Commission economists support the view that classified boards are contrary to shareholder interests. These studies demonstrate that adoption of a classified board can result in loss of share value.[85] There is the greater issue of accountability, however. Shareholder advocates believe that holders have the right to vote on all of their directors every year.[86] They believe that staggered boards, in protecting directors from raiders, also serve to "protect" the board from the company's shareholders. In making it more difficult for an outsider to present shareholders with an alternative, the staggered board structure makes it even more difficult for shareholders to play a meaningful role in the election of directors.

Despite the arguments of defense-oriented corporate counsel,[87] companies began to return to annual election of directors following the post-Enron reforms. In 2011, following shareholder proposals from the Florida pension fund and the Nathan Cummings Foundation, 13 companies switched to annual election of directors.

CONFIDENTIAL VOTING

Conflicts of interest, both political and commercial, make confidential voting an important issue to many shareholders. These conflicts are inherent in any situation where management (or its agents) is counting the nonconfidential votes. Without the protection of confidentiality, corporate managers know as soon as the votes come in who has voted and how they voted. Since new proxies can be submitted at any time up to the moment votes are counted, intense pressure can be placed on shareholders who also happen to have a close business relationship with the company in question. It was common practice for companies to call dissident shareholders and persuade them to change their votes to support management.[88] (See the discussion of conflicts of interest among institutional investors in chapter 2 and the case in point about the pressure Hewlett-Packard put on Deutsche Asset Management in the fight over the merger with Compaq, demonstrating the obstacles to effective shareholder oversight that result from a lack of confidential voting.) The beneficial holders, for example, the individuals who are pension plan participants or investors in mutual funds, had no way of finding out how votes are cast on their behalf. For that reason, it was easy for institutional investors to succumb to pressure to vote with management.

Many companies have adopted some form of confidential voting policy, in part because the corporate community has decided that it costs them little and means a lot to shareholder activists. However, some of these policies are written very narrowly. Often they do not apply in the case of a proxy contest, exactly the situation where confidential voting proponents argue they are most needed.

The Department of Labor has directed ERISA fiduciaries to monitor the way that proxies are voted by the money managers they retain,[89] which means that money managers must disclose their votes to the fiduciaries. There are two important aspects of full disclosure missing (or at least not explicit) in this requirement, however. First, the disclosure may apparently be in general or aggregate form. Unless the ERISA fiduciary insists on more detail, the information may be disclosed as "number of votes cast in favor of management-sponsored proxy issues relating to stock option plans" rather than "vote on the stock option plan proposed by Widget Co." Second, the disclosure is made to the ERISA plan fiduciaries, and not to the beneficial holders, the plan participants, or to the public. Still, this requirement does provide information to at least some of those who make the decision about which money managers to use. California now requires institutional investors subject to state law to make public the record of their proxy votes in order to limit their liability for any failure to cast the votes appropriately. This makes them more accountable to their plan participants, but it also exposes them to political pressure.

Should there be a requirement, along the lines of required disclosures for performance information, for institutional investors to disclose their proxy policies? Their proxy votes? To whom should the disclosures be made?

In January of 2003, the SEC issued a new rule that for the first time required money managers and mutual fund managers to disclose their proxy voting policies and any votes inconsistent with those policies. A report co-issued in 2006 by the American Federation of State, County, and Municipal Employees, AFL–CIO, and The Corporate Library, called "Enablers of Excess," analyzed the proxy voting records of 18 of the largest 25 mutual fund families for all executive compensation-related proposals at corporate annual meetings from July 1, 2004 to June 30, 2005. This report's purpose was to determine the extent to which mutual funds have voted to limit executive compensation or to tie it more closely to company performance. The report showed that mutual funds in general are enabling executive compensation excesses. With a few exceptions, the largest mutual fund families are complicit in runaway executive compensation because they have not used their voting power in ways that would constrain pay by tying it more closely to individual company performance. In the aggregate, the mutual funds voted to support management recommendations on compensation issues – both recommendations to vote in favor of management compensation proposals and recommendations to vote against shareholder proposals seeking executive pay reform – 73.9 percent of the time and rejected the management position only 23.7 percent of the time.

The most recent update of the report found the average level of support for management proposals on compensation issues in 2009 was 84 percent, up from 75.6 percent in 2005. The average level of support for the nine categories of compensation-related shareholder proposals rose sharply to 56 percent in 2009, up from 40 percent the year before.[90] As the financial meltdown made even clearer the link between incentive compensation and risk management, mutual funds continued to act as "pay enablers." (See the discussion of mutual funds in chapter 2.) However, there was a lot of variance in the voting patterns. "The average level of votes for directors selected for this study was 50 percent in 2009, up from 48 percent in 2008 but lower than the 58 percent level found in 2007.

Table 3.1 "Composite ranking" based on voting.

Rank	Fund	Score	Rank	Fund	Score
1	TIAA–CREF Asset Management	6.5	16	Smith Barney Asset Management	15.5
2	T. Rowe Price Group	7.5	17T	Fidelity Investments	16
3	Columbia Management	8	17T	Oppenheimer Funds	16
4	Federated Investors	9	17T	Vanguard Group	16
5	JP Morgan Funds	9.5	20	Dreyfus Corporation	16.5
6T	Janus Capital Group	10	21	Morgan Stanley Funds	17
6T	DWS Scudder	10	22	Van Kampen Investments	17.5
8	Legg Mason Funds	10.5	23	American Funds	18
9	Schwab Funds	12	24T	Merrill Lynch Investment Managers	21
10T	Franklin Funds	13.5			
10T	Templeton Funds	13.5	24T	Ameriprise Financial	21
10T	MFS Investment Management	13.5	26	Lord Abbett	22.5
			27	AIM Investments	23
13T	Salomon Brothers	14	28	Barclays Global Investors	24
13T	American Century Investment Management	14	29	Alliance Bernstein Investments	25
15	Putnam Investments	14.5			

"1" = fund being most pay constraining on compensation issues.
"29" = greatest pay enables.

Voting results were quite polarized, with six fund families supporting all of the selected directors on whose election they voted and six supporting none of them."

To develop a comprehensive picture of how each fund family dealt with pay issues, a "composite ranking" was created by averaging each fund family's rankings based on their votes in the categories of management proposals and shareholder proposals (see table 3.1).

Despite the fiduciary standard theoretically applied to the majority of equity holders, mutual funds, pension funds, and other institutions, the electoral system still falls short of providing shareholders with any meaningful ability to make a change in the board. (See further discussion in chapter 2.)

This is an area where the rules and opportunities are changing quickly, however. The proxy voting disclosure requirement and general increased sensitivity to the issues of corporate governance in the post-Enron era have led to greater sensitivity to shareholder concerns in proxy voting. The 2009 change to the "broker vote" rules by the NYSE eliminated the "routine" category for many votes to give beneficial holders the right to vote on their own behalf. Groups like the Shareholders Education Network and Moxy Vote make information available for retail investors and others to understand proxy issues better. The majority vote and proxy access initiatives discussed below make the votes more meaningful, shifting the cost/risk–benefit analysis to make voting more valuable and thus worthy of careful analysis.

STICKS, PART 2: SUING FOR FAILURE TO PROTECT THE INTERESTS OF SHAREHOLDERS – ARE THE DUTIES OF CARE AND LOYALTY ENFORCEABLE?

Review the "Delaware factor" discussion above. Trans Union was a rare case finding in favor of the shareholders. The threats by large corporations to leave Delaware following that decision are likely to have played a role in the decades of pro-management decisions that followed. It is true that many frivolous shareholder lawsuits are filed and then settled quickly, giving the plaintiffs' lawyers a large fee, the nominal plaintiffs a nominal payment, and the defendant corporations protection from more legitimate and diligently prosecuted lawsuits. However, it is also true that with the exception of board members in Enron and WorldCom, no directors have had to pay any penalties out of their own pocket (and in those cases the penalties were negotiated in settlements, not imposed by courts) and no directors have had any personal liability for failure to meet their fiduciary obligation without direct, personal, embezzlement-style corruption.

Without an enforceable fiduciary standard, how can shareholders provide meaningful oversight?

FUTURE DIRECTIONS

Boards have an extraordinary range of responsibilities (see figure 3.3). Academics, judges, legislators, shareholders, managers, board advisers, and even directors themselves have made a number of recommendations for improving their ability to perform. The General Motors and American Express case studies show how boards overcame the obstacles of the current structure to respond to crises. In this section we will discuss some of these proposals to improve the performance of boards of directors that might allow – or even encourage – boards to pre-empt crises.

The post-takeover era has resulted in a new focus on independent directors as a group separate from the other directors. Increasingly, shareholders are looking to outsiders to take the lead on board issues. They are also asking for more of a role in setting the criteria for board service, if not involvement in the selection of the candidates themselves.

MAJORITY VOTING AND PROXY ACCESS

As noted above, corporate elections are based on plurality, not majority. Unless there is an opposing candidate, which occurs in less than one-tenth of 1 percent of director elections, a nominee does not need a majority of votes outstanding or even a majority of votes cast to be elected to the board. All a candidate needs is one vote, even his own. The "just vote no" or "withhold vote" approach first popularized by Stanford law professor (and former SEC Commissioner) Joseph Grundfest is, at most, symbolic. When a majority of the shareholders of AIG "withheld" approval for one of the candidates in 2005, it did not stop the board from seating him. The upcoming SEC rule on proxy access and the voluntary commitment of an increasing number of companies to seat only directors approved by a majority of the votes cast will make boards independent in a way they have not been before.

Delaware corporate law establishes plurality voting as the default, but allows corporations to establish a different threshold in their bylaws or articles of incorporation. Shareholders, increasingly

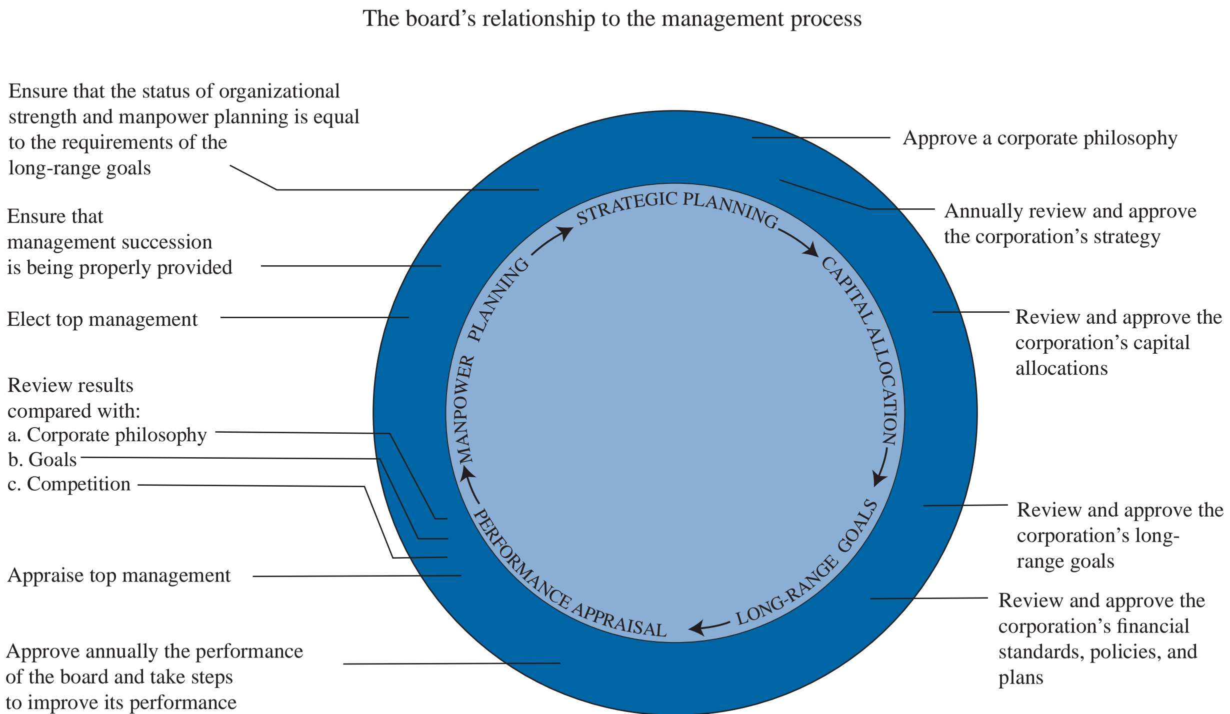


Figure 3.3 The board oversees the full cycle of management activities.

focused on board composition as the key factor, are pushing companies to adopt amendments providing that directors who do not receive the support of a majority of shareholders will not serve.

There are some tricky logistical challenges. The Delaware law states: "Each officer shall hold office until such officer's successor is elected and qualified or until such officer's earlier resignation or removal." To make sure that managers cannot remove directors just for disagreeing with them, the law provides that directors cannot be removed without cause, and cause typically means criminal activity. Even if the director who does not get majority support resigns, who fills the vacant seat? Someone selected by the remaining board members. For shareholders, this could be going from the frying pan into the fire as it will be a year at least, possibly (if the board terms are staggered) three years, before they get a chance to vote on the appointed candidate.

A report from Institutional Shareholder Services[91] notes the support for majority voting from the two most influential shareholder groups, the International Corporate Governance Network and the Council of Institutional Investors, and the work being done by the American Bar Association and other groups to develop mechanisms for implementing a majority vote standard. It also addresses the primary criticisms of a majority vote standard (that it will make directors unwilling to serve; that it is unnecessary or destabilizing) and finds them unpersuasive.

In 2010, The Corporate Library's database showed that more than 800 companies had adopted some form of majority vote, up from 500 only a few years earlier. It is likely that majority voting will become pervasive, if not universal, within the next decade. Even companies without such a standard will find it impossible to permit directors to serve if they have not received majority support from the shareholders. After all, the premise of the business judgment rule is that shareholders have delegated the authority to the board; it is hard to argue that they have done so if the directors have not mustered majority support. We predict that director and officer liability insurers will be unwilling to extend coverage to those directors; as a practical matter, then, they will not be able to be board members. Proxy access and majority vote will increase the independence of boards even without any action from investors as companies will need to demonstrate the ability of the directors to provide meaningful oversight to prevent use of these tools.

IMPROVING DIRECTOR COMPENSATION

As noted above, boards have already made a lot of progress in this direction, with increasing proportions of director compensation in the form of stock or stock options.

INCREASING THE AUTHORITY OF INDEPENDENT DIRECTORS

The scandals of 2002 and the financial meltdown of 2008 led to calls for more effective boards of directors. The New York Stock Exchange's post-Enron listing standards require listed companies to have a majority of independent outside directors and to have all of the key committees composed exclusively of independent outsiders. The Investor Responsibility Research Center's analysis showed that before adoption of this rule, 13 percent of NYSE listed companies did not have a majority of independent outside directors. With the new requirements to disclose whether there is a "financial expert" on the audit committee and increased sensitivity to the issue of independence from investors, director and officer liability insurers, and rating agencies, and the greater demands on time that have made it impossible to serve on as many as eight to ten boards, turnover has increased.

It intuitively seems a good rule of thumb to have a majority of the directors independent (with the caveats about the problems of determining true "independence" noted above), and many authorities recommend that the CEO should be the only insider on the board. Shareholders have submitted proposals asking that companies have a majority of outside directors, or that crucial committees like nominating, audit, and compensation be made up exclusively of outside directors. Some companies, including General Motors in 1991 (which already had a majority of outside directors, and even adopted a bylaw making it formal) agreed to the terms of the proposals, so they never went to a vote. It is now considered best practice and all but universal.

Proposals to split the positions of chairman and CEO fall into this category as well. The idea has been around for a while. In the UK, where there are often a number of insiders on the board, an independent outside chairman is the norm.

There is growing support for splitting the positions of CEO and board chairman, as described in chapter 2. One of the core challenges for a board is making sure that they get the information they need and the opportunity to deal with the most pressing issues, even if they are not the issues the CEO wants scrutinized at the moment. Splitting the two positions and giving an independent outsider the authority over the agenda and information could be the most powerful option for increasing effective, independent oversight. There is an exceptionally thoughtful discussion of the benefits of this approach in Sir Adrian Cadbury's book, *Corporate Governance and Chairmanship: A Personal View* (Oxford University Press, 2002).

In 1992, a shareholder resolution advising that Sears, Roebuck separate the two positions won 27 percent of the vote. The following year, the proposal was resubmitted and won 32 percent. The sponsor of the resolution at Sears explained the reasons for recommending a split:

> *I believe a person in the position of Chairman/CEO is subject to an inherent conflict of interest that the shareholders of Sears can no longer afford. This conflict, in my opinion, results from the obvious concentration of power and lack of accountability that results from combining the two positions. The CEO is the company's most senior manager, responsible for executing corporate strategy. When the same individual is chairman of the board of directors, which is charged with the duty of monitoring management on behalf of shareholders, it can create an untenable situation.*[92]

Sears resisted the pressure, but other companies targeted by shareholders have not. At General Motors, Westinghouse, Disney, Waste Management, Hewlett-Packard, and American Express – companies where the chief executive was forced to resign – the board took the opportunity to separate the roles of CEO and chairman, at least for a transitional period.

Many governance activists have backed the moves to separate the roles. Jamie Heard, then president of Institutional Shareholder Services, said: "The goal here is really not to emasculate CEOs; the goal is to empower the board."[93] Jay W. Lorsch of the Harvard Business School called such a separation "the single most significant thing to be done" by a company's board.[94] John Nash of the National Association of Corporate Directors said that the CEOs' attitude is that: "'It's my company and it's my board.' They don't get it that it's not."[95] The popularity of the "lead" or "presiding" director as a sort of vice-chairman who presides over the executive session meetings and serves as a liaison/ombudsman for the outside directors is an effort to address these concerns.

True independence will always be an issue as long as the CEO plays a dominant role in selecting directors. An independent nominating committee, working on the basis of a thoughtful board evaluation and in conjunction with a search firm, with a majority vote provision for shareholders to remove directors who do not meet their standards (and/or a proxy access provision to allow them to nominate their own candidates), is the only way to achieve real independence of thought and action.

"A MARKET FOR INDEPENDENT DIRECTORS"

A widely circulated proposal by Stanford's Ronald J. Gilson and Harvard's Reinier Kraakman suggests that institutional investors create "a market for independent directors" by "recruiting a class of outside directors who actively monitor public corporations, much as LBO sponsors or universal banks in Japan and Germany actively monitor their own companies."[96] They suggest that the institutions, perhaps through some coordinating entity like the CII or ISS, develop a cadre of full-time directors whose entire professional obligation would be to serve as director of five or six companies. Gilson and Kraakman point out that the institutions have the votes to make this possible. They suggest that compliance with SEC rules should not be too burdensome, as control is not at issue (though they recognize that reform of the proxy rules would be a significant help). They also suggest that a director of five companies is unlikely to become co-opted by any one of them.

The National Association of Corporate Directors (NACD) is a trade association based in Washington. NACD provides courses, studies, surveys, and materials, hosts conferences, convenes working groups on topics like executive compensation and CEO and director evaluation, and tracks and comments on legislation. Its publications include *Director's Monthly.* NACD also evaluates boards, provides training courses for directors, and maintains a database of director candidates. It has the potential for developing along the lines of the Gilson–Kraakman proposal.

In 1982, a group of British financial and industrial institutions, including the Bank of England, the Institutional Shareholders Committee, and the Confederation of British Industry established "PRO NED," a clearinghouse/headhunting firm to provide boards with qualified independent ("nonexecutive" in the UK) directors. PRO NED stands for the Promotion of Non-Executive Directors. Sir Adrian Cadbury, chairman of PRO NED, described the group as having three main tasks:

1. To promote the wider use of nonexecutive directors through publicity and other means; to provide general guidance for nonexecutive directors on the discharge of their duties; and to contribute to current thinking on the structure of company boards, the role of nonexecutive directors, and legislative and other developments (including prospective developments in the EEC) concerning these matters. PRO NED holds seminars and discussions on aspects of the nonexecutive director's role and work.
2. To maintain an extensive register of names of actual and/or potential nonexecutive directors, of high quality and of a wide range of business experience and qualifications.
3. To provide companies on request with the names of suitable candidates for their boards, of the right quality and background, from which a choice may be made, and to give help on the assessment of the overall capabilities of individual candidates and of their suitability for particular appointments.

PRO NED was ultimately purchased by an international search and consulting firm.

Would a PRO NED work in the US? What are the advantages and disadvantages of the kind of full-time director Gilson and Kraakman envision? Would this process ensure that the directors felt beholden to the shareholders rather than to management for their job? Gilson and Kraakman suggest that these directors would not worry about opposing management when necessary because the possible loss of one director position (out of five) would not be too great a financial risk. Do you agree?

In June of 2010, CalPERS announced that it was developing a database of director candidates so they can have them available to nominate as directors of underperforming portfolio companies.

"DESIGNATED DIRECTOR"

An interesting legislative initiative in Michigan permitted companies incorporated there to designate an independent director meeting certain criteria for special compensation, rights (including communication with shareholders at company expense), and responsibilities (including determinations on indemnification, transactions that raise conflict questions, and derivative litigation). This designation is limited to a three-year term. Significantly, companies who exercise this option have more limited liability. An organization called the Independent Director Foundation was created to encourage companies to take advantage of the new Michigan law and gather information on the way that independent directors are used. This idea, ahead of its time, never went anywhere, but it could serve as a model for reform in the post-Enron era.

Compare this with the "lead director." What are the advantages and disadvantages of both proposals?

BOARD EVALUATION

The National Association of Corporate Directors published a report on the performance evaluation of CEOs, boards, and directors in 1994. At that time, evaluation of the board's effectiveness and evaluation of particular directors was almost unheard of. Prepared by a Blue Ribbon Commission of directors, shareholders, academics, and corporate officers, the report urged boards to develop a system for setting goals and evaluating the performance of individual directors, board committees, and the board as a whole. One key recommendation was a separate evaluation of the CEO in his capacity as chairman, if the CEO serves in both positions. NACD's subsequent reports on director professionalism, CEO succession and strategic planning, and audit committees have been influential in promoting policies like director stock ownership, executive session meetings for outside directors, and making sure that directors are independent and have core competence in matters of finance.

EXECUTIVE SESSION MEETINGS

One of the key advances of the past decade has been the regular scheduling of executive session meetings of the outside directors, without any of the management team present. As one executive put it, "Having the meetings on the schedule following every board meeting means that no one ever has to ask that awkward question." The 1999 Korn/Ferry study reported that 69 percent

of the directors surveyed meet in executive session on an average of three times a year. It is now universal, thanks to a post-Enron reform imposed by the stock exchanges, and most directors say it has been the single most significant change in their experience as board members.

SUCCESSION PLANNING AND STRATEGIC PLANNING

Boards are becoming more involved in both succession planning and strategic planning, which, of course, are closely related. Both, in the past, have often been controlled by the CEO. NACD has also issued a worthwhile report on this task, the most complex and least-often successful task most directors face.

MAKING DIRECTORS GENUINELY "INDEPENDENT"

The primary conclusion of this chapter is that America's boards of directors have, more often than not, failed to protect shareholders' interests. In one respect, this was inevitable. We demand too much of corporate boards. They are selected, compensated, and informed by those they are supposed to oversee. We expect directors to be able to monitor management and direction of a company that may generate billions in sales with hundreds of thousands of employees in dozens of countries. There is the theory of the fiduciary standard holding them accountable, and the reality of actually being able to.

Independent directors were meant to be a means to an end. It was thought that informed, intelligent, and wise directors, of proven integrity, bound by a fiduciary standard, would effectively oversee management. Being outsiders, they wouldn't face the conflicts that might face, say, the chief operating officer, reluctant to criticize his boss and in no position to call for his ouster. The idea proved to be a mirage. Independence is an intangible concept. Outsiders cannot be guaranteed to be independent any more than insiders can be assumed to be compromised. At Sunbeam, for example, it was the inside managers who leaked to the press and the board the information that led to Al Dunlap's departure. (As table 4.1 shows, it is difficult to stay at the top over the long term.) Personality plays a strong role, so that the CEO's brother may be able to evaluate the boss's performance while an outsider with no connection may not.

Directors do not become independent just because they have no economic ties to the company beyond their job as a director. Disinterested outsiders can mean uninterested outsiders. The key is not "independence," arbitrarily defined, but whether a director's interests are aligned with those of the shareholders. If a director is to represent the interests of the shareholders, he must share those interests. More, he must be vitally connected to those interests. Majority vote requirements may make a difference in applying a market test and reminding directors where their responsibility lies. Even then, the dangers of co-option through control of the information and agenda mean that eternal vigilance by each individual and regular board-wide self-evaluation will be required. However, so far, the data show that the factor that makes the most difference is whether the director is, in terms of his own net worth, a significant shareholder.

The key to a good board is ownership. Each director's personal worth should be closely tied to the fortunes of the company. No director is going to remain passive if a quarter, or even a tenth, of his net worth is at stake.

CASE IN POINT **SALOMON INC.**

A CEO of Wall Street securities house Salomon Inc. described that company's criteria for board membership. The first such criterion was: "Be owner oriented – usually best demonstrated by an investment in Salomon's stock that is significant in relation to the individual's net worth."[97] Like Ben Rosen's involvement in Compaq, Salomon was saved by the intervention of a major shareholder (Warren Buffett) and then sold. ■

INVOLVEMENT BY THE FEDERAL GOVERNMENT

Before the enactment of Sarbanes–Oxley, Ira Millstein and John C. Whitehead, co-chairs of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, proposed that Congress enact legislation to:

1. Create and federally fund a Corporate Governance Conduct Board (or some such denominated entity):
   (a) with a chairman selected by the SEC, with the consent of the Senate, who is charged with selecting eight other members in consultation with the SEC,
   (b) members of which would be representative of the corporate governance constituency: shareholders, corporate directors, corporate management, investment banks and institutions, the New York Stock Exchange and NASDAQ,
   (c) charged with developing, through outreach and discussion, issuing and updating, as appropriate, a voluntary corporate governance code of conduct ("the Code").
2. Direct (and, if necessary, empower) the SEC to require that reporting companies disclose on an annual basis whether they comply with each element of the voluntary Code and explain any areas of noncompliance ("comply or explain").
3. Direct the Corporate Governance Conduct Board and the SEC to regularly survey and report to Congress and the public on the degree of compliance.

Following the financial meltdown, the government unexpectedly and unhappily found itself involved as a lender and a shareholder in a number of failing companies.

What governance reforms would a private equity group have insisted on in those circumstances and what made the government's position stronger or weaker in achieving those reforms?

Sarbanes–Oxley and the post-meltdown legislation Dodd–Frank included small but unprecedented incursions into corporate governance by the federal government. They did not go as far as Milstein and Whitehead had hoped, but they did strengthen the role of the independent directors, provide more transparency, and give shareholders access to the corporate proxy to nominate directors.

INVOLVEMENT BY SHAREHOLDERS

Whether it is the Exxon Committee or a special purpose monitoring organization, there are several proposals for shareholders to assert and exercise control over the selection and ordering of priorities of the board through some kind of collective action vehicle.[98] "*The mere fact that the directors will know that they have been chosen by investors should make them more responsive to shareholder concerns.*"[99] The most important factor to ensure effective oversight by directors is effective oversight by shareholders. As we have said on other occasions, boards of directors are like subatomic particles – they behave differently when they are observed.

SUMMARY AND DISCUSSION QUESTIONS

Unless there is a crisis, the board is almost universally overlooked. This chapter makes it clear that, whether they are a positive force, a negative force, or completely neglectful and ineffective, they play a crucial role in corporate strategy, reputation, and sustainability.

The single major challenge addressed by corporate governance is how to grant managers enormous discretionary power over the conduct of the business while holding them accountable for the use of that power. This is the function of the board of directors – at least in theory. In reality, as this chapter shows, directors have too often behaved as – and been treated as – an operating division of the company.

In the context of the post-Enron reforms, it is important to make a distinction between regulatory/legislative/compliance-related changes and best practices that developed as a reaction to market forces. The chapter spends some time on the duties of care and loyalty to understand what they mean in theory and in practice and how standards are evolving.

> *In the Disney/Ovitz case, what were the most significant factors that led the court to uphold a pay package that was universally agreed to be unjustifiable in business or market terms? (Note the judge's proviso that the leeway granted to the Disney board reflected the standards of behavior expected at the time and that courts may look at things differently in the future.)*

Control of information is a key issue in board effectiveness. "I didn't know" is a frequent defense offered in cases of corporate fraud and other meltdowns.

> *If directors have a duty of care and a duty of loyalty, how do they meet the duty of care in making sure that they get the information they need? When, if ever, is an 'I didn't know' defense sufficient for a director? How can directors make sure they do not get 'spun'?*

These questions serve as a good way to look at the overall conflict between giving corporate management enough authority to do the job while maintaining sufficient accountability to make sure that the job is done for the benefit of shareholders.

The biggest challenge for a board is often CEO succession planning, because it is there that the CEO/chairman's control of the agenda, information, and access to senior staff can provide an impenetrable barrier to independent oversight. The traditional control by the CEO over the selection of directors has also led to a self-perpetuating closed circle of failure of oversight more attributable to the process than to the ability or lack of goodwill on the part of the board members.

What is the basis on which a director should not be re-nominated? What information should the shareholders have in the event of such a decision? What do you think of the directors' responses to disagreements with management quoted in the chapter? What, if anything, would you have done differently? What do you think of the result? What, if anything, would improve it?

Should the law require that the director's real reasons for declining to serve on the board be disclosed to shareholders? (Note that it was exactly this issue that led to the disclosure of the 'pretexting' scandal at Hewlett-Packard. A director objected to the company's failure to disclose his reasons for leaving the board in its public filings.)

Is collegiality an essential boardroom virtue? More so than independence? How can the two virtues be reconciled? Would a company be hurt if a minority of non-executive directors spoke out publicly but amicably? Do non-executive directors serve at shareholders' pleasure, or management's? Is the Emap episode actually a good advertisement for corporate democracy? After all, the final decision was left to shareholders.

What initiatives can shareholders, managers, or directors themselves take to better align director pay with corporate performance? With director performance?

While evidence of the conflicts of interest on the Enron board and others due to "related party transactions" may suggest that these relationships impair the ability of the directors to provide effective oversight, there is no evidence that absence of these connections correlates to lower risk or higher return.

The chapter examines why is there no "market for independent directors," as proposed by Stanford's Ronald J. Gilson and Harvard's Reinier Kraakman.

What does it mean to be a genuinely 'independent' director? Is there such a thing as independence when management decides who is on the board? What can make directors more independent? Where have the post-Enron reforms been successful and what have they failed to address?

The post-Enron reforms imposed new obligations on the board, especially on the audit committee. The challenge now is to make sure the forest of good corporate governance does not get lost in the trees of checklists and compliance.

To what extent has that helped and hindered the ability of the board to focus on strategy and leadership? What boards work well? What boards do not? How do we know?

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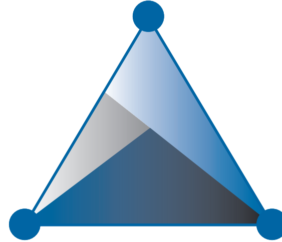
MANAGEMENT: PERFORMANCE



CONTENTS

- Introduction 348
- What Do We Want from the CEO? 354
- The Biggest Challenge 359
- Risk Management 363
- Executive Compensation 363
- Stock Options 374
- Restricted Stock 379
- Yes, We Have Good Examples 380
- Shareholder Concerns: Several Ways to Pay Day 380
- Future Directions for Executive Compensation 388
- CEO Employment Contracts 389
- CEO Succession Planning 391
- Sarbanes–Oxley 392
- Dodd–Frank 394
- Employees: Compensation and Ownership 395
- Employee Stock Ownership Plans 399
- Mondragón and Symmetry: Integration of Employees, Owners, and Directors 403
- Conclusion 409
- Summary and Discussion Questions 410
- Notes 411

INTRODUCTION

A 2002 cartoon by Mark Magee had a mother trying to break up a fight between two children. "Mommy!" one of them said, in tears, "Billy just called me a CEO!"

A year earlier, CEOs were up there with rock stars as figures of glamour and magic. For decades, *Time* magazine's men of the year were figures from politics and international affairs. In the 1990s, however, three were from business: CNN's Ted Turner, Intel's Andy Grove, and Amazon's Jeff Bezos. When long-time General Electric CEO Jack Welch retired, he was lauded as the greatest business leader of the twentieth century.

However, by the end of 2002, the CEOs with household names are the ones audiences watched refusing to testify before Congress. Welch's reputation also took a bad hit when his messy divorce led to disclosure of post-retirement goodies paid for by the company (and its shareholders) that included lifetime Knicks tickets, dry cleaning, flowers, and use of the corporate jet. The financial meltdown led to another wave of resentment as Wall Street bonuses continued after the bailout, even for those whose decisions had directly led to the collapse.

The rest of the business school curriculum is primarily devoted to issues of management, and we will not replicate those topics here. From the perspective of governance, the primary management-focused topics are incentive compensation and succession planning. This chapter will cover those topics as a way of examining the relationship between the CEO and the board and between the CEO and the shareholders. The best way to think of those relationships is in terms of those decisions that represent a potential conflict of interest. Investors want a compensation plan with a great deal of performance-based volatility, to reduce agency costs by aligning their interests. Managers are inclined to want less volatility and more certainty. It is the job of the board to resolve that conflict on behalf of the shareholders. As we have discussed in chapter 3, that is a challenge when management controls the choice of directors, the information they get, and their compensation. Similarly, investors want robust and independent oversight of succession planning. Most often, however, managers want to keep control of that process. This is the most difficult task for boards and the one at which they most often fail. We will cover those issues for their own sake and as examples and indicators of executive failures in managing risk and developing and executing sustainable growth strategies. (All of the case studies illustrate this point, especially General Motors, Lehman Brothers, Massey, and AIG.) We will also spend some time on employees and their role as staff and, through their pension funds, as owners.

CEOs like to think of themselves as leaders who communicate and inspire, but the business community has shown little leadership when it comes to speaking out on the failures on Wall Street and BP and before that at Tyco, WorldCom, Enron, Qwest, HealthSouth, Adelphia, and Global Crossing. Mismanagement at those companies cost investors hundreds of billions of dollars and thousands of employees their jobs. Business leaders blame the victims by describing the declining market as a crisis of investor confidence when it is more accurately a crisis of management credibility.

The credibility of corporate executives and indeed of the American form of capitalism has been damaged by excessive compensation that often appeared to have an inverse correlation to performance. The 1990s and 2000s saw one of the greatest wealth transfers in history, as CEO pay skyrocketed both in absolute terms and as a multiple of what the average worker took home. By 2006, the average CEO made 431 times more than the average worker.[1] If the minimum wage had risen at the same rate as executive pay since 1990, it would be $21.41 an hour as opposed to $5.15.

In the 1990s, CEOs reaped windfall profits from mega-grants of stock options, made possible in part by accounting quirks that did not require the value of the options to be subtracted from the balance sheet at the time of the award. CEOs also overdid the perks, with shareholders paying for their home security systems, their vacation air travel on corporate aircraft, their financial planning, even their taxes. Investors and employees believe that executives who are paid tens of millions of dollars should pay for their own cars and plane tickets. They also believe that compensation should vary with performance. In 2008–2009, the bonuses paid to executives at the companies receiving bailouts led to furious objections from legislators, regulators, and just about everyone who did not work on Wall Street. Adjustments were at best cosmetic. In 2009, CEO pay declined by 9 percent, but the pay was really just deferred – retirement benefits went up by 23 percent.

In the 1990s, the cult of the CEO was based on the idea that vision and the ability to inspire were what made the CEOs worth the hundreds of millions of dollars they were paid. However, a book by Harvard Business School professor Rakesh Khurana, *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs*, makes a compelling case that corporate boards err seriously when they pick chief executives based on "leadership" and "vision." Bringing in a CEO with a great record at another company may give the stock price a short-term boost, but with high-profile transplants such as Al Dunlap at Sunbeam (which went into bankruptcy) and Gary Wendt at Conseco (which went into bankruptcy), CEOs should have to make the same disclaimers that money managers do: "Past performance is no guarantee of future performance."

In the past, corporate board meetings have been more often pep rallies than meaningful exchanges. The late Tom Wyman reported that when he served on the board of General Motors "the briefing materials were delivered by forklift," but there was never any time on the agenda for questions or discussion. The meetings were presentations "followed by sage nodding," followed by goodbyes. He said, in a presentation to the National Association of Corporate Directors, that, in retrospect, the most troubling part of all was that it never occurred to anyone on the board that this was not acceptable.

As noted in chapter 3, in almost all US companies, the CEO also acts as chairman, setting the agenda and determining the quantity, quality, and timing of the information. There have been encouraging reports in the post-Enron, post-Sarbanes–Oxley, post-bailout era that boards are asking more questions and insisting on meeting without management present, but there have also been discouraging reports that CEOs are responding by involving (or distracting) board members in the minutiae of the financial reports and compliance checklists. The board is supposed to pay attention to the big picture.

Also as noted in chapter 3, CEOs have not set a good example of responsible share ownership. The largest investors in the world are America's corporate pension plans. The trustees of those plans are the very CEOs who run public companies. CEOs entrust their employees' retirement money to fund managers who have too often neglected early signs of problems at companies such as Global Crossing and Enron because they were dazzled by short-term returns or felt obligated to meet short-term benchmarks in order to keep the business. CEOs should make sure that before fund managers invest employee retirement money in the stock of a company, they look carefully at its corporate governance practices for risk factors – and they should make sure that those factors at their own companies are minimized. While they hold the stock, CEOs should have insisted that fund managers continue to monitor the boards of the companies they invest in on behalf of America's working families.

Of course the CEO's primary focus is on the leadership of his or her own company. Management of the modern corporation involves a series of Herculean challenges. Many of the corporate

governance issues concerning corporate management have been raised earlier, in the discussions of the corporation, the role of shareholders, and the CEO's relationship with directors. In this section, we will examine some of these issues from the perspective of its full-time, in-house leadership.

There seems to be a pendulum swing between reports that CEOs have unchecked power and reports that boards of directors are asserting their authority. In January 1993, a *Fortune* magazine cover story had a provocative headline echoing the Declaration of Independence: "The King is Dead." It went on: "Booted bosses, ornery owners, and beefed-up boards reflect a historic shift in corporate power. The imperial CEO has had his day – long live the shareholders." The article ran down a list of recently deposed CEOs, 13 from the Fortune 500 in just 18 months. How did this happen? Veteran journalist Thomas Stewart saw the events in Shakespearean terms:

> *And in the encircling tents, their armor glittering, their coffers brimming with gold, the Bolingbrokes of the piece: institutional investors, activist shareholders, and even the boards of directors themselves, the king's own court, to whom he gave preferment, now demanding his obeisance – if not his head . . . . What's manifest here is large, basic, and historic.*[2]

Stewart explained where the idea of the "CEO-King" began:

> *The passing of generations had attenuated the power of founding families (noted Adolf Berle and Gardiner Means), while the rise of the public corporation had spread ownership among tens of thousands of individual share-holders, none of whom could cast a meaningful vote in the governance of their companies. The result, Berle and Means showed, was a new class of professional managers who owned little of the corporation they nevertheless controlled. The merest whim of the imperial executive echoed like thunder down a valley. The CEO has to be careful, ran an old joke at General Electric: if he asks for a cup of coffee, somebody might run out and buy Brazil.*[3]

Stewart went on to say that, "paradoxically, executive leadership is becoming more indispensable than ever. Only the executive can mediate among the multitude of constituencies vying to influence every corporation: investors and lenders, communities, employees (who may be big investors), customers. The CEO may be on a shorter leash, but he's a more valuable dog."[4] Harvard's John Pound predicted that in the future CEOs will be more like a politician than a monarch, negotiating agreement with all of the different parts of the corporate constituency. As a long-time counsel to CEOs and directors Ira Millstein advises CEOs to adjust to a more consensus-based corporate governance structure. He wrote, in an article addressed to CEOs: "I ask you . . . to determine to what extent the board procedures at your companies encourage independence and hence suggest credibility. After all, if you don't, shareholders, plaintiffs, and the government may."[5]

In any relationship, especially one as intertwined as that of the CEO, board, and shareholders, any change in one party has an impact on the others. As shareholders and directors have become more active, the imperial CEO in the General Electric joke has begun to seem like a quaint cartoon figure.

It was only a very short time before that CEOs (and their lawyers and "their" boards) were quite comfortable with the idea that the CEO was, if not a king, then a benevolent dictator. Just three years before the "King is Dead" cover story, *Fortune* magazine ran a cover story about the "Pharaonic CEO," noting: "Pharaoh in all his glory would have envied today's CEOs their perquisites and ever-sweetening pay. Too busy living the cosseted life, America's managerial elite have lost touch with the humble employee. Workers' faith in top management is collapsing. CEOs who don't come down from the heights are in for trouble."[6] The article predicted that CEOs could not expect the support of employees who consider them out of touch. "Hourly workers and supervisors indeed agree that 'we're all in this together,' but what 'we're in' turns out to be a frame of mind that mistrusts senior management's intentions, doubts its competence, and resents its self-congratulatory pay."

CASE IN POINT — MERCK CREATES A PRODUCT NO ONE CAN PAY FOR

In 1978, William Campell, a veterinary researcher at pharmaceutical company Merck came to then-research laboratory director Roy Vagelos with a proposal that was a certain money-loser. Campell believed that an animal medication they had developed could be adapted for human use against one of the world's most devastating diseases, river blindness. The problem was that no one who was at risk for river blindness would be able to afford medication. The disease was only found in the poorest part of Africa. Vagelos approved the research necessary for developing the drug, knowing that it could reach $200 million or more, without notifying, much less getting permission from, the board. By the time the drug was ready for use, Vagelos was CEO. He developed a program to give the drug away, even though free distribution might create additional costs by cannibalizing sales of the veterinary form of the medication. This was consistent with a previous Merck program that provided antibiotics to Japan just after World War II to treat tuberculosis. This turned out to be more than just a humanitarian program; Japan permitted Merck to enter its markets as a result of their contribution. The river blindness program also led to other contributions from pharmaceutical companies.

In 1996, Glaxo Wellcome donated Malarone, used to prevent and treat malaria.
In 1998, SmithKline Beecham donated albendazole for another filarial parasitic disease.
In 1998 Pfizer Inc. donated zithromax for trachoma, a bacterial eye infection.

Sandy Smith: What's the approximate value of the product that's been donated so far?

Roy Vagelos: What is the value of preventing 18 million people from going blind? I don't know what the cost of the program is, but in the case of these sophisticated drugs, mostly the research and development part. The provision of the chemical is a minor

side, so it's not a significant cost. I can imagine that this program has cost Merck hundreds of millions of dollars over the years.

I've been asked why we did it. Because the company is so dedicated to health, our philosophy is that we do research and development to help people's health. And to have such a dynamite product that could never reach the people, that would be a very, very bad thing for that company, for scientists in general. So we thought we couldn't do that, and therefore we took this decision, and it had an incredibly positive effect on the scientists, who felt that this was exactly what Merck should be like. And it helped our recruiting forever. So it was worth whatever the cost is to raise morale and to help the recruiting of the scientists of the future. It sort of set a standard for the world.[7]

Should the board have been consulted? If you were on the board, how would you evaluate this program? ■

Interestingly, the insistence on a less "Pharaonic" CEO came not from employees but from elements never considered by the author of the "Pharaonic" article: the shareholders and the board. The CEOs of the early twenty-first century may resemble the Pharaonic model in some respect, particularly in the level of pay, but the "King is Dead" syndrome still prevails. A 1998 report by Tom Neff and Dayton Ogden of consulting and search firm Spencer Stuart identified "several trends that make the job of today's CEO more like 'The Perils of Pauline' than the 'Triumph of Succession.' The principal pressure comes from a demand for performance and board control of succession. Independent directors have made a CEO's seat much less secure and open to external benchmarking – not just within the industry where a company competes, but across industries." In addition, they noted the impact of mergers and acquisitions, pressure to perform, and another kind of pressure – from potential successors – as factors in reducing tenure. They found that 60 percent of the CEOs in the Fortune 200 served only five years or less. A 2006 report by Booz Allen Hamilton found:

> “*Global turnover of CEOs set another record in 2005, with more than one in seven of the world's largest companies making a change in leadership, compared with only one in 11 a decade earlier, according to our annual study of chief executive succession at the world's 2,500 largest public companies. The rate of outright dismissals was also near its peak: four times as many of the world's top CEOs were forced out last year as in 1995. Ten years ago, the CEO's job was all about "stewardship" of the corporation's assets for stakeholders; today, it's all about the bottom line for investors.*
>
> *There is reason to think that the wave of CEO turnover is cresting, however. The global rates of CEO departures, including CEOs who are fired as well as those who retire or leave as part of a planned succession, are starting to flatten out. Nonetheless, we don't expect turnover to decline too much. Investors' focus on performance is here to stay.*[8]”

Still, the idea of the CEO as benevolent dictator has support in some quarters. In a 2002 speech at the Stern School of Business, Federal Reserve Chairman Alan Greenspan said that, "it has increasingly fallen to corporate officers, especially the chief executive officer, to guide the business, hopefully in what he or she perceives to be in the best interest of shareholders." He admits that there is no such thing as an "independent" director, as long as management decides who gets to be on the board. What if the CEO doesn't pay enough attention to shareholder value? Greenspan was sanguine. "When companies do run into trouble, the *carte blanche* granted CEOs by shareholders is withdrawn." He is content to rely on "existing shareholders or successful hostile bidders." However, there is an inconsistency in his position; he then goes on to say that only a handful of investors have the capacity to make these judgments.

Past experience has shown that only a handful of boards have that capacity. General Motors, Bear Sterns, and Citigroup had prestigious boards that failed to assess risk and ensure a sustainable business model. As noted in chapter 3, Rakesh Khurana's book *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs* documents the mistakes made by boards of directors in selecting "superstar" CEOs who can dazzle the analysts and investors, but who may not have what it takes to run a company. Khurana makes it clear that the top priority should be managerial skills, not "leadership." Indeed, the kind of show-boating that leads to magazine covers and paying for sports stadiums should be an indicator that it is time to short the stock. Vision is good. Execution is better.

CASE IN POINT — TONY HAYWARD AND BP'S DEEPWATER HORIZON OIL LEAK

BP paid for an expensive ad campaign to rebrand itself. BP no longer stood for "British Petroleum," it told the world. It stood for "beyond petroleum" (the decision to use lower case letters communicated its unassuming friendliness). Like tobacco companies, BP had to find a way to deal with the plummeting public perception of its core product. BP adopted a cheery new logo that communicated its environmental sensitivity. Not everyone was impressed. A 2006 op-ed in the *New York Times* by a former branding consultant to the company claimed a better reading of the initials was "beyond propaganda."[9] He found it hypocritical to use that advertising campaign when the company was increasing its oil production.

When that piece was published, then-CEO Lord Browne had worked hard to promote the company's commitment to sustainable energy. It has gone beyond the required disclosures in revealing its environmental impact, including oil spill and emission information, employee satisfaction, days lost through injury at work, and community investment. When Lord Browne was CEO, the company was ranked in the Corporate Knights global "good guy" list in 2005 and 2006. However, Browne had just announced his departure, accelerated due to safety issues at an Alaskan facility and an explosion at a Texas refinery.

It fell off the "good guy" list after his successor, Tony Hayward, took over. Then, on April 20, 2010, the company's Deepwater Horizon rig blew up, killing 11 people and creating the biggest accidental oil spill in history, nearly 5 million barrels over three months, before it was capped.

Hayward's response came across as insensitive, clumsy, and out of touch. Arguably, the company's reputation suffered less from the spill itself than from by the way they handled it. Hayward had a chance to establish himself and his company as credible and capable. All he had to do was accept responsibility, be clear and candid about the steps they are taking to protect the employees and the inhabitants and wildlife affected by the spill, and explain how they will prevent future disasters.

Instead, he told the press that it was not BP's fault, blaming their contractors. Shockingly, he tried to minimize the impact of what will be the worst oil contamination in American history, claiming that the spill is "relatively tiny" compared with the "very big ocean." As oil gushed into the Gulf, he took time off to attend a yacht race. The company's board initially released a statement supporting him but then removed him as CEO and literally sent him to Siberia to oversee their Russian operations. In the fall of 2010 he resurfaced to announce that he has no regrets about the substance of the company's response, though he joked that he might have done better with some training as an actor about how to communicate because the company was unprepared for the intensity of the media coverage.[10]

Hayward was right about one thing. He admitted, "I will be judged by the nature of the response."

How could Hayward and the board have handled this more effectively? How could they have reduced the risk or mitigated the damage? ■

WHAT DO WE WANT FROM THE CEO?

The one certainty in business, as in life, is change. If it were possible, we all – investors, lenders, communities, employees, and customers – would want a CEO who could predict the future and guide the company accordingly. Since that is impossible, what we want is a CEO who is able, by virtue of ability, expertise, resources, motivation, and authority, not just to keep the company ready for change but ready also to benefit from changes, ideally to lead them. The CEO must be powerful enough to do the job, but accountable enough to make sure it is done correctly. The challenge for all of the participants in corporate governance is to make sure that there is enough of a balance between the two so that, overall, the decisions made by CEOs are in the long-term interests of the shareholders (and thus, by definition, all other constituencies) rather than in their own interests.

One of the key areas for achieving and evaluating this balance is executive compensation, discussed later in this chapter. The essential conflict between the goals of shareholders and management

is not over the amount of pay but over its variability and risk. Shareholders want a compensation plan with maximum variability based on corporate performance, and management's natural tendency is to want a compensation plan with maximum security. Before we can understand how to best link management compensation to corporate performance, however, we must take a look at how we measure corporate performance.

All methods of evaluating a company's value and performance are useful for evaluating the CEO. Perhaps one of the clearest indications of CEO quality is the structure of the organization itself. In general, the more diversified and conglomerated the company, the more likely it is to reflect the CEO's empire building and the less likely that it demonstrates focus and commitment to shareholder value (see the Sears and American Express case studies in chapter 7). As one management consultant put it, "The design trick is to be small where small is beautiful and then be big where big is beautiful."[11]

CASES IN POINT AT&T AND NCR

After the end of the go-go years of the 1980s takeover era, there was only one genuinely hostile takeover, and it was not by a raider like Carl Icahn or Donald Trump; it was AT&T's purchase of NCR. When NCR, a very entrepreneurial enterprise, made the classic argument of the target, that its special culture and constituencies required its independence (indeed, it was a pioneer of the constituency concept), it fell on deaf ears, ironically the ears of a board of directors that included several CEO veterans who had fought off their own would-be hostile acquirers, characterizing them as all but in league with the devil. Under their direction, AT&T, the giant bureaucracy, was willing to go forward at (literally) almost any cost. The shareholders were hard pressed to refuse. "As a stockholder, I have to say: 'Take the money and run. . . .' It's a major premium on the market by a qualified buyer. I don't see how they can say 'no.'"[12]

The acquisition was a disaster, destroying almost all of the value of NCR.

What was the logic of this deal? Why would an AT&T want an NCR? Why would an NCR resist? Keep in mind that such deals are generally supported by advice from lawyers and investment bankers who receive fees from the company, and evaluation by directors who have every reason to support management (and who get some satisfaction from presiding over an empire), and shareholders who say "take the money and run." So who is going to stop the bad deals and develop the good ones? More recent examples of disastrous acquisitions include Snapple at Quaker, The Learning Company at Mattel, and Telerate at Dow Jones. What happened to the CEOs who made these acquisitions?

If, as one thoughtful consultant argues, in order to master change, the primary requirement for organizational health over the long term is a continual sense of renewal, then what investors and other corporate constituents most want from the CEO is someone who will create a "culture of questions."

> *If you look at the history of companies, there's an irony in that the more successful they become, the more convinced they become of their knowledge and the rightness of their view of the world, and the more arrogant and insular they become. Whatever helped them become successful in the past becomes institutionalized. The more successful, the more institutionalized, and the more this is a danger. It's not surprising that the problems at GM or IBM or Sears developed while the companies were clearly their industry leaders.*[13]

CASES IN POINT BEYOND THE BALANCE SHEET

Hewlett-Packard. H-P announced in a filing submitted just moments before close of business on a Friday afternoon that their CEO, Mark Hurd, was leaving the company. He had been one of the most successful CEOs of the previous five years, creating billions in shareholder value and turning around a company in turmoil following the tumultuous departure of Carly Fiorina.

However, Hurd falsified his expense accounts in a tawdry series of incidents involving a one-time actress-turned seminar leader, and this came out after she filed a sexual harassment complaint against him. An investigation cleared him of the harassment charge, but found that the expense account fiddle was grounds for termination. It was not, apparently, grounds for termination "for cause" (a term not defined in Hurd's employment contract). Hurd left with a $40 million severance package and, because he did not have a noncompete, shortly got another job – at Oracle.

Boeing. The board of aerospace company Boeing thought they had solved their problem when they brought back former CEO Harry C. Stonecipher after a procurement scandal led to a jail sentence for its CFO and the departure of the CEO, Philip M. Condit. Stonecipher had been the company's COO, and he took over with a reassuring commitment to the highest standards of ethical conduct. However, 15 months later, in March of 2005, he, too, was out, when the board discovered that he had been having an affair with a subordinate and exchanging inappropriate emails with her on the company's computer network.

Radio Shack. When it was first revealed in early 2006 that Radio Shack's CEO, David Edmondson, had amplified his resumé with two degrees he did not have, the board first

issued a statement of support. Within days, however, they decided that he could no longer remain as CEO. Leonard Roberts, Radio Shack's chairman and himself former CEO of the company, said the move was necessary to restore the company's credibility.

Raytheon. A book of folksy business wisdom called *Swanson's Unwritten Rules of Management* by Raytheon CEO William H. Swanson was widely circulated by the company, which printed over 300,000 copies. The magazine *Business 2.0* featured it in a cover story, but it turned out that much of it was plagiarized from a 1944 book written by an engineering professor. Of Swanson's 33 rules, 17 were in the professor's book, often word for word. The board allowed him to keep his job, but cut his pay by nearly $1 million shortly after, in May of 2006, just before the company's annual shareholder meeting.

In all four of these cases, some people argued that the CEOs' mistakes were not related to the company's performance and should not be factored into decisions about whether they should stay in their jobs. In the case of the Raytheon CEO, who did keep his job, some argued that the $1 million pay cut was not an adequate response, that like the CEOs of Radio Shack and Boeing, he should be terminated.

What actions are outside the scope of performance in evaluating the CEO? How should issues of integrity and credibility be considered?

CASE IN POINT MORE ABOUT H-P AND HURD

The stormy tenure of H-P CEO Carly Fiorina finally led to a stormy departure in February of 2005, less than six years after she was hired as its first noninsider chief executive and chairman, following a 50 percent decline in share value during her time as CEO. The board appointed a nonexecutive chairman, Patricia Dunn, and brought in a new CEO, Mark Hurd. Dunn and some of the other directors were concerned about leaks, especially after some details of the board's strategic retreat were published. Dunn asked the board members if anyone wanted to admit being the source, and, when no one came forward, she asked the general counsel, Ann Baskins, to oversee an investigation. She was advised that as a target of the investigation, she could not be informed of all of the details, but was assured by Baskins and by outside counsel that it was within the law. It turned out that the investigation involved "pretexting," lying to cellphone companies to get copies of the records of the directors' phone calls. When the leaker was identified, he refused to resign, but

another director resigned in protest over the tactics. The company did not reveal the reason for his resignation in their SEC filing. It was not until his protest over this as a failure to include material information that the scandal became public, leading to a Congressional hearing, the resignation of both Dunn and Baskins, and indictments under state law.

At the hearing, Hurd accepted responsibility but explained that he had not known about the pretexting. He was not indicted and he kept his job.

The board fired Fiorina and retained Hurd. How do you compare the two decisions?

Five years later, the H-P board terminated Mark Hurd for what appeared to be a minor fiddle with his expense reimbursements, and there were many complaints that this was an over-reaction, most notably from Larry Ellison of rival Oracle. Many said it was a trivial violation from a very successful man and it should have been handled privately, with reimbursement and a stern talking to. This overlooks the post-Enron reforms providing that in order to do any business with the government (including eligibility for certain licenses to do business abroad) companies need to be able to demonstrate that they have "tone at the top" ethics and compliance in place. It says a good deal about our system of corporate governance – and our media and ourselves – that the announcement came as H-P was in the midst of settling a $50 million false claim charge with the federal government. Perhaps because this story did not have the sizzle of a sexual harassment charge from a small-time actress, it did not result in either disciplinary action against the CEO or headlines in the financial press or mainstream media.

When the government investigates companies in these cases, the authorities have to decide whether to prosecute criminally or settle for a civil fine. They also have to decide whether to target the company as a whole or just some lone, unauthorized employee. To make such decisions, the government has said it will look to see whether the top management – starting with the CEO – has sent unambiguous messages that noncompliance will not be tolerated. Has misconduct been punished in the past? Have people been fired for violations? Or does management turn a blind eye for the sake of business expediency? If it is the latter, the government says the whole company will be penalized. This is not just true of government contracts, it is true of overseas payments that violate the Foreign Corrupt Practices Act, it is true of books and records violations under S-Ox, and it is true of export control violations. DOJ and SEC policies are quite clear on this.

Companies will always argue that any violation is just the act of some rogue employee. The government, in determining whether this is the case, has to make some assessment of the corporate culture and controls. In the post-Enron, post-meltdown world, investigators are not impressed with color brochures and fat books of guidelines. They insist on seeing how violators are treated. If a middle manager would be fired for

exaggerating (otherwise known as cheating or stealing) on his reimbursements, then the guy who's been paid more than $100 million has to be fired, too.

Beyond that is the actual (not just apparent) tone at the top, which is the board's responsibility. They cannot keep in place an executive who has demonstrated such a failure of judgment and responsibility. They cannot keep in place an executive they cannot trust. It is hard not to conclude that the culture that created a $50 million liability to settle fraud charges needs a new leader.

How can a board justify characterizing a termination over an ethics violation as a resignation and not a "for cause" termination, when the difference is $40 million in severance payments? Hurd's initial contract had an unusual provision that stated all of his first-year performance goals were "deemed to have been met," so he would get his full bonus regardless of his performance. What signal did that send to him? What signal should it have sent to the investors? Given that this is the same board that mis-handled the hiring and firing of Carly Fiorina, the "pretexting" scandal, and now the Hurd termination and his going to work for a rival firm, what options are available for shareholders who would like to prevent further failures of corporate governance? ■

THE BIGGEST CHALLENGE

Unquestionably, the biggest challenge a company faces is not failure, but success. If we look at the most spectacular swan dives and meltdowns of the last thirty years, most were at one time almost as spectacular successes. The giants of the 1960s – Xerox, Kodak, Sears, Waste Management, General Motors, and others – became the problems of the 1980s and 1990s. Enron, Tyco, Global Crossing, Qwest, Adelphia, WorldCom, HealthSouth, UnitedHealth Group, and others that set records in the 1990s saw their names become synonyms for corruption and mismanagement in the early years of the twenty-first century. The financial meltdown of 2008 led to the greatest increase in bank failures since the FDIC began, from three in 2007 to 25 in 2008 and 140 in 2009. Previous high performers Countrywide, Bear Stearns, Lehman Brothers, Chrysler, and more failed or were absorbed into other companies. Table 4.1 shows how difficult it is to stay at the top over the long term.

When a company is failing, it will try almost anything. On the other hand, a company that is successful generally does not know where the roots of that success lie. There is consequently a tendency to fall into a pattern of not changing anything.

> It is often better to have a great deal of harm happen to one than a little; a great deal may rouse you to remove what a little will only accustom you to endure.
>
> *Sir Fulke Greville*

See the General Motors and Sears case studies for more details.

Table 4.1 The twenty largest companies worldwide, by stock market valuation ($ billions).

	1972			1982			1992			2010	
1	IBM	46.8	1	IBM	57.0	1	Exxon	75.8	1	Exxon Mobil	358.06
2	AT&T	29.2	2	AT&T	52.2	2	General Electric	73.9	2	Apple	291.08
3	Eastman Kodak	23.9	3	Exxon	25.7	3	Wal-Mart	73.5	3	PetroChina	239.57
4	General Motors	23.2	4	General Electric	21.6	4	Royal Dutch/Shell	71.8	4	Microsoft	232.00
5	Exxon	19.6	5	General Motors	19.0	5	Nippon Tel. & Tel.	71.4	5	China Mobile	213.13
6	Sears Roebuck	18.2	6	Royal Dutch/Shell	16.9	6	Philip Morris	69.3	6	Royal Dutch/Shell	205.07
7	General Electric	13.3	7	Eastman Kodak	14.2	7	AT&T	68.0	7	Wal-Mart	203.70
8	Xerox	11.8	8	Schlumberger	13.4	8	Coca-Cola	55.7	8	Berkshire Hathaway	203.55
9	Texaco	10.2	9	Toyota Motor	12.6	9	Mitsubishi Bank	53.5	9	Google	199.76
10	Minnesota Mining & Mfg	9.7	10	Amoco	11.7	10	Merck	50.3	10	IBM	184.73
11	Procter & Gamble	9.1	11	Chevron	10.9	11	Indus. Bank of Japan	46.5	11	Proctor & Gamble	183.73
12	Royal Dutch/Shell	9.1	12	Mobil	10.7	12	Sumitomo Bank	45.6	12	General Electric	178.65
13	Coca-Cola	8.9	13	Sears Roebuck	10.3	13	Toyota Motor	44.1	13	Johnson & Johnson	177.43
14	DuPont	8.4	14	Atlantic Richfield	10.2	14	Fuji Bank	41.8	14	AT&T	172.42
15	Ford Motor	8.0	15	Hitachi	9.9	15	Daiichi Kangyo Bank	41.8	15	Chevron	170.50
16	Avon Products	7.9	16	Procter & Gamble	9.8	16	Sanwa Bank	37.9	16	JP Morgan Chase	161.18
17	Mobil	7.5	17	Matsushita Electric	9.6	17	British Telecom.	37.8	17	BHP Billiton	152.76
18	Johnson & Johnson	7.4	18	Ind. General Electric Co. (UK)	9.3	18	Procter & Gamble	36.4	18	Wells Fargo	151.98
19	Chevron	6.8	19	Johnson & Johnson	9.3	19	Glaxo Holdings	36.1	19	Vodafone	149.39
20	Merck	6.6	20	British Petroleum	8.7	20	Bristol-Myers Squibb	35.1	20	Oracle	145.96

CASES IN POINT EXXON, AT&T, AND GENERAL ELECTRIC AND CREATIVE DESTRUCTION – INTERNAL AND EXTERNAL

AT&T. Ironically, AT&T has thrived because it lost an antitrust case and was required to break itself up into seven "Baby Bell" companies. The breakup forced a rigorous redefinition of the company's mission. IBM, by contrast, emerged from its antitrust suit victorious but floundered as a result of its failure to undertake just such a review.[14] Similarly, the "Baby Bells" are coming together again in a reverse Balkanization, and have swallowed up the once-monolithic AT&T.

Exxon. Exxon, of course, had its own experience with antitrust a century earlier, and there is some irony in the 1999 merger with Mobil, the reuniting of two of the divisions split up by one of the first major antitrust enforcement actions. The world demand for oil has been so consistent that Exxon has not been required to alter its strategy radically to stay ahead. Exxon, unlike Sears, IBM, or General Motors, has not been the victim of a dramatically shifting marketplace – yet. However, it has been affected by consolidation in the industry, which included the BP–Amoco merger; the refining and marketing consolidation of Shell, Texaco, and Star; Tosco's acquisition of Unocal's California refineries; Ultramar Diamond Shamrock's acquisition of Total's refining and marketing operations; and the Marathon/Ashland consolidation.

General Electric. In 1980, General Electric (GE) was a huge and sprawling conglomerate, though in rock-solid financial condition, with an AAA bond rating and a handsome 19.5 percent return on equity.[15] The company was the eleventh largest corporation in *Fortune*'s list of the most highly valued companies in the US. In December 1980, the company announced the appointment of a new CEO and chairman, John F. Welch. Jack Welch did not believe that GE's respectable results reflected the true value that the company could generate. Over the succeeding decades, Welch shook up the conglomerate from top to bottom. It is arguable whether, without Welch, GE would still feature in *Fortune*'s list of the world's largest companies.

Welch insisted that each of GE's divisions be the number one or number two business of its kind in the world. Any business that failed to meet this test would be sold. Over the next decade, GE sold or closed almost $10 billion-worth of businesses and product lines, and over $18 billion was spent on acquiring further businesses to boost those that remained. Notable acquisitions included Kidder Peabody in 1986 to join GE Financial Services and NBC to join GE's broadcasting operations.

However, Welch was not satisfied with merely buying and selling businesses. His aim was to drive change through every part of GE's massive operation. He wanted the

company to be as lean and responsive as the smallest startup. Partly, he did this by downsizing the company and stretching middle management to the limit. Welch's notion was that if employees were overworked, they would spend less time in committee meetings or on other bureaucratic procedures that inhibited the company's ability to respond.[16] The effects of these changes were far-reaching. GE shed over 100,000 employees through the 1980s. While Welch was criticized for these cuts at the time, and while many managers complained that the changes undermined security and loyalty, evidence of their worth was made plain in ever-improving financial results.

Welch decided to reinvigorate every employee, from the bottom up. He insisted on full-scale cultural change at GE, and that meant shaking up the entire workforce. He was committed to "six sigma" standards of excellence and introduced a concept called "workout," a practice similar to German methods of employee relations. Workout introduced sessions in which 50–100 employees, generally chosen to represent a cross-section in terms of rank and tenure, would meet for two days to discuss their work. The lowliest employees were encouraged to make suggestions as to how their job could be made easier or more efficient, and how ingrained bad habits could be eliminated. In its first two years, more than 2,000 workout sessions were held, some including suppliers and customers.

Though some have criticized Welch's "empowerment" approach as futile,[17] there can be no doubting the impact that Welch's changes had on the bottom line. According to a 1999 *Forbes* story called "The Jack Factor,"

> *Consensus has it that General Electric is the best-run company in the world. Yet this giant is an eclectic collection of seemingly unrelated pieces – jet engines and light-bulbs, synthetic polymers, and* Friends *sitcoms. ITT, Westinghouse, and other conglomerates failed to make sense of their disparate mishmash of businesses, but GE has made it all work, in the sense that it carries a very rich multiple on Wall Street (44 times trailing earnings).... Under Welch's leadership, GE defies the conventional logic that the sum of the parts is worth more than the whole. Other corporate grab bags traded at a cheaper value than the sum of their parts, yet GE (priced lately at $137 a share for a market value of $450 billion) gets a premium of 40 % to 70 % over its bust-up value.*

It is unlikely that any CEO will ever be able to match Welch's record of hitting projected earnings numbers precisely over many years. If one did, today's investors might be more skeptical than impressed, concerned about earnings management. Welch's successor Jeffrey Immelt has not been able to maintain anywhere near the same level of performance. He sold NBC and made a big bet on "ecomagination" – green technologies, especially wind power. In early 2010 he announced that "the worst is behind us" but commentators were speculating that he would not last much longer in the job. ■

What did GE do that GM failed to do? How do companies ensure renewal?

As far as the "dinosaurs" are concerned, there can be no doubt that the failure of IBM, GM, and Sears was at least partly a failure of governance. It is not surprising, for instance, that the problems at Sears developed when the same person held the jobs of CEO, chairman of the board, CEO of the largest (and worst-performing) operating division, chairman of the nominating committee of the board, and trustee of the 25 percent of the company's stock that was held on behalf of the employees (see Sears case study). The company had circumvented all of the systems set up to ensure that the right questions would be asked by putting the same person in all of the positions that were supposed to monitor each other. It is impossible to identify what Hirschman calls "repairable lapses"[18] when the same person is both making the decisions and evaluating them.

The best way to make sure that the right questions are asked of the right people is to create a structure that aligns the interests of the CEO with the long-term interests of the shareholders as much as possible. Indeed, it is just this alignment that gives managers the expertise and the credibility to do their job effectively.

> *Although managers are self-interested, this interest can be aligned with that of investors through automatic devices, devices that are useless when those in control are 'disinterested'; hence the apparent contradiction that self-interested managers have more freedom than disinterested regulators.*[19]

RISK MANAGEMENT

Risk management has become a hotter topic following the financial meltdown. Wall Street had many highly trained analysts who thought that they were managing risk by creating credit default swaps and collateral debt obligations. Adam Turteltaub of *Corporate Compliance* cautions that talking about managing risk or even promising to manage risk is very difficult to do. "What we need to do is end our romance with risk, start treating it more warily, and remind the business people that risk calculations are often highly faulty. In addition, we must ensure that everyone in the business recognizes that risk can only be managed up to a point."[20] Perhaps the beginning of risk management is understanding how little is within our control. The best way to manage it is to think about what your options will be when things do not go as planned.

EXECUTIVE COMPENSATION

It took the abuses of the takeover era to wake up the institutional investors, and almost before they got started, the takeover era ended. By that time, however, there was a new issue to provoke outrage: excessive CEO compensation. In some ways, this was an ideal corporate governance issue for the new activists. Complaints about compensation could be made in a sound bite, with political and economic appeal, to say nothing of the "lifestyles of the rich and famous" gossip value. This was the first corporate governance issue to go from the financial pages to the front pages to the editorial pages to the comic pages – even "Doonesbury" got in a few digs. This was not just some Capra-esque populist movement. No one complained about the money Bill Gates made at

Microsoft, but when pay was not related to performance, the business press was just as outraged as the shareholders. Even "capitalist tool" *Forbes* ran a cover story on executive pay with a banner headline: "It doesn't make sense."[21] Since that time, the pay/performance link has become even weaker. As CEO shelf-life shrinks, new candidates insist on even more downside protection in their contracts, ensuring that the contracts will have even more tenuous ties between pay and performance. Ostensibly market-based, pay is increasingly based on "peers" that are manipulated to justify even less variability rather than on empirically-based incentives.

Some people dismiss the issue of executive compensation as immaterial because the amounts involved, as staggering as they are, are a tiny fraction of the company's market capitalization, even its annual budget. However, every dollar of executive compensation must meet the same rigorous standards for return on investment as any other asset allocation. The record of American corporations in providing a competitive rate of return on the money spent on CEO pay is very poor. Increasingly, following the Wall Street meltdown, executive compensation has been viewed as an indicator of risk.

Compensation is also an issue uniquely suitable for being addressed by shareholders. Pay for performance is an obviously relevant issue; no shareholder initiative could have a more direct impact on shareholder value. If compensation is connected to performance, all other shareholder initiatives become secondary. If compensation is unrelated to performance, however, all the shareholder resolutions in the world won't make a difference. The role of the shareholders with regard to compensation starts with one simple point: compensation presents an investment opportunity. The compensation plan is a clear indicator of the company's value as an investment. It reveals what the CEO's incentives are. If homeowners are deciding between two realtors who want to sell their house – one who charges a flat fee and one who charges a percentage of the sale price – they know they are likely to do better with the one whose compensation is tied to the money they themselves will eventually receive. Similarly, a shareholder should want to invest in a CEO whose compensation depends on the money the shareholder will receive. Compensation plans also reveal what the company's goals are and how confident the CEO and board are of the company's future.

Former compensation consultant Graef Crystal, in his book on executive compensation, *In Search of Excess*,[22] discusses the impact that compensation plans should have on stock-picking by sophisticated investors. His conclusion that restricted stock grants are made by boards who do not think the stock will go up is supported by his data on companies that have made these awards. If his analysis is correct, selling short on companies that make restricted stock grants should be a highly profitable investment strategy.

Furthermore, compensation issues present shareholders with some of their most cost-effective (highly leveraged) opportunities for "investing" in shareholder initiatives. A shareholder can submit a shareholder proposal about executive compensation for little more than the cost of a stamp. Shareholders can distribute information about their views to other shareholders under the enormously simplified revised proxy rules for little more than the cost of a couple of dozen letters or phone calls. With a high likelihood of improving returns through this visible focus, and negligible, if any, downside risk, this is an "investment" that shareholders, especially fiduciary shareholders, will find increasingly appealing.

Shareholder initiatives on compensation have special appeal. CEOs can only justify getting paid a lot because they take risks. Their compensation should provide the appropriate incentives for those risks. To the extent that a shareholder initiative can better align these incentives, it is an investment with substantial returns.

The question, then, is not whether there will be increased activism by shareholders on the subject of compensation; the question is what form it will take. With the exception of a few extremists, shareholders have not objected to chief executives earning a lot of money, as long as they created a lot of value for shareholders first. The late Roberto Goizuetta's $81 million stock grant got four standing ovations from the Coca-Cola shareholders, who were delighted with the 38.2 percent annual returns during his tenure. What shareholders have objected to is chief executives being paid a lot of money without earning it. Their focus has been on strengthening the link between pay and performance.

It is a very small group at the top of the compensation scale: rock stars, movie stars, athletes, investment bankers, and CEOs. All but CEOs are compensated for performance, and it is not coincidental that, of that group, CEOs are the only ones who pick the people who set their compensation. In all of the other categories, pay and performance are closely linked, and that means financial performance. Meryl Streep can get a record number of Oscar nominations, but she doesn't sell a lot of tickets. Therefore, she is paid an average of $7–9 million for a movie, while unlikely-to-get-anywhere-near-an-Oscar Arnold Schwarzenegger got a record $30 million for making *Terminator 3*. Investment bankers who earned bonuses in the millions in the 1990s were laid off when deals disappeared. Statistics showed that CEOs do well regardless of performance, and the publicity for those numbers provided much of the momentum for the reforms on compensation disclosure.[23] Table 4.2 shows the top US pay packages in 2010.

Of course, some of the fuss missed the point. The problem is that the extreme cases point out the failure of the system as a whole. If shareholders, as the consumers of executive compensation, cannot act when it is out of control, the system simply isn't working. Executive compensation unrelated to performance is just one symptom of a corporate governance system that fails to ensure management accountability.

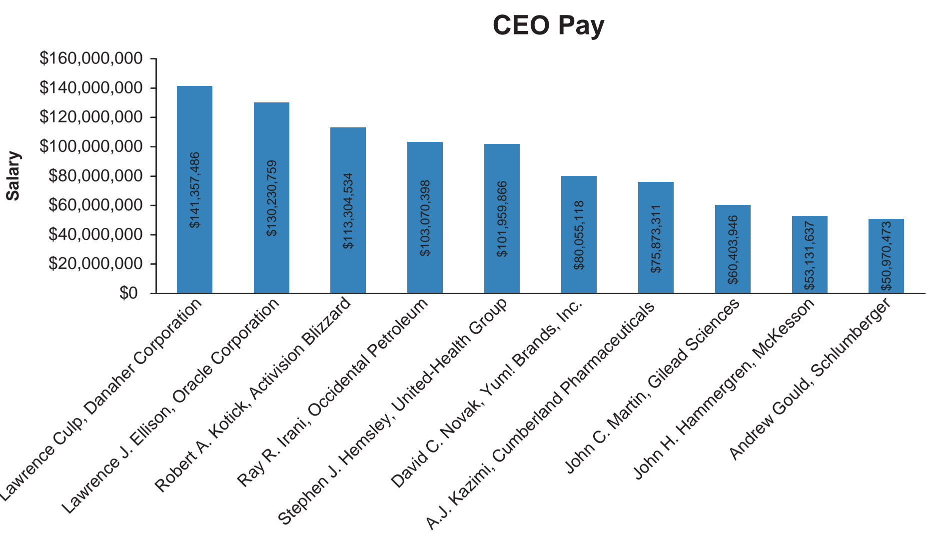
The issue is not only matching compensation to performance. There is almost always some standard that can be used to support a bonus, and compensation consultants are good at providing a mix of "performance plans" that ensure that at least one of them will pay off. Crystal's book devotes an entire chapter to document in devastating detail the compensation package of Time Warner's late chairman, Steve Ross, dubbed by Crystal "The Prince of Pay." Ross's seven different long-term incentive plans included $21.1 million in stock options, $69.6 million in bonus units (plus $3.8 million in dividend equivalent payments), and another set of units that would pay out based on the stock's highest average price over an eight-week period over the previous two years.[24] There was also another set of units tied to the Warner stock price that paid him $58.7 million because the stock was valued at the time of the acquisition by Time. According to Crystal, "[h]is total take from all seven plans was $236 million over a period of effectively 17 years or about $14 million a year."[25] It is worth noting that Ross's employment contracts were voted on by a board that included five officers of his company, without whom the contract would not have been approved.

Ross's performance at Warner may have been terrific. The problem was that the high compensation was almost coincidental; the compensation plan did not link compensation to performance. The issue shareholders should focus on is not just tying compensation to performance, but really improving performance.

What kinds of plans, in which kinds of circumstances, motivate what kinds of managers to guide a company to maximum total shareholder returns over the long run? Which plans have consistently led to the best long-term performance? What are the indicators of a good plan and, maybe more important, what are the indicators of a bad one?

Table 4.2 Top US CEO Pay Packages in 2010.

Company Name	CEO Name	Industry	Pay
Danaher Corporation	Henry Lawrence Culp	Machinery	$141,357,486
Oracle Corporation	Lawrence J. Ellison	Software	$130,230,759
Activision Blizzard	Robert A. Kotick	Software	$113,304,534
Occidental Petroleum	Ray R. Irani	Oil, Gas & Consumable Fuels	$103,070,398
UnitedHealth Group	Stephen J. Hemsley	Health Care Providers & Services	$101,959,866
Yum! Brands, Inc.	David C. Novak	Hotels, Restaurants & Leisure	$80,055,118
Cumberland Pharmaceuticals	A.J. Kazimi	Pharmaceuticals	$75,873,311
Gilead Sciences	John C. Martin	Biotechnology	$60,403,946
McKesson	John H. Hammergren	Health Care Providers & Services	$53,131,637
Schlumberger	Andrew Gould	Energy Equipment & Services	$50,970,473



CASE IN POINT WARNACO

In 1999, Graef Crystal named Linda Wachner of Warnaco his "pay anti-hero," based on the following excerpt from the Crystal Report (April 19):

- Base salary of $2.7 million – 299% above the market – and that doesn't count a further salary of $1.1 million she received for running a smaller public company, Authentic Fitness. [Given the company's performance, it is particularly striking that her board allowed her to have another full-time job. Perhaps this is why they voted to buy Authentic Fitness from her in 1999, a deal in which she and several of her directors were on both sides of the table.]
- Total current compensation of $8.7 million – 638% above the market.
- Total direct compensation of $73.8 million – 1,818% above the market.
- That 1,818% market overage was higher than that for any of the 857 CEOs in our 1998 pay study. The next overage was a mere [*sic*!] 893%.
- The options granted in 1998 had an estimated present value of $58.2 million.
- In addition, she exercised options in 1998 for a gain of $75.6 million.

Crystal noted, "Her board is also excessively paid – large fees and extra-large option grants."

In June of 2001, Warnaco filed for bankruptcy, its stock trading at 39 cents a share, down from $44 dollars a share in 1998. The press release about the bankruptcy blamed a soft retail market and insufficient support of the retailers. The fault was entirely the board's, once described by *Fortune* as "notoriously ineffectual," for not just enabling but rewarding a CEO whose self-dealing and bad decisions all but destroyed the company.

Wachner took over Warnaco in 1986 in a hostile takeover and built the apparel maker into a $1.4 billion company, responsible for manufacturing and distributing more than a third of all the bras sold in the US.

Wachner was fired shortly after the bankruptcy filing. It should be noted that Wachner submitted notice to the bankruptcy court that since she had been terminated without cause, she was entitled to have her $25 million severance payment classified as an "administrative expense" and thus given top priority among the creditors. She later settled for $452,000, promising to donate $200,000 of that to charity.

Warnaco emerged from bankruptcy in February of 2003. ■

It is all very well to talk about incentive plans, but all the incentives in the world cannot work if there are other impediments to getting the job done. There is no incentive plan that can make a weekend athlete into an Olympic gold medallist and no incentive plan will make a CEO who is in over his head suddenly able to turn the company around. More troubling, some so-called

"incentive plans" can be manipulated. Targets can be hit by divesting a subsidiary instead of increasing product sales. When Mark Hurd became CE of H-P, his contract provided that his first-year goals were "deemed to have been met." So what was the incentive to actually meet them?

This inherent conflict of interest between shareholders and management with regard to compensation is not over the amount of compensation, but over the variability of the compensation. Shareholders want compensation to vary with performance as much as possible, while managers understandably want as much certainty as possible; even those who want a lot of variability on the upside are less willing to allow it on the downside.

This inherent conflict did not become obvious until the early 1990s, when executive compensation became the subject of magazine cover stories, *Nightline* and *Crossfire* debates on television, and hearings before the US Congress. In 1991, CalPERS called for shareholders to withhold their votes from the board of directors of ITT, where CEO Rand Aroskog's compensation more than doubled as the stock sank. The 1 percent of "withhold" votes cast led to a massive overhaul of the company's compensation plan. At Fairchild, an overpaying company that merited an entire chapter in Crystal's book, the board approved substantial revisions to the company's compensation plan, including a $250,000 cut in CEO Jeffrey Steiner's cash compensation, cancellation of 50,000 options, and agreement to no new options until 1993 and no raises until 1996. This was in settlement of a shareholder lawsuit, worth noting because courts are very reluctant to permit challenges to executive compensation.

General Dynamics reacted to the sobriquet "Generous Dynamics," accorded it by *Business Week* for a compensation package that gave its executives double their salary for a ten-day rise in stock prices. The company called a special meeting to get shareholder approval for substantial changes after pressure from shareholders – and a visit from *60 Minutes*. United Airlines executives agreed to increased disclosure of their compensation in the proxy statement, after negotiations with the United Shareholders Association. Many companies announced cuts; at USAir, the directors took a 20 percent compensation cut, to mirror the cuts they were asking of employees.

In 1992, the focus on compensation continued, as the SEC reversed its long-time policy and allowed advisory (nonbinding) shareholder resolutions on compensation (for further discussion of shareholder proposals, see chapter 2). Later, they reversed another policy to allow votes on proposals that would require companies to obtain shareholder approval before re-pricing stock options. Re-pricing, of course, subverts the entire justification for option grants, which are supposed to align the interests of shareholders and management with both an upside and a downside. However, when options are "below water" (the stock price is below the option's strike price) boards and managers are under a lot of pressure to get rid of the downside and "re-price" an option, essentially a "do-over" by surrendering or exchanging the underwater options and immediately replacing them with new options with an exercise price equal to the new lower stock price, or amending the terms of the option to provide for a lower exercise price. Shareholder protests ultimately led to an end to re-pricing, but in 2006 the "options backdating" scandal raised the same issues even more sharply, as backdating provided the benefits of re-pricing without the tricky problem of having to disclose it.

Media and politicians emphasize the size of executive compensation packages. Shareholders focus, as Michael Jensen and Kevin Murphy put it, not on "how much," but on "how."[26] Two crucial elements of the "how" are stock options and restricted stock grants, and shareholders began to make some important distinctions.

Compensation consultants Towers Perrin found that the average face value of stock options to CEOs had doubled from the mid-1980s to the mid-1990s, to more than twice the value of annual compensation. According to one study, in 1992, 53.92 percent of firms included stock options as a part of a compensation package. By 1997, it had risen to 71.85 percent.[27] It is now all but universal. In recent years, a growing component of executive pay has been restricted stock grants. The Corporate Library's report on CEO pay in 2010 found that more than half of the CEOs in the sample received some form of salary hike in 2009 whereas less than 20 percent took less salary than the year before. While a slight rise in base salaries is driving some of the increase in total annual compensation, there were still only 11 more bonuses (both annual and longer-term) paid out in 2009 than in 2010. The top-paid CEOs represented a variety of industries. That list included some perennials like Occidental Petroleum's Ray Irani, but the highest paid of all was Henry Culp, the CEO of machinery manufacturer Danaher Corporation. Driving his high pay was $84 million in option profits from a grant that he held for nine years, while presiding over a 225 percent increase in the stock price. One of the most significant changes to compensation practices in recent years has been the continued shift from options to stock. Now vastly more CEOs received restricted stock (generally considered an indicator of skepticism about a rise in stock prices, because unlike options, equity grants have value unless the stock goes to zero), and it was worth significantly more than the option awards.

In the late 1990s, a "How you gonna keep 'em down on the farm?" attitude caused the CEOs of established companies to insist on pay to match that of the new economy high-tech entrepreneurs. Most of their boards complied, even in the absence of any evidence that there was any risk that they might accept – or get – a competing offer.

The new economy executives received superstar pay for lackluster performance. AOL's Steve Case grossed $303.3 million from 1996 to 1999, while average return on equity was –119 percent. The old economy executives did the same. Disney's Michael Eisner, once the poster boy for good pay due to his low base salary and premium-priced options, came in last in the annual *Business Week* pay–performance survey, with three-year pay of $636.9 million for a three-year performance of 28 percent. Metro-Goldwyn-Mayer re-priced the options of a retired CEO, from $24 to $14.90 per share. Philip Morris decided to pay dividends on stock options, so that even if the options were underwater, the executives would still get an income stream. Sears Roebuck reacted to the news that its employees did not meet the performance goals that would have triggered bonuses by extending the deadline, subverting the pay–performance link. The sheer number of options granted became staggering. George Shaheen of Webvan received, in addition to the 1,250,000 unrestricted shares, 15 million options. The company later went into bankruptcy and, as guaranteed by his employment contract, Shaheen's lifetime annuity was first in line among the company's creditors. Joseph Galli was recruited to Amazon with a promise that if his options were not worth at least $20 million by 2003, he would get that amount in cash. Robert Annunziata was recruited to Global Crossing, its fourth CEO in five years, with a signing bonus that included $10 million in cash and two million options at $10 a share below market, with a present value of $20 million. His contract also included a Mercedes (make and model specified in detail), full use of the corporate jet, and, since he had to move from New Jersey to California to take the job, monthly first-class airfare for his family to come visit, including his mother.

From 1995 to 2005, corporate profits rose by 106.7 percent, CEO pay rose 298.2 percent, while the average worker pay rose 4.3 percent. The post-meltdown lowered stock prices prompted a bonanza of mega (more than 500,000) grants of stock options. In 2009, just over half of the larger US public companies made mega-grants, averaging 1,847,780 options per grant. The awards at record

low prices led to some windfall payouts, led by Sirius XM Radio Inc., where Mel Karmazin's 120,000,000 grant gave him a profit of $69,600,000 when the market rebounded.

What does this tell us about the board of directors?

In the post-Enron, post-dot-com era, CEO compensation continues to rise as CEO tenure shrinks. The Corporate Library's review of CEO compensation in a sample of the 1,400 largest companies in 2005 noted that the median increase was about 16 percent in 2002–3, about 30 percent in 2003–4, and about 16 percent in 2004–5.

> The salary of the chief executive of the large corporation is not a market award for achievement. It is frequently in the nature of a warm personal gesture by the individual to himself.
>
> *John Kenneth Galbraith*

THE PAY CZAR

The Obama administration appointed Kenneth Feinberg as a "special master" to oversee executive compensation issues at the bailout companies and set top executive pay for the small group of companies where the United States had become the largest shareholder. Feinberg, previously assigned to manage the impossible valuation issues in overseeing compensation for 9/11 victims and their families, was known for scrupulous procedural fairness and near-infinite patience. His required report on pay was eagerly anticipated. "Pay Czar Slams Banks for Executive Pay," said the headline from broadcaster ABC. "Wall Street Exhales After Sidestepping Pay Czar's Wrath" said the *Wall Street Journal*. In a sense, both were right. Feinberg called the pay packages "ill advised and bad judgment" but concluded that no rules had been broken and no money had to be returned to shareholders or taxpayers. Feinberg asked the bailout firms to voluntarily adopt a provision that would give the boards of directors and compensation committees the right to terminate any binding or expected payments to employees in the event of another financial crisis. The companies responded that they would take his request "under advisement." Feinberg did require pay cuts at the five firms under his authority as well as holding periods for stock granted in compensation. Feinberg has now left to oversee the payout of the Deepwater Horizon oil spill funds. Some of the companies under his authority accelerated their payback of TARP funds in part so they would not be bound by his restrictions.

POST-MELTDOWN PAY

A 2010 *Wall Street Journal* study showed pay at Wall Street banks, investment banks, hedge funds, money-management firms, and securities exchanges on pace to break a record high for a second consecutive year, with more than three dozen top banks and securities firms paying $144 billion in salary and benefits. Compensation was expected to rise at 26 of the 35 firms.[28]

While a 1998 study showed that CEOs in the US earned 45 percent higher cash compensation and 190 percent higher total compensation than their UK counterparts, that gap is narrowing, with what remains reflecting the higher proportion of risk-related pay in the US. An Incomes Data Services survey of chief executive and director remuneration (pay) at UK companies found

that the people at the top had a 55 percent increase, with the average FTSE 100 CEO now earning £4.9 million a year, almost 200 times the average wage.[29]

THE COUNCIL OF INSTITUTIONAL INVESTORS

The US trade association of pension funds and other institutional investors has issued this list of red flags to help members target companies where pay deserves careful scrutiny and where dialogue may be most urgent.

1. *Stock ownership and holding policies*
   - Do top executives have paltry holdings in the company's common stock and can they sell most of their company stock before they leave?

     Senior managers who don't own much company stock may not be guided by what is in the best interest of long-term shareowners. Executives who can cash their stock out quickly may be emboldened to take excessive risks that pump up short-term gains at the expense of long-term value creation. Compensation committees should ensure that top executives own a meaningful position in the company's common stock, after a reasonable amount of time, and that they hold a significant portion of their equity-based compensation for a period beyond their tenure.
2. *Clawbacks*
   - Does the company lack provisions for recapturing unearned bonus and incentive payments to senior executives?

     Strong clawback policies may discourage a CEO from taking questionable actions that temporarily lift share prices or accounting numbers but ultimately result in a financial restatement.
3. *Performance drivers*
   - Is only a small portion of the CEO's pay performance-based?
   - Is the company's disclosure of pay-related risk management controls and procedures nonexistent, vague, or suggestive of weak oversight by the board?
   - Is the CEO's annual bonus based on a single metric?
   - Is long-term incentive pay also linked to the same target?

     To promote long-term shareowner value creation, a majority of senior executive compensation should be based on performance, and pay-related risk should be properly disclosed, managed, and overseen by the company and the board. A mix of metrics that support the business strategy makes it harder for a CEO to game the result than if just one metric is used (and check your wallet if EPS is the sole metric because it is relatively easy to manipulate). Diverse metrics also discourage executives from focusing on one goal while ignoring others. Using the same metrics for short- and long-term incentive pay rewards executives twice for the same performance.
4. *Perquisites*
   - Are executive perks excessive?
   - Do they seem unrelated to legitimate business purposes?

     Lucrative special perks can be a sign that the board is in the CEO's pocket. They can also harm employee morale.
5. *Internal pay equity*
   - Is there a wide pay chasm between the CEO and those just below?

This can indicate poor succession planning and a weak compensation committee. It can also demoralize promising senior managers. Many compensation experts draw a line at CEO pay that is more than three times that of the next layer of executives.

6. *Stock option practices*
   - Did the company reprice underwater options for executives, thereby shielding them from downside risk?
   - Did the CEO receive options that vest after a period of time, with no performance requirements?

   A rising market or sector can lift the share prices of all players, even those performing poorly relative to peers. To isolate management's contribution to stock price performance, stock options should be indexed to a peer group or should have an exercise price higher than the market price of common stock on the grant date and/or vest on achievement of specific performance targets that are based on challenging quantitative goals.

7. *Performance goals*
   - Did the CEO get a bonus even though the company's performance was below that of peers? Incentive pay is supposed to motivate executives to deliver superior, sustainable returns exceeding those of peers. A company that rewards below-median performance is likely to get it.
   - Does the company disclose performance goals? Investors cannot evaluate the rigor and pay-for-performance alignment of pay programs without knowing the targets that the CEO was shooting for.

8. *Post-employment pay*
   - Does the company guarantee severance payments to executives who leave as a result of poor performance – whether they are terminated, resign under pressure, or the board fails to renew their contract?
   - Are change-in-control payments (including a large slug of options that vest upon the control change) so lucrative as to incentivize executives to sell the company even if that is not in the best interests of shareowners?
   - Do retired executives get perquisites? That can be a sign of a board that is in thrall to the CEO; top executives are usually paid well enough to cover the costs of their own retirement.
   - Does the company make payments beyond earned or vested compensation upon the death of executives?
   - Do supplemental executive retirement plans (SERPs) use guaranteed or above-market rates of return or add phantom years of service or other sweeteners that are not available to other employees?

   Lavish post-employment compensation can hurt morale, the company, and shareowners.

9. *Compensation policy and philosophy*
   - Is the Compensation Discussion and Analysis confusing, vague, or incomplete?
   - Does the narrative focus on the whats and hows, with short shrift to the whys?
   - Does the disclosure fail to explain how the overall pay program ties compensation to strategic goals and the creation of long-term shareowner value?
   - Does the company's list of pay peers leave you scratching your head and does the company do a poor job of explaining and justifying its process for selecting pay peers?

   Investors need to understand whether and how the executive pay program encourages superior, sustainable, long-term shareowner value creation. A company that does not make

a cogent, convincing case may have a muddled pay program and a compensation committee that is not doing its job. Also, a company's choice of pay peers can have a major impact on the size and structure of compensation – investors must take care that the pool of peers is legitimate and not designed to pump up pay for executives.

10. *Compensation adviser independence*
    - Does the firm advising the compensation committee earn much more from services provided to the company's management than from work done for the committee?

      Consultants who count on lucrative actuarial or employee benefits business from senior management may be inclined to recommend overly-generous pay packages for those executives. Helpfully, the SEC now requires proxy disclosure of all fees paid to the compensation committee's consultants if the consultant or its affiliates earns more than $120,000 for work performed for the company beyond executive and director compensation services. Disclosure must be broken down between: (1) aggregate fees for executive and director pay consulting and (2) aggregate fees for other services.

CASE IN POINT ICGN ON COMPENSATION

In 2006, the International Corporate Governance Network, representing $9.5 trillion in assets under management, adopted revised policies on executive compensation. These excerpts give some sense of its take on the issues:

> *Institutional investors have both a fiduciary responsibility and an economic interest in ensuring that executive remuneration or compensation is well aligned with their interests.... Three principles underpin these updated guidelines:* ***transparency****, so investors can clearly understand the program and see total pay;* ***accountability****, to ensure boards maintain the proper alignment in representing owners in part by obtaining shareowner approval of a remuneration report; and* ***performance-based****, so the programs are linked to relevant measures of company performance over an appropriate timescale. This should also reflect due regard for the reputational aspects of remuneration.... The traditional view of executive remuneration or compensation is to attract and retain qualified personnel. While true in simple terms, this definition fails to consider the significance of compensation programs in the overall governance of organizations. For long-term investors, a much broader view of remuneration is required that encompasses proper alignment, incentives to pursue optimal capital allocation and good corporate governance.... Because remuneration programs have such a significant impact on the alignment and incentives of management, they are inexorably linked to the long-term viability of the company....*
>
> *The ICGN believes equity ownership guidelines and holding requirements should be an integral component of a company's equity plan and overall compensation philosophy. Equity ownership guidelines are generally expressed as a multiple*

of salary and bonus opportunity, and serve to align the interests of the management team with the long-term owners. Accordingly, the guidelines should require significant ownership levels over an appropriate period of time. Holding requirements generally require that executives shall hold significant portions of equity grants for extended periods, which should include requirements to hold some portion of grants for a fixed period of time after separation (such as retirement or other event in which employment is ceased).

The ICGN believes the following equity plan characteristics are inappropriate: discount options; re-load provisions; gross-up provisions; accelerated vesting upon change in control; and repricing without shareholder approval. Companies should also provide clear guidance regarding the circumstances under which key plan criteria may be amended, including performance targets, including notification to shareowners (disclosure).

Equity (and equity-like) remuneration should have vesting terms that are clearly consistent with the company's capital allocation and investment horizon. The ICGN believes that, as a general rule, vesting of long-term incentives should be a minimum of three years.

The ICGN is opposed to share repurchase plans that are strictly designed to offset equity plan dilution. Share repurchase plans should be an integral component of the company's capital allocation decision, not its remuneration program. Share repurchase plans designed to offset equity plan dilution may lead to poor capital allocation decisions or poor timing of repurchase activity." ■

STOCK OPTIONS

Stock options, of course, are supposed to be the ultimate example of compensation for performance. The company gives the option recipient the right to purchase a block of the company's stock at some specified point in the future at a "strike price" set at the time of award, often the current trading price. Therefore, if the stock rises between the time of award and the time the option is exercised, the executive will get the benefit of the gain, without having had to make the capital expenditure to buy the stock.

Theoretically, at least, the person granted the options will not make any money unless the stock goes up. A typical description of a stock option plan notes, "The company's stock option program is designed to focus attention on stock values, and to develop Company ownership, promote employee loyalty, reward long-term business success and develop a parallel interest between key employees and shareholders." However, as one compensation consultant argues, market and industry factors (over which company management have no control) account for about two-thirds of the stock price's movement.[30] Warren Buffett noted in one of his annual reports that stock options do not tie individual performance to individual compensation:

> "*Of course, stock options often go to talented, value-adding managers and sometimes deliver them rewards that are perfectly appropriate. (Indeed, managers who are really*

exceptional almost always get far less than they should.) But when the result is equitable, it is accidental. Once granted, the option is blind to individual performance. Because it is irrevocable and unconditional (so long as a manager stays in the company), the sluggard receives rewards from his options precisely as does the star. A managerial Rip Van Winkle, ready to doze for ten years, could not wish for a better 'incentive' system . . . .

Ironically, the rhetoric about options frequently describes them as desirable because they put owners and managers in the same financial boat. In reality, the boats are far different. No owner has ever escaped the burden of capital costs, whereas a holder of a fixed-price option bears no capital costs at all. An owner must weigh upside potential against downside risk; an option holder has no downside. In fact, the business project in which you would wish to have an option frequently is a project in which you would reject ownership. (I'll be happy to accept a lottery ticket as a gift – but I'll never buy one.)[31] ”

Fans of options say that they are effective in motivating long-term performance, but Philip Morris gave CEO Hamish Maxwell options on 500,000 shares on his retirement, when motivation and performance were scarcely relevant.

The most troubling aspect of stock option awards is "re-pricing," re-issuing stock options when the stock price is below the option price. Companies that have re-priced executive options included Apple Computers, Salomon Brothers, and Occidental Petroleum.[32] This removes all of the risks to management (and all of the benefits to shareholders) of a stock option grant. For the purpose of incentives, it is just like giving the managers cash. One of the most beneficial aspects of shareholder involvement is that re-pricing of stock options has been widely discredited.

At the same time another kind of option award with almost no relation to performance is gaining in popularity. That is the awarding of huge option grants, so that an increase of one dollar a share will lead to a million-dollar payoff even if the gain is at or even less than the rest of the market. Like re-pricing, enormous option grants remove any downside from the compensation plan. Leon Hirsch, CEO of US Surgical was awarded so many options that his compensation risk was all but removed. Four years' worth of grants gave him nearly six million shares on option. If the stock climbed by as little as one dollar he would make $5.9 million. As then-SEC chairman Richard Breeden noted, "Mega-grants of options are an increasing and quite disturbing trend. Some mega options make mini sense for shareholders . . . shareholders are entitled to expect the directors who make those awards to have an affirmative reason for every award and its pricing."[33] Following the financial meltdown, when many stock options were underwater, stock and option grants were issued at market lows so that executives would be rewarded when the market rebounded, with no connection to the individual performance of the executive or even the company.

Options are a good idea but they have been badly abused. They are now awarded in such stunning number that their marginal utility is not just diminishing but vestigial.

Is there ever any reason to grant stock options without regard to performance targets? Without indexing them to the peer group or the market as a whole?

CASE IN POINT THE CHAIRMAN SPEAKS

Some thoughtful comments on stock options from then-Chairman of the Federal Reserve, Alan Greenspan, in a speech delivered at the 2002 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia (May 3, 2002):

> *The seemingly narrow accounting matter of option expensing is, in fact, critically important for the accurate representation of corporate performance. And accurate accounting, in turn, is central to the functioning of free-market capitalism – the system that has brought such a high level of prosperity to our country . . . . I fear that the failure to expense stock option grants has introduced a significant distortion in reported earnings – and one that has grown with the increasing prevalence of this form of compensation . . . .*
>
> *Stock-option grants, properly constructed, can be highly effective in aligning the interests of corporate officers with those of shareholders. Such an alignment is an essential condition for maximizing the long-term market value of the firm.*
>
> *Regrettably, some current issuance practices have not created the alignment of incentives that encourages desired corporate behavior. One problem is that stock options, as currently structured, often provide only a loose link between compensation and successful management. A company's share price, and hence the value of related options, is heavily influenced by economy-wide forces – that is, by changes in interest rates, inflation, and myriad other forces wholly unrelated to the success or failure of a particular corporate strategy.*
>
> *There have been more than a few dismaying examples of CEOs who nearly drove their companies to the wall and presided over a significant fall in the price of the companies' stock relative to that of their competitors and the stock market overall. They, nonetheless, reaped large rewards because the strong performance of the stock market as a whole dragged the prices of the forlorn companies' stocks along with it.*
>
> *Stock or options policy should require that rewards reflect the success or failure of managements' decisions. Grants of stock or options in lieu of cash could be used more effectively by tying such grants through time to some measure of the firm's performance relative to a carefully chosen benchmark. Many corporations do tie the value of stock and option grants to relative performance, but most do not. To be sure, an untied option grant can be thought of as an option whose value moves with the performance of the corporation relative to the competition, coupled with a call option on, for example, the S&P 500 stock index. It can be argued that the latter is merely another form of compensation that helps firms retain valued employees. I am sure that is right, but does a compensation system tied to the overall stock market serve a company well?*
>
> *To assume that option grants are not an expense is to assume that the real resources that contributed to the creation of the value of the output were free.*

Surely the existing shareholders who granted options to employees do not consider the potential dilution of their share in the market capitalization of their corporation as having no cost to them.

The particular instrument that is used to transfer value in return for labor services is irrelevant. Its value is not. Abstracting from tax considerations, one must assume that the value is the same for the employer irrespective of the nature of the instrument that conveys it – which could be cash or its value equivalent in the form of stock, free rent, a college annuity for one's children, or an option grant.

The ability of options to substitute for cash obviously rests on an expectation by an employee that the price of the company's stock will rise. Expectations of stock price movements, in turn, appear to be significantly influenced by recent stock price behavior. Thus, there is little surprise that stock options gained considerable favor as a form of compensation with the steep rise in stock prices in the late 1990s. Similarly, one might reasonably expect that in an environment with slower stock price gains, option grants would no longer be so favorably viewed by employees as a substitute for cash. As a consequence, more cash or its equivalent might then be required to fund labor services.

One may argue that, because option grants are fully disclosed and their effect on earnings can, with some effort, be estimated reasonably well, financial markets in their collective wisdom see through the nature of any bookkeeping transactions. Hence, how expenses and profits are reported is of no significance, because nothing in the real world is altered. Cash flows, for example, are unaffected. The upshot of this reasoning is that stock prices should be unaffected by whether option grants are expensed or not. Clearly, most high-tech executives believe otherwise. How else does one explain their vociferous negative reaction to expensing if its only effect were to change the book profit reported to shareholders?

I fear they may be right. Indeed, most American businesspeople must believe expensing is more than bookkeeping. Current accounting rules encourage firms to expense option grants. However, only two of the S&P 500 firms reportedly chose to do so in the year 2000. If expensing does indeed matter, at least some of the unsustainable euphoria that surrounded dot-com investing at its peak may have been exacerbated by questionable reported earnings.

The measure of diluted earnings per share currently reported by corporations partially reflects the number of shares that employees could obtain with vested but, as yet, unexercised options. Some have maintained that this is all that is required to capture the effects of option grants. Clearly, this adjustment corrects only the denominator of the earnings per share ratio. It is the estimation of the numerator that the accounting dispute is all about.

Some have argued against option expensing on the grounds that the Black–Scholes formula, the prevailing means of estimating option expense, is approximate. It is. But, as I indicated earlier, so is a good deal of all other earnings estimation. Moreover, every corporation already implicitly reports an estimate of option expense on its

income statement. That number for most companies, of course, is exactly zero. Are option grants truly without value?

As I noted earlier, critics of option expensing have also argued that expensing will make raising capital more difficult. But we need to remember that expensing is only a bookkeeping transaction. To repeat, nothing real is changed in the actual operations or cash flow of the corporation. If investors are dissuaded by lower reported earnings as a result of expensing, it means only that they were less informed than they should have been about the true input cost of creating corporate revenues. Capital employed on the basis of misinformation is likely to be capital misused.

Critics of expensing also argue that the availability of options enables corporations to attract more productive employees. I am sure that is true. But option expensing in no way precludes the issuance of options. To be sure, lower reported earnings as a result of expensing, should it temper stock price increases, could inhibit option issuance. But, again, that inhibition would be appropriate because it would reflect the correction of misinformation.

It is no more valid, in my judgment, to assume that option grant expense is zero than to arbitrarily assume depreciation charges are zero. Both assumptions, excluding interest, increase reported pretax earnings. Both imply that the inputs that produce valued corporate outputs are free. ”

CASE IN POINT BORDEN

At Borden, just after the proxy statement explained that the CEO did not get a bonus because the company had not met its performance goals, the board awarded the CEO options to purchase 100,000 shares of the company's common stock at a price to be set in the future, subject to shareholder approval at the next annual meeting. Furthermore, according to the employment contract: "In the event that the Stock Option Plan is not approved by shareholders at the Corporation's next annual meeting of shareholders, the Corporation shall provide the executive with compensation of equivalent value as determined by the Compensation Committee." In other words, if the shareholders decided that the CEO should not get the new stock options, the CEO would get the equivalent in the form of cash.

What connection is there between pay and performance in this arrangement? What does this show about the directors' representation of the shareholders who "elected" them?

Note: this plan also provided that the company would pay for two residences for the CEO, along with all applicable taxes. Note further that despite the contract's provision that the CEO could not be removed for any reason other than commission of a felony, he was removed within six months of signing this contract. While he no longer had the job, this did not affect his salary. He received the present value of the full five years of pay. ■

What shareholders look for in options is some way to make sure that they tie returns to the particular company's performance rather than to the performance of the market as a whole. One way to do this is to index the options, so that the "strike price" rises with the stock market. That way, the compensation reflects the performance of the particular company's stock. Another option is to grant the options at a price greater than the current stock price. Compensation consultant Ira Kay, of Hay Group management consultants, says that committees should build downside risk into their plans by *selling* jumbo stock option grants, paying bonuses for executives who retain option shares, and granting premium options. Shareholders are becoming more sophisticated about compensation. According to the Investor Responsibility Research Center, the percentage of shareholders voting against option plans was 3.5 percent in 1988 and 12 percent in 1991. In 1998, 15 proposals were defeated by shareholders and 270 had at least 30 percent opposed.

A study presented at the American Accounting Association in 2010 found that shareholder "vote-no" campaigns have turned out to be a highly effective way to address excessive compensation, resulting on average in a single-year CEO pay drop of about $7.3 million (about 38 percent) in firms where pay was excessive. Companies that significantly reduced CEO pay as a result of shareholder initiatives during the study's time span (1997–2007) included Yahoo, UnitedHealth, United Natural Foods, Sanmina-Sci, Saks Inc., Sprint, Qwest Communications, Legg Mason, Lennar, KB Home, Constellation Energy, and Apple. In the first few months of the Dodd–Frank legislation's required "say on pay" votes, there were majority votes against excessive pay at fifteen companies and against management's attempt to schedule shareholder votes on pay every three years instead of annually at twenty-seven companies.

RESTRICTED STOCK

Instead of stock options, some companies make "restricted stock grants," awarding stock with limits on its transferability for a set time, usually two or three years, but sometimes for the executive's tenure with the company. Some restricted stock grants have performance requirements as well, as at FleetBoston, where the stock will vest only if executives meet "aggressive financial targets." Restricted stock becomes more appealing in a down market (or when executives think the stock is not going to increase in value) because, unlike an option, restricted stock has value unless the stock goes down to zero. Crystal is leery of restricted stock grants, arguing that they should be a signal to the market that even management does not think that the stock price will go up. They are low in risk. Compare Lee Iacocca's compensation plans at the beginning of his time at Chrysler with

the plan at the end. He once ran Chrysler for a dollar a year, but with some "monster [very large] options" that paid out $43 million in six years. On the other hand, between 1983 and 1987, Iacocca received 455,000 shares of restricted stock. By the end of the 1980s, Chrysler stock had halved. In 1991, Chrysler's bonus-eligible executives received grants of restricted stock, with restrictions that lapsed within months. Since they paid nothing for these grants, this was additional compensation that was all upside and little downside.

In 2002, the board of Bank of America Corporation granted Chief Executive Kenneth Lewis an $11.3 million restricted stock award in addition to 750,000 stock options. Awards of restricted stock instead of – or, as here, in addition to – stock options continue to rise as market pressure or changes in accounting rules force options grants to be expensed, thus removing the balance sheet advantage of options over stock, and as CEOs hedge their bets in an uncertain market.

YES, WE HAVE GOOD EXAMPLES

British advertising firm WPP is a rare example of "skin in the game" CEO compensation, where executives must invest their own money in shares, which will then be matched or not to the extent that a relative total shareholder return target is met. And the TSR must equal or exceed the median for any match. Compare this to Morgan Stanley's "Leveraged Coinvestment Program" in which execs were "allowed" to defer shares they had just "been given for free" as part of the annual bonus plan into a "fund of funds". The company gives a two for one match (regardless of performance) and the participants receive all the investment returns on the whole amount though, at the end of the day, they will only receive their own deferred shares when the plan is cashed out. Note that the fund of funds invests in everyone else's shares, not the company's, so any alignment with the interests of shareholders disappears.

SHAREHOLDER CONCERNS: SEVERAL WAYS TO PAY DAY

Some other issues of shareholder concern include the following abusive compensation practices.

THE "GUARANTEED BONUS" – THE ULTIMATE OXYMORON

Compaq CEO Michael Capellas was brought in as CEO of WorldCom after it entered bankruptcy following the disclosure of accounting fraud. His proposed pay included an annual salary of $1.5 million, a $2 million signing bonus, and a $1.5 million guaranteed bonus in 2003. Lucent's Pat Russo had a base salary of $1.2 million and a guaranteed bonus of $1.8 million. Jim Adamson, the new chief executive of K-Mart, also in bankruptcy, got a $2.5 million signing bonus just for agreeing to be the new CEO – his salary to be a minimum of $1 million a year, with a contingency payment of $4 million the next year, and with a guaranteed bonus of more than $1 million a year. That's at least $8.5 million in only his first year – guaranteed. Hewlett-Packard's CEO Mark Hurd

got a multimillion dollar deal that included a guaranteed bonus. His contract provides that all of his first-year goals were "deemed to have been achieved."

The whole purpose of a bonus is to adjust pay up or down based on performance. To give a CEO a guaranteed bonus in any circumstance is to make the term itself meaningless, but it is particularly difficult to justify in a turnaround situation, where shareholders want someone who is willing to bet on himself. Gary Wendt insisted on a $45 million cash signing bonus (showing up money) when he went to the troubled Conseco. This was a clear signal that he was not sure the turnaround would work, but he was sure he would do fine either way. Under his leadership, the company went into bankruptcy.

DELIBERATE OBFUSCATION

New executive compensation disclosure rules promulgated by the SEC in 1992 (discussed in greater detail below) were designed to prevent companies disguising compensation awards in pages of numbing legal narrative. As soon as the new rules were issued, however, lawyers and compensation consultants began designing ways to make compensation less clear to shareholders. In 2006, new rules went into effect to plug the loopholes lawyers had stretched so wide that hundreds of millions of dollars-worth of compensation were not disclosed. The Jack Welch example earlier in this chapter, for instance, came about because the rules anticipated that post-retirement compensation would not be significant and therefore did not need to be disclosed. Therefore, compensation committees started to push more and more of the pay packages into the post-retirement category.

Favorite gimmicks include: deferring more pay until after retirement, creating a two-tier bonus arrangement, and altering stock option plans by setting a maximum number of possible options that may be awarded. One compensation consultant told the *Wall Street Journal*: "The professional fees generated by this piece of legislation will far outweigh the tax revenue it generates."[34] The unintended consequence of this rule turned out to be the award of unprecedented levels of stock options that brought executive compensation to hundred-million-dollar levels during the roaring 1990s. With the post-2001 down-market and the pressure to expense option grants, pay began to move away from options to restricted stock and other forms of pay not tied to the stock price. The bad publicity from the post-meltdown bonuses on Wall Street led to some changes. They still gave bonuses; they just changed the name. The 2010 statement from Goldman Sachs makes no mention of the word "bonus" at all, referring only to "discretionary compensation."

> *"Alan Johnson, a compensation consultant with his own New York-based firm, said the change in language is no coincidence. He has been advising his clients, which include the largest investment and commercial banks, to banish the word 'bonus' and use 'incentives' instead. 'We try to avoid the term wherever we can because it is a flash point,' Johnson said. 'We're going back to using what it really is, it's an incentive.'*[35]"

Note that the 2006 rules impose the following new or enhanced disclosure obligations:

The compensation committee must have a compensation disclosure and analysis (CD&A) report, a narrative overview explaining the material elements of compensation for the company's named

executive officers, focusing on the material principles underlying the company's executive compensation policies and decisions and the most important factors relevant to analysis of those policies and decisions and avoiding boilerplate and jargon. The rules have a detailed list of what must be included, from the impact of accounting and tax treatment on the committee's consideration to the specific reasons for the elements in the compensation mix. And, the CD&A will be considered "filed" with the SEC, subjecting the company to a higher level of securities law liability than the currently "furnished" compensation committee report.

There will also be a new "total compensation table" that will be a more comprehensive overview of the complete package, including perquisites. The new rules require valuations for non-cash elements of pay and separate disclosure of awards under performance-based incentive plans (both cash and equity) and time-based awards. The dates of option grants and any gap between grant strike price and trading price must be disclosed.

The new rules require two tables relating to holdings of equity-related interests: one disclosing the outstanding equity awards held by each named executive officer at year-end and the other disclosing the value realized upon exercise or vesting of stock-based awards during the most recently completed fiscal year.

They expand the disclosure of director compensation as well, including charitable donations on behalf of the director.

The Dodd–Frank legislation adds further disclosure requirements including additional information about the pay–performance link and a comparison of the CEO pay to the mean for employees.

THE CHRISTMAS TREE

Many compensation plans contain elements that are in themselves admirable, but in combination with a host of other plans add up to a package that has no sensitivity to performance. For example, stock options and performance unit plans are all too often usually an addition to compensation packages, not a substitute for something else.

COMPENSATION PLANS THAT ARE ALL UPSIDE AND NO DOWNSIDE

These plans include any grants of stock or stock options that fail to discount for overall market gains or that are cushioned against loss of value through compensatory bonuses or re-pricing. Management will face increased opposition to these kinds of plans. Increasingly, investors are likely to push for option grants that are premium-priced, with amounts based on achievement of specific performance goals or indexed to the company's peer group as more directly tied to performance.

LOANS

The corporate scandals of 2002 included extraordinary abuses of corporate loans, including "non-recourse" loans that do not have to be repaid. The board of WorldCom authorized an astounding $408 million loan to CEO Bernie Ebbers and the Rigas family got $3.1 billion in loans that the

board now says they did not authorize (see case studies). Tyco's Dennis Kozlowski got $88 million in loans and Conseco's Stephen Hilbert got $162 million in loans.

While the origins of insider loans may have been legitimate, like almost every other element of executive compensation it has been distorted and abused. It is also widespread. In fiscal 2002, a third of the largest 1,500 companies in the US had outstanding loans to one or more executives. Only 362 of the 508 companies disclosing loans actually indicated in any detail whether loans were interest bearing or not and whether they would be required to be paid back. Of these 362 companies, 102 had forgiven or were forgiving loans. Many companies even paid the taxes for the executive when the loans were forgiven.

There is little justification for using corporate assets to make loans to people who can get loans from any commercial lending facility. Loans to executives are prohibited by Sarbanes–Oxley, so investors must watch closely to make sure that "nonrecourse" loans do not become outright grants.

ACCELERATED VESTING OF OPTIONS

The Financial Accounting Standards Board finally required companies to expense options when they were granted, so some companies took advantage of the time before the new rules went into effect to accelerate the vesting of options to avoid having to comply. *Newsweek*'s Alan Sloan wrote:

> *How would you like to be able to chow down on other people's cake, but be able to tell them with a straight face that you're doing it for their own good? It's as if you can prove your parents wrong by not only eating your cake but having it, too.*
>
> *Welcome to a quirk in the accounting rules that has allowed more than 200 U.S. companies to give executives (and regular employees) billions of dollars of free cake – all in the name of fattening future profits and share prices. They can report higher profits tomorrow by giving gifts at shareholders' expense today . . . .*
>
> *[A]t least 212 companies have accelerated vesting in the past year, according to Jack Ciesielski, editor of the Analyst's Accounting Observer. (That was the count in May – he hasn't yet updated for June.) Ciesielski has given this strategy a wonderful name: 'vest fleece.' Vest fleecing, he says, is 'a use of management's time and shareholders' funds to do only one thing – keep investors in the dark about the way management pays itself.' By his count, companies valued these options at about $2.6 billion when they were given as gifts to executives and other options holders.*
>
> *More than 20 percent of the total is from just two companies: Viacom ($277 million) and Sun Microsystems ($260 million).*[36]

MANIPULATION OF EARNINGS TO SUPPORT BONUSES

At Union Pacific, the extraordinary income from an asset sale was calculated as earnings to trigger bonus payments to executives. Many other companies game pay–performance formulas by artificially lowering the triggers or other dodges.

MANIPULATION OF PEER GROUPS

Timberland, a small shoe company, decided that for the purpose of pay its peer group included Nike, a much larger shoe company. Nike might be many times larger, but they both make shoes, and everyone likes to be in the same peer group as the highest-paying companies so they can appear to be moderate by comparison. One study provided support for the self-dealing aspect of peer group manipulation by noting the correlation between peer group manipulation and smaller peer groups, where the CEO is the chairman of the board of directors, where the CEO has longer tenure, and where directors are busier serving on multiple boards.[37]

HUGE DISPARITY BETWEEN CEO AND OTHER TOP EXECUTIVES

GE CEO Jeffrey Immelt told the *Financial Times* that "to motivate staff and avoid excesses, chief executives' pay should remain within a small multiple of the pay of their 25 most senior managers. 'The key relationship is the one between the CEO and the top 25 managers in the company because that is the key team. Should the CEO make five times, three times or twice what this group make? That is debatable, but 20 times is lunacy.'" One risk factor for Moody's in determining credit and debt ratings is high disparity; when CEO pay is more than triple that of any other executive named in the proxy statement, they consider it a red flag. (Another risk factor is incentive compensation designed to encourage earnings manipulation.)

IMPUTED YEARS OF SERVICE

When it comes to some elements of pay, CEOs are like dogs, with one year of service the equivalent to seven for humans. Former Treasury Secretary John Snow, as CEO of CSX, had "imputed years of service" to qualify him for 44 years of service though he only worked there for 25, giving him $2.47 million a year for the rest of his life.

EXCESSIVE DEPARTURE PACKAGES

Jill Barad of Mattel got a $45 million departure package that included not only forgiveness of the mortgage on her house but the tax payments on the imputed income from that forgiveness. What had she done to deserve this? Under her direction, the stock of the company had declined by 70 percent. Carly Fiorina's tenure at Hewlett-Packard was controversial and the stock price sank while she was CEO. Her $180 million compensation package for the five years she served included a $20 million departure package. Severance provisions in CEO contracts often provide that the three years of pay that continues after termination includes not just salary but target bonuses, whether or not those targets have been met. CEOs should not make more money leaving than they were entitled to if they had stayed. When Richard Cheney left his position as CEO of Halliburton to become Vice-President of the United States, his departure was characterized as a "retirement" rather than a "resignation" so that all of his options vested and he was entitled to his post-employment benefits – including his retention bonus, despite the fact that he was not actually retained.

Lee Raymond got a $400 million departure package from Exxon. Robert Nardelli got a $200 million departure package from Home Depot despite poor performance. Thomas E. Freston

served as president and CEO of Viacom for less than a year, yet under the terms of the employment agreement, Viacom paid him approximately $84.7 million in connection with his termination of employment. Pfizer's Hank McKinnell's departure package amounted to $213 million, despite his being well paid for five years of presiding over a 42 percent decrease in stock value (while he spent time running the Business Roundtable), showing that Pfizer's claim to best-in-class corporate governance was more letter than spirit.

BACKDATING, BULLET-DODGING, AND SPRING-LOADING OPTIONS

In 2005, University of Iowa finance professor Erik Lie published the explosive results of his research on the timing of stock option grants.[38] He found that the incidence of granting the option at the lowest price was so frequent it could not be "lucky" – it had to be manipulated after the fact. Companies were permitting "lookbacks" to allow executives to decide which date in the past would be the grant date for the stock – of course they picked the date with the lowest stock price, making the grants automatically "in the money."

As much as 10 percent of pay may have been the result of these actions – which would have been legal had they been disclosed, but in the overwhelming majority of cases were not. By the end of the year, over 2,000 companies had been implicated in the "backdating" scandal, resulting in CEOs and other executives at companies like KB Homes and UnitedHealth Group losing their jobs and a number of federal investigations and civil lawsuits. More were expected – a subsequent study by Lucian Bebchuk, Yaniv Grinstein, and Urs Peyer suggested as many as 12 percent of public companies could be implicated and recent disclosures indicate that directors as well as executives may have benefited from backdating. Former SEC Chief Accountant Lynn Turner commented: "This scandal has now touched perhaps more companies than any other single scandal, except for the one involving illegal payments and bribes during the Watergate era, which led to the Congressional mandate that companies have adequate internal controls." Turner also noted that, despite the breadth and depth of the backdating scandal, many companies were not planning to include some basic steps to prevent future backdating or other manipulation of stock option grant dates. A study by The Corporate Library showed there was a statistically significant group of directors and officers who were repeatedly connected with companies implicated in the backdating investigations.

Backdating, while not strictly illegal as long as it is disclosed and properly accounted for, subverts the entire justification for stock options. Stock options are supposed to align the interests of executives and shareholders, but investors do not get a chance to look back a few months and pick a strike price after the fact. The Sarbanes–Oxley legislation all but eliminated the ability to backdate options but the problem persists. The time of the option grant may be fixed so that it cannot be changed after the fact, but the timing of the announcements of good and bad news can be manipulated to make sure that the options are granted at the optimal moment. Spring-loading is setting an option grant date just before an announcement of good news and bullet-dodging is setting the date just after the announcement of bad news. Both all but guarantee good results. Boards and HR departments must be very clear and very careful about making sure that option grant dates are independently determined and investors must be very careful to make sure that is the case.

In the post-meltdown era, when executives' holdings and option grants lost a lot of value, companies made up the difference with new awards at the market low. As the market went back up to its pre-meltdown levels, they received windfall profits that bore no relation to the performance of the individual or the company.

PHONY CUTS

In a down market, no one wants to be in the top quartile any more. Some companies made highly publicized "cuts," but again, all too often, these "cuts" are more than made up for by mega stock options, restricted stock grants, plain old cash, or other awards. In 2003, Citigroup CEO Sandy Weill said that he would not accept a cash or stock bonus because the company's stock fell 30 percent. Weill also had 4 million underwater options that expired. However, the forgone bonus was overshadowed by a new option grant three times greater than his previous grants. In 2001, Weill took in $25.7 million in bonus and restricted stock, and $27.5 million the year before. Since Weill held just under 23 million shares of Citigroup, it is hard to imagine that additional option grants provide significant additional incentives.

When Steve Jobs returned to Apple in 1997, the company he founded, he took $1 a year in compensation. After all, as the company's largest shareholder, he had already (in theory) every incentive to do well. In January 2000, Apple's board gave Jobs an option grant covering 20 million shares and carrying a strike price of $43.59 a share. Compensation expert Graef Crystal estimated its value at $471 million. However, the stock price fell, and so the board gave Jobs another option grant in 2001: 7.5 million shares with a strike price of $18.30. The stock fell to $14.91. So much for stock options. The board swapped the options for more of what Jobs already had – 5 million free shares, worth $74.6 million at the time of their grant, and, of course, guaranteed to be worth at least something unless the stock went down to zero. In 2006, it was revealed that the original option grants had been backdated to get the lowest available price. The company argued that this was immaterial, as he had relinquished the options. However, their value, based on the backdated strike price, was used to determine the amount of the stock he received in exchange, so it did make a difference.

GOLDEN HELLOS

Sometimes called joining bonuses, compensation for income opportunities forgone, reimbursement for benefits forfeited from a former employer, these "golden hellos" are now almost ubiquitous in executive recruitment. The range of terms used to describe golden hellos is only exceeded by the range in the size of such payments, from a high of $45 million paid to Gary Wendt by Conseco to a low of $150,000 for Steve Odland of Autozone. In one case that attracted a lot of attention, Ron LeMay was recruited from Sprint to be the CEO of Waste Management (see case study). His pay package included *Sprint* options, on the theory that Waste Management shareholders should make sure he was able to benefit (apparently without having to buy any stock) from the work he had done at Sprint. Those who thought this continuing interest in Sprint was a bad sign about his commitment to Waste Management were proven right when he returned to Sprint after less than five months. LeMay and his boss, CEO William Esrey, were removed from their positions at Sprint in 2003 after disclosure of a tax avoidance scheme that allowed them to shelter $288 million in stock option profits.

TRANSACTION BONUSES

The golden parachutes for Sprint executives were triggered not by completion of a merger with MCI but by a vote in favor of the merger by the board. Thus, when the merger was not approved by federal regulators, the shareholders got the worst of both worlds – a failed deal for which they

had to pay out bonuses to the executives. Some CEOs also get "transaction bonuses" for acquisitions, regardless of subsequent performance by any measure. To give a bonus for a transaction is to create a perverse incentive, especially if the executive can get another transaction bonus for selling or spinning off the acquisition when it does not work out.

GROSS-UPS AND OTHER PERQUISITES

"Gross-ups" are tax payments made by the company on behalf of the executive. They were first instituted when a change in the tax code imposed some unanticipated costs, but have lingered on because some executives do not want to pay their taxes. There may have been some justification for these payments to prevent unequal treatment during a transition period just after the excise tax rules were adopted, but it is harder and harder to justify as time goes on. This is the Leona Helmsley "only little people pay taxes" approach. These people are getting paid a lot. They should be able to pay their own taxes, just like the rest of us.

Many CEO pay packages include perquisites that (a) the CEOs are well able to afford and (b) have no relationship to performance. New York University's David Yermack found that at firms that have disclosed the popular perquisite of access to the corporate aircraft, average shareholder returns under-perform market benchmarks by more than 4 percent annually, "a severe gap far exceeding the costs of resources consumed." Around the date of the initial disclosure, firms' stock prices drop by an average of 1.1 percent.[39] Other disclosed perquisites have included cars, "cleaning services" (domestic employees), rugs, apartments, horses, and benefits for family members. In late 2006, Lockheed Martin became the first company to announce that it was eliminating some perquisites like country club memberships, limousine services, tickets to baseball games, and financial planning services as a part of its compensation package – but was increasing cash compensation up to $40,000 to make up for the cuts. Other companies are likely to make similar changes.

RETIREMENT BENEFITS

Post-employment compensation for CEOs is not subject to the same rigorous disclosure standards as pay while the CEO is still in his job. It took an ugly divorce proceeding to make public the lavish benefits given to former GE CEO Jack Welch. The public filing simply said that he would have "continued lifetime access" to company facilities. Companies that make a clear statement about what is – and is not – covered after retirement will benefit from enhanced credibility as shareholders learn to be more skeptical, and more inquisitive, about this category of compensation.

OBSTACLES TO RESTITUTION WHEN CEOs ARE OVERPAID

Companies and shareholders have found it difficult to get restitution when bonuses are paid out based on numbers that are subsequently restated. According to the *Wall Street Journal*, when FPL Group executives were awarded $62 million-worth of bonuses for a merger that never took place, the company was not able to force them to pay it back. "After three years and millions in legal bills, executives returned $9 million, based largely on a technicality. Insurers paid another $12.5 million."[40] Even in cases of fraud, with the involvement of the SEC, boards have not always been able to get the money back.

FUTURE DIRECTIONS FOR EXECUTIVE COMPENSATION

In 2006, the SEC issued new rules on the disclosure of executive compensation. Improved disclosure is also important to investors because it will enable them to make an informed investment decision, whether it is voting proxies or deciding to buy or sell a company's stock. Nothing is of greater interest to an investor considering whether to buy or sell than whether the company has an incentive scheme that aligns the interests of management and shareholders. Nothing is of more interest to a shareholder who is considering candidates for election to the board (including members of the compensation committee) than the priorities reflected in the compensation plan they approve and the independence of the members of the committee. Shareholders will use the increased clarity and consistency of the information available to them to make decisions about when to buy and sell, and about when to submit or support a shareholder initiative. Smart managers will want to seize the initiative to reach out to the shareholders and address their concerns.

Compensation should be seen as one item – and an important one – on the board's report card. How does a board balance conflicting interests of managers (who want less variability in pay) and shareholders (who want more)? The way the board reconciles these interests is a crucial indicator of their focus, independence, and ability. Bad compensation schemes are not the disease; they are the symptom. The disease is bad boards, and shareholders must now be persuaded that bad boards must be fixed.

This does not mean that CEOs will be paid less; it means that they will be paid better. Shareholders have learned that if they do not make sure they get what they pay for, they will certainly pay too much for what they get. In the words of the then-SEC chairman Richard Breeden, echoing his predecessor of the Carter administration in the late 1970s, Harold Williams stated: "The best protection against abuses in executive compensation is a simple weapon – the cleansing power of sunlight and the power of an informed shareholder base."[41]

In other words, as SEC Commissioner Roel C. Campos said in his remarks on the proposed changes:

> *What seems clear is that simple shame for being overpaid and for unearned riches does not seem to exist very much any more.*
>
> *At the end of the day, the SEC is not and will not pass judgments on the level of pay and whether it is too high. That judgment will continue to be made by directors and shareholders. These proposals should provide a useful tool to determine with precision and comparability what executives truly earn. It seems to me that shareholders will have no one to blame but themselves if executive pay continues to rocket upward in an unacceptable way.*
>
> *These proposals do not and cannot create backbone for directors to make hard decisions about the correct level of pay for their executives and whether paying executives like rock stars is an appropriate use of shareholder assets.*
>
> *It will continue to be difficult for directors to 'just say no' to unearned and excessive pay. However, increasingly it may be the role of shareholder owners to expect their directors to impose limits and restraints and seek to replace directors who do not.*

CEO EMPLOYMENT CONTRACTS

The CEO's annual salary is just the tip of an iceberg. To get the full story, you need to move past the proxy statements and look at CEO employment contracts, which are theoretically public, but in reality very hard to find. They are filed as an attachment to the company's 10-K, but not sent out to shareholders. Since there is no way to know when they were signed or amended, it can take a search through years of filings before finding the contract.

These contracts are thoroughly massaged by lawyers, compensation consultants, and headhunters. Because the same consultants and advisers work on so many of them, there is a "lowest common denominator" aspect – one bad idea (like having the company pay the fees of the lawyer who represented the CEO in the negotiation) gets picked up by others, so that they tend to have a numbing sameness to them. There are, however, a few outliers – good and bad – worth mentioning.

In 2000, Robert Annunziata announced his departure from Global Crossing just a week after The Corporate Library selected his contract as the worst of the S&P 500. The stock price rose very quickly during Annunziata's tenure, but his contract's pay–performance link was weak. As the company's performance leveled off, Annunziata's compensation did not diminish commensurately. As noted earlier, just for showing up, Annunziata got a $10 million signing bonus and two million stock options at $10 a share below market. He got a "guaranteed bonus" of not less than half a million dollars a year. The make and model of the Mercedes the company had to buy for him and his wife were spelled out in the contract. He got use of the corporate jet for commuting until such time as he might find it appropriate to move, and to keep him from getting homesick, his family got first-class airfare to come see him once a month, including his mother.

The board, and even its shareholders, might argue that the cost of the family's first-class airfare and the "brand-new 1999 model Mercedes-Benz SL 500" for the use of the CEO and his wife were trivial in light of the importance of the job and the value the company has created. But anyone who gets the equivalent of $30 million just for showing up can pay for his own airfare and Mercedes. Also, much more important, anyone who is willing to make a real commitment to the company can take options at or above market. Shareholders like to bet on people who are willing to bet on themselves. By filling Annunziata's contract with a series of ridiculous perks, Global Crossing's board was sending the wrong message to employees, customers, and investors.

In January of 2002, amid disclosure of accounting improprieties and self-dealing, Global Crossing filed for the fourth largest bankruptcy in the history of the United States.

Annunziata's departure shows that while it may be necessary to include provisions like these to attract certain executives, that does not mean that those are the executives a board should want to attract. The contract succeeded in getting him on board, but it did not succeed in keeping him. Annunziata was one of three Global Crossing CEOs in less than two years.

In 2000, The Corporate Library picked the contract of GE's Jack Welch as an exemplar of good corporate governance. On its face, it was short, simple, and with that rarest of provisions, the right of the board to fire the CEO for failure to perform. Unlikely as it was, given Welch's reputation as the greatest CEO of the century, it was still a classy touch. However, an acrimonious divorce case led to revelations in 2002 that Welch had undisclosed post-retirement perquisites including lifetime use of the corporate jet, apartment, and Knicks tickets. After paying him over $900 million, his retirement benefits included having the company pay for his dry-cleaning, caterer, and postage stamps. Welch quickly gave up these benefits, which he valued at about $2 million a year, saying that while they were proper when he entered into them, the climate had changed and they were no longer acceptable.

More interesting than the extremes is standard operating procedure. A 2006 study of CEO employment contracts found that CEOs do a better job than other executives in insisting on clauses that protect their interests more than the corporation's.[42]

CAUSE

In addition to compensation abuses cited above, from "gross-ups" to "imputed years of service," these contracts also typically define "cause" very narrowly. CEOs who are terminated for cause do not receive the full package of termination benefits that they would if they were terminated without cause. This makes sense. Anyone terminated without cause should be entitled to some financial arrangement as compensation.

The problem is that in the world of CEO employment contracts, terms like "cause" are redefined. The contracts whittle away at the definition to make it impossible to terminate employment based on poor performance without substantial expense. "Cause" is most often defined as felony, fraud, embezzlement, gross negligence, or moral turpitude. As noted above, at H-P, Mark Hurd's contract omitted any definition, which meant that when he was terminated for expense account fraud, that did not constitute "cause" and the company had to pay his $40 million severance package. At Toys-R-Us, the contract for former CEO Michael Goldstein provided that he could not be fired for cause without "a felony involving moral turpitude." Newmont Mining's Ronald C. Cambre had a contract that requires three-quarters of the board to find that he acted in bad faith in order to support termination for cause. Richard J. Kogan's contract at Schering-Plough provided that if he challenged a for-cause termination, his own determination of good faith prevailed unless there was a final and nonappealable judgment to the contrary by a court. The most outrageous of these provisions was surely the now-notorious contract for Dennis Kozlowski of Tyco, which provided that conviction of a felony was *not* grounds for termination unless it was directly injurious to the company. He had no contract for the first four years he served as CEO, so it now seems clear that he only asked for it after he knew he was under investigation for sales tax evasion. Apparently, his board did not consider the timing or language to be of concern.

Very few contracts even mention poor performance as the basis for termination for cause, though some contracts do include willful refusal to follow the direction of the board. Some of those that do refer to performance require a showing of bad faith to make it clear that failure to perform alone is not sufficient for "cause." One study found that only 3.47 percent of CEO contracts considered incompetence to be grounds for termination for cause.[43]

The recent push to make termination-without-cause payments equal those for termination in connection with a change of control is particularly troubling. Change of control payments are intended to align the interests of the CEO with the shareholders in evaluating a business combination. Payments for termination without cause are intended to ease a nonperforming CEO out the door. They can also provide an incentive for a bored CEO to trigger his own parachute with a buyout deal that may be contrary to the long-term interests of the shareholders.

The cost of these provisions may be small in comparison to the peace of mind that comes from being able to fire an unsatisfactory CEO without worrying about litigation. However, we think that boards can do better than this. One of the justifications often claimed for astronomical amounts of CEO pay is the element of risk, but provisions like this can make the position risk-free or even provide an incentive to leave, as departures of CEOs from H-P, AT&T, Mattel, Disney, and Global Crossing demonstrate.

Any other employee at any other level has some accountability for poor performance. What can boards do to make performance a factor in these contracts?

CHANGE OF CONTROL

As with "cause," there is a through-the-looking-glass quality to the definition of "change of control." Summit Bank is one company that requires acquisition of 51 percent of the stock, but other boards do not make any effort to require a CEO to work with substantial block-holders of stock, even though studies show that block-holders can be effective monitors of shareholder value, especially when they have representation on the board. Many contracts define change of control that can trigger a parachute as low as 20 and even 15 percent.

We believe that it can be in the shareholders' interests to ensure that a CEO must make every effort to work cooperatively with a substantial block-holder. Making departure so painless can be a disincentive for those considering the purchase of a block of stock. This can discourage the involvement of substantial investors, who will not want to buy in knowing that the CEO can just walk out the door, taking a hefty sum from the corporate coffers on the way out.

Furthermore, these low triggers can create perverse incentives. The motivation for the disastrous Time Warner/AOL deal became clearer when Graef Crystal revealed in his newsletter that the deal paid out at least $1.8 billion in option profits for Time Warner executives, and that this was triggered not by completion of the deal but merely by the vote of the directors in its favor.[44] Similarly, the Sprint executives received their golden parachutes for the merger with MCI, even though regulators refused to approve the deal, so that it was never completed. A 2003 settlement of a shareholder lawsuit against Sprint had a precedent-setting 50 governance improvements, including a commitment not to trigger future parachutes unless the transaction was completed.

HALF NOW, HALF LATER

An ideal contract for a chief executive should provide incentives and protections solely designed for tying compensation to the creation of shareholder value. Anything that distracts from or contradicts that goal is an indication that a company's board is not sending a clear message to the CEO, the officers, and employees, or to the investment community about its priorities.

These contracts are most important not because of what they show us about the CEO but for what they show us about corporate boards. Shareholders want CEOs to be aggressive, and even a little greedy, but shareholders depend on directors to make sure that those qualities are directed at shareholder value. It is fine for the CEO to ask for the moon, but it is the job of the directors to say, "Sure! You can have half of the moon now, and the other half when the stock price doubles." When the board fails to do so, it is the job of the shareholders to remind them that they demand accountability.

CEO SUCCESSION PLANNING

The leading expert on CEO succession successes and failures is Yale professor Jeffrey Sonnenfeld, who likes to quote one CEO who answered his question about his succession plan: "I'm talking to those people who made Dolly the sheep." Even if cloning were available, it would not be the

answer, as even the ideal CEO for one period in a company's history may not be the right choice for the next challenge.

In his classic book *The Hero's Farewell*, Sonnenfeld found that CEOs were significantly less willing to contemplate stepping down than were other senior executives. For example, 30 percent had made no preparations for retirement, compared with only 16 percent of senior managers. Not surprisingly, CEOs were less likely to retire of their own volition than other top managers and, even after retirement, CEOs hung around: 57 percent of them retained an office at the firm for at least two years (compared with 23 percent of senior managers). Sonnenfeld categorizes the different approaches: "Monarchs," who do not leave voluntarily; "Generals," who leave reluctantly and plot to return; "Ambassadors," who leave gracefully and retain close ties to their old firms; and "Governors," who leave willingly to pursue new challenges. Increasingly, boards are assuming control of the CEO succession planning process, creating a new category for the CEO: "Adviser." Increasingly, they are also creating incentive compensation specifically designed to communicate to the CEO the importance of making sure that his or her successor is not a clone or a disaster that the former CEO must come back to rescue but the best possible choice for the strategic challenges the company will face.

CEO succession planning is of increasing interest to shareholders given the shrinking tenure of chief executives and rising concerns about perverse incentives in compensation. Outside candidates are more expensive both due to the cost of the search, the costs of bringing an outsider up to speed, and the documented premium in pay for outsiders. The ability to cultivate internal talent is also an important indicator of CEO effectiveness. In 2009, the SEC reversed its previous policy and decided to permit (nonbinding) shareholder proposals on the subject of CEO succession planning.

SARBANES–OXLEY

The Sarbanes–Oxley Act of 2002 (Pub. L. No. 107-204, 116 Stat. 745), also known as the Public Company Accounting Reform and Investor Protection Act of 2002 and commonly called SOX or Sarbox, was signed by President George W. Bush on July 30, 2002. It was a response to Enron, WorldCom, Tyco, and the other string of massive frauds and failures between 2001 and 2002, and was the most significant piece of federal legislation governing public corporations since the post-1929 stock market crash legislation creating the SEC. Contrary to popular belief, however, it was not cobbled together quickly and nearly all of its provisions had been under consideration by the Senate and Congressional committees in various forms for several years. Significantly, the legislation did not change the essential allocation of corporate governance authority to the states, and for that reason, like other SEC laws, its focus is on disclosure and penalties rather than substantive requirements. Its biggest change was the creation of a new agency for overseeing the accounting profession and on new disclosure requirements and enforcement authority for federal agencies. Its most controversial provision is "Section 404," concerning internal controls, discussed in more detail below.

The most significant provisions of Sarbanes–Oxley are as follows.

CREATION OF THE PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Before enactment of this legislation, the accounting profession was self-regulated, overseen by its own American Institute of Certified Public Accountants. Sarbanes–Oxley created a private-sector,

nonprofit corporation with members appointed by the SEC. Its primary roles and responsibilities include:

- registering public accounting firms that prepare audit reports for issuers;
- setting auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports by issuers;
- conducting inspections of registered public accounting firms;
- conducting investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms.

Each of these powers is subject to approval and oversight by the Securities and Exchange Commission. Individuals and audit firms subject to PCAOB oversight may appeal PCAOB decisions, including any disciplinary actions, to the SEC and the SEC has the power to modify or overturn PCAOB rules. The PCAOB is subject to SEC inspections and enforcement and the Sarbanes–Oxley Act gives the SEC the power to censure or remove the PCAOB members for cause.

In February 2006, the Free Enterprise Fund and Beckstead and Watts, LLP (a small Nevada-based accounting firm required by the PCAOB to restate the financial reports of two clients) filed a lawsuit in the federal court challenging the constitutionality of the PCAOB. According to the lawsuit, the provision of the Sarbanes–Oxley Act establishing the PCAOB violates the "Appointments Clause" of the US Constitution, since the PCAOB members should be viewed as "officers of the United States" because of the public purposes PCAOB serves and, as such, must either be appointed by the President of the United States, with the advice and consent of the US Senate, or by the "head" of a "department," whereas PCAOB's board is appointed by the SEC, rather than by the Chairman of the SEC. The lawsuit also challenged the PCAOB as violating the Constitution's separation of powers, since the organization has quasi-executive, legislative, and judicial functions. In 2010, the Supreme Court upheld all of the PCAOB legislation with one exception: the provision that limited the SEC's authority to remove PCAOB commissioners. The Court ruled that they must be subject to removal by the SEC at will.

SECTION 404

As noted above, the most controversial section of the law is the requirement that companies report on the effectiveness of their internal controls. A number of corporate complaints point to the expense of complying with this requirement and there have been several calls for making it less burdensome and costly, especially with regard to smaller companies. It is important to note, however, that companies have been required to have internal controls since 1977, when the Foreign Corrupt Practices Act became law. All Sarbanes–Oxley adds is the requirement that companies find out whether they work or not and report on their findings. It may be expensive to answer that question; it is certainly expensive not to answer it. While there have been some legitimate complaints that giving auditing firms the authority to direct these investigations has led to unnecessary costs, the delay in imposing the requirement on smaller companies and amended rules and guidelines from the SEC and PCAOB are likely to alleviate these concerns. Most important, a 2006 study by proxy advisory firm Glass–Lewis found that companies who were in compliance with Section 404 were less likely to issue restatements, supporting the idea that the requirement is cost-effective.

OTHER CHANGES

- The law imposes new "certification" requirements on CEOs and CFOs of public companies. They must now personally sign off on financial reports and auditors must "attest" to the report on internal controls.
- Audit committees, which previously had to have only a majority of independent outside directors, now must have no insiders at all.
- Almost all personal loans to any executive officer or director are forbidden.
- The deadlines for reporting insider trading were shortened.
- Insider trades during pension fund blackout periods were prohibited.
- The law increased criminal and civil penalties for violations of securities law and imposed significantly longer maximum jail sentences and larger fines for corporate executives who knowingly and willfully misstate financial statements. (Note, however, that maximum sentences are largely irrelevant because judges generally follow the Federal Sentencing Guidelines in setting actual sentences.)
- The law provided additional protections for corporate fraud whistleblowers.

DODD–FRANK

The massive financial reform legislation titled the Wall Street Reform and Consumer Protection Act, but often referred to as Dodd–Frank, was signed by President Barack Obama on July 21, 2010. It is 2,200 pages long, with 16 titles, and directs enactment of over 200 new or expanded regulations from federal agencies. It encompasses a wide range of reforms, including the creation of an oversight panel for financial stability, expanded regulatory authority over the ratings agencies, a system for responding to future "too big to fail" disasters, and reorganizing and expanding various current operations into a consumer protection agency to write and enforce rules governing how loans and other financial products are offered, bearing on everything from the type of mortgages people can get to the fees on their credit cards. The most significant corporate governance-related provisions of the Dodd–Frank legislation are:

Executive Compensation. At least once every three years, a public corporation is required to submit executive compensation to a nonbinding "say on pay" shareholder vote. The frequency of these votes must itself be put to a vote at least once every six years. Golden parachute payments are also put to a nonbinding vote and companies must make additional disclosures about the relation of pay to performance and the ratio of CEO pay to the median of the company's employees. All members of the compensation committee must be independent.

Proxy Access. The SEC has authority to issue rules requiring companies to permit shareholder-nominated candidates to be included on the company's proxy card. This "proxy access" gives significant long-term shareholders the right to use the company's proxy to put their candidates to a shareholder vote.[45] Companies must also explain why they have one person as CEO and chairman or why they decided to split the two positions. At this writing the proxy access provision is being challenged in court by the National Chamber of Commerce.

EMPLOYEES: COMPENSATION AND OWNERSHIP

> The employer puts his money into . . . business and the workman his life. The one has as much right as the other to regulate that business.
>
> *Clarence Darrow*

What role should employees have in the setting of corporate policies and direction? Should employees be owners? What is the role of the employees in corporate governance? Or, to be more specific, what is the best way to align their interests with the long-term growth of the company?

Scholars from law and economics, and, more recently, from management theory have shown that giving employees more authority over their work and more of an ownership interest makes companies stronger and more productive. Some even suggest that employment itself creates a form of ownership, echoing the sentiments of Clarence Darrow quoted above.[46] The role of the employees in corporate governance is another area where it is particularly useful to examine models from different countries. As the examples in this section show, a number of different approaches have worked very well.

Many times each day, every employee is faced with a choice between performing the job to maximize benefit for the company or performing it to benefit himself. *What is the best way to make sure that the employee will be likely to make the right decision?* Let's look at one such choice: business travel. Once the employee leaves the office, he has a number of opportunities to affect the returns to the firm from the trip. He can fly first class, with very little, if any, benefit to the company. He can schedule the trip to make the time or the place more congenial for him. He can pad his expense vouchers and keep the difference. Most companies address this "agency cost" issue by imposing rules. Employees below a certain level, for example, must fly coach. They must get extra approval for travel that includes a Friday or Monday, to make sure the trips are not designed to give the employee a free weekend away from home. A few rare companies take the opposite approach. Their view is that if they trust the employee to conduct their business in their interests, they trust him to arrange travel in their interests as well.

Trust alone is not enough, however. What makes this approach possible is that it is just one part of a system of involvement, ownership, information, and authority that minimizes agency costs. Development of prescriptive rules can divert employees' attention from the company's objectives, provide a false sense of security for executives, create work for bean counters, and "teach[es] men to stone dinosaurs and start fires with sticks."[47] Rules of this kind are more likely to be used to shield someone from accountability ("I was following the rule!") than to create accountability.

How do we create a governance and ownership structure that gives employees the optimal role, from the perspective of fairness (to recognize their past contributions) and productivity (to maximize their future contributions)?

If we accept that the advantage of the corporate structure is that it enables different groups to combine capital and labor for the benefit of all of them, we must recognize that one of the core issues is how those benefits are divided.

Indeed, the debate over this issue goes back to Plato, who wrote extensively on the subject of property in virtually all of his works. Karl Marx argued that "ownership" ultimately belonged to those whose labor created a "product." The capitalist employer enjoys what Marx called "surplus value." He meant that all value is the result of work. The capitalist employer pays the worker less than the value he produces and keeps the surplus for himself as profit. Marx predicted that in future

socialist economies workers may receive "from the social supply of [the] means of consumption a share corresponding to their labor time."[48]

Shann Turnbull, an Australian scholar and businessman, considers the question of "surplus value" from a modern perspective. His perspective is that of an investor in a resource-rich but capital-poor country trying to induce foreign investment to create jobs and wealth. In that context, "[i]t does not make good business or macroeconomic sense to pay foreign investors more than they require to attract their investment. It is simply not a good deal to export surplus profits. It should be considered economically subversive to use corporate concepts which provide external interests with unknown, uncontrolled and unlimited financial claims on a host community."[49]

Turnbull analyzes the factors involved in making a decision to invest: "It is the time horizon rather than the rate of return which becomes the overriding factor for investment decisions" by large institutions.[50] Each sets a rate of return that must be yielded if the investment is to be accepted; this can be translated into the number of years necessary to pay back the original investment. This in turn relates to risk – the shorter the time period for payback, the less the risk. In balancing risk and return, investors traded off maximization of potential profit to secure protection against risk. Turnbull hazards, as a rule of thumb: "We may conclude from the above analysis that, as a rule, all cash received from an investment after ten years represents surplus profits or incentives."[51] This leads to his most important conclusion: "[I]t is evident that investors do not require perpetual property rights to provide them with the incentive to invest."[52] After the investor has recovered sufficient cash to compensate him (or, to look at it another way, to provide optimal incentives) for risking the initial investment, ownership entitlement may be directed to other corporate constituencies – pre-eminently, the employees.

Go back to our original questions: *What decisions must be made? Who is in the best position to make each decision? Does that person have the authority to make it?* Over the long term, the employees may be the ones who are in the best position to decide many aspects of corporate direction, based on their superior access to information and their minimal conflicts of interest. After all, no one has a longer-term commitment to the company or a more closely aligned interest in the company's long-term vitality. The employees do not just represent members of the community; they *are* the members of the community. When it comes to questions of factoring in the long term and allocating externalities, they may have the fewest agency costs or conflicts of interest.

Four reasons for employee ownership

1. Employee owners are the only party affected by corporations who are able to monitor its activities at the micro and macro levels. Put another way, they have minimal agency costs.
2. Ownership is a responsibility as well as a right. As the party with the ultimate interest in enterprise, owners not only can be, they also should be responsible for its impact on society. Because of their ability to represent the interests of the suppliers of work and capital and the interests of the community, employees are well suited to this role.
3. Ownership requires a level of vigilance that is hard to obtain from a holder of securities, a rather indirect form of "ownership" at best.
4. In order for the ownership function to be discharged within the corporate structure, there must be "owners" who are:
   - rationally informed and involved;
   - unrestricted by laws and regulations in the exercise of their ownership; and
   - free from the "morbidity" arising out of removal from active involvement in the venture.

This concept is also very relevant to the macro perspective, going back to the discussion of the basis for establishing the corporate structure. From the earliest times, the law has created barriers to limiting the use of property or removing it from commerce for an indefinite period of time. These "mortmain" statutes were referred to by Justice Louis Brandeis in a dissenting opinion in the 1933 case of *Liggett Co. v. Lee* discussing the reasons that the early laws of incorporation imposed a time limit to a corporation's existence. He noted that the law gave perpetual operating authority to religious, educational, and charitable institutions while withholding it from private corporations for fear of "encroachment upon the liberties and opportunities of the individual" and fear "that the absorption of capital by corporations, and their perpetual life, might bring evils similar to those which attended mortmain." The most famous example of the law's concern over mortmain (literally "dead hand") is the Rule against Perpetuities in trust and estate law, which prohibits holding inherited property in trust – and, therefore, removing it from commerce – for longer than 21 years beyond the life term of those in existence at the time the trust is created. In other words, though the rule is somewhat arcane and peculiar in its application, in essence it is intended to prevent someone from limiting the use of his property far into the future according to the judgment of his time. This rule reflected the concern that making it more difficult for assets to meet contemporary needs would have the effect of a "dead hand" on society.

This characterization of share capital in perpetual ventures acting as a permanent drain on productivity recalls the view of capital in the middle ages.[53] It is not difficult to make an analogous argument about the provider of capital. While the "ownership" changes continuously, as shares are bought and sold, the uses of capital are still limited by the "dead hands" that established the structure.

Many observers argue that giving the passive shareholder perpetual rights to the ultimate fruits of enterprise promotes economic inequality and perpetuates a dead hand element at the heart of the national economy. Their position is that whatever value the provider of capital contributed has long since been rewarded, and the continued siphoning of the fruit of enterprise must diminish the opportunity, and therefore the incentive and the morale of others who must make a living from the enterprise. They conclude that thus, even if a venture has perpetual existence, the entitlement of "owners" can be appropriately limited to a set term. The theory is that the corporation evolves from a structure that best benefits from widely dispersed public ownership (with the inducements of limited liability and easy transferability to attract capital) to a structure that is ultimately hampered by it. As the company matures, the best guarantee of continuous renewal is ownership by a group more vitally connected to the enterprise.

There is a lot of appeal in the notion that those who provide the labor have an "ownership" right to the economic value of a corporation. One of the great business leaders of the years between the two world wars was Owen D. Young, for many years the CEO of the General Electric Company and a genuine "industrial statesman." In a 1927 speech at the dedication of the George P. Baker building at the Harvard Business School, he shared a vision of ownership of corporations by their employees seldom before or since articulated by business leaders.

> "*Perhaps some day we may be able to organize the human beings engaged in a particular undertaking so that they truly will be the employer buying capital as a commodity in the market at the lowest price. It will be necessary for them to provide an adequate guarantee fund in order to buy their capital at all. If that is realized, the human beings will then be entitled to all the profits over the cost of capital. I hope the day may come when these great business organizations will truly belong to the men who are giving their lives and their efforts to them, I care not in what capacity. Then they will use capital truly as a tool and*

they will be all interested in working it to the highest economic advantage. Then an idle machine will mean to every man in the plant who sees it an unproductive charge against himself. Then every piece of material not in motion will mean to the man who sees it an unproductive charge against himself. Then we shall have zest in labor, provided the leadership is competent and the division fair. Then we shall dispose, once and for all, of the charge that in industry organizations are autocratic and not democratic. Then we shall have all the opportunities for a cultural wage which the business can provide. Then, in a word, men will be as free in cooperative undertakings and subject only to the same limitations and chances as men in individual businesses. Then we shall have no hired men.[54] ”

This same theme – the ultimate ownership of an enterprise by its employees – is prevalent in modern-day Japan. "For instance, when asked about who owns the company, in theory most Japanese reply the shareholders, but when asked who in fact owns the company, they reply the employees."[55] The author of those words, Ben Makihara, was the American-educated then-CEO of a Japanese company, Mitsubishi. A second-generation career Mitsubishi employee, he is married to the daughter of the company's founder, whose family was divested of substantially all of its ownership in the Mitsubishi group following World War II. Makihara, thus, is connected to his company in a way few employees are.

In the six decades since Hiroshima, Japan has been single-minded about creating an exporting industrial colossus. Executives work without holiday and for pay levels very much less than their counterparts in the West; employees hold themselves to standards of diligence that are viewed with awe all over the world; and the government has supported and encouraged this effort. The results have been extraordinary: in one generation Japan rose from total destruction to ascendancy over the world's economy.[56]

Robert Ozaki in *Human Capitalism*[57] describes this essentially Japanese creation first by contrasting it with the conventional Western prototype and then by carefully evoking a structure based on mutual concern that is capable of moral judgments:

“ *Contemporary capitalists typically are not insiders involved in the affairs of the firm they 'own.' They are interested in the company only to the extent that it serves their own interest. At a sign of unprofitability, they have the option of selling their shares and investing their money in another firm. Understandably, they are interested in short-run maximization of the firm's profit; the executives who opt for long-term growth at the expense of short-term profits run the risk of losing their positions . . . .*

An individual will predictably be motivated when he assumes rights and responsibilities for his conduct. The contemporary firm is a grouping of many individuals. For it to behave like a highly motivated individual, it must, freely and independently of outside interference, be able to make its own decisions toward maximization of its own gains, and at the same time it must take responsibility for the consequences of its failure.

There are different ways to construct a firm so that it can control its own destiny and in effect become a well-motivated quasi-person. A worker-owned and -managed producer-cooperative type firm is one alternative . . . .

The humanistic firm has enabled itself to behave like a motivated individual by separating ownership from control through mutual stockholding, an extensive reliance on debt financing, and (more recently) the use of accumulated earnings.

> *Management and workers form one group, exercising joint sovereignty and sharing a common interest. The firm's gain is their gain. Given the internalized nature of the human resources market, they must pay a high price if their firm fails.*
>
> *The ethos of the humanistic firm requires new thinking about the very concept of ownership and control. Ownership of the humanistic firm is clearly not public in the socialist sense, nor is it purely private in the capitalist sense. It is not somewhere in between, either, and cannot be well articulated under the dichotomy of public versus private ownership. The members of the humanistic firm do not perceive their firm to be owned by stockholders. They may not legally own it, yet it belongs to them, as they occupy the firm and operate its facilities. One may argue that this is an instance of usufruct and that they are usufructuaries. These terms are not satisfactory, however, since usufruct implies that the property one is authorized to use is privately owned by someone else, whereas the members of the humanistic firm do not consider themselves to be leasing their firm from capitalists. In the absence of the appropriate expression, we might say that they are the quasi-private owners of the firm.* ”

Shann Turnbull proposes a specific mechanism for transferring ownership from shareholders to others. "A dynamic tenure system transfers property rights from investors to operational stakeholders after the investors' time horizon. This would encourage those people who are operationally involved in the creation of surplus profits to promote further profits. In this way, the inefficiency and inequity of surplus profits being returned to investors is replaced with improved efficiency and equity arising from stakeholder control and ownership."[58]

EMPLOYEE STOCK OWNERSHIP PLANS

In the United States, there is another approach that, at least partially, transfers ownership from outside shareholders to employees: the employee stock ownership plan (ESOP). ESOPs were created in 1974 by two forces: the legislative efforts of legendary Louisiana Democrat and long-time Senate Finance Committee Chairman Russell Long and the philosophical evangelicalism of Louis Kelso, who dedicated his career to advancing employee ownership. Kelso wrote:

> “ *The problem with conventional financing techniques is that they address only the productive power of enterprise and the enhancement of the earning power of the rich minority. Sustaining or increasing the earning power of the majority of consumers who are dependent entirely upon the earnings of their labor, or upon welfare, is left to government or governmentally assisted redistribution of income and to chance.*[59] ”

In Kelso's view, there are no developed mechanisms through which an individual – no matter how talented or hard working – can secure "capital" in exchange for his work. Kelso has promoted "self-financeability" by which employees "earn" a capital position as a result of their labor. This requires tax incentives and credit arrangements. "Thus, the logic of a market economy itself, that legitimate income must be earned by participation in production, requires a form of capital credit for the acquisition of capital ownership by individuals who will use its income to support their consumption of goods and services."[60]

The ESOP is the modern American effort to enable employees to acquire meaningful ownership interests in the firms in which they work. Conceptually, ESOPs work rather as Turnbull has urged. The government provides a substantial tax incentive for companies to borrow in order to be able to acquire their own stock in the ESOP trust, which is then distributed to employees over a long period of years corresponding with their continued employment – or, in Turnbull's terms, when the ownership entitlement of the original investor expires. ESOPs, like the one at Polaroid, which are "stockholder neutral," are funded by the deferral of raises and bonuses by employees.[61] Over a relatively short period of time, employees can acquire a significant block of their company's stock. Indeed, it is not uncommon that the employee benefit plan is substantially the largest owner of large modern corporations – for example, Sears, Roebuck and Westinghouse. Lockheed Corporation carried this a logical step further: the company intended its ESOP to become the majority holder of its equity securities.

Note, however, that in some cases, corporate management has used the ESOP form to protect itself from prospective hostile acquirers (see the Polaroid and Carter Hawley Hale case studies). In these cases, employee ownership is arguably only the extension of management's desire to maintain its incumbency. The problem is that the employees "own" the stock but it is the executives who appoint the trustees. As long as the executives decide who will have the lucrative jobs of administering the ESOPs, the employees will not be able to exercise the kind of independent oversight necessary for effective governance.

Some substantial questions remain as to whether ESOPs will carry out their authors' intention of making owners out of employees. Their status as "trusts" under ERISA and their use as financing devices for the fundamental benefit of management or outside entrepreneurs have severely restricted their utility as ownership vehicles for employees.

> *In 1985 concern about the role of workers in worker ownership surfaced from an unexpected quarter. In proposals that stunned traditional supporters of ESOPs, the Reagan administration, acting through the Treasury Department, called for fundamental changes in the ESOP as part of the giant tax reform package. The administration said that employees must have all the rights of direct ownership, including voting rights and in some circumstances dividend rights, if employee ownership were to merit the tax expenditures it demanded. It questioned whether ESOPs that restrict the 'traditional incidents of ownership' could really improve profitability or employee motivation. The administration proposed to remove ESOPs from retirement law and continue to encourage them with tax incentives as a socially desirable goal. It called the bluff of ESOP apologists by saying plainly that, if ESOPs were not retirement plans, they should be vehicles of real ownership.*[62]

In 1986, after 12 years of active ESOP advocacy, Senator Long made a last effort before his retirement to make sure that ESOP legislation would be seen primarily as intending to enable employee ownership:

> *The Congress has made clear its interest in encouraging employee ownership plans as a bold and innovative technique of corporate finance for strengthening the free enterprise system. The Congress intends that such plans be used in a wide variety of corporate financing transactions as a means of encouraging employers to include their employees as*

beneficiaries of such transactions. The Congress is deeply concerned that the objectives sought by this series of laws will be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of employee stock ownership trusts and employers to take the necessary steps to utilize ESOPs in a wide variety of corporate transactions, and which otherwise impede the establishment and success of these plans.[63] ”

CASE IN POINT UNITED AIRLINES AND EMPLOYEE OWNERSHIP

In late 1992, the employees of United Airlines agreed to buy 53 percent of the company (63 percent, if the stock price hit certain levels in the plan's first year) in exchange for about $5 billion in wage and work-rule concessions over the next six years. This is the biggest and most dramatic example of a growing trend toward employee ownership. The objective of the employees in designing this deal was to save their jobs. To stay employed, they were willing to take pay cuts of 10 to 17 percent. In addition, there were other concessions, like unpaid lunch breaks and reduced pension plan contributions. It is unlikely that they would have been willing to make these concessions without majority ownership to guarantee the management of their choice. Interestingly, however, the 13-member board of directors has seats for only four employee representatives, one from each of the three unions and one to represent nonunion employees.

“ *Can employees think like owners? What structures are likely to encourage them to make decisions for the long-term value of the shareholders, as well as (and possibly instead of) the employees? Compare the employee ownership plans at other companies. At Wierton Steel, the company did extremely well at first, ahead of its peers. But the board replaced the CEO, a favorite of employees, with an outsider, a mutual-fund executive. A worker group filed a shareholder suit accusing the officers and directors of mismanagement. The board's efforts to raise capital (and dilute the workers' share) by issuing new stock led to a major battle.* ”

Following severe setbacks, including the post-September 11 increase in expenses and decrease in air travel, United filed for bankruptcy in late 2002, promising it would be seeking deep cuts from its pilots, mechanics, flight attendants, and other employees, the "owners" of the company. As noted in chapter 2, the employees sued the money managers for holding on to the United stock.

Bankruptcy Judge Eugene Wedoff approved United's plan to terminate employee pensions, clearing the way for the largest corporate-pension default in American history. United made two rounds of severe labor cuts, with more than $3 billion in annual savings. It borrowed $3 billion and emerged from bankruptcy in 2006. ■

CASE IN POINT THE "TEMPING" OF THE WORKPLACE

In contrast to the notion of employees as partners, or even owners, is the increased reliance on temporary employees. As companies save storage and other carrying costs with "just in time" inventory, they are increasingly taking advantage of the benefits of "just in time" employees. In 1993, the largest single private employer in the United States was a temp agency, Manpower, Inc., with roughly 600,000 people on its payroll. By some calculations, one in four employees in the US are now members of the "contingency work force." Once thought of as a place to call if the receptionist was out sick or on vacation, these agencies are now relied on for "outsourcing" facilities for photocopying, word processing, accounting, and other technical operations. Some companies even go to temp firms for higher level employees. Many hospitals outsource their emergency rooms to independent groups of physicians. Matthew Harrison works for Imcor, a firm that supplies high-level temporary employees. Reflecting on his experience as a high-level employee at four companies in seven years, he said, "There can be a real value in having a throwaway executive, who can come in and do unpleasant, nasty things like kill off a few sacred cows."[64] British consultant Charles Handy says, "Instead of being a castle, a home for life for its defenders, an organization will be more like an apartment block, an association of temporary residents gathered together for mutual convenience. [Corporations will still conduct business] but to do so they will no longer need to employ."[65]

Former Manpower CEO Mitchell Fromstein noted that outsourcing is a good choice when there is high turnover with high training costs and when work is highly cyclical. Increasingly, companies are outsourcing overseas, with IBM, Dell, Amazon, Cisco Systems, Motorola, and Merrill Lynch among the major corporations using non-US operations for everything from call centers to manufacturing.

Unquestionably, temping has made some companies more productive, and it has provided flexibility for workers like parents of young children and others who do not want the demands of a full-time career. However, it has also been used as a tax dodge, at least in the view of the US Internal Revenue Service, which has insisted on recategorizing some 439,000 workers as employees (and therefore subject to withholding requirements). It has also been used as a way to avoid the cost of benefits. Microsoft uses temp employees because it does not have to share its lucrative stock options with them. Temp agencies do not give the employees they send out to other companies comprehensive health and pension benefits.

What is the impact on the corporation when a substantial portion of its workforce receives a paycheck from someone else? How does the "contingency workforce" fit in to corporate governance? How do we permit employees to contribute to corporate direction if, as Handy says, corporations will "no longer need to employ"? ■

MONDRAGÓN AND SYMMETRY: INTEGRATION OF EMPLOYEES, OWNERS, AND DIRECTORS

Governance is ultimately concerned with the alignment of information, incentive, and capacity to act. The challenge is aligning the responsibilities and authorities of all of the various constituencies to achieve the optimal conditions for growth and renewal. One of the most dramatic examples is the employee-owned enterprise, essentially taking the ESOP to its final conclusion. In this model, the two constituencies with the largest interest in the success of the venture are identical. It is not perfect; there are problems with the dual nature of the workers' interest, for example. In the short run, they want to maximize their compensation for work performed, but as owners they have a long-term interest in maximizing the value of the enterprise. Overall, however, this model probably does the best job of minimizing agency costs. Figures 4.1, 4.2, and 4.3 illustrate the contrasts between Mondragón and the traditional Anglo-Saxon corporate structure.

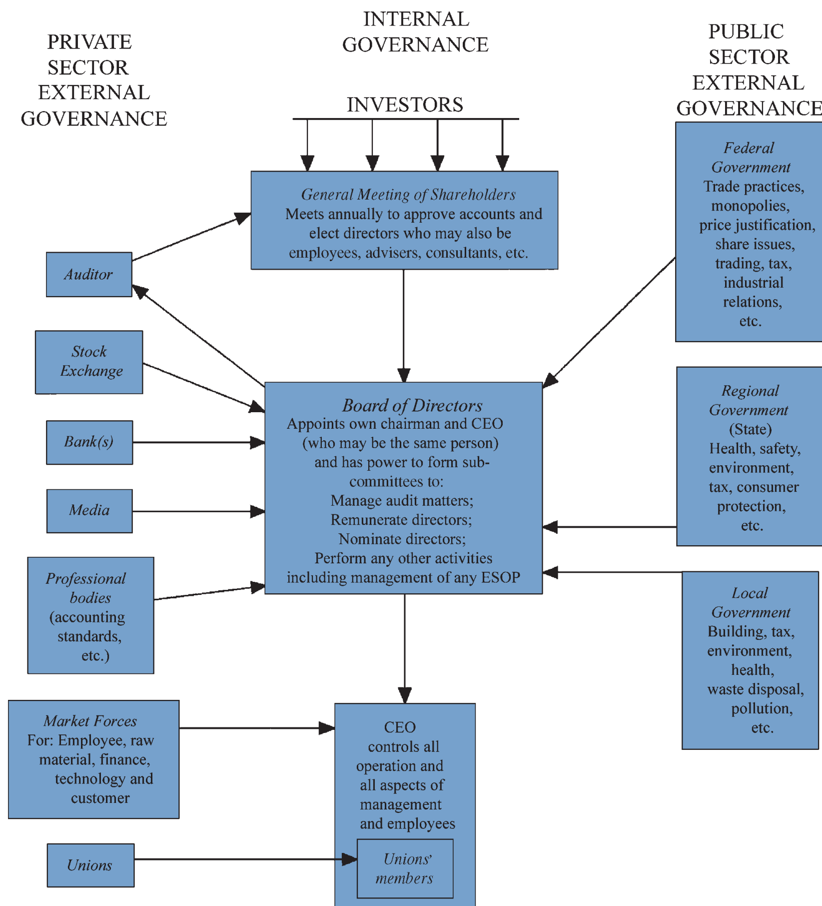
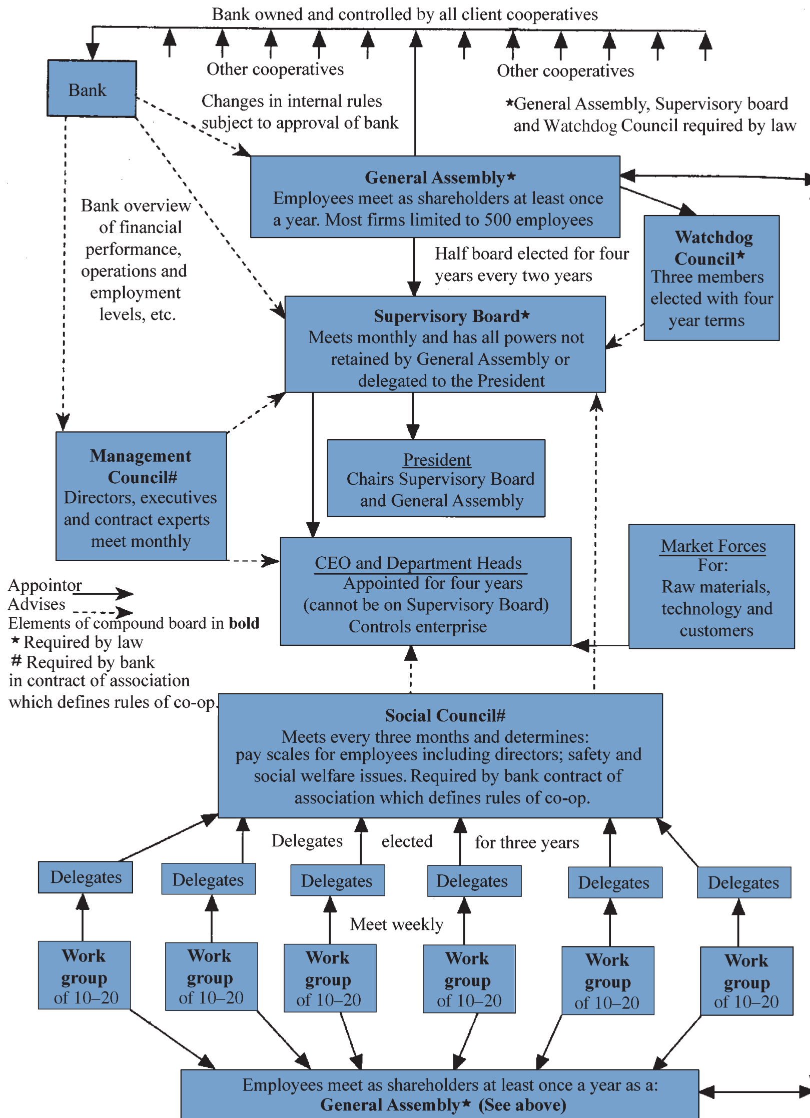
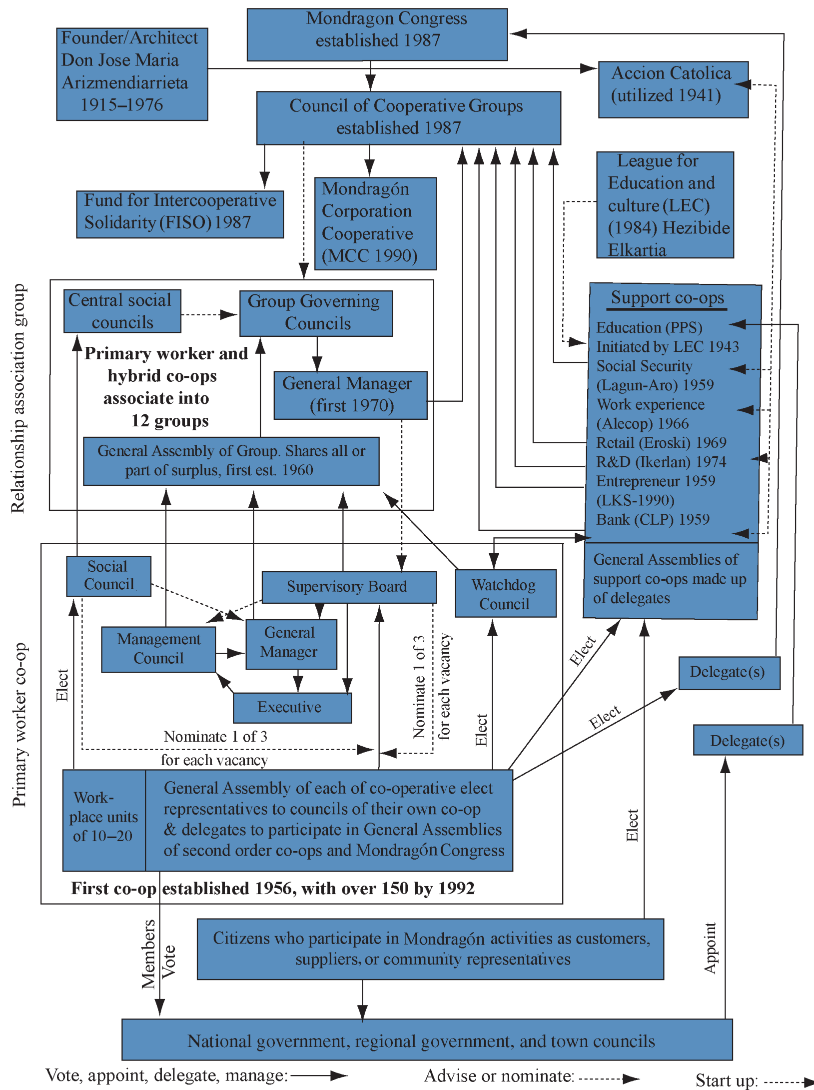


Figure 4.1 Anglo-Saxon corporate governance (Courtesy Shann Turnbull).



Sources: Based on information from: D. P. Ellerman, *The Socialization of Entrepreneurship: The Empresarial Division of the Caja Laboral Popular* (Industrial Co-operative Association, Sommerville, MA, 1992); W. F. Whyte and K. K. Whyte, *Making Mondragón: The Growth and Dynamics of the Worker Co-operative Complex* (ILR Press, Ithaca, NY, 1988); R. Morrison, *We Build the Road as We Travel* (New Society Press, Philadelphia, PA, 1991).

Figure 4.2 Information and control architecture of Mondragón cooperatives.



Sources: Based on information from: CLP, 1992, *Annual Report* (Caja Laboral Popular, Euskadiko Kusxa, Spain); MCC, 1992, *Annual Report* (Mondragón Corporacion Cooperativa, Mondragón, Spain); T. Mollner, *The Prophets of the Pyrenees: The Search for the Relationship Age* (Trustee Institute, Northampton, MA, 1991); R. Morrison, *We Build the Road as We Travel* (New Society Press, Philadelphia, PA, 1991); W. F. Whyte and K. K. Whyte, *Making Mondragón: The Growth and Dynamics of the Worker Co-operative Complex* (ILR Press, Ithaca, NY, 1988).

Figure 4.3 Mondragón cooperative system, with dates of establishment.

CASE IN POINT

MONDRAGÓN AND "COOPERATIVE ENTREPRENEURSHIP" OR "COOPERATION INSTEAD OF COMPETITION"

The Mondragón cooperatives were founded as a training facility for apprentices by a priest and some students in a small Basque city in the north of Spain. It has grown from 23 employees in one cooperative in 1956 to 19,500 employees in more than 100 enterprises in 1986 and 78,000 workers in more than 150 enterprises in 2005. In 2005 the sales were $11.8 billion. Mondragón includes a large bank, a chain of department stores, schools, clinics, high-tech firms, appliance manufacturers, and machine shops. The individual cooperatives range in size from six employees to 2,000, from one location to 180.

Mondragón is almost like a living organism, with each enterprise like a cell that divides when it grows too large. (In this way, it is similar to Semco, which compares itself to an ameba.) There is no set limit, but practice has shown that 400–500 members is the maximum, since "beyond that size bureaucracy almost unavoidably intrudes and attenuates cooperative intimacy and solidarity."[66] Its achievement is not just in its growth, but in the success rate of the enterprises; there have been only three failures. Perhaps its greatest strengths are the commitment of its members (based in part on their role in its governance) and the cooperatives' ability to respond to change (based in part on the system for communication and the flexibility of the structure).

It has important manufacturing and engineering interests, as well as retail, financial, and educational arms. Its supermarket arm, Eroski, is the largest Spanish-owned retail food chain and the fourth largest retail group in Spain.

The sovereign body is the 650-member Co-operative Congress, with its delegates elected from across the individual cooperatives. The annual general assembly elects a governing council, which has day-to-day management responsibility and appoints senior staff. For each individual business, there is also a workplace council, the elected president of which assists the manager with the running of the business on behalf of the workers. Its organization is designed to match entitlement and responsibility. Every employee has one vote. The companies operate according to ten cooperative principles:

1. Admission is open to anyone who agrees with the basic cooperative principles.
2. All workers must be members. All members have one vote, and all governing structures are democratically elected and are responsible to the general assembly.
3. Labor is sovereign; the workers make the decisions.
4. Everyone must make a capital contribution (generally equal to one year's salary of the lowest-paid member). Members get a set return on capital, not tied to losses or surpluses of the co-ops.

5. Cooperation requires both individual effort and individual responsibility. This means information on which to make an informed decision must be available and all those who are affected by a decision must be consulted.
6. The difference between the lowest and highest paid member of a cooperative may not be more than 1 to 6. Compensation must be comparable to local markets.
7. "Cooperation exists on three levels: among individual co-ops organized into groups; among co-op groups; and between the Mondragón and other movements."[67]
8. Mondragón is committed to "social transformation." "The cooperatives invest the major portion of their surpluses in the Basque community. A significant portion goes toward new job development, to community development (through the use of social funds), to a social security system based on mutual solidarity and responsibility, to cooperation with other institutions (such as unions) advancing the cause of Basque workers, and to collaborative efforts to develop Basque language and culture."[68]
9. The members are committed to solidarity with everyone who works for economic democracy, peace, justice, human dignity, and development in Europe and elsewhere, especially in the Third World.
10. They are dedicated to education for young people and workers.

Neither members (employees) nor outsiders own stock in any Mondragón cooperative. Instead, a cooperative is financed by members' contributions and entry fees at levels specified by the Governing Council and approved by the members. It is as if members are lending money to the firm. So each member thus has a capital account with the firm in his or her name. Capital accounts involve paper transactions between the members and the firm. Real money is, of course, involved because management is obligated to manage the cooperative with sufficient skill and prudence so that the firm can meet its financial obligations to members if they leave the firm or retire.

Ultimate power resides in the General Assembly in which all members not only have the right, but the obligation, to vote. The General Assembly meets at least annually. The Governing Council is the top policy-making body of the firm, which is elected on the basis of one vote per worker. The Governing Council includes only worker-members. Key executives may attend council meetings, but they are not members of the council.

Members of the Governing Council are elected every two years for four-year terms. Members are not specially compensated for their council responsibilities but continue to be paid their regular salaries. The Council has overall responsibility for management policies and programs. It selects the manager, who serves for a four-year term unless he is deposed by the Council. There is an audit committee consisting of three persons elected by the members.

There is also a Management Council, which consists of the manager and chief department heads. Finally, there is a Social Council, which has the right to advise the

Governing Council on matters such as safety and health on the job, social security, systems of compensation, and social work activities or projects.

Mondragón is thus a structure of interested parties. No one is permitted access to the governance structure who has not made a material contribution of personal resources to the enterprise. No one is permitted the speculative profits that arise out of public ownership. Thus, a level of alignment is possible, because only interested parties are involved in setting values. The vagaries of the outside world are not permitted to upset the careful economic equilibrium of a Mondragón cooperative. In a sense, Mondragón is saying that jobs and the continuity of the enterprise are too important to permit the involvement of the speculative money interests. ■

The Mondragón model, like any other model, should not and cannot be applied in all cases. As it has grown, it has attracted criticism and controversy, with some claims that it has abandoned its traditional commitment to remaining a cooperative by giving some of its new partners outside of Spain fewer rights. However, it does raise the question as to what extent "capital" is pre-eminently a commodity of use to the market speculators and to the expensive providers of financial advice. Also, it does provide one example of a system that minimizes conflicts of interest and maximizes information.

> *The record shows that a worker cooperative is likely to find itself in a Catch-22 situation: it disappears if it goes bankrupt or it is highly successful. When stock provides the basis of ownership, a successful firm must deal with the problem we call collective selfishness. As new workers are needed so that the firm can expand or replace those who leave, the original worker-owners recognize that they can increase the value of their investment if they resort to hiring labor . . . [examples of successful cooperatives leading to going public or selling out to a major] . . . . Unless the problem of collective selfishness is prevented in the way the firm is initially structured, we can expect this scenario to occur in financially successful cooperatives; the worker-owners will be reluctant to include new workers as owners; when they retire, they will be glad to sell to co-workers, but the value of the stock will make this impractical. The structure and financial policies of Mondragón prevent this problem from occurring. No stock is issued, and the constitution and by-laws of the individual cooperatives impose a 10 percent hiring limit on non-members. Because their capital accounts are non-transferable and no stock is issued, members cannot profit from selling shares to outsiders. There remains just one theoretical possibility for collective selfishness. The original members of a growing cooperative could vote to change their constitution and by-laws to allow more than 10 percent of their employees to be non-members. In that case, the value of the individual member's share in profits would increase. This has never happened in Mondragón.*[69]

For more information about Mondragon, please see:
www.mondragon.mcc.es/ingles/menu_ing.html,
www.sfworlds.com/linkworld/mondragon.html, and
www.ping.be/jvwit/Mondragon.html.

One especially interesting aspect of the Mondragón structure is the separate governing bodies for social and financial purposes. Compare this to the dual board system in Germany (see chapter 5). Here is one other idea about this approach:

> *Professor Manning has sketched the outlines of an idea which has intriguing implications and merits further exploration. His suggestion is addressed primarily to the issue of accountability, rather than to the problem of providing tangible mandate. His article proposes to consider the large, publicly held corporation as if it were in law what it often is in fact, a kind of voting trust, where the stockholder delegates all his rights save that of collecting his dividend to the directors – that is, to management. Viewing the corporation in the light of this theory of itself, he points out, immediately brings certain problems into the foreground, and indicates certain possibilities for remedial action. In order to establish more effective procedures for visitation and control, he has in mind the development of a new device, public or private, which could carry out certain functions presently neglected, or relatively neglected. He seems to visualize this device as preferably private, and as a kind of "second chamber," distinct from the board of directors, and with more limited powers. This "extrinsic" body would presumably review decisions of the board where conflicts of interest arise, particularly with regard to the compensation of officers; it could also pass on other board and managerial decisions, notably where corporate funds are spent for charitable contributions not directly related to the company's business. It might well have broader powers, in enforcing a full disclosure of the corporation's financial and business affairs, for example. In a corporate world organized in this way, the stockholder would hold in effect certificates in a voting trust. He would 'own' his stock, and not the equity of the corporation, save for such problems as the determination of creditors' rights, where Professor Manning would not alter the existing law of contractual priority.*[70]

CONCLUSION

We return to our original questions: *Who is in the best position to make a given decision about the direction of a corporation and does that person or group have the necessary authority?* The material we have covered has given us a context for developing the answers. The person or group in the best position to make any decision about the corporation's direction is determined by two factors: conflicts of interest and information. Decisions should be made by those with the fewest conflicts and the most information.

This applies from the smallest decision to the largest. Who should decide what color the walls should be painted in the workroom? The people who work in that room have the best information about which color suits them best. Furthermore, looking at them as a group, there is no possible conflict of interests because there are no agency costs; they are deciding something that affects them. The question of how often the walls should be painted is another question, however. Workers are not in the best position to determine how often the money should be spent to repaint. They would be acting as agents for management if they made this decision, and the agency costs would be considerable. There is a way to minimize these agency costs, if so desired by any of the parties, of course. If the workers are meaningfully responsible for budget allocation (which is a system with

some benefits), they will "feel" the impact of the decision enough to align their interests with those of management.

The corporate structure has been so robust that it has outgrown most of the structures, including the political structures, designed to control it. Accountability must come from within, and that requires an effective governance system that is itself accountable. All three major players in corporate governance, the board, the shareholders, and the management, must be able to act and must be motivated and informed enough to act correctly. There is no one perfect corporate governance model, just as there is no one perfect financial structure. The ultimate aim of a corporate governance structure must be that it is continually re-evaluated so that the governance structure itself can adapt to changing times and needs.

SUMMARY AND DISCUSSION QUESTIONS

The best way to think about the CEO in the context of his or her relationship to boards, directors, and other constituencies is through the problem/conundrum of executive compensation, both the symptom and the cause of misalignment of shareholder and management interests.

> *What do we want from a CEO? How can we design a pay package to keep the CEO not just ready for change but ready to benefit from changes, and ideally to lead them?*

When a company is failing, it will try almost anything, but when a company is successful, it generally does not know why it is successful, and so, like an athlete on a lucky streak who won't change his socks, it will fall into an almost superstitious pattern of not changing anything. The best way to make sure that the right questions are asked of the right people is to create a structure that aligns the interests of the CEO with the long-term interests of the shareholders as much as possible. Indeed, it is just this alignment that gives managers the expertise and the credibility to do their job effectively. Here again, compensation packages play a key role.

> *What kinds of compensation plans, in which kinds of circumstances, motivate what kinds of managers to guide a company to maximum total shareholder returns over the long run? Which plans have consistently led to the best long-term performance? What are the indicators of a good plan, and, maybe more important, what are the indicators of a bad one?*

The challenge for all of the participants in corporate governance is to make sure that there is enough of a balance between pay and performance so that, overall, the decisions made are in the long-term interests of the shareholders (and thus, by definition, all other constituencies). The board should also talk about the "for cause" provisions of CEO employment contracts that make it all but impossible to terminate a CEO's employment without calling it a "resignation" and paying departure costs that can total in the hundreds of millions. The Boeing, Raytheon, and

Radio Shack cases in point show us cases where bad behavior by the CEO that was not directly related to performance on the job became an issue for the board.

> *How should boards look at "personal" misbehavior and poor job performance? When and how do they become relevant in determining whether a CEO should be disciplined or replaced?*

Scholars from law and economics, and, more recently, from management theory, have shown that giving employees more authority over their work and more of an ownership interest makes companies stronger and more productive. Many times each day, every employee is faced with a choice between performing the job to maximize benefit for the company or performing it to benefit himself.

> *What is the best way to make sure that the employee will be likely to make the right decision? How do we create a governance and ownership structure that gives employees the optimal role, from the perspective of fairness (to recognize their past contributions) and productivity (to maximize their future contributions)?*

If we accept that the advantage of the corporate structure is that it enables different groups to combine capital and labor for the benefit of all of them, we must recognize that one of the core issues is how those benefits are divided.

> *Who is in the best position to make a given decision about the direction of a corporation, and does that person or group have the necessary authority?*

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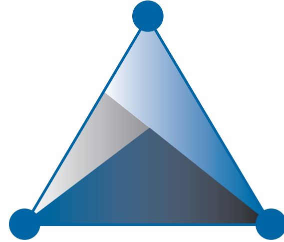
5

INTERNATIONAL CORPORATE GOVERNANCE



CONTENTS

- The Institutional Investor as Proxy for the Public Interest 429
- The International Corporate Governance Network 433
- The Global Corporate Governance Forum 435
- GovernanceMetrics International (GMI) 445
- World Bank and G7 Response 458
- The Global Carbon Project (GCP) 464
- A Common Framework for Sustainability Reporting 465
- Towards a Common Language 468
- Vision 470
- Summary and Discussion Questions 471
- Notes 473

> The proper governance of companies will become as crucial to the world economy as the proper governing of countries.
>
> *James D. Wolfensohn, President of the World Bank, 1999*

> By adopting principles of good corporate governance, companies in developing countries can often command higher valuations, improve their profitability, and gain better access to outside capital than their poorly governed peers. Developing countries can attract more interest from local and foreign investors and reduce their vulnerability to financial crises.
>
> *World Bank website on Corporate Governance*

In the early days of the twenty-first century it seems that all clashes between cultures, political systems, and religions are overshadowed by the triumph of one overarching belief system – the belief in capitalism. No single political creed was the victor of The Cold War, but free enterprise and corporations go where diplomats cannot. You want to buy a Big Mac? Just the "C" countries on the list at McDonald's website are: Canada, Chile, China, Columbia, Croatia, Cyprus, and the Czech Republic – countries with very different cultures and political and legal systems, but the same place to buy shakes and fries. Also on the list: constitutional hereditary monarchies (Bahrain, United Kingdom), emirates (United Arab Republic, Qatar), and democracies. China and Taiwan do not have a relationship with each other, but they both have relationships with McDonald's. The *New York Times'* Thomas Friedman has observed that no country with a McDonald's has gone to war with another. That is not entirely true – but it is close.

It has been variously attributed to British Prime Minister Winston Churchill, French statesman Georges Clemenceau, and architect of German unification Otto von Bismarck – and possibly said by all of them: "He who is not a socialist at 20 has no heart; he who remains a socialist at 40 has no brain." Socialism has enormous theoretical appeal, especially to those who have no vested interest in the status quo. However, it has never been successfully implemented without restrictive political control. If there is a way to make it align with the human instinct for competitiveness and enterprise, no one seems to have figured out what that is.

So as the twenty-first century gets underway, it appears that at least for now capitalism has triumphed and its prophet is the global corporation and its religion the language of economics with its apparent precision, focus, and impartiality. The hegemony of economics has increasingly dominated other languages in the formulation of policy, with the result of expanding the role of corporations in public life around the globe. The creation of wealth has become overwhelmingly the principal objective of society. The corporate form of organization has been accepted as the most efficient means to achieve that objective. In one recent example, oil conglomerate Halliburton, a Houston-based company whose former CEO left to become Vice President of the United States, announced in March of 2007 that it was moving its corporate headquarters to Dubai, "an Arab boomtown where free-market capitalism has been paired with some of the world's most liberal tax, investment, and residency laws."[1] Halliburton would maintain an office in Houston but have its top executives run its operations from the UAE. The ease of relocation of this American company and the rise in non-US IPOs in the early twenty-first century demonstrate that political and cultural and language boundaries are dissolving in favor of global flows of capital, goods, and jobs.

This system, like any other, has its costs. On a global scale, conflicts occur as corporate interests and political interests try to control one another. Corporations rely on sovereign countries for permission to operate and for protection from liability and competition. Political regimes rely on corporations for money, job creation, and the contributions they make to a stable economy and community. At its best, this works symbiotically. At its worst, it can be a death spiral.

CASE IN POINT OFFSHORE OUTSOURCING

Companies that find they cannot sustain operations in their country of domicile due to wages, environmental compliance, or other costs, relocate their operations to other countries with unfettered access to cheap labor and without expensive occupational safety and environmental restrictions.

> *The McKinsey Global Institute estimates that the volume of offshore outsourcing will increase by 30 to 40 percent a year for the next five years. Forrester Research estimates that 3.3 million white-collar jobs will move overseas by 2015. According to projections, the hardest hit sectors will be financial services and information technology (IT). In one May 2003 survey of chief information officers, 68 percent of IT executives said that their offshore contracts would grow in the subsequent year. The Gartner research firm has estimated that by the end of this year, one out of every ten IT jobs will be outsourced overseas. Deloitte Research predicts the outsourcing of 2 million financial-sector jobs by 2009.*[2]

According to a 2004 Department of Commerce report, the average annual pay for software workers is:

United States:	$63,000
Japan:	$44,000
Canada:	$28,174
Indonesia:	$12,200
Thailand:	$11,124
Russia:	$7,500
Philippines:	$6,550
Poland:	$6,400
Hungary:	$6,400
Pakistan:	$4,860
China:	$4,750

Outsourcing means that operations are moved to a location with lower costs, not just payroll but also compliance with environmental, occupational safety, and other standards.

The issue of outsourcing is echoed in other aspects of globalization, including global access to capital and the race to the bottom for establishing corporate domiciles. In late 2006, London's AIM (Alternative Investment Market) stock exchange was in the headlines for a series of accounting scandals. London's listings soared as companies unhappy with the stricter post-Enron US rules opted for looser controls, from 5 percent of the world's IPOs to 25 percent. The result was a 40 percent spike in fraud, according to a report from accounting firm BDO Stoy Hayward, at a cost of over $2.7 billion.

How does the government of an impoverished country weigh the short-term benefits of these operations against the costs?

The twenty-first century edition of the global corporation varies substantially from its predecessors. When we think of authority over our responsibility for impact, we have tended to think of corporations in terms of their nationality – where are they legally domiciled, where are their principal operations, from whence do they derive profit, and where are their headquarters located? This characterization may be useful in considering corporations that are largely owned or controlled by the state, but is inadequate in the context of the publicly traded enterprise with global operations.

Take Exxon Mobil – the largest earning corporation in the history of commerce – as an example. Its headquarters are in Dallas, Texas, but its legal domicile is New Jersey. Its stock trades on the New York Stock Exchange. It has principal operations in virtually every industrialized country in the world. Less than one-third of its 2005 earnings derived from operations in the United States. The traditional notion that Exxon Mobil is an American corporation leads to many wrong conclusions: the scope of Exxon's operations is not co-terminous with the geography of any single political entity. No single polity creates the framework within which Exxon Mobil functions. The sense that corporations have nationality and that, therefore, there is some kind of accountability to the law and customs of a host nation is at best a convenient fiction.

Volumes have been written as to whether political entities have the capacity to tax, to account for, and to require compliance with health, safety, and environmental regulations of particular operations of the modern corporation. Ultimately, it is clear that today's corporation exists outside the traditional scope of political control. There is asymmetry between the limits of authority of all political entities and the functioning of the modern multinational corporation. While national and domiciliary laws are important, they are only one element in defining the relationship of the business enterprise to the citizenry. It is, therefore, important to consider other factors taking the historic place of the nation state in holding corporations effectively to account.

Corporate governance is demonstrably of greatest importance in those countries having a need to attract foreign capital. Such capital-rich countries as Japan can concern themselves with international governance standards for many reasons, but they are not compelled to adjust their own practices so as to attract capital. The opposite is the case in countries like Brazil, with gigantic investment opportunities and inadequate domestic sources of capital. There is also another layer of even more concern as the United States and other countries find themselves in a trade deficit with nondemocratic countries like China – even superpowers may find our ability to manage foreign policy and national security concerns compromised by the problems of trying to negotiate with the countries on whom we are so dependent for capital and other resources, and who hold so much US debt.[3] As emerging economies move into capitalism, the risk of what Nobel Prize – winning economist Joseph Stiglitz calls "briberization" demonstrate the inability of governments to impose controls on international corporations.

CASE IN POINT RUSSIA'S HOSTILE TAKEOVER

The world's largest integrated oil and gas project is a $22 billion operation located in Yuzhno-Sakhalinsk, in the Siberian Arctic. Originally Royal Dutch Shell had the controlling interest in the venture through its Sakhalin Energy Investment Corp., which had a production-sharing agreement that gave it the right to recoup all of its costs plus a 17.5 percent rate of return before Russia would get a 10 percent share of the

hydrocarbons coming from the ground, according to a deal signed in 1996, when oil was $22 a barrel.

Following 12 years of what *Fortune* magazine described as "a calamitous safety record, a failure to meet local expectations for new roads and schools, a fuel spill in Sakhalin's third-largest city, and environmental concerns that caused anger and resentment toward Shell's leadership, earning it a reputation for stubbornness and for consistently misreading political realities," the Russian government gave Shell an offer it could not refuse – give control of the operation to Russian-owned Gazprom or risk a $50 billion lawsuit over the environmental violations. "A guy says, 'Give me half of what is in your pocket, or I shoot you and kill you,' " says Oppenheimer oil analyst Fadel Gheit. "You give him half and say, 'Thank God I am alive to live another day.' They could have lost all of it."[4] In January of 2007, the European Bank for Reconstruction and Development decided not to invest in the Shell-operated Sakhalin-2 oil and gas project after state-owned Gazprom agreed to become the majority owner, citing environmental concerns. According to the *St. Petersburg Times,* "While the EBRD was under pressure to rule that the project did not meet its strict environmental and social criteria for lending, the decision to pull out was prompted by the new shareholder structure."[5]

Note also: some investors raised concerns about BP's investment in PetroChina, based on concerns that government control of the "private" company would result in the same kind of after-the-fact reneging on the contractual arrangements. In early 2007, Venezuelan president Hugo Chavez nationalized electricity and telecommunications companies in his country, including Electricidad de Caracas, owned by US-based firm AES. Its shares slid by 20 percent and trading was halted. ■

CASE IN POINT EMBRAER

Brazil

Brazil has been a leader among emerging economies in the area of corporate governance. It established the Brazilian Institute for Corporate Governance in 1995 and issued a code of best practices, which has since been updated twice. Brazil encourages companies to comply with corporate governance best practices through its Novo Mercado (new market), a separate listing segment for companies that are willing to comply with rules that exceed the statutory requirements, with greater transparency and stronger rights for shareholders. It also gives investors and companies access to a Market Arbitration Panel for conflict resolution between investors and companies, a safer, faster, and specialized alternative to litigation. There are two different levels of qualifying provisions, which

gives companies and investors a range of options. From 2004 to 2006, Novo Mercado companies maintained a price/earnings multiple almost double that of the São Paulo Stock Exchange and over 70 percent of the listed companies outperformed the index.

A fine illustration of the governance challenges facing an emerging world company in its efforts to attract global financing and local ownership is the Brazilian airplane manufacturer Embraer.

Embraer

Based in São José do Campos, Brazil, Embraer was initially founded in 1969 as a state-owned company, but was privatized on December 7, 1994. Since its privatization, Embraer has become one of the largest aircraft manufacturers in the world by focusing on specific market segments with high growth potential in commercial, defense, and executive aviation. Equally important, Embraer provides a superior product package, with comprehensive aircraft and after-sales support for parts, services, and technical assistance. Embraer has five plants in Brazil in three different locations, as well as subsidiaries, offices, technical assistance, and parts supply distribution centers in China, Singapore, the United States, France, and Portugal, together representing in December 2005 a workforce of more than 16,900 employees.

Embraer's 1994 privatization meant a deep cultural transformation process, in which the former engineering and industrially oriented culture predominating during the state-owned years was merged with a new entrepreneurial and administratively oriented culture brought by the new controlling shareholders. Evolution of the company's governance was an integral part of Embraer's cultural transformation.

Embraer is regarded by the Brazilian government as a strategic company. This status carries with it several implications for the company's governance:

- Embraer's privatization notice stipulated that the interest of foreign entities in Embraer's voting capital should be limited to 40 percent.
- There is a special class of Golden Share held by the Brazilian government. The Golden Share provides the same voting rights as those of the holders of common shares. However, in addition, the Golden Share carries veto power over, among other things, changes of control or of corporate purpose and creation and alteration of defense programs.

As a result of the privatization, the company not only recovered its financial soundness but was also able to embark on a new expansion process, primarily driven by the ERJ 145 family project. In the following years, by launching the Embraer 170/190 family and the Legacy executive airplane, as well as intelligence, surveillance, and reconnaissance (ISR) products and the ALX/Super Tucano project, Embraer significantly increased its aeronautical market share, resulting in growing revenues in diversified marketplaces.

The development of new products by Embraer, as well as its future growth, depends on its flexibility to access capital markets. On July 21, 2000, Embraer simultaneously issued new shares on the New York and São Paulo Stock Exchanges. By extending its access to international capital markets, the company was able to raise $250 million to support the development of the Embraer 170/190 family, the E-jets, launched in 1999.

In more recent years, a number of important events occurred that consolidated the company's prosperous and sustainable economic and social development, such as the entry into service of the new Embraer 170/190 family of commercial jets, a program that has required investments of approximately $1 billion; the confirmation of Embraer's commitment to the executive aviation market with the launch of new products such as the Phenom 100, the Phenom 300, and the Lineage 1000 executive jets; and the expansion of Embraer's presence in the aeronautical services market, with the acquisition of specialized maintenance, repair, and overhaul (MRO) companies such as OGMA – Indústria Aeronáutica de Portugal.

Embraer's well-established family of regional airliners places it among the largest commercial aircraft manufacturers in the world. Though its historical focus has been on the small to medium market segment of 30- to 50-seat jets, a few years ago, Embraer also developed a new jetliner family in the 70- to 110-seat category. Today, Embraer is the world's leading manufacturer of commercial jets up to 110 seats. Embraer's defense aircraft market segment is also strong, as measured by the more than 20 air forces around the world deploying Embraer aircraft and defense systems for surveillance, combat, and training missions. In addition, the executive jet market provides significant growth opportunities for Embraer. The company expects to offer products in all categories of the executive jet market, from the "very light" to the "ultra large" categories. Embraer has endeavored to understand and respond to market and customer needs, continually improving the product and customer support for its commercial and executive aircraft.

From 1995 through 2005, Embraer exported $20 billion-worth in products and services. It was ranked as the largest Brazilian exporter from 1999 to 2001. During this ten-year period, the company accounted for $8 billion of the country's trade balance.

Capital Restructuring and Ownership Structure

Before 2006, Embraer's capital structure was limited by the Brazilian Corporate Law in terms of the distribution between common and preferred shares. Consequently, Embraer's capital structure not only limited access to the capital markets but also restrained the liquidity of the company's shares, since it limited the adoption of higher levels of corporate governance standards. However, on March 31, 2006, the majority of Embraer's shareholders, including common, preferred, and American Depositary Share (ADS) holders, approved Embraer's capital restructuring proposal providing a simplified

capital structure composed of a single class of shares – common shares – and enhanced corporate governance practices and transparency.

The primary goal of the corporate restructuring was to create a basis for sustainability, growth, and continuity of Embraer's businesses and activities. Effectively, the restructuring broke down controlling blocks of shareholders. As a result, Embraer became the largest public company in Brazil with fully dispersed ownership. This should facilitate Embraer's access to capital markets and increase its prospects for obtaining new sources of financing. Additionally, the restructuring is likely to result in higher liquidity to all shareholders and better means for a "voice" in company affairs, by virtue of voting rights provided to all shareholders. In other words, without a permanently defined control block, the shareholders will have to meet, assess, and depend on the alignment of their interests to make decisions in each annual general meeting.

On June 5, 2006, Embraer began trading its single class of common shares on the prestigious Novo Mercado, the corporate governance-based tier of BOVESPA (São Paulo Stock Exchange). Embraer's American Depositary Receipts (under its Level III ADS program) are traded on the New York Stock Exchange (NYSE). Each ADS represents four common shares of Embraer.

Under Embraer's new bylaws, approved in March 2006, protective mechanisms were created to ensure not only the dilution of the shareholding control but also the holding by Brazilian shareholders of the majority of votes in the company, so that the decision-making power is held by Brazilian individuals. This is consistent with the 40 percent restrictive condition set forth during the company's privatization process. The following mechanisms are in force:

- No shareholder or group of shareholders, national or foreign, may vote at each AGM with more than 5 percent of the total outstanding shares. This limitation seeks to prevent the excessive concentration of shares or ADSs in the hands of one shareholder or a group of shareholders.
- The total votes granted to foreign shareholders, individually and collectively, is limited to 40 percent of the total votes to be cast at the general meeting.
- Any shareholder or group of shareholders is prohibited from acquiring participation equal to or higher than 35 percent of Embraer's stock, except if expressly authorized by the federal government, as the holder of the Golden Share, and subject to the holding of a public tender offer ("Oferta Pública de Aquisição" – OPA).
- The ownership structure must be disclosed whenever: (i) a shareholder's interest reaches or exceeds 5 percent of the company's shares and (ii) any shareholder's interest exceeds 5 percent of Embraer's capital.

Prior to the capital restructuring, 60.0 percent of outstanding common shares were held by Embraer's former controlling shareholders – Cia. Bozano, Previ, and Sistel – and

were subject to a shareholders' agreement and equally divided into 20.0 percent stakes for each party. The Brazilian government held 0.8 percent of common shares, in addition to the Golden Share. Upon implementation of the capital restructuring, the shareholders' agreement was terminated, and Cia. Bozano, Previ, and Stistel now hold 11.1 percent, 16.4 percent, and 7.4 percent of shares, respectively. A group of leading European aerospace companies – Dassault Aviation, EADS, and Thales – each individually own 2.1 percent and SAFRAN (formerly known as Snecma) owns 1.1 percent. The Brazilian government retains 0.3 percent of the capital. The remaining 57.4 percent free float is traded on the local and international markets.

To demonstrate to the market that the former controlling shareholders and the management of Embraer remained committed to the company and believe in its future, a six-month lock-up period was approved, during which the former controlling shareholders could not trade their shares.

Corporate Governance Improvements

Capital restructuring was only part of Embraer's strategy for growing the company and improving its value. The other part of the strategy included adopting a model of corporate governance that embodied a clear distinction of responsibilities among the board of directors, the executive officers, and the fiscal board ("Conselho Fiscal").

The board of directors is responsible for approving and keeping track of the company's strategy as well as annual budgets and investment programs established in the action plan prepared by the executive officers.

Embraer's board of directors, elected on March 31, 2006, is composed of 11 members and their respective alternates. To ensure the stability of corporate actions and the continuity of management guidelines during the period immediately subsequent to the approval of the capital restructuring, the initial term of the board of directors is three years, after which a maximum two-year term must be observed.

During this transition period, the company's chairman of the board, Mr. Maurício Novis Botelho, also served as the chief executive officer until April 2007, when the board of directors had to elect a new CEO. Since that date, it is expressly prohibited to serve concurrently as a member of the board of directors and member of senior management. With the exception of the CEO, the representative of the Brazilian government and the two representatives of Embraer's employees, all current members of the board are independent.

The board of directors appoints an Executive Committee, which is composed of up to four members, with the purpose of assisting in the performance of the board functions with respect to its executive compensation policy, strategic decisions, and corporate governance-related measures. The company's executive officers are responsible for day-to-day management of the company's affairs. The CEO and CFO were professionals

hired after the privatization of the company, while the majority of remaining executive officers had built their careers at the company.

Embraer implemented a plan in 1998 that ties employees' profit sharing to dividend payments. Every time the company pays dividends to its shareholders, it also distributes up to 25 percent of the dividend amount among employees who have achieved strategic goals established in the action plan approved by the board of directors. Therefore, Embraer's profit-sharing plan is a true partnership among shareholders, executive officers, and employees that helps increase productivity and ensures the alignment of shareholders' and employees' interests.

Under the plan, the company may pay additional amounts of up to 5 percent of such dividend payment to the executive officers and some employees that have performed exceptionally, on a discretionary basis. In April 2005, the board of directors approved certain changes to the company's profit-sharing plan related to the additional 5 percent distribution. These changes were based on recommendations made by an advisory committee of the board of directors, which was formed in 2004 for the purpose of reviewing the company's policies with regard to compensation. The new policy provides that the additional distribution of up to 5 percent is limited to an amount equal to 50 percent of the company's net income adjusted for certain cash flows. For the executive officers and certain senior employees, two-thirds of the distribution will be provided in cash and the remaining one-third will be allocated as "virtual common shares" and payments related thereto will be made over a three-year period, using a weighted average share price. As a result, the value of these payments is tied to the future market performance of the company's shares. The board of directors and the fiscal board are not entitled to receive payments under the profit-sharing plan. Their remuneration is based on market analysis conducted by a human resources consultant firm.

For the fiscal year ended December 31, 2005, the aggregate compensation that was paid to the board of directors, fiscal board, and executive officers was $8.8 million.

The fiscal board's main responsibility is to oversee acts of the executive officers and examine whether financial statements comply with transparency and good corporate governance policies. In view of the requirements placed by the 2004 Sarbanes–Oxley Act on foreign corporations listed in US markets, Embraer implemented several changes in its fiscal board. Such adaptations included changes in:

- its composition, with the addition of a member acting as financial specialist and
- the internal regulations to distribute responsibilities and provide for a broader scope in assessments and analyses undertaken by its members.

As a result, Embraer's fiscal board is now composed of five sitting members, of which one is a financial specialist. All are approved to a one-year term of office. This new

fiscal board fully complies with the requirements of the US Securities and Exchange Commission (SEC).

In addition to its listing on the NYSE, since 2001 Embraer reports simultaneously its quarterly and annual financial results in Brazilian GAAP and US GAAP.

The company's external auditors are accountable to the full board while the internal audit function is the responsibility of the company's risk and internal controls office, under the supervision of the CFO and directly reporting to the fiscal board. The CFO reports to the fiscal board, ensuring the necessary independence and competence to assess the design of the company's internal controls over financial reporting.

In addition to being subject to the Novo Mercado regulations that include rules on corporate governance, Embraer has adopted and observes a disclosure policy, which requires the public disclosure of all relevant information pursuant to guidelines set forth by the Brazilian Securities and Exchange Commission (the CVM), as well as an insider trading policy, which, among other things, establishes blackout periods and requires insiders to inform management of all transactions involving the company's securities.

The Results

Embraer's commitment to its investors, its solid management structure, and the adoption of best corporate governance practices have together clearly had an important impact on the company's market value in recent years. At the end of 2005, Embraer reported significant milestones. Net sales increased 11.3 percent from 2004 to 2005, reaching $3.829 billion – the highest ever recorded in the company's history. Net income in 2005 reached $445.7 million, 17.2 percent higher than in 2004. Net cash on December 31, 2005 was $360.1 million compared with net cash of $22.1 million at the end of 2004, growing more than 16 times. Total operating expenses, including profit sharing and research and development expenses, were $650 million for the year ending December 31, 2005, up 3.38 percent from $629 million for the year ending December 31, 2004.

Over this period, Embraer generated significant wealth for its investors – market capitalization has grown $4.8 billion in the last six years, from $2.2 billion as of December 1999 to $7 billion as of December 2005 (between 2004 and 2005, market capitalization grew 16.67 percent from $6 billion to $7 billion). In that same period, Embraer distributed $943 million in dividends to its shareholders. In the same period its share price appreciated 157 percent and increased from R$7.01 in December 1999 to R$18.00 at the end of 2005, while the Ibovespa Stock Index appreciated only 98 percent (between 2004 and 2005, the share price appreciated 14 percent from R$15.80 (common shares) to R$18.00).

Similarly, the performance of the company's ADSs listed on the NYSE was recorded as high as $39.10 during 2005's last session, an appreciation of 111 percent since its listing in July 2000.

Embraer's advancements in corporate governance are recognized and well-received by the market. The Institutional Research Group, a pioneering research company in Latin American stock markets, awarded Embraer first place in the Best Buy-Side Investor Relations Survey in 2005. This ranking was based on compiled opinion survey results from 53 buy-side investors and 59 sell-side analysts.

The market has also recognized Embraer's transparency standards as exceptional. Embraer was selected as one of ten finalists for seven years in a row – and the winner in 2000 – of the Financial Statement Transparency Award given by the National Finance, Management and Accounting Executives Association in Brazil. In addition, the Brazilian Listed Companies Association (ABRASCA) ranked Embraer among the top ten finalists for the 2005 edition of its annual report.

Finally, Embraer's emphasis on high social and environmental standards has also been recognized, as demonstrated by the company's outranking of its industry competitors on both the Dow Jones Sustainability Index and the BOVESPA Corporate Sustainability Index.

Embraer believes that having high levels of corporate governance is a journey, not a destination. Over the past three years, many improvements on the company's corporate governance practices were implemented, including the conclusion of its restructuring process during the first half of 2006. Embraer is currently undergoing a transition period from being a company with defined ownership to having dispersed shareholding. The company is committed to making the necessary adjustments to meet the new market demands. With the highest standards of corporate governance and transparency, Embraer hopes to stay an investor-friendly company for years to come.[6] ■

The most important fact to keep in mind in examining global corporate governance is that it is changing very rapidly. Every country from the most established economy to the would-be-emerging is undergoing extensive examination of every aspect of its governance codes and practices as a matter of risk management and competitiveness. Before turning to the international efforts to devise enforceable codes of corporate conduct, we need to keep in mind that perspectives on corporations vary sharply from country to country.

Corporations exist in a variety of forms throughout the world, so we may mean something quite different in using the same word in the context of different countries. Take one significant term: accounting. The same accounting firms have operations in dozens of countries and prepare audited financial reports with the same letterhead and logos, but the outputs differ tremendously because accounting standards differ tremendously. Take another significant term: executive compensation (called "remuneration" in some countries). It is almost impossible to compare across boundaries not just because cultures and amounts differ so enormously but because disclosure rules differ so enormously. A Japanese CEO may have millions of dollars' worth of perquisites that are not disclosed. And there are emerging economies with exemplary corporate governance codes – on paper – but in practice little compliance. Also, how about a third term: independence, a crucial

determinant of freedom from conflicts of interest. In the US and in many countries, independence is considered compromised if a director has a business relationship with the company other than service on the board, but stock ownership is considered a good thing that aligns the director's interests with shareholders, not management. However, in South Africa, it has been considered a conflict of interest for directors to own stock.

Just as there is a distinction between rules-based and principles-based accounting, there is a distinction between governance codes that are mandatory and those that are "comply or explain," giving companies the opportunity to adapt provisions to their circumstances and encouraging innovation.

Most countries have one board of directors, but some have dual boards. In Germany, for example, the two-tier board structure dates back to the 1870s. Public companies must have both a management (insider) board and a supervisory (outsider) board. In companies with over 500 employees, one-third of the supervisory board are employee representatives; in larger companies, they make up one-half.

In Israel, almost all public companies are still controlled by the first or second generation of the founding families. In Japan, under the well-established system of *keiretsu*, interlocking business holdings and share ownership are centered around a bank. Both systems limit the ability of outside shareholders to provide feedback or oversight.

In the United Kingdom, government retains more oversight over private power than in many of the established economies. It was not long ago that the principal British institutions providing infrastructure services – transportation, mail, phone, coal, steel – were, in fact, owned by the government and this pattern of private accountability to public authority remains meaningful some twenty years post-privatization. Corporations continue to be instruments of national policy to a greater or lesser extent in Japan, France, Italy, Germany, and Korea. For example, the question as to whether working conditions for Volkswagen employees in Lower Saxony can be modified by the directors of the company or whether it can only be decided as part of a national political dialogue continues to be an open question in Germany.

Japanese industrial groups are not infrequently asked to execute "national" projects, protected in so doing by government's willingness to share some portion or all of the risks.

The Korean government has made express commitment to the *Chaebol* form of conglomerate as a way of creating wealth and, thereby, advancing the national interest. The actual power of private enterprise is not yet evident to outsiders in the emerging colossi of China, Russia, and India. The Putin government has made clear that wealth creation outside of political involvement will be tolerated, but that particular expressions of corporate opinion will be severely punished. Southeast Asia seems poised to become an economic superpower but at the moment there is no real sense that Indian industries have an independent source of power against the state. Corporate governance is, thus, preponderantly a matter of private contract in the US and the UK and fundamentally a matter of government policy in Russia and China, with the rest of the world falling in between.

It is important to keep in mind the extent to which chartering countries are prepared to empower private individuals to create sources of wealth and, therefore, legitimate power that is independent of the political authority. One end of the spectrum is represented by the United States, where there is virtually no tradition of government ownership of commercial enterprises, a high level of "privatization" of services that are usually delivered by public authorities in other countries, and a sustained willingness by government to co-exist with independent business power. This climate of government acquiescence and support of corporate power may well account for the extraordinary success of the private sector in the United States and its capacity for wealth creation. However, the

risk is that there will be occasions and circumstances when corporate power may acquire an inappropriately large influence. At the other end of the spectrum are countries that maintain extensive government control, even of "public" corporations open for investment. For example, PetroChina's largest outside shareholder is none other than Nebraska's Berkshire Hathaway, led by legendary investor Warren Buffett, but Berkshire has only 1.3 percent. The controlling shareholder is the Chinese government. (Note also that because of its investment link to Sudan, several institutional investors such as Harvard and Yale decided, in 2005, to divest from this company. As of 2007, Buffett declined to follow their example, explaining that continuing his shareholding gave him greater influence.)

On a global scale, there is a fundamental asymmetry that parallels the "race to the bottom" of state control of corporate governance laws in the United States. A country's capacity to control conduct stops at its borders and yet the preponderance of corporate activity takes place across many nations. The traditional notion that corporate conduct can be controlled by the country of its domicile is obsolete. At the risk of discouraging further investment from abroad, countries plainly have the power to control activities within their borders. The only participant in the corporate constellation having the same motivation, scope, and power as management is the newly emergent class of institutional owners, who are trustees for a significant part of the population (see previous chapters).

Thus, we will now revisit the capacity and energy of global institutional investors as monitors of corporate governance in the international context by looking at The Norwegian Government Pension Fund and the international perspective on appropriate conduct by institutional investors. This chapter will include a review of how several countries deal with the challenge of assuring that corporate managers faithfully carry out their various responsibilities and a full extract of a global governance rating system. We will also compare governance structures relating to management and the board in several major and emerging markets, including internal and external, supply-side (investor), and demand-side (management and board) elements.

This chapter will then address the impact of corporate "externalization" of liabilities and the tendency towards multinational codes attempting or purporting to regulate corporate conduct in particular spheres, particularly corruption and environmental impact. We will conclude with nascent efforts to create a universal language of accountability. The old maxim goes that you can manage what you can measure; the important questions in the corporate governance context are what components are included and how are they measured.

CASES IN POINT CAPITAL FLIGHT, TAX AVOIDANCE, AND TAX COMPETITION

One significant symptom of a global race to the bottom is "capital flight" to avoid taxation. A September 2005 report from the Tax Justice Network estimated $255 billion in lost tax revenue from the $11.5 trillion of personal wealth held in offshore tax havens by individuals. Global corporations structure their trade and investment to flow through paper subsidiaries in tax havens, which can "provide a secure cover for laundering the proceeds of political corruption, fraud, embezzlement, illicit arms trading, and the

global drug trade. The lack of transparency in international financial markets contributes to the spread of globalized crime, terrorism, bribery of underpaid officials by Western businesses, and the plunder of resources by business and political elites."[7] The report cites an Economic Policy Institute finding that: "There is little evidence that state and local tax cuts – when paid for by reducing public services – stimulate economic activity or create jobs. There is evidence, however, that increases in taxes, when used to expand the quantity and quality of public services, can promote economic development and employment growth." However, countries face a collective choice or prisoner's dilemma problem in addressing this issue; the gain for mutual cooperation is smaller than the gain for one-sided defection.

> *There is an old story about a number of people in a small boat. All of a sudden, one man begins to drill a hole under his seat. When the other passengers complained, he said, 'It's not your business. I'm only drilling the hole under my own seat.' Finally, a wise man answers him, 'We are all in the same boat. The hole may be under your seat, but the water that comes in will make the boat sink with all of us in it.'*

THE INSTITUTIONAL INVESTOR AS PROXY FOR THE PUBLIC INTEREST

Among public and private institutions in the corporate constellation, only the fiduciary shareholder, especially the pension fund, has interests congruent with the modern corporation. By definition, they are long-term investors and, by definition, they want sustainable growth from companies that provide useful goods and services and good jobs at good wages. Pension funds and corporations have the same scope and ultimate objectives – the optimization of long-term value. These vehicles of pooled savings – largely the funded retirement and savings schemes of the US, UK, Canada, Australia, Scandinavia, the Netherlands, and Japan – are important, and they are increasingly controlling owners of publicly traded enterprises throughout the world. Like the corporations in which they invest, these ownership groups can transcend national regulation.

As discussed in the previous chapters, majority stock ownership is managed by fiduciaries and the exercise of ownership rights has been compromised by conflicts of interest and the collective choice problem. While, in theory, these funds are directed by fiduciaries whose sole obligation is to the beneficial owners, the trustees are most often conglomerate financial service institutions with many important commercial relationships with those companies whose shares are held in their trust departments. Public and private entities have failed to enforce the legal obligation of the trustees to act as owner of portfolio companies "for the exclusive benefit" of plan participants; the result has been the neutering of a substantial portion of the ownership spectrum.

Trust and fiduciary duty are exhilarating concepts, but their dysfunction in the modern commercial context tends not only to disappoint but to mislead. Add to this the disinterest of highly prestigious institutions – such as the Ford and Gates Foundations, Harvard University, Cambridge

University, and their counterparts throughout the world – to discomfort those on whose continued support their own future so importantly depends.

The appearance of fiduciary ownership promises a world of responsible accountability that, unfortunately, is yet to come. These themes, which we have explored in earlier chapters, are also evident outside the United States.

The Norwegian Government Pension Fund has many of the characteristics necessary for the ideal corporate owner. It is large enough to have significant stakes in portfolio companies; indeed, it now has more than $323 billion in assets. Notwithstanding its name, it is not a pension fund with specific liabilities to present and future retirees. It is a fund for the benefit of the Norwegian people into perpetuity. The Norwegian government determined that the wealth extracted in the form of oil from beneath the North Sea should be used to purchase ownership of publicly traded corporations on behalf of the entire population of Norway. Formerly known as The Petroleum Fund of Norway, it changed its name in 2006.

This fund can achieve its objectives only if the marketplace can be a reliable investment in perpetuity, providing sustainable equity returns at historic levels. It thus has the incentive – indeed, it has no choice other than – to be involved in assuring the continuing quality of the marketplace as a whole. The government, the Norges Bank, and a skilled cadre of managers have begun the difficult process of trying to combine wealth-maximization with sensitivity to the ethical consequences of certain investments and has established an Advisory Council on Ethics to make recommendations about companies whose activities "constitute an unacceptable risk of the Fund."

Beyond a boycott of armament producers – including United Technologies, Boeing, Northrop Grumman (production of ICBMs), Honeywell International (simulations of nuclear explosions), BAE Systems, Finmeccanica (nuclear missiles for planes), and SAFRAN (nuclear missiles for submarines) – from the portfolio, after a suggestion from the Advisory Council on Ethics, the Norwegian government in 2006 took the step of divesting its more than $400 million holdings in Wal-Mart in protest over policies of employment and compliance with law. The Advisory Council's report noted:

> *An extensive body of material indicates that Wal-Mart consistently and systematically employs minors in contravention of international rules, that working conditions at many of its suppliers are dangerous or health-hazardous, that workers are pressured into working overtime without compensation, that the company systematically discriminates against women in pay, that all attempts to unionize by the company's employees are stopped, that employees are in a number of cases unreasonably punished and locked in, along with a number of other circumstances. What makes this case special is the sum total of ethical norm violations, both in the company's own business operations and in the supplier chain.*
>
> *It appears to be a systematic and planned practice on the part of the company to hover at, or cross, the bounds of what are accepted norms for the work environment. Many of the violations are serious, most appear to be systematic, and altogether they form a picture of a company whose overall activity displays a lack of willingness to countervail violations of norms in its business operations.*

The Fund attempted to contact Wal-Mart to initiate discussion on these issues, but the company did not respond. Therefore, it determined that divestment was appropriate.

In 2006, the Fund also made its first divestment for environmental concerns, from Freeport McMoRan Copper and Gold, based on allegations that the company had caused extensive environmental damage by disposing of tailings (including arsenic, cadmium, and mercury) from its Papua and Indonesia copper mines into a natural river system. The company denied the claims but did not provide any supporting documentation.

Governance of the Norwegian Government Pension Fund itself involves a balance between the government, which uniquely makes decisions to disinvest from particular sectors and companies, and Norges Bank, which is committed to an activist program of global corporate governance in the effort to assure the continuing integrity of the equity sector of publicly traded companies. Knut Kjaer, Executive Director of the Norwegian Petroleum Fund Global, spoke in November 2006 of the commitment to active ownership:

> *A challenge that I could also have discussed at length is our task of acting as a demanding owner vis-à-vis the more than 3,000 companies in which we have an equity stake. So far this year, for example, we have voted on 23,363 issues in 2,189 companies.*
>
> *We have high ambitions with regard to playing a leading role internationally in fostering corporate governance and we are subject to a demanding requirement from the Ministry of Finance to take particular account of an investment horizon that spans many generations ahead. This implies imposing ethical requirements on companies.*

The problems of conflicting commercial interests that have elsewhere diluted active and effective ownership involvement have not to date manifested themselves in the administration of the Norwegian Fund.

NORWAY IN THE DRIVER'S SEAT

> Through its Petroleum Fund, Norway has an unprecedented opportunity for helping promote improved corporate governance practices around the world,
>
> *B. Espen Eckbo, Professor of Finance, Tuck Business School, Dartmouth College, US*

As is well known, the Ministry of Finance – the owner of the Petroleum Fund – requires the Petroleum Fund to be highly diversified, adhering to the prudent investment principle of "don't put all your eggs in one basket." Accordingly, the manager of the Fund, Norges Bank, has invested 60 percent of the Fund in bonds and 40 percent in more than 3,000 publicly traded companies in over 30 countries.

However, it is less well known that Norges Bank also engages in active long-term corporate governance intiatives. The latter may somewhat loosely be said to follow Mark Twain's principle of "if you put your eggs in one basket – then protect that basket!" To protect the "basket" of equity investments, Norges Bank has established a corporate governance group, headed by Henrik Syse. The group's primary objective is to assist Norges Bank in its efforts to maximize the Fund's long-term financial returns.

Active corporate governance implies that an owner uses its ownership stake – typically in co-operation with other large owners – to push for changes in the company. This is fundamentally different from decisions to exclude companies from the Fund's portfolio. A decision to exclude

stocks from the Fund is the domain of the Ministry of Finance's Advisory Council on Ethics, not Norges Bank.

Active corporate governance is important because costly conflicts of interest may arise in some of the underlying portfolio companies of the Petroleum Fund. Wherever the Fund's ownership is in the form of stocks or bonds, it is important to be able to identify such conflicts of interest as early as possible, and to make reasonable proposals for solutions that minimize the costs to the Fund.

A corporate governance system represents a set of constraints on the possibilities and incentives for corporate management and the board to expropriate the rights of external investors. The risk of expropriation is clearly highest in poorly developed securities markets and in countries where the legal system is corrupt. However, recent corporate scandals in Western countries – such as Enron and WorldCom in the US, and Parmalat and Ahold in Europe – have shown that problems related to investor expropriation also arise in countries with seemingly well-developed capital markets.

Research has demonstrated that the design of a country's corporate governance system is of utmost economic importance for the macroeconomy. A particularly vivid illustration of this importance is provided by the events that followed in the wake of the Asian currency crisis in 1997, and which led to a sharp decline in many countries' stock markets. Research shows that the countries with poor corporate governance systems experienced the largest stock market declines. In many of those countries, outside investors' contractual rights were routinely expropriated by strong corporate insiders.

For example, in Korea, corporate assets were quietly transferred from conglomerates to outside companies where insiders had financial interests. In Russia, creditors were given virtually no legal protection for their bankruptcy claims. In Thailand, capital was secretly transferred to foreign accounts, and so forth.

Research shows that a country's corporate governance system was actually a more important explanatory factor for the stock market price decline than all of the traditional macroeconomic variables typically used to explain dramatic stock market declines.

Undertaking corporate governance activities such as monitoring management obviously entails costs. The problem in any stock market is that small shareholders (rationally) refuse to bear these costs. As a result, whenever the vast majority of a company's shareholders are small, monitoring of management does not take place. In such firms, the key monitoring role that shareholders are supposed to play breaks down.

In the absence of shareholder monitoring, management and other corporate insiders reign more or less freely. This freedom often leads company insiders to expropriate ownership rights. Research shows that when this occurs, there are tendencies for insiders to unduly influence the director election process; for company investments to shift in favor of management's personal preferences rather than to maximize share value; for defensive strategies to be devised against acquisition of the company; etc.

The solution is to revive the corporate governance system. The primary catalysts for this solution are the large pension funds in the Western world. Pension funds have a unique financial incentive to develop an active corporate governance strategy. Unlike typical mutual funds with a shorter time horizon, pension funds benefit from the more long-term improvements in a company's corporate governance system. This also applies to the Petroleum Fund, which is run like a pension fund and which is now among the largest funds in the world.

Active corporate governance involves applying pressure directly on a company's board of directors whenever governance problems are suspected. Understandably, directors are highly sensitive

to such pressure from external investors. To succeed with such delicate pressure, the Fund must have expertise across disciplines such as financial economics, law, and ethics. This is the reason why the corporate governance group in Norges Bank was established.

When applying pressure on the board to implement governance changes, it is important to focus on the governance system itself rather than on the personal characteristics of directors. Thus, when Disney CEO Michael Eisner was forced to resign as board chairman, the argument was that it is generally difficult to combine the role of CEO with the function of board chairman, irrespective of the qualities of the individual involved. In a modern governance system, the board represents the interests of the firm's owners, which may from time to time conflict with those of the firm's insiders.

By cooperating with other large pension funds and by maintaining the reputation for integrity the Petroleum Fund enjoys among international investors, Norway has an unprecedented opportunity for helping promote improved corporate governance practices around the world. In the process, the Petroleum Fund helps safeguard its financial return in the long run.[8]

THE INTERNATIONAL CORPORATE GOVERNANCE NETWORK

The ability and incentive for institutional investors to transcend the rules and limitations of their domicile economies is evident from the creation of international associations dedicated to sharing information and developing global policies on investment and shareholder rights and responsibilities. The most prominent is the International Corporate Governance Network (ICGN), established in 1995, and now including membership overseeing over $10 trillion in assets. Its four primary purposes are:

1. to provide an investor-led network for the exchange of views and information about corporate governance issues internationally;
2. to examine corporate governance principles and practices;
3. to develop and encourage adherence to corporate governance standards and guidelines; and
4. to generally promote good corporate governance.

ICGN has recently expanded its earlier work setting forth what owners expect of companies, but it also focuses on the obligations and conflicts of its own members and other institutional investors. The following extract focuses on the specific problems of responsibility of trustees, managers, and other fiduciaries when there are many parties in the decision chain.

ICGN: STATEMENT OF PRINCIPLES ON INSTITUTIONAL SHAREHOLDER RESPONSIBILITIES

3.0 Internal Governance

3.1 As described above, different intermediaries in the institutional investment chain play different roles. Each intermediary should have internal governance arrangements that reflect the particular nature of their own role and responsibilities.

The overarching obligation of each of the intermediaries is to safeguard the interests of beneficiaries.

3.2 Four main elements apply to the internal governance of those involved in the investment chain if this fundamental principle is to be met: transparency, which enables beneficiaries to satisfy themselves that their funds are being handled appropriately; disclosure and management of conflicts of interest; expertise, which enables institutions to make sound decisions on beneficiaries' behalf; and oversight structures that are suitably balanced so that decisions are taken in the interests of beneficiaries.

3.3 Transparency

3.3.1 This requires regular disclosure to ultimate beneficiaries about material aspects of governance and organization, including financial statements. Governing bodies and, where relevant, individuals in a fiduciary position of responsibility for ultimate investors, such as pension fund trustees and representative boards, should be aware of their primary oversight role and ensure that the objectives of their beneficiaries are being met by portfolio managers and other agents employed. They should make clear which, if any, public or regulatory authorities have responsibility to monitor and enforce their fiduciary functioning.

3.3.2 Governing bodies should develop clear standards with regard to governance of investee companies and its link to the investment process, and for voting of shares and related issues like stock lending. The standards should inform their selection of portfolio managers and other agents. They should be critical both in the selection of consultants and in evaluating the advice they receive from them, and ensure they receive value for the fees they pay, including for brokerage.

3.3.3 Governing bodies should hold their portfolio managers and other agents employed to account for adhering to the standards set for them. They should develop clear channels for communicating their policies to beneficiaries, their portfolio managers, and the companies in which they invest. They should regularly evaluate and communicate their achievements in meeting these policies.

3.3.4 Asset managers and others in a similar agency position should also develop clear decision-making procedures and policies with regard to the governance of investee companies and for voting of shares held on behalf of clients. Their incentive structures should be aligned with the interests of the beneficiaries. Charges incurred on clients' behalf, for example brokerage commissions and payment for research, should be justifiable. Asset managers should encourage brokers and research analysts whose services they use to factor governance considerations into their reports.

3.4 Conflicts of Interest

Conflicts of interest will inevitably arise from time to time. It is of paramount importance that these are recognized and addressed, if the overarching principle of safeguarding the interest of beneficiaries is to be respected. The first requirement for this is disclosure, ideally to the governing body of the fund. The governing body should have clear policies for managing conflicts and ensure that they are adhered to. ”

THE GLOBAL CORPORATE GOVERNANCE FORUM

www.gcgf.org/ifcext/cgf.nsf/Content/About_the_Forum

Corporate governance is increasingly recognized as an important element of sustainable private sector development. The Forum contributes to the efforts of the international community to promote the private sector as an engine of growth, reduce the vulnerability of developing and transition economies to financial crises, and provide incentives for corporations to invest and perform efficiently, in a socially responsible manner. It fosters cooperation with various corporate governance programs and plays a coordinating role among donors, founders, and other relevant institutions. The Forum seeks to address the corporate governance weaknesses of middle-income and low-income countries in the context of broader national or regional economic reform programs.

The Forum has an extensive work program to support corporate governance reform in developing countries. The focus of the work program is based on four core pillars as defined in its charter.

The work program of the Forum is executed, managed, and implemented by the Secretariat, which is the executive arm of the Forum. The Secretariat is also responsible for disbursing funding in accordance with the procedures and criteria agreed by the Steering Committee of Donors and Founders.

Corporate governance in the United States and Great Britain addresses in large part the problems caused by an absence of effective ownership; in the rest of the world, the problem is otherwise – the problem is the existence of a controlling owner, whether it is a family, another corporation, or the governance. Throughout the world, nuances of governance orthodoxy may differ but concern is universally the failures of ownership to protect the rights of the minority – usually the public shareholder. The language of accountability is different in the Anglophone world, with its traditions of trusteeship and the language of fiduciaries, and the rest of the world, with its civil law history.

It is instructive to consider how various countries attempt the delicate balance of incentivizing the wealth-creation capability of corporations without incurring unacceptable cost to the various affected constituencies. One of the continuing tensions of corporate advance is an appropriate balance between the power of public authority and that exercised by private interests. The range extends from the United States, where government has traditionally maintained a slender control over corporate activity, to countries where, until recently, companies have been 100 percent owned by the government. Independent corporations represent a basis of power, particularly in a globalized world with the free movement of currency and security ownership, which can be taken to be a threat to traditional political authority.

In recent times, we have several examples of how this problem is resolved.

SWEDEN

Sweden has a highly literate population, egalitarian traditions, socially conscious government, and hereditary capitalism.

Since the end of World War II, the controlling ownership in Swedish firms is typically concentrated to one or two owners. Often, but not always, the controlling owners are Swedish families. Thus, the model resembles the typical corporate control model of Continental Europe. A distinguishing feature of the Swedish model is that control is typically based on a smaller capital

base than in other European countries. This feature is a result of a seemingly paradoxical policy concerning private ownership. Tax policy has consistently disfavored the accumulation of private wealth, but at the same time corporate law has greatly facilitated the wielding of control based on a small equity base.

Our analysis shows that the large gap between ownership and control makes the Swedish corporate control model both politically and economically unstable. The major political threat to date has been the proposal of the Swedish Trade Union Congress (the LO) and the Social Democratic Party to introduce a scheme that would result in the gradual takeover of the Swedish corporate sector by union-controlled wage-earner funds.

After the political defeat of this proposal in the 1980s, economic policy was changed in a more market liberal direction. This policy change has uncovered the economic instability of the model. The weak financial base of the controlling owners makes it difficult for them to take an active part in the current international restructuring of the corporate sector. Two forces are now seen as the major threat to the Swedish ownership model: (a) a rapidly increasing foreign takeover of Swedish firms and (b) large state and corporatist pension funds. Their financial assets are far larger than those of today's dominant control owners and extensive mandatory and/or tax-favored systems for pensions saving ascertain that their relative financial strength will continue to grow sharply in the future.

In a 2011 paper titled "The Swedish Corporate Control Model: Convergence, Persistence or Decline?" Magnus Henrekson and Ulf Jakobsson describe the effects of deregulation and globalization on the dominant mode of corporate governance in Swedish public firms. They found that dispersed ownership with management control along the lines of the US model has not proven to be a viable model of corporate governance for Swedish listed companies. The dominant form of corporate control continues to be large block holders. But they also found that the control models with the most rapid growth in recent decades are found outside the stock market and that the Swedish stock market's importance for the Swedish economy is again in decline after a major revival.

Henrekson and Jakobsson conclude that global investors' resistance to the one share, one vote model of corporate governance, and other limits on the rights of outside investors, imposes a discount on the shares of Swedish companies and explains the increase in non-stock market forms of investment. They also discuss the restrictions on managers assuming the level of control that has occurred in the US and other economies.

Table 5.1 Investor's 10 largest shareholders by voting rights and percentage of ownership (2005).

	% of votes	% of capital
Knut and Alice Wallenberg Foundation	40.0	18.6
EB Foundation	4.9	2.3
Skandia Liv	3.9	3.0
Nordea's mutual funds	3.7	2.0
Marianne and Marcus Wallenberg Foundation	3.5	1.6
Robur's mutual funds	3.5	3.8
Marcus & Amalia Wallenberg Memorial Fund	2.6	1.2
Custodial Trust Company	1.9	0.9
SEB	1.6	1.1
AMF Pension	1.5	4.1

The voting leverage in Investor (see table 5.1) is modest compared with the levels at Ericsson in recent times. There is always the contention that the national interest requires maintaining control in reliable hands. This same argument has been raised by Morgan Stanley in the United States with respect to the shareholding structure of the New York Times. But it did not seem to be a factor in the very successful 2011 IPO of LinkedIn; despite a dual class structure that kept the controlling voting shares inside, the stock price more than doubled on the first day of trading.

CANADA

No country has contributed more to the dialogue of corporate governance than Canada. One of many reform groups has actually proposed a timetable and a methodology for ending the dual-class stock situation.

> *"Second Class Investors," Shareholder Association for Research and Education (April 2004)*
>
> *DUAL-CLASS SHARES, WHATEVER THE CLAIMS THAT CONTROLLING SHAREHOLDERS MAY MAKE in favor of them, raise the risks of poor performance, private expropriation of benefits and poor corporate governance. It is also a red herring to blame foreign ownership limits imposed by the government given that there are companies with single-class structures that fall under similar rules. Despite the prevalence of dual-class structures in Canada, there may be signs that they are falling out of favor, among investors and the people who run Canadian companies. Dual-class share structures promote the practice of poor corporate governance, violate the standard that participation in a public company should be related to equity participation, and deserve no significant place in modern and well-run capital markets. Their end would not be mourned.*
>
> *Based on the foregoing discussion, it is time for Canadian securities regulators and stock exchanges to take steps to address the effects of dual-class share structures on Canadian equity markets. Accordingly, SHARE recommends that the Toronto Stock Exchange and Canadian securities regulators adopt the following . . . recommendations. In each case, currently listed companies would be allowed a two year implementation grace period or longer, where indicated:*
>
> *Recommendation 1: Prohibit new dual-class share structures on the Toronto Stock Exchange. Require a three year sunset provision for companies with existing structures. Dual-class share structures would be permitted for firms listed on the TSX Venture Exchange subject to the conditions in the recommendations below.*
>
> *Recommendation 2: Abolish non-voting common stock.*
>
> *Recommendation 3: For companies listed on the TSX Venture Exchange, require subordinate class approval for the continuation of dual-class share structures at least every three years.*
>
> *Recommendation 4: Permit subordinate class shareholders to directly elect a portion of the Board of Directors.*
>
> *Recommendation 5: Limit voting strength of multiple voting shares to a total of 51% of total outstanding votes and to no more than 10 votes per share.*
>
> *Recommendation 6: In the event of a takeover bid, treat all shareholders equally (one share, one vote) or, alternatively, require subordinate class approval for any transfer of super-voting shares that effects a change in control.*
>
> *Recommendation 7: Clearly label dual-class shares and exchange ticker symbols to identify issues that have multiple votes, limited votes, or no votes at all.*

SINGAPORE

Tan Lye Huat, Chief Executive of HIM Governance, was a central player in a pioneering engagement at Isetan Singapore. Governance for Owners operates in Southeast Asia in association with HIM Governance, an independent consultancy dedicated to promoting good corporate governance. In early 2007 the activists initiated engagement on behalf of the minority shareholders.

Enhanced Value Engagement: Isetan (Singapore)

Company profile. Isetan (Singapore) operates a number of department stores and a supermarket. It is in the retail (apparel) industry and the services sector. It has a 61 percent shareholder, Isetan Japan (including the Isetan Foundation).

Relevant corporate governance features of Singapore. Singapore has a Code of Corporate Governance which states that: an independent director is "one who has no relationship with the company, its related companies or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of the director's independent business judgment with a view to the best interests of the company." Also, independent directors should make up a third of the board. Resolutions on the removal and appointment of directors require only a simple majority.

The importance of the Isetan Singapore engagement. This case illustrates that the interests of controlling and minority shareholders are not necessarily the same and is an example of why nonexecutive directors need not only to act independently but to be seen to be independent. It also illustrates the effectiveness of stepped engagement (i.e. raising issues privately but ultimately being prepared to take a public stance when all else fails). Most importantly, it shows that even in markets like Singapore in which shareholder engagement is thought to be a hostile action on the one hand and a mission impossible on the other, especially for those with only small stakes, constructive engagement can achieve the desired outcome. Standing up to be counted is the first step.

Issues at Isetan

1. Concern that the independent directors were not acting in the interests of all shareholders (i.e., had been "captured" by the majority shareholder, Isetan Japan) and had "adopted an increasingly partisan management attitude."
2. Two of the "independent" directors (Tan Boen Ho and Tan Boen Hian) are brothers, have been board members since 1981 (when Isetan listed in Singapore), and have previously had family-related commercial connections with Isetan.
3. Poor investor relations program towards minority shareholders. The company had not publicly explained how or if it planned to use its Section 44 tax credit balance of over S$60m (which would allow a tax-franked dividend payment of S$305m or S$7 per share). Minority shareholders wanted Isetan to pay an additional dividend to use the credit. Because most of the company's (Singaporean) minority shareholders are taxed at an income tax rate of 8.5 per cent (or not at all, given generous personal tax allowances, etc.) they would get a refund of 11.5 percent or 20 percent, respectively, on such a dividend (based on the corporate tax rate of 20 percent (in FY2006) less the personal rate of 8.5 percent, or nil). The proponents were concerned that the company was not planning to use the credit in this way because the majority shareholder (Isetan Japan) is taxed at the much

Source: Reuters.

Figure 5.1 Share price performance of Isetan Singapore and Straits Times Index (October 2006–March 2007).

higher 40 percent Japanese corporate tax rate. Shareholders had raised the matter at AGMs for the previous four or five years and were told each year that their points had been noted by the board. The company did not clarify what it intended to do despite the growing unease among the minority shareholders that the tax credits would not be used. As a result of changes to the tax regime in Singapore, any unused tax credits would lapse on December 31, 2007.

4. The returns on the real estate assets of the company, in particular, Wisma Atria, Orchard.
5. No clear proposal from the board as to how it would use its cash reserves of S$95.8m, around 90 percent of which is held in fixed deposits.
6. The royalty payments made to Isetan Japan. Minority shareholders felt that the royalty payments to Isetan Japan were not justified and should be discontinued.

Actions

1. On November 29, 2006, a group of 43 minority shareholders representing slightly over 10 percent of Isetan's capital sent a letter to the Isetan board outlining the concerns of minority shareholders and requesting the board to call an EGM.
2. The company duly called an EGM for January 10 to vote on the removal of the incumbent independent directors (Tan Boen Ho, Tan Boen Hian, and Adrian Chan Pengee) and the appointment of alternative independent directors nominated by the minority shareholders (Tan Lye Huat, Eng Guan Siah, and Soh Suwe). (Note that TLH is Chief Executive of

HIM Governance, an independent advocate of best practice in governance. He was not a shareholder in Isetan and nor was he connected to the management, incumbents, or those proposing his appointment.)

The shareholders calling for the EGM had also asked that resolutions be tabled on other matters including the tax credit issue (proposed to pay a S$2 per share dividend to use up part of the credit), making a rights issue, and stopping royalty payments to Isetan Tokyo, but the board chose not to do so on the basis that these were not appropriate issues for a shareholder vote (the company took legal advice to that effect).

Outcomes

1. From late November 2006 through to March 2007 there was widespread public debate about the actions of the minority shareholders at Isetan. The debate concentrated on a few themes including the effectiveness of (and need for) shareholder activism and the role and responsibilities of independent directors, particularly in the context of Asian companies where shareholdings are often concentrated in the hands of a few major investors and thus minority shareholders bear the risk of expropriation by controlling shareholders. Some points emerging from that debate:
   - A proposal (in the press, BT 20061201) that regulations should be introduced to prevent controlling shareholders from voting on the appointment of independent directors.
   - Controlling shareholders generally have provision to appoint their own nominees, which implies that independent directors should represent, or at least take more account, the interests of minority shareholders.
   - Singaporean regulators might do more at the margins to review the independence of directors where there is clear doubt (i.e. regulators should take a role in enforcing the Singapore Code of Corporate Governance).
   - Companies can help themselves in such situations by keeping shareholders informed of pertinent information (such as how the board is dealing with the tax credit and cash balances).
   - The questionable suggestion that a tough stance toward a board, especially a Japanese one, should not be undertaken as "face" is critical in an Asian context, and loss of face would result in one going home "empty-handed."
   - Institutional investors need to be more active in promoting governance best practice and not using the "sell-sell" approach to address their concerns as shareholders.
2. The EGM held on January 10 was attended by about 200 shareholders and lasted around 3 hours. Although generally cordial, and despite advice from Isetan chairman Toshiaki Nakagawa that "a fighting approach" would not help the case of the minority shareholders, several of those speaking up did not mince their words, with one gentleman suggesting that if the board could not deal with the issues raised by the minority shareholders, Isetan Tokyo should buy out the minority investors.

   Given that Isetan Japan holds 21.75 million shares and the Isetan Foundation holds 3.44 million shares, it was no surprise that the minority shareholders did not succeed in replacing the incumbent independent directors with their nominated alternatives. Of the vote present, 25.1 million shares were voted against the proposals while about 5.1 million (roughly 16.7 percent) were voted in favor. However, the company made a commitment to advance the dividend issue by the April AGM.
3. On February 7, 2007, Isetan announced to the Singapore Exchange that "it continues to seriously explore with its tax and other advisers various avenues and options regarding the

utilization of the tax credits available to the company." Isetan's share price increased nearly 3 percent on the news.

4. On February 27, 2007, Isetan proposed a S$1.50 special and final dividend but abandoned initial plans to make a rights issue after failing to get the support of Isetan Japan. This was not necessarily negative, perhaps even welcome, as the rights issue was originally proposed to ameliorate any concerns of Isetan (Singapore) of the negative impact of a large cash payout. The dividend was broadly welcomed although not all minority shareholders were satisfied, one of the proposed independent directors saying that it barely made up for 10 years of consistently low dividends and did not use up a sufficient proportion of the tax credit.
5. Several other Singaporean companies subsequently announced plans for dealing with their tax credits.
6. Isetan Singapore's share price rose from S$4.72 (29/11/06) to S$6.65 (28/02/07), a 41 percent increase over the main period of the engagement (see figure 5.1).

RUSSIA

German zoologist Ernst Haeckel pioneered the notion that "ontogeny recapitulates phylogeny," a theory in biology that notes the parallels between the embryonal development of a species and evolutionary history. In other words, each embryo passes through all of the evolutional stages up to its own. While that theory has been proven more true as metaphor than as science, it seems to apply to the emerging economies in the post-Soviet countries. It is impossible for a socialist economy to turn into a capitalistic economy overnight. It requires more than rules; it requires established structures and financially sophisticated investors, lawyers, judges, journalists, and investment bankers. We have seen that the experiments in the laboratories of capitalism have been able to accelerate the stages of evolution but not to skip them. Russia thus seems to be in the robber baron stage right now, with a very few people creating vast fortunes and little assurance that investors in publicly traded securities can rely on managers – or the purported but unenforced rules and policies – to protect their interests.

The conversion from state to private ownership in Russia was punctuated by the accumulation of massive shares of the country's industry by a relatively small class of citizens, known as the oligarchs. As part of the re-election campaign of Boris Yeltsin, massive advertising programs were financed and reorganization of the corporate sector was characterized by a flood of conversions of debt into equity, whereby a few individuals ended as the owners of the country's industry. When Vladimir Putin became prime minister, he apparently assured the oligarchs that he would not disturb the ownership arrangements so long as they kept out of politics.

Conspicuously, Mikhail B. Khodorkovsky, the owner and chief executive officer of Yukos, the largest oil company in Russia, became active in the political sector, raising the prospect that he himself would be a candidate for office in the future. He was the leading Russian industrialist to strengthen relationships with the international community through the commitment to reform the system of corporate governance. Under Khodorkovsky, Yukos set itself apart from other Russian businesses by embracing greater financial transparency, equal footing for all shareholders, and a strong corporate governance charter. All this was unavailing. The government acted decisively. Khodorkovsky has been imprisoned under severe conditions; Yukos has been dismembered on account of the assertion of cumulative tax liabilities. Other oligarchs have moved abroad, but there has been no effort to reclaim their wealth.

GERMANY

In 2002, Germany adopted a new corporate governance code to respond to criticism of its previous system, and issued an amended version in 2006, with a commitment to an annual review. Highlights include:

- One share, one vote, with management obligated to "facilitate" the casting of proxy votes.
- Use of technology like the internet to make annual shareholder meetings accessible.
- "Good corporate governance requires an open discussion between the Management Board and Supervisory Board as well as among the members within the Management Board and the Supervisory Board. The comprehensive observance of confidentiality is of paramount importance for this."
- "In the event of a takeover offer, the Management Board and Supervisory Board of the target company must submit a statement of their reasoned position so that the shareholders can make an informed decision on the offer."
- Annual report of compliance with governance principles by the company.
- Disclosure of compensation and conflicts of interest.
- "All members of the Supervisory Board are bound by the enterprise's best interests. No member of the Supervisory Board may pursue personal interests in his/her decisions or use business opportunities intended for the enterprise for himself/herself."

Dr. Roland Rott evaluated the impact of the new Code on the traditional perception of the German corporate governance system as one of a functioning insider system of control.

A Systemic Evaluation of the German Corporate Governance Code: The Battle between Inconsistency and Persistence

Dr. Roland Rott 1 March 2007 (citations omitted)

Abstract

The development of corporate governance codes of best practice continues on a global scale. A major reason for their international spread is the flexibility they allow for improved investor protection without legal or political interference since companies can always choose to opt out subject to investors' approval. Codes of corporate governance are generally designed to address deficiencies in existing corporate governance systems relating to the protection of shareholders' rights, to improve firms' corporate governance practices, and thereby to promote investors' interests.

Authorized by the German government, the Baums Commission recommended in its final report of 2001 the development of a code for Germany as a means by which to promote necessary corporate governance reform. At the beginning of its work in 2000, the Commission was first concerned with suitable areas for deregulation as the German stock corporation was (and still is) perceived as over regulated. Of the three core legal rules, i.e. creditor protection, employee protection, and investor protection, the Baums Commission found only the third to be suitable for a flexible reform approach and suggested a code of best practice as a promising instrument for improving German corporate governance. At least five areas were identified by the Commission in which the German governance system may be regarded as deficient: (i) insufficient consideration of shareholders' interests, (ii) dual board structure, (iii) lack of transparency, (iv) lack of independence of supervisory board members, and (v) limited independence of the auditor. The report of the Baums Commission stated that in order to be effective, a code of best practice cannot be allowed to depart too far from the underlying legal and functional framework. The German Corporate Governance Code was published accordingly in February 2002.

In this paper the governance reform as proposed in the code is subject to analysis to determine whether the code has the potential to stipulate change in the governance of listed German companies. Following Hart, an economic analysis of code recommendations should be undertaken in the context of corporate governance generally as "there is no reason to think that [a code] is a substitute for the [existing governance] mechanisms." Thus, agency theory determines one dimension of the analysis of the code in this paper. Besides analyzing the institutions required to deal with the agency problem and their potential interrelations, a second dimension is concerned with the specific value that governance mechanisms take within a corporate governance system. The respective evaluation of all code elements borrows from the systemic approach as developed by Hackethal, Schmidt, and Tyrell in their research on the German financial system and applies a framework of two polar (stylized) governance systems, i.e. the insider and outsider systems of control. Although the systemic approach is applied, no attempt will be made in the paper to evaluate simultaneously the multitude of recent developments in German corporate governance and the financial system. In particular, developments in the corporate and capital market laws, takeover activities, and changes in ownership and financing patterns of the firms are not considered unless they are tangible and directly linked to the development of the code.

The starting point of the analysis is the perception that, in 2002, the German corporate governance system could still be described as a functioning insider system of control. Owing to the self-regulatory reform approach of the code, the analysis mainly addresses the internal governance mechanisms relevant for the control of German listed companies. Taking the main interest groups represented in the two successive governance commissions into account might give rise to the expectation that the code would tend to aim at strengthening the traditional inside-oriented governance structures. However, the evaluation of the code provisions reveals that, on the contrary, it in fact comprises rather strong elements of an outside control system and as such amplifies the potential inconsistency of the German governance system.

As the result of a spirited bidding contest, the English firm Vodafone successfully acquired a majority of the shares of Mannesmann, one of the principal communications companies in Germany. The directors of Mannesmann determined to pay special bonuses to its executives on account of the enhanced sales price achieved through their skill in the negotiations.

The former CEO Klaus Esser and his successor, the Swiss, Josef Ackerman, have been the subject of two prosecutions launched by the Dusseldorf public prosecutors alleging untreue – literally a betrayal of trust. It was first argued that supplemental bonuses to key executives were paid in order to induce them to favor a merger that was otherwise not in the interest of the corporation's constituencies. This argument was dropped. It was then alleged that the payments were improperly authorized. Finally, in November 2006 the case was settled with all charges being withdrawn and the several defendants making payments. Criminal law has not provided a consistent or predictable mode for asserting or protecting the public good.

CHINA

As with the former Soviet and Eastern Bloc countries, China is evolving from a state-owned enterprise (SOE) system, with companies controlled by a committee of the Communist Party, the trade union, and employees' representatives, to something more along the lines of a public corporation, directed by shareholders and directors. However, the Chinese government continues to maintain block holdings in many "public" companies that guarantee it still has control. Signals are mixed and inconsistent and so are results.

The Chinese government recognized the limitations and disadvantages of state control of businesses, using the term "scientific management" as an alternative to the problems of "random decision-making, relaxed management, undisciplined job performances, and low-level managerial abilities" in SOEs. Business enterprises need effective mechanisms of incentive and restraint and

the implementation of checks and balances inside the corporate governance structure. The corporate law of 1994 was designed to promote and provide incentives for these new structures. Some government agencies, however, still insist on approval of corporate decision-making, effectively short-circuiting structural efforts to assure some independence. The law gives shareholders rights in matters left to directors in other countries, like approving the budget and profit distributions. This may be a reflection of the government's interest in maintaining control or it may be a reflection of the cultural priority of shared decision-making. In either event, it does not qualify as "scientific management."

The Chinese Securities Regulatory Commission has adopted a Code of Corporate Governance (2002) and guidelines for independence of directors (2001). However, their legal foundation is uncertain and is at this writing being challenged. Enforcement is weak and there are not enough qualified directors to serve on boards. Spencer Stuart's 2007 *Corporate Governance Lexicon* cites an economic study by Qiao Liu and concludes, "shareholder protection is poor, insider trading rife, and listed companies tend not to take the maximization of shareholder value as their prime directive."

The hugely publicized effort in China to modernize has obscured the fact that the bottom line is about ensuring the party maintains its monopoly on political power. There continues to be a rash of trials for "corruption" as there continues to be seemingly limitless commitment to expansion in whatever combination with foreigners seems to suit the moment. Yet: "The party remains a nimble beast. A few years ago, it noticed the explosive growth of the private sectors. So the party began inviting entrepreneurs to officially join its ranks and establishing cells inside private companies to ensure they did not incubate an alternative political force."[9]

Chinese enterprise exists on perhaps the highest level of productivity in the world. The extent of citizens' capacity effectively to assert the integrity of "property" rights against the government must be considered uncertain. What about the sustainability of a system of government that combines political authoritarianism and economic liberalization? Ms. Ying Fang says: "Economic reforms will naturally affect the political system and, in the long run, democracy will emerge. But that will take time as the legal framework is in its infancy.... China has made a transition from communism to pragmatic socialism. Make no mistake. Private businessmen understand the need to provide returns to shareholders. But they are also supportive of a modernized ideology that most believe offers the best way for China to develop the economy to make it strong enough to take on the world. It is about patriotism." She adds: "As Deng Xiaoping said: 'It does not matter if the cat is black or white, so long as it can catch mice.'"[10]

JAPAN

Corporate governance in Japan used to be characterized by cross-shareholding among banks and client companies or companies that formed conglomerates. The cross-holding companies and banks exerted influence on the management of a certain company as client or creditor in addition to or rather than as a shareholder. The interests of other stakeholders such as employees and clients also tended to come before the power held by shareholders. "Thus, given the context of cross-shareholding, decisions made by the executive board were considered to reflect the will of employees, clients, or regulatory agencies rather than that of shareholders. Against this background, the composition of shareholders in Japan began to change due to various factors such as bursting of the bubble economy, the consequent downslide of the status of banks, the growing tendency to seek more efficient fund management, increasing foreign investment in Japan because of the internationalization of the capital market, and the expanding influence of institutional investors."[11]

Yoshiaki Murakami comes from a wealthy Osaka family and has a traditional background as a regulator in the Japanese bureaucracy. He became persuaded that Japanese companies were poorly governed and that values were lost and careers diluted because of the entrenchment and inefficiency. He organized funds, with some foreign backing, and began a program of trying to bring corporate governance in Japan up to global levels. His now-defunct MAC Fund called for higher dividends and equity repurchases, using the proxy power associated with large equity holdings and making hostile bids.

Early in 2006, Murakami was arrested for making use of "insider information" in the management of his funds. He pled not guilty, but his fund was liquidated. The question arises as to whether Murakami is really being prosecuted for challenging the Japanese establishment. However, the fate of his fund has not deterred activist investor Warren G. Lichtenstein's Steel Partners Japan Strategic Fund, which is stepping up efforts to challenge vulnerable Japanese firms by inducing them to boost stock prices under the threat of acquisition.

Financial Times journalist John Plender wrote on March 15, 2007: "Whatever the outcome in the courts, it is already clear that Japan's transition to a more shareholder-friendly form of corporate governance will be a very slow process. The problem for which more western-style corporate governance is part of the solution is Japan's chronic tendency to over invest and generate poor returns on capital by global standards."

GOVERNANCEMETRICS INTERNATIONAL (GMI)

GMI is an independent research and ratings agency founded in 2001 to provide institutional investors with an objective way of assessing corporate governance risk as well as governance leaders in their portfolios. GMI starts the rating process by developing a governance profile incorporating hundreds of variables per company plus analysts' insights. In addition to reviewing board composition, board leadership, company documents, and websites to identify stated policies and procedures, GMI also reviews regulatory actions, legal proceedings, and other sources to determine whether company behavior is consistent with its stated policies.

> *New York, September 18, 2006 – GovernanceMetrics International (GMI), the corporate governance research and ratings agency, today announced new ratings on 3,800 global companies, including for the first time 321 emerging market companies from 25 countries.*
>
> *Thirty-eight companies achieved GMI's highest rating of 10.0. They include firms from Australia, Canada, the United Kingdom, and the United States. Three companies, Colgate-Palmolive, BCE of Canada, and PepsiCo, have been among the highest rated in every GMI rating release since 2003. GMI ratings and company reports are used by pension funds, investment managers, mutual funds, banks, insurance underwriters, and regulators to assess governance risk, as well as corporate advisory firms and corporate issuers to benchmark performance and conduct peer comparisons. The firm's investment industry clients include many of the world's largest institutional investors.*
>
> *Gavin Anderson, GMI's CEO, said that 'the inclusion of a universe of emerging market companies is most timely, given the increasing investment interest in these*

markets and the growing appearance of such companies as acquirers in industrialized nations. Investors have long perceived that emerging market companies have relatively poor governance attributes, and our research shows that perception, for the most part, is reality.' As a group, the average rating of all 321 emerging market companies was 4.3, which GMI characterizes as below average. Indeed, only two emerging market companies achieved ratings that were above average on a global basis – Taiwan Semiconductor Manufacturing and Goldfields of South Africa, both of which were rated 7.5.

Our research into emerging markets uncovered:

- *a steel company where the Chairman, CEO, and CFO duties, until last month, all resided with the same person for the past three years. Related-party transactions, some of which involved entities in which the Chairman's family is invested, totaled $130 million over this period. A bank controlled by the Chairman's family was also used to manage certain investment funds and for foreign currency swap arrangements and received a commission for these services (Brazil);*
- *a securities company with only one independent director on its ten member board and a network of family controlled companies owning 18% of the company. This firm is now embroiled in a regulatory investigation concerning misappropriation of $100 million-worth of shares in the company of a customer (South Korea); and*
- *a mining company where 44% of the votes are held by the government, which has exercised its influence to force constant reshuffles of management and directors (27 supervisory board members and 16 executives in the past 6 years) as political winds change in the country. In the six years, the company has had four new CEOs and four new chairmen (Poland).*

GMI compared the characteristics of emerging market companies to those of all industrialized market companies and found that only 35% of emerging market companies have a majority of independent directors, compared with 75% for companies in industrialized markets. Fully 27% do not disclose the presence an audit committee, compared with only 13% for all industrialized companies. Where audit committees are disclosed among emerging market companies, only 29% are composed solely of independent directors, compared with 70% at all industrialized companies covered by GMI. Further, half of the emerging markets companies have no compensation committee whereas 86% of companies in the developed markets have such committees. Lastly, 22% of the emerging market companies have shares with unequal voting rights, slightly above the 21% in developed markets. The discrepancies are even starker when comparing emerging market companies with Australian, Canadian, UK, and US companies, which as a group consistently rate higher than others in corporate governance practices. The chart (see figure 5.2) shows these comparisons.

At the same time, not all emerging markets are equal. South African companies had better governance practices on average than the average for German, Singapore, Spanish, or Swedish firms. After eliminating countries with only a handful of companies reviewed, the country whose companies had the lowest average ratings was South Korea, with a rating of 2.3 (51 companies examined), slightly below Greece, where the average rating was 2.5 (24 companies examined).

Of those companies that scored GMI's lowest rating of 1.0, two-thirds were located in emerging markets. The country tally of the lowest scoring companies was: South Korea with twelve, Greece with eight, China with seven, Brazil with three, France with two, and one each in Belgium, Chile, Egypt, Japan, and Portugal. The companies selected for GMI's emerging markets universe are those constituents of the MSCI

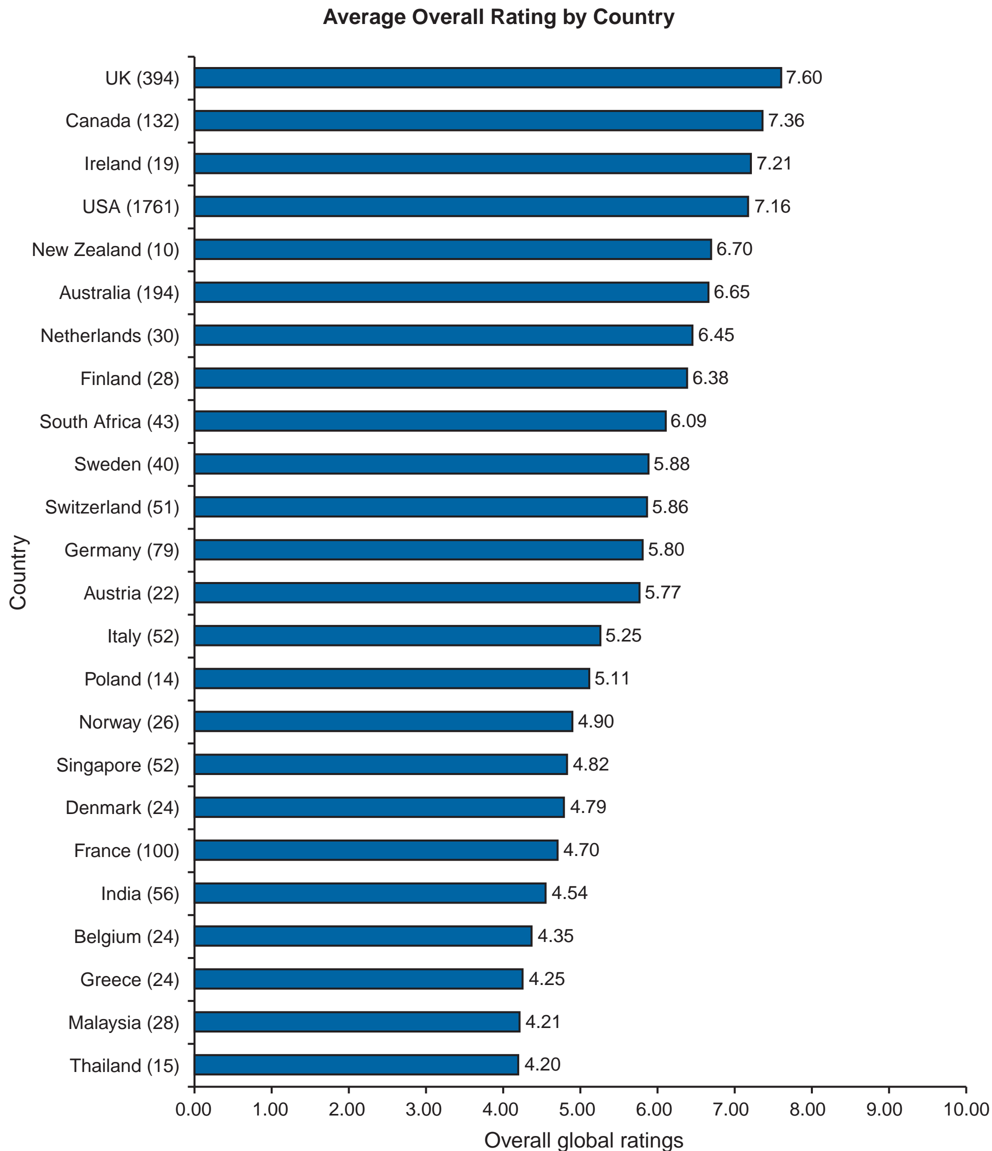


Figure 5.2 Average overall GMI rating by country 2010.

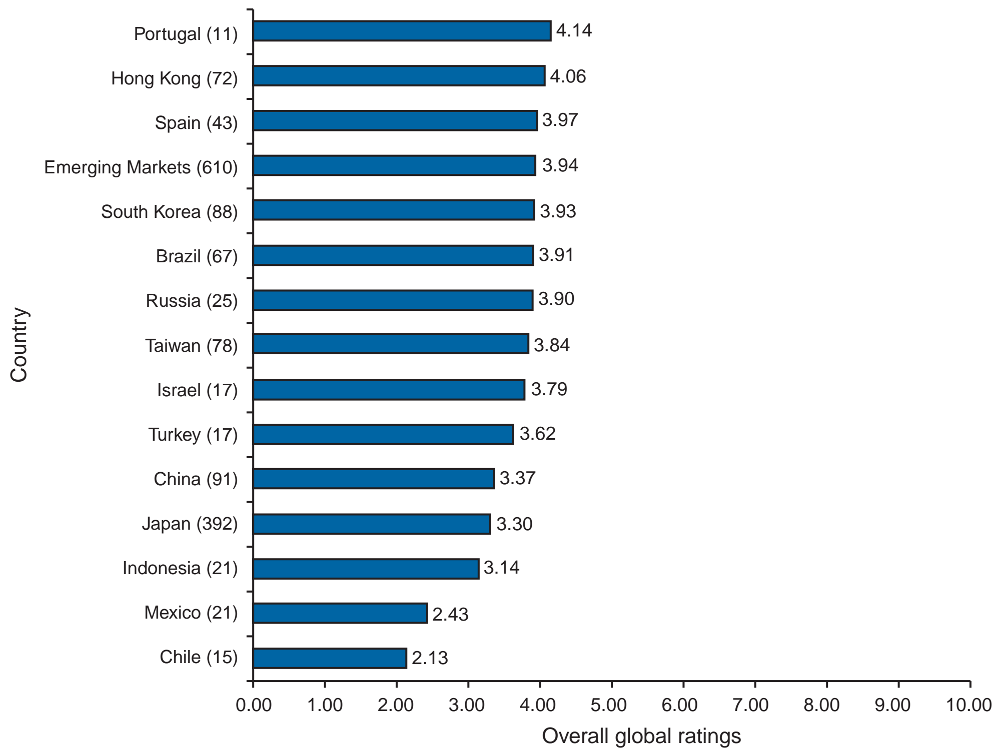


Figure 5.2 (*Continued*).

Emerging Markets index with free float market capitalizations of at least $750 million. The 321 companies represent approximately 40% of the total number of companies included in the MSCI Emerging Markets index but account for almost 90% of the total index market capitalization.

Developed markets not immune to governance weaknesses. *At the same time, investors in developed markets know too well that governance risk has no boundaries. Many shareholders of Livedoor learned to their pain of the accounting and conflict of interest problems associated with that high-flying Japanese company earlier this year as its price plummeted on the arrest of its CEO. In Europe, shareholders of European Aeronautical Defence and Space (EADS) were treated to a 25% reduction in market cap when it became known that there would be severe delays in the delivery of new planes, thus causing the cancellation of contracts. The remarkable feature of this debacle was that while executive directors knew in advance of the delay and were selling shares, fellow directors, according to the chairman, did not know about this production failure until the company announcement. Livedoor was not rated by GMI. EADS has had a below average score since 2003.*

Meanwhile, in the US over the past several months, more than 100 firms have disclosed they are either undertaking internal reviews and/or are under investigation for backdating of options grants to management and other employees. Under Sarbanes–Oxley legislation, the timing of option grants must now be reported within two days, so this backdating practice is unlikely to surface again. But, these companies are investigating options grants made years ago. Of the companies that have disclosed such investigations so far, 73 are rated by GMI. We looked at their very first GMI rating to see if these problems were occurring at well-governed companies or were confined to companies whose governance profile was weak to begin with, and, accordingly, might be more prone to governance oriented problems. In the vast majority of instances, our first rating of the company was in 2002 or 2003, a few years after most of these backdated grants had occurred but not too long a gap for boards to dramatically change. Interestingly, only four of the 73 companies we reviewed had an above average rating from GMI at the time of their first rating. This does suggest that governance ratings might help identify companies with a greater likelihood of some future problem.

Ratings changes and stock performance. *The GMI ratings system relies on approximately 400 individual metrics and subjective analysis. As a result, there must be some substantial change to a company's governance profiles before a rating change of more than a point occurs. GMI recently looked at the effects of significant ratings changes on total shareholder returns over a three-year period and found evidence suggestive of a relationship. We examined S&P 500 companies whose GMI rating as of June 2003 had either increased or decreased by three points or more – a significant swing. As the chart below demonstrates, companies whose GMI rating improved by three points or more over the period both outperformed the index as a whole and had total shareholder return out-performance of 13.54% over those whose ratings declined by three points or more over the period.*

Time frame tested: July 1, 2003–June 30, 2006

- Companies whose overall rating increased by 3 or more points returned 12.85%.
- The S&P 500 Index returned 11.63%.
- All S&P 500 companies rated by GMI in 2003 that still traded in 2006 returned 9.96%.
- Companies whose overall rating decreased by 3 or more points returned –0.69%.

Performance measure: average annualized TRS with dividends reinvested.

While not considered conclusive, the results do suggest that there may be a linkage between significant changes in governance relative to a large peer group and medium-term shareholder returns.

Please see [figure 5.2] for the average overall global rating by country for each market covered by GMI. ”

There is no Global Corporation Law. Many of the largest global enterprises have developed detailed and persuasive undertakings with respect to their own conduct in areas like workplace practices, safety, and environmental impact. The juridic significance of these undertakings is not yet settled, but the evolution of a Global Corporate Governance Law is a possibility worthy of monitoring. Major corporations have developed codes of practice undertaking levels of conduct in the various spheres affecting society so as to give governments and consumers worldwide confidence in dealing with them. These codes comprise the "brand" and are very valuable as they encourage all constituencies to deal with confidence.

The promises and challenges in the development of a global system of corporate governance can be uniquely told from the perspective of British Petroleum, LLC over the past several years. No company has articulated and published a more exhaustive statement of the goals to which it holds itself. No company has suffered such disasters as the 2005 explosion in Texas City and the 2010 Deepwater Horwin disaster. No company has been investigated as thoroughly.

British Petroleum, LLC – from its 2006 Annual Report:

> *We have stated that our long-term goals are 'no accidents, no harm to people, and no damage to the environment.' We have made clear that: 'Everyone who works for BP, anywhere, is responsible for getting HSE right.'*
>
> *We have put Health, Safety, and Environmental (HSE) management systems and processes in place to help us live up to these aspirations. Our document 'Getting HSE Right' provides a clear framework for achievement of consistent HSE performance at a local level, including the assessment and management of environmental risks and impacts. This approach is further strengthened for our major operational sites, which are all required by 'Getting HSE Right' to use the international environmental management systems standard ISO 14001.*
>
> *By the end of 2004, we had achieved our goal to have 100% of our major sites certified to this standard by independent auditors. However, our performance faltered in 2005 with the suspension of the ISO certification at our Texas City refinery. The refinery intends to recertify after completing planned work to strengthen its HSE management.*
>
> *Our management framework sets out clear principles to management on how authority and accountability are delegated to individuals in BP. This includes clear expectations on assessing risks, taking action to mitigate these risks and monitoring performance. The framework also includes our group values, which inform our employees on the manner in which BP will carry out its business. Two of these values cover HSE responsibilities related to our operations and are stated as:*
>
> *Health and safety: to ensure that there are no accidents, no harm to people or that anyone is subject to unnecessary risk while working for the group.*
>
> *Environmentally sound operations: to conduct the group's activities in a manner that, consistent with the board goals, is environmentally responsible with the aspiration of 'no damage to the environment.' The group will seek to drive down the environmental impact of its operations by reducing waste, emissions and discharges, and by using energy efficiently.*

A third group value relates not just to HSE performance of our employees and facilities but includes aspects of environmental responsibility which extend beyond our operational control into our sphere of influence.

'Transcending the environmental trade-off': to contribute to human progress by applying our resources so that the perceived trade-off between global access to heat, light and mobility and the protection and improvement of the natural environment may be overcome.

This value embodies the precautionary principle and reflects our position on issues such as climate change. It underpins the group's commitment to the responsible treatment of the planet's resources and to the development of sources of lower carbon energy and renewable energy sources.

We aim to comply with local, national and international environmental regulations and monitor how well we meet these legal requirements. Our performance shows that we have made considerable progress over time, but we do not always succeed. In 2005 we paid $56 million to settle matters related to alleged health, safety or environmental violations which occurred in 2005 or in previous years.

Management processes

In addition to management systems including Getting HSE Right and ISO 14001, environmental and safety management processes are integral to projects and operational activities conducted by BP businesses.

Our first priority is prevention – we take steps to improve our processes in order to avoid incidents and minimize activities which threaten the environment. When incidents with the potential to cause damage to the environment occur, or our systems lapse and regulatory non-compliances result, we aim to be timely and transparent in our response.

If an incident or impact on the environment does occur, our priority shifts to mitigation: to minimize further impacts and remediate damage. We try to learn from experience and to improve our facilities, systems, processes and procedures in order to prevent repeat incidents.

In our Health, Safety, and Security section we describe a number of specific processes which help our business units and functions improve their performance. In addition to these, the following processes cover environmental, as well as health and safety aspects of performance:

- *project health, safety, security and environment review (PHSSER) – a process developed to make sure HSSE issues are addressed at every stage of the project lifecycle, from planning through to delivery;*
- *environmental and social impact assessments (ESIA) – studies carried out to help BP and our stakeholders understand the potential environmental or social impacts of a proposed project;*
- *environmental performance management and reporting – the collection of performance data from reporting units across our businesses: this data is now used to produce both local site reports and aggregated.* ”

When a corporation with strict codes of conduct has an impact on society in a dramatic way, as did British Petroleum in March 2005 in the Texas City industrial accident causing more than two-dozen deaths, there is practical assurance that the matter will be dealt with in a responsible way because of the importance of the "brand." Irrespective of the strictures of local law, BP claims to hold itself to a higher standard. We can start this story through a journalist's account.

BP battles to clear its Augean stables

By Carola Hoyos
Published: September 20, 2006, 03:00

On March 23 last year, a cloud of highly flammable hydrocarbons erupted at BP's Texas City refinery, after a catalogue of mechanical failures. Alarms remained silent, level indicators failed to judge the mounting danger and valves jammed.

At 1.20 pm, probably ignited by a spark from a pick-up truck, the cloud burst into flame, setting off a series of explosions.

Fifteen workers in two trailers next to the tower died and 170 others were injured.

Long after families had buried their dead and the refinery had been rebuilt, the explosion continues to tear through BP's corporate fabric.

Until the day of the tragedy, BP and Lord Browne, its chief executive, had enjoyed as celebrated and successful a run as is possible in one of the world's most dangerous and unpredictable industries. Lord Browne was regularly voted Britain's most admired business leader.

However, on March 23, BP crossed a 'fault line,' Lord Browne would later say, that would force a 'fundamental change' in the way the company operated. For BP, Texas City has been as profound an event as Exxon's huge oil spill at Valdez in Alaska in 1989. The explosions at Texas City marked the beginning of a wretched 18 months. In that period, BP's flagship Thunder Horse platform in the Gulf of Mexico was damaged in a hurricane in July 2005 and its Alaska pipelines corroded so badly that almost exactly a year after the Texas City disaster they caused the biggest onshore spill in the state's history and forced the company to shut America's largest oil field.

This summer, the US government accused BP's traders of having tried to corner the propane market in 2004; and Lord Browne himself was strong-armed by his chairman into announcing he would retire promptly in 2008.

The run of trouble has prompted investors to sell BP shares and to ask whether the company had a systemic problem.

This week's announcement that BP would have to delay the restart of Thunder Horse a third time deepened the company's malaise. It prompted analysts to warn that, as a result, its earnings per share would fall 4.5 per cent in 2007 and 6 per cent in 2008.

BP's shares have already retreated so far that Royal Dutch Shell in August knocked it off its perch as Europe's second-biggest listed energy group.

Moreover, BP's troubles have thrown Lord Browne's succession into doubt, with four of the five candidates, many of them groomed for decades, embroiled in the trouble. Lord Browne and BP's senior executives have steadfastly maintained that the recent events in the US were unconnected.

During 2006, Robert A.G. Monks kept a contemporary account of the BP situation:

July 31, 2006

1. [Then-CEO] Sir John Browne formally committed the merged BP and Amoco enterprise "... to conduct our operations without accidents, and to ensure that our activities do no harm to people.... We will make mistakes. When we do make mistakes, we will distinguish those which are genuine, where the challenge is to learn the lessons and to avoid any repetition, from willful or careless breaches or neglect, which will be treated as serious disciplinary matters. This document describes what we stand for. It sets out not just what BP Amoco expects of its people, *but also what society as a whole can expect of us"* (emphasis added) ("What We Stand For – Our Business Policies," February 1999).
2. There is evidence that 38 persons have died as a result of industrial accidents arising out of refining and chemical operations over 30 years on facilities now generally identified as Texas City. Horrible as the words may impress, the reality is that the BP operation has a death rate of roughly one person every nine months. In recent times, under BP control, the rate has cruelly increased – one death in 2003, another in 2004, and finally the March 23rd disaster, with 15 deaths and more than 175 persons injured.
3. Oil refining is an intrinsically dangerous business. The acknowledged industry leader – Exxon Mobil – has not eliminated risk to life. "Exxon Mobil's global health goal is zero injuries.... Tragically, we had eight workforce fatalities in 2005" (Exxon Mobil 2005 Corporate Citizenship Report at p. 44).
4. The finality of death requires pushing beyond even the most sincere undertakings to provide a safe workplace in order to understand the responsibility of corporations conducting intrinsically dangerous operations. Certain life-threatening operations are not legally permitted in certain countries. For example, in Scandinavia underground mining has long been illegal. There is no question but that operating an oil refinery is legal in Texas and that it was legal on March 23, 2005. In most cases where corporate functioning conflicts with the public good, as particularly when operations threaten environmental quality, conflicting interests can be resolved. Uniquely, when the loss of human life is a statistically certain result of industrial activities, there is no ultimate accommodation – death is final.
5. There is no dispute but that the various constituencies of BP accept the reality of a death rate arising out of their operations. Shareholders, employees, supervisors, managers, and executives accept their dividends, salary, and bonuses in full knowledge of their linkage with death.
6. Companies must be held accountable to the most strict standards of conducting their activities so as to minimize risk of bodily harm to employees. For companies with operations in many different countries, the undertaking to articulate precisely commitment to safety is an essential component of their being permitted to do business in each country. To the extent that safe operations are an indispensable element of Global Corporate Governance, governance is the foundation of the all-valuable "brand" that expresses a company's universal reputation.
7. It is appropriate to recognize the exemplary response – precisely within the tenor of John Browne's undertaking set forth in 1 above – of British Petroleum to the disaster:
   a. [Then-CEO] Lord Browne personally appeared at the disaster site, made himself available to employees, victims, their families, and the press.
   b. Lord Browne undertook, as clearly as the English language permits, that British Petroleum would make whole – as far as money permits – those injured by the incident.

   c. There was a prompt and comprehensive report by senior company executive J. Mogford, analyzing the causes of the disaster, which was made public in its entirety.
   d. Replacement within 18 months of all BP personnel in the line of responsibility, right up to the level of chairman of North American operations.
   e. Establishment of an "independent" commission under the chairmanship of Houston-native, former Secretary of State, James Baker to review the company's "safety culture" and its responsibility for the disaster.
   f. Prompt settlement of most claims.
   g. An undertaking to invest amounts in excess of $1 billion in order to re-establish a safe refinery operation.
8. It is agreeable to report that BP not only "talked the talk, but they walked the walk" following the disaster; it is disappointing in the extreme to witness that the company's conduct prior to the disaster was far short.
9. Governance is not simply a matter of aspirations; there is requirement that all resources be effectively deployed to the realization of these aspirations. It is not appropriate to repeat what has been laid out carefully and at length by those personally involved. We should here simply consider certain factors importantly impinging on the reality of good governance:
   a. How much time following an "acquisition" should be accorded to the acquiring corporation in order to bring up to their own advertised governance standards the operation of acquired facilities? It is clear in this situation that many years had passed and the obligation on British Petroleum to run Texas City according to their highest aspirational standards is undiluted. Enough time had passed so that BP was entirely responsible for any managerial or process failures within the Texas City operation.
   b. Can a company be justified in continuing operations at an inferior safety level if the "economics" of the business do not generate sufficient revenue to support needed improvements? BP struggled mightily at the turn of the millennium to be able to operate profitably with oil in the range of $15/bbl. The question as to whether a company *must* shut down an operation (to avoid bankruptcy) rather than operate unsafely is not required to be answered in the context of the March 23, 2005 disaster. At least by 2003 Texas City was generating substantial profits; there is some evidence that its near $1 billion earnings in 2004 were a record for any single refinery ever.
10. Failure to invest, failure to install appropriate safety equipment, failure to train personnel, failure to create a culture of safety – all of these are redolent in the depositions already submitted.
11. The ultimate failure is the absence in any of the depositions or, indeed, the massive written undertaking of British Petroleum of a credible commitment to a Culture of Safety. Unhappily, there is nowhere amidst all the undertakings to compensate fairly and promptly, amidst the huge disbursement of money for damages of all kinds, the reinvestment for a highest quality future operation, and the personal dignity and undoubted sincerity of senior BP executives, exemplified by John Browne, any kind of expression that has the integrity spontaneously volunteered by Rex Tillerson, the new CEO of Exxon Mobil, at that corporation's May 31, 2006 Annual Meeting: "Safe operations are our highest priority."

In fact, Lord Browne's retirement was successively advanced to June 30, 2007 for reasons relating to embarrassing revelations about his personal life (see discussion of CEO termination in chapter 4). The company's exposure to criminal prosecution continues. As noted above, James Baker, formerly

Secretary of the Treasury and of State of the United States and a distinguished lawyer, headed a commission that made the definitive study of the disaster.

Baker considered with the utmost care the responsibility of the board of directors of British Petroleum with respect to the Texas City explosion.

> *A 2006 report prepared on behalf of the UK HSE presents an outline framework for what best practices in occupational health and safety governance should look like. While the report relates specifically to occupational safety governance, the Panel believes the principles discussed are instructive as well for process safety governance. The report notes, in particular, 'that directors are still unclear as to their role in Occupational Health and Safety (OHS) leadership and in ensuring that risks to OHS within their business are properly controlled.' The Panel believes that the same lack of clarity may also apply to process safety. The 2006 report notes that there are no specific, positive duties on directors of UK companies for governing occupational health and safety matters. The report outlines, however, seven basic principles that the authors of the report believe form the framework of what constitutes best practices for occupational health and safety governance. The Panel recites the principles for possible best practices for process safety governance for companies that conduct businesses that involve process risks. Throughout the text below, the Panel substitutes the term 'process safety' for 'OHS' (standing for occupational health and safety) as appearing in the 2006 report. (1) Director competence – All directors should have a clear understanding of the key [process safety] issues for their business and be continually developing their skills and knowledge. (2) Director roles and responsibilities – All directors should understand their legal responsibilities and their role in governing [process safety] matters for their business. Their roles should be supported by formal individual terms of reference, covering as a minimum setting [process safety] policy and strategy development, setting standards, performance monitoring and internal control. At least one director should have the additional role of overseeing and challenging the [process safety] governance process. (3) Culture, standards and values – The board of directors should take ownership for key [process safety] issues and be ambassadors for good [process safety] performance within the business, upholding core values and standards. They should set the right tone at the top and establish an open culture across the organization with a high level of communication both internally and externally on [process safety] issues. (4) Strategic implications – The board should be responsible for driving the [process safety] agenda, understanding the risks and opportunities associated with [process safety] matters and any market pressures which might compromise the values and standards, and ultimately establishing a strategy to respond. (5) Performance management – The board should set out the key objectives and targets for [process safety] management and create an incentive structure for senior executives which drives good [process safety] performance, balancing both leading and lagging indicators and capturing both tangible and intangible factors. Non-executives should be involved in establishing the appropriate incentive schemes. (6) Internal controls – The board should ensure that [process safety] risks are managed and controlled adequately and that a framework to ensure compliance with the core standards is established. It is important that the governance structures enable management systems, actions and levels of performance to be challenged. This process*

should utilize, where possible, existing internal control and audit structures and be reviewed by the Audit Committee. (7) Organizational structures – The board needs to integrate the [process safety] governance process into the main governance structures within the business, including the activities of the main board and its sub-committees, including risk, remuneration and audit, or the creation of an [process safety] committee.

The Panel notes that the Board has been monitoring process safety performance of BP's US operations, as BP executive and corporate management have presented that performance to the Board. Management has made reports to the Board and proposed various actions to address perceived shortcomings in the implementation of BP's HSSE management system. As to personal safety, management efforts have largely been effective to improve performance. In the area of process safety, however, neither executive management nor refining line management generally implemented an integrated, comprehensive, and effective process safety management system for BP's US refineries. In the context of reviewing the conduct of the Board, the Panel is guided by its chartered purpose to examine and recommend any needed improvements to corporate safety oversight and leadership. This purpose does not call for an examination of legal compliance but, in the Panel's judgment, calls for excellence. In more practical terms, the Panel wishes to make recommendations to ensure that a tragic process accident like the Texas City explosion does not happen again. It is in this context, and in the context of best practices, and not because the Panel believes that BP's Board failed to comply with any applicable, legal duties, that the Panel believes that the Board can and should do more. In particular, the Panel believes that the Board should consider the seven best practice areas cited above as possible guidelines for use in improving its oversight of process safety management affecting BP's US refineries. The Panel does not believe that BP implemented an integrated, comprehensive, and effective process safety management system for its US refineries. Although BP's executive and refining line management was responsible for ensuring the implementation of such a system, BP's Board did not ensure, as a best practice, that management did so. (Baker report, pp. 233, 234)”

Baker went further to focus on the responsibility of all levels of management of BP:

“*BP's executive management either did not receive refinery-specific information that suggested process safety deficiencies at some of the US refineries or did not effectively respond to the information that they did receive. Neither BP's executive management nor its refining line management has ensured the implementation of an integrated, comprehensive, and effective safety management system for BP's five US refineries. (Baker report, p. 231)*”

The questions of criminal liability remain open. This is yet a further example, alongside the situations cited above in Germany and Japan, of the inutility of criminal law as a mode to condition corporate conduct. While BP has achieved a new high standard of acting after the crisis to mitigate damages and to prevent their reoccurrence, declining to prosecute might be seen as encouraging harmful conduct, given the explosion and oil spill at Deepwater Horizon in 2011. On the other hand, it is plainly in society's interest to encourage companies to co-operate. The conundrum

remains. *What more could government, management, the board, or shareholders have done following the 2005 explosion to prevent the worse explosion in 2010?*

Many companies have developed their own explicit rules for global functioning. Consider the commentary by Neville Isdell, CEO of Coca-Cola (*Wall Street Journal*, weekend edition, February 3, 2007).

> *International corporations today face growing pressure for greater accountability and transparency. Corporate leaders, inevitably, must address critical choices: whether to engage stakeholders or turn a deaf ear, whether to complain of unfair treatment or accept accountability as part of the social license to do business.*
>
> *But corporate social responsibility need not conflict with the obligation to shareholders to be financially successful. In my experience, constructive engagement with a broad range of interest groups – including harsh critics – is the best way to use their pressure to drive profitability.*
>
> *Coca-Cola operates in more than 200 countries, and our business model relies on local businesses to make, distribute, and sell our beverages. When a company plays a major role in creating jobs, tax revenues, adjacent businesses and public services, the result is sustainable communities and higher living standards.*
>
> *This also functions as a powerful self-correcting mechanism. A business can be only as healthy as the communities in which it operates; for it to succeed, it must be integrally and functionally part of every community. For globalization to succeed, it must lead to inclusive development that offers opportunities to the rural poor as well as to the urban elite.*
>
> *Because we are a local business on a global scale, it is inevitable that advocates for a wide range of interests – from environmental protection to social justice to economic development – will scrutinize us. This is logical. Businesses usually respond to market forces faster than governments.*
>
> *Furthermore, businesses are often better positioned than governments to realize globalization's benefits locally. However, a small minority of activists will always prefer confrontation, with its attendant publicity, to the search for mutually beneficial common ground. With such groups there is little room for dialogue. In these situations, a company has no choice but to vigorously confront parties who seek to use its brand to push their own agenda.*
>
> *On the other hand, I believe we can – and should – deal with those responsible stakeholders who recognize that we cannot abandon or undermine our fundamental economic purpose. The business advantage that comes from such engagement is not merely to reduce criticism.*
>
> *Effective engagement can be a catalyst for programs that improve local living standards. This, in turn, will lead to new or more satisfied consumers, who prefer companies not only on the basis of brands and products, but because of the values they hold and how they conduct business.*
>
> *For instance, because most of our beverages are made locally for sale locally, Coca-Cola's success depends on the availability of local water resources. Thus, our partnership with communities on water challenges helps align our respective interests in ensuring the health of the watersheds that sustain both our business and the communities where we operate.*
>
> *In Mali, we are joined with the US Agency for International Development to install hand- and Pedaflow-pumps for wells throughout the country. In Bamako, Mali's*

capital, we partnered with women's groups to set up a water-fee program to expand and maintain the system and fund a microenterprise job-creation program, and we are helping extend municipal water taps into outlying communities.

Such programs help reduce waterborne illnesses, increase crop yields, provide new sources of income, and improve local living standards. This 'virtuous cycle' yields a social license to operate in a global economy. It also forms the foundation for long-term success, as discerning consumers choose businesses that are aligned with their larger social interests and values.

This is the business rationale behind our recent microenterprise initiatives, such as our program to expand the number of pushcarts, kiosks and mini-tables provided to entrepreneurs, as well as sales training. We started a pushcart program for disadvantaged women in Vietnam in 2002 with 2,000 participants.

By the end of 2005, the number of participants had doubled, and the program was embraced by the Women's Union in Ho Chi Minh City for creating sustainable women-owned businesses. Our microenterprise programs similarly benefited people displaced in Thailand and Indonesia by the 2004 tsunami, people with HIV/AIDS in Ghana, and unemployed young people in Egypt.

We shall continue to seek engagement with accountable and responsible advocates, and we have partnered, around the globe, with many organizations on issues such as environmental impact, water stewardship, climate protection, workplace rights, disaster relief and HIV/AIDS.

Successful collaboration is built on finding the common ground where a company's self-interest and the needs of communities converge. This is hard work, but work worth doing. The integration of the global economy, advanced with respect and concern for local interests and cultures through broad stakeholder engagement, remains the most effective means to lift people out of poverty and advance prosperity. That creates motivated consumers – and that is good business. ”

There have been many efforts to devise global standards – some through the United Nations and its subsidiaries such as UNEP, the World Bank and the International Monetary Fund, the OECD and the Global Corporate Governance Forum – by which enterprise will regulate its own functioning.

WORLD BANK AND G7 RESPONSE

Corporate governance came to the center of the international development agenda following the East Asian financial crisis of the late 1990s. In addition, increased privatization, financial market liberalization, and high-profile corporate failures also contributed to the World Bank's increased focus on corporate behavior, management, and policies. It pays particular attention to the governance of the banking sector, due to the sector's enormous influence on developing economies, especially where stock markets are underdeveloped. It is also very aware of the importance of good corporate governance as a mechanism for decreasing corruption. "The resulting international debate has shown that underlying principles of fairness, transparency, accountability, and

responsibility reflect minimum standards necessary to provide legitimacy to the corporate sector, reduce financial crisis vulnerability, and broaden and deepen access to capital."[12]

At its October 1998 annual meeting, the World Bank announced an initial raft of measures to improve governance worldwide, including expert and technical assistance, knowledge sharing, and loans tied to governance reform. Shortly thereafter, the Bank opened an internet site offering a catalogue of governance codes, research, and links.

UK then-Chancellor Gordon Brown, speaking to the meeting, called for the Bank to endorse the OECD's governance principles, and for the Bank's individual country reports to list how each market was implementing them. Brown made similar calls at a Commonwealth summit and at a meeting of the finance ministers of the G7 group of leading industrial nations. The G7 called for "international principles and codes of best practice … on corporate governance and accounting" as part of efforts to stabilize the global economy.

The seriousness with which the World Bank took governance reform was highlighted at the end of 1998 when Bank chief James Wolfensohn endorsed governance reform in the *Economist*'s late-1998 forecast of the coming year. "Strong corporate governance produces good social progress," he asserted. "Good corporate governance can make a difference by broadening ownership and reducing concentration of power within societies. It bolsters capital markets and stimulates innovation. It fosters longer-term foreign direct investment, reduces volatility, and deters capital flight."

Wolfensohn demanded "tough rules of transparency and disclosure" and said that in Southeast Asia the Bank will lay down "strict requirements for financial and corporate restructuring" in return for financial assistance. The Bank's crisis loans to Korea ($2 billion), Indonesia ($1 billion), Thailand ($400 million), and Malaysia ($300 million) depended partly on corporate governance reforms being made by those countries.

The reforms were underpinned by research conducted by the Bank's own chief economist, who found that countries that pursue privatizations without putting good governance structures in place experience worse economic growth. The results reflected frequently voiced criticism of the International Monetary Fund for promoting free market policies without securing meaningful securities law, regulation, disclosure practices, etc.

Corporate governance has been adopted as one of 12 core best-practice standards by the international financial community. The World Bank assesses the application of the OECD Principles of Corporate Governance as part of the World Bank and International Monetary Fund (IMF) program on Reports on the Observance of Standards and Codes (ROSC).

The goal of the ROSC initiative is to identify weaknesses that may contribute to a country's economic and financial vulnerability. Each Corporate Governance ROSC assessment reviews the country's legal and regulatory framework, as well as the practices and compliance of its listed firms, and assesses the framework relative to an internationally accepted benchmark.

The World Bank's assessments are on their websites, covering countries from Armenia to Zimbabwe. The following are excerpts from sample reports.

AZERBAIJAN

[T]hree steps for improvement of corporate governance in Azerbaijan are:

1. Institution building, including strengthening of enforcement and independence of SCS;
2. Legal reform, specifically taking stock of recent legal changes and assuring their smooth interaction and functioning; and

3. Focus on several key areas for enforcement:
   – Related party transactions;
   – Reporting and transparency, including ownership disclosure and annual reporting;
   – Supervisory boards and other company governance organs;
   – Continued enforcement of bank CG rules;
   – Awareness raising.

SLOVAKIA

Principle IF: Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights.

Assessment: Materially not observed.

Description of practice: Shareholder activism in Slovakia depends on each shareholder's degree of control. Typically, publicly traded companies operate with the controlling influence of one or two shareholders, who tend to monopolize AGMs. True institutional investors in Slovak shares appear to be rare. A leading insurance company and investment fund both reported zero holdings. There is little shareholder activism. Open mutual funds are required to disclose their voting policies and activities, but closed-end funds and private pension plans are not.

Policy recommendations: Pension funds should be obliged by regulation to disclose their voting policy. Voting should be made as easy as possible. Awareness of successful international experiences of shareholder activism should be raised. Those redrafting a Corporate Governance Code may also want to consider the question of investor responsibility.

JORDAN

Principle IE: Markets for corporate control should be allowed to function in an efficient and transparent manner.

Assessment: Partially observed.

Description of practice: Given the ownership structure, there is little acquisition activity. The SL provides few tender offer rules. Any person intending to acquire at least 40 percent of capital must do so in a public tender offer to all shareholders, at the highest price offered. If tendered shares exceed those demanded, allotment is made on a pro rata basis. The existing tender rules are recognized by the market and regulators as insufficiently detailed. Listing Instructions of the ASE govern delisting; there are no requirements for shareholder approval or buyouts. JSC has made it a medium-term priority to develop additional regulations.

Policy recommendations: To maximize transparency and avoid surprises to investors, JSC should clearly state its tender offer rules in the medium term. Policymakers should review recent international experience in takeover policy and the recent EU recommendations for squeeze-out and sell-out rights, as well as price regulations on those. The tender offer regulations should be expressed

as a threshold upon the crossing of which the offer is triggered. The price should be held to equal the highest price during a given limited period of time in the past.

THAILAND

Since 1998, Thailand has made significant progress in improving its corporate governance. In 2002, the National Corporate Governance Committee was established, and the year 2002 was officially designated as the Year of Corporate Governance. The committee is presided over by the prime minister, with participation from the private sector. Six subcommittees have been established to intensify efforts to improve various aspects of corporate governance practices. The effort has been focused on enhancing regulatory enforcement, instituting market discipline, and promoting self-regulation....

However, the reform agenda remains incomplete. Changes in the regulatory framework need to be extended to actual practice.

While these are commendable efforts, the reform agenda remains incomplete, both in terms of legislative and regulatory reform, and in terms of changes in practices. Progress in revising relevant laws, including the Public Limited Companies Act (PCA) and Securities and Exchange Act (SEA), and the drafting of class action lawsuits has been slow. It is important to set a reasonable time frame for authorities for enactment of these legislations. In the area of financial reporting and disclosure, Thailand has announced a plan to adopt international accounting standards fully by 2006.

The question that remains is the extent to which these efforts have translated into improvement in actual practices. Corporate governance reform is a long-term process. It requires changes in incentives and behavior. There is an urgent need to persist with corporate governance reform and complete the unfinished agenda in order for Thailand further to develop its capital market and increase its competitiveness.

POLAND

Poland is at an advanced stage of corporate governance debate, discussion, and reform. Since the previous assessment, Poland has adopted new legislation, effectively promulgated a corporate governance code, and continued to develop strong regulatory and enforcement institutions. These improvements have resulted in a corporate governance framework that complies with many of the OECD Principles. The basic minority rights and disclosure framework are in place. Several issues drive the requirements for future reform, including the growing power of pension funds, which are rapidly becoming significant holders of Polish shares.

The report identifies several potential problems and remedies, including:

- insufficient regulation of the corporate governance activities of the pension funds;
- weakness of the supervisory board;
- problems in the delisting/squeeze-out process; and
- insufficient approvals of related party transactions.

Policy recommendations are based on Poland's competition with increasingly sophisticated markets in OECD countries and the need for corporate governance policy to rise above basic minimum standards.

Key recommendations

Establish state ownership policy for SOEs: The Government should set a clear and transparent policy on state ownership of enterprises.

The Polish Government should consider developing its SOE ownership policy. The development of the MST Principles is a significant and welcome step forward; the MST Principles clarify many details related to the exercise of state ownership, but do not set an overall state ownership policy. In particular, in view of the planned finalization of the privatization processes, the scope and strategy of the state's involvement as investor in competitive sectors should be clarified.

The corporate form should be applied to all nonfinancial SOEs operating on a for-profit basis.

The state's ownership policy should cover all SOEs: The state should ensure effective supervision of all SOEs, including companies (subsidiaries) that are part of holding structures established by SOEs. In order to effectively supervise all SOEs, the state could consider narrowing its company portfolio to larger SOEs of strategic significance for the state interests.

Performance goals should be clearly defined for each SOE: The maximization of SOE economic value should be the main guideline for the exercise of the state ownership rights. The state should also consider identifying any commercial and noncommercial (public interest) goals for each SOE, e.g., in the SOE charter. These goals should determine the operation strategy employed in particular SOEs and would determine the factors of evaluation of their performance.

The degree of control of the state over a company's capital should determine the scope and intensity of the exercise of state ownership supervision: Like companies in the private sector, the intervention of the state in the functioning of a company should be dependent primarily on the level of state ownership. The breakdown of corporate governance requirements into wholly, majority, and minority state-owned SOEs, as set forth by the MST Principles, may not reflect the actual control of the state over the particular SOE in companies where the State is the controlling or significant minority shareholder. For those companies, the application of standards of state ownership supervision created for majority state-owned SOEs should be considered.

Reorganize state ownership function: The ownership entities should separate the ownership function from other regulatory/policy-making functions of the state.

The exercise of state ownership should be further professionalized and focus primarily on enhancing economic performance of the supervised entities. The Government should separate the ownership function from the market regulation/policy-making functions of the state. It is especially important in light of the recent changes introducing special intervention rights of the state in companies in certain strategic sectors (the "Golden Veto"). To minimize the potential for conflicts of interest that could occur between the exercise of the ownership function and the exercise of other functions of the state, the Government should ensure that internal governance systems are established within each of the ownership entities that address the potential for conflicts of interest. This can be done through the introduction of a set of internal procedures for the ownership supervision units regarding their operation and their contacts with other Governmental bodies whose functions may be conflicting with the functions of the ownership entities. For example, there should be an institutional separation between the exercise of the state aid functions and the exercise of the ownership functions of the state.

Full centralization of state ownership supervision within one professional and commercially oriented ownership entity is recommended: As a second alternative, the Government should create a coordination mechanism that harmonizes the exercise of ownership supervision by different ownership entities. The Government should eliminate the divergence of corporate governance standards applied by different ownership entities and apply a uniform disclosure framework to all SOEs. The Government should consider the possibility of establishing a single state ownership entity. At a minimum, the Government should harmonize the rules and policies of the different ownership entities. The recent resolution of the Council of Ministers of Poland, which requires the harmonization of standards of ownership supervision among various ownership entities, should be welcomed.

Increase transparency: The ownership entities should develop a well-functioning uniform disclosure and reporting system. The level of transparency of large SOEs should be comparable with the level of transparency of listed companies.

The Government should continue to develop the system of public disclosure for unlisted SOEs. In addition to disclosure through the court registry and the official journal (*Monitor Polski*), the Government should consider facilitating the access to SOE information through increasing further the use of internet as a channel of disclosure. In particular, the scope of the key information available on the internet should be increased, as required by the Law on Access to Public Information. To improve the timely updates of the information about the SOEs, the Government could consider publishing at least the key parts of the periodic reporting submitted by the SOEs by means of the Integrated Information System pursuant to the MST Principles directly to a database available on the internet, such as the Public Information Bulletin. The Government and the ownership entities should consider further improvements of the system of aggregate annual reporting on SOE performance through:

- inclusion of all types of SOEs in the annual reports on economic performance (in particular SOEs with significant minority ownership of the state, bankrupt SOEs or SOE subsidiaries),
- modifications of the methods of data aggregation and the reporting formats to increase the comprehensiveness of the data or deepening the analysis of SOEs supervised by ownership entities other than the MST.

The Government could consider requiring large nonlisted SOEs to prepare their consolidated financial statements in conformity with International Financial Reporting Standards. The internal audit of the SOEs should be further developed based on the model of large public companies with the application of international best practices. Especially in large SOEs, strengthening of risk management, financial controls, and governance procedures is recommended.

Exercise ownership rights: The ownership entities should exercise the state ownership rights through supervisory boards and through other key mechanisms of exercise of shareholder rights. The use of particular mechanisms of corporate governance of SOEs should be determined in accordance with the general principles of corporate governance. The appropriate use of available corporate governance mechanisms prevents distortion of balance between the state and other SOE shareholders, as well as stakeholders. To provide for a complete picture of the mechanisms through which the state exercises its shareholder rights, the MST and other ownership entities could consider including the standards of the use of the key corporate governance mechanisms other than the supervisory and executive boards, such as active participation at the General Meetings, voting and requesting

information as a shareholder, in the MST Principles and in other possible codifications of SOE governance standards.

Professionalize the supervisory boards: The Government should increase the professionalism and independence of the SOE supervisory board members to ensure that the SOE supervisory boards are empowered to play an active role in SOE governance. The MST and other ownership entities should closely monitor the nomination of supervisory board members to ensure that it leads to the choice of candidates who meet the highest standards of professionalism. The participation of experienced and well-trained persons, in particular private sector specialists, on SOE supervisory boards should be sought. To achieve this, the Government should consider revisiting its compensation policies for supervisory board members and linking compensation to performance.

Executive and supervisory board members of SOEs should be required to act solely in the best interest of the SOE. The legal and regulatory framework for the boards and board members should not inhibit their independence and loyalty of the board members to the interests of the SOE. When exercising the state's ownership rights, the ownership entities should put stress on setting up efficient communication between the state-designated board members and other members of the board, enabling the board to act as a whole in the best interest of the SOE. The SOEs should comply with standards of the Best Practices in Public Companies 2005 of the Warsaw Stock Exchange with respect to the appointment of independent supervisory board members. The MST and other ownership entities should consider reducing the number of civil servants serving as members of supervisory boards, and work to increase the number of independent supervisory board members from the private sector who bring special knowledge, contacts, and other benefits to the company.

THE GLOBAL CARBON PROJECT (GCP)

There is no better illustration of the challenges and necessity of global coordination on corporate governance matters than the problem of climate change and global warming. Companies can select favorable domiciles when it comes to tax codes and limiting liability, but there is nowhere to hide from the impact of greenhouse gases.

The Global Carbon Project was formed to assist the international science community to establish a common, mutually agreed knowledge base supporting policy debate and action to slow the rate of increase of greenhouse gases in the atmosphere.

The growing realization that anthropogenic climate change is a reality has focused the attention of the scientific community, policymakers, and the general public on the rising concentration of greenhouse gases, especially carbon dioxide (CO_2) in the atmosphere, and on the carbon cycle in general. Initial attempts, through the United Nations Framework Convention on Climate Change and its Kyoto Protocol, are under way to slow the rate of increase of greenhouse gases in the atmosphere.

These societal actions require a scientific understanding of the carbon cycle and are placing increasing demands on the international science community to establish a common, mutually agreed knowledge base to support policy debate and action.

The Global Carbon Project is responding to this challenge through a shared partnership between the International Geosphere–Biosphere Programme (IGBP), the International Human

Dimensions Programme on Global Environmental Change (IHDP), the World Climate Research Programme (WCRP), and Diversitas. This partnership constitutes the Earth Systems Science Partnership (ESSP).

The scientific goal of the Global Carbon Project is to develop a complete picture of the global carbon cycle, including both its biophysical and human dimensions together with the interactions and feedbacks between them. This will be:

- *Patterns and variability:* What are the current geographical and temporal distributions of the major pools and fluxes in the global carbon cycle?
- *Processes and interactions:* What are the control and feedback mechanisms – both anthropogenic and nonanthropogenic – that determine the dynamics of the carbon cycle?
- *Carbon management:* What are the dynamics of the carbon–climate–human system into the future and what points of intervention and windows of opportunity exist for human societies to manage this system?

A COMMON FRAMEWORK FOR SUSTAINABILITY REPORTING

The Global Reporting Initiative (GRI) has made vast progress in enlisting companies and institutions to report in a consistent manner on their impact on society.

Its vision is that reporting on economic, environmental, and social performance by all organizations should become as routine and comparable as financial reporting. GRI accomplishes this vision by developing, continually improving, and building capacity around the use of its *Sustainability Reporting Framework*. It describes itself as: "An international network of thousands from business, civil society, labor, and professional institutions to create the content of the Reporting Framework in a consensus-seeking process."

Trucost, an independent organization founded in 2000, is an environmental research organization working with companies, investors, and government agencies to understand the impacts companies have on the environment.

> *Information is being gathered. Institutions such as carbon exchange markets are evolving. We are not yet at a place where we can confidently predict the future in this direction. Substantial progress has been made in publicly identifying the environmental impact of the operations of most publicly traded companies. Sophisticated analysis has reduced this to 'public costs' and has enabled the analysis of investment portfolios from the perspective of their 'carbon footprint.' In other words, investors may now choose between one set of pooled securities and others in aid of investing their money in the most carbon friendly enterprises. Trucost LLC has done an analysis of a portfolio for Henderson.*
>
> *Over the past year, climate change has continued to rise in importance as a critical issue for investors. The reality of the physical impacts of climate change hit home with the unprecedented damage caused by the 2005 hurricane season in the Gulf of Mexico. Munich Re believes there are 'strong indications' that the increasing number*

of hurricanes each year is due to climate change, while the Lloyd's insurance market in London believes that 'if we do not take action now to understand the risks and their impact, the changing climate will kill us.'

Regulatory efforts to curb the emissions of greenhouse gases also intensified, with the establishment of the EU emissions trading scheme driving a global carbon market worth some $10 billion in 2005. Incentives to promote low carbon alternatives also broadened, notably through China's new renewables strategy, announced in November 2005, and the California solar initiative, bringing extra $2.9 billion in incentives in January 2006. Climate change presents a new generation of risks, opportunities, and responsibilities for investors. Henderson's Sustainable and Responsible Investment (SRI) funds have long placed climate change at the heart of their strategy, seeking out companies providing solutions to the problem – the Industries of the Future – as well as encouraging corporate best practice in carbon management.

Henderson also strongly supported initiatives such as the Carbon Disclosure Project and the Institutional Investors Group on Climate Change in order to raise awareness of the threat across financial markets as companies need to improve the quality and quantity of their reporting on climate change. It is also important for investors to become transparent about their own policies and practices. To this end, Henderson published the first carbon audit of an investment portfolio in June 2005, commissioning Trucost to compare the emissions associated with the Global Care Income fund with its benchmark, the FTSE All Share. Results showed that the fund was 32% less carbon intensive than the overall market, testimony to the environmental criteria that guide investments. This year we have repeated the exercise to understand how the fund's performance had evolved. Trucost calculated the carbon emissions (CO2e) associated with the fund's holdings and the wider index on 31 December 2005, making estimates where data was reported. These results were then normalized using the value of the fund and the index to produce a measure of carbon intensity.

2006 Results

Overall, the Global Care Income extended its out-performance compared with the benchmark, so that it is now 34% less carbon intensive by the FTSE All Share.

In absolute terms, the carbon associated with the stocks in the fund fell by 1%. The fund's relative carbon intensity – emissions per million pounds of investment – fell faster, declining by 7% to 554 tCO2e/£ million. Within the fund, some companies cut their emissions, such as BT and Pennon, while others increased their carbon output, such as Centrica and Scottish & Southern Energy. The fund's focus on high-yielding stocks gives it a high weighting in utilities, notably Scottish Power, Centrica, and Scottish & Southern Energy, which account for over 40% of the fund's carbon footprint. Turning to the wider stock market as measured by the FTSE All Share, absolute emissions rose by 5%, but its relative carbon intensity fell by 4%. This was largely due to the departure from the index of carbon-intensive companies – such as BPB, Exel, and P&O – and increased valuations for the oil and gas sector. By and large, new entrants to the index were 15% less intensive than those that exited the All Share. Portfolio companies had considerably higher levels of carbon disclosure than the index, with 52% reporting their emissions, compared with less than 20% for the FTSE All Share.

Looking ahead

Climate change is set to become even more of an imperative for investors in the years ahead, with increasing evidence of impacts and tightening curbs on carbon emissions. In addition, mergers, disposals and acquisitions already underway will further change the relative intensity of both the fund and the index. For example, Trucost estimates that Scottish Power's disposal of its largely coal-fired Pacificorp subsidiary in the USA could cut the intensity of the FTSE All Share by 3.9% and the fund intensity by 12%. Capital markets are also likely to face increasing pressures for transparency about their own carbon performance, and Henderson is committed to continuing the carbon audit process for its SRI funds.

- *Nick Robins, Head of SRI Funds: sri@henderson.com*
- *Munich Re, Hurricanes – More intense, more frequent, more expensive, February 2006*
- *Lloyd's, Climate Change – Adapt or Bust, June 2006*
- *World Bank/IETA, State and Trends of the Carbon Market 2006, May 2006*
- *Climate change – Improving transparency for investors*

Relative sector performance

... The portfolio's underweight positions in the Basic Materials and Oil & Gas sectors are making the largest positive contribution to the portfolio's carbon footprint, whereas the overweight position in utilities makes the biggest negative contribution to the footprint.

Background

This report summarizes the analysis of the carbon emissions associated with the Global Care Income fund managed by Henderson Global Investors. The greenhouse gas emissions for each holding in the portfolio have been calculated and converted to tonnes of carbon dioxide equivalent (tCO2e).

The direct emissions from each company are taken into account as well as the indirect emissions from the first tier of suppliers (e.g. from purchased electricity). Each holding's contribution to the emissions profile of the portfolio is then calculated on an equity ownership basis. The 'carbon footprint' of the fund is the sum of all of these contributions. The 'carbon intensity' of the portfolio is the carbon footprint normalized by its value.

This analysis has also been carried out on the portfolio's benchmark, the FTSE All Share, for the purposes of comparison. The carbon intensity of the portfolio is 34% lower than the benchmark. This means that on a weighted basis, the holdings of the portfolio are less carbon intensive than companies in the benchmark.

Overall Performance Portfolio FTSE All Share
Total Value (£m) 109 1,679,548
Carbon Footprint (tCO2e) 60,497 1,417,329,718
The Portfolio is 34% lower than benchmark taking the environment into account. Placing numbers and prices on environmental impact can be expected to inform the language of corporate responsibility in the future.
[Extract used with permission. Citations omitted.] ”

TOWARDS A COMMON LANGUAGE

At present, there is no common language of accountability for corporate functioning. Simon Thomas and others have suggested a new measure in *Integrated Environmental and Financial Performance Metrics for Investment Analysis and Portfolio Management* (vol. 15, no. 3, May 2007).

> “*Industries produce both salable outputs and undesirable residuals. Many companies generate and discharge enormous amounts of waste, much of which pollutes the natural environment and imposes damage costs on households and other enterprises. Economists call these damages ‘externalities’ because their costs typically fall not on the firms that discharge the wastes but on those that suffer the damages. Consequently, accounting systems don’t ascribe these costs to their source or even quantify them systematically . . . . The TRUEVA measure is useful to investment managers because it integrates a financial measure of a company’s environmental exposure with a superior measure of the company’s profitability. A company with profits that exceeds its environmental exposure by a large margin is a less risky investment, other things being equal.*

As of this date, there continue to be the most profound differences in the language and practice of accounting. The same accounting firm will issue financial reports in different countries that appear to be consistent but in reality are based on different rules and assumptions. For example, two countries, closely linked by history, custom, language, and ethnic background, the United States and the United Kingdom, have completely different accounting standards.

> “*Under British company law, the purpose and the authority in financial reporting matters stems from the same source, namely the shareholder base and their corporate objectives . . . . Under the British governance and reporting model, the end customer and the enforcement mechanism is the body of shareholders. There is a unity of purpose, authority and enforcement.*
>
> *The US reporting, enforcement and governance regimes are handled in a way the British regime is not. The US federal law created the 1933 Act as the purpose for financial reporting, and the Securities and Exchange Commission (SEC) was set up under the 1934 Act as the regulatory enforcement agency for financial reporting matters. At the same time, privacy and relevance are divided between two different jurisdictions. Governance of company behaviour is wholly a state matter and because of weak rights of shareholders in certain US states, shareholders most often have few enforceable rights.*
>
> *As the US reporting model is focused largely on market pricing tests, this can lead to a confusion of financial reporting objectives in addition to the paradox referred to above.*
>
> *Accounting for things that have taken place and valuation, which is predominantly forward-looking, were recognized as different prior to 1933.*[13] ”

This is compounded by inconsistency in transparency requirements under law. It is impossible to compare, for example, CEO remuneration across borders because the data are not publicly

available. All of these systems are based on notions that are in many cases more suitable to eighteenth and nineteenth century business models and notions of what constitutes an asset than twenty-first century companies, whose primary assets are often human capital and intellectual property. After all, what investors want from financial reports is not so much what the company has but how sustainable its business model is.

The prospects for a unified system of accounting language even in Europe and the United States seem unpromising.

> *ICAEW – the Institute of Chartered Accountants in England and Wales. (January 2007) Emerging Issues*
>
> *How differences between US and UK securities markets create pressures and point to opportunities for international policy, investment, business and accounting.*
>
> 17. *International Financial Reporting Standards convergence*
>
> *Is complete convergence between US GAAP and IFRS possible or will US standards always need to be different to reflect the US legal environment? In recent years the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) have been coordinating their work programmes. Their aim is to eliminate differences between International Financial Reporting Standards (IFRS) and US GAAP to such an extent that the SEC would no longer require foreign registrants to prepare a reconciliation from IFRS to US GAAP. Whilst there has been broad support for this convergence programme, many people see mutual recognition of two systems with shared principles but different amounts of detail as a more practical outcome than full convergence. This is in large part due to the view that US standards will always need to be different to reflect the US legal environment. However, there must be some doubt about the sustainability of such a practical outcome and the following reasons for this are set out as issues for discussion:*
>
> 17.1 *It may not be possible to establish common principles for IFRS and US GAAP. The recent publication of the first two draft chapters of a common IASB and FASB conceptual framework has highlighted major differences of opinion between US and UK standard setters and commentators about the objectives of financial reporting which are rooted in differences in corporate governance systems. Whilst in a US context, financial statements are required by securities legislation purely to enable market participants to make buy, sell or hold decisions, UK company law also requires directors to prepare accounts for shareholders because they are accountable to shareholders for their stewardship of company assets. It remains to be seen whether this disagreement will have any practical impact on convergence between IFRS and US GAAP.*
>
> 17.2 *The quest for consistent application of IFRS could become a Trojan Horse for more rules. The intention of work to encourage consistent application is sensible. However, securities regulators and other users of financial information must recognise that absolute consistency is not compatible with principle-based standards. If efforts focus on financial reporting outputs, such as whether*

companies have applied a particular standard in a uniform manner, then they risk creating more rules. To maintain the principle-based nature of IFRS, regulators should focus on 'inputs' to financial reporting such as the way preparers approach the determination of accounting policies, selecting appropriate accounting bases, staff training and development, and methods of dispute resolution. The initial signs are not encouraging. In enforcing compliance with IFRS as it sees it, the SEC is in danger of adding rules and interpretations to the IFRS literature that companies and auditors will feel compelled to consult when applying IFRS. As a result IFRS could be absorbed into US GAAP. ”

VISION

Corporate activity will only achieve the goal of sustainable wealth maximization if doing so is compatible with long-term policy goals like a healthy environment and a strong economy. One outstanding effort to make this explicit is the King Report:

“ *THE KING REPORT ON CORPORATE GOVERNANCE FOR SOUTH AFRICA – 2002*
P17/18

38. Governance in any context reflects the value system of the society in which it operates. Accordingly, it would be pertinent to observe and to take account of the African worldview and culture in the context of governance of companies in South Africa, some aspects of which are set out as follows:

- *38.1 – Spiritual Collectiveness is prized over individualism. This determines the communal nature of life, where households live as an interdependent neighborhood.*
- *38.2 – An inclination towards consensus rather than dissension helps to explain the loyalty of Africans to their leadership.*
- *38.3 – Humility and helpfulness to others is more important than criticism of them.*
- *38.4 – In the main, African culture is non-discriminatory and does not promote prejudice. This explains the readiness with which Africans embrace reconciliation at political and business levels.*
- *38.5 – Co-existence with other people is highly valued. The essence of ubuntu (humanity) that cuts across Africa is based on the premise that you can be respected only because of your cordial co-existence with others.*
- *38.6 – There is an inherent trust and belief in fairness of all human beings. This manifests itself in the predisposition towards universal brotherhood, even shared by African-Americans.*
- *38.7 – High standards of morality are based on historical precedent. These are bolstered by the close kinship observed through totem or clan names and the extended family system.*

38.8 – An hierarchical political ideology is based on an inclusive system of consultation at various levels. The tradition of consultation as practiced by the chiefs since time immemorial should form the basis of modern labor relations and people management practices.

38.9 – Perpetual optimism is due to strong belief in the existence of an omniscient, omnipotent, and omnipresent superior being in the form of the creator of mankind. ”

SUMMARY AND DISCUSSION QUESTIONS

History has taught us that governments, cultures, and economies have cycles and that, "American exceptionalism" notwithstanding, there are no guarantees that any superpower will stay that way. It is therefore worth examining the range of approaches to corporate governance as indicators of future flows of capital.

On a global scale, conflicts occur as corporate interests and political interests try to control one another. Corporations rely on sovereign countries for permission to operate and for protection from liability and competition. Political regimes rely on corporations for money, job creation, and the contributions they make to a stable economy and community. At its best, this works symbiotically. At its worst, it can be a death spiral. Labor and capital are now redirected more easily than ever before in history and there is a risk of a "race to the bottom" that reflects a global collective choice problem.

“ *How does the government of an impoverished country weigh the short-term benefits of jobs and money against the costs that may be externalized?* ”

The twenty-first century edition of the global corporation varies substantially from its predecessors. When we think of authority over our responsibility for impact, we have tended to think of corporations in terms of their nationality – where are they legally domiciled, where are their principal operations, from whence do they derive profit, and where are their headquarters located? This characterization may be useful in considering corporations that are largely owned or controlled by the state, but it is inadequate in the context of the publicly traded enterprise with global operations. Examining one or more major international conglomerates indicates which jurisdictions have what kinds of authority over them.

“ *What do we learn from the problems of the Yuzhno-Sakhalinsk case study? Is there a way to protect both the interests of outside investors like Royal Dutch Shell and the local community?*

Examine the Embraer case study. How transferable are these approaches to other cultures and legal systems? ”

We note that there are global differences not just in the cultural and legal systems affecting management and directors, but also among investors. It is worth achieving a thorough understanding of the Norwegian Government Pension Fund. This fund can achieve its objectives only if the marketplace can be a reliable investment in perpetuity, providing sustainable equity returns at historic levels. It thus has the incentive – indeed it has no other choice – to be involved in assuring the continuing quality of the marketplace as a whole. The government, the Norges Bank, and a skilled cadre of managers have begun the difficult process of trying to combine wealth maximization with sensitivity to the ethical consequences of certain investments and has established an Ethical Council to make recommendations about companies whose activities "constitute an unacceptable risk to the Fund."

What factors should go into the decision to divest? What are the alternatives for achieving the goals?

Research has demonstrated that the design of a country's corporate governance system is of utmost economic importance for the macro-economy. A particularly vivid illustration of this importance are the events that followed in the wake of the Asian currency crisis in 1997, and which led to a sharp decline in many countries' stock markets. Countries with poor corporate governance systems experienced the largest stock market declines. In many of those countries, outside investors' rights were routinely expropriated by strong corporate insiders.

Are there indispensable elements of a workable corporate governance system that should be the foundation of every country's approach? A World Bank report said that every system should include three elements: independence, accountability, and transparency. What is the best way to ensure that these three goals are met? What elements of the systems described in this chapter are particularly effective or appealing? What should be required by law and what should be left to individual companies to determine and give investors a choice?

Most of the public policy focus and energy, especially in emerging economies, is on the "supply side" of corporate governance – what managers and directors must do. However, it is just as important to make sure that the "demand side" is set up with the authority, ability, and incentives aligned to enable effective oversight and market response. Financial accounting standards and open disclosures on climate change also deserve particular attention.

What is the impact of different accounting approaches and standards in different countries and what are the incentives for convergence?
What kinds of disclosures should investors expect – and insist on – to help them understand the impact of portfolio companies on climate change, including upside (savings from green operations, strategies to benefit from increased spending on alternative energy sources) and downside (litigation and liability risk management)?

NOTES

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5. Tom Bergin, "Greens Praise EBRD Stance Over Sakhalin," *St. Petersburg Times*, Jan. 16, 2007.
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9. Richard McGregor, Commentary, *Financial Times*, July 25, 2006.
10. Sundeep Tucker, "Ying Fang: A Former Communist Insider Is Using Skills Learned under Mao Zedong to Help Chinese Companies List in London," *Financial Times*, July 31, 2006.
11. Seki Takaya, "Towards the Establishment of a New Shareholder - Corporate Relationship in Japan," J-IRIS Research, Japan Investor Relations and Investor Support, Inc., October 29, 2003.
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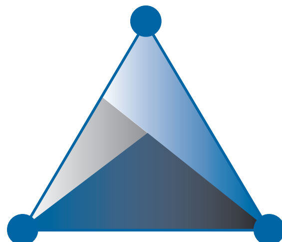
6
AFTERWORD: FINAL THOUGHTS AND FUTURE DIRECTIONS



CONTENTS

- Beyond the Nation State 477
- Government as Shareholder: The Institutional Investor as Proxy for the Public Interest 484

> What is wrong with the British and American system is that far too many shareholders, both institutional and individual, do not behave like owners.
>
> *Rupert Pennant-Rea, 1990*

What progress, if any, has there been since this diagnosis described in *The Economist* twenty years ago?

The Treasury committee investigating the financial meltdown for the UK seemed to think Pennant-Rea was still right.

> *Institutional Investors have failed in one of their core tasks, namely the effective scrutiny and monitoring the decisions of boards and executive management in the banking sector, and hold them accountable for their performance.*[1]

So does the UN.

> *We also believe that one of the most important lessons from the crisis is that institutional investors responsible ownership needs to be strengthened in order to be fit for purpose.*[2]

And so does Nobel Prize-winning economist Joseph Stiglitz:

> *So basically we have a system in which the corporate executives, the CEOs, are trying to make sure the legal system works not for the companies, not for the shareholders, not for the bondholders – but for themselves. So it's like theft. These corporations are basically now working for the CEOs and the executives and not for any of the other stakeholders in the corporation, let alone for our broader society.*[3]

What is our best hope for addressing this imbalance?

The fundamental premise of most of the world's developed economies is that capitalism is the best way to ensure a stable, productive, competitive society. The fundamental premise of the capitalist system is that a system of market-based accountability, enforced by law, provides legitimacy for the exercise of private allocation of outside funds and other decisions that affect the community, including employees, customers, suppliers, and neighbors. This was accomplished through application of the fiduciary standard to those in the key positions – board members and top executives and institutional investors, acting as intermediaries. However, as discussed throughout this book, the balance and oversight that was supposed to ensure the credibility of the system has been difficult to maintain due to complexity that creates conflicts of interest at all levels, including the government that is supposed to be the backstop.

We have seen what failure to maintain this balance can produce. The question is whether we can find some way to realign the incentives. As long as board members are primarily selected,

compensated, and informed by management we cannot expect more than incremental improvement. As long as corporations are able to evade or redirect legal restrictions, the most likely avenue for change will come from shareholders (some of themselves government entities) who increasingly see governance as an element of risk management.

BEYOND THE NATION STATE

Corporations are the creatures of the state. Their existence, their accountability, their scope, and their authority are all determined by law, though as we have shown they can influence and even direct government as well. In recent times, particularly since the end of World War II, multinational, perhaps more accurately described as extra-national, corporate operations across the globe have become the norm. The ties – physical facilities, headquarters, jobs, earnings, products, sales – that once linked a particular company to a particular domicile have been diluted. The notion, for example, that Exxon Mobil with only 31 percent of its sales in the US is exclusively an American corporation is as meaningless as the conclusion that British law governs the Gulf Oil spill by British Petroleum.

Problems of legal enforcement persist due to the growth of the modern corporation beyond the physical limits of its chartering nation state. Following the pattern of American corporations "racing to the bottom" to incorporate in states where management favorable conditions prevail, multinational companies flee to what may be styled "flags of convenience" countries. The location of physical facilities, for example, has no relationship to the company's place of incorporation and location of its board and executives in the UK, which in turn may not coincide with the residence of the company's registered owners. Halliburton, with its corporate headquarters in Texas and its one-time CEO leaving to become Vice President of the United States, moved its legal domicile to Dubai.

If we no longer can rely on a meaningful link between corporate operations and a source of governing law and enforcement, what standards exist for the global functioning of the modern corporation?

There is also less and less of a connection between the domicile of the investors and the domicile of the portfolio company. The largest investor in the world may shortly be the Sovereign Wealth Funds (SWF), central bank reserves that accumulate as a result of budget and trade surpluses, and revenue generated from the exports of natural resources, invested on behalf of the entire population. They are currently valued at $2.5 trillion. With the greatest accumulation of investable securities in the US, that means that US-domiciled companies will have significant investment coming from the SWFs of the United Arab Emirates and Norway.

How will the incentives and conflicts be different with this investor category?

The ability of global corporations to arbitrage legal systems is perhaps most sharply felt when it comes to determining liability and enforcing judgment. The US federal courts – particularly in the Southern District of New York – will grant jurisdiction for claims arising out of violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 concerning the issuance and trading of securities. This makes it an attractive forum for non-US claimants as non-US corporations in need of the access to capital and liquidity of the US trading markets subject themselves to the substantive American laws governing underwriting and selling securities. In June 2010, however, the

United States Supreme Court made it clear that US courts could not be availed of by non-American citizens buying shares on markets outside the United States in companies domiciled elsewhere.[4] This reversed four decades of lower-court case law that permitted claims of non-US investors against non-US issuers to recover losses from purchases on non-US securities exchanges. Perhaps this ruling will inspire the development of a single binding international law of Corporate Governance or even a "comply or explain" set of best practices. Several multinational organizations, ranging from the European Commission (the "EC"), the Organization for Economic Co-operation and Development ("OECD"), the Basel Committee, to the International Corporate Governance Network, have promulgated codes of optimal behavior with the aspiration that individual countries will be usefully guided, but these are not binding and far from universally adopted.

For example, the EC has sponsored debate on several aspects of corporate governance, including discussion of adopting "one share one vote" as a general policy. After strenuous negotiation the proposal was withdrawn. The EC has recently summarized the governance failures apparent in the financial crisis in terms that make clear the difference between aspirational codes and legally enforceable provisions. Several theories have been put forward to explain this situation:

> *— The existing principles are too broad in scope and are not sufficiently precise. As a result, they gave financial institutions too much scope for interpretation. Furthermore, they proved difficult to put into practice, in most cases leading to a purely formal application (i.e. a box-ticking exercise), with no real qualitative assessment.*
> *— The lack of a clear allocation of roles and responsibilities with regard to implementing the principles, within both the financial institution and the supervisory authority.*
> *— The nonbinding nature of corporate enterprise principles: the fact there was no legal obligation to comply with recommendations by international organizations or the provisions of a corporate governance code, the problem of the neglect of corporate governance by supervisory authorities, the weakness of relevant checks, and the absence of deter penalties all contributed to the lack of effective implementation by financial institutions of corporate governance principles.*[5]

The "green paper" starkly calls into question the viability of a corporate governance model based on accountability to shareholders – and the risk of failure to do so.

> *The financial crisis has shown that confidence in the model of the shareholder-owner who contributes to the company's long-term viability has been severely shaken, to say the least.... Several factors can help to explain the disinterest or passivity of shareholders with regard to their financial institutions:*
> - *certain profitability models, based on possession of portfolios of different shares, lead to the abstraction, or even disappearance, of the concept of ownership normally associated with holding shares.*
> - *the costs which institutional investors would face if they wanted to actively engage in governance of the financial institution can dissuade them, particularly if their participation is minimal.*
> - *Conflicts of interest.*

The lack of effective rights allowing shareholders to exercise control (such as, for example, the lack of voting rights on director remuneration in certain jurisdictions), the maintenance of certain obstacles to the exercise of cross-border voting rights, uncertainty over certain legal concepts (for example that of "acting in concert") and financial institutions' disclosure to shareholders of information which is too complicated and unreadable, in particular with regard to risk, could all play a part, to varying degrees, in dissuading investors from playing an active role in the financial institutions in which they have invested.[6] ”

While there is not much support for worldwide policies on governance, there is support for some limited requirements considered necessary to establish a credible and sustainable capital market. In September 2010 the Basel Committee released its much-anticipated new minimum capital requirements rules for banks. Yet unless it is adopted by the G20, which in practice requires the support of the banking community it is suppose to control, it may end in limbo like some of the provisions of its predecessor. This is the conundrum of even the most important and carefully articulated multinational accords – the lack of enforceability.

If corporations are able to avoid or subvert accountability through law, it will have to come from the market. It may be that as government controls are getting weaker, the opportunities for shareholder control are getting stronger. At least, there are some promising indicators along those lines. There are some groups and associations working on coordination of efforts.

The UK's Institutional Shareholders Committee (ISC) is a forum for the UK's institutional shareholding community to exchange views "and, on occasion, coordinate their activities in support of the interests of UK investors." Its constituent members are: The Association of British Insurers (ABI), the Association of Investment Companies (AIC), the Investment Management Association (IMA), and the National Association of Pension Funds (NAPF). Its reluctance to coordinate systemic engagement is evident in its use of the term "on occasion." While there have been instances in the past of ISC activity focused on particular companies and there have been leaders – Mike Sandland of Norwich Union and Donald Bryden at Barclay's days – overall it has been rare that the ISC has committed substantial time or resources to governance challenges.

The institutional investor members of the International Corporate Governance Network ("ICGN") represent over $10 trillion in assets. The ICGN has described the role of shareholders as a question of the responsibility of the fiduciaries, not as conventionally described as a right. It addresses the problems raised by the EC as to the feasibility of a governance system based on effective ownership involvement and has recently published a code of best practices,[7] but again, this is not binding on its members (it is a "network," not even an "association"), much less their portfolio companies.

“ *3.2 Four main elements apply to the internal governance of those involved in the investment chain if this fundamental principle is to be met:*

i Oversight

Arrangements for oversight of agents should be such that decisions taken at every stage along the investment chain reflect the interest of their ultimate beneficiaries. Governing bodies should have a structure and constitution, which reflects this and should be

disclosed to beneficiaries. They should have mechanisms in place to receive feedback from beneficiaries and respond to their concerns. Governing bodies, and where relevant, individuals in a fiduciary position of responsibility for ultimate investors, such as pension fund trustees and representative boards, should be aware of their primary oversight role. They should be clear about the objectives of their beneficiaries, communicate them to portfolio managers and other agents employed and ensure they are being met. They should make clear which, if any, public or regulatory authorities have responsibility to monitor and enforce their fiduciary functioning.

The way in which individuals are appointed to serve on the governing body should be disclosed as well as the criteria that are applied to such appointments. Such criteria should always take account of the need for expertise and understanding of the matters for which the governing body is responsible . . . .

ii Transparency and accountability
This requires regular disclosure to ultimate beneficiaries about material aspects of governance and organisation. Governing bodies should develop clear standards with regard to governance of investee companies and its link to the investment process through its impact on value, and for voting of shares and related issues like stock lending. The standards should inform their selection of portfolio managers and other agents . . . .

iii Conflicts of interest
Conflicts of interest will inevitably arise from time to time. It is of paramount importance that these are recognised and addressed by governing bodies and other agents in the chain, if the overarching principle of safeguarding the interest of beneficiaries is to be respected . . . .

iv Expertise
Decision makers along all parts of the investment chain should be appropriately resourced and meet relevant standards of experience and skill in matters subject to deliberation. ”

With even large institutions as well as individual investors, conflicts of interest and the collective action problem are daunting. Economists speak of "rational apathy." Warren Buffett said, "when we own stock, we are not there to try and change people,"[8] but this most rational of investors will do so when necessary – when the costs of failing to step in exceed those of doing so. Buffett "rescued" Salomon Brothers as a minority owner. While he protected his own holdings (and those of his own investors), the overall impact of his effort was to make money for people whose conduct caused the problem in the first place.

In general, there are two categories of potential long-term shareholders who should, in theory, have an incentive to be more engaged – the unthinking index and computer shareholders and the activist portion of McKinsey's "intrinsic" holders. They have very different characteristics. The index funds are in competition with active managers for the portion of investors funds allocated to equity. One of the principal competitive advantages they have is lower costs. If the index funds are to be an element in the activist shareholder of the future, some economic arrangement will be necessary in order not to prejudice their competitive posture. Their perspective will inevitably be systemic. As discussed in chapter 2, the conflicts of interest faced by institutional investors, whether financial firms hoping to do business with portfolio companies or endowments hoping for contributions or the largest category of institutional money, the ERISA funds managed by the companies themselves,

there are powerful inhibitors to action and, even more important, no direct adverse consequences for failing to act. Absent oversight from long-term major investors leaves the default relying on short-term activists – raiders, arbitrageurs, "locusts," hedge funds – for market corrections. Their business model rewards thrusts into the marketplace. They often appropriate disproportionate returns for themselves and when they fail they leave behind unjustly enriched and entrenched managers.

Alan Greenspan spoke for the then-conventional wisdom in 2002: "After considerable soul-searching and many congressional hearings, the current CEO-dominant paradigm, with all its faults, will likely continue to be viewed as the most viable form of corporate governance for today's world. The only credible alternative is for large – primarily institutional – shareholders to exert far more control over corporate affairs *than they appear to be willing to exercise*."[9] He never considers the issue of fiduciary responsibility, understandable because that obligation is never enforced. Therefore, activist fiduciaries would be perceived as "volunteers," almost "officious intermeddlers," if they depart from the conventional. Yet Greenspan, however inferentially, confirmed the right place to begin.

David A. Moss of Harvard Business School developed a chart that ties deregulation of financial institutions to income disparity, showing the consequences of the Greenspan model (see figure 6.1).

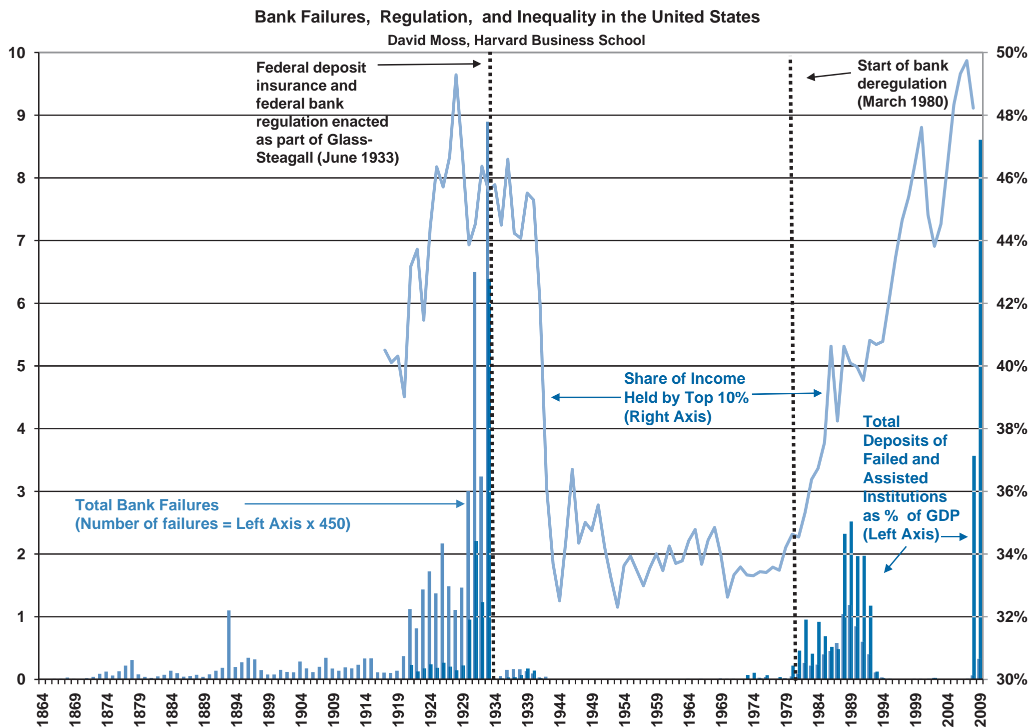


Figure 6.1 Bank failures, regulation and inequality in the United States. Reprinted with the permission of David A. Moss of Harvard Business School, who created this chart with the assistance of Darin Christensen and Arthur Kimball-Stanley. The original chart (with commentary) is available at http://www.tobinproject.org/conference_economic/papers/BankFailures_ChartwithComments_Moss.pdf.

The core problem has been the disappearance of any practical or legal meaning for the fiduciary standards that ensure a beneficiary of the loyal competence of the person responsible for managing his property. We have tolerated conflicts of interest throughout the commercial system with the result of enriching service providers and impoverishing beneficiaries. In theory, both boards of directors and those who manage portfolio investments for others are subject to the strictest standard of responsibility of our legal system. In reality, as a matter of law and practice, both are not much more than vestigial. Worse, this regulatory neglect has placed the rare conscientious fiduciary at a competitive disadvantage. In the case of the 2008 financial meltdown, for example, some of the largest investors in the companies at most risk for subprime exposure were money management divisions of those same companies. In this case, "too big to fail" meant "too big to succeed," as the very size and complexity and inherent conflicts of the big Wall Street financial institutions made it impossible to sustain the kind of vigorous market-based or fiduciary-based oversight that is the essential foundation for a free market.

The term "active management" means stock-picking, not strategic deployment of shareholder rights like proxy voting, lawsuits, and proxy contests. That form of "activism" is not generally attractive, either from the perspective of value adding incentive or of avoiding discipline or fine for fiduciary failure.[10] Simply, the "carrot" has not been sufficient inducement and the "stick" has not been sufficiently daunting. The result is that, with a few honorable exceptions – TIAA/CREF in America, BTPS and Hermes in the UK – activism has been limited to union and public employee pension funds. As discussed in chapter 2, they have their own conflicts of interest and other impediments; even if they did not, they cannot do it alone.

Only government can definitively impose and enforce the responsibilities of shareholders – shares loaned, shares sold short, shares whose vote is contracted away from the economic beneficiary. Government is itself a shareholder as with GM in the US and the UK's entity to manage its investment in the bailout financial institutions, UKFI. As a matter of public policy – that category of decision that cannot be left to the market – government, whether by law or judicial decisions, must be the one to place responsibility for stewardship on one of the parties in the fiduciary chain.

The same issue of legislative gaps and gaming arises in this context. The UK can promulgate rules for its own institutions but it cannot bind institutions domiciled. As the Walker report duly notes, a voting regime can only be imposed on UK domiciled funds. "The aim is to embed commitment to the Principles of stewardship (on a 'comply or explain' basis) on the part of UK-authorized entities and thereafter to encourage voluntary participation by SWFs and other non-resident investors on the basis that this is likely to be in their own interest and in that of their clients as ultimate beneficiaries."[11]

The threshold question must be whether we feel stewardship objectives can be achieved within the current framework of "comply or explain" or whether significant alterations will need to be made to the incentives and penalties governing the ongoing system. There are such a myriad of conflicting considerations that a new transcending and binding resolution has appeal. We have to deal with real problems. How is our hypothetical honorable chief executive going to reconcile stewardship with his customers' reasonable expectations if there is not unequivocal requirement that his competitors comply with the same requirements? How are we going to induce those institutional categories, strangling in conflict of interest, without legal insistence that they act as stewards solely in the interest of their beneficiaries? Is it fair to impose a burden of additional expense on "stewards" without making possible a reallocation of rewards?

> *Unfortunately, Walker's proposals lack teeth and risk becoming nebulous when economic health returns and investors must look to prevent the next crisis, not cast an eye over*

their shoulder at the last. What will they really achieve in seriously promoting long term investment? Where is the 'incentive' for the ultimate shareholders – the institutional investors – to become owners with their eyes fixed firmly on durable returns and their service providers clearly aligned in this direction also? (n.b. Fund manager votes against corporate management remain pitifully low).[12] ”

One of the authors of this book co-authored a paper with Allen Sykes[13] that included four comprehensive proposals for effective stewardship:

- Governments should affirm, in support of the fundamental principle that there should be no power without accountability, that creating an effective shareholder presence in all companies is in the national interest and that it is the nation's policy to aid effective shareholder involvement in the governance of publicly owned corporations. A national level Council should be created so as to ensure authorities, stock exchanges and other similarly involved entities.
- All pension fund trustees and other fiduciaries (insurance companies, mutual funds) holding shares must act solely in the long-term interests of their beneficiaries and for the exclusive purpose of providing them with benefits. The scope of required shareholder activism is to ensure, on a continuous basis, the functioning of an appropriate board of directors.
- To give full effect to the first two proposals institutional shareholders should be made accountable for exercising their votes in an informed and sensible manner above some sensibly determined minimum holding ($15m/£10m). Votes are an asset (voting shares always have a market premium over nonvoting ones). Accordingly they should be used to further beneficiaries' interests on all occasions. In effect, the voting of all institutionally held shares would be virtually compulsory.
- To complete and powerfully reinforce the other three proposals shareholders should have the exclusive right and obligation *to nominate* at least three nonexecutive directors per major quoted company.

"Comply or explain" is a step in the right direction because it forces shareholders to be more explicit in explaining their policies and actions and gives beneficiaries more transparency on which to base their own decisions. Instead of a prescriptive, one-size-fits-all rule, "comply or explain" creates opportunities for creativity and competition. However, more will be necessary, including new carrots and sticks – or, to put it another way, removal of the subsidy for inaction that exists in the current system. The stick would be an effective enforcement of existing law to require fiduciaries to take appropriate action to protect and enhance the value of portfolio securities. The carrot would be financing "activism" either as an appropriate corporate expense or as a designated portion of the investment management fees.

One option can be the creation of two classes of stock to distinguish between active and passive investors. When Warren Buffett invests in marketable securities, he is usually able to secure a special classification that reflects the value added by his involvement. The dual class prevalent in Scandinavia has not lowered long-term equity returns. Even American scholars comment favorably on such a notion: "Providing long-term shareholders a greater number of votes per share should become a permissible option."[14] The suggestion of time-increase of voting rights (for example, a share of stock would go from one vote to ten if held for more than five years) is also worth considering, as is a capital structure that over time turns the enterprise into one that is fully employee-owned.

Another option is recognition that stewardship in the interest both of the corporation and of society is appropriately an expense of the corporation. If a sum is to be made available for those willing to undertake the costs and exposure of stewardship, there would be an adequate incentive for index funds to perform the key long-term role.

The governance infrastructure varies from country to country. Cost effectiveness for shareholder activism requires that relevant information be required to be made public; that there are in place mechanisms for the enforcement of violations of the obligation of those in power to minority investors; and that the cost of remedies be affordable (or, to put it another way, that they be sufficiently cost/effective that their exercise does not constitute "waste" by trustee owners). The modern practice is based on the absence of all three of these "conditions" in any country. Shareholder activism can only be based on the entrepreneurial initiative of those who have already decided that they want and can afford to be activist. Only 20 percent of shareholdings belong to holders capable and willing of forming intent to be activist.[15] Of this 20 percent, a substantial fraction has chosen to be passive without regard to fiduciary obligation.

The political reality is that no country will tolerate "shareholder activism" if there is anxiety about the stability of political power. The saga of the oligarchs in Russia is a condensed history of semi-violent changes of political and economic power.

GOVERNMENT AS SHAREHOLDER: THE INSTITUTIONAL INVESTOR AS PROXY FOR THE PUBLIC INTEREST

Among public and private institutions in the corporate constellation, only the fiduciary shareholder, especially the pension fund, has interests congruent with the modern corporation. By definition, they are long-term investors and, by definition, they want sustainable growth from companies that provide useful goods and services and good jobs at good wages. Pension funds and corporations have the same scope and ultimate objectives – the optimization of long-term value. These vehicles of pooled savings – largely the funded retirement and savings schemes of the US, UK, Canada, Australia, Scandinavia, the Netherlands, and Japan – are important, and they are increasingly controlling owners of publicly traded enterprises throughout the world. Like the corporations in which they invest, these ownership groups can transcend national regulation.

As discussed in the previous chapters, majority stock ownership is managed by fiduciaries and the exercise of ownership rights has been compromised by conflicts of interest and the collective choice problem. While, in theory, these funds are directed by fiduciaries whose sole obligation is to the beneficial owners, the trustees are most often conglomerate financial service institutions with many important commercial relationships with those companies whose shares are held in their trust departments. Public and private entities have failed to enforce the legal obligation of the trustees to act as owner of portfolio companies "for the exclusive benefit" of plan participants; the result has been the neutering of a substantial portion of the ownership spectrum.

The Nathan Cummings Foundation is one of the few institutional investors that takes a holistic approach, managing its grants and the ownership rights attached to its portfolio in support of the same principles. It explicitly ties its investment decisions, including proxy voting and shareholder proposals, to the investment risk of poor long-term corporate strategy, including perverse

incentive compensation and bad management of climate change. Director Lance E. Lindblom wrote:

> *Each year, American foundations give away billions of dollars to address social and environmental issues. This number, though substantial, is dwarfed by the amount of assets that remain invested in foundations' endowments. Few foundations, however, recognize the vast funds in their investment portfolios as anything other than a source of income to fund grants and operating expenses. This is unfortunate because, as the Nathan Cummings Foundation (NCF) and some of its forward-thinking peers have shown, the funds in a foundation's investment portfolio can in fact be leveraged to address numerous social and environmental issues while preserving or even enhancing the long-term value of the portfolio.*
>
> *Over the last eight years, NCF has successfully pursued active ownership strategies including proxy voting, resolution filing and other forms of corporate engagement. Because its approach is based on active ownership, the Foundation has been able to avoid one of the major obstacles facing more traditional approaches to socially responsible investing; the fear that returns may be sacrificed for the benefit of some abstract conception of the greater good. In fact, all of NCF's shareholder activities, and indeed the majority of the most successful shareholder campaigns out there, are premised on the idea that addressing the issue in question will actually serve to protect or even enhance shareholder value over the longer-term.*
>
> *A prime example of this is NCF's work on climate change. In addition to being a major focus of the Foundation's Ecological Innovation program, climate change is an investment issue with significant and well-recognized implications for long-term shareholder value.... Another example of an issue with both ties to NCF's programmatic objectives – in this case its crosscutting focus on social and economic justice – and implications for long-term shareholder value is executive compensation.*[16]

There are initiatives like the 2010 climate change statement from 259 investors from North America, Europe, Asia, Australia, Latin America, and Africa with collective assets totaling more than $15 trillion – more than one-quarter of global capitalization. Signatories included Allianz, HSBC, APG, and a dozen US public pension funds and state treasurers. The statement cited potential climate-related GDP losses of up to 20 percent by 2050 and the economic benefits of shifting to low-carbon and resource-efficient economies. The accompanying release explicitly recognized that investors could have more power to address the issue than governments. Similarly, the UN has undertaken an in-depth multijurisdictional project investigating the role of corporate and securities law and human rights, with the understanding that corporations and governments must both be involved to make sure that human rights are protected throughout the world.[17] The Social Investment Forum's 2010 Trends Report found that sustainable and responsible investment (SRI) assets in the US now stand at $3.07 trillion, and have a market share over 12 percent. Assets under some form of SRI management grew 13 percent over the last three years of market uncertainty, far outpacing the 1 percent growth in the broader universe of professionally managed assets. The SRI asset categories included issues relating to Sudan and tobacco and governance. The report showed some $350 billion in assets under management subject to governance-related analysis,

which typically leads to engagement. At the 2010 Trade Union Conference, general secretary Brendan Barber, the general secretary of the TUC, told the group: "Amid this great uncertainty, there has never been more need for stronger stewardship, for trustees and investors to use their collective clout to facilitate real change in the way companies are run and the way they behave. That's not only the best way of safeguarding pensions and delivering sustainable returns for the long term, it is also essential [to] avoid a repeat of the financial turmoil of the past few years." At the same meeting, Alan MacDougall, founder and managing director of the Pensions Investment Research Consultants (PIRC) said, "Stewardship means handing something on to successors in better shape than you inherited it through the active and responsible management of entrusted resources, taking account of the interests of stakeholders now and in the longer term. Now, I don't know about you guys, but I wouldn't use that as the definition of what most asset managers are doing with your money today."[18]

The appearance of fiduciary ownership promises a world of responsible accountability that may be possible. We will conclude with a statement on this subject from Supreme Court justice Harlan Fiske Stone in a 1934 essay in the Harvard Law Review:

> *When the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that 'a man cannot serve two masters' . . . yet those who serve nominally as . . . trustees but relieved by clever legal devices, from the obligation to protect those whose interests they purport to represent . . . corporate officers and directors who award to themselves huge bonuses from corporate funds without the assent or even knowledge of their stockholders . . . the loss and suffering inflicted on individuals, the harm done to the social order founded upon a business base and dependent upon its integrity are incalculable.*

As we approach the 100th anniversary of those words, perhaps we are ready to learn their lesson.

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6. Ibid., at p. 8.
7. ICGN Statement of Principles on Institutional Shareholder Responsibilities, as approved by the ICGN members at the 2007 AGM in Cape Town, South Africa.
8. Global Edition of the *New York Times*, May 9-10, 2009.
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INDEX

A. H. Robins 25, 91
A&P 230
Abercrombie & Fitch 196
accelerated vesting of stock options 374, 383
accountability 12–14, 16–17, 51, 54, 128
  boards of directors 304, 324–30
  BP 450
  CEOs 354
  corporate democracy 140–1
  corporate structure 410
  diffused 31
  dual board system 409
  employees 395
  ICGN Principles 373, 480
  international governance 435, 457
  lack of 125
  management 129, 135
  market-based 476
  pension funds 163, 164
  political 50, 82–3
  of shareholders 141–3
  standards 82, 83
  trustees 229
  World Bank goals 93, 472
  see also liability; responsibility
accounting 48–9, 62–79
  common language for 468–70
  double-entry bookkeeping 107–8
  GAAP 47, 62, 65–6, 71, 73, 79, 84, 280, 469–70
  international differences 426
  pension funds 157–8, 204
  perverse incentives 79
  Sarbanes-Oxley Act 392–3
  social 86, 87
  stock options 66–9, 377–8
  Thailand 461
  see also audit committees
Ackerman, Josef 218, 443
Ackman, Bill 221
acquisitions and mergers 65, 78, 217–20, 282, 454
  Jordan 460–1
  NCR 355
  Reader's Digest 153
  Shearson Lehman Hutton 173
  Topps/Upper Deck 274–6
  transaction bonuses 386–7
  see also takeovers
active corporate governance 431–3
active money management 132, 133, 482
Activision Blizzard 366
activism 202–3, 206–20, 222–35, 480–4
  executive compensation 364–5
  hedge funds 220–1
  public pension funds 173–88
  Slovakia 460
  TIAA-CREF 200
Adams, Carol 54
Adams, Kirk 166
Adamson, Jim 380
Adelphia 22, 139, 296, 302, 348, 359
AES 96 n11
agency costs 136–7, 145, 319, 348, 395, 409
Ahold 296, 432
AIM Investments 147, 330
Air France 23
Akers, John 292
Alabama State Pension Fund 173, 190
Alaska 190
Alcoa 183, 196
Alexander, Lamar 40
Alleco 24
Alleghany Corporation 266
Allen, Robert 71
Allen, William T. 282, 292
Alliance Bernstein Investments 330
Alliance Capital Management 227
Allianz 183, 485
Allied Corporation 290
Allied Signal 74, 76
Allstate 197
Alternative Investment Market (AIM) 417
Amaranth Advisors Fund 220
Amazon.com 348, 369, 402
America Online (AOL) 49, 183, 230, 369, 391

American Accounting Association 379
American Bar Association 43, 51, 333
American Century Investment Management 330
American Crossroads 44
American Express
  AFSCME proposals 196
  board of directors 258, 305, 331
  CEO resignation 212, 292
  separation of chairman/CEO role 334
  shareholder activism 227, 230
American Federation of State, County, and Municipal Employees (AFSCME) 148, 191, 195–7, 213, 329
American Funds 330
American Institute of Certified Public Accountants 392
American International Group (AIG) 44, 196, 331
American Law Institute 20, 82, 280–1
American Stock Exchange (AMEX) 241 n78
Ameriprise 330
Amnesty International 207
Amoco 360, 361, 453
AmSouth Bancorporation 276–8
Anadarko Petroleum 197
Anderson, Gavin 445–6
Angelides, Philip 173, 175
Anheuser-Busch 259
annual retainers 319–20, 322, 323
Annunziata, Robert 307, 369, 389
Anti-Referral Payments Law (ARPL) 282
antitrust violations 22, 23, 88–90, 361
Antoinette, Marie 107
APG 485
Apple Computers 5, 360
  CalPERS investment 124
  CEO dismissal 212
  directors' compensation 322
  executive compensation 375, 379, 386
Araskog, Rand 211, 368
Archer Daniels Midland 320
Arculus, David 315–16, 318
Aristotle 106
Arkansas 190
Armstrong World Industries 53, 211
Arthur Andersen 7, 31
Asian financial crisis (1997) 39, 432, 458, 472
Association of British Insurers (ABI) 187, 479
Association of Investment Companies (AIC) 187, 479
AT&T 8, 182, 259, 360
  antitrust case 361
  CEO dismissal 212
  economic value added 71, 72
  executive compensation 390
  NCR acquisition 355
Atkins, Betsy 60–1, 280
Atlantic Richfield 360
audit committees 48–9, 214, 255–6, 264, 280, 284
  AmSouth Bancorporation 278
  "financial experts" 322, 333
  GMI research 446
  Sarbanes-Oxley Act 394
  special obligations 265
audits 47–8, 63, 425
Australia 445, 446, 447, 484
Austria 447
Authentic Fitness 367
authority 8, 9, 16, 34, 333–5, 418
Autozone 386
Avon 360
Azerbaijan 459–60

Babington, Deepa 204
bad faith 273, 277, 390
BAE Systems 23, 430
Bakan, Joel 5
Baker, James 454–6
Baldacci, John 160
Balkcom, John 72
Ball, David 154
Banc of American Securities LLC 140
Banco Santander Central Hispano SA 223
Bandow, Doug 60
Bank of America 44, 196, 258, 259, 380
Bank of Boston v. Bellotti 40
Bank of England 80, 335
Bank of New England 29–30
Bank of the United States 111–12
Bank Secrecy Act (BSA) 276–7, 278
bank trusts 145–6
bankruptcies 31, 65, 119, 153, 299, 367, 389, 401
banks 19, 111, 133, 173–4, 359, 370, 479, 481
Barad, Jill 384
Barber, Brad M. 177
Barber, Brendan 486
Barclays 148, 198, 330, 479
Basel Committee 478, 479
Baskins, Ann 357–8
Bass brothers 287–8
Baums Commission 442
BB&T 196
BCE 445
bear markets 163, 204
Bear Stearns 296, 353, 359
Beatty, David 139
Bebchuk, Lucian 385
Beckstead and Watts, LLP 393
Beech-Nut 35, 91
Belgium 447
Ben and Jerry's 14
Bendix 290
Bennett, Phillip R. 140
Berg, Olena 205–6

Berkshire Hathaway 58–9, 64, 204, 224–5, 239 n40, 254, 360, 428
Berle, Adolf A. 120, 124, 126, 350
Beulieu of America 40
Bezos, Jeff 348
BHP Billiton 360
Bicks, Robert 89
Bierce, Ambrose 5–6
"big bath" restructuring charges 63–4
Biggs, John 199, 200, 305
Bill of Rights 11, 12, 108
Bipartisan Campaign Reform Act (BCRA) 40, 41
Bismarck, Otto von 416
Black, Conrad M. 299
Black, Hugo 12
Black-Scholes option pricing model 67, 377
BlackRock 198
Blackstone Group 150
Blackstone, Sir William 108
Blair, Margaret M. 73
Blockbuster 221, 328
Blue Arrow 65
BMW 184, 193
boards of directors *see* directors, boards
The Body Shop 14
Boeing 146, 356, 410–11, 430
Bogle, Jack 132, 235–6
bonds 156, 160
bonuses 59, 150, 349, 365, 369, 486
  AFSCME proposals 196
  "clawback" provisions 151, 152, 371
  directors 320–2
  guaranteed 380–1, 389
  manipulation of earnings to support 383
  Mannesmann 443
  transaction 386–7
  Wall Street 348
Boothbay Harbor Electric Light Co. 126–8, 145
Boothby, Lord 252
Booz Allen Hamilton 70, 352
Borden 227, 292, 378–9
Borne, Brooksley 13
Botelho, Maurício Novis 423
BPB 466
Brabeck-Letmathe, Peter 185–6
Brabeck, Peter 61
Braithwaite, John 31, 32–3
Brancato, Carolyn Kay 144
Brandeis, Louis D. 6–7, 8, 126–7, 141–2, 224, 240 n50, 258, 397
Brazil 418, 419–20, 421, 422–3, 446, 447, 448
Breeden, Richard 77, 299, 375, 388
bribery 22–3, 32–3, 112, 175, 283, 429
  see also corruption
Brightline simulation 79
Brin, Sergey 10
Bristol-Myers Squibb 360
British Airports Authority 107
British Airways 107, 204
British Petroleum (BP) 13, 22, 41, 56, 360, 450–6
  Amoco merger 361
  climate change 183
  Deepwater Horizon spill 25, 354, 477
  ESG assessment 84
  failure of leadership 348
  human rights issues 200
  marketing campaign 61
  pension fund activism 174
  PetroChina 419
  privatization 107
  rebranding 184, 353
  reputation 5
British Telecom (BT) 107, 221, 232, 360, 466
Brocade Communications 181
"broker nonvotes" 246 n158
Bronner, David 173
Brookings Institution 73
Brossy, Roger 72
Brown, Aaron 216
Brown Brothers Harriman 323–4
Brown, Gordon 459
Brown, Steve 233
Brown, Terrell 216
Browne, Lord John 41, 56, 353, 452–4
Bryden, Donald 479
BTPS 482
Buckley, James 36–7
Buffett, Warren 64, 69, 224, 226, 239 n40, 338, 480, 483
  boards of directors 254
  charitable donations 58–9, 149
  conflicts of interest 225
  hedge funds 241 n69
  pension fund 204
  PetroChina 428
  political contributions 42
  preferred shares 234
  stock options 374–5
bull markets 157, 163, 203, 296
bullet-dodging 385
Buntrock, Dean 307
Burke, James E. 81
Burkle, Ron 171
Burma (Myanmar) 200
Burns, John J. 266
Burrows, Peter 218
Burson-Marsteller 166
Bush, George H. W. 211
Bush, George W. 39, 91, 157, 188, 206, 392
business judgment 20, 268, 270, 273, 282, 286
Business Roundtable 52, 136, 201, 280, 385
Businesses for Social Responsibility 60

Butler, Peter 233
buyouts 125

Cadbury Code 186
Cadbury paradigm 79–83
Cadbury Report 325
Cadbury, Sir Adrian 79–80, 85, 87, 307, 334
California 188, 329
California Public Employees Retirement System (CalPERS) 154, 157, 166, 169–70, 226, 229, 244 n112, 310
  Apple Computers 124
  board 170
  climate change 183
  constructive engagement 175
  criticism of trustees 171
  database of director candidates 336
  economically targeted investments 189, 190, 191, 192
  Enron 169
  executive compensation 368
  Harrigan's removal as chairman 176
  scandals 171–2
  shareholder activism 177–83, 208, 211, 213, 214, 217, 223, 227, 248 n199, 248 n205
  USAir 345 n88
California State Teachers Retirement System (CalSTRS) 177, 185
California Urban Real Estate (CURE) 192
Cambre, Ronald C. 390
Cambridge University 429–30
Camejo, Peter 84–5, 194
Campbell Soup Company 202–3, 322
Campbell, William 351
Campos, Roel C. 388
Canada 417, 437, 445, 446, 447, 484
Canadian Coalition for Good Governance 139
Canion, Rod 294
Capellas, Michael 380
capital
  cost of 72, 74–7, 78
  demand for 192
  morbid 413 n53
  "mortmain" statutes 397
capital flight 428–9, 459
Capital One Financial Corporation 196
Capital Research & Management Co. 230
capitalism 5, 110–11, 143, 233–4, 348, 376, 416, 440, 476
Carbon Disclosure Project 466
Cardinal Health, Inc. 181–2
Cardozo, Benjamin 102, 145
Caremark International Inc. 196, 277–8, 282
Carlucci, Frank 267
Carnegie, Andrew 10, 113, 120
cartels 39, 112–13
Carter Hawley Hale 121, 258, 290
Carter, Jimmy 86
Case, Steve 230, 369
cash
  cash balance plans 162
  cash flow 71
  value of 74–7
Cathcart, Alun 318
"cause", termination for 390
CellStar 214–15
Cendant 48, 214, 265
Center for Research in Securities Prices (CRSP) 75–6
Central Bank of Norway 306
centralized management 7, 9, 129
Centrica 466
CEOs (chief executive officers) 64, 348–59, 410–11, 476
  alignment of interests with shareholders 363, 376
  Anglo-Saxon corporate structure 403
  boards of directors 256, 257–8, 261, 292–3, 295–6, 326, 335
  certification of 342 n22, 394
  compensation 66–8, 150–1, 152, 243 n107, 348–9, 354–5, 363–88, 389, 410
  criminal activity by 35–6
  employment contracts 365, 389–91, 410
  "ERISA's Fundamental Contradiction" 128
  evaluation of 262, 263, 303, 336
  ex-CEOs as directors 306–7, 344 n68
  Mondragón cooperatives 404
  North Dakota law 47
  performance measurement 71
  replacement of 74
  resignation of 292
  role in nominations 309–10
  separation of chairman/CEO role 47, 304–6, 334, 433
  shareholder activism 212, 233
  social goals 15, 16
  succession planning 308–9, 312–13, 337, 340, 391–2
Cerberus Capital Management LP 78
Ceres 183
certificates 131
certification 342 n22
chairmen 47, 196, 261, 295, 304–6, 334
Chamber of Commerce 43, 44–5, 147–8
Champion International 212, 224
Chandler, Chancellor 219
charitable donations 58–9, 60, 61, 149
Charkham, Jonathan 123–4
Charles Schwab 148, 196, 330
charters, corporate 112, 114, 140
Chavez, Hugo 419
Chayes, Abram 222
checks and balances 16, 130
Cheney, Richard 384
Chesapeake Energy 266
Chevedden, John 208
Chevron 360
Chicago 190

Chicago Mercantile Exchange (CME) 256
Chick-fil-A 57
Chile 106, 447, 448
China 107, 427, 443–4
  energy strategy 466
  GMI rating 447, 448
  human rights issues 200
  IT sector pay 417
  McDonald's 416
  PetroChina 428
  US debt to 418, 473 n3
China Mobile 360
Christie, Agatha 252
Chrysler 36–8, 78, 203, 359, 379–80
CHUM 139
Churchill, Winston 416
Ciesielski, Jack 383
"circuit breakers" 131
Cisco Systems 144, 165, 185, 402
Citibank 19
Citicorp 146, 167
Citigroup 197, 353, 386
Citizens United case 11, 17, 41–5
citizenship, corporate 59
Claessens, Stijn 111
Clancy, John J. 107–8
Clark, Dean 115
Clark, Robert 7, 94
Clemenceau, Georges 416
climate change 178, 183, 451, 464–7, 472, 485
Clinton, Bill 40, 322
Clinton, Hillary 41
CNN 348
Coase, Ronald 95 n1
Coates, John 44
Coca-Cola 69, 71, 72, 212, 254, 320–2, 360, 365, 457–8
codes of corporate governance 338, 438, 442–3, 444, 450, 478
Coffee, John C., Jr. 29, 79, 96 n26
Colgate-Palmolive 322, 445
collective choice 143–4, 145, 149, 199, 201, 235, 429, 471
collective selfishness 408
Colorado 190
Columbia Management 330
Committee on Investment of Employee Benefit Assets (CIEBA) 202, 247 n189
Commodities Futures Trading Commission 13
communism 107, 110
Companies Act (UK, 2006) 325
Compaq Computers 123, 148, 212, 217–20, 293–4, 338
compensation
  AFSCME proposals 196, 197
  backdating options 271–3
  CalPERS activism 180, 181–2
  Campbell Soup Company 203
  CEOs 66–8, 150–1, 152, 243 n107, 348–9, 354–5, 363–88, 389, 410
  conflicts of interest 348
  directors 266, 319–24, 333
  Disney 268–71
  Dodd-Frank Act 394
  Embraer 424
  financial services sector 133
  Green Tree Financial 64–5
  Harvard endowment 152
  Institutional Shareholders Committee 187
  International Corporate Governance Network 234
  international differences 426
  Mondragón cooperatives 407
  moral hazard 133
  mutual funds 148, 329–30
  Nathan Cummings Foundation 485
  North Dakota law 46
  perverse incentives 79
  Poland 464
  shareholder activism 207, 208, 211, 213, 214, 215
  TIAA-CREF 199–200
  Wiederhorn 59
  see also severance agreements; stock options
compensation committees 46, 150, 264, 269, 273, 280, 322, 373, 446
complex adaptive systems, corporations as 12–13
compliance 34, 35, 267, 281
"comply or explain" 338, 427, 482, 483
Compuserve 75–6
Conard, Alfred F. 109
Condit, Philip M. 356
Confederation of British Industry 335
Conference Board 305, 309
confidential voting 145, 328–9
conflicts of interest 8, 61, 92, 225, 348, 409, 476, 482
  charitable contributions 61
  confidential voting 328
  directors 280, 300, 302, 321, 340, 426–7
  Enron 295
  executive compensation 368, 388
  ICGN Principles 434, 480
  institutional investors 237
  Norwegian Government Pension Fund 432
  pension funds 165, 167, 171, 173, 174, 201
  Poland 462
  shareholders 124, 138, 229
  takeovers 284
  trustees 127
Conley, John M. 163–4, 202
Connecticut 190
Conseco 65, 349, 381, 383, 386
Consolidated Gas Co. 206
Constellation Energy 379
Constitution of the United States 11, 12, 108–9, 393, 413 n53

consultants 168, 202, 373
contracts, CEO 365, 389–91, 410
Control Data Corporation 55–6
convertible preferred stock 224
Cook, Jackie 258, 259
Cooke, Joe 315–17
cooperatives 403–9
Cordiner, Ralph 50–1, 90
corporate culture 26, 27, 358–9, 455
corporate homicide 28, 96 n23
corporate killing 27–8
corporate manslaughter 26–8
corporate social responsibility *see* social responsibility
corporate structure 6–9, 115–17, 131, 252–3, 403–5, 410
corporations 4–5, 477
  accountability 16–17
  definition of 5–6
  early concepts of 107–8
  international governance 416–18, 471
  objective of 20, 82, 87
  political contributions 40–5, 68
  purpose of 9–12, 60
corruption 112, 164–5, 177, 283, 331, 428, 444, 458
  see also bribery; fraud; scandals
Coss, Lawrence 64–5
cost of living adjustments (COLAs) 156, 163
costs
  agency 136–7, 145, 319, 348, 395, 409
  compliance 267
  externalization of 50, 117
  monitoring 432
  pension plans 161–2
  "real" 86
Cotswold Geotechnical Holdings 28
Council of Institutional Investors (CII) 151, 172, 265, 287, 296, 309, 333, 335, 371–3
Countrywide Financial Corporation 359
Cracker Barrel Old Country Store Inc. 207
Crawford, Gordon 230
Crawford, Richard 72–3
"creation myths" 164
Credit Suisse First Boston 22, 140
criminal law 20–31, 33–6, 394, 443, 456
crisis management 263, 291–4
Crown Emak Partners LLC v. Kurz 132
"crown jewel" strategy 290
Crystal, Graef 151, 211, 323, 364, 365, 367, 379, 386, 391, 413 n44
CSG Systems International, Inc. 325
CSX 305, 319, 384
Culp, Henry Lawrence 366, 369
culture, boardroom 292–3
Cumberland Pharmaceuticals 366
Cummins Engine, Inc. 203, 258
Cuomo, Mario 189
CVS 196
Czechoslovakia 110–11

Daiichi Kangyo Bank 360
Daimler-Benz 77–9, 223
DaimlerChrysler 193
Daines, Robert 46
Dalkon Shield 25
Dallas, George 123
Danaher Corporation 366, 369
Darrow, Clarence 395
Daum, Juergen 73
Davis-Bacon Act (1931) 11
Davis, Evelyn Y. 206
Davis, Gray 171
Davis, John P. 119
debarment 30–1
decision making 55–61, 92, 268, 406–7, 409–10, 480
Del Mar Fairgrounds 166
Del Monte 263
Delaware 11, 45–6, 51–2, 114, 263, 292
  board role 267
  business judgment 282
  "Delaware regulars" 214
  demand requirement 273
  director exculpation clause 277
  Disney-Ovitz case 268, 270–1
  election of directors 331–3
  McPadden v. Sidhu 278
  Pennzoil Co. 248 n199
  "poison pills" 288, 289
  "race to the bottom" 19, 96 n16
  reincorporation to 197
  takeovers 284–5
  Topps/Upper Deck case 274–6
  voting interest 132
deliberate obfuscation 381–2
Dell 197, 402
democracy 92, 140–1
Democratic Party 40, 42
Deng Xiaoping 444
Denmark 447
Denning, Lord Justice 26
Department of Labor (DOL) 202, 203, 208, 234–5, 240 n52, 247 n188, 329, 342 n26
"designated directors" 336
Deutsche Asset Management 145, 148, 218–20, 328
developing economies 93, 416, 435, 446–8, 458–64
Dial 212
directors 9, 251–345
  authority 333–5
    boards 13, 251–345, 350, 476–7
      accountability 16
      active corporate governance 432–3
      agenda 263, 266–7, 281–3
      Anglo-Saxon corporate structure 403

Buffett on 254
CalPERS activism 178–9, 180, 181–2
CEO contracts 391
communication with shareholders 264–5
compensation and incentives 266, 319–24, 333
conflicts of interest 348
corporate crime 34–5
corporate democracy 140
denial of minority representation 142
diversity 264
dual board systems 409, 427
duties 280–1
election of 117, 246 n158, 324–30, 331–3
Embraer 423, 424–5
evaluation of 336
ex-CEOs as directors 306–7, 344 n68
executive compensation 388
executive session meetings 336–7
failures of 353
Germany 442
GMI research 446
history of 255–6
Honeywell 210
information checklist 303–4
information flow 295–301
inside/outside mix 257–60, 294, 304, 334
Institutional Shareholders Committee 188
international differences 426–7
legal framework 267–81
limits to oversight 295, 301–2, 318–19
meetings 263, 264, 349
nominations 309–18, 325–8, 335, 340, 483
North Dakota law 46–7
occupational safety 455, 456
performance measurement 48
Poland 464
qualifications 261
regulatory neglect 482
separation of chairman/CEO role 47, 304–6, 334, 433
shareholder activism 211, 212–17, 230
succession planning 308–9, 312–13, 337, 340
TIAA-CREF 200
crisis management 291–4
"designated" 336
duty to shareholders 6, 50, 51–2
Hermes programmes 232
Institutional Shareholders Committee 187
Isetan 438, 439
lead directors 215, 261–3, 305–6, 313, 334
limited liability 20
majority voting 46
mutual fund support for management nominees 148
nonexecutive 315–18, 325, 335, 438, 483
Pennsylvania law 52–3
perpetual directorships 13
removal of 34
resignation of 151–2, 212, 308
stakeholder laws 51
disclosure 62, 91, 257
charitable contributions 61
climate change 183
consultant fees 373
Daimler-Benz 77
Embraer 425
ERISA fiduciaries 329
executive compensation 324, 381–2, 388
ICGN Principles 434, 480
Sarbanes-Oxley Act 392
TIAA-CREF 200
voluntary 73
discount options 374
discrimination 11, 14
Disney
board of directors 257, 314
consultants 151
Crawford's shares in 230
director liability 277
Disney World theme park 70
executive compensation 369, 390
Ovitz case 268–71, 339
separation of chairman/CEO role 334, 433
shareholder activism 212, 214
Disney, Roy 212, 221
Disney, Walt 10
diversification 121, 123, 155, 167, 168, 205, 431
divestment 10, 174, 175, 188–9, 430–1
Djankov, Simeon 111
Dodd, David L. 213–14
Dodd, E. Merrick 189
Dodd-Frank Act (2010) 213, 246 n158, 338, 394
executive compensation 133, 150, 151, 208, 379, 382, 394
insurance companies 243 n97
proxy access 117, 324–5, 327, 394
Dodge v. Ford Motor Co. 56–7, 98 n67
Dollar Tree Stores, Inc. 180
Donaldson, William 77
Douglas, William O. 105
Dow Chemical 196
Dow Corning 91
Dow Jones 84, 237, 355, 426
Dowling, James 166
Drexel Burnham Lambert 24–5, 31
Dreyfus Corporation 330
Drucker, Myra 204
Drucker, Peter 47, 155, 291, 295
Du Pont, Pierre 223–4, 225
dual board systems 409, 427
dual-class structures 135–6, 137, 139, 144, 213, 237, 437, 483
Dubai 416

Dubreville, Anthony 278–9
Dukakis, Michael 19
Dunlap, Al 225, 294, 337, 349
Dunn, Patricia 357–8
DuPont 183, 223–4, 360
duty of care 268, 270–1, 273, 277–9, 282, 339
duty of loyalty 268, 270, 273, 276–9, 284–5, 287, 339
DWS Scudder 330

earnings 63–8, 74
 directors' compensation 320–1
 manipulation of 383
 pension funds 203–4
 stock options 377–8
earnings per share (EPS) 70–1
Easterbrook, Frank H. 13, 137
Eastern Europe 110–11
Eastman Kodak 74, 235, 292, 359, 360
Eaton, Peter 28
Ebbers, Bernard 21, 382–3
Ebner, Martin 436
Eccles, Robert G. 84
Eckbo, B. Espen 431, 473 n8
economic value added (EVA) 71–2
economically targeted investments (ETIs) 189–93, 205–6
Edison Electric 208
Edmondson, David 356–7
Edvinsson, Leif 73
efficiency 10–11, 134
Egypt 447, 458
Eisenberg, Melvin Aron 124, 125
Eisner, Michael 66, 212, 257, 269–71, 274–6, 314, 369, 433
El-Erian, Mohammed 150
Electricidad de Caracas 419
Electronic Data Systems (EDS) 203, 320
Eli Lilly & Co. 22, 179, 196
Ellis, Charles D. 132
Ellison, Larry 358, 366
Emap 315–18, 340
Embraer 420–6
Emerson Electric 259
Emmett, Martin F. C. 297–8
employee-owned enterprises 403–9
Employee Retirement Income Security Act (ERISA, 1974) 130, 164, 168, 201–2, 208, 226, 229
 administration of 247 n188
 conflicts of interest 167
 diversification 155
 enforcement 235
 ESOPs 400
 fiduciary restraint 205
 "Fundamental Contradiction" 128
 insurance companies 149, 249 n212
 shareholder activism 186
 voting disclosure 329
employee stock ownership plans (ESOPs) 121–2, 284–5, 300, 399–401
employees 14, 85, 155, 351, 395–401, 411
 criminal liability 28–9
 economically targeted investments 189
 Embraer 424
 General Electric 362
 global pay differences 417
 Malden Mills 57–8
 Mondragón cooperatives 406–8
 pension plans 156, 160, 161–2
 temporary 402
 Wal-Mart 430
enforcement 234–5, 478, 479, 483, 484
Engel, David 87, 92
Enron 5, 90, 359, 392, 432
 bailout attempt 39
 board of directors 291, 295, 296, 299–300, 302, 331, 340
 destruction of documents 31
 failure of leadership 348
 Joint Energy Development Investment LP 169
 prison sentences 21
 retirement fund 349
 "special purpose entities" 12
Entine, John 194
environmental issues 22, 56, 83, 116, 183, 184–5
 BP 450–1
 Global Carbon Project 464–5
 IKEA 61
 Norwegian Government Pension Fund 431
 One Report system 84
 sustainability reporting 465–7
environmental, social and corporate governance (ESG) 83–7, 184–6, 426
Epstein, Edward Jay 130, 326
equality 107
equilibrium 79–83
equity securities 196, 197, 198, 220
Ericsson 437
Esrey, William 386
Esser, Klaus 443
Estes, Ralph 87
ethical contract 54
ethical issues 82, 184–6, 430, 431
ethnic minorities 189, 264
European Aeronautical Defence and Space (EADS) 448
European Bank for Reconstruction and Development (EBRD) 419
European Commission (EC) 478–9
exchange offers 135, 136, 139, 144
executive compensation 150–1, 243 n107, 348–9
 backdating options 271–3
 boards of directors 280, 281, 295
 CEOs 354–5, 363–88, 389, 410
 Disney 268–71
 Dodd-Frank Act 394

financial services sector 133
International Corporate Governance Network 234
international differences 426
mutual funds' proxy voting 329–30
Nathan Cummings Foundation 485
shareholder activism 207, 208, 211, 213, 214, 215
TIAA-CREF 199–200
Wiederhorn 59
see also compensation
executive session meetings 336–7
Exel 466
expenses 297, 356, 358
externalities 79, 116, 128, 468
externalization 50, 116, 117, 428
Exxon 22, 92, 213, 360, 361, 384, 452
Exxon Mobil 418, 453, 454, 477

F&C 123
failed owners 128, 143
"fair price provisions" 290
Fairchild 368
Fanto, James 219
Fastow, Andrew 300
Faulk & Co. 257
Favaro, Ken 309
Federal Election Campaign Act (FECA) 40
Federal Election Commission (FEC) 40
Federal Employees' Retirement System (FERS) 197–9
Federal Employees' Retirement System Act (FERSA) 157, 197, 198, 226
Federal National Mortgage Association (Fannie Mae) 10, 107, 152
Federal Reserve 39
Federal Trade Commission (FTC) 138
Federated Investors 148, 330
Feinberg, Kenneth 370
Ferris, Edward 309
Feurstein, Aaron Mordecai 57–8
Fidelity Investments 114, 148, 188–9, 330
fiduciaries 102, 121, 126, 127, 429
"bad governance" discount 128
ERISA 229, 329
ICGN Principles 434
non-neutral 168, 201, 205, 233–4
ownership rights 130, 131
pension funds 154, 164, 168, 172, 201–2, 205, 233–4, 484
fiduciary duty/obligation 6, 51–2, 121–4, 429, 486
directors 268, 269, 273, 284
institutional investors 142
investment advisers 103–4
pension funds 168, 192, 194, 196, 226
Topps/Upper Deck case 275
fiduciary standard 102–3, 145, 164, 476, 482
directors 284–5, 337
pension funds 234, 235
Fifth Third Bancorp 196
Financial Accounting Standards Board (FASB) 46, 49, 62, 66–9, 73, 383, 469
financial crisis 4, 5, 13, 476, 478
AFSCME resolution 195
bank failures 359
CEO bonuses 348
failure of accountability 17
FASB ruling 62
separation of chairman/CEO role 306
shareholder activism 213
Financial Executives Institute/Financial Executives International (FEI) 49, 72
"financial experts" 322, 333
financial services sector 133, 417
financial statements 62, 67, 280, 303, 394, 463, 469
see also reporting
fines 20–3, 25, 29–31, 89, 96 n26, 394
Finland 447
Finmeccanica 430
Fiorina, Carly 218, 219, 356, 357–8, 359, 384
First Amendment 8, 17, 21, 41
Fischel, Daniel R. 13, 137
FleetBoston 379
flip-in/flip-over plans 288
Flom, Joe 290
Focus Funds 222, 231, 232, 233
Fog Cutter Capital Group Inc. 59, 258
Ford Foundation 149, 150, 429
Ford, Henry 4, 10, 56–7
Ford Motor Company 38, 56–7, 98 n67, 113–14, 135, 320, 360
Foreign Corrupt Practices Act (FCPA, 1977) 22–3, 283, 358, 393
Foshee, Douglas L. 61
Foss v. Harbottle 117–18
foundations 149–50, 153, 429–30, 485
Fouse, William 132
FPL Group 387
France 427, 447
Franklin Electronics Publishers 53
Franklin Funds 330
fraud 21–5, 31, 35–6, 63, 392, 417
AmSouth Bancorporation 276–8
backdating options 272–3
Cendant 265
Fog Cutter 258
Hewlett-Packard 390
obstacles to restitution 387
pension funds 165, 176
Refco 140
Sunbeam 225
tax havens 428
UNH scandal 183
whistleblowers 186
see also corruption; scandals

Freddie Mac 107
Free Enterprise Fund 393
free rider problem 143–4, 167, 199, 201, 234, 235
Freedom of Information Act 8
freedom of speech 11, 41, 92, 109
Freeport McMoRan Copper and Gold 431
Freidheim, Cyrus F., Jr. 70–1
Freston, Thomas E. 384–5
Friedman, Milton 82, 83, 85
Friedman, Thomas 416
Fromstein, Mitchell 65, 402
Fuji Bank 360
Furr's/Bishop's 210
Future Tech International (FTI) 40

G7 nations 459
Galbraith, John Kenneth 370
Galli, Joseph 369
Gates, Bill 10, 120, 363–4
Gates Foundation 149, 150, 429
Geneen, Harold 304
General Accounting Office 234–5
General Dynamics 368
General Electric (GE) 51, 74, 360, 397
  CEO 348, 350, 361–2, 387, 389
  directors' retainers 320
  false billing scandal 24
  institutional investors 144
  price fixing 20, 88–90
General Mills 132–3
General Motors (GM) 173, 356, 359, 360, 482
  board of directors 13, 291, 313, 331, 334, 349, 353
  CEO resignation 212, 292
  directors' retainers 320
  DuPont 223–4
  failure of governance 363
  government bailout 38
  hedge funds 221
  pension fund 13–14, 203
  reputation 5
  separation of chairman/CEO role 334
  shareholder activism 206, 212, 230
Generally Accepted Accounting Principles (GAAP) 47, 62, 65–6, 71, 73, 79, 84, 280, 469–70
Genovese, Kitty 92
Germany 225, 427, 442–3, 446, 447
Ghana 458
Gheit, Fadel 419
Gibbs, Sir Roger 122
Gifford, John 272
Gilbert brothers 206, 211
Gilead Sciences 366
Gillett, George 325
Gillette Co. 19, 224
Gillmor, Paul 61
Gilson, Ronald J. 335, 336
Ginsburg, Douglas H. 29, 30, 34, 35
Gitano Group 25
Glass-Lewis 148, 393
Glass-Steagall 226
Glaxo 122, 360
Glaxo Wellcome 351
GlaxoSmithKline 41
Global Carbon Project (GCP) 464–5
Global Corporate Governance Forum 93, 435, 458
Global Crossing 307, 348, 349, 359, 369, 389, 390
Global Reporting Initiative (GRI) 84, 86–7, 465
Goizuetta, Roberto 71, 365
"golden coffins" 196
"golden hellos" 386
"golden parachutes" 151, 391
Goldfields of South Africa 446
Goldman Sachs 23–4, 41, 44, 45, 140, 196, 220, 261, 381
Goldstein, Michael 390
Gompers, Paul 139, 291
Goobey, Alastair Ross 231, 487 n10
good faith 277, 278–9, 282
goodwill 63, 65, 99 n76
Goodyear 74, 75
Google 5, 10, 139, 237, 360
Google Finance 84
Gore, Al, Jr. 40
Gould, Andrew 366
Governance for Owners 233, 438
GovernanceMetrics International (GMI) 445–9
  backdating scandals 385
  board interlocks 258, 259
  CEO contracts 389
  director database 302, 328, 344 n68
  directors' compensation 266, 319, 320
  directors with minority support 325
  ex-CEOs as directors 306
  executive compensation 369, 370
  majority voting 333
  mutual funds 148
  shareholder resolutions 147
government 18–20, 476, 482, 484
  Anglo-Saxon corporate structure 403
  bailouts 36–8, 39–40
  intervention 338, 462
government sponsored enterprises (GSEs) 107
Graham, Benjamin 213–14
Grant Thornton LLP 140
Gray, William 301
Greece 446, 447
Green Tree Financial 64–5, 265
Greenburg, Les 217

greenmail 287–8
Greenspan, Alan 13, 353, 376–8, 481
Greider, William 12
Greville, Sir Fulke 359
Grinstein, Yaniv 385
Griswold, Benjamin H. 218
Gross, Daniel 32, 123
gross-ups 196, 374, 387
Grove, Andrew 305, 348
Grundfest, Joseph 75–6, 331
guaranteed bonuses 380–1, 389

Haeckel, Ernst 440
Halberstam, David 113–14
Halliburton 23, 384, 416, 477
Halperin, Michael 72
Hamilton, Alexander 255–6, 267
Hammergren, John H. 366
Handlon, David 71–2
Handy, Charles 402
Hanks, James J., Jr. 51
Hanson, Dale 172, 212, 310, 345 n88
Harrigan, Sean 176
Harrison, Matthew 402
Hartford Financial Services Group 197
Hartmarx 289
Harvard University 149, 150, 152, 429
Hausbank 225
Havel, Vaclav 110–11
Hawaii 190
Hawley, Philip M. 258
Hayek, F. A. 50, 52
Hayward, Tony 41, 56, 174, 353–4
HCA 22
Health, Safety and Environmental Management (HSE) 450–1, 455
HealthSouth 21–2, 90, 296, 348, 359
Heard, Jamie 334
Hearst, William Randolph 103
hedge funds 220–1, 235, 241 n69, 481
Helliwell, Arthur L. 238 n8
Helmsley, Leona 387
Hemsley, Stephen J. 366
Henderson Global Investors 465–7
Henderson, Nina 263
Henrekson, Magnus 436
Herald of Free Enterprise tragedy 26–8
Hermes 144, 221–2, 231–3, 482, 487 n10
Hershey Candy 122–3
Hershey, Milton 122
Hevesi, Alan 177
Hewlett-Packard (HP)
  AFSCME proposal 213
  board of directors 292
  CEO goals 368
  directors' retainers 320
  executive compensation 380–1, 384
  Foundation 123
  merger with Compaq 148, 217–20, 328
  scandals 128, 295, 314, 340, 356, 357–8, 359, 390
  separation of chairman/CEO role 334
Hewlett, Walter 217–19
Hiatt, Arnold 60
Hicks, Tom 325
Hilbert, Stephen 383
HIM Governance 438, 439
Hirsch, Leon 375
Hirschman, Albert O. 240 n62, 363
Hitachi 360
Hodgson, Paul 320–2
Hollinger 139, 296, 299
Home Depot, Inc. 227, 295, 303–4, 384
Honeywell International 209–10, 430
Hong Kong 448
Horton, Odell 25
Hoskyns, Sir John 315–17
Hospitality Properties Trust 179
Houston Firemen's Relief Retirement Fund 166
Hoyos, Carola 452
HSBC 485
Huff, John R. 266
human capital 63, 72–3, 74
human rights 189, 200, 207, 485
humanistic firms 398–9
Hungary 417
Hurd, Mark 295, 357–8, 359, 368, 380–1, 390
Hurst, James Willard 98 n67, 124
Hurwitz, Charles 153

i2 Technologies, Inc. 278–9
Iacocca, Lee 36, 379–80
IBM 80, 356, 360
  AFSCME proposals 196
  antitrust case 361
  board of directors 291
  CEO resignation 212, 292
  failure of governance 363
  outsourcing 402
  pension fund 203
  shareholder activism 212, 230
Icahn, Carl 132, 147, 175, 210, 221, 235, 288, 328
identity, corporate 11
IKEA 61
Illinois 157, 166, 176, 188, 189, 190
ImClone 36
Imcor 402
Immelt, Jeffrey 362, 384
immunity from prosecution 36
Imperial Chemical Industries 283
imprisonment 21, 25, 36, 59, 88, 140, 394
imputed years of service 384
incorporation 45–6, 96 n16, 109, 112, 114

Ind. General Electric Co. (UK) 360
independence
  directors 235, 257–9, 261, 283–4, 308, 324, 333–7, 340, 426–7, 438–9
  World Bank goals 93, 472
index funds 132, 134, 226–7, 480, 484, 487 n10
  FERS 198–9
  Hermes 222
  pension funds 165, 167
India 427, 447
Indiana 189, 197
Indonesia 417, 431, 448, 458, 459
Industrial Bank of Japan 360
Industrial Rayon 138
Infinity Broadcasting 265
inflation 63
information flow 295–301
information technology (IT) sector 417
In re Caremark International Inc. Derivative Litigation 277–8, 282
Initial Public Offerings (IPOs) 15, 32, 96 n11, 140
Inland Steel 258
innovation 73
Institute for Policy Studies 150
Institute of Chartered Accountants in England and Wales (ICAEW) 469–70
institutional investors 123, 125, 144–50, 234, 237, 478, 484–6
  active money management 132
  activism 208, 211, 215, 217, 222–3, 226–8, 231–3, 480–1
  climate change 183
  conflicts of interest 124
  divestment initiatives 188–9
  economically targeted investments 189–93, 205–6
  election of directors 328, 329–30
  executive compensation 373
  failure of 476
  FERS 197–9
  GMI ratings 445
  growth of 130, 134
  Hermes 144, 221–2, 231–3, 482, 487 n10
  ICGN Principles 433–4
  "ideal owner" concept 229, 235
  international governance 428, 429
  level of ownership 166–7
  market for independent directors 335
  responsibilities 142
  voting 483
  see also pension funds; shareholders
Institutional Investors Group on Climate Change 466
Institutional Research Group 426
Institutional Shareholder Services, Inc. (ISS) 209, 212, 218, 306, 317, 333, 334, 335
Institutional Shareholders Committee (ISC) 187–8, 231, 479
insurance companies 144, 149, 226, 243 n97, 249 n212, 483
intangible assets 73, 74, 98 n75
Intel 144, 305, 348
Interfaith Center on Corporate Responsibility 206
internal controls 282, 393, 394, 455–6
Internal Revenue Service 162, 203, 402
International Accounting Standards Board (IASB) 69, 93, 232
International Corporate Governance Network (ICGN) 93, 234, 333, 373–4, 433–4, 478, 479–80
International Financial Reporting Standards (IFRS) 469–70
international governance 415–73
  common language for accounting 468–70
  Global Carbon Project 464–5
  Global Corporate Governance Forum 435
  Governance Metrics International 445–9
  ICGN Principles 433–4
  sustainability reporting 465–7
  World Bank country assessments 458–64
International Monetary Fund (IMF) 458, 459
International Paper 199
internet 216, 217, 235, 301, 442, 463
Interpublic Group of Companies Inc. 180
investment
  active money management 132, 133
  decision to invest 396
  defined-contribution pension plans 156
  directors' concerns 282
  economically targeted 189–93, 205–6
  executive compensation 388
  limited liability 6, 7–8, 116
  Sharia-compliant 184, 185
  socially responsible 83–5, 169, 194, 237
  sustainable and responsible 485–6
  Volkswagen 193–4
  see also institutional investors; shareholders
investment advisers 103–4
Investment Company Act (1940) 103–4, 138, 140, 146, 220, 226
Investment Management Association (IMA) 187, 479
Investor AB 436–7
Investor Network on Climate Risk 183
Investor Responsibility Research Center 333, 379
"invisible hand" 16, 106, 155, 156
Irani, Ray R. 366, 369
Ireland 447
Isdell, Neville 320, 457–8
Isetan 438–40, 441
Ishii, Joy L. 139, 291
Islam 184
Israel 427, 448
Italy 427, 447
ITT Corp. 211, 212, 304, 322, 362, 368

J. C. Penney 222
Jackson, Shirley 260, 261
Jacobs, Michael 74
Jakobsson, Ulf 436
Janklow, Bill 19
Janus Capital Group 330
Japan 418, 444–5
  CEO resignations 35
  cost of capital 77
  employee ownership 398
  GMI rating 447, 448
  institutional investors 484
  IT sector pay 417
  keiretsu 427
  Merck antibiotics program 351
  relationship investing 225
  US debt to 473 n3
  voluntary restraint agreement 38–9
Japan Airlines 35
Japan Atomic Power Company 35
Jay, John 65
Jensen, Michael C. 125, 368
JetBlue Airways Corporation 179
"Jewish dentist" takeover defense 290
Jobs, Steve 10, 386
Johnson & Johnson 80–1, 87, 360
Johnson, Alan 381
Johnson, F. Ross 102, 125, 297, 298
Johnson, James 319
Johnson, Norman 63
Joint Energy Development Investment LP (JEDI/JEDI II) 169
joint-stock companies 108
Jones, Sir John Harvey 283
Jordan 460–1
Jordan, Vernon 322–3
Jouvenel, Bertrand de 130
JP Morgan Chase 44, 196, 220, 227, 330, 360
Juno Lighting 257

K-Mart 230, 380
Karlsson, Per-Ola 309
Karmazin, Mel 370
Karpoff, Jonathan M. 53, 98 n64
Kay, Ira 379
Kaysen, Carl 16–17
Kazimi, A. J. 366
KB Homes 379, 385
KBR, Inc. 23, 185
Kean, Thomas 319
Kefauver, Estes 88
Kellogg Brown & Root LLC 23
Kelso, Louis O. 399
Kennedy, Anthony 41
Kennedy, Edward 234
Kennedy, John F. 197
Kerr-McGee 221
Kerry, John 40
"Kew Gardens" principle 92
Khodorkovsky, Mikhail B. 441
Khurana, Rakesh 308, 349, 353
Kidder Peabody 361
killing, corporate 27–8
King Pharmaceuticals 132
King Report (2002) 470–1
Kinnear, Jim 288
Kinsley, Michael 40
Kirkorian, Kirk 221
Kjaer, Knut 431
KKR 170
Klein, Ezra 42
KLM 23
knowledge capital 74
Knowledge@Wharton 139
Knowlton, Winthrop 293, 326
Kogan, Richard J. 390
Kopper, Michael 299
Koppers 173
Korea 427, 432, 446, 448, 459
Korn/Ferry 256, 266, 267, 304, 307, 310, 336–7
Korologos, Ann 319
Kotick, Robert A. 366
Kozlowski, Dennis 314, 383, 390
Kraakman, Reinier 335, 336
Kramer, Orin 157–8
Kravis, Henry 102, 125
Krepps, Juanita 86
Krzus, Michael P. 84
Kuwait Investment Company 290

La-Z-Boy Incorporated 178–9
Laborers' International Union of North America 212
Ladish Company 58
Land, Edwin 55
Langbein, John 168
Lapides, Morton M. 24
late trading 147
Law Commission, United Kingdom (UK) 27–8
Lawndale Capital Management 223
lawsuits 15–16, 117–18, 331
  AFSCME 196
  AmSouth Bancorporation 277–8
  CalPERS 183
  "Delaware regulars" 214
  Disney-Ovitz case 268–71
  PCAOB oversight 393
  pension funds 191
Lay, Kenneth 21, 299
Layne Christensen Corporation 85
lead directors 215, 261–3, 305–6, 313, 334
The Learning Company 355
Lederer, Jack L. 298

legal personality 7, 8, 102
Legg Mason Funds 330, 379
Lego, Paul 306–7
Lehman Brothers 275, 296, 319, 359
LeMay, Ron 386
Lennar 379
Lens 235
Lessig, Lawrence 43
Lev, Baruch 73, 74
Levi Strauss 60
Levin, Carl 291
Levitt, Arthur 48–9, 68–9, 138–9, 242 n80, 305
Lewis, Drew 258
Lewis, Kenneth 380
LG Display 23
liability
  criminal 20, 28–9, 35, 456
  directors 277, 282, 331
  limited 4, 6, 7–8, 20, 105, 115–16, 129, 237
  pension funds 160–1
Lichtenstein, Warren G. 445
Lie, Erik 272, 385
Lieberman, Joseph 68
Liener, Gerhard 77–8
Liggett Co. v. Lee 8, 397
limited liability companies (LLCs) 95 n2
Lincoln Financial International 197
Lindblom, Lance E. 485
Lipton, Martin 46, 262, 290, 301, 313
liquidity 121, 129, 131, 143, 146, 282
Livedoor 448
Livent 48, 214
Liverpool Football Club 325
loans 36–7, 382–3, 394
lobbying 91, 117
Locke, John 106
Lockheed Corporation 36–7, 400
Lockheed Martin 387
Lone Star Industries 297
Long, Russell 399, 400–1
Long-Term Capital Management (LTCM) 39
long-term strategy 47, 48, 50–5, 92–3
Loomis, Carol 13
Lord Abbett 330
Lorsch, Jay W. 262, 301, 313, 334
Lower Saxony 193–4, 427
loyalty, duty of 268, 270, 273, 276–9, 284–5, 287, 339
Luby's 217
Lucent 380
Lusk, Edward J. 72

MAC Fund 445
MacDougall, Alan 486
Mace, Myles 326
Madoff, Bernard 36, 239 n46
Magee, Mark 348
Magus Corp. 290
Maine 188
Maine Public Employees Retirement System (MePERS) 159–63
Maine State Retirement System (MSRS) 172
majority voting 46, 213, 325, 331–3, 337
Makihara, Ben 398
Malatesta, Paul M. 53, 98 n64
Malaysia 447, 459
Malden Mills 57–8
Mali 457–8
management 332, 348
  accountability 129, 135
  BP 456
  centralized 7, 9, 129
Mannesmann 443
Manning, Bayless 128–9, 283, 284, 409
Manpower, Inc. 402
manslaughter, corporate 26–8
Marathon/Ashland 361
Marbach, Carl B. 212
Marcus, Bernard 303–4
Marcus, Lucy P. 301
market test 40, 47–8, 285, 337
market timing 147
market value 69–70
marketing 61
Markopolos, Harry 36
Markstone Investment Partners 177
Marquette Nat. Bank of Minneapolis v. First of Omaha Service Corp. 19
Marshall, John 109
Martha Stewart Omnimedia 139
Martin, John C. 366
Martin Marietta 290
Marx, Karl 107, 252, 395–6
Mason, Edward 54
Massachusetts 11, 176, 190, 328
Matsushita Electric 360
Mattel 212, 222, 292, 355, 384, 390
Maxim Integrated Products, Inc. 272–3
Maxwell, Hamish 375
Maxxam 153
McCain, John 91
McCall, H. Carl 173
McCullough v. Maryland 109
McDonald's 221, 416
McEntee, Gerald W. 196
MCI 391
McKesson 366
McKinnell, Hank 385
McNealy, Scott G. 266
McPadden v. Sidhu 278
Means, Gardiner C. 120, 124, 126, 350
media and journalists 14, 282
meetings 118, 263, 264, 336–7, 349
mega-grants 349, 369–70, 375
Mellon, Andrew 120

Mellon Capital Management 132
Mellon Financial Corporation 181
Mentor Graphics Corporation 289
Merck 15, 351–2, 360
Mercury Finance 265
Meredith, David R. 298
mergers *see* acquisitions and mergers
Meriwether, John 39
Merrill Lynch 173, 174, 183, 272, 330, 402
Merton, Robert 39
Metrick, Andrew 139, 291
Metro-Goldwyn-Mayer 369
Mexico 448
Meyer, Jack 150
Meyer, Pearl 298
MFS Investment Management 330
Michigan 189, 190, 336
Mickelthwait, John 5
Microsoft 90, 120, 144, 185, 360, 363–4, 402
MicroStrategy 49
Milken, Michael 24–5, 31
Miller, Robin 315–16
Millstein, Ira M. 229, 293, 326, 338, 342 n22, 350
Minnesota 176
Minnesota Mining and Manufacturing Company 5, 360
minority shareholders 142, 435, 438–40, 484
Minow, Nell 230
Mirabilis 49
Mitsubishi 360, 398
Mittelman, David R. 152
Mobil 360, 361
Mokhiber, Russell 21, 36
Mondragón 403–9
monitoring 132, 292
  institutional investors 187, 228, 234
  investment managers 342 n26
  by shareholders 124, 140–1, 229, 235, 432
  see also oversight
Monks, Robert A. G. 110–11, 211, 213, 325–6, 453–4
monopolies 107
Monsanto 72
Monster Worldwide 322
Moody's 74, 384
Moore, Richard 173
moral hazard 133
Morales, Jennifer 166
morality 14, 141, 470
Moran v. Household International, Inc. 288
morbid capital 413 n53
Morgan Stanley 40, 148, 220, 246 n158, 330, 380, 437
Moritz, Michael 37
"mortmain" statutes 397
Moss, David A. 481
Motley Fool 301
Motorola 227, 402
Movie Gallery 319
Moxy Vote 217, 330
Mueller, Robert K. 303
Murakami, Yoshiaki 445
Muravyev, Alexander 139
Murdoch, Rupert 42–3, 223
Murninghan, Marcy 43
Murphy, Kevin J. 368
mutual funds 114, 123, 144, 146–9, 245 n139
  activism 226
  hedge fund comparison 220–1
  proxy voting 329–30
  Slovakia 460
  stewardship principles 483
Mylan 132, 196
Myners, Paul 186, 231

Nabisco 134
Nabors 196
Nader, Ralph 35, 206
Nafus, Edward C. 325
Nakagawa, Toshiaki 440
Nardelli, Robert 384
Nash, John 334
Nathan Cummings Foundation 42–3, 256, 328, 484–5
National Association of Corporate Directors (NACD) 265, 305, 323, 324, 334, 335, 336, 337
National Association of Pension Funds (NAPF) 187, 232, 479
National Grid 183
NBC 361, 362
NCR 355
Neff, Tom 352
Neilson, Gary L. 309
Nesbitt, Stephen L. 223, 248 n205
Nestlé 61, 123, 185–6
NetChannel 49
Netherlands 447, 484
New Deal legislation 11, 140
New Jersey 174, 176, 188, 237
New York 158, 166, 169–70, 173, 177, 192, 206, 229, 230
New York City Employees' Retirement System (NYCERS) 207
New York Public Library 150
New York State Common Retirement Fund 173–5
New York State United Teachers Fund 173
New York Stock Exchange (NYSE) 114, 131, 223, 265
  audit committees 284
  "broker vote" rules 330
  certified financial statements 62
  Daimler-Benz 77, 78
  directors 261, 333, 338
  Embraer 421, 422, 425
  executive compensation 152
  Hermes 232
  non-voting stock 242 n80
  voting rights 135–6, 138–9, 241 n75, 241 n78

New York Times Company 237
New Zealand 447
Newark Morning Ledger v. US 98 n75
Newmont Mining 390
News Corp. 42–3
Nike 200, 384
Nippon Tel. & Tel. 360
Nocera, Joseph 45–6
Nokia 5
nominating committees 264, 309–10, 325, 335
non-voting stock 242 n80
nonowners 128
nonprofits 149–50
Norges Bank 430–3, 472
Norris, William Charles 55–6
North Carolina Public Employees' Retirement System 173–4
North Dakota 46–7
Northern 148
Northrup Grumman 430
Northwestern 70
Norway 447, 477
Norwegian Government Pension Fund 430–3, 472
Norwich Union 479
Novak, David C. 366
Novell Inc. 182
Novo Mercado 419–20, 422, 425
Nuevo Energy 61

Obama, Barack 150, 370, 394
O'Barr, William M. 163–4, 202
"obligation of significant ownership" 124
O'Brien, Justus 309
Ocado 259
Occidental Petroleum 50, 212, 292, 366, 369, 375
occupational safety 86, 450–1, 453–4, 455–6
Oceaneering International 266
O'Cleiracain, Carol 154, 207
O'Connell, Kathleen 204
Odland, Steve 386
Ogden, Dayton 352
Ohio 189
Olds, Irving S. 326
Olson, John 263
Omnibus Budget Reconciliation Act (OBRA) 98 n75
Omnicom Group 197
One Report system 84
one share, one vote 134–9, 141, 237, 241 n75, 442, 478
OpenSecrets 43, 44
Oppenheimer Funds 330
Oracle 185, 356, 358, 360, 366
Oregon 188
Organization for Economic Co-operation and Development (OECD) 93, 458, 459, 461, 478
organizational structure 72, 355, 456
Ortiz, Juan 40
outsourcing 59, 402, 417
overpayments 387
oversight 12–13, 482
  bad faith 277
  dereliction of duty of 278
  Enron 300
  government 427
  ICGN Principles 479–80
  limits to 295, 301–2, 318–19
  PCAOB 392–3
  see also monitoring; regulation
Ovitz, Michael 269–71, 339
ownership 8, 105–11, 134
  directors 266
  employees 395–401, 411
  executive compensation 373–4
  FERS 198
  fractionated 9, 125–9
  "ideal owner" concept 228–34
  "obligation of significant" 124
  pension funds 166–9, 202
  separation of ownership and control 118–25, 126, 129–34
  SOEs in Poland 462–4
  Sweden 436
  see also shareholders
Ozaki, Robert 398–9

P&O 26–7, 466
Packard, David 217–18
"PacMan" takeover defense 290
Pagell, Ruth A. 72
Pakistan 417
Pampered Chef 59
Pantry Pride 286
Paramount Communications, Inc. 230, 290, 313
Parents Television Council 206–7
Parker, Hugh 305
Parker, Jeffrey 21
Parmalat 296, 432
partnerships 7, 9, 95 n6, 115, 116
Paterson, David A. 158
Patterson, D. Jeanne 189
"pay to play" arrangements 175, 177
peer group manipulation 384
Penn Central Railroad 36
Pennant-Rea, Rupert 476
Pennon 466
Pennsylvania 11, 52–3, 98 n64, 123, 211
Pennzoil Co. 248 n199
Pension and Welfare Benefits Administration (PWBA) 168
Pension Benefit Guarantee Corporation (PBGC) 166
pension funds 13–14, 123, 154–69, 245 n139, 349, 484

active corporate governance 432
active money management 132
activism 169–70, 173–88, 229, 230, 482
AFSCME 195–7
diversification 121
economically targeted investments 189–93, 205–6
ERISA 130
FERS 197–9
Fog Cutter Capital Group 59
General Mills 132–3
Hermes 221–2
"ideal owner" concept 233–4
international governance 429
as investors 164–6
Norwegian Government Pension Fund 430–3, 472
as owners 166–9
Poland 461
private 144, 155, 156, 157, 163–4, 167, 168, 201–6, 226, 233
public 144, 155, 157–8, 159–64, 167, 169–200, 226–7, 233
Slovakia 460
socially responsible investing 194
stewardship principles 483
Sweden 436
tax incentives 155
pension plans 55, 130, 154
defined-benefit 127, 128, 156, 159–63, 170, 204
defined-contribution 156–7, 162, 163, 175, 197
Pension Protection Act (2006) 156
Pensions Investment Research Consultants (PIRC) 486
PepsiCo 184, 445
performance
CEO contracts 390
compensation linked to 151, 182, 203, 292, 320–3, 364–5, 371–3, 376, 379, 382
Embraer 425
occupational safety 455
pension funds 163
performance measurement 47–8, 70–1, 72, 92, 355
Perot, Ross 173
perpetual rights 397
perquisites 371, 372, 382, 387, 389, 426
Perry, Richard 132
Pershing Square Capital Management 221
Personnel Corporation of North America (PCA) 297–8
"persons", corporations as 4, 6, 11, 12
Peterson, Peter 305
PetroChina 360, 419, 428
Peyer, Urs 385
Pfizer, Inc. 22, 295, 351, 385
PG&E 25, 183, 322
pharmaceutical corporations 91
Pharmacia & Upjohn Company 22
Phelan, John J. 135, 136
Philip Morris 200, 360, 369, 375
Philippines 417
phony cuts 386
Pickens, T. Boone 207, 290
Pilgrim, Gary 147
Pinera, Jose 106
Pirate Capital 221
Pitt, Harvey 207
plan sponsors 202
Planned Parenthood 58, 59
Plato 395
Plender, John 204, 445
Pohl, Gerhard 111
"poison pills" 8, 119, 199, 202, 213–14, 229, 286, 288–9, 342 n37, 343 n38
Poland 417, 446, 447, 461–4
Polaroid 55, 114, 290, 300, 400
police pension funds 173
policy 14, 232
political action committees (PACs) 40, 42, 44
politics 13, 82–3, 91–2, 418, 484
China 444
corporate contributions 40–5, 68
pension funds 170, 171, 175, 177
Porter, Michael 228, 235
Portugal 447, 448
Pound, John 350
power 108, 112, 252, 281
discretionary 253, 339
limitation of 16–17
"obligation of significant ownership" 124
Powers, William, Jr. 299–300
PPG Industries 203
Premark 72
Premier Pacific Vineyards Inc. 171
price fixing 20, 30, 34, 88–90
PriceWaterhouseCoopers (PWC) 262, 263
Principles for Responsible Investment 83–4
prisoner's dilemma 143–4, 429
Pritzker, Jay 285
Private Equity Conference 125
privatization 106–7, 158, 238 n18
Czechoslovakia 110–11
developing economies 458, 459
Embraer 420
Poland 462
United States 427
pro forma reports 65–6
PRO NED 335–6
Procter & Gamble 360
profit maximization 50, 53, 54, 82, 83, 130, 398
profit-sharing plans 424
property 7, 106–9, 143
morbid capital 413 n53
"mortmain" statutes 397
separation of ownership and control 119, 120, 126

Proudhon, Pierre-Joseph 107
proxies 117, 125, 145–6, 234, 282
  AFSCME 196, 197
  confidential voting 329
  Dodd-Frank Act 394
  election of directors 324, 327, 329–30, 331–3
  ERISA funds 201, 202, 203, 208
  Harvard University 150
  insurance companies 149
  investment managers 342 n26
  mutual funds 147, 148
  North Dakota law 47
  Pennzoil case 248 n199
  shareholder activism 213, 215, 217
Proxy Democracy 217
Proxy Governance Inc. 212
prudence 164–5, 192, 201
Public Company Accounting Oversight Board (PCAOB) 392–3
public interest 167, 201, 206, 429
Public Utility Holding Company Act (1935) 138, 140, 242 n80
Pulte Homes 197
Putin, Vladimir 441
Putnam Investments 330

Qiao Liu 444
Quaker Oats 72, 292, 355
Quattrone, Frank 22
Quickturn Design Systems, Inc. 289
Qwest 348, 359, 379

R. J. Reynolds 134, 298
R. P. Scherer Corporation 146
"race to the bottom" 11, 19, 45, 79, 96 n16, 114, 417, 428, 471, 477
Radio Shack 356–7, 411
Radler, F. David 299
Ramada Inc. 125
Rand, Ayn 5
Rappaport, Alfred 70
ratings agencies 74
rational ignorance 144, 172
Raymond, Lee 384
Raytheon 197, 357, 410–11
re-load provisions 374
Reader's Digest 153
Reagan, Ronald 38
Refco 140
Regan, Edward V. 47, 157, 170, 174–5, 189, 213, 229–30
Regions Financial 196
regulation 11, 13, 18–20, 46, 50, 338
  China 444
  environmental 83, 451, 466
  financial 33
  insurance companies 149
  one share, one vote 138–9
  Pennsylvania 52–3
  Poland 461
  regulatory neglect 482
  shareholders 140–1
  Thailand 461
  see also Dodd-Frank Act; Employee Retirement Income Security Act; oversight; Sarbanes-Oxley Act; Securities and Exchange Commission
Reich, Robert 168
Relational Investors 221, 222–3
relationship investing 225
remuneration *see* compensation
reporting
  climate change 183
  Embraer 425
  Global Reporting Initiative 84, 86–7, 465
  international 468, 469–70
  Poland 463
  sustainability 84, 85, 465–7
Reports on the Observance of Standards and Codes (ROSC) 459
Republican Party 40, 43, 44
reputation 5, 51, 184, 282
research analysts 32
responsibility 6, 80, 105
  directors 280–1, 302–3, 315, 337
  pension funds 164
  shareholders 105–6, 126–7, 141–3, 482
  see also accountability; liability; social responsibility
restricted stock grants 364, 368, 379–80, 381
restructuring charges 63–4
retirement packages 372, 381, 384, 387, 389
return on equity (ROE) invested 64
Revlon 275, 276, 284, 286–7
Rigas, John 22, 382–3
rights 12, 17, 21
  China 444
  ownership 105, 124, 130–1, 144, 202, 234, 235, 463–4
  perpetual 397
  property 108–9, 120
  shareholder 117–18, 119, 129, 213–14, 229, 253
Ripley, William Z. 137–8
Ripplewood Holdings LLC 153
risk 131, 165, 237, 282, 319, 396
  cash balance plans 162
  executive compensation 364
  externalization of 116
  foundations 153
  moral hazard 133
  pension funds 154, 157, 168
  risk management 255, 363, 477
Rite Aid 322
RJR Nabisco 50, 102, 296–7, 298
Roberts, George 102
Roberts, Leonard 357
Robinson, James D., III 227, 258, 292
Rockefeller, John D. 113, 120

Roe, Mark 205, 226
Rose Foundation for Communities and the Environment 153
Rosen, Ben 293–4, 338
Ross, Stan 198
Ross, Steve 365
Rott, Roland 442–3
Rove, Karl 44
Royal Bank of Scotland (RBS) 325
Royal Dutch/Shell 360, 361, 418–19, 452
Ruback, Richard 137
Rudman, Warren 305
Rumsfeld, Donald 40, 91
Russia 107, 139, 432, 440–1, 484
  GMI rating 448
  government policy 427
  IT sector pay 417
  Sakhalin Energy Investment Corp. 418–19
Russo, Pat 380

safety issues 450–1, 453–4, 455–6
Safeway 176, 196
SAFRAN 430
Sakhalin Energy Investment Corp. 418–19
Saks Inc. 379
Salomon Brothers 224, 226, 330, 338, 375, 480
Salvage, Lynn 298
Samuels, Maurice 152
San Diego employees' pension system 176
Sandland, Mike 479
Sanmina-Sci 379
Sanwa Bank 360
Sara Lee Corporation 180
Sarbanes-Oxley Act (2002) 35, 79, 217, 296, 338, 392–4
  audit committees 265
  backdating options 385, 449
  board independence 235, 258
  compliance costs 267
  departure of directors 314
  Embraer 424
  financial experts 322
  loans 383
  Section 404, 393
  violations 358
SBC Communications 259
scandals 17, 296–300, 302, 305, 392, 417, 432
  audit 48–9, 214, 265
  backdating options 272–3, 385, 449
  CEOs 356–7
  conflicts of interest 61
  Hewlett-Packard 128, 340
  Madoff 239 n46
  mutual funds 147
  pension funds 170, 171–2, 175–7
  price fixing 88–90
  private equity firms 125
  Refco 140
  UNH 183
  see also corruption; fraud
Scherer, Karla 146
Schering-Plough 22, 390
Schlumberger 360, 366
Schmookler, Andrew B. 91–2
Scholes, Myron 39
Schwab 148, 196, 330
Schwarzenegger, Arnold 175, 365
Schwarzman, Stephen 150
Scott Paper 212, 292
Scottish & Southern Energy 466
Scottish Power 466, 467
Scrushy, Richard 21–2
Seagram 343 n38
Seaman, Barrett 37
Sears, Roebuck & Co. 235, 356, 359, 360
  ESOP 400
  executive compensation 369
  failure of governance 363
  Monks' board contest 211, 325–6
  separation of chairman/CEO role 334
  shareholder activism 212
Securities Act (1933) 140, 220, 477
securities analyst settlement 32
Securities and Exchange Act (1934) 140, 468, 477
Securities and Exchange Commission (SEC) 18, 36, 48, 86, 468
  accounting rules 62, 65–6, 469, 470
  AOL accounts 49
  audit committees 265
  boards of directors 338
  "circuit breakers" 131
  classified boards 328
  climate change 183
  compensation disclosure 381–2, 388
  consultant fees 373
  director nominations 310
  disclosure requirements 77, 257
  FASB recommendations 67
  Hermes 232
  market for independent directors 335
  mutual funds 148
  nonfinancial performance data 73
  PCAOB oversight 393
  Pennzoil case 248 n199
  pension fund scandals 175, 176
  proxies 197, 217, 248 n195, 329, 331
  securities analyst settlement 32
  shareholder proposals 207, 208, 211, 215, 368
  succession practices 309, 392
  Sunbeam 225
  UNH scandal 183
  voting rights 135, 136, 137, 138
Securities Exchange Act (1934) 272
Segal, Harvey H. 112
self-interest 120, 130, 133

self-regulation 17, 32–3, 67, 86, 135, 443
severance agreements 295, 372, 384–5
 CalPERS activism 181–2
 Disney-Ovitz case 270–1
 Hewlett-Packard 356, 359, 390
 Institutional Shareholders Committee 187
 Tambrands 298
 Warnaco 299, 367
 Westinghouse 307
Shaheen, George 369
Shamrock Capital Advisors 221
shareholders 101–249, 350, 477
 activism 169–70, 177–88, 200, 202–3, 206–20, 222–35, 364–5, 480–1, 484
 AFSCME resolution 195–7
 alignment of CEO's interests with 363, 376
 American Law Institute principles 82
 change of control 391
 China 444
 "choice" 115
 Citizens United case 17
 communication with 264–5
 consent 124–5
 corporate crime 20, 33–4
 directors as 301–2, 337
 directors' duty to 50, 51–2, 253
 disclosures to 61
 disenfranchisement of 125, 131, 136
 Disney-Ovitz case 270–1
 Dodd-Frank Act 394
 election of directors 324–30, 331–3
 Embraer 421–3
 executive compensation 364–5, 368, 379, 388
 fiduciary standard 102–3
 financial reporting 469
 Ford Motor Company 113
 fractionated ownership 9, 125–9
 Hermes 222
 Hollinger 299
 "ideal owner" concept 228–34
 interests 54–5
 Isetan 438–40
 Japan 444–5
 lawsuits 15–16
 limited liability 6, 8, 105, 129, 237
 maximization of returns to 58, 71
 monitoring by 124
 North Dakota law 46–7
 oversight by 12–13, 339
 passivity 478–9, 484
 Pennsylvania law 52–3
 "poison pills" 288–9
 prisoner's dilemma 143–4
 profit maximization 83
 removal of directors 34
 resolutions on governance 148–9
 responsibility 105–6, 126–7, 141–3, 482
 rights 117–18
 separation of ownership and control 118–25, 126, 129–34
 Slovakia 460
 stakeholder laws 51, 54
 stewardship principles 482–3
 SUM 255–6
 takeovers 285, 286–7
 voting rights 134–9
 "Wall Street rule" 129, 318–19
 see also institutional investors
Shareholders Education Network 217, 330
shares 67, 68, 131
 dual-class 135–6, 137, 139, 144, 213, 237, 437, 483
 Embraer 421–3, 425
 ICGN policies 374
Shaviro, Daniel 32
Shearson Lehman Hutton 173
Sherman Act 89
Sherman, Howard D. 306
Shlensky v. Wrigley 15–16
Shorin, Arthur 274, 275
Sibson & Co. 72
Siedle, Edward 165–6
Siemens AG 22–3
Sierra Club 61
Silvester, Paul J. 175
Simmonds, Ken 315–17
Simmons, Ruth 261
Simpson, Anne 123–4
Simpson, O. J. 265, 319
Singapore 438–40, 446, 447
Singapore Technologies 200
Singer, Joseph W. 57–8
Sirius XM Radio Inc. 370
Six Flags theme park 70
Skandia 73
Skilling, Jeffrey 21, 300
Sloan, Alan 147, 383
Slovakia 460
Smith, Adam 106, 108, 154, 252–3
Smith Barney Asset Management 330
Smith, Sandy 351
Smith v. Van Gorkom 284, 285–6
SmithKline Beecham 351
Snapple 355
Snow, John 305, 319, 384
Snow, William 319
social accounting 86, 87
social investing 83–5, 169, 189–93, 194, 237
Social Investment Forum 185, 485
social responsibility 14, 15–16, 60–1, 83–7, 194, 206
 Cadbury paradigm 80
 Institutional Shareholders Committee 187
 international operations 457

Mondragón cooperatives 407
Nathan Cummings Foundation 485
shareholder influence 184–6
Social Security 157, 161–2, 197, 199
socialism 155, 171, 198, 395–6, 416, 440
Society for Establishing Useful Manufactures (SUM) 255–6
"soft dollar" industry 247 n187
solicitation expenses 197
Sonenshine Partners 279
Sonnenfeld, Jeffrey 308, 391–2
Soss, Wilma 206
Sotheby's 314
South Africa 55, 58, 206, 427
divestment from 174–5, 237
GMI rating 446, 447
King Report 470–1
Triple Trust Organization 86
South Dakota 19
Sovereign Bank 222–3, 290, 321–2
Sovereign Wealth Funds (SWFs) 477, 482
Spadoni, Charles B. 175
Spain 406, 446, 448
"special purpose entities" 12, 169, 300, 302
specialization 109
Spencer Stuart
boards of directors 256, 257, 261, 266, 284
CEOs 212, 352
China 444
directors' compensation 319, 322
succession planning 308
women directors 264
Spitzer, Eliot 32, 173
spring-loading 385
Sprint 72, 379, 386, 391
Stack, Christopher A. 175
staggered boards of directors 327–8
stakeholder laws 51, 52–3, 54
Standard & Poor (S&P) 74, 132, 157, 165, 198, 204, 266, 267, 301, 449
Standard Brands Inc. 298
Standard Oil Company 112–13
standards 18, 92
accountability 82, 83
accounting 49, 63, 64
environmental 56, 86
see also fiduciary standard
Stanley, Albert 23
Star 361
State of Wisconsin Investment Board (SWIB) 214–15
state-owned enterprises (SOEs) 443, 462–4
State Street 148
Steel Partners Japan Strategic Fund 445
Steffen, Christopher J. 74
Steiner, Jeffrey 368
Steiner, Ken 208
Steiner, William 323
Stern, Joel 70
Stern Stewart 70, 71, 267
Sterndent 290
Stevens, John Paul 41
Stevens, Ted 198
stewardship 482–4, 486
Stewart, James 297
Stewart, Thomas 350
Stiglitz, Joseph 238 n18, 476
stock market 47, 113–14
stock options 46, 49, 63, 150–1
accelerated vesting of 374, 383
backdating 271–3, 368, 385, 386, 449
CEOs 349, 365, 367, 368–70, 372, 374–9, 381, 389
directors 266, 319, 320, 323, 333
disclosure 382
phony cuts 386
re-pricing 68, 203, 368, 369, 374, 375, 382
Tambrands 298
valuation of 66–9
stock prices 71–2, 129, 272, 323, 368, 377, 379
Stoller, Martin 216
Stone & Webster 5, 13, 121
Stone, Christopher D. 35
Stone, Harlan Fiske 236, 486
Stone v. Ritter 277
Stonecipher, Harry C. 356
strategic planning 337
Strauss, Robert L. 297
Streep, Meryl 365
Stride Rite Corporation 59–60
succession planning 308–9, 312–13, 337, 340, 348, 391–2
Emap 315–16
Institutional Shareholders Committee 187
lead directors 263
Sudan 188, 428, 485
Sumitomo Bank 360
Summers, Larry 13
Summit Bank 391
Sun Microsystems 183, 266, 383
Sunbeam 48–9, 212, 214, 225, 265, 294, 337, 349
SunTrust 196
Supreme Court 12, 19, 109, 477–8
Citizens United case 11, 17, 41, 43
ERISA 249 n212
fiduciary duty 104
Newark Morning Ledger v. US 98 n75
political contributions 40
sustainability 84, 85, 184–6, 426, 465–7
sustainable and responsible investment (SRI) 485–6
Swanson, William H. 357
Sweden 435–7, 446, 447
Switzerland 447
Sykes, Allen 483
Symantic Corporation 118
Syse, Henrik 431

T. Rowe Price 147, 148, 330
Taiwan 416, 448
Taiwan Semiconductor Manufacturing 446
Takagi, Yasumoto 35
takeovers 129–31, 284–91, 327
  anti-takeover laws 11, 19, 52–3, 211
  Germany 442
  stakeholder laws 51
  two-tier tender offers 134
  see also acquisitions and mergers
Tambrands Inc. 297–8
Tan Lye Huat 438, 439
Taney, Roger B. 112
Target 45
tax incentives 11, 45, 155, 162, 400
taxation 150, 159, 387, 428–9, 438–9
Taylor, William 223–4
Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF) 169–70, 188, 199–200, 208, 210, 305, 330, 482
Telerate 355
Templeton Funds 330
temporary employees 402
Tenneco, Inc. 203
Tennessee Valley Authority (TVA) 88–9
termination of CEOs 390
Teslik, Sarah A. B. 296
Texaco 147, 175, 287–8, 360, 361
Texas City industrial accident (2005) 450, 452, 453–6
Thailand 417, 432, 447, 458, 459, 461
Thatcher, Margaret 106
Thiesfield, Lisa A. 175
Thomas H. Lee Partners 140
Thomas, Simon 468
Thurlow, Edward, First Baron 20
Tibet 200
Tillerson, Rex 454
Timberland 384
Time Warner 230, 286, 290
  AOL deal 391, 413 n44
  CalPERS lawsuit 183
  competition with Disney 70
  executive compensation 365
  hedge funds 221
  "poison pill" 119, 343 n38
  police pension funds 173
  political contributions 40
Tokarz, Michael 260
Tontine Associates LLC 220
"too big to fail" concept 36–8, 39
Topps Company 274–6
Toronto Stock Exchange 139, 437
Tosco 361
Total 361
Towers Watson (formerly Towers Perrin) 151, 369
Toyota 360
Toys-R-Us 390
Trade Services Corporation (TSC) 278–9
trade unions 155
Trades Union Congress (TUC) 486
Trans Union 284, 285, 331
transaction bonuses 386–7
transferability 7, 8, 105, 118–19, 124, 229
  consequences for corporations 134
  "poison pills" 213–14
  separation of ownership and control 129, 131
transparency 78, 217, 235
  Embraer 426
  global corporate governance 457, 459, 468–9
  ICGN Principles 373, 434, 480
  Poland 463
  sustainability reporting 85
  World Bank goals 93, 472
Travelers' Insurance Company 172, 212, 322
Tribune Company 322
Triple Trust Organization (TTO) 86
Trollope, Anthony 252
Trucost 465–7
Trump Hotels 65–6
trustees 103–4, 112, 121–2, 126, 429
  accountability 229
  AFSCME 195
  bank trusts 145–6
  conflicts of interest 127
  FERS 198
  foundations/universities 149–50
  non-neutral 201
  pension funds 154–6, 167–8, 170, 171, 192, 202, 234, 484
  R. P. Scherer Corporation 146
  stewardship principles 483
trusts 112, 113, 145–6, 400
Tsai, Gerry 114
Tucker, Lawrence 323–4
Turkey 448
Turnbull, Shann 396, 399, 400
Turner, Lynn 385
Turner, Ted 348
Turteltaub, Adam 363
Twain, Mark 431
Twitter 301
two-tier tender offers 134
Tyco 19, 359, 390, 392
  board of directors 296, 302, 314
  failure of leadership 348
  loans 383
Tylenol 80–1

Ultramar Diamond Shamrock 361
Union Pacific Corp. 258, 383
Unisys 212
Unitarian Universalist Association 188–9

United Airlines 122, 368, 401
United Arab Emirates 416, 477
United Companies Financial (UC) 215–16, 235
United Food and Commercial Workers Union 176
United Kingdom (UK)
 accounting standards 468–70
 boards of directors 255–6, 259, 261, 264, 293, 304, 325, 334
 derivative lawsuits 117–18
 executive compensation 370–1
 financial crisis 476
 GMI rating 445, 446, 447
 goodwill 65
 governance as private contract 427
 government oversight 427
 Hermes 144, 221–2, 231–3, 482, 487 n10
 institutional investors 484
 Institutional Shareholders Committee 187–8, 479
 joint-stock companies 108
 occupational safety 455–6
 political contributions 44
 privatization 106
 shareholder activism 186
 stewardship principles 482
United Nations (UN) 185, 458, 464, 476, 485
United Natural Foods 379
United Shareholders Association (USA) 207–8, 368
United States (US)
 accounting standards 468–70
 boards of directors 255, 283–4, 304
 debt to China 418, 473 n3
 derivative lawsuits 117
 environmental laws 83, 86
 evolution of the corporation 111–14
 executive compensation 370
 FERS 197–9
 GMI rating 445, 446, 447
 goodwill 65
 governance as private contract 427, 435
 institutional investors 144, 484
 IT sector pay 417
 legal jurisdiction 477–8
 politics 91
 property rights 108–9
 Sovereign Wealth Funds 477
United States Steel Corporation 113
United States Synthetic Fuels Corporation 10
United Technologies 84, 290, 430
UnitedHealth Group (UNH) 183, 359, 366, 379, 385
universities 149–50, 429–30
Unocal 51, 200, 284, 361
Unruh, Jesse 287
The Upper Deck Company 274–6
US Surgical 375
USAir 224, 345 n88, 368
Vagelos, Roy 15, 351–2
Valero Energy Corporation 196
value 47, 62–72
 of cash 74–7
 externalities 79
 human capital 72–3, 74
 long-term 93
 Topps Company 275–6
 value chains 73
Van de Kamp, Andrea 314
Van Gorkom, Jerome William 285–6
Van Kampen Investments 330
Vanderbilt, Cornelius 120
Vanguard 132, 148, 330
Venezuela 419
venture capital 168, 189
"vest fleecing" 383
vestigial owners 128
Viacom Inc. 383, 384–5
Vietnam 458
Villalobos, Alfred 171–2
Virginia 176
Virginia Company of London 255
Virginia Company of Plymouth 255
Visual InfoSoft/MaterialExpress.com (VIS/ME) 278–9
Vodafone 360, 443
Volkswagen AG 193–4, 427
voluntary restraint agreements (VRAs) 38–9
voting 129, 229, 241 n78
 CalPERS activism 178–82
 confidential 145
 directors 324–30, 331–3
 Dodd-Frank Act 394
 dual-class stock 483
 Embraer 420, 422
 GMI research 446
 institutional investors 483
 Institutional Shareholders Committee 188
 Investor AB 436–7
 majority 46, 213, 325, 331–3, 337
 Mondragón cooperatives 406, 407
 one share, one vote 134–9, 141, 237, 241 n75, 442, 478
 shareholder activism 212–13, 214
 Slovakia 460
 see also proxies

W. R. Grace & Co. 227
Wachner, Linda 298–9, 367
Waksal, Sam 36
Wal-Mart Stores 25, 120, 207, 360, 430
Walden Asset Management 85, 185
Walker report 482
"Wall Street rule" 129, 318–19
Wallace, David 297
Wallace Foundation 153

Wallman, Steven M. H. 73
Walton, Sam 120
Wang 135
Warnaco 298–9, 367
Washington Post Company 69, 135, 254
Waste Management 5, 48–9, 214, 265, 359
  CEO departure 212, 292, 307
  fraud judgment 25
  "golden hellos" 386
  separation of chairman/CEO role 334
  shareholder activism 222
wealth creation 10, 416, 427
Webvan 369
Wedoff, Eugene 401
Weidner, David 24
Weill, Sandy 386
Weinstock, Lord 74
Weissman, Robert 36
Welch, Jack 348, 361–2, 381, 387, 389
Wellcome Trust 122
Wellpoint 197
Wells Fargo 19, 196, 198, 360
Wells, Frank 269
Wendt, Gary 349, 381, 386
Westinghouse Electric Corp. 204, 306–7, 362
  CEO resignation 292
  ESOP 400
  price fixing 20, 88–90
  restructuring charges 64
  separation of chairman/CEO role 334
  shareholder activism 212, 230
Westly, Steve 175
Weyerhaeuser Co. 182
whistleblowers 35, 186, 394
white knights 224, 290
Whitehead, John C. 338
Whitworth, Ralph 223
Wiederhorn, Andrew 59, 258
Wierton Steel 401
Williams, Harold 388
Wilshire Associates 53, 98 n64, 223
Wilson, Pete 175
Wilson, Tylee 296–7
Wilson, Woodrow 114
Winokur, Herbert S., Jr. 300
Wisconsin 173, 189, 214–15, 230
Wolfensohn, James D. 416, 459
Wollock, Richard 171
women 189, 264, 458
Wood, Kimba 207, 248 n195
Wooldridge, Adrian 5
World Bank 93, 416, 458–64, 472
World Wildlife Fund (WWF) 61
WorldCom 5, 90, 359, 392, 432
  board of directors 296, 331
  executive compensation 380
  failure of leadership 348
  loans 382–3
  prison sentences 21
WPP 380
Wrigley Corporation 15–16
Wriston, Walter 307
Wyman, Tom 349

Xerox 114, 204, 359, 360
XTO Energy 196

Yahoo! 216, 379
Yahoo Finance 301
Yeltsin, Boris 441
Yerger, Ann 151
Yermack, David 387
Ying Fang 444
Young, Owen D. 397–8
Young, Shirley 259
Young, Whitney 55
Yucaipa, Co. 171
Yukos 441
Yum! Brands, Inc. 366

Zion, David 204
Zuckerberg, Mark 10