A Real Look at Real World CORPORATE GOVERNANCE

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Preface

The contents of this book are the result of many years of diligent research by the authors. Our area of interest is "corporate governance," a broad field of study that involves organizational decisions made by the senior-most individuals of a corporation. These include:

- How do you assemble the *best* board of directors?
- How do you pick the *best* CEO?
- How much should a CEO *really* be paid?
- How do you *really* make sure the company is succeeding?

The list of questions goes on.

In the course of our study, we have noticed certain tendencies among the most vocal "experts" in corporate governance today. These include the tendencies to simplify decisions that are inherently complex, to prescribe uniform solutions to problems that are anything but uniform, and to be confident that their recommendations are correct when the evidence is anything but conclusive. We wrote this book, in part, to correct these tendencies.

In addition, we wrote this book for curious readers who are interested in corporations, how they are run, and how to make them better. You might be executives, directors, or employees. You might be investors, regulators, or other observers. This book takes an honest look at the issues and decisions that really matter for corporate success and lays them out in a way that allows you to reach your own conclusions about what works, what doesn't, and why. In the end, it's your judgment—not the judgment of "experts"—that counts the most.

We would like to thank Michelle E. Gutman, our long-time researcher and close friend, whose unending effort underlies every page of every chapter in this book. Over the years, we have written many articles and papers, none of which would have been possible without her.

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Introduction

It never fails. Following every large-scale corporate collapse come calls for corporate reform. It doesn't matter whether the failure was Enron in 2001, the Penn Central Railroad in 1970, or the Knickerbocker Bank in 1907. The aftermath is the same: an insistence on the part of societal leaders and activists to do *something* to influence, curtail, or restrict corporate activity so that future crises are prevented and the damages they inflict avoided.

Today is no different. The bankruptcy of Lehman Brothers in 2008—which nearly brought down the entire United States banking sector—elicited a chorus of governmental leaders agitating for change. To the White House, the problem was one of "greed and irresponsibility on the part of some." To the Federal Reserve, it was "misaligned incentives and excessive risk taking." To the Senate, it was a "lack of responsibility and accountability to shareholders." Consensus is that *self interest* nearly brought down the system and only a reduction in self interest would save the system in the future.

To achieve this, Congress passed a legislative bill that was monumental in both name and scope: the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Over 2,300 pages in length (35 times longer than the Sarbanes-Oxley Act of 2002), the law imposed rules and regulations impacting all aspects of the financial system, including banking, consumer credit, mortgage lending, derivative trading, insurance, and private partnerships. It also mandated a series of corporate governance reforms that applied to all publicly traded companies, regardless of industry or activity.

Dodd-Frank was not the end. No sooner was the law enacted than shareholder groups demanded new reforms beyond the act's scope. These groups sought changes to all aspects of corporate oversight, including the composition and workings of the board of directors, the size and structure of executive compensation, and the rights of shareholders to influence corporate matters. In the words of shareholder activist Carl Icahn, "Lax and ineffective boards, self-serving managements, and failed short-term strategies all contributed to the entirely preventable financial meltdown. It is time for battered shareholders to fight back."[1]Unanswered in the debate are perhaps the most important questions of all: Will any of these reforms work? Is this the solution to the problem?

At least one prominent observer is wary. In a *New York Times* article, Professor Steven Davidoff of Ohio State University Law School argues that while corporate governance reforms have the potential to improve the accountability of corporations to their shareholders, their ultimate success is unclear. He warns of "unintended consequences," including the unfortunate tendency of regulators and activists to emphasize "procedure over substance." He recommends that shareholder advocates study the effectiveness of their recommendations before compelling adoption. To this end, he calls governance "an empirical question."[2]

We agree. Corporate governance *is* a complex issue. Governance involves organizational decisions made at the senior-most level that directly influence the incentives, motivations, and behavior of all employees. These decisions are not easy to make, because it is not always clear *in advance* how structural and procedural changes will cascade throughout an organization to impact the dedication, drive, and honesty of its members.

We also agree that many of the so-called "best practices" promulgated today by governance experts have created an unintended emphasis on procedure over substance. While the problems of corporate governance might be obvious—repeated instances of accounting scandal, entrenched management, disengaged boards of directors, excessive compensation, and poor oversight—the solutions to these problems are not. As a result, the quick fixes that many experts have offered (and regulators subsequently adopted) tend to be superficial in nature. This has led to the situation in which we find ourselves today where the worst offenders check the boxes and claim compliance, while perfectly honest organizations continue to have to justify their unwillingness to conform.

In the long run, the best solution—indeed, the only workable solution—is to test various governance practices to see whether or not they work. Corporate governance is *empirical* in nature. Through standard social science tools (observation, objectivity, and measurement) we can learn which approaches are effective and which are not. This means that we do not need to resort to guesswork to advise corporations and their directors how to improve accountability and shareholder value, nor do we need to employ ideological arguments. We need to examine the research evidence, taking into account the idiosyncratic nature of each company's specific situation, and draw reasoned conclusions about the best courses of action.

This book is fundamentally dedicated to this approach. In the following chapters, we examine important governance issues through a lens that incorporates *both* research and experience. The conclusions are not always simple, but we believe this approach provides considerably more insight than theoretical arguments not grounded in fact. It also promises a new appreciation for the complicated issues that directors, managers, and shareholders grapple with each day.

WHAT IS CORPORATE GOVERNANCE?

Before we jump in, it is important to explain just what we mean by "corporate governance"—a term widely used but rarely defined. The theory of corporate governance rests on the idea that a separation between the ownership of a company and the management of a company creates the *potential* for management to take actions that further their own self interests, with the cost of these actions borne by shareholders. This is a classic economic problem, called the "agency problem." The phrase "agency problem" means just what the words imply: a problem that occurs when you hire another person to work on your behalf. We all know that agents—whether they are sales reps, real estate agents, or investment professionals managing your retirement account—care about their personal success as well as your own. Whether they take actions that are primarily in *your* best interest, *their own* best interest, or a combination of these is an important question that you will want to understand, but also a difficult one to predict in advance.

The same applies to the business world where the individuals running a business are not always the same as those who own the business. For example, imagine that you purchase the bar in your local town and decide to hire a manager to operate it on your behalf. This person is, in effect, your agent. If he or she works diligently to maximize profits, then you do not have much of an agency problem to worry about. If, on the other hand, this person takes cash out of the cash register, pours drinks for friends without charging them, undercharges patrons so that they in turn over-size their tips, or periodically takes bottles home for personal consumption, then you have a full-fledged agency problem on your hands. How you deal with this problem will depend on what solution you think is likely to work in a cost-effective manner. You might choose to add *control* systems, such as a cash register or inventory management system. You might choose to add a *monitoring* system, such as closed-circuit cameras or asking people you trust to periodically stop in to observe your manager's behavior. You might change the *incentive* system, such as offering your manager a percentage of the profits. Or you might make a *cultural* change, such as implementing a policy of only hiring people who

are trustworthy in nature or highly ethical and then reinforce the importance of these behaviors through organizational routines (such as recognizing an "employee of the month"). The purpose behind these approaches is to forestall or reverse problems caused because the person managing the business is not the same as the person who owns the business. Not all of these approaches, however, will be cost-effective and as the owner you are interested only in adopting the ones that are.

The shareholders of large, publicly traded multinational corporations have the same concerns as the owner of the local bar, only on a much larger scale. The professional manager hired to run the corporation is an "agent" of the shareholders. The processes and procedures put in place to ensure that this agent works diligently to maximize profits are known as "the system of corporate governance." These might include control systems, such as inventory management or risk management protocols. They might include monitoring systems, such as a board of directors or an internal or external auditor. They could be incentive-based, such as a compensation system that includes performance bonuses. Or they might be cultural, such as an emphasis on ethical behavior and doing the right thing. What is clear in the corporate world, as in our earlier example, is that not all solutions are equally effective. Unnecessary or arbitrary requirements are likely to do more harm than good and, as Davidoff points out, can lead to a focus on procedure rather than substance.

HOW PREVALENT ARE GOVERNANCE PROBLEMS?

Unfortunately, everyday experience suggests that agency problems in the corporate world are a real problem that shareholders need to be concerned about. Because these behaviors are by nature concealed, and in some cases illegal, we can only estimate their prevalence. Approximately 8 percent of publicly traded companies each year have to restate their financial results due to previous manipulation or error. Approximately 10 percent of Chapter 11 bankruptcy cases involve allegations of fraud. And approximately 5 percent of publicly traded companies have been accused of retroactively changing the grant date of stock options to increase their compensation value to executives (so-called "stock option backdating"). These are severe cases of governance violations, and the frequency of low-level abuses—such as misuse of corporate spending accounts and small-dollar graft—are likely to be higher. According to a recent survey of financial service professionals in the United States and United Kingdom, 26 percent of respondents claim to have observed unethical or illegal behavior first-hand. Sixteen percent say they would commit illegal insider trading if they believed they could get away with it.[3] These are shocking figures that suggest agency problems are widespread and should not be ignored.

However, as we said earlier, recognizing the problem is not the hard part. Cost-effective solutions are the real challenge. Throughout this book we will examine a variety of topics, issues, and controversies in corporate governance. These include the obvious big-scale problems, such as financial manipulation ("cooking the books") and international bribery. They also include important "everyday" issues involving the composition of the board of directors, picking the right CEO to run the company, and designing correct pay packages for senior executives. Throughout, we will keep our attention focused on the fundamental big-picture question of which solutions work and which do not. To guide us, we will rely on empirical research and close observation. A superficial analysis will not suffice. Still, we warn you that these are complicated issues. Drawing sound conclusions will require sound judgment. It might also require changing prior beliefs. In the end, we hope that you are left with a greater appreciation for the problems that many large public corporations face and the types of solutions that do, and do not, fix them.

Part I: The Board of Directors

The board of directors is the most recognized and central player in the corporate governance system. The board of directors is a group of individuals elected by shareholders to represent their economic interests and oversee management. The New York Stock Exchange (NYSE) requires that all publicly traded companies have a board—this is not discretionary—and the majority of the board's members must be "independent" of management (a term we will define shortly). For the most part, this is also true globally.

The role of the board is both to advise and to monitor management. These are two very different functions, and a qualified director is expected to do both. The dual nature of the board's mandate can create confusion among shareholders about exactly which decisions directors are expected to make and which they are not.

In its *advisory* capacity, the board consults with management regarding strategy and operations: which products and services the company should offer, in what regions or countries it should compete, how it should position itself relative to competitors, etc. Management proposes a corporate strategy to the board to address these issues, and the board tests the strategy by asking questions of management, pushing back, and raising important considerations—all with the purpose of ensuring that management's plan is the correct one to make profitable use of corporate assets and build shareholder wealth. In its advisory capacity, the board acts *cooperatively* with management. Qualified directors are those who have relevant industry, functional, or geographic experience to advise on the issues at hand.

In its *oversight* capacity, the board is expected to monitor management and make sure that the executive team is acting in the best interest of shareholders. The board is responsible for such actions as hiring and firing the CEO, measuring corporate performance in relation to strategy, evaluating management contribution to performance, and designing the right compensation packages to attract, retain, and motivate qualified talent. The board also oversees legal and regulatory compliance, including the external audit, reporting requirements for publicly traded companies, and industry-specific regulations. To fulfill these responsibilities, the board typically relies on the advice of legal counsel and other paid professionals. In this regard, qualified directors are those who maintain *independence* from management and ensure that proper policies and procedures are in place and adhered to.

In short, effective directors are those who can cooperate and remain independent, as circumstances dictate.

What Is "Independence"?

The concept of independence might seem straightforward. Independence is the ability of an individual to maintain perspective or judgment that is unbiased by a relationship with others.

But how exactly do you *regulate* independence?

According to the NYSE, an independent director is one with "no material relationship with the listed company." It defines a material relationship as one in which the director or a family member:

- Has been employed as an executive officer at the company within the last three years.
- Has earned direct compensation in excess of $120,000 from the company in the last three years.
- Has been employed as an internal or external auditor of the company in the last three years.
- Is an executive officer at another company where the listed company's present executives have served on the compensation committee in the last three years.
- Is an executive officer at a company whose business with the listed company has been the greater of 2 percent of gross revenues or $1 million within the last three years.

If these requirements seem arbitrary, they are. Why does $120,000 in compensation compromise independence but not $100,000? Why is business representing 2 percent of gross revenues "material"? Why is three years the relevant time frame beyond which independence is restored?

As in the case of all regulations, the line must be drawn somewhere and NYSE rules do just that. For investors, this means that mistakes will be made *on both sides of the line*. Some directors will meet the independence standards of the NYSE and not be truly independent in their judgment, while others will not meet these standards and yet be perfectly capable of maintaining independence from management.

Unfortunately, it can be very difficult for shareholders to determine which directors on their board are truly independent.

Another point that is often misunderstood is that the responsibilities of the board are not the same as those of management. Directors are expected to advise on managerial items such as corporate strategy and risk management, but not to develop plans and policies themselves. They are expected to ensure the integrity of financial statements but not to prepare the statements themselves. *The board is not an extension of management*. The board is a governing body elected to oversee management and represent the interest of shareholders. When companies fail (as many do), the board is accountable not because the board mismanaged the company but because the failure occurred under its supervision. We emphasize this point because it is difficult to diagnose the source of corporate failure and offer effective remedy without first understanding the proper roles of the board and management to understand which party (if either) made a mistake.

So why is it that so many boards end up overseeing failed corporations? What does it mean for a board to be "well functioning" and what attributes and processes are associated with "dysfunction"? How can shareholders tell in advance if their company has the right board in place to satisfy the dual obligations of advising and overseeing management? In the next three chapters, we will consider these questions from various angles.

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