THE ROLE OF CORPORATE GOVERNANCE

In the first two sections of this chapter we addressed how management can exercise strategic control over the firm's overall operations through the use of informational and behavioral controls, respectively. Now, we address the issue of strategic control in a broader perspective, typically referred to as "corporate governance." Here, we focus on the need for both shareholders (the owners of the corporation) and their elected representatives, the board of directors, to actively ensure that management fulfills its overriding purpose—increasing long-term shareholder value.

Robert Monks and Nell Minow, two leading scholars in corporate governance, define it as "the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management (led by the chief executive officer), and (3) the board of directors".[1] Consistent with Monks and Minow's definition, our discussion will center on how corporations can succeed (or fail) in aligning managerial motives and the interests of the owners of the business (the shareholders) through their own efforts as well as the efforts of their elected representatives, the board of directors. As you will recall from Chapter 1, we discussed the important role of boards of directors and provided some examples of effective and ineffective boards.[1]

There is little doubt that effective corporate governance can affect a firm's bottom line. Good corporate governance plays an important role in the investment decisions of major

[1] Management, of course, cannot ignore the demands of other important firm stakeholders such as creditors, suppliers, customers, employees, and government regulators. At times of financial duress, powerful creditors can exert strong and legitimate pressures on managerial decisions. However, in general, the attention to stakeholders other than the owners of the corporation must be addressed in a manner that is still consistent with maximizing long-term shareholder returns. (For a seminal discussion on stakeholder management, refer to: Freeman, R. E. 1984. *Strategic Management: A Stakeholder Approach*. Boston: Pitman.)

institutions and a premium is often reflected in the price of securities of companies that practice it. The corporate governance premium is larger for firms in countries with sound corporate governance practices as compared to countries with weaker corporate governance standards.[2] In addition, there is a strong correlation between strong corporate governance and superior financial performance. Strategy Spotlight 9.6 briefly summarizes three studies that provide support for this contention.

Strategy Spotlight 9.6
Good Corporate Governance and Performance: Research Evidence

Below, are summaries of the results of three studies that found a positive relationship between the extent to which a firm practices good corporate governance and its performance outcomes.

1. There is a strong correlation between corporate governance and price performance of large companies. Over a recent three period, the average return of large capitalized firms with the best governance practices was over five times higher than the performance of firms in the bottom corporate governance quartile.

2. Across emerging markets: In 10 of the 11 Asian and Latin American markets, companies in the top corporate governance quartile for their respective regions had a significantly higher (averaging 10 percentage points) return on capital employed (ROCE) than their market sample. In 12 of the emerging markets analyzed, companies in the lowest corporate governance quartile had a lower ROCE than the market average.

3. McKinsey & Company conducted three surveys from September 1999 to April 2000. The surveys studied attitudes toward investing in Asia, Europe, United States, and Latin America. Over three-quarters of the more than 200 investors surveyed agreed that "board practices were at least as important as financial performance." Over 80 percent of investors agreed that they "would pay a premium for the shares of a better-governed company than for those of a poorly governed company with comparable financial performance". Interestingly, the study demonstrated that the value of good corporate governance, that is the premium that investors are willing to pay, varied across regions. Good corporate governance in the United States and the United Kingdom brought the lowest premium, at 18 percent. For investments in Asian and Latin American countries, however, the premium rises to between 20 and 28 percent. The difference in premium reflects the lack of good corporate governance standards

in Asia and Latin America as compared to companies in the United States and the United Kingdom.

Sources: McKinsey & Company, *Investor Opinion Survey on Corporate Governance*, June 2000; CLSA, *Corporate Governance in Emerging Markets: Saints and Sinners*, April 2001; and Low, C. K. 2002. *Corporate Governance: An Asia-Pacific Critique*. Sweet & Maxwell Asia: Hong Kong.

As indicated in our discussion above and in Strategy Spotlight 9.6, there is solid evidence linking good corporate governance with higher performance. At the same time, there are few topics in the business press that are generating as much interest (and disdain!) as corporate governance. Quoting from a recent article in *Business Week*, we find that….

> Faith in Corporate America hasn't been so strained since the early 1900s, when the public's furor over the monopoly powers of big business led to years of trust busting by Theodore Roosevelt. The latest wave of skepticism may have started with Enron Corp.'s ugly demise, but with each revelation of corporate excess or wrongdoing, the goodwill built up during the boom of the past decade has eroded a little more, giving way to a widespread suspicion and mistrust. An unrelenting barrage of headlines that tell of Securities & Exchange Commission investigations, indictments, guilty pleas, government settlements, financial restatements, and fines has only lent greater credence to the belief that the system is inherently unfair. [3]

A few recent notable examples of flawed corporate governance include:[4]

- AOL buys Time Warner in a deal worth $183 billion—which later results in a $54 billion write-off, the largest ever. (April 25, 2002)

- Oracle CEO Larry Ellison exercises 23 million stock options for a record gain of more than $706 million—weeks before lowering earnings forecasts. (January 2001)
- Arthur Andersen (of Enron fame!) agrees to pay $110 million to settle a shareholders suit for alleged fraud in its audit of Sunbeam. (May 2001)
- Al Dunlap agrees to pay $15 million to settle a lawsuit from Sunbeam shareholders and bondholders alleging that he cooked the books of the maker of small appliances. (January 11, 2002)
- Global Crossing, once a high-flying telecom-service provider, files for Chapter 11. In the preceding three years, the company's insiders had cashed in $1.3 billion in stock. (January 28, 2002)
- Tyco International discloses that it paid a director $10 million in cash and gave another $10 million to his favorite charity in exchange for his help in closing an acquisition deal. (January 29, 2002)
- The New York State Attorney General charges that Merrill Lynch analysts were privately referring to certain stocks as "crap" and "junk" while publicly recommending them to investors. (April 8, 2002)

Clearly, because of many lapses in corporate governance, there are many benefits associated with effective practices. However, corporate managers may behave in their own self-interest—often to the detriment of shareholders. Next, we address the implications of the separation of ownership and management in the modern corporation, which can result in a divergence between managers' interests and those of shareholders (the owners of the firm). We then address some mechanisms that can be used

to ensure consistency (or alignment) between the interests of shareholders and those of the managers to minimize these potential conflicts.

A. The Modern Corporation: The Separation of Owners (Shareholders) and Management

Some of the proposed definitions for a corporation include:[5]

- "The business corporation is an instrument through which capital is assembled for the activities of producing and distributing goods and services and making investments. Accordingly, a basic premise of corporation law is that a business corporation should have as its objective the conduct of such activities with a view to enhancing the corporation's profit and the gains of the corporation's owners, that is, the shareholders." *Melvin Aron Eisenberg*
- "A body of persons granted a charter legally recognizing them as a separate entity having its own rights, privileges, and liabilities distinct from those of its members." *American Heritage Dictionary*
- An ingenious device for obtaining individual profit without individual responsibility." *Ambrose Bierce, The Devil's Dictionary.*

All of these definitions have some validity, and each one including that from *The Devil's Dictionary*, reflect a key feature of the corporate form of business organization—its ability to draw resources from a variety of groups and establish and maintain its own persona that is separate from all of them. As Henry Ford once said, "A great business is really too big to be human."

Simply put, a corporation is a mechanism created to allow different parties to contribute capital, expertise, and labor for the maximum benefit of each of them. The shareholders (investors) are able to participate in the profits of the enterprise without taking direct responsibility for the operations. The management can run the company without the responsibility of personally providing the funds. And, in order to make both of these possible, the shareholders have limited liability as well as rather limited

involvement in the company's affairs that includes the right to elect directors who have the fiduciary obligation to protect their interests.

Approximately seventy years ago, Columbia University professors Adolf Berle and Gardiner C. Means addressed the divergence of the interests of the owners of the corporation from the professional managers who are hired to run it. They warned that widely dispersed ownership "released management from the overriding requirement that it serve stockholders." The separation of ownership from management has given rise to a set of ideas called "agency theory." Central to agency theory is the relationship between two primary players—the *principals* who are the owners of the firm (stockholders) and *agents* (who are the people paid by principals to perform a job on their behalf). The stockholders elect and are represented by a board of directors who has a fiduciary responsibility to ensure that management acts in their best interests to ensure long-term financial returns for the firm.

Agency theory is concerned with resolving two problems that can occur in agency relationships.[6] The first is the agency problem that arises when (a) the *goals of the principals and agents conflict*, and (b) it is *difficult or expensive for the principal to verify what the agent is actually doing*. In a corporation, this would mean that the board of directors—elected by the shareholders—would be unable to confirm that the managers were actually acting in the shareholders' interests. This is simply because, in most cases, managers are "insiders" with regard to the businesses that they operate and thus are better informed than the principals. Thus, managers may act "opportunistically" in pursuing their own interests—to the detriment of the corporation.[7] Managers may, for example, spend corporate funds on expensive perquisites (such as company jets and expensive art), devote time and resources to pet projects (initiatives for which they have personal interests but that have limited market potential), engage in power struggles (where they may fight over resources for their own betterment—to the

detriment of what is best for the firm), and negate (or sabotage) attractive merger offers because they may result in increased employment risk.[8]

The second issue is the *problem of risk sharing*. This arises when the principal and the agent have different attitudes and preferences toward risk. For example, the executives in a firm may favor additional diversification initiatives because it—by its very nature—increases the size of the firm and, thus, their level of compensation. At the same time, such diversification initiatives may not help the firm to achieve some of the synergies that we discussed in Chapter 6 (e.g., building on core competencies, sharing activities, or enhancing market power), and subsequently erode shareholder value. In effect, agents (executives) may have a stronger preference toward diversification than shareholders because it reduces their personal level of risk from potential loss of employment. By contrast, research has shown that executives who have large holdings of their firm's stock were more likely to have diversification strategies that were more consistent with the shareholder interests, that is, increasing long-term returns.[9]

Examples of self-interest behaviors are not limited to U. S. corporations. Strategy Spotlight 9.7 provides an example from a European corporation.

Strategy Spotlight 9.7
Ineffective Corporate Governance: European Style

Effective and ineffective corporate governance has no national boundaries. Below we will provide an example of the latter from the German company Mannesmann:

Most people probably expected Mannesmann's 2001 annual meeting to be a rather routine affair. It was, after all, its last one following its approximately $100 billion acquisition by Vodafone, the telecommunications giant and the second largest company on the London stock market. However, things got tense as many German shareholders lined up to accuse the departing executives of being "crooks" and "looters."

What was the basis of the controversy? Severance bonuses of £50 million were given to outgoing Mannesmann CEO, Klaus Esser and 20 other departing executives. Mr. Esser himself, as one would expect, came out best with £30 million, Germany's largest severance payoff.

A German court is investigating the circumstances surrounding these bonuses and whether they were intended to influence the bid. Those under investigation include Esser, Vodafone CEO Chris Gent, and other Mannesmann directors.

Vodafone initially said that it knew nothing about the bonuses until after the merger was formally approved. However, Vodafone's Gent later said that the idea for the bonuses had come from Hutchinson Whampoa, the Hong Kong industrial group that was a large Mannesmann owner. Thus, Vodafone had indeed been informed and had promised to honor the payments.

A interesting "punch line" to this story: A member of Mannesmann's board of directors, Klaus Zwickel, criticized Esser's huge payoff as "indecently high." That is, until it emerged that he had voted in favor of the bonuses when they were first proposed!

Sources: Anonymous. 2001. The weakness of Euro-governance. *International Corporate Governance*. September, 4: 6-7; www.news.bbc.co.uk/hi/English/business; www.1boro.ac.uk/elsewise/overvie; and www.vodafone.com.

Governance Mechanisms: Aligning the Interests of Owners and Managers

As noted above, a key characteristic of the modern corporation is the separation of ownership from control. To minimize the potential for managers to act in their own self-interest, or "opportunistically", there are some governance mechanisms that the owners can implement.[10] In the next three sections, we address three of these. First, there are two primary means of monitoring the behavior of mangers. These include (a) a committed and involved *board of directors* that acts in the best interests of the shareholders to create long-term value for shareholders, and (b) *shareholder activism*, wherein the owners of the corporation view themselves as share*owners* instead of share*holders* and become actively engaged in the governance of the corporation. As we see later in this section, shareholder activism has increased dramatically in recent years. Second, there are managerial incentives, sometimes called "contract-based outcomes" which consist of *reward and compensation*

agreements. Here, the goal is to carefully craft managerial incentive packages to align the interests of management with those of the stockholders.

A Committed and Involved Board of Directors. The board of directors acts as a fulcrum between the owners and controllers of a corporation. In effect, they are the "middlemen" or "middlewomen" who serve to provide a balance between a small group of key managers in the firm based at the corporate headquarters and a vast group of shareholders typically spread out all over the world. In the United States, the law imposes on the board a strict and absolute fiduciary duty to ensure that a company is run consistent with the long-term interests of the owners, the shareholders. The reality, as we have seen already, is somewhat more ambiguous.[11]

The Business Roundtable, representing the largest U.S. corporations, describes the duties of the board as follows:

1. Select, regularly evaluate, and, if necessary, replace the chief executive officer. Determine management compensation. Review succession planning.
2. Review, and where appropriate, approve the financial objectives, major strategies, and plans of the corporation.
3. Provide advice and counsel to top management.
4. Select and recommend to shareholders for election an appropriate slate of candidates for the board of directors; evaluate board processes and performance.
5. Review the adequacy of the systems to comply with all applicable laws/regulations.[12]

Given these principles, what makes for a good board of directors?[13] According to the Business Roundtable, the most important quality is directors who are active, critical participants in determining a company's strategies.[14] That does not mean board members should micromanage or circumvent the CEO. Rather, governance experts say they should provide strong oversight that goes beyond simply

rubber-stamping the chief executive's plans. Today, a board's primary responsibility is ensuring that strategic plans undergo rigorous scrutiny, evaluating managers against high performance standards and taking control of the succession process.

Another key component of top-ranked boards is director independence. Governance experts believe that a majority of directors should be free of all ties to either the CEO or the company. That means a minimum of "insiders" (past or present members of the management team) should serve on the board, and that directors and their firms should be barred from doing consulting, legal, or other work for the company.[15] Interlocking directorships—in which CEO's serve on each other's boards—are out: governance experts believe that such ties lead directors to align themselves too closely with management. But perhaps the best guarantee that directors act in shareholders' best interests is the simplest: Most good boards now insist that directors own significant stock in the company they oversee.[16]

Such guidelines are not always followed. At times, it would appear that the practices of some company's board of directors are the antithesis of such guidelines. Consider the Walt Disney Company. Over a recent 5-year period, Michael Eisner pocketed an astonishing $531 million. Granted, he had led Disney to shareholder returns over a 10-year period of over 20 percent, but is there a limit to gluttony? Eisner likely had very little resistance from his board of directors. Let's take a look:

> Many investors view the Disney board as an anachronism.[17] Among Disney's 16 directors is Eisner's personal attorney—who for several years was chairman of the company's compensation committee! There was also the architect who designed Eisner's Aspen home and his parents' apartment. Joining them are the principal of an elementary school once attended by his children and the president of a university to which Eisner donated $1 million. The board also includes the actor Sidney Poitier, seven current and former Disney executives, and an attorney who does

business with Disney. Moreover, most of the outside directors own little or no Disney stock. "It is an egregiously bad board—a train wreck waiting to happen," warns Michael L. Useem, a management professor at the University of Pennsylvania's Wharton School.

This example also demonstrates that "outside directors" are only beneficial to strong corporate governance if they are engaged and vigilant in carrying out their responsibilities.[18]

Many firms have exemplary board practices. Exhibit 9.6 addresses some of the excellent practices at Intel Corporation, the world's largest semiconductor chip manufacturer with $27 billion in 2001 revenues.

Exhibit 9.6

Intel Corporation's Exemplary Governance Practices

One of the best examples of governance guidelines are those of Intel Corporation. Their practices address some of the most important current issues in governance (e.g., director independence, meetings of outside directors, evaluation, and succession planning). The guidelines are on the Intel web site for everyone to see. How many other companies would be that proud of their governance Magna Carta? Below, are a few highlights:

BOARD COMPOSITION

1. Mix of Inside and Outside Directors

The Board believes that there should be a majority of independent Directors on the Board. However, the Board is willing to have members of Management, in addition to the Chief Executive Officer, as Directors.

2. Board Definition of What Constitutes Independence for Directors

The Board has an independent director designated as the Lead Independent Director, who is responsible to coordinate the activities of the other independent directors and to perform various other duties. Service as Lead Independent Director shall not exceed five consecutive years.

3. Selection of New Director Candidates

The Board should be responsible for selecting its own members. The Board delegates the screening process to the Nominating Committee.

BOARD MEETINGS

1. Board Presentations and Access to Employees.

The Board has complete access to any Intel employee.

The Board encourages Management to schedule managers to present at Meetings who: (a) can provide additional insight into the items being discussed because of personal involvement in these areas, or (b) have future potential that Management believes should be given exposure to the Board.

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2. Outside Director's Discussion

The Board's policy is to have a separate meeting time for the outside directors regularly scheduled at least twice a year during the regularly scheduled Board Meetings. The Lead Independent Director will assume the responsibility of chairing the regularly scheduled meetings of outside directors.

MANAGEMENT REVIEW AND RESPONSIBILITY

1. Formal Evaluation of Officers

The Compensation Committee conducts, and reviews with the outside directors, an evaluation annually in connection with the determination of the salary and executive bonus of all officers (including the Chief Executive Officer).

2. The Chief Executive Officer reviews succession planning and management development with the Board on an annual basis.

Sources: Ward, R. D. 2000. *Improving Corporate Boards*. New York: John Wiley & Sons; and, www.intel.com/intel/finance/corp_gov.htm

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Shareholder Activism. As a practical matter, there are so many owners of the largest American corporations that it makes little sense to refer to most of them as an "owners" in the sense of individuals becoming informed and involved in corporate affairs. However, even as an individual shareholder, one does have several rights. These include: (1) the right to sell the stock, (2) the right to vote the proxy

(which includes the election of board members), (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.[19]

This is not to say, of course, that shareholders—either individually or as a group—are always passive. To the contrary, shareholders collectively have the power to direct the course of corporations. This may involve such acts as being party to shareholder action suits and demanding that key issues be brought up for proxy votes at annual board meetings. In addition, the power of shareholders has intensified in recent years because of the increasing influence of large institutional investors such as mutual funds (e.g., T. Rowe Price and Fidelity Investments) and retirement systems such as TIAA-CREF (for university faculty members).[20] Institutional investors hold approximately 50 percent of all listed corporate stock in the United States (about 60 percent of the largest 1,000 largest corporations). In addition, the largest 25 pension funds account for 42 percent of the foreign equity held by all U.S investors.[21]

Many institutional investors are aggressive in protecting and enhancing their investments. In effect, they are shifting from "traders to owners." They are assuming the role of "permanent shareholders" and rigorously analyze issues of corporate governance. In the process they are reinventing systems of corporate monitoring and accountability.

Consider the proactive behavior of CalPERS, the California Public Employees' Retirement System, which manages approximately $150 billion in assets and is the third largest pension fund in the world. Every year, CalPERS reviews the performance of U.S. companies in its stock portfolio and identifies those that are among the lowest long-term relative performers and have governance structures that do not ensure full accountability to company owners. This generates a long list of companies each

of which may potentially be publicly identified as a CalPERS "Focus Company"—corporations to which CalPERS directs specific suggested governance reforms. CalPERS meets with the directors of each of these companies to discuss performance and governance issues. The CalPERS Focus List contains those companies that, at the end of the process, continue to merit public and market attention. Exhibit 9.7 identifies some of the companies on the CalPERS Focus list for 2002, the extent of CalPERS's shareholdings, and their suggested governance changes.

Exhibit 9.7

The CalPERS 2002 Focus List

CalPERS, the California Public Employees' Retirement System, is actively engaged in monitoring the stocks in its portfolio. Below are two of the corporations on the CalPERS Focus List for the year, 2002. Included below are the firm's name, location, the extent of CalPERS's holdings, and the governance changes that CalPERS is trying to institute.

Corporation (CalPERS Holdings in Shares; Percent of Outstanding Shares)	**CalPERS Proposed Governance Changes**
Cincinnati Financial (CINF) (717,218; .45 percent)	• Perform a formal governance review using an external consultant, preferably forming a governance committee. • Review and revise the current Director compensation plan given that some Directors have relatively minor holdings. • Adopt a resolution requiring the Board to consist of a majority of independent directors, including adoption of a written definition of independence. • Appoint a lead independent director.
Gateway (GTW) (1,112,190; .35 percent)	• Conduct a formal governance review using an external consultant. • Request that the Board declassify itself into one class of directors whereby each director stands before the shareholders for re-election each year. • Adopt a resolution requiring that exclusively independent directors chair the key committees. • Separate the Chairman and Chief Executive Officer positions, or consider the appointment of a lead independent director.

Source: www.calpers-governance.org/alert/focus

While appearing punitive to company management, such aggressive activism has paid significant returns for CalPERS (and other stockholders of the "Focused" companies). For example, a Wilshire Associates study of the "CalPERS Effect" of corporate governance examined the performance of 62 targets over a five-year period. The results indicated that while the stock of these companies trailed the Standard & Poors Index by 89 percent in the 5-year period before CalPERS acted, the same stocks outperformed the index by 23 percent in the following five years, adding approximately $150 million annually in additional returns to the Fund.

No company CEO wants the scrutiny of CalPERS. In addition to the negative publicity, CalPERS always tacitly threatens to sell the shares—a potentially visible act that could dampen a firm's stock value immediately. Boards and management typically voluntarily and proactively take steps to improve their own accountability and independence.

Managerial rewards and incentives As we discussed earlier in the chapter, with the problems experienced by Lantech (Strategy Spotlight 9.3), incentive systems must be designed to help a company achieve its goals. Similarly, from a governance perspective, one of the most critical roles of the board of directors is to create incentives that align the interests of the CEO and top executives with the interests of owners of the corporation: long-term shareholder returns.[22] After all, shareholders rely on CEOs to adopt policies that maximize the value of their shares. A combination of three basic policies may create the right monetary incentives for CEOs to maximize the value of their companies:

1. Boards can require that the CEOs become substantial owners of the company stock.
2. Salaries, bonuses, and stock options can be structured so as to provide rewards for superior performance and penalties for poor performance.
3. Threat of dismissal for poor performance can be a realistic outcome.

In recent years the granting of stock options has enabled top executives of publicly held corporations to earn enormous levels of compensation. In fact, in 2001, the CEOs of large corporations in the United States averaged $11 million, or 411 times as much as the average factory worker. Over the past decade, rank-and-file workers wages only increased 36 percent while CEO pay climbed 340 percent. Stock options can be a valuable governance mechanism to align the CEO's interests with those of the shareholders. The extraordinarily high level of compensation can often be grounded in sound governance principles.[23] For example, Howard Solomon, CEO of Forest Laboratories, received a total compensation of $148.5 million in 2001.[24] This represented $823,000 in salary, $400,000 in bonus, and $147.3 million in stock options that were exercised. However, shareholders also did well—receiving gains of 40 percent. The firm has enjoyed spectacular growth over the past five years and Solomon has been CEO since 1977. Thus, huge income is attributed largely to gains that have built up over many years. As stated by compensation committee member Dan Goldwasser: "If a CEO is delivering substantial increases in shareholder value…it's only appropriate that he be rewarded for it."

However, the "pay for performance" principle doesn't always hold. Consider Oracle, for example:

> By 2001, with the tech bubble bursting, Oracle stock was in a free fall. Rather than sit tight in a show of confidence, CEO Laurence Ellison sold 29 million shares in a single week in January, flooding the market when investors already were jittery.[25] He exercised 23 million options the same week for a gain of more than $706 million.
>
> Within a month, Oracle stock had lost a third of its value and the company was announcing that it would miss third quarter forecasts. That triggered further price declines and a rash of shareholder lawsuits alleging that Ellison engaged in "what appears to be the largest insider trading in the history of the U. S. financial market," according to one suit. Ellison's stock sales

were a factor in the sell-off that followed, says Henry Asher, president of Northstar Group Inc., which owns 48,000 Oracle shares. "Was that a ringing endorsement for the company's short-term prospects?" asks Asher. "I don't think so."

There is a fundamental difference between investors, who risk their own money, and executives with stock options, who do not.[26] Good governance endeavors to balance the interests of executives with those of the corporation. On the one hand, this suggests that the board of directors' compensation committee should provide appropriate incentives for outstanding performance. On the other hand, corporate boards must use incentives to protect shareholders' interests. However, boards of directors often have not upheld shareholders' interests by, in effect, shielding top executives from a falling market and erosion of their firms' market values. Many have awarded huge option grants despite poor performance and others have made performance goals easier to reach. In 2002, nearly 200 companies swapped or re-priced options—all to enrich wealthy executives who are already among the country's richest people. Some experts have suggested that a basic tenet of corporate governance should be to never re-price or swap a stock option that is under water (that is, when the actual price of the stock is below the price at which an option can be exercised). After all, no company should hand out free shares to stockholders to make them whole in a falling market. As noted by Peter Clapman, chief counsel for TIAA-CREF, the world's largest pension system with $275 billion in assets: "It's sort of heads you win, tails let's flip again."[27]

In addition to the granting of stock options, boards of directors are failing to fulfill their fiduciary responsibilities to shareholders when they lower the performance targets that executives need to meet in order to receive millions of dollars. For example, at General Motors, CEO G. Richard Wagoner Jr. and other top executives were entitled to a special performance bonus if the company's net-profit margin reached 5 percent by the end of 2003. However, the 5 percent target was later lowered. And, Coca-

Coca's CEO Douglas Daft was scheduled to receive one million performance-based shares if the firm achieved 20 percent annual earnings growth over a five-year period. In 2001, this target was lowered to 16 percent. So much for sound corporate governance…

TIAA-CREF has provided several principles of corporate governance with regard to executive compensation.[28] These include such issues as the importance of aligning the rewards of all employees—rank and file as well as executives—to the long-term performance of the corporation, general guidelines on the role of cash compensation, stock, and "fringe benefits," and the mission of a corporation's compensation committee. An underlying principle is that such compensation should stand the tests of reasonableness and fairness according to industry standards; size of the business in terms of sales, assets, number of employees and market capitalization; and performance measures which reflect the achievement of tangible financial measures: earnings, return on invested capital or equity, growth, and other measurable benchmarks. Exhibit 9.8 addresses TIAA-CREF's principles on the role of stock in managerial compensation.

Exhibit 9.8

TIAA-CREF's Principles on the Role of Stock in Executive Compensation

Stock-based compensation plans are a critical element of most compensation programs, and can provide opportunities for managers whose efforts contribute to the creation of shareholder wealth. In evaluating the suitability of these plans, considerations of reasonableness, scale, linkage to performance, and fairness to shareholders and all employees also apply. TIAA-CREF, the largest pension system in the world with over $275 billion in assets, has set forth the following guidelines for stock-based compensation. Proper stock-based plans should:

- Allow for creation of executive wealth that is reasonable in view of the creation of shareholder wealth. Management should not prosper through stock while shareholders suffer.

- Have measurable and predictable outcomes that are directly linked to the company's performance.
- Be market oriented, within levels of comparability for similar positions in companies of similar size and business focus.
- Be straightforward and clearly described so that investors and employees can understand them.
- Be fully disclosed to the investing public, and be approved by shareholders.

Source: www.tiaa-cref.org/pubs

In this section we have focused on what may be termed internal control mechanisms because they deal with the firm itself and its relevant stakeholders. At times, internal controls fail and the firm may become subject to what are termed "external governance mechanisms."[29] Here, the financial performance of the firm has eroded and the stock has become depressed. Thus, individuals or firms may see an attractive opportunity to acquire the firm at relatively low cost by purchasing large blocks of the outstanding shares. They can then "vote out" the under performing managers and choose more effective replacements through control of the board of directors. Such a threat of hostile takeovers provides either an incentive for the firm's management to improve the firm's performance or, alternatively, to begin takeover defense tactics such as those that we discussed in Chapter 6—greenmail, golden parachutes, and poison pills. Generally, in the latter case, executives are not fulfilling their fiduciary responsibility to the owners of the firm to maximize their long-term returns.

ENDNOTES

[1] Monks, A. G. & Minow, N. 2001. *Corporate Governance*. 2nd edition. Malden, MA: Blackwell Business.

[2] Pound, J. 1995. The promise of the governed corporation. *Harvard Business Review*, 73(2); 89-98.

3 Byrne, J. A. Lavelle, L., Byrnes, N. Vickers, M. & Borrus, A. 2002. How to fix corporate governance*.* *Business Week*: May 6: 44-52.

4 *Ibid.*

5 This discussion draws upon: Monks, A. G. & Minow, N. *op. cit.*

[6] Eisenhardt, K. M. 1989. Agency theory: An assessment and review. *Academy of Management Review*. 14 (1): 57-74. Some of the seminal, early contributions to agency theory include: Jensen, M. & Meckling, W. 1976. Theory of the firm: Managerial behavior, agency costs, and ownership structure. *Journal of Financial Economics*, 3: 305-360; Fama, E. & Jensen, M. 1983. Separation of ownership and control. *Journal of Law and Economics*, 26: 301: 325; and Fama, E. 1980. Agency problems and the theory of the firm. *Journal of Political Economy*, 88: 288-307.

[7] Managers may also engage in "shirking", that is, reducing or withholding their efforts. See, for example: Kidwell, R. E. Jr. & Bennett, N. 1993. Employee propensity to withhold effort: A conceptual model to intersect three avenues of research. *Academy of Management Review*, 18 (3): 429-456.

[8] For an interesting perspective on agency and clarification of many related concepts and terms, consider the following website: www.encycogov.com.

[9] Argawal, A. & Mandelker, G. 1987. Managerial incentives and corporate investment and financing decisions. *Journal of Finance*, 42: 823-837.

[10] For an insightful, recent discussion of the academic research on corporate governance, in particular the role of boards of directors, refer to: Chatterjee, S. & Harrison, J. S. 2001. Corporate governance. In Hitt, M. A., Freeman, R. E., & Harrison, J. S. (Eds.) *Handbook of Strategic Management*, Malden, MA: 543-563.

[11] This opening discussion draws on Monks and Minow, *op. cit*, pages 164 and 169. See also Pound, J., *op. cit*.

[12] *The Business Roundtable, Corporate Governance and American Competitiveness*, March 1990: 7.

[13] Byrne, J. A., Grover, R., Melcher, R. A. 1997. The best and worst boards. *Business Week*, November 26: 35-47.

[14] The three key roles of boards of directors are monitoring the actions of executives, providing advice, and providing links to the external environment to provide resources. See: Johnson, J. L., Daily, C. M. & Ellstrand, A. E. 1996. Boards of directors: A review and research agenda. *Academy of Management Review*, 37: 409-438.

[15] There are benefits, of course, to having some insiders on the boards of directors. Inside directors would be more aware of the firm's strategies. Additionally, outsiders may rely too often on financial performance indicators because of information asymmetries. For an interesting discussion, see: Baysinger, B. D. & Hoskisson, R. E. 1990. The composition of boards of directors and strategic control: Effects on corporate strategy. *Academy of Management Review*, 15: 72-87.

[16] Hambrick, D. C. & Jackson, E. M. 2000. Outside directors with a stake: The linchpin in improving governance. *California Management Review*, 42(4): 108-127.

[17] *Ibid*.

[18] Disney has begun to make many changes to improve its corporate governance such as assigning only independent directors to important board committees, restricting directors from serving on more than three boards, and appointing a lead director who can convene the board without the CEO. In fact, in recent years, the Disney Company has shown up on some "best" board lists.

[19] Monks and Minow, *op. cit*., page 93.

[20] There is strong research support for the idea that the presence of large block shareholders are associated with value-maximizing decisions. For example, refer to: Johnson, R. A., Hoskisson, R. E., & Hitt, M. A. 1993. Board of director involvement in restructuring: The effects of board versus managerial controls and characteristics. *Strategic Management Journal*, 14: 33-50.

[21] This discussion draws upon: www.corpgov.net.

[22] Jensen, M. C. & Murphy, K. J. 1990. CEO incentives—It's not how much you pay, but how. *Harvard Business Review*, 68(3): 138-149.

[23] Research has found that executive compensation is more closely aligned with firm performance in companies with compensation committees and boards dominated by outside directors. See, for example, Conyon, M. J. & Peck, S. I. 1998. Board control, remuneration committees, and top management compensation. *Academy of Management Journal*, 41: 146-157.

[24] Lavelle, L., Jespersen, F.F., & Arndt, M. 2002. Executive Pay. *Business Week*, April 15: 66-72.

[25] *Ibid*.

[26] Byrne, J. A., Lavelle, L., Byrnes, N. Vickers, M. & Borrus, A. *op. cit*.

[27] Lavelle, L., Jespersen, F. F. & Arndt, M. *op. cit.*

[28] www.tiaa-cref.org/pubs.

[29] See, for example: Hitt, M. A., Hoskisson, R. E., Johnson, R. A., & Moesel, D. D. 1996. The market for corporate control and firm innovation. *Academy of Management Journal,* 39: 1084-1119; and Walsh, J. P. & Kosnik, R. D. 1993. Corporate raiders and their disciplinary role in the market for corporate control. *Academy of Management Journal*, 36(4): 671-700.