THE MYTHS OF CORPORATE GOVERNANCE

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Corporate governance is an issue which resounds around the world today. One only has to look to the cartoons of the New Yorker, which epitomize the follies and foibles of corporate America, to find a satirical glimpse at life in the board room and at shareholder meetings. The stereotypical caricature of the chairman of the board -- fat, bald and with wispy mustache gloating over profit increases with his fellow brethren who sit complacently like frogs basking on lily pads around the expansive mahogany altar of success -- embodies a prevalent view of what transpires in the inner sanctums of the board room. In one cartoon, a young director asks the chairman: "What is a debenture?" Although its significance is not immediately apparent, this perspective carries with it great weight. Many people today feel that the primary quality of a good director is not mental acumen, but a clean heart. This dilemma underscores only one part of societal misconceptions of corporate directorship.

There is another cartoon in which the chairman of the board queries his directors with: "Now you know how 63.9% of the stock feels. How do the rest of you feel?" This inquiry exemplifies another stereotypical notion of corporate governance which can be summed up with the following: whoever owns the most stock controls the outcome -- and the rest of the world be damned!

A cartoon which is a particular favorite of mine depicts an elderly woman at a shareholder's meeting, hands firmly gripped on the microphone, being interrupted by the chairman who quips apoplectically: "There has been a motion to the effect that the directors are not dealing from a full deck. Is there a second?"

The boardroom cartoons don't end here. The chairman's harsh reproof to the other directors that "my God, if they want integrity, we'll give them integrity" evinces an attitude many hold of how American business responds poorly to consumer demands.

Another shareholder vignette portrays a persistent shareholder resembling Evelyn Y. Davis, with a lock on the microphone, being upstaged by a director on the podium who whispers to another "This is the part of capitalism I hate."

Accountants haven't escaped the unrelenting wit of the New Yorker. In one amusing sketch, the Chairman of the Board introduces a young man to the Board and says: "This is Mr. Smith, who is going to audit our books in accordance with generally accepted accounting principles, if you know what I mean."

The preceding examples illustrate the myths surrounding corporate governance and reveal how popular perceptions of corporate governance are divorced from the realities. Recent developments in corporate governance have been effective. These measures include audit committees, nominating committees, increases in the number of and a heightened awareness of responsibility on the part of outside directors, and the embarrassing questions asked frequently of management. The speeches of SEC Chairman Harold Williams are significant because the corporate community has responded well to his suggestions. The white paper of the Business Roundtable sounds like something a 1930 Ralph Nader might write. The American Bar Association Section on Corporations, Banking and Business Law, which I chair, has put out two publications on the responsibilities of directors and overview committees. The New York Times stated, commenting on the Williamsburg Conference last spring in which influential corporate leaders charted new directions for corporations, imprecisely that business leaders were far ahead of their lawyers in thinking progressively about corporate governance. Excessive speculation and misconception interfere with solid reflection on this subject. The myths that persist regarding corporate governance ultimately boil down to four or five categories.

The first group of myths concerns shareholders. There was a notion in the 1930's that if you could establish an effective corporate democracy, the problems of corporate accountability, restraint, and social responsibility would be solved. The idea evolved, summarized in Means and Berle's ***Modern Corporation and Private Property***, that ownership and control of corporations should not be separated. Several people, influenced by this book, drew the conclusion that the abuses of the corporate world could be ameliorated if shareholders had an opportunity to be effective participants in corporate governance.

An outgrowth of this theory developed with the Securities Exchange Act of 1934 which gave the SEC broad powers to regulate the proxy solicitation process. The SEC for the past 46 years has vigorously pursued this power and has expanded the requirements for disclosure and proxy solicitations.

The problem remains that, except in proxy contests which are extremely rare, the entire proxy process doesn't mean much at all. Shareholders consistently adopt management's proposals because they always elect management's slate. The fact is that corporate democracy hasn't had very much significance. Shareholder voting has not had a substantial influence on the development of corporate morality, responsibility and management. This is an unfortunate thing;

nevertheless, the truth is that the corporate proxy solicitation machinery doesn't make much difference in the way corporations conduct themselves.

A sub-myth of shareholder democracy is the talisman that shareholders have the right to nominate directors. Two pieces of legislation introduced in Congress, the Metzenbaum bill and the Rosenthal bill providing for shareholder nomination of directors, are doomed to extinction. These proposals are some of the most ludicrous ideas ever espoused because they are patterned from political handicraft which has no relevance to the corporate governance structure. Politicians, Congressman, and all others in public life conduct their affairs in the sunshine. Debates, hearings, and committee meetings of the Senate and House take place in open environments. Congress has, reluctantly, opened up certain proceedings to the public which had previously been closed. Myriad public information exists for constituents to assess the record of their incumbent. The situation is, however, different with corporations which are run less publicly and more efficiently than the Congress. As a shareholder, one has no conception of whether one director or another has done a good job in his post. Shareholders have no notion of whether I am a good or bad director because directors' meetings are private. The communications I have with the officers of the company are privileged; thus shareholders have no conceivable basis on which to judge my performance. The patterning of a corporation according to the political process is, simply, nonsense.

The expense of conducting contested elections for directors is astronomical. There are 10,000 publicly-held companies, a number determined by companies that file registration materials with the SEC. The thought of 10,000 corporations holding contested directors' elections defies rationality. Who wants to be deluged by constant requests from all the corporations in which we own stock? Even if it were financially feasible, where does the money come from? Are shareholders willing to take it from their own pockets? Can you imagine what a Herculean exercise it would be for a company to select its directors after it has been inundated with conflicting statements by nominees for the board of directors! The asininity of the above reflects uninformed choices by shareholders who base their judgments concerning directors on everything but competence. A random mix of directors nominated by shareholder pressure groups and elected by unthinking or unknowing shareholder constituencies is undesirable because the least we owe the chief executive officer is a board of directors that doesn't necessarily always agree with him, but shows concern for the problems he confronts.

No concrete evidence has been offered to show that boards of directors elected by shareholder nominees will out perform directors nominated by nominating committees and elected (in the fashion in which there are "elections") by shareholders. Vituperative shareholders who nominate directors have special axes to grind and would use the corporate suffrage machinery to impose their narrow, secular, and irrelevant interests upon uninformed shareholders.

Shareholders are, however, concerned primarily with economic affairs. Shareholder elections would develop into contests pitting directors, nominated by management, who put privacy of shareholder interest at the top of their priorities, against politico nominees with popular names and compelling slogans. Competent and qualified candidates for directorship would not enter this contest. Directors would forego the opportunity to serve in their capacity if the price of every term was a political struggle.

Another myth regarding shareholders is that they are unhappy with the way corporations are governed. In 1978 the Opinion Research Corporation conducted a study for the Business Roundtable and found that 52% of shareholders of companies in which they invested were completely satisfied, 38% were fairly satisfied, and the remaining 10% were not really satisfied with the manner in which the board of directors managed the company. Other figures illustrate myths surrounding shareholders: 71% thought the procedure for director nominations was fair; 88% aware of the composition of boards were satisfied with their makeup; 3% thought that the opportunity to vote for directors was an important factor in buying stock; and 5% stated that they purchased stock because of the chance to have an active voice in the government of the corporation.

Myths regarding boards of directors are constantly surfacing. The first is that boards of directors manage corporations. This misconception originates with state corporation statutes that say corporation directors shall manage the corporation. These statutes were not intended to remove management prerogatives; they were cast to prevent the shareholders from managing the corporation. One of the early concerns embodied in these statutes was to prevent shareholders’ intrusion upon the management by allowing the board of directors to manage. Today, most of the modern corporation laws provide for management of the corporation to occur under the direction of the board. Directors monitor the management; this concept has replaced the earlier notion that directors manage the corporation.

The idea that shareholders manage the corporation is truly a myth. It is impossible as a practical matter for the board to manage a corporation because of the infrequency of times they meet. The board can oversee and direct the management, but it cannot actually manage the corporation.

A second myth with respect to the board is that if the board is properly constituted it can prevent the corporation from doing foolish acts, ***e.g.***, management mistakes, bad economic decision, wasting corporate assets, committing further illegalities, and involvement in questionable overseas payments. I have often suggested the desirability of an empirical study to uncover the compositions of the boards of the 400 or more companies that have made disclosures reflecting improper overseas payments. I would suspect that these companies had nearly ideal boards with many outside directors sitting on them. The problem with these boards was, understandably, that they never got involved in the nitty-gritty of how business was being conducted overseas.

Many people view directors as policemen on the block and that at every meeting a director should read Title 18 of the United States Code (the criminal section) and check to see if anybody in the corporation has committed any violations. This is reminiscent of the story of the young groom who came home one night breathless and agitated and said to his bride: “Honey, somebody at the bar told me that you used to be shot out of the cannon at the circus. Is that right?” She replied, “Why yes, I was.” He responded angrily, “Well, why didn’t you tell me?” She whined back diminutively, “You never asked me.” The same situation exists with directors. Directors simply cannot ask all the questions and investigate on a monthly basis any possible violations of the criminal code by members of a vast corporation.

Directors can, however, make certain that programs are put into effect that operate as controls. For example, an adequate antitrust compliance program should be implemented to assure that all personnel are aware of antitrust compliance and the penalties assessed for infractions.

Irving Shapiro, quoted in a recent article in ***Fortune*** discussing legal violations by 117 offenders among 1,043 companies that have been on the ***Fortune*** 800 list sometime during the past ten years, states that these violations result from poor management. This weakness means that directors must be cognizant of the quality of management and the existence of controls and compliance systems, but directors can’t serve as policemen.

Another myth regarding boards is the magic of their composition and the special powers of an agenda-maker. Harold Williams contends in mythic posture that it is important to have someone other than the Chairman of the Board or Chief Executive Officer control the agenda. Intelligent, responsible, and aggressive outside directors of a board will insure that any significant matter will be placed on the agenda.

A large body of myths is beginning to accumulate with respect to the audit committee. The first is that the audit committee resolves all problems of corporate governance; an audit committee composed of outside directors that heals the wounds of corporate irresponsibility and allows the full board to relax. What a vainglorious myth! It is true that audit committees have improved over the years, the scope of their responsibilities has broadened, and the sensitivity of their members reflects a heightened awareness. But, they are, nevertheless, only part-time and run the danger of being given too much responsibility. They are overburdened with trying to make recommendations concerning outside auditors, supervise internal audit functions, quiz the external auditor on the scope of the audit, and investigate anything of an exceptional nature. But now they are expected to police the code of conduct, investigate <u>an</u>y matters that come to their attention, peruse the expense accounts of executives, and act generally as internal watchdogs. These expectations present a real danger in two ways. An audit committee cannot perform its function as a liaison between internal and external auditors if it is overloaded with responsibilities. As more and more burdens are given to the audit committee, directors become complacent and assume their job and the customary functions of the board will be performed by the audit committee. As a matter of law, this situation is precarious because the law clearly establishes that other directors have a duty of care in selecting, supervising, and overseeing the board on matters regarding any committee or board.

Another misconception pertaining to audit committees is that their members become experts in all the corporation's affairs once they are appointed by the board. The massive literature about internal audits and controls available to audit committees cannot be absorbed by the committee members. I sit on two audit committees, but I can honestly say that I am not an expert on the complexities of internal audits and controls.

Audit committees are not instant experts and must rely on the expertise of management, the internal auditor, and the external auditor. They must ask sensible questions and insure that systems are in place to have responsible participants in the corporate governance process.

The meaning of the term "corporate responsibility" is a myth in itself. A prevalent view of corporate responsibility is that it is nothing more than corporations abiding by the law. Corporate responsibility does not, however, simply mean corporations conforming to the law. Corporations should abide by the law for the same reasons individuals do. Adhering to the law does not make one an outstanding citizen. Corporate responsibility or accountability means that corporations do things which are socially useful. No law requires corporations to perform socially beneficial acts, and it would seem a tyranny of corporate freedom if corporations were forced by law to do these tasks.

One of the toughest problems facing management today is the decision to engage in corporately-responsible acts without jeopardizing basic economic functions and goals. I am not aware of any corporation which is financially committed to corporately responsible acts that adversely effect the interests of their shareholders. Corporations known for their socially irresponsible acts would eventually collapse because shareholders rail against these practices and discontinue their support. The long range concerns of corporations in a society in which so much is expected of them should be cost-effective measures to do things which, although not required or not prohibited by law, will be socially beneficial .

The misconception still survives that corporations can solve all the social ills of this country. The government can't, with all its experience, resources, and opportunities, even perform this Leviathan task. Now to look at corporations as the rectifiers of the problems of race relations, economic imbalances, and general social dysfunctions is an improper and misguided imposition.

The last myth finds its nourishment in one of Milton Freedman's theories. His model is that the only concerns of corporations, directors, and managements should be profits, shareholder benefits, and the "bottom line." Corporations, directors, and management should not be indifferent to these issues. The law in the United States is that directors have a fiduciary responsibility to shareholders. This responsibility does not, as a matter of law, extend to anyone else. But other notions of accountability are developing under the auspices of other branches of law that would require directors to be responsible to employees, communities, and "constituencies." While constituency rights may not be enforceable, they should be observed by corporate management because of the inherent long-term benefits to the corporation.

An area analogous to corporate responsibility is the takeover situation. An early concept in this field echoed the belief that corporate management should concentrate only on what was good for shareholders when it was confronted with a takeover bid. Recent literature, written primarily by highly esteemed and competent attorneys, and speeches by Harold Williams and others take a different stance. They advocate that directors should be obligated to consider those other constituencies.

These ideas are beginning to crystallize in other countries; powerful and persuasive theories have a tendency to cross borders and oceans. In the United Kingdom, the recently enacted Companies Act of 1980 provides that directors have an obligation to take heed of the welfare of their employees. Interestingly, the Act does not give the employees the right to enforce that duty upon directors. The Institute of Chartered Accountants in the U.K. indicated, with respect to the reporting responsibilities of corporations, that corporations were responsible to twelve or thirteen constituencies which had a right to have corporations report to them. The Canadian Institute of Chartered Accountants published recently a similar study on reporting and identified fifteen groups who had the right to receive some corporate report. There exists an obvious correlative duty on corporations to report to these groups for both of their benefits.

The bottom line profit scenario has changed. In this country it is no longer feasible for competent management to regard its sole obligation as maximization of profits at the expense of all other interests. The long-term benefits of corporations and the corporate community require that corporations be privy to other concerns beside profit expansion because society will no longer tolerate the denizens of capital to be indifferent to the public weal.

The greatest challenge today that is pressed against the brow of corporations is how to reconcile long-term commitments that are appropriate to shareholder interest and economic benefits with the increasing demand by society for social responsibility even though the efforts by the corporation might fall short of solving all of society's problems. This challenge is not a myth and represents the reality which confronts the corporate world. An unpleasant alternative would result if corporations fail to respond to this challenge and devise innovative and aggressive ways to face this struggle. Greater control of the activities and destinies of corporations would, unfortunately, ensue.