1 What Is a Corporation?

Definitions of the term *corporation* reflect the perspectives (and the biases) of the people writing the definitions. Anyone who tries to come up with a definition is like 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. Similarly, some lawyers and economists 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] Here are some other attempts to describe or define the corporation:

Definitions

"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*[2]

"A corporation is an artificial being, invisible, intangible, and existing only in the contemplation of the law. Being the mere creature of the law, it possesses only those properties which the charter of its creation confers on it, either expressly or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality, and, if the expression be allowed, individuality; properties by which a perpetual succession of many persons are considered the same, and may act as a single individual." *Chief Justice John Marshall*

"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 artificial person or legal entity created by, or under the authority of, the laws of a state . . . The corporation is distinct from the individuals who comprise it." *Black's Law Dictionary, 6th edition, 1990*

"When they [the individuals composing a corporation] are consolidated and united into a corporation, they and their successors are then considered as one person in law . . . for all the individual members that have existed from the foundation to the present time, or that shall ever hereafter exist, are but one person in law – a person that never dies: in like manner as the river Thames is still the same river, though the parts which compose it are changing every instant." *Blackstone*

"An ingenious device for obtaining individual profit without individual responsibility." *Ambrose Bierce, The Devil's Dictionary*

What do these definitions tell you about the corporation? Are any of them incompatible, or do they differ only in their emphasis? Can you think of a better definition?

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

In our view, a corporation is a mechanism established 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 still 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. The corporation's relationship to its employees varies, for example, depending on the circumstances: whether or not they are members of a union, whether or not they are pension plan participants. And 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 in fact a structure. The corporate structure was developed to meet particular needs that were not being met by earlier forms available to business. It evolved 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

Figure 1.1 The Company Corporation advertisement
Reproduced with permission from *The Company Corporation*

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.[3]

Even as recently as 1932, US Supreme Court Justice Louis Brandeis argued that "The privilege of engaging in such commerce in corporate form is one which the state may confer or may withhold as it sees fit."[4] He emphasized the importance of making sure that states conferred the privilege of the corporate structure only in those cases where it was consistent with public policy and welfare, as, for example, "as a means of raising revenue; or, in order to procure for the community a public utility, a bank, or a desired industry not otherwise attainable; or . . . an instrumentality of business which will facilitate the establishment and conduct of new and large enterprises deemed of public benefit."[5] He noted that:

> The prevalence of the corporation in America has led men of this generation to act, at times, as if the privilege of doing business in corporate form were inherent in the citizen, and has led them to accept the evils attendant upon the free and unrestricted use of the corporate mechanism as if these evils were the inescapable price of civilized life, and hence, to be borne with resignation. Throughout the greater part of our history, a different view prevailed. Although the value of this instrumentality in commerce and industry was fully recognized, incorporation for business was commonly denied long after it had been freely granted for religious, educational, and charitable purposes. It was denied because of fear. Fear of encroachment upon the liberties and opportunities of the individual. Fear of the subjugation of labor to capital. Fear of monopoly. Fear that the absorption of capital by corporations, and their perpetual life, might bring evils similar to those which attended mortmain.[6] There was a sense 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.[7]

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."[8] 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.[9]

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. But 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, the individual members of the corporation are not individually liable.

If a dozen people pool their funds to create a partnership, they risk losing not just their stakes, but everything they have. Partners who operate a restaurant are personally liable for debts to unpaid creditors and employees, for any injuries to a patron who sues after falling down the restaurant stairs, and for the misconduct of fellow partners, even of which they had no knowledge or control. Investors in a corporation that operates a restaurant have no such risk. If Beech-Nut (see case in point in the introduction) had been a partnership, all of the partners could have been liable to pay the fine as well as for any damages the court might award to the consumers who purchased the adulterated juice.

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.[10] But 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.

One other note on limited liability. During the 1980s, another form of limited liability became popular, as a result of revisions in the bankruptcy law, giving shareholders a second chance to profit from failing enterprises. Airline companies were able to avoid union contracts and asbestos companies were able to avoid tort liability. Most prominently of all, Texaco was able to negotiate down the damages assessed against it arising out of the Pennzoil acquisition. It became expedient even for companies with substantial assets to declare bankruptcy because of the protections – and the extra time – it gave them. Ultimately, many of these companies emerged from bankruptcy with their liabilities better organized, and the shareholders – whose downside liability was always limited – were given a second chance to profit.

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.

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. One is demonstrated by the Beech-Nut example in the introduction, where 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. Another is in the First Amendment example in the introduction, where corporate management is allowed to use investors' money to promote a political agenda with which they may not agree. Another 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 life span 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.

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. But 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 assure 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 is 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. It helps to spend some time talking about the purposes that corporations serve.

Human satisfaction

Business corporations provide an outlet for the satisfaction of essential human drives – quests for fulfilment, 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.

Social structure

Human beings have created social structures since their cave days, in order to foster cooperation and specialization. Corporations offer lasting and resilient social structures. 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 the Crusades. The gross national product of the continent was devoted to the 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 study in chapter 2).

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 assure 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. That organizations own corporate governance problems in 2003 – the abrupt departure of the top three executives amid accusations of accounting problems – shows that this public–private combination is no better at preventing abuse than one that is strictly government or strictly private.

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 prohibiting discrimination on the basis of age, race, gender, and disability, rules requiring employers to grant "family leave" to those who required it, and rules enlisting private companies to help gather information on suspected terrorists.

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 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 (even, as in Massachusetts, signed by the governor in the headquarters of the company in question) are just one example.

Identity

Indeed, corporations have a life, and even citizenship, of their own, with attendant rights and powers. They appear to have personalities. We speak of "Ma Bell" and "Big Blue."

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. They are entitled (at least to some extent) to freedom of speech. They can contribute money to political causes and campaigns, though some restrictions apply, due to post-Watergate reforms.

As the source of jobs, and therefore of the livelihood for people who vote, they have significant political capital. Corporations, therefore, are powerful participants in the deliberations of our lawmakers.

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.

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 modem 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.[11]

THE CORPORATION AS A COMPLEX ADAPTIVE SYSTEM

In the authors' first book, we said that the corporate structure was designed to be so vital and robust that it was like an "externalizing machine." There is no malice involved – it is just the flip side of its purpose of wealth generation. Therefore, it will do whatever it can to hang on to its earnings and push its costs off of its balance sheet. This can be done, for example, through legislation that increases barriers to entry for its competitors or limits its liabilities. The self-perpetuating life force built into the corporate structure fights the systems intended to impose accountability, and through that, legitimacy.

"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."

These systems, whether in physics, biology or economics, can be analyzed as patterns and modes of behavior that can inform activity in other fields. One cannot literally find in corporate behavior a repetition of the interaction of subatomic particles; one can, however, notice living patterns that seem to replicate in corporate experience – tendencies towards immortality, for unlimited size, unlimited power, unlimited license.

Only when one understands that corporations have adaptive characteristics does it become clear that modification of their behavior must come from within the organizations. It has not been convenient for society to recognize the general ineffectiveness of external restraints on corporate activity. Neither government nor marketplace has the capacity to require corporate functioning to conform to society's interests. Large corporations retain the services of the most talented professionals, the most persuasive lobbyists: former Senator George Mitchell, "hero" of the Irish peace talks, is the principal lobbyist for the tobacco industry. They control the most influential newspapers, TV (all three American networks are owned by diversified conglomerates – GE, Disney, and Westinghouse) and magazine outlets, and the best lawyers. With such competitive strength, it is difficult for the widely dispersed elements that comprise society to effectively assert a contrary view. 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, in 2001, General Motor's pension assets of $74 billion were worth 271 percent of the company's market capitalization. And in 2003 the *Washington Post* reported that the $19 billion under-funding of GM's pension fund was driving the company to slash car prices to raise money quickly. This astonishing development – a pension deficit as the driver of corporate strategy – had a predictable result. GM's competitors also discounted prices, resulting in reduced margins and earnings for the entire sector. The only way in which to attempt societal harmony with corporations is to understand that they are complex adaptive systems and change must come from within.

THE CORPORATION AS A "MORAL PERSON"

Thomas Donaldson provides an analytical structure to consider how a corporation can be structured to make "moral" decisions:

> In order to qualify as a moral agent, a corporation would need to embody a process of moral decision making. On the basis of our previous discussion, this process seems to require at a minimum:
>
> 1. The capacity to use moral reasons in decision-making.
> 2. The capacity of the decision-making process to control not only overt corporate acts, but also the structure of policies and rules.
>
> [The first] is necessary to raise the corporation above the level of a mere machine. To be a moral agent, something must have reasons for what it does, not simply causes for what it does, and for something to be a moral agent, some of those reasons must be moral ones. Obviously, corporations are unable to think as humans, but they can employ reasons of a sort, and this is shown by the fact that they can be morally accountable. That is, with the proper internal structure, corporations, like humans, can be liable to give an account of their behavior where the account stipulates which moral reasons prompted their behavior.[12]

Can business "do well by doing good?" This is a perennial question. On one end of the scale, companies such as 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. But can companies thrive when the cost of social responsibility raises prices too high, instead of making the products more marketable making them less so? Clearly, there is some point past which the company's goods and services will become too expensive.[13]

At one end of the scale are the most basic aspects of social responsibility, like compliance with the law. 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.

Look again at the very first example in this book – the lawsuit challenging the decision not to put lights in Wrigley Field. 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. Later we will consider the example of Stride Rite, which profited from its (well-deserved) reputation for commitment to the community, while it was making the (economically necessary) decision to move jobs out of the community.

The key question here, one of the core issues of corporate governance, is "Who decides?" 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. But 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?

Case in point: Union Carbide and Bhopal – what happens when the company is bought out?

This is how a successor/purchaser corporation characterized a devastating chemical spill, acknowledging the tragic consequences, absolving itself of responsibility, but portraying itself as a generous and concerned entity.

From the Dow Chemical website <http://www.bhopal.com/position.htm>:

What happened in Bhopal 18 years ago was a tragedy of unprecedented gravity and human cost, which no one in industry will ever forget.

During the early hours of December 3, 1984, methyl isocyanate gas (known as MIC) leaked from a storage tank sited at a pesticide manufacturing facility in Bhopal. As it escaped, the gas drifted across the neighboring communities with devastating consequences. According to the Indian government, some 3,800 people died and thousands more were injured as a direct result of exposure to the lethal fumes.

When the disaster occurred, the Bhopal plant was operated by Union Carbide India Limited (UCIL), a 51 percent affiliate of Union Carbide Corporation. At that time, Dow had absolutely no connection with either the facility or any of the companies linked to the incident.

But 16 years after the tragedy, on February 6, 2001, Dow acquired Union Carbide's shares. Before doing so, as you might expect, the company conducted an exhaustive assessment to ensure there was absolutely no outstanding liability in relation to Bhopal. There was none; the company Dow acquired retained absolutely no responsibility for either the tragedy or for the Bhopal site.

That conclusion was based on a number of key facts:

- On February 14, 1989, a settlement agreement was reached between Union Carbide, Union Carbide India Limited and the Indian government through which Union Carbide paid $470 million in compensation, covering all claims relating to the incident.
- On October 3, 1991, the Supreme Court of India announced the findings of its review of the settlement agreement. They upheld the settlement – concluding that the amount was just, equitable and reasonable.
- Within those same findings, the Supreme Court also directed that the Government of India make up any shortfall which might in the future arise in the settlement fund and ordered it to purchase a group medical insurance policy to cover 100,000 citizens of Bhopal in case of future illnesses. These measures were specifically put in place to address any potential future issues arising from the tragedy.
- Two years later, on October 4, 1993, the US Supreme Court reaffirmed earlier US Court rulings that the only State with jurisdiction in the case against Union Carbide on matters relating to the Bhopal tragedy was India. They based this decision on the fact that UCIL was a separate and independent legal entity, managed and operated exclusively by Indian citizens in India.
- In November 1994 – more than six years before Dow acquired Union Carbide – Union Carbide sold its interest in Union Carbide India Limited to MacLeod Russel (India) Ltd. of Calcutta (later renamed Eveready Industries India Ltd. – or EIIL). As a consequence of that sale, Union Carbide retained no interest in or liability for the Bhopal site. EIIL took exclusive possession of the land under lease from the government of Madhya Pradesh. The money from this transaction was used to fund a hospital in Bhopal which now provides specialist care to victims of the tragedy.
- In 1998, the government of Madhya Pradesh revoked the EIIL lease for the Bhopal site, reclaiming the property "as is" and stating it would take responsibility for managing any cleanup or remediation work required on the site.

All of this means that when Dow completed its stock acquisition in February 2001, Union Carbide retained no responsibility whatsoever in relation to the tragedy.

But of course there is also an entirely separate humanitarian question – that is: can Dow, in its role as a corporate citizen, help to address any of the present day needs which are apparent in Bhopal?

That is why, for some time, Dow has been exploring various initiatives which might address some of those needs – just as we do in other parts of the world where we have business interests. This work continues and we remain hopeful that we can find an appropriate initiative in the not too distant future.

The issues surrounding Bhopal are extremely emotive. It is a tragedy that should never have happened. Like the rest of industry, Dow has an obligation to learn from what took place that terrible night and to take whatever measures are necessary to prevent anything like it from ever happening again.

Case in point: Imperial Chemical Industries plc

In 1993, Sir Denys Hendersen explained to his shareholders why he was proposing to downsize Imperial Chemical Industries (ICI), a dominant company in one of the most important worldwide industries – the chemical and pharmaceutical business. ICI had sales in the tens of billions of dollars, earnings in the billions and employees in the hundreds of thousands. Yet in 1993 it proposed a "demerger" of a major unit, Zeneca.

A detailed proposal was sent to shareholders to explain the move. The company cited "important, broader trends," including "intensified competition in industrial chemicals, most notably from the Middle East and Asia Pacific, increased costs of maintaining and developing new technology, especially in the bioscience areas, together with the adverse effects of the worldwide economic recession which began in 1990" as reasons for the demerger. In response to these trends, ICI pledged "to reshape its operations . . . focusing on those businesses and territories where it enjoyed strong market positions, reducing costs in order to remain competitive and disposing of non-strategic operations. These measures continue to be vigorously implemented, although the profit improvement benefits to date have been more than offset by the impact of the economic recession."

Henderson continued in the traditional language of business and finance, explaining, "In recent years, ICI's bioscience activities have expanded rapidly and have become increasingly distinct from its traditional chemical operations, and both face very different opportunities and challenges in the years ahead. The bioscience activities employ different technologies, are more R&D intensive and serve a largely separate customer base. The Chemicals businesses are, in contrast, for the most part capital intensive, volume driven and based on large scale process technology."

What was more important, however, was what Henderson left out. He did not mention Hanson Industries, whose purchase of a significant stock position in ICI was widely credited with being the prime cause of the demerger. ICI had performed poorly for some years, and its stock price had become heavily discounted as a result. Hanson was a known raider, and when the company announced its substantial holding in ICI, commentators asked when, not if, Hanson would attempt to take over the chemical giant.

The ICI demerger pre-empted the possible bid. Hanson, had he taken over ICI, would almost certainly have completed a similar break-up. The fact that ICI restructured on its own volition made the company a far less tempting target, since the company was able to realize the kinds of values that a raider would look to achieve. Thus, the threat of takeover forced ICI to split itself into two smaller, leaner, more competitive companies.

Not that Hanson Industries applauded the demerger. As Lord White, Hanson's chairman said: "If ICI had not spent so much time during the last year fighting a bid that was never made and spent it on seeing how it could improve shareholder value it might have come up with a better solution a lot earlier."[14] (See also the Sears case study.)

Lords Hanson and White were the bearers of the new wisdom. Even the largest and richest of corporations needs to assess its position constantly and to make whatever changes are necessary to be competitive. The basis of a corporation's existence is wealth maximization – this is its reason for being. There is no such thing as a "good" corporation that is not competitively profitable. Corporations live in a world where the market determines what people will buy and what they will pay. A corporation that does not produce goods that people want at a price they are willing to pay has no reason to exist.

THE CORPORATION IN SOCIETY

Before we evaluate the effectiveness of the major players in corporate governance, we should look at corporations from the perspective of what our society wants and needs from them. We want jobs that pay a decent wage and goods and services that meet our needs. We want challenges to our creativity and ingenuity, and when we meet those challenges, we want to feel proud of the results, and we want to be rewarded. We want corporations to work with us to keep the workplace and the environment safe. We want a continual sense of progress 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.

Two connected sets of laws 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. To go back to our original criteria for determining who is in the best position to make a particular decision, the government should set the standards when it has better information and fewer conflicts of interest than any (or all) of the other parties who play a role in setting the course for the corporation.

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.

> 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. *Adam Smith*

To the extent that corporate governance standards are established by public law, one could argue that these provisions' greatest value is in providing the illusion of accountability. For example, an article written by two thoughtful observers of corporate governance, one a law professor, one a judge, 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. The rules that inspire this confidence are:

> States almost uniformly forbid perpetual directorships; they set quorum rules, which typically require a third of the board and sometimes half of the investors to participate on critical decisions; they require "major" transactions to be presented to the board (occasionally shareholders too) rather than stand approved by managers or a committee; they forbid the sale of votes divorced from the investment interest and the accumulation of votes in a corporate treasury; they require managers to live up to a duty of loyalty to investors. Federal law requires firms to reveal certain things when they issue securities, and public firms to make annual disclosures.[15]

The authors go on to acknowledge that, "Determined investors and managers can get 'round' many of these rules, but accommodation is a sidelight."[16] Throughout this book, there are examples of getting "round" these rules. It does not mean much to "forbid perpetual directorships" if management continues to re-nominate the same people. 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. 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.)

Many of the laws that govern corporations are designed to make it possible for them to externalize their costs. These laws vary tremendously from state to state and country to country. The tendency for states to try to outdo each other in accommodating business has been called a "race to the bottom" competition because of the way that the states compete for corporate chartering business through increasingly diluted provisions for oversight.[17] 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. Globalization may expand the "race to the bottom," resulting in most of the world's major corporations incorporating in the world equivalent of Delaware, perhaps the Cayman Islands. Or, if providers of capital are able to communicate their concerns by directing their funds to enterprises governed by more investor-friendly laws, competition for capital could turn the race to the bottom into a race to the top.

The marketplace

Corporations also operate under the laws of the marketplace. While these laws can be influenced to some extent by the legislature, the marketplace is the ultimate arbiter of corporate performance. No matter where a company is located and what it produces, these laws affect, even determine, every decision made by its directors and officers. We would call this the law of economics, if we could use that term without then limiting ourselves to the narrow vocabulary and assumptions of that academic specialty, so we will just call them the laws of capitalism.

This set of laws reacts to and influences the first set. When a company changes its state of incorporation for tax reasons, for example, that is a function of economics. So too is a company's consideration of the differing social laws of states and nations, such as varying regulations governing occupational safety and environmental standards. Like a consumer selecting a car, the corporation's choice of domicile is based on an evaluation of the costs and benefits of all of the options. The same kind of evaluation applies to decisions about whether to invest in research and development or whether to update a local factory (or retrain local workers) versus reducing costs by moving the operation abroad.

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. In order 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 five overall goals outlined above, or at least so that they do not conflict with them. The law should be process-oriented, not substantive. Its focus should be 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 assurances 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 last 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 (<http://www.gcgf.org/>), co-sponsored by the World Bank and the OECD, is a new international initiative which will bring together the leading bodies engaged with governance reform worldwide: multilateral banks active in developing countries and transition economies, international organizations, country groupings engaged with governance reform, alongside professional standard-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 practice; and to coordinate activities and identify and fill gaps in the 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.

CORPORATE POWER AND CORPORATE PERFORMANCE

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). In order 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?",[18] Carl Kaysen outlines the various alternative modes for containing corporate power, 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.[19]

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."[20]

But, as the scandals of 2002 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.

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 two 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.

Cases in point: Some instances of corporate crime – Enron, Global Crossing, Tyco, Adelphia, and WorldCom

In 2002 and 2003, allegations about negligence and abuse, from accounting fraud to embezzlement, led to a new focus on corporate crime. We do not know at this writing whether any of those executives will go to jail.

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:

The top ten corporate criminals of the 1990s

1. F. Hoffmann-La Roche Ltd.
Type of crime: Antitrust (price-fixing for vitamins)
Criminal fine: $500 million

2. Daiwa Bank Ltd.
Type of crime: Financial (falsification of records to cover up trading losses)
Criminal fine: $340 million

3. BASF Aktiengesellschaft
Type of crime: Antitrust (price-fixing for vitamins)
Criminal fine: $225 million

4. SGL Carbon Aktiengesellschaft (SGL AG)
Type of crime: Antitrust (price-fixing)
Criminal fine: $135 million

5. Exxon Corporation and Exxon Shipping
Type of crime: Environmental (Valdez oil spill in Alaska)
Criminal fine: $125 million

6. UCAR International Inc.
Type of crime: Antitrust (price-fixing)
Criminal fine: $110 million

7. Archer Daniels Midland
Type of crime: Antitrust (price-fixing)
Criminal fine: $100 million

8. (tie) Banker's Trust
Type of crime: Financial (appropriation of client funds)
Criminal fine: $60 million

9. (tie) Sears Bankruptcy Recovery Management Services
Type of crime: Fraud (widespread misrepresentation to bankrupt debtors)
Criminal fine: $60 million

10. Haarman & Reimer Corp.
Type of crime: Antitrust (price-fixing)
Criminal fine: $50 million

When the companies paid these fines, who bore the cost? How many of the responsible parties served time in jail?

Some additional examples

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 inside 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 intra-uterine 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.

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 – it transpired that 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. But 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."

But how do you punish the body corporate? As we have discussed, you cannot put it in jail, and any fines will ultimately be paid by those who were not responsible (the shareholders).

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. But 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.

And yet disasters such as that of 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 discussed above, 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 manslaughter in English legal history highlights the difficulties. In 1994, a jury convicted the owner-operator of an adventure 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." (In the US, corporate homicide charges are equally rare. One successful prosecution involved a worker who was killed through on-the-job exposure to hazardous chemicals. The boss had actually removed the warning labels.)

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.

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?

The American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (Proposed Final Draft, March 31, 1992)

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.

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, as a matter of both legislated and economic rules. Compare the current corporate system to the prevailing Western system of political legitimacy and accountability. We allow the legislature to make economic tradeoffs. We give this level of authority to the government, which derives its legitimacy from its accountability through the political process. And 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.

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."[23] 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.[24]

> 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.[25]

In the US, the decade of the 1990s was a time in which 10 percent of the value of listed companies – roughly $1 trillion in value at the top of the market – was transferred from the shareholders to the CEOs. While shareholders did very well during that period, CEOs did much better.

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CORPORATE CRIME: "WITHIN THE LIMITS OF THE LAW"

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*

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. And these costs are enormous. A single price-fixing case was found to cost the affected consumers more than all of the robberies of that year. 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 chapter 3) 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.

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. And 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; and 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. And, 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."[26]

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.

How can a corporation be sentenced to probation? 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.[27]

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."[28] 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.[29]

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.[30] 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.[31]

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.

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 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." And one thing they wanted was no individual consequences. No one went to jail. No one was made ineligible for future employment on Wall Street.

Is there 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 make it?

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."[32]

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 chapter 2). 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."[33]

How can shareholders make this system work? They have no interest – much less competency – in developing or prescribing internal corporate procedures. Yet they do have some responsibility for this area. 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 establish mechanisms for preventing and responding to corporate crime in the past. In the future, shareholders need to make it unmistakably clear that continued corporate crime will not be tolerated. But 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.[34]

Shareholders, along with directors and officers, must 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. Unquestionably, the board of directors 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.[35]

The Sarbanes–Oxley legislation underscored the authority of the directors to establish policies requiring management to implement obedience to the law as a corporate priority. And 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. 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."[36] Other reformers recommend that mechanisms to administer spot checks on compliance with the principal statutes should be created. Similar mechanisms can insure that corporate "whistle blowers" and non-employee 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*[37] 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.

The Sarbanes–Oxley legislation gives the SEC authority to debar individuals from serving on corporate boards. In 2003, the SEC used this authority to negotiate the resignation of former Xerox CEO from his other boards, even though he did not admit guilt in the $22 million settlement of accounting fraud charges at Xerox.

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? Look again at the Beech-Nut example in the introduction. 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.[38]

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

CORPORATIONS AND GOVERNMENT: CO-OPTING THE MARKET

Many observers have argued that corporate power has created a framework within which only the illusion of free choice exists. One example is that of the Chrysler Corporation.

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 market place." 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 out-lining 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 aids. 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."[39]

This case shows that only the small companies are really at risk of any meaningful market test. In a more recent example, the Federal Reserve organized a 1998 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 Ph.D.s 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). But 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 bail-out, because it did not use public funds and because LTCM investors were not made whole. But a government entity did orchestrate the soft landing for LTCM, which makes it another example of a company that is "too large to fail." (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 issue.)

A corporation that is large enough cannot be allowed to go broke in a "free" capitalist society. 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 non-partisan elections. But, 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. But, 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 were 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 72 percent higher than in 1997–8, the most recent non-presidential 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. The economic power of corporations is dominating the political process. And that power distorts the ability of the marketplace to discipline corporations.

Lord John Browne of British Petroleum has pledged to terminate all political contributions from that company. The elimination of "soft money" donations in the McCain legislation in the US will have some impact, though, if past experience is any indicator, it will not be long before corporations figure out some other way to continue to give money to politicians.

Case in point: Corporate political donations in the UK

One of the issues that dominated the 1997 general election in the UK was "sleaze." Numerous Members of Parliament of the incumbent Conservative administration had, or were alleged to have, a range of consultancies and relationships with business that compromised their political work. The opposition Labour party also argued that the Conservatives received numerous foreign and undisclosed donations from not altogether "clean" sources.

Labour made a manifesto pledge that, if elected, they would appoint a commission to study the funding of political parties in the UK. Once elected, they were good as their word, and the Committee on Standards in Public Life, chaired by a senior lawyer, Lord Neill, began work. One of its tasks was to investigate donations made by public companies.

The state of the law, at that time, was that UK companies were free to donate to political parties as long as any donation over £200 (about $300) was disclosed. Companies were under no obligation to seek shareholder permission in the form of a vote at the annual meeting or explain why the gift was in the company's interests. (Shareholders could challenge the gift in court, but their chances of winning were slim and the costs would undoubtedly be greater than the benefits.)

These conditions gave UK companies considerable freedom to donate, and they made the most of it. Research by the independent London-based consultancy Pensions and Investment Research Consultants showed that companies gave about $15 million between 1991 and 1997 to political parties or groups. The average donation in 1997 was about $50,000. The largest donors were P&O and Hanson, which both donated about $150,000 in 1997. To an overwhelming extent, this history of corporate giving benefited just one party, the Conservatives. Between 1991 and 1997, the Conservatives received over 97 percent of all donations made to any of the three leading political parties.

Although, as the Neill committee began deliberations, there was a general decline in corporate political donations (perhaps mirroring the decline of the Conservative party itself), there was a considerable lobby for change. At the vanguard of this call for reform were Labour-controlled local authorities and trade-union pension funds, who were in the unhappy position of seeing funds belonging to the company they owned being donated to their political adversaries. These left-wing funds could, of course, have sold their shares. But as we have argued elsewhere in this book, that is no choice at all.

These shareholders argued that, in principle, it was wrong for companies to make donations on such an emotive and personal issue as politics without shareholder permission. The anti-donation lobby argued further that there were considerable conflicts of interest inherent in the system. For example, one of the leading donors was the insurance group Guardian Royal. One of the non-executive directors was Lord Hambro, former treasurer of the Conservative party and thus chief fundraiser for the party. Lord Hambro also served on the boards of Taylor Woodrow and P&O, which together donated more than $1 million to the Conservative party in 1997.

And what did shareholders get in return for their generosity? One political commentator found that half the political honors (peerages, knighthoods and so on) were awarded to the 6 percent of companies that made donations to political parties. In other words, were business leaders able to spend shareholders' money on securing for themselves a place in Britain's political elite?

Nor was the disclosure requirement as comprehensive as might appear. The law required companies to disclose cash gifts to political parties, but gifts to political organizations escaped the net, as did gifts in kind such as personnel, equipment or facilities. For example, groups such as Aims of Industry or the Northern Industrialists Protection Association were known to be closely allied with the Conservative party. Some companies disclosed gifts to these bodies, others did not.

In June 1993 the UK newspaper the *Independent* obtained a copy of a scheme drawn up by the Conservative Central Office to boost political donations. Companies were invited to put money into a current account with the party's bankers. The bank, instead of paying the company interest, would reduce the charges on the party's $24 million overdraft. One of the advantages cited by the Conservative Central Office? The proposed interest-free loans would not need to be disclosed to shareholders.

The Neill committee sought the testimony of some leading business figures. Stanley Kalms, chairman of electrical goods retailer Dixons, said "I have been persuaded by the argument that shareholders who represent a mixed range of views might feel that their views are not represented by a political donation."

Sir Neil Shaw, chairman of sugar manufacturer Tate & Lyle, argued that, in the absence of a national system for funding political parties, companies should make donations in order to promote the wider interests of democratic society. Tate & Lyle was one of the few companies who gave money to more than one party, although its gifts were overwhelmingly made in favor of the Conservatives.

The Neill committee published its findings in the Fall of 1998. It recommended "that Parliament enact a raft of measures to make political funding more transparent and democratic." Among the measures was the recommendation that companies wishing to make a donation first seek a general prior authority from shareholders. The committee suggested that:

- the authority be sought at least once every four years;
- disclosure should include non-cash donations; and
- an upper limit for donations should be specified.

The Labour government has promised to enact the recommendations.

> *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?*

Not only have corporations succeeded in dominating the executive and legislative branches of government in the United States, but they have made substantial inroads into 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. During the takeover era of the 1980s, the courts seemed to do the same, as you will see in chapter 3. 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"[40]

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.

MEASURING PERFORMANCE

We cannot tell what the future impact of corporate strategy will be on shareholder value. Will spoiling the customers produce devoted loyalty or will it drive up prices too high? Will a long-term research and development project pay off? Will cost-cutting measures expose the company to future liability claims? Will the acquisition of a new business provide synergy or cause loss of focus? *How can anyone – shareholders, directors, or managers – evaluate a company's performance if they cannot predict its future?*

In order 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 of 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.[41]

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, as long as they 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 – in theory – its board of directors. It is in the "creative tension" between the informed, involved, motivated 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 SEC during the Clinton administration. And no one was singled out for more vituperative recrimination than the accounting industry.

On September 28, 1998, then chairman of the Securities and Exchange Commission (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 concern 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 the case study in chapter 6). 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 heat Wall Street's estimate of 19 cents. But 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 continue 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 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 FASB, which sets accounting standards, was too independent, and not supportive enough of business. It 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 FEI could persuade 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 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 the Arthur Andersen case study.)

Case in Point: Mr. Biggs testifies

The following are excerpts from the testimony of then TIAA-CREF CEO John Biggs before the US Senate Committee on Banking, Housing and Urban Affairs (February 27, 2002).

> The three changes we have needed for some time and that bear directly on the circumstances of Enron are these: (1) a means of dealing with the widespread overuse and abuse of fixed price stock options; (2) the need for some basic common sense regarding auditor independence; and (3) the need for a strong regulatory model to oversee the accounting profession.

Overuse and Abuse of Stock Options

Several accounting professionals have attempted to lay the problems of Enron's accounting on the FASB. I believe they are seriously mistaken. In fact, during the late 80's and early 90's the FASB was aware of the very issues that Enron eventually faced. Among other things, the FASB addressed the absurd policy of accounting for stock options by which they appear to be "free" even though they form a central feature of executive compensation plans and obviously have very substantial costs.

Enron used such options extensively, covering all their management employees and granting large awards to their senior executives. Sixty percent of Enron employees had options. The cost of these options was never reported in Enron's earnings statements although the exercise gains were so great that in several years Enron paid no taxes.

The IRS allows as a deduction for compensation expense the difference between the option price and the stock's price when it is exercised (for most employee stock options). But in reports to shareholders that difference, or any other amount, has never been shown as an expense. Through its long, tedious, but open process the FASB explored all theoretical aspects of stock options. It put out tentative proposals, conducted exhaustive hearings so that all participants could comment, and heard arguments pro and con. The process took several years.

Many critics now say the FASB is too slow, but at other times critics have said it was too fast, especially when the issue was an unpopular one such as stock compensation or derivatives. The final proposal would have required a charge to expense for stock options given to employees as compensation. After extensive lobbying of Congress by companies and auditing firms, and following legislative threats to the existence of private sector standard setting, the FASB and the SEC capitulated. Arthur Levitt has publicly stated that he believes this was the greatest mistake made by the SEC during his chairmanship.

In capitulating, the FASB published a rule in 1995, known as Financial Accounting Standard 123, that offers the choice of expense recognition or disclosure in footnotes. If disclosure is chosen, the income statement will show expense for options only under certain circumstances required by the Accounting Principles Board (the predecessor to the FASB) in its Opinion No. 25 (1972). The FASB said the following in FAS 123, a statement with which I completely agree: "The Board chose a disclosure-based solution for stock-based employee compensation to bring closure to the divisive debate on this issue – not because it believes that solution is the best way to improve financial accounting and reporting." (Paragraph 62) In other words, disclosure in footnotes is inappropriate reporting to shareholders of the costs of operations.

As you might expect, most corporations prefer to use the obsolete accounting model of 1972 which treats the fixed price stock option as "free" and treats performance options as potentially very expensive. Significantly, most companies use virtually no other form of stock award than the fixed at-the-money option. Note that the Black–Scholes option-pricing model was created a year later, in 1973, and forms the basis for understanding financial transactions involving uncertainty. I can assure you that high-tech executives in Silicon Valley use the Black–Scholes model to value their own options. Most companies also use Black–Scholes to communicate total compensation to employees. Those same executives know that having to show the results of that calculation to shareholders would reduce or even eliminate the earnings of their companies.

I serve as a Director of the Boeing Company, which is the only major US company to adopt FAS 123 expense, in order to report to its shareholders the true cost of its stock compensation plan. Boeing's executive compensation plan is based heavily on tough performance tests which are prohibitively expensive under the 1972 accounting model used by all other companies. For the record, Boeing adopted its plan and FAS 123 in 1996, before I became a director.

I might mention a further example of the strong-arm tactics of US corporations. Last year the Financial Executives International issued a press release threatening to withdraw funding for the newly formed International Accounting Standards Board if the Board dared to study the issue of accounting for stock-based compensation. The use of options and stock as employee compensation is a growing phenomenon overseas, with little or no accounting guidance in place. I am happy to say that both Paul Volcker, Chairman of the Foundation supporting the IASB, and Sir David Tweedie, Chairman of the IASB, are standing their ground, and the project is proceeding.

The use of questionable accounting methods for stock options has several negative results:

1. Explosive growth in the use of stock options since 1995 – huge, indeed, incredible awards to CEOs and in some companies awards to every employee. For several years, this practice has been a major concern addressed by TIAA-CREF's corporate governance program.
2. The serious distortion of earnings statements so that some companies report large earnings at the same time that no taxes are paid. This is because of peculiar accounting that results in fixed price stock options as zero "cost" in public income statements while allowing the employee gain to be shown as a "cost" for the tax return.
3. Unprecedented focus on the stock price by all the employees of the company, to the point where serious ethical dilemmas are posed for employees. When excessive stress is placed on company accountants and their auditors, malfeasance may result. Business ethics experts wonder if potential "whistle blowers" are intimidated by their colleagues' or their own concern for their stock options.
4. The dramatic decline in dividends is a direct result of so much recent attention to stock options. A dollar per share paid to a shareholder as a dividend reduces the stock price by a dollar. Can anyone wonder why corporate managers find many reasons to justify a reduction or elimination of the dividend?
5. In many companies, stock options have replaced pension plans entirely. When we protested the action of IBM in abandoning its defined benefit plan, the

company responded by pointing out that its competitors in the technology world had no pensions whatsoever.

6. There has been an almost exclusive use of the fixed price stock option in employee compensation plans. More desirable stock compensation plans could be devised that would better align management and shareholder interests. Such plans are effectively prohibited by the 1972 rules because they require that management show an expense for them. For example, a plan that requires performance better than the general market performance is not considered a “fixed price option” and results in truly onerous accounting treatment under 1972 rules. FASB Statement 123 provides sensible expense accounting for performance plans.

I have long been a strong advocate for the principle that the private sector (i.e. FASB or GASB (the Governmental Accounting Standards Board) or IASB) should set accounting standards. Congress, through the political process, should not enter into such technical issues, but it should demand a fair and open process. I stand by that view. Some expression of support by your Committee, or by the full Senate or House of Representatives – the form of which you understand better than I – might make it possible for the IASB to study the issue, and for the FASB to reopen the question.

I believe that history would see this action as an extraordinary benefit coming out of the many lessons to be learned from Enron.

Auditor Independence

My company has two important provisions in its Audit Committee Charter. Our auditors may not do any work for TIAA-CREF other than what is directly related to the audit function (this exclusionary rule also applies to our tax work); and rotation of the auditor is considered after a five- to ten-year period. The first rule was heatedly contested by our auditors at the time we imposed it; our current auditors knew the rule when they began working for us in 1997 and now accept it. We have had two auditor rotations since I have been Chairman, and each has been not only successful but also highly energizing for our financial management work. . . .

There seems to me a widespread lack of sensitivity to conflicts for auditors that must be addressed. And there need to be more examples of lucrative opportunities turned down than there are.

I applaud the recent changes made by the accounting profession on limiting the types of non-auditor work. Several of the firms saw the public need to do this in 2000 when the SEC proposed limitations. The others have grudgingly assented, arguing, to my astonishment, that the Andersen–Enron relationships had no independence problem.

A far more powerful antidote to this blindness to conflicts of interest would be to require auditor rotation every five to seven years. Such a requirement will be fiercely opposed by the accountants and the companies, who will see only additional costs of having to make such changes. But I can vouch from my experience that the costs can be managed and that there are many positive benefits. Even if the cost-benefit ratio were unfavorable, which I doubt, isn’t such a simple solution worthwhile, given the importance to our capital markets of confidence in financial reports? . . .

A Strong Regulatory Model

The Public Oversight Board (POB) on which I have served for the past several months, attempted to oversee a bewildering array of monitoring groups. One was the Quality Control Inquiry Committee (QCIC) that reviews auditor performance in contested audits (i.e., where a lawsuit had been filed). A second was the Peer Review Board that participates in inter-firm peer reviews.

There were others as well. The POB oversaw the Professional Ethics Executive Committee (PEEC) that reviews members' actions in all types of ethical issues. It oversaw the Auditing Standard Board (ASB) and the SEC Practice Section (SECPS). Finally, the POB had the opportunity to raise questions with the FASB if accounting standards seemed in need of repair.

Being a non-accountant and an independent director, I found the POB very hard work, especially for a sitting CEO. The other four members were retired, and I succeeded Paul O'Neill who, as you know, moved from retirement to a very active position. What was often most frustrating was our lack of authority if we found something that we thought should be changed. While the major firms and the AICPA were outwardly co-operative when the SEC demanded action, they were unwilling to change in response to any significant POB initiative. At one point, the AICPA threatened to withhold funding from the POB, but was finally forced by the SEC into an unwilling marriage, documented by a new charter that gave us assurance of being able to pay our staff. No one will really miss us after March 31.

In short, we need something better for a regulatory body . . . The investigative authority of a new accounting regulatory body needs to be clear-cut and not simply a derivative of the SEC. Accounting firms must know that they cannot refuse to open their books or prevent their staff from co-operating with this new agency. Of course, it must have the ability to keep the information gathered out of the hands of the litigating lawyers. And it must have the authority to discipline firms and individuals without the delays of an AICPA investigating process.

The new agency must have licensing authority, beyond that of the states, for individuals who will practice at the SEC bar. It should have authority, I believe, to approve or disapprove business affiliations of licensed practitioners – for example, is it appropriate for American Express or H&R Block to become major players in providing audit services? Should accounting firms with an SEC audit practice be allowed to go into all the major financial businesses that the Big Five have now entered?

The new agency should also have a reliable funding source that does not come from the accounting profession on a voluntary basis. Nor should it come from the business community through the "tin-cup" process now used by the Financial Accounting Foundation and the Foundation for the International Accounting Standards Board.

Concerning this point, I have served on fund-raising committees for both the FASB and the IASB. I can assure you that voluntary giving to support the regulation of the auditing profession will not work. Raising money for a much more benign purpose – for instance, establishing accounting principles in the private sector – has been a very tough sell. Those of us asking for the money feel compromised. The unspoken question is this: "If I give, will I have more influence on FASB decisions?" The investment community has largely refused to support either the FASB or the IASB, with a very few exceptions to that rule. The usual contributors are those with a strong sense of community interest – the major banks, investment banking concerns, and several large global businesses.

We should devise instead a fee on stock market transactions, or registrations, or some other financial activity that will be devoted to paying for auditing oversight, the work of the Financial Accounting Foundation, and perhaps even the American share of the IASB's needs.

Given the welcome demise of the POB, the ball is squarely in the court of Congress and the SEC to define a strong regulatory body. It should have real teeth, adequate funding (without membership fees from the very institutions the new body will regulate), and a fair chance of bringing a new ethic and culture to a profession that needs to change.

It is my hope that we will succeed in these three areas: First, that we can make companies provide transparent accounting for stock options; second, that we can assure greater independence of auditing through auditor rotation; and third, that a strong regulatory body can be created. If these goals are reached, I believe we may look back on Enron as being a short-term financial tragedy for its employees and the holders of its securities, but a major long-run benefit for the US capital markets.

BALANCING INTERESTS

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 blithely approve paying for a $120 million art museum with the shareholders' money is obviously operating without such a system. So is the CEO who will spend $68 million on developing an (ultimately disastrous) "smokeless" tobacco cigarette before informing his directors. (See the discussion of both of these cases in chapter 3.)

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 is to have government, accountable through the political process, make the ultimate determination when the issue involves a tradeoff of corporate profits against social goals. Government regulation is justified 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. The danger lies in allowing corporate managers to make policy tradeoffs 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.[42]

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 emblazons 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."[43]

In recent times, more than half of the states in the US have passed "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.[44] 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."[45] 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. And most 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.

> *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. But we agree with Hanks 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."[46] The Committee also noted that the Delaware Supreme Court's decision in the *Unocal* case (see discussion in 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 non-shareholder constituency at the expense of shareholders."[47] 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

In 1990, Pennsylvania risked the consequences F.A. Hayek warned about when it adopted the notorious Act 36 of 1990, which went far beyond 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 interests 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: 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.

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 under-performed 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.[48]

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.[49]

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?

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 at interest. That allows all other interests to be factored in without losing sight of the goal of long-term wealth maximization. But without a clear and direct and enforceable fiduciary obligation to shareholders, the contract that justifies the corporate structure is irreparably shattered.

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."[50]

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 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, it is the hypothetical pension plan participant whose long-term time horizon and wish to retire into a world with a sound economy and environment can serve as a worthwhile standard.

GOOD AND BAD CORPORATIONS?

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 case in point is an actual 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, 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?*
- 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 it decides, instead, to give its 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 itself?*
- 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 anti-social decisions for economic reasons. Let us look at some examples of companies 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.[51] 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 that 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. Its 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 (see the introduction to this book).*
- 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 forgoing 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 its 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. And he 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 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 to 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 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. It is then confronted with employees, shareholders, and consumers who object to the cancellation, and demand that the company continue 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?*

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."[52] And 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."[53]

For the sake of this argument, let's define "social judgments" as explicit tradeoffs 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.[54]

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.

For another approach to charitable giving, consider Warren Buffett's Berkshire Hathaway. From 1981–2003, Berkshire allowed each shareholder to designate a charity. While admitting that his approach may not be suitable for companies with institutional investors having "short-term investment horizons," Buffett believes it is a more principled approach to corporate giving.

> 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.[55]

In 2003, a tiny anti-abortion group objected to the shareholder-designated donations to Planned Parenthood, and Berkshire shut down the program. Over 22 years, it had contributed almost $200 million to over 1200 charities, mostly schools and religious institutions. 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 non-profit community prevented it from becoming part of the package of reforms that were ultimately enacted.

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?[56]

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

Case in point: Johnson & Johnson[57]

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, including one on the "Donahue" television program.

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?

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 corporation 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). Readers should note that the operative term here is "generally accepted," not "certifiably accurate."

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 assure a consistent (if minimal) level of disclosure. What they measure is measured consistently over time and between companies, and that has some utility. But it is crucial to remember that 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 its 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. And 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."

But 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 the accounting scandals of 2002–3 made it clear how subjective the standards 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 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 to 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 6, 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 6, 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. Research by New York University accounting professor Baruch Lev suggests that the disparity between a company's tax and financial accounting is a compelling indicator of problems.

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 she is going to re-engineer the company and be compensated according to new reported earnings, costs may be calculated another way. And if 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. In order to motivate the executives, they devised a compensation package that provided an incentive for an improved return on the equity invested (ROE). 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 – all from an accounting formula to create incentives for salespersons.

Case in point: Sears Automotive

In the summer of 1992, the California Department of Consumer Affairs conducted a number of undercover investigations at the auto repair stores of Sears, Roebuck & Co. They found systematic charging and regular performance of unnecessary repairs. A similar operation in New Jersey reached similar conclusions. California consumer regulators demanded the closure of all 72 auto stores in the state. Had the closedown been enforced, Sears would have lost $200 million in annual revenue, and 3,000 employees would have lost their jobs. Sears settled the New Jersey accusations with a payment of $200,000 to a fund set up to study auto malpractice nationwide. At least a dozen class-action suits relating to the fraud were filed. Finally, the auto stores, one of Sears' most profitable operations, showed a 15 percent decline in business in the months following the scandal.

In responding to the crisis, Sears blamed the compensation practice of its auto department. In early 1990 Sears stopped paying its auto workers by the hour, and instead instructed them to perform a certain number of repairs each shift. Mechanics and repairmen would be paid a commission on the work during the shift. In other words, the employees had an incentive to perform more expensive repairs than was necessary. Complaints about the stores jumped 29 percent in the year that the new commission program was introduced, and a further 27 percent the next year, leading to the investigation by consumer regulators.

Sears' chairman and CEO Ed Brennan admitted at a press conference that the incentive scheme "created an environment where mistakes did occur."

Case in point: Green Tree Financial

Green Tree CEO Lawrence Coss 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, hooking the returns on loans as though there would be no defaults. Ironically, the problem was not defaults but prepayments. 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 pre-tax profits, the restatement forced him to give back an estimated $40 million of his then record-setting $102 million payday.

Note: 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 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.[58] 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."[59] 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 multi-million-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.

So, when a company pays a CEO in cash, that payment is treated as an expense: it is deducted from company earnings on the earnings statement, and the company claims that expense as a tax deduction. But when a CEO exercises 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 an independent 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.

But 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 cashflow 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.

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 the Street*, former SEC chairman Arthur Levitt says that he made a serious mistake in encouraging FASB to give up on 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-to-9 vote on a non-binding 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 has proposed that all stock option grants be expensed. FASB is expected to try again, following indications from Congress that it would not try to obstruct the rule again. In the meantime Coca-Cola, followed by more than 300 other companies, announced that it would begin to expense stock option grants without waiting for the change in GAAP.

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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. It calculates 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. But the fact that the market valuation is independent 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 enormous losses 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. But 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, saying, for example, that its 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.[60] 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. Friedheim 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, 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. And 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.[61]

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.[62]

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 SEC in 2001 recommended that non-financial performance data be released to investors. Similarly, the FASB has called for further review of methods to account for intangible assets. So far, both groups have recommended that disclosure remain voluntary.

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

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 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.

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 commercialisation 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.

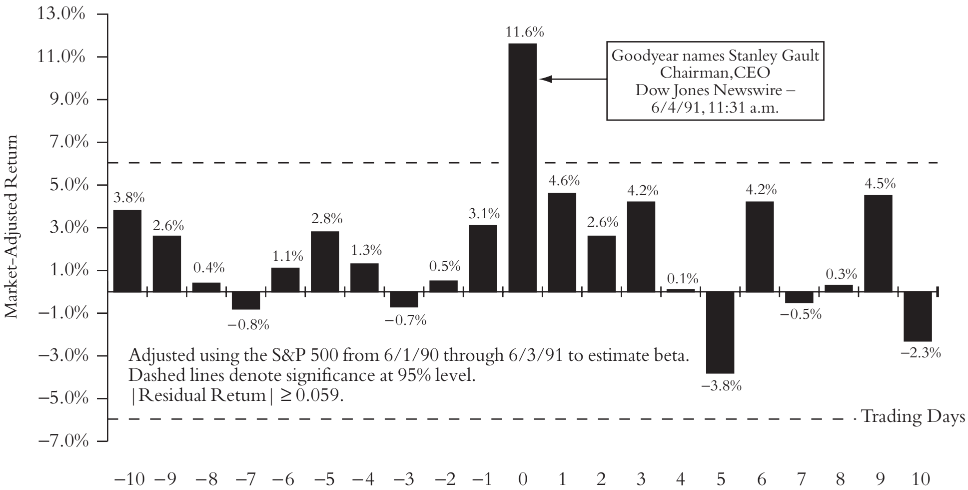
Cleary, the greatest challenge for financial reporting in the twenty-first century will be finding some way to account for the value of intangibles, from patents to Ph.D.s, and from client relationships to risk assessment strategies. As the ratings agencies, including S&P and Moody's, begin to factor 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. But in today's companies, "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

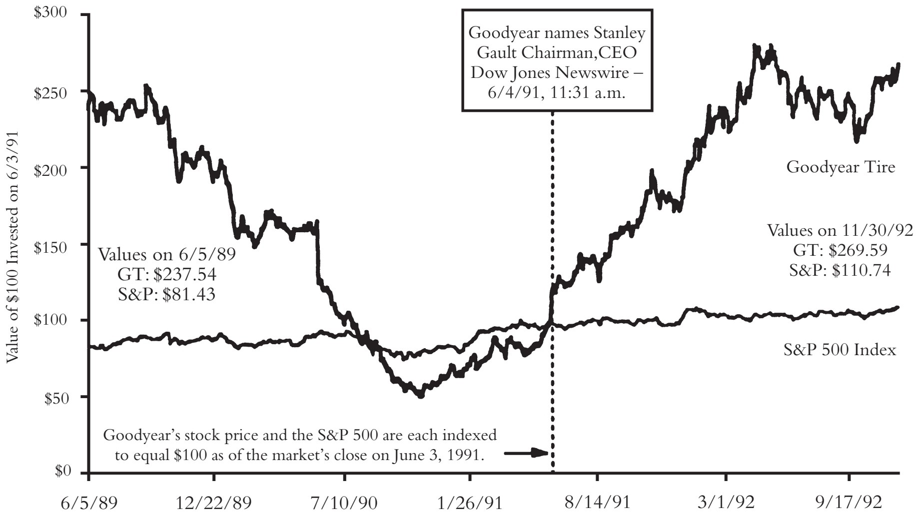
Ultimately, a company is valued because of analysts' conviction that it can generate certain levels of positive cashflow from present and future operations. Any calculation of company value necessarily is based on "guesses" as to what will happen in the future. Some of the guesswork is taken out of the 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 underperforming company replaces its CEO, the market's reaction can be highly positive. See figures 1.2–1.5, which show the market's response when Goodyear and Allied Signal replaced poorly 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.



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 Goodyear Tire market-adjusted returns, May 21–June 18, 1991



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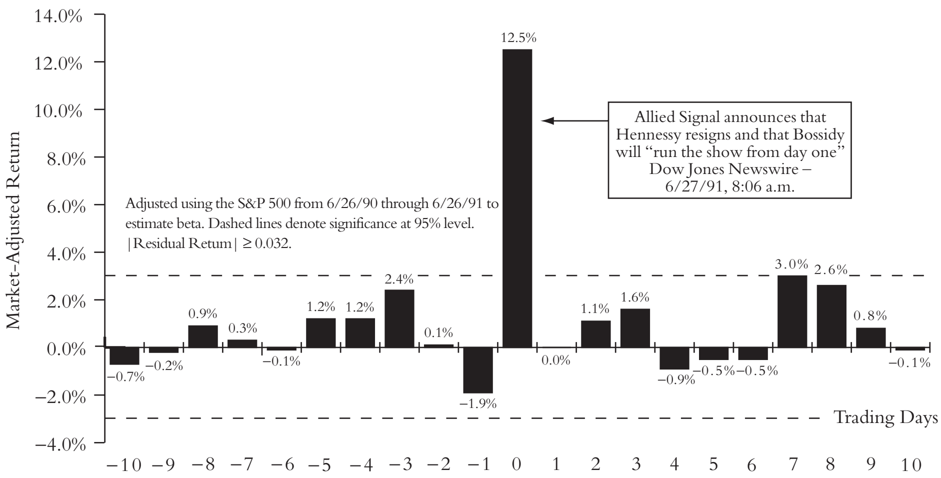
Sources: Compuserve and the Center for Research in Securities Prices (CRSP), University of Chicago, daily return tapes.

Figure 1.3 Value of $100 invested in Goodyear Tire and the S&P 500 index on June 3, 1991 (June 5, 1988–November 30, 1992)



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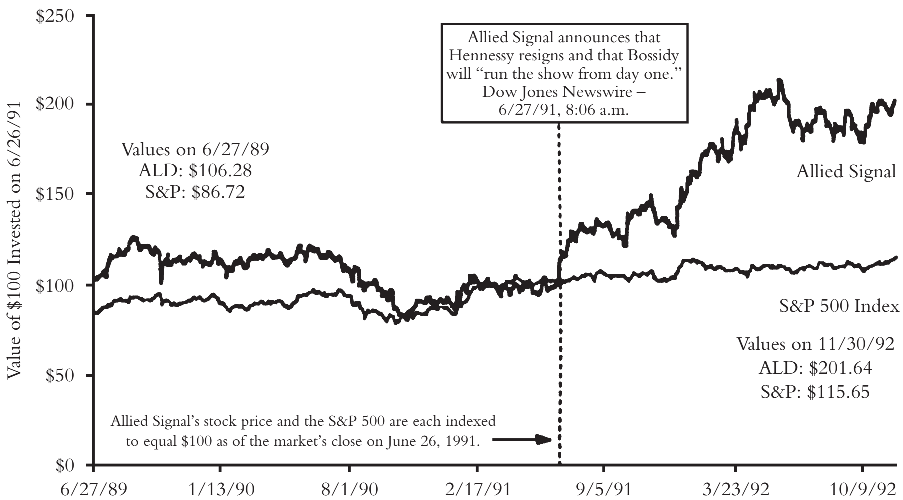
Sources: Compuserve and the Center for Research in Securities Prices (CRSP), University of Chicago, daily return tapes.

Figure 1.4 Allied Signal market-adjusted returns June 13–July 12, 1991



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

Figure 1.5 Value of $100 invested in Allied Signal and the S&P 500 index on June 26, 1991 (June 27, 1989–November 30, 1992)

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*,[63] the international competitiveness of a country – the United States in his account – rests on its ability to provide capital to domestic 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.[64] Debt that was attractive one year suddenly is non-competitive 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[65]

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, NYSE chairman and CEO William Donaldson, and then SEC chairman Richard Breeden regarding disclosure requirements for the listing. And 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.

In order to list its shares on the NYSE, Daimler-Benz was required to provide greater financial disclosure than is required under German law. Breeden stressed that the SEC has not changed US policy regarding disclosure requirements for foreign companies seeking listings on US stock exchanges. In fact, he referred to the agreement as a "complete rejection of the approach suggested by the [New York] stock exchange." For years, the NYSE has advocated that the SEC relax some disclosure requirements in order to attract foreign companies, but the SEC has remained steadfast.

Key aspects of the agreement included:

- Daimler-Benz AG, the parent company, proposed to adjust its earnings upward by DM4 billion ($2.42 billion) in 1992, by claiming hidden reserves of this amount as "extraordinary earnings." This move highlights one of the most controversial aspects of German company law and accounting practices, whereby companies may accumulate large hidden reserves, thereby artificially deflating the company's value. The result of this practice is that most German companies, including Daimler-Benz, are undervalued on the stock exchange. The decision to allocate these reserves indicates that the disclosure regime demanded by the SEC will provide greater transparency regarding the company's financial situation.
- Daimler-Benz will have the choice of one set of financial data for German investors and another set for US investors in accordance with SEC requirements, or a single set complying with requirements of both jurisdictions. (While German disclosure requirements are quite high in comparison with other continental European jurisdictions, they are not as stringent as SEC requirements.)
- Daimler-Benz will be required to present cashflow statements in accordance with US accounting principles.
- Daimler-Benz will not be required to offer financial information on previous years in accordance with US accounting principles.

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 ago, 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,[66] 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 it promised at the time of the merger to continue to issue US-style proxy statements, in the year following the merger it did not. It 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.

Transparency (disclosure) and good governance can produce a lower cost of capital, as equity markets increasingly recognize the value of reduced agency costs. But 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.

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.

On his website at <http://www.ragm.com> one of the co-authors of this book has created the Brightline simulation, a simplified, 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.

Case in point: Socially responsible investing

A 2002 book, *The SRI Advantage: Why Socially Responsible Investing has Outperformed Financially*, by Peter Camejo, 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 fund 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."

The quotation from Adrian Cadbury earlier in this chapter speaks of a second level of company responsibility – considering the implications of a corporation's operations for 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. This is referred to as a "corporate externality." 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.

Some companies have made significant, if sporadic, efforts over the last decades to reflect the "real" (in contrast to GAAP) cost of their operation. During the administration of US President Jimmy Carter, Commerce Secretary Juanita Kreps actually proposed a formal methodology for "social accounting." Her 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."[67]

One attempt to design "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;
- reasons for 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.[68]

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.

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? 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. But, 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."[69]

A recent study concluded that companies that make a public commitment to social responsibility outperform those that do not.[70] 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 area 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," which follows.

Case in point: Prototype plc[71]

The following Success Model is an excerpt of a recent attempt to provide a report that reflects social accounting at Prototype plc.

success model – *targets & achievements…*

Key performance measures describe our success model. Here we indicate these measures for the year 2000 as they relate to our **direct stakeholders**.

Customers	Target	Achievement	
Percentage of customers retained	95%	81%	▼
Share of available market	3%	8%	▲
Quality ratings	90%	81%	▼
Support services ratings	95%	79%	▼
Innovation ratio	16%	10%	▼

Shareholders			
Dividend payment growth	7%	8%	▲
Share price increase	30%	31%	▲
Shareholders return for the sector – 1 year	12%	14%	▲
– 5 years	20%	15%	▼
Employee shareholding	20%	19%	▼

Suppliers			
Purchases from partners	55%	60%	▲
Budget for co-operative development	£2.5m	£2.504m	▲
*Number of SEQUA awards	2	3	▲

* (Supplier Excellence and Quality Awards)

Employees			
Value of the Company's knowledge bank	25%	28%	▲
Morale rating	90%	79%	▼
Competitive pay indicators	100%	91%	▼

success model – *targets & achievements…*

The Company's **indirect stakeholders** also invoke measures of performance which indicate the quality of relationships with these stakeholders. For the year 2000 these are:

Local Communities	Target	Achievement
Budget for the coming year	£1.5m	£1.5m
• Salaries	£240k	£240k
• Equipment	£1.1m	£1.1m
• Cash	£160k	£160k
Disabled persons in Prototype training programmes	120	116
Prototype employees assigned to community projects	38	28

Environmental Interests	Target	Achievement
Employee travel modalities		
• Car	20%	28%
• Public Transport	60%	62%
• Foot	10%	6%
• Cycle	10%	4%

Education Community	Target	Achievement
Number of research projects	10	11
Number of graduates recruited	60	67
Number of patents applied for	1	2
Budget for coming year	£1m	£908k

providers of capital

£000's	Results 31 December 1999	2000	Actions Taken	Future Plans
Turnover	115,900	127,090	Sales force increased Margin based commissions instituted	Continental distributions increased. More focussed benchmarking studies
Operating surplus (after taxation)	14,000	16,950	Value engineering programmes inaugurated	Training aimed at 20% productivity improvement
Revenue Investment	2,894	3,770		
R&D	1,700	1,860	More academic links	Customer inspired product innovation programme
Training	1,194	1,910	Distance learning programmes inaugurated	Focus on technical skills and improvement in telelearning courseware
Net surplus accruing to the business	11,106	13,180		Goals to improve to 20% of turnover
Dividends per share	14p	15p	Paid above market average in sector	Relate more closely with inflation indicators
Market capitalization	£160m	£182m		Reach £200 million by 2002

The Company has created a line of credit with three European banks to provide funds for physical asset procurement, research projects and new education investment. Terms are related to market rates and vary according to the nature of the expenditure. At the year end this line of credit amounts to £15m.

Equity Capital Ownership Profile

Among our institutional shareholders are those from outside the UK who held 21% of the capital at the year end.

Of the total shareholders, 31% have held their shares for 5 years or more. They comprise:

Employees:	**15%**
Financial institutions:	**12%**
Private individuals:	**4%**

Total shareholding analysis

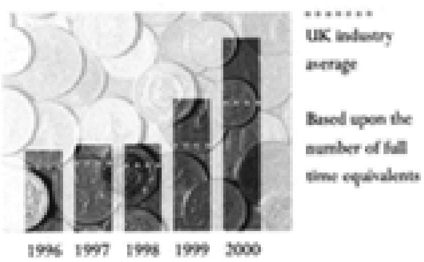
providers of capital

Assets

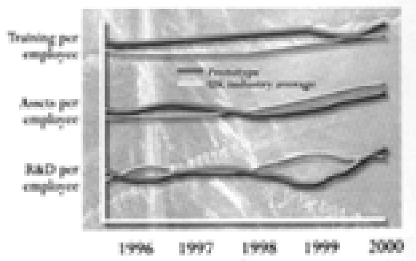
	1999 £'000	2000 £'000
Physical Assets, at cost, less amounts owed (5,000) Management analysis, valuation and independent assessment shows that the values of Prototype physical assets are greater than the amounts owed on them.	19,000	21,000
Brands – at value Brand values are based upon independent multi-year research into market values of owned brands as perceived by customers, suppliers and competitors.	1,700	2,000
Knowledge bank Collective improvement for future earning potential.	2,540	3,900
Technology Key systems and methodologies valued at estimated cost of entry (less provision for technology change risk).	1,000	1,400
Patents Valued on the basis of revenue generating expectations.	510	600
Total Intangible Assets	5,750	7,900
Cash	1,800	2,190
	7,550	10,090
Less liabilities	3,130	3,620
	4,520	6,470
Total Assets	23,520	27,470

Future cash streams for Prototype depend crucially upon the exploitation of intangible assets. These assets include brands, technology and patents. In addition, the knowledge bank of the Company – which results from valuing the direction and nature of employee activity and training – represents a significant indicator of such future cash streams.

Turnover per Employee



Performance Trends

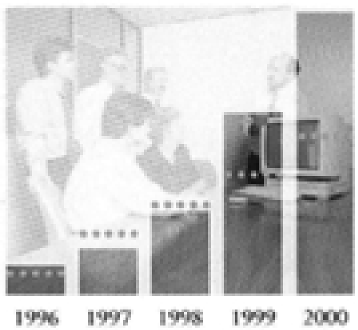


employees

Open Forum

The Company has created a "conversations" programme in which employees at all levels meet, discuss and comment upon many issues which concern the Company's future. All employees are now linked by electronic mail and internal video conferencing.

Number of Employees



• • • • • • •
Number of part time employees.

1,550 full time equivalents at the end of year 2000.

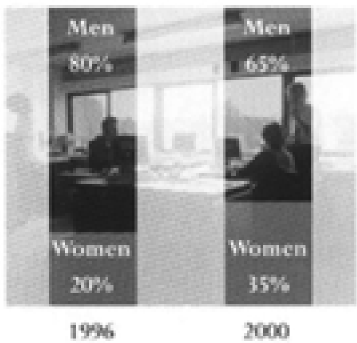
Note: Employee benefits apply equally in proportion, to both full and part time employees.

Knowledge Bank

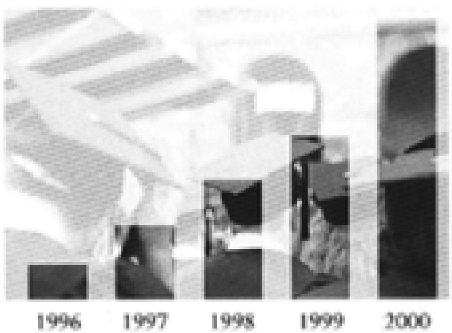
	1999	2000
	£000's	
Total employee cost	42,610	49,800
Expensed	40,070	45,900
Deferred value*	2,540	3,900
Increase in value of knowledge bank	280	1,360

*Cost of activities and training judged to generate future cash streams

Male / Female Ratio



Employees Holding 1st Degrees



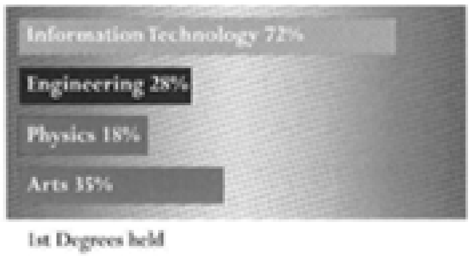
Increased recruitment and focus upon outstanding graduates has enabled the Company to attract an increasing number of holders of 1st degrees – currently at 103 graduates.

In addition, the Company has inaugurated a programme for work based degrees which has proved successful.

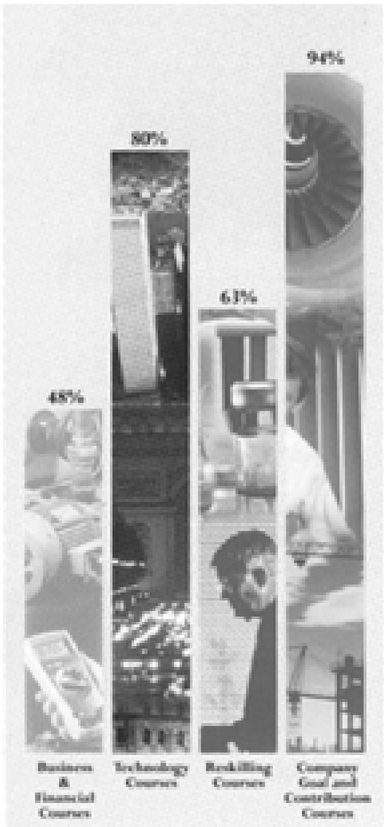
employees

Morale Indicator

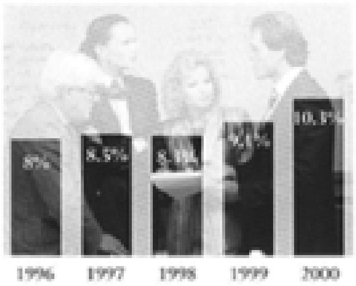
Employee Educational Profile



Employees Completing Training Plans



Employee Turnover



Innovation Ratio

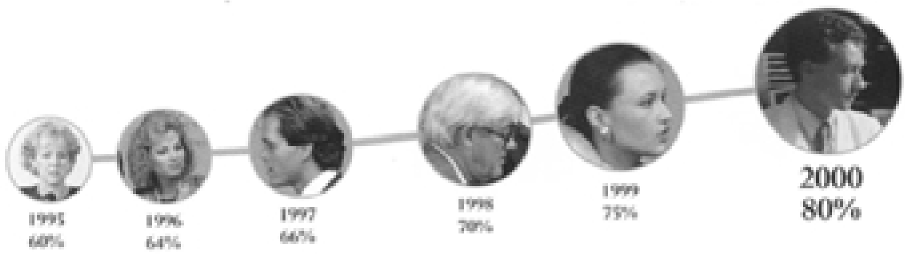
Management measures the ratio of its expenditures on research, development, training and product branding to the value added by employees. The goal is to reach by the year 2004, value added equal to 20 times such expenditure.

£000's	**1999**	**2000**
Total expenditure	5,000	7,600
Value added	73,290	77,290
Innovation ratio	14.6	10.2

customers

Retained Customers

Prototype is steadily increasing the percentage of customers who are regular buyers of our products. This reflects better customer relations and improving product quality.



Environmental Issues

Energy Conservation

During the year 2000, Prototype completed an Energy Conservation Study. Plans are now being made to increase energy savings of 40% by the year 2005. Over this period, we will invest £350,000 and expect to achieve annual savings of £600,000.

Employment Related Illness

Employees are monitored regularly by Prototype's medical experts and identifable work related illnesses are treated accordingly. We are finding fewer cases of RSI and other ergonomic related illnesses although air quality remains a problem. Considerable resources are addressing noise problems and a three year plan of active noise cancellation has begun.

Communication

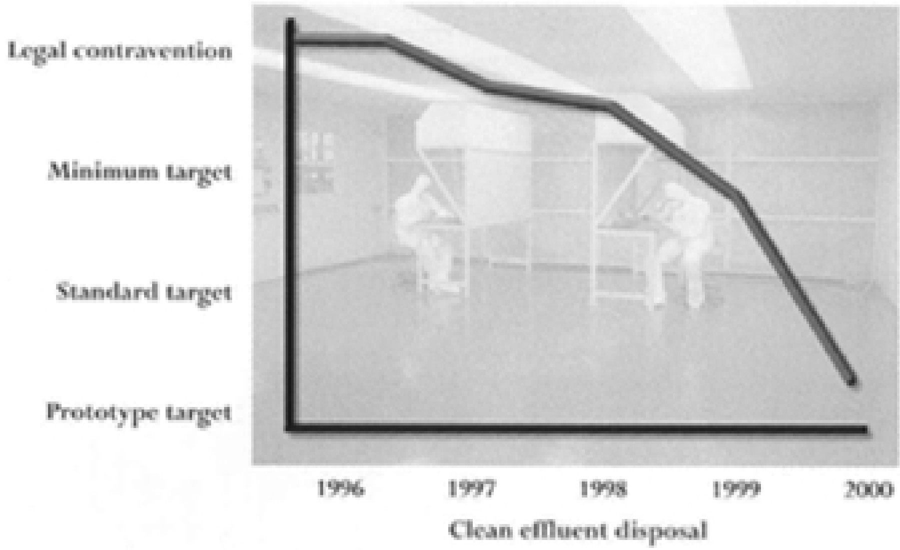
During the year 2000, 312 employees attended more than one seminar on environmental issues of interest to both Prototype and the communities in which we operate.

Replaceable Materials

The increased use of electronics in the Company has led to a 27% reduction in the use of paper over the past three years. We are targeting a further reduction of 10% in the year 2001 through the adoption of electronic commerce applications.

Environmental Issues

Pollution



Noise Reduction in Prototype Premises

Germany
Noise levels have reduced by 22% over 5 years

United Kingdom
Noise levels have reduced by 18% over 5 years

France
Noise levels have reduced by 16% over 5 years

Belgium
Noise levels have reduced by 24% over 5 years

We aim to reach levels acceptable to our employee monitoring group by the year 2002.

All our manufacturing premises are fitted with emission controls and air quality is monitored regularly. Air purity is probably impossible, but scientific analysis is showing a continuous reduction in airborne bacteria and other noxious impurities.

Education community

Prototype's Licence to Operate

The Company believes it must constantly renew its licence to operate, essentially through its success and behaviour.

Corporate Behaviour

The Company has to the best of its knowledge, conformed with all the corporate governance recommendations in Europe. It has also complied with current relevant European Directives and has advanced plans in respect of Directives in preparation.

In addition, the Company monitors on a regular basis the ethical codes which it has adopted and the internal controls which pertain to the sound running of the business.

The Company permits no discrimination on grounds of colour, race, religion, gender or age.

Company Values

The Company's values are very important components of its way of doing business. It monitors behaviour and promptly addresses any allegations which impinge negatively upon these values, with a right of appeal directly to the Chairman of the Board.

Contribution to Society

As a wealth generator and employer, Prototype is conscious of its opportunities to contribute to the improvement of conditions in the communities which accommodate its operations. Specific responsibilities are assumed in these communities for strong and positive relationships with people in these constituencies.

Balanced Achievement

The Company seeks a balanced set of key performance measures which reflect economic, social and educational achievements. It holds a clear commitment to this definition of success.

Education community

Financial Auditor's Summary Report

We have satisfied ourselves that the business of Prototype plc has sufficient working capital to sustain its planned operations for the coming year.

We have examined the internal audit procedures and activity for the year and have concluded that the internal audit checks carried out, together with the results of those checks, provide a sufficient verification of trading activities and the assets and liabilities at the 31st December 2000.

In assessing the stated financial results, we have concluded that the management of the Company has employed a range of key performance measures with which to control the business and to fairly reflect relevant measures for all the Company's stakeholders.

GMPK plc

Environmental Auditor's Summary Report

Prototype plc has complied with all the current legislation relating to environmental issues during the year under review. In addition where good practice has been the subject of public and/or professional communication, the Company has programmes in hand to meet the recommended criteria of such practice.

We have pointed out to the management of the Company the need to reach standards for noise levels and effluent quality which the 1998 European Directive has announced and which will take effect in 2002.

We have concluded that Prototype plc is in compliance with its responsibilities and that the Company's awareness programme of the issues is extensively communicated.

WP Associates

Social Auditor's Summary Report

Our observations during the year 2000 lead us to conclude the Prototype's management has in its behaviour and in its procedures, endeavoured to meet its proclaimed social values.

Cases of alleged breach are referred to the Social Audit Committee and there are currently 5 unresolved cases being investigated. Prototype has established clear procedures regarding issues of ethics and discrimination which are properly communicated.

LC & Associates

NON-ECONOMIC CONSIDERATIONS IN CORPORATE MANAGEMENT

When should corporate management pursue objectives that are not directly 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.[72] In the "Balancing Interests" section above, we discussed 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 tradeoffs 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. The ultimate crime in recent times was the so-called "electrical price-fixing" scandal of the late 1950s. 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 electricity-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. General Electric 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.[73] Between 1950 and 1956, General Electric 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.[74]

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."[75]

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 General Electric 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."[76] 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 General Electric 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."[77]

In 1961, General Electric'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."[78]

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, General Electric 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 to 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, the administration changed, and the effort to split the company was abandoned.

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: Dow Corning's research on the health hazards of its breast implants, A.H. Robins' research on its intra-uterine 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. And 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. But 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 tradeoff 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 its 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.[79]

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 are responsible for monitoring corporate performance: the shareholders and the board of directors.

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. Melvin Aron Eisenberg, Koret Law Professor at the University of California School of Law in Berkeley (*The Business Lawyer*, 48, 4, Aug. 1993, p. 1275). Professor Eisenberg gave an interesting description of the corporation in another article: "A corporation is a profit-seeking enterprise of persons and assets organized by rules. Most of these rules are determined by the unilateral action of corporate organs or officials. Some of these rules are determined by market forces. Some are determined by contract or other forms of agreement. Some are determined by law." "The Structure of Corporation Law," *Columbia Law Review*, 89, 7, Nov. 1989, p. 1461.
3. 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.

4. Opinion in *Louis K. Liggett Co. v. Lee*, 53 S. Ct. 487 (1932).
5. Ibid.
6. Mortmain is a legal term indicating concern that rules or restrictions established by a "dead hand" (a previous generation) would impede trade or capital allocation. Brandeis speculates in a footnote that this concern was the reason for limiting corporations to fixed terms of 20, 30, or 50 years in the early statutes.
7. *Liggett Co. v. Lee*, p. 490. Citations omitted.
8. Ibid., p. 493.
9. Robert C. Clark, *Corporate Law* (Little, Brown & Co., Boston, 1986), p. 2.
10. 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.
11. William Greider, *Who Will Tell the People? The Betrayal of American Democracy* (Simon & Schuster, New York, 1992), pp. 348, 349.
12. Thomas Donaldson, *Corporations and Morality* (Prentice-Hall, Englewood Cliffs, NJ, 1982), p. 30.
13. See, for example, Anne Murphy, "Too Good to be True?", *Inc.*, June 1994, p. 34.
14. Paul Abrahams and Roland Rudd, "ICI to float drugs unit in break-up of group interests," *Financial Times*, July 31, 1992, p. 1.
15. Easterbrook and Fischel, "The Corporate Contract," pp. 1417–18.
16. Ibid.
17. 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.
18. 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.
19. Ibid., pp. 103, 104.
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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.
23. Milton Friedman, *Capitalism and Freedom* (University of Chicago Press, Chicago, 1962), p. 133.
24. A.B. Schmookler, *The Illusion of Choice: How the Market Economy Shapes Our Destiny* (State University of New York Press, Albany, 1993), pp. 24, 25.
25. A.A. Berle Jr., "For Whom are Corporate Managers Trustees?", *Harvard Law Review*, 45 (1932), pp. 1365, 1367.

26. 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.
27. Statement of Douglas H. Ginsburg, Assistant Attorney General, Antitrust Division, before the United States Sentencing Commission, Hearings Concerning Alternatives to Incarceration, July 15, 1986.
28. "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." Coffee, "No Soul to Damn," p. 413, citations omitted.
29. Braithwaite, *Corporate Crime in the Pharmaceutical Industry*, p. 324.
30. Russell Mokhiber, *Corporate Crime and Violence: Big Business and the Abuse of the Public Trust* (Sierra Club Books, 1988), p. 19.
31. Richard W. Stevenson, "Many are Caught but Few Suffer for US Military Contract Fraud," *New York Times*, Nov. 12, 1990.
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37. Christopher D. Stone, *Where the Law Ends: The Social Control of Corporate Behavior* (Harper & Row, New York, 1975), p. 148.
38. "Nuclear Executives in Japan Resign over Recent Mishaps," *New York Times*, May 14, 1981.
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40. Joseph Nocera, "Delaware Puts Out," *Esquire*, Feb. 1990, p. 47.
41. Private letter from Peter F. Drucker to Robert Monks, June 17, 1993.
42. F.A. Hayek, *Law, Legislation, Liberty*, vol. 3: *The Political Order of a Free People* (University of Chicago Press, Chicago, 1979), p. 82.
43. Published by the National Association of Corporate Directors, Washington, DC.
44. James J. Hanks, in "From the Hustings: The Role of States with Takeover Control Laws," *Mergers and Acquisitions*, 29, 2, Sept.–Oct. 1994. This was part of the protectionist surge that followed the 1987 US Supreme Court decision in *CTS Corp. v. Dynamics Corp. of America*, which permitted certain kinds of state anti-takeover statutes.
45. Ga. Code Ann. Sec. 14-2-202.5.
46. The American Bar Association on Corporate Laws, "Other Constituency Statutes: Potential for Confusion," *The Business Lawyer*, 45, 4, Aug. 1990, p. 2261.
47. Ibid., p. 2259.
48. The Wilshire study focused on 63 Pennsylvania companies with a stock market capitalization greater than $5 million. The period of study was from Jan. 1, 1989 through Aug. 15, 1990. These two studies and others like them drew fire from proponents of state anti-takeover legislation, who said the studies were biased. But in an unpublished paper dated June 17, 1994, entitled "State Takeover Legislation and Share Values: The Wealth Effects of Pennsylvania's Act 36," Karpoff and Malatesta demonstrate (again) that the "wealth effect" associated with the October 13 new announcement was "negative, large, and statistically significant."

49. Tom Cannon, *Corporate Responsibility* (Pitman Publishing, Marshfield, MA, 1992), p. 79.
50. Edward S. Mason, *The Corporation in Modern Society* (Harvard University Press, Cambridge, MA, 1959), pp. 11–12.
51. James Willard Hurst, *The Legitimacy of the Business Corporation in the Law of the United States: 1780–1980* (University of Virginia Press, Charlottesville, 1970), pp. 82–3. "[I]n *Dodge Brothers v. Ford Motor Company*: Management's prime obligation was to pursue profit in the interests of shareholders and not to adopt pricing policies designed to promote the interests of wage earners or to effect wider sharing of the gains of improved technology."
52. Joseph Pereira, "Split Personality: Social Responsibility and Need for Low Cost Clash at Stride Rite," *Wall Street Journal*, May 28, 1993, p. A1.
53. Ibid.
54. Doug Bandow, "Social Responsibility: A Conservative View," *Utne Reader*, Sept.–Oct., 1993, pp. 62–3. Reprinted from *Business and Society Review*, Spring 1992.
55. 1989 Berkshire Hathaway annual report, pp. 52–3.
56. Sir Adrian Cadbury, *The Company Chairman* (Fitzwilliam Publishing, Cambridge, 1990), p. 149.
57. Steven Prokesch, "How Johnson and Johnson Managed the Tylenol Crisis", *New York Times*, Feb. 27, 1986.
58. Prior to passage of the 1993 Omnibus Budget Reconciliation Act (OBRA), only some types of intangibles could be written off, and of these, some had to be written off over a period of no less than 28 years. This conservative approach began to change in 1993. First, the US Supreme Court declared in *Newark Morning Ledger v. US* that if the value of an acquired asset can be measured and will appreciate over time, it can be depreciated. Then the US Congress passed OBRA, which set a maximum of 15 years for amortization of intangibles, some formerly considered non-amortizable goodwill, with even shorter periods allowed for some categories.
59. John Jay, *Sunday Telegraph*, Feb. 4, 1990. See also Bob Hagarty, "Differing Accounting Rules Snarl Europe," *Wall Street Journal*, Sept. 4, 1992; and "Foreign Firms Rush to Acquire US Companies," *Wall Street Journal*, July 1, 1994. The last article notes that the International Accounting Standards Committee issued a new rule that will force European companies to deduct the value of goodwill from their profits, as in the US.
60. Jan. 13, 1992. All quotes in this section are from that paper.
61. Letter to the editor, *Fortune*, Oct. 18, 1993, p. 34.
62. "Usefulness of Operating Income, Residual Income, and EVA®: A Value-Relevance Perspective," Shimin Chen and James L. Dodd: <http://www/drake.edu/cbpa/acctg/Dodd/mbaa/article.html>.
63. Michael Jacobs, *Short-Term America* (Harvard Business School Press, Cambridge, MA, 1991).
64. For an in-depth study of the growing Japanese need for equity-based capital, see Howard D. Sherman and Bruce A. Babcock, "Redressing Structural Imbalances in Japanese Corporate Governance: An International Perspective," *The Corporate Governance Advisor*, 1, 8, Dec. 1993, p. 28.
65. This case in point has been reproduced from Geoffrey P. Mazullo, "Germany's Daimler-Benz First to List Shares on New York Stock Exchange," *ISSue Alert*, 8, 4, Apr. 1993. Used with permission.
66. *Board Directors and Corporate Governance: Trends in the G7 Countries Over the Next Ten Years* (Oxford Analytica, UK, Sept. 1992).
67. *Corporate Social Reporting in the United States and Western Europe*, Report of the Task Force on Corporate Social Performance, US Department of Commerce, July 1979, p. 3.
68. Rob Gray, Dave Owne, and Keith Maunders, *Corporate Social Accounting: Accounting and Accountability* (Prentice-Hall International, Englewood Cliffs, NJ, 1987), p. 89.

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