



## Chapter 3

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# The Problem

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### *Corporate Hegemony Threatens a Free Society*

In its few centuries of existence, the modern corporation has empowered individual genius and bestowed great social benefits. Yet the modern corporation has also done social harm. Therefore, no history of modern investment would be complete without a direct reckoning with the dark side of corporate history.

In his famed *Wealth of Nations* (1776), Adam Smith set forth the clear purpose of modern corporations. They enable pursuit of private interest creating an “invisible hand” that works for the public good. Despite his generally favorable view of the private sector, Smith identified four threats posed by the corporate form as it was evolving in his era. Writing about “joint stock companies,” Smith expressed concerns about their unlimited life, unlimited size, unlimited power, and unlimited license.<sup>1</sup>

#### **Four threats posed by modern corporations**

Today Smith’s concerns about lack of limits on corporations appear to be borne out.

- Corporations have a potentially infinite *lifespan* cut off only by bankruptcy, merger, or reorganization and sometimes not even then. Early corporate charters permitted corporations to operate according to stated missions, expressed as socially useful purposes. If corporations failed to follow those purposes, their charters could be revoked. That notion is



long gone. A corporation may change every single thing about itself, yet still be chartered to operate. Bankruptcy no longer means going out of business. Rather, it means a chance to reorganize – and persist.

- Corporations also have seemingly limitless *size*, with each new mega-merger larger than the last. In 1989, the world gasped at the sheer size of Kohlberg Kravis Roberts' \$25 billion buyout offer for RJR Reynolds. At the time, it was by far the largest price any company had ever fetched. Just 10 years later, Exxon paid \$79 billion for Mobil – three times that old record, without sparking any discussion of gigantism. And in early 2000, two pharmaceutical firms paid \$161 billion to buy two firms again, without provoking commentary.<sup>2</sup> The merger of Mannesmann and Vodafone created a company worth in excess of £225 billion. Yet as many corporate critics have noted, this amount of money is many times the gross domestic product of entire nations and even some continents. By anybody's standards, corporations are thought properly to cut a wide swath across society.
- As for *power*, examples are legion. Corporations have political action committees (PACs) that make contributions to candidates for elected office, creating conflicts of interest for the legislators they support and have made "soft dollar" contributions on such a scale as virtually to eliminate participation by individuals.
- And finally, there is *unlimited license* – the ultimate fruit of the other three main corporate traits. Of all the threats posed by a large, modern corporation, this one is the most troubling.

### The social downside of unlimited license

License means the freedom to do what one wishes. As every schoolchild knows, freedom and responsibility go hand in hand. Therefore, in every culture, there is an effort to instill an internal sense of values – one that can go beyond the letter of laws. Why? Because human laws, by their very collective nature, suffer from a paradox: they will always be oppressive yet inadequate. This is, was, and always will be true of every set of laws enacted from the Hammurabi Code in the twenty-first century BC to the statutes of every nation in the twenty-first century AD – and before and after these arbitrary points in time.

In the case of individual human beings, responsibility picks up where the laws leave off. The faculty of human conscience, combined with ethical precepts, enables most individuals to dedicate their individual genius to the good of society. To a great degree, the corporate structure can lend greater life, size, power, and license to this good purpose.

But these same four traits can cause harm as well. That is, the corporate *structure itself* can encourage and empower *irresponsible* actions, problems made all the worse through corporate hegemony.

### A panorama of change

It would be overly ambitious for me, a mere student of history (albeit a life-long student) to pretend to present a complete “history” of the corporate form in the years since Adam Smith. This is a task best left to professional historians, and I commend them to it. I will, however, report here as a kind of “financial journalist” some reflections – both original and derivative – about these years.

Royal issuance of corporate charters, mentioned in Chapter 2, established a pattern that would last until the late nineteenth century. Business enterprises were literally creatures of the state in those years. As such, corporate activities were, by definition, in the public interest. By the beginning of the nineteenth century in the United States this sovereign power had transferred to the state legislatures. Oftentimes, the granting of corporate status was conjoined – as in the case of the East India Company – with the conferral of a monopoly franchise such as sole right to build a ferry, a bridge, or a canal. This development converted the largely theoretical question of chartering into a highly practical struggle for gain. Monied and powerful applicants for charters corrupted the government process.

By the 1840s, “reform” resulted in corporation laws, which permitted use of that form by anyone as a matter of right. No one noticed that the connection with public interest had been severed. Slowly but surely, for much of the balance of the century, corporations moved away at restrictions on capital, longevity, and purpose. Corporation lawyers earned their keep by devising techniques to avoid these restrictions, and state governments competed to pass laws with progressively diminishing limitations on corporate functioning, in order to attract the lucrative business of legal domiciling. Substantive limitations on corporate functioning ceased to be an integral

part of the grant of the franchise. By the end of the century corporations were free of restraints imposed by their charters. Control from within the corporate structure itself was a matter of the past.

The federal government responded decisively to the problems of burgeoning corporate power. Early in the twentieth century the US federal government enacted far-reaching laws seeking to prohibit monopoly and unfair competition. Following the financial binge of the 1920s, the federal government focused reform on specific markets. Over a ten-year period, comprehensive legislation regulating the issuance and trading of securities, the functioning of investment companies, and the abolition of public utility holding companies was enacted. In the 1960s and 1970s federal legislation was enacted respecting fairness in hiring practices, limitations on environmental impact, campaign finance reform, and prohibition against bribery. Over the past two decades, the US Congress has spent a good deal of its legislative time refining those statutes.

This pattern of “external” regulation of corporations has been only a mixed success. While the creation of normative standards is necessary in a federalist country and a pluralist world, the realities of bureaucratic implementation are daunting. It has been said that America at the end of the twentieth century was a country where “you either obey the law or hire a lawyer, and you either pay taxes or hire an accountant.” The inherent weakness of government in trying to regulate one of its largest sources of revenue is evidenced by the growth in both lobbying and campaign financing by corporations. Government efforts at “reform” of these processes range from the ludicrous – lawyers weren’t “lobbyists,” for example – to the genuinely tragic escalation of campaign costs to the level where non-corporate involvement is virtually irrelevant.

The asymmetry between corporate and state power has been exacerbated by the globalization of business enterprise. Corporations can choose any domicile in any country and will, predictably, choose the least confining one. As a result legal restraint on corporate functioning worldwide is becoming less effective. The century-end burst of antitrust initiatives in the case of Microsoft seems to belong more to the American pattern of distrust of the big (i.e. Milken in the 1980s) than to a resurgence of corporate regulation. Increasingly, international institutions – the Organization for Economic Cooperation and Development (OECD) and the World Bank – have developed international codes of governance best practice. The importance of these is not so much in the substance (although the OECD’s antibribery

code has been adopted by many countries), but in a growing conviction that minimum governance standards are essential. Leadership in this field belongs to the United Kingdom, where the work of Sir Adrian Cadbury has sparked worldwide scholarship, concern, and change. I have been both witness and participant in the extensive reexamination of the role of corporations in society that have been taking place in the United Kingdom for most of the decade of the nineties. As a consultant to the reworking of the Company's Act by the Department of Trade and Industry, and as a frequent speaker to interested groups, I have been deeply impressed by the intellectual discipline and determination of Britons from all parts of the political spectrum to find a way of accommodating corporate energy to the public good. This brings the circle full cycle and back to the effort to contain corporate power from "inside."

Arthur Schlesinger, Jr, has identified a cyclical pattern in American history of roughly thirty years duration during which national concern swings back and forth between selfishness and generosity – between fixation over personal enrichment and a more spacious commitment to national and international values. So, during the last century, we had:

- The greed of the "robber barons," followed by antitrust legislation and World War I.
- The "Roaring Twenties" followed by Depression and rebuilding through government help.
- World War II and the prosperity of the 1950s, followed by the protests of the 1960s and reforms of the 1970s (notably the Foreign Corrupt Practices Act and the conviction of prominent individuals for illegal campaign contributions).
- The zeal for reform and evidence of corporate misconduct uncovered in the 1970s ultimately led to the introduction of comprehensive reform bills in both Houses of Congress during the second session of the 96th Congress: "Protection of Shareholders' Rights Act of 1980," introduced by Senator Howard Metzenbaum, and "Corporate Democracy Act of 1980," introduced by Congressman Benjamin Rosenthal. Unfortunately, national attention and energies shifted, and neither bill was reported out of Committee.<sup>3</sup>
- The Wall Street Boom and "trickle-down" economics of the 1980s and 1990s followed by the current period of anti-corporate protest.

## The problem: corporate hegemony

Many of the ills of modern life – nonsustainable levels of personal and institutional debt, toxic air and water, workplace injury, loss of livelihoods for communities, and political bribery, to name a few – all these can be traced to the corporate lack of responsibility to one or more constituencies.

Corporations do not create these results intentionally. No corporation wants to cause poverty, pollution, disability, unemployment, and corruption. Rather, corporations want to make profits. But in the pursuit of profits, corporations may find that antisocial behavior pays. As a practicing lawyer, I was profoundly disappointed with how much of our energies went into obviating the law's spirit while ensuring that our clients literally complied with its words to the letter. An example was the work we did on behalf of a client having a near monopoly in the abrasives business. Junior lawyers reviewed the files and removed documents which had any air of "anti competitiveness" about them. These were turned over to the senior partner as part of a program with the Orwellian title of "The Records Retention Program." The short-term economic gains from some bad behavior (such as paying less than a living wage) are often higher than the cost of refraining from them. Either the odds of getting caught are low, the fine is less important than the profits from bad behavior, or a combination of the two. Therefore, to achieve profits in the short term, corporations exact a "social price."

## A high social price

This social price is high, and rising. At the turn of the new millennium, a number of groups expressed their resentments against international trade and financial organizations and, in direct association with these, multinational corporations.

- In December 1999, talks of the World Trade Organization "collapsed in a cloud of tear gas in Seattle," as an AP newswire recently reminisced. Representatives of the 117 nations subscribing to WTO free trade principles had to go home, their work undone, because of street protests by a variety of groups.

- In April 2000, these same groups, now loosely affiliated in an umbrella group called the “Mobilization for Global Justice,” reconvened for more activity, this time targeting the World Bank and the International Monetary Fund. Groups present for the April demonstrations included the American Federation of International Labor – Congress of Industrial Organizations (AFL-CIO), as well as environmental groups such as Friends of the Earth, and small political groups, such as Forum of Indian Leftists.
- In the fall of 2000, further and more expansive protests took place at the annual meetings of the World Bank and the International Monetary Fund in Prague.
- Throughout 2000, a group called the Jubilee 2000 Coalition has called for “cancellation of the debt of the world’s poorest countries by the year 2000 under a fair and transparent process.”<sup>4</sup>

Although these groups focus first and foremost against international trade and financial organizations, they all cast some blame on the “multinational corporation” – a term that appears on many a protest poster in their mass rallies.

These protesters, and other corporate critics in recent times, see corporations as entities that yield a great deal of power, and use this power as a free license to perpetuate themselves and their managers, rather than to enrich society.

Concern has spread from capitalism’s traditional opponents to its most reliable supporters. *Forbes* magazine’s cover story starts:

*“Anticapitalist demonstrations have always been a part of the life of this country. But, until recently, they’ve been pretty much confined to college campuses, where such protests are a perennial rite of passage. These days, though, resentment against US corporations, and the drug industry in particular, has boiled over into the American mainstream. The drug industry’s prices are high, its profit margins are fat. Those profits are at risk. We’re not talking about fringe politicians or Naderites as the enemies of profits. We’re talking about Republicans.”*<sup>5</sup>

*Business Week* lectures to the Roundtable: “The business elite ought to take more responsibility for the impact of their global operations on workers, communities, and the environment.”<sup>6</sup> And it devotes a cover story to a

burning economic question: “Global Capitalism: Can It Be Made to Work Better?”<sup>7</sup>

*The Financial Times* writes about “Unpopular Capitalism” and cautions: “As long as the demands of the public and capital markets are in conflict, politicians will conclude that anti-business populism promises electoral dividends. The message for big [read global] business is hardly reassuring.”<sup>8</sup>

### Four propositions

As we look back at the East India Corporation, we might well ask: How did this happen? Here is the logic of the corporate “DNA” strands that brought us to our present state.

- *Proposition 1. Limited liability encourages investment.* Perhaps the most famous trait of the corporation is the limited liability it offers its owners. This trait has caused the corporate form to proliferate greatly in the past 400 years. It must foreclose any effort to impose obligation or responsibility on to individual “owners.” In any given year, tax officials in nations around the world receive returns from thousands or, in the case of large developed countries such as the US, millions of corporations – many of them new and small. In one advertisement, a single US attorney claims to have helped set up “110,000 corporations in the past 22 years.”<sup>9</sup>
- *Proposition 2. The opportunity for profit encourages externalization of risk and responsibility.* As it goes through life, a corporation takes many actions that have many potential consequences. Rather than suffering the consequences themselves, corporations have shifted them onto the buying and taxpaying public. Generally accepted accounting principles in the US (and similar systems worldwide) have enabled them to do this. Later on in this book, readers will encounter the language of accountability, with solutions to this self-perpetuating problem.
- *Proposition 3. Distant externalities, lacking the scrutiny of any government, permit antisocial corporate behavior in pursuit of profit.* These externalities may be 8000 miles away – the distance spanned by the East India Company – or merely eight – the number of miles that might separate an absentee landlord from a rental property inhabited by low-income renters. In either case, the pursuit of profit may encourage behavior that benefits the corporation at the expense of some of its constituencies.

- *Proposition 4. Aggression invites corrective action.* Justice has a way of making itself felt sooner or later, and corporate aggression is generally curbed in the end. Unfortunately the normal savior is the government, to the woe of taxpayers.

Now, 400 years later, we are living with the legacy of that logic. The costs that would be externalized by the young company could be a metaphor for the attacks on the environment, workplace safety, governmental functioning, and the whole panoply of modern complaints we hear (and sometimes lodge) today.

### Brandeis' warning

Supreme Court Justice Louis D. Brandeis offers wisdom in this regard. In his court decisions and congressional testimony, he warned that a corporation, unconstrained by chartering law, would develop along the lines of the Church and the nation state into a menace that would undermine the critical elements of a free society. Here are some of his strongest words:

*“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 that attended mortmain.*

*“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 for the community to gain some specific benefit otherwise unattainable. The later enactment of general corporation laws does not signify that*

*the apprehension of corporate domination had been overcome.”<sup>10</sup> (Emphasis added.)*

## New voices of protest

Today, apprehension over large corporations continues. A Country Western song entitled “God Bless the Little Man” paints a picture of small towns closed down because of large shopping centers, and independent stores closed because of pressures from larger chains. The central figure, a storeowner, operated independently “‘til the big money shut him down.” Any listener whose life has spanned more than 20 years, and who has some experience with suburban and exurban areas can empathize with the imagery – and perhaps with the experience itself.

### *The anti-corporate movement: some points of friction*

- *Artistic control.* Rock musicians, independent filmmakers, and other artists are rebelling against control by big media and retail companies.
- *Brands.* In-your-face marketing campaigns have sparked antibrand attitudes among students.
- *CEO pay.* Nearly three-fourths of Americans see executive pay packages as excessive.
- *Commercialism in schools.* Parent groups have mounted battles in hundreds of communities against advertising in the public schools.
- *Consumerism.* Anger and frustration are mounting over high gasoline and drug prices, poor airline service, and HMOs that override doctors’ decisions. The latest fiasco: faulty auto tires.
- *Frankenfoods.* Europeans’ skepticism about genetically modified food is taking hold in the US, making targets of companies such as Monsanto.
- *Globalization.* Environmentalists, students, and unionists charge that global trade and economic bodies operate in the interests of multinational companies.
- *Politics.* Public revulsion over the corporate bankrolling of politicians has energized campaign-finance reform activists.

- *Sweatshops.* Anti-sweatshop groups have sprung up on college campuses; they routinely picket clothing manufacturers, toy makers, and retailers.
- *Urban sprawl.* Groups in more than 100 cities have blocked big-box superstores by Wal-Mart and other chains.
- *Wages.* Some 56% of workers feel they are underpaid, especially as wages since 1992 have topped inflation by 7.6%, while productivity is up 17.9%.

*Business Week*, September 11, 2000

<http://www.businessweek.com/2000.htm>

Let us listen at some length to the rage of Carolyn Chute who speaks for the “underclass” of one of America’s poorest states – Maine. Chute speaks of citizens whose ancestors have been in the staff of Maine since the European settlement. These people feel “left behind” in the national progress and prosperity. Their inherited skills – attuned to needs for food, shelter, and sustenance – have been rendered irrelevant by what Chute calls corporatization. Slowly but surely, those living in a traditional way grow impoverished in spirit as well as pocket book. The gap between haves and have-nots widens – with cruel results.

I see this all around me as a resident in Maine. My family has maintained an island farm in the poorest town of the poorest county of the state since the beginning of the 19th century. I myself have driven to every town in Maine over the last 30 years of active involvement in politics. From this vantage point, I have witnessed first hand the worsening fate of those living on the margin of a corporatist economy. Even as that economy generates tremendous wealth for many, it has also created poverty for some, as natural resources – wood and fish – have disappeared or become less competitive.

Chute is right. When profits, determined in the conventional narrow way, provide the sole informing energy for corporate management, there is a heavy social cost.

As Chute writes:

*“(To the tune of “This Land is Your Land ...”)*

*This land is NAFTA’s!*

*This land is GATT’S land!*

*These owners tell us*

*To just keep moving!*

*Forget our families!*

*Forget our hometown!  
Just shut up and buy, buy, buy!"*

Chute has recently written *Snow Man*,<sup>11</sup> which in some 250 pages is the outline of a much longer work in process fulminating against the damage caused to ordinary citizens by the corporate world. She maintains an active correspondence with the Second Maine Militia and answers letters as "Revolutionary Abby." A comprehensive bill of indictment emerges as well as a sense of what is wrong and what should be done to cure it.

*"Also imagine corporations limited in size, limited in life, limited in rights (very limited), limited in power (like NO POWER)... just back-and-forth healthy business. Business should not be about power. It should only be BUSINESS. No representation in our government for business. Only human beings should have representation. No Constitutional human rights to corporations whatsoever. No corporation in our government – lobbies or campaigns. Campaigns redesigned so that they do not COST MONEY, especially through media, THE PEOPLE'S AIRWAVES. Corporations will not be allowed to have sneaky little seminars with our educators, judges, legislative advisors, governors, and mediafolk ... No more trying to do this MIND CONTROL thing, the PR to get us to think of corporations as Heavenly Fathers, etc. Charters should be written with conditions and limits and then REVOKED when these rules are broken. Now THIS would be Free Enterprise!"*

Chute is neither wrong nor alone in decrying lobbies. Indulgent talk of the "best government that business can buy" is the staple of American history, but the twenty-first century has created the worst government in this way, by removing the individual from involvement with the public agenda. More than one voice has protested this development. As Jacques Barzun notes in his tour de force, *From Dawn to Decadence*:

*"Originally, the national interest was to be determined by each member individually, and his view determined his party allegiance and his vote. But now a committee chairman weighed the arguments of the lobbyists and bargained with other chairmen to secure in advance the vote of the chamber. True, group interests had always been influential; but when lobbies became part of the machinery, the aim was to seek a balance of many competing groups instead of ascertaining the*

*needs of the nation's large constituencies land, commerce, finance, empire and the poor.*"<sup>12</sup>

### The fallacy of corporate citizenship

Chute makes a valid point. Corporate citizenship is a grave fallacy. The Founding fathers of the American Republic did not contemplate that corporations would be citizens. Indeed, the word "corporation" is not mentioned in the Constitution. The notion that corporations would be entitled to constitutional protections, such as the right to participate in the electoral process through expenditure of funds, entered the nation's law through a circuitous route. It appears in a single, unargued sentence in *Santa Clara County v. Southern Pacific Railroad Company*, the 1886 case relating to the voting rights of freed slaves. The court asserted that each legal person, including corporations, has the right to one vote. Error has followed error and the US Supreme Court in a series of recent decisions – notably *Buckley v. Valeo* 424 US 1 (1976) and *First National Bank of Boston v. Belotti* 435 US 765 (1978) – has apparently set in concrete the status of corporations as citizens.

In the *Buckley* case, the Supreme Court ruled that the First Amendment of the Constitution of the United States protects the spending of corporate political action committees as a type of free speech.

In the *Belotti* case, decided 5 to 4, the court validated the right of the First National Bank of Boston to advertise in opposition to an income tax referendum in Massachusetts.

A contemporaneous article in the *Atlantic Monthly* noted:

*"In some quarters this and other related court decisions were perceived as unleashing the mighty economic power of big corporations to influence public opinion unfairly. In fact, in writing for the minority, Justice Byron White saw the majority opinion as opening the door to corporate domination of 'not only the economy, but also the very heart of our democracy, the electoral process.'*<sup>13</sup> *But Justice Lewis Powell, Jr., for the majority, said, 'The inherent worth of the speech in terms of its capacity for informing the public does not depend upon the identity of its source, whether corporation, association, union or individual.' And Chief Justice Warren Burger, in a separate opinion, added that 'media conglomerates' pose 'a much more realistic threat to valid [political] interests' than other corporations."*

Chief Justice Rehnquist, dissenting in the same case, stated that "... the blessing of potentially perpetual life and limited liability ... poses special dangers in the political sphere."

These dissenting voices echo earlier cautions. In *Railroad Co. v. Collins* 40 GA 582, the court stated:

*"All experience has shown that large accumulations of property in hands likely to keep it intact for a long period are dangerous to the public weal. Having perpetual succession, any kind of corporation has peculiar facilities for such accumulations, and most governments have found it necessary to exercise caution in their grants of corporate charters. Even religious corporations, professing and in the main, truly, nothing but the general good, have proven obnoxious to this objection, so that in England it was long ago found necessary to restrict them in their powers of acquiring real estate. Freed, as such bodies are, from the surebounds – the grave – to the schemes of individuals they are able to add field to field, and power to power, until they become entirely too strong for that society which is made up of those whose plans are limited by a single life."*

By permitting corporations to participate in politics although not to vote, the Supreme Court has importantly changed the polity. The question isn't the amount of money. Ross Perot is personally in a position, as is Malcolm Forbes and Nelson Rockefeller before him, to invest as much money in election efforts as any corporation or, indeed, as all corporations cumulatively.

The question is the identity of the source and the capacity of individuals to have representation of their interests. Put another way – whose country is it? Does it belong purely to flesh-and-blood individuals, rich and poor – or does it belong to corporations as well?

Concern is not uniquely the province of political extremists. Consider the admonition of lawyer–author Scott Turow:

*"But my view is that Buckley may well come to be regarded as a sort of twentieth century stepchild to Dred Scott, the case that held that the property rights of Southern slaveholders in their slaves had to be recognized in the North.*

*"To our eyes, Buckley appears far less iniquitous. But as in Dred Scott, the Court used formalistic reasoning to find constitutional protection for economic interests at the cost of fundamental notions of equality. We can only hope that the long-run damage to the Republic is not as severe."<sup>14</sup>*

What is the long-run damage to any nation that allows corporations to have many of the same rights as citizens? And how precisely do these rights operate to the public detriment? In order to consider these questions, we turn to consideration of a particular industry: tobacco.

### The tobacco industry: a case in point

The intense confrontation between the US tobacco industry and the whole spectrum of federal and state legislative, executive, administrative, and judicial systems provides an important lesson. It clearly illustrates the corporate tendency to influence – even to dominate – the creation of public consensus that is ultimately the basis for law. Indeed, the tobacco drama suggests the most serious of problems: an industry with enough power and skill to co-opt the political process.

The tobacco industry in the US has long been welcomed into corporate citizenship. But in recent decades, the American public began to focus on tobacco's health effects. Rumors of unspecified risks evolved into well-documented reports of deaths – half a million fellow citizens dying of tobacco-related causes every year.

In recent years, there has been a barrage of lawsuits and proposed new laws in this industry. A close look at the turmoil surrounding this change exposes the fundamental chasm that can separate the culture of commerce from concerns about the public good.

In light of these legal issues, it is not surprising that the board of RJR Nabisco, the country's largest tobacco company, hired a lawyer as its CEO: Steve Goldstone, formerly of Davis, Polk & Wardwell LLP.

In a *New York Times Magazine* cover story, Goldstone set forth a concise version of his responsibilities when dismissing the moralism of industry critics:

*"I know these guys like to put this in moral terms, but if they can't convince Congress to ban this product, **we don't have any choice but to sell it.** As far as I am concerned, the day after any bill passes, we'll be selling cigarettes."<sup>15</sup>  
(Emphasis added.)*

In Goldstone's view, if a certain behavior is legal, it is acceptable, end of story: It is inappropriate to probe any further. "I have no moral view of this

business,” Goldstone told a *New York Times* reporter. “I view it as a legal business. You shouldn’t be drawing a moral judgment about a business our country says is perfectly legal and is taxed like crazy by it.”<sup>16</sup>

### The legislative background

While Goldstone’s statement that he as a businessman is obligated to sell cigarettes unless their sale is made illegal has surface credibility, it rings hollow when one considers the extent of his power to determine what the law is. Not only does Big Tobacco participate largely in the conventional electoral process, but it also commits defining resources for creating the public opinion that underlies popular consensus.

Goldstone made his telling comment, by happenstance, in the context of an unexpected tobacco industry success in defeating an ambitious anti-tobacco bill. The measure would have increased the price of cigarettes by \$1.10 a pack in taxes, creating government revenue to be spent on smoking-related health research and services, and an anti-smoking advertising campaign. This initially popular bill was killed by a \$40 million advertising campaign – large even by American standards – that managed to persuade voters that the bill was about boosting tax revenues and expanding bureaucracy rather than on curbing smoking among the young.<sup>17</sup>

Money and persistence are the ultimate Washington weapon. The *Wall Street Journal* chronicles how it works:

*“On the day the Senate killed comprehensive tobacco legislation, Sen. Mitch McConnell stood up at a closed-door meeting of Republican senators to deliver good news: The tobacco industry would mount a television ad campaign to support those who voted to knock off the bill. Such ads, Mr. McConnell says now, ‘would be generally helpful to people who decided to kill this bill as a big tax increase on working Americans.’”<sup>18</sup>*

How could any group of corporations turn the tide of history so handily? The tobacco industry is a master at the process, using a surefire combination of tactics.

One tactic is an inspired program of charitable contributions to high visibility activities. Take for example Philip Morris, which has tried to associate itself “at every opportunity with positive social values, institutions and

ideas,” according to Richard Kluger’s portrait of the company in *Ashes to Ashes*. “If it behaved like a sterling corporate citizen,” Philip Morris reasoned, “people would overlook the unfortunate tendency of the core product to shorten life expectancy.”<sup>19</sup>

You can’t fool all the people all the time. “I don’t want to live in peace with these guys,” declared Dr Kessler, former head of the US Food and Drug Administration, in an interview with the *New York Times*. “If they cared at all for the public health, they wouldn’t be in this business in the first place. All this talk about it being a legal business is euphemism. They sell a deadly, addictive product. There’s no reason to allow them to conduct business as usual.”<sup>20</sup>

Talk of legalism and showy charity are not the only tactics up the sleeve of big cigarette companies. Other tactics for winning friends and influencing people include:

- soft money contributions (\$13,972,640 from January through June 1997, mostly to the Republican party);<sup>21</sup>
- large campaign contributions to key legislators; and
- huge retainers to former leaders-turned-lobbyists.

This last ploy is bread and butter for Verner-Liipfert, Bernhard, McPherson and Hand, Chartered, Washington, DC, a law firm that exemplifies Washington’s famous “revolving door.” This power brokering law firm employs former majority leaders from both sides of the Senate aisle: Democrat George Mitchell and Republican Robert Dole. In the months leading up to the legislative victory, Verner-Liipfert collected over \$10.2 million in lobbying fees from the tobacco industry, prompting one observer to note that, “last week, the industry got its money’s worth.”<sup>22</sup>

A victory like this makes influence peddling worthwhile, despite the seeming apostasy of “bought” supporters in the short term. To be sure, legislators may accept pro-tobacco money with one hand, and then vote against tobacco with the other. Over time, however, the hands do move in sync.

Former House Majority Leader Newt Gingrich once boldly declared, “I don’t care how much they gave in the past, or how much they will give in the future. The cigarette makers do not deserve our protection.”<sup>23</sup> But at just the time Gingrich was reading today’s polls, his Senate colleague Mitch

McConnell, Chairman of the Republican Senate Campaign Committee, was preparing tomorrow's – and clearly, in this instance, the effort paid off.

Not surprisingly, given the way the corporate–government partnership has evolved, tobacco company CEOs like Goldstone see their jobs as creating a receptive environment for their companies through public relations, lobbying, and financing the election of favorable officials – apparently without financial, governance or ethical restraint – and in maximizing its immediate profits.

Even this, admittedly legalistic and narrow, approach is not problem free. The “market” simply will not attach a multiple to earnings from tobacco sources that is competitive. This is why the tobacco industry embarked on its apparent misguided efforts for settlement with the State Attorney Generals. In Goldstone's words:

*“The opportunity was so unique – I was able to go to the board, to the shareholders and to the employees who own stock and say What is the point of producing earnings if nobody puts a value on them? We're getting Pyrrhic victories in these cases, because nobody is putting a value on our earnings. Call it Coke envy: the tobacco companies are revenue machines, and yet the stock market fearing the instability of endless litigation is not embracing them as they do other consumer products giants like Coca-Cola ...”<sup>24</sup>*

Goldstone the manager cannot be content simply with producing great earnings; he has to concern himself with the multiple placed on those earnings in the market place to produce value for his shareholders. This is where the two components of governance – legitimacy and competitiveness – converge. *The market place appears to penalize companies whose functioning affronts societal standards.* This raises the cost of capital and tends to make those companies uncompetitive. We will consider this phenomenon at length in Appendix I.

### *Strategic mistake*

It would appear as if the managements of US tobacco companies have made a strategic mistake in choosing to risk their owners' values on an income stream deemed suspect by the public and politicians. The oldest US tobacco company – American Tobacco – some ten years ago diversified its opera-

tions out of domestic tobacco, changing its name first to American Brands and then to Fortune Brands.

### *Legal battles*

In the 1990s, the tobacco industry successfully resisted a proposed federal law that would have included substantive regulatory requirements. Instead, they settled for the morass of litigation and laws pending in the various states. At other times, they have championed federal laws over state laws – a switching back and forth they use to suit their purposes.

In 1982, the US Supreme Court declared in *Edgar v. Mite Corp.*, 457 US 624 (1982), that an Illinois antitakeover law was in conflict with federal law, which permitted hostile takeovers. For the next several years, lobbyists tried unsuccessfully to persuade the Congress to pass laws prohibiting hostile takeovers, but in the end, they did not need too. The Supreme Court, in *CTS Corp. v. Dynamics Corp. of America*, 481 US 69 (1987), reversed its decision in *Edgar v. Mite*, and affirmed the right of states to pass antitakeover laws.

At that point the corporations headed to the state houses. This same tendency in the tobacco situation takes the “law” from the relatively public limelight of Washington, DC, to the rather murky, usually unenforced and ineffective, disclosure requirements of the state capitals. “While it is no secret that lobbyists in Albany use expense accounts to garner support, the practice has largely escaped scrutiny because state lawmakers have declined to require disclosure of all gifts.”<sup>25</sup> While lawyers are usually included in the most recent federal requirements to disclose lobbying expenses, the pattern in the state houses is different. Listen to Raymond Harding:

*“In an interview Harding said he did legal work for Philip Morris, not lobbying. He said that he had spoken to government officials on behalf of Philip Morris, but only in the context of legal matters, not legislative or administrative ones. ‘I give them legal advice about dealing with various government organizations’, Harding said. ‘I never lobbied for them.’”<sup>26</sup>*

As Florida, Minnesota, Mississippi, and Texas reached settlement, the attorney generals of several key states tried to salvage some sort of master agreement. Eventually, the 46 state attorney generals agreed to drop pending lawsuits in return for payments of \$206 billion. Add in the other four states,

and the total bill for the Big Four tobacco companies rose to \$246 billion, to be paid over the next 25 years. Meanwhile the federal government has reopened litigation. The price of a pack of cigarettes has gone up, and tobacco companies are now acting as *de facto* tax collectors. Predictably, their profits will go up – in the short term.

The public would not be wrong to conclude that politics and therefore law itself is a game – a very expensive and complicated game. Indeed, one rock song by Sting, “If I Ever Lose My Faith in You,” laments that our politicians “... all seem like game show hosts to me.” Like most games, it is won by those with the best advisors and the most patience.

What is disturbing is the tobacco industry’s ability to claim on the one hand that it acts in the open and simply does what is legal, while on the other hand spending vast amounts on advertising to change the forum where the “law” is decided. This presents the most difficult facet of the multi-faceted problem of corporate legal compliance.

*The Report of the Committee of Experts on Tobacco Industry Documents* (July 2000), published by the World Health Organization, is the most comprehensive and credible analysis of the world-wide efforts of the industry to dominate institutions supposedly in the position to monitor its functioning. The report states:

*“Evidence from tobacco industry documents reveals that tobacco companies have operated for many years with the deliberate purpose of subverting the efforts of the World Health Organization (WHO) to control tobacco use. The attempted subversion has been elaborate, well financed, sophisticated, and usually invisible.”*

Are corporate managers obligated to follow the route of the US tobacco industry and simply drive the determinations to a forum they can secretly dominate? It is plain that this is not a decision that an individual CEO can make. The profit-maximizing role will be interpreted as requiring the CEO to take every step that can be described as legal (even if nobody would consider it within the spirit of the law) until and unless those for whom he works direct otherwise. Will the board of directors do that? We have already witnessed the pressures they confront in the low value that the stock market places on their equity. Twice in the past three years, this opportunity to buy low sell high has attracted the attention of the investor Carl Icahn,

one of the few individuals with the experience, the money and the chutzpah, to be able to mount a credible claim to taking over the company.

Who, then, is to decide what are the appropriate benchmarks to govern corporate conduct in availing itself of different legal systems? While we are focusing largely on questions involved in the US federal system, their present scope is Global, as was made clear in the widely applauded sale of its tobacco interests by Sarah Lee. Revolutionary Abby knows where this leads:

*“We are here to insist that DEFENSE must be the PEOPLE. We are here to insist that the great Industrial Centralized Power Gorgon is not just about a bunch of guys in suits behind closed doors having martinis with our Senators, judges, the Pres. and his Cabinet (yes, all presidents, not just this or that one) ... we are saying that the terrifying tyrannical creature is not just this behind closed doors, it’s about all the public institutions erected in the service of this monster ...*

*“We are here to ask you to join us in challenging the corporate-owned government to ask if BY WHAT AUTHORITY do they strain and divide and trick and exploit the American people and people of other countries? If the Constitution says WE, the People, then having given the Corporation human rights was an act of treason by a high court in 1886, all those that have assured human rights to any corporation since then have also committed TREASON.”*

We need to consider the legitimacy of Abby’s rage. Does the corporate system constitute such a menace to the survival of a free society that we need respond to a state of emergency? Is the inevitable effect of Globalization going to be the exacerbation of the problems which inflame Abby? Can a profitable economic system – to say nothing of a free society – long endure this pervasive sense of oppression?

A final quote from Revolutionary Abby:

*“For over a hundred years, Big Money, Bankers and Trusts and Foundation and Corporations have all been pouring their resources into ingenious PR (Public Relations) to get us all to THINK Corporate. Before TV. Long before TV. They have been pumping up the Corporate Values for a long, long, time.”*

**Table 3.1** Corporate values vs. values of common sense and common decency.

Corporate values	Values of common sense and common decency
<b>Type A</b>	<b>Type B</b>
<i>Success!</i>	Neighborliness
<i>Performance</i> , top speed, high volume	Compassion
Winners and Losers	Trust
Upward Mobility	Quality of work
Inequality	Responsibility to others
<i>Bettering one's self</i>	Equality
Competition	Patience
Honors for some	Questioning wrongs, challenging wrongs
Let the weak ones fall by the wayside; they deserve it. They were given every opportunity. They just didn't try hard enough	He ain't heavy; he's my brother
It's their fault, punish them	Cooperation
Obedience to the "inevitable"	Not feeling guilty about a day off
Isolation	Respect for the planet
Distrust	Trust your senses
Watch your back. It's a jungle	Fairness
Be hard	Prudence
Believe <i>only</i> the experts	Honesty
Be assertive.	Hopes and dreams
Only bullies win	Honor for all

Excerpt from Caroline Chute's undated brochure

### *Media companies*

Earlier, we quoted Justice Warren Burger in the *Belotti* case, when he noted that "media conglomerates" pose "a much more realistic threat to valid [political] interests" than other corporations. This may be true – but the threat itself is an outgrowth of the corporate form.

The pattern of communications companies assembling worldwide into conglomerate form is now established. There are virtually no radio, television, or newspapers that are not part of multi-industry, multi-national companies. The organs of communication are now governed by the same profit maximization rules as other businesses. We will not pause to opine on the ethical, informational, and aesthetic differences between national television like BBC and network television, or between Rupert Murdoch's Page 3

topless photo in the *Sun*. The communications industry has unique and essential properties in a free society – the capacity to frame the agenda and to mobilize discussion of critical issues. Every organ of communication will reflect its owners’ predisposition, whether it is the Soviet newspaper *Pravda* or the Sulzburgers’ *New York Times*. Communications companies uniquely possess the power to direct and control public dialogue on issues that importantly affect themselves.

The recent history of US federal legislation affecting the right to use the broadcast spectrum compels the conclusion that the present balance of power, the dynamics underlying our society, produces unacceptable results. Former majority leader Bob Dole has probably accepted more campaign and charitable contributions than any other American currently active. “TV broadcasters have rightly kept a watchful eye on a bloated government. Whether it was \$600 toilet seats or \$2000 coffee pots, they have always helped us quickly identify waste. But they have been strangely silent on this issue ... When it comes to billion dollar giveaways to them ‘mum’ is the word.”<sup>27</sup> The communications media have successfully thwarted all efforts to solve the “campaign finance” problem through offering free or reduced price Television time to candidates. Even Senator John McCain (R-AZ), whose courage is legendary, withdrew the proposal for free television from his campaign reform proposal. At the time of the inconclusive November 2000 elections in the United States, one commentator declared an unlikely victor: “This year’s presidential race may be too close to call, but one clear winner has already emerged: local TV stations. Local broadcasters are reaping the bounty from the most expensive election cycle in history. Armed with unrestricted “soft money,” political parties and special interest groups have joined presidential candidates in an \$850 million TV-ad battle to woo narrowly targeted groups of voters. *What’s more, the scramble for air time in certain media markets has sent ad rates soaring.*” (Emphasis added.) They even raised the rates for public service!<sup>28</sup>

Our concern is specifically focused on the importance of communications in a free society. As Dean Alger notes in *Megamedia*:

*“If the public has reason to doubt the independence and integrity of new operations, a vital part of democracy is damaged. It is equally vital for democracy to have a truly diverse set of media sources present in the public arena, a variety of alternative information and perspectives representing a real competition of approaches to news definition and thoughts on the direction in which our society*

*should head. The continuing advance of megamedia and their increasing domination of the prime mass media spell a profound constriction of that diversity and a severe diminution of the marketplace of ideas, and thus a danger to democracy.”<sup>29</sup>*

The media – television, print, radio – is increasingly consolidating worldwide into a few huge corporations. The major US television networks are all subsidiaries of conglomerates – General Electric, Disney, Viacom. This expands largely the scope of subjects that will not be covered for public scrutiny. A chilling example comes from Jane Meyer, writing for *The New Yorker*, one of the few publications today not owned by a major conglomerate.

*“When a producer at ‘20/20’ considered doing a piece on executive compensation, two people familiar with the deliberations say, the idea was dropped because no one wanted to draw attention to the extraordinarily rich pay package of Disney’s chairman, Michael Eisner ... Another producer for the network, who asked not to be named, says that the news division’s need to steer clear of Disney comes up all the time.”<sup>30</sup>*

### **Emergence of the publicly owned corporation as the dominant mode for investment**

The publicly traded corporation has become recognized as the optimal mode for investment. Much of the explanation for this lies in its characteristics:

- Corporations can be organized by anyone for any purpose anywhere with virtually no minimum requirements. This makes the corporate form available to all who seek the opportunity to convert their genius, energy and good fortune into marketable wealth.
- A corporation with publicly traded stock permits an optimal division of specialties. Those capable of providing ideas, energy and management can be rewarded alongside those whose contribution is limited to money.
- Investors are safe in limiting the extent of their liability to the amount that they invest in the corporate enterprise.

- Once money is invested as part of the equity of a corporation, management can employ that money however it wishes to achieve its objectives without fear that the money will be removed.
- The investor in a publicly traded stock has the ability to dispose of his holding at will. Thus long-term capital for the enterprise is a short-term commitment for the capital provider.
- Corporations are creatures of the state and are, therefore, in theory, subject ultimately to the state's determination of limits on its operation, as dictated by the public interest.

### *Corporate self-financing*

The large publicly held corporation has certain attributes that importantly affect its behavior. Mature corporations are largely self-financing. The corporate system as a whole withdraws more equity capital from the market than it raises. Buybacks are more frequent and, in the aggregate, bigger than initial public offerings.

In most recent times, corporate values are unaffected by the payment of dividends. Corporations with the same level of earnings are valued the same whether or not they distribute a portion of those earnings to shareholders. Nor are corporations dependent on banks for financing. The sale of certificates of deposit in the market place gives large corporations direct access to liquidity. The much-advertised regulation of corporate behavior through the financial marketplace is largely fiction.

Corporations are important buyers of professional services. This means that the leading firms in hometowns and oftentimes in the money center cities as well are "conflicted" out of representing any challengers to the leading corporations. Advertising and public relations expenditures assure the existence of a generally supportive atmosphere about corporate functioning. The glossy business magazines invariably confirm CEOs of the largest advertisers to be "business executives of the year" and the like. When the disastrous mismanagement of a company such as Marks & Spencer was confirmed in 1999, no one thinks back to the recent years in which it had been acclaimed as Europe's best.

The large corporation in today's society is a largely autonomous self-referential energy. This energy can be applied in a variety of ways. It may be applied in the direction of maximization of shareholder values as in the case of Westinghouse (now Viacom) At another extreme, it can be applied to

permit the gradual liquidation and decreased relevance of the institution as in the case of General Motors. In the extreme case of Microsoft it can prosper while ignoring and defying political considerations.<sup>31</sup> *The large corporation is intrinsically constructed to exist profitably in society with only minimal consideration of forces outside of the enterprise.* Corporations invoke the metaphor of the self-sealing tire, they are not immune to puncture but they are organized to seal any incursion.

### *Wisdom from James Hurst*

The late James Willard Hurst, the greatest American scholar of the relationship of corporations to society, has described how society stopped legislating the behavior of corporations, and instead began adjusting in response to corporate interests: “We ... ceased to build general social controls into corporate structure because the larger business corporation grew to involve a wider range of interests than the corporation’s own internal constitution could mediate; hence, the law moved into an expanding variety of specific subject matter regulations which, though not formally so limited, in fact mainly concerned *adjustment of societal interests* affected by large corporation behavior.”

Secondly, Hurst alludes to the problem that government had in dealing with the reality of corporate power. “The trend of policy also implied a judgment on methods of legal regulation in an economy in which large-scale firms were the most influential private decision makers. Experience indicated that nothing short of specialized, continuous executive or administrative attention would supply significant external checks on the responsibility of those who held central power in corporations with large numbers of shareholders.”

Hurst pointed out the most effective governmental presence is in the area of finance. “As large corporations increased the range of their impact on society, a wider spread of problems challenged public policy processes – concerning the market as an institution of social control, concerning diffuse public interests in national resource conservation and in public health and safety, and concerning important interests (those of labor, dealers and suppliers, and consumers) outside the formal structure of the corporation but affected in more focussed ways by what the corporation did.” He concludes: “Thus, in 1970, as in the 1880s, we had reached an apparent equilibrium

of policy in law concerning corporations, but it seemed likely to prove as unstable an equilibrium as that of the 1880s.”<sup>32</sup>

In Hurst’s view, the impact of large corporations can be accommodated to societal interest either from outside – laws, regulation, the marketplace – or from inside – its charter, its CEO, its shareholders. How one assesses the relative attractiveness of the potential “controls” depends in the first instance on the “language” used to describe the corporation. Lawyers are apt – like Professor Hurst – to seek formal solutions from the courts or the legislature or in the incorporation documents; economists and accountants look to the market; management experts look to the modern “CEO – philosopher king.”

These perspectives are too linear to adequately describe the dynamic functioning of a large corporation with its freedom from the market and its power to influence, even to dominate, the rule setters. An historic view with the lens of a particular discipline inevitably will reveal a static series of relationship rather than the ideal expression of human genius that is the modern corporation.

The “genius” of the corporation lies in its unique capacity to respond to change. This is why publicly held companies have triumphed over those managed by the most elite of bureaucrats, why government direction is almost invariably inferior and why co-operatives ultimately have to join the Global environment or perish. The essence of the publicly held company – Microsoft’s 180° turn in 1995 and the *hegira* of Westinghouse/CBS/Viacom described earlier in this book – is the pursuit of an identifiable objective with virtually all the resources that management is intelligent enough to identify and charming enough to enlist. This kind of impact is self-evidently beyond the capacity of stationary regulatory mentality and even the finest institutions.

### *Adapting to change – grudgingly*

The corporation is best understood as a “complex adaptive system” with certain imperatives, growth, perpetuation and rejection of containing or challenging forces. What did it take to persuade Dow Chemical not to manufacture napalm in the 1960s; how to stop ITT from bribing foreign officials or Occidental Petroleum from illegal campaign contributions in the United States; how to change Shell’s behavior in Nigeria – it took external pressure of various kinds. It took a great amount of pressure. Essentially, the

complex system adapts to required change grudgingly – Shell agrees to the “wrong” environment solution with Brent Spar, Microsoft will give minimum satisfaction to the Department of Justice. *Clearly, remediation is simpler if it comes from within.* There is a huge literature on the efficacy of change through “hostile takeover.” Whatever the benefits – and they are real – the price is too high. The wrong people make too much money at the expense of the surviving venture. The term owner is cheapened when speculators buy stock (sometimes based on inside information) and then sell to the hostile acquirer.

*The level and rate of increase of CEO pay calls the legitimacy of the corporation into question*

But when it comes to money, the biggest culprits are the leaders of those corporations themselves, in some cases. The levels of CEO pay exceed any historical precedent, comparison with compensation in other countries, and – most importantly – correlation with increased value for shareholders. Consider the astounding numbers recently appearing in *Business Week*:

*“In 1999, the average total pay garnered by CEOs at 362 of the largest US companies again shattered the record, rising 17% from 1998’s \$10.6 million to an average of \$12.4 million. That compares with a 19.5% rise in the Standards & Poor’s 500-stock index and a 32.8% boost in earnings for 1999. **That \$12.4 million is more than six times the average CEO paycheck in 1990.**”<sup>33</sup> (Emphasis added.)*

*Forbes* magazine, the usually reliable publisher of materials sympathetic with top management, makes it clear that the rise is *not* due to improved corporate performance – the conventional explanation for these large awards: Indeed, a study performed for *Forbes* by Monitor Group Corporate Finance Practice, based in Cambridge, MA, found virtually no correlation between annual changes in pay and shareholder returns. (Monitor Group studied compensation and total return to shareholders for each of the 399 *Forbes* 500s companies included in *Forbes* pay issues from 1995 through 1999. The *Forbes* article about the study concludes:

*“Compensation committees are hesitant to make pay-for-performance stick. If the stock shoots up, the chief keeps his reward, if it collapses and he manages*

*not to get fired, he either gets old options repriced or gets a new slug at the low price.”<sup>34</sup>*

Through the exercise of their large option grants, now top managers (hereinafter referred to collectively as CEOs) have become substantial corporate owners. Option holdings represent more than 10 percent of the total publicly outstanding stock. Institutional Shareholder Services reported as early as 1992 that the top 15 individuals in each company received 97 percent of the stock options issued to all employees. *Business Week* reported that the 200 largest corporations set aside nearly 10 percent of their stock for top executives, stating that in almost all cases, “it’s the superstar CEO who takes the lion’s share of these stock rewards.”

The lion’s share is large indeed. The compensation of top corporate officials in the United States today exceeds by orders of magnitude every comparative measure of pay irrespective of time and place. Today the average CEO makes about 475 times what the full-time factory employee does.<sup>35</sup> The levels and method of compensation of the CEOs of corporations threaten to metastasize into a cancer that will destroy the market-driven free enterprise system now prevailing in the United States and most of the world.

### *Process of setting pay – gap between appearance and reality*

How this has happened is an important story. Law has been followed “to the letter,” but to make this possible the entire business community has accepted the use of words directly contrary to their accepted meaning. Process has prevailed over common sense and the result is an emerging hegemony of the CEO, which portends significant change in the role of corporations in this society.

Appearance and reality are utterly different in several critical respects, as shown in Table 3.2.

Through the phenomenon of runaway CEO pay, the corporate system has been significantly perverted. The original ideal of management accountability to boards and shareholders has been stood on its ear. CEOs have used their power and the accommodating skill of their professional advisors to confer wealth on themselves. There is no “free” market in executive pay, it has been rigged. This corruption at the core is a cancer to the legitimacy of the corporation.

**Table 3.2** The process of setting pay – the gap between appearance and reality.

Appearance	Reality
1 Shareholders' interests are secured through the <i>election</i> of directors who protect their interests.	Shareholder action with respect to the election of directors can best be described as "coerced ratification." No matter how shareholders vote, those individuals listed on the management proxy are elected.
2 The preponderance of directors are "independent" according to the rules of the SEC, the New York Stock Exchange, the Nasdaq Stock Exchange, the Internal Revenue Service, the Council of Institutional Investors, and governance-minded companies such as Campbell Soup and GM, among others.	Boards of directors are <i>self-perpetuating</i> . The CEO has at the least the power to veto nominees, but usually actively participates in the selection process. Membership is highly valued and those selected are conscious of benefit conferred on them.
3 Most boards have compensation committees comprised entirely of "independent" directors.	Most directors are nominated and/or approved by the CEO–Chairman. How can anyone be considered "independent" of someone to whom they are personally beholden?
4 Best practice requires the use of "professional" compensation consultants.	The realities of a successful professional practice include not being perceived as insensitive to the needs of those who are retaining you.
5 The "free market" ensures that competitive factors control the levels of CEO pay.	There is no "free market" in top executive compensation. CEOs control the critical stages of the process, including government and professional accounting treatment.

"Why doesn't anybody protest?" you might ask. "Why doesn't anybody do anything?" Graef (Bud) Crystal, a refugee from the compensation consulting business, has cried loud and clear, but his is a voice in the wilderness. Other credible witnesses as to the inappropriateness of the redistribution of corporate wealth earn fine livings, which are controlled by those to whom this wealth is being diverted.

*CEO power over government and rule setters changes the accounting for pay*

The legitimacy of corporate power must be questioned closely in light of the change in the language and rules for CEO compensation. The Business Roundtable is an organization comprised exclusively of the CEOs of major companies. Their agenda purports to be that of their corporations they lead. In the case of compensation, unfortunately, their agenda is entirely personal. The BRT has led a most successful co-optation both of the United States government and of the previously independent rule-setters for the accounting profession.<sup>36</sup> This was exemplified by the 88–9 vote of the United States Senate in 1994 expressing its “sense” [sic!] that the current cost of issuing options should not be reflected on companies’ income statements. The Business Roundtable successfully organized a lobbying effort to pressure the Financial Accounting Standards Board (“FASB”) to reverse its proposal that account be taken of the “value” of options at the time they were granted. Thanks to the Roundtable’s lobbying skills and power – henceforth, options not only are a one-way street, but they are also “free” – they don’t cost anything.

Warren Buffett, whose ability to make money deprived the country of a great literary talent, wrote to Senator Chris Dodd, then Chairman of the Securities Subcommittee of the Senate Committee on Banking:

*“The most egregious example of let’s-not-face-up-to-reality behavior by executives and accountants has occurred in the world of stock options. The lack of logic is not accidental: For decades, much of the business world has waged war against accounting rule makers, trying to keep the costs of stock options from being reflected in the profits of the corporations that issue them. Typically, executives have argued that options are hard to value and therefore their costs should be ignored. At other times managers have said that assigning a cost to options would injure small start up businesses. Some of them have even solemnly declared that ‘out of the money’ options (those with an exercise price equal to or above the current market price) have no value when they are issued. It seems to me that the realities of stock options can be summarized quite simply: If options aren’t a form of compensation, what are they? If compensation isn’t an expense, what is it? And if expenses shouldn’t go into the calculation of earnings, where in the world should they go? ... Managers thinking about accounting issues should never forget one of Abraham Lincoln’s favorite riddles, ‘How many legs*

*does a dog have if you call his tail a leg?’ The answer: ‘Four, because calling a tail a leg does not make it a leg.’ It behooves managers to remember that Abe’s right even if an auditor is willing to certify the tail is a leg.”*

The CEO community’s success in overpowering FASB, the supposedly independent accounting rule-setting organization, flies in the face of public opinion, which is becoming ever more suspicious of corporations and their managements.

The American public is profoundly concerned with the extent of corporate power. *Business Week* magazine (September 11, 2000) devoted its cover and primary article to the question: “Too Much Corporate Power?” *Business Week* together with Harris conducted a poll in the late summer of 2000 which contained the question:

*“Which of the following statements do you agree with more strongly?”*

	2000	1999
<i>US corporations should have only one purpose – to make the most profit for their shareholders – and their pursuit of that goal will be best for America in the long run</i>	4%	5%
<i>US corporations should have more than one purpose. They also owe something to their workers and the communities in which they operate, and they should sometimes sacrifice some profit for the sake of making things better for their workers and communities</i>	95%	95%
<i>Not sure/No answer</i>	1%	0%

*Business Week*, September 11, 2000,  
<http://www.businessweek.com/2000>

M&A activity increased CEO pay. Furthermore “The American Disease” threatens to export via merger.

Acquisitions have accelerated the progression (if that is the right word) of the CEO into an independent entity with entitlements far greater than those of the corporation’s other constituencies. In the recent merger of BP Amoco (itself the product of a previous merger of British Petroleum and American Oil) and Atlantic Richfield, BP Amoco paid off the CEO and top officers for selling a “merger of equals” to those lower in the organization – shortly to be laid off. Compensation in these deals is out of sight. Not only are all

options vested and all parachutes opened, but CEOs like Frank Newman of Bankers Trust are paid additional king's ransoms simply not to go to work. Donald Marron, the 66-year-old CEO of Paine Webber, has made a piker out of Frank Newman. Not only does he get all the goodies, not only will he not have to retire (like everyone else in the organization), not only will he not have to report to anybody, but he also gets a big customer for his new business – Paine Webber's acquirers – (UBS of Switzerland) – have agreed to put some of their money (reported to be \$500 million) to be managed by a new Marron controlled and owned enterprise.<sup>37</sup>

The American experience is inviting imitation from abroad. Following the aforementioned merger of British Petroleum and American Oil, there was a well-choreographed cry that UK salaries should be competitive with those on the world level. As a practical matter, this meant that BP executives received previously unimaginable pay raises. The same pattern was repeated in the Chrysler merger with Daimler Benz with the added fillip that under German law the surviving company discontinued the American practice of disclosing the level of top executive pay.

What has happened to the concept of corporate officers having a fiduciary relationship with other corporate constituencies? Corporations are truly getting to the same place as Church and nation state before them, where the position of the leader rather than the institution becomes paramount. This is the condition that precedes loss of legitimacy and collapse.

## A solution

So what is the solution? Is it enough for shareholders simply to rely on market pressures to drive management out of antisocial activities? Society does not speak with a single voice. Gambling and liquor earnings are highly valued; General Electric's persistent refusal to admit responsibility for fouling the Hudson River has not prevented it from being the second most highly valued corporation in the world. Not even GE's occasional lapses into conduct classified as criminal have dimmed its luster. Nor have findings of anticompetitive behavior kept Microsoft periodically from being Number One; UK companies purchase tobacco operations from America without stock market loss or moral encomium. But as we shall see in later chapters of this book, the gains from antisocial behavior are not sustainable. In the

long run, shareholders and fund beneficiaries do not benefit from such behavior.

Is it tolerable for the corporate constituencies to acquiesce in the dramatically changed compensation arrangements for the principal executives? Will history record that this was an event comparable to the selling of indulgences by the Church or Marie Antoinette's "Let them eat cake" in signaling the destroyed legitimacy of a previously vigorous institution?

Clearly the tides towards an economically determined world have moved too far, and some solution must emerge. Can government laws alone force good behavior? In most cases, the answer is no. The reason is that the cost of fines for breaking the law in many cases is lower than the potential profits a corporation can make from breaking the law.

What agency, then, if not government, can ensure accountability for today's large modern corporation? The next chapter of this book will identify such an agent – long-term, responsible investors in corporate equities.

## Endnotes

- 1 I reflect at length on Smith's analysis of these in my book, *The Emperor's Nightingale: Restoring Corporate Integrity* (Capstone/Addison Wesley, 1998). (Note that Addison Wesley was the original publisher in the US, but the US operation was subsequently sold to Perseus Books.)
- 2 In early 2000, Glaxo Wellcome PLC paid \$76 billion for SmithKline Beecham PLC and Pfizer Inc. paid \$85 billion for Warner Lambert.
- 3 The bill numbers were S 2567 and H.R. 7010.
- 4 This is the motto proclaimed at [jubilee2000.org](http://jubilee2000.org), which is based in London, England, and part of a larger world movement on the Web called [netaid.org](http://netaid.org). This Jubilee 2000 movement is not identical with the Jubilee 2000 movement of the Roman Catholic Church, which is broader in scope. However, the Roman Catholic Church has endorsed the notion of debt forgiveness for the poorest nations, and has been promoting this cause at Catholic universities and in local parishes. The biblical roots for debt forgiveness in a "jubilee" year can be found throughout the Old Testament book of Leviticus.
- 5 Robert Lenzner, "Corporate Saboteurs," *Forbes*, November 27, 2000, pp. 157, 158.

- 6 Jeffrey E. Gartner, "Time for a Shakeup at the Business Roundtable," *Business Week*, October 9, 2000, p. 12.
- 7 Cover story, *Business Week*, November 13, 2000. See also a previous cover story, "Backlash: Behind the Anxiety Over Globalization," *Business Week*, April 24, 2000.
- 8 John Plender, Comment & Analysis, *Financial Times*, September 11, 2000.
- 9 Robert A.G. Monks and Nell Minow, *Corporate Governance* (Oxford: Blackwell, 1995), p. 10, Fig. 1.1.
- 10 Opinion in *Louis K. Liggett Co. v. Lee*, 53 S. Ct. 487 (1932). (Emphasis and paragraph breaks added.)
- 11 Caroline Chute, *The Snow Man* (New York: Harcourt Brace, 1999). Revolutionary Abby and other manifestos are sent at different times to friends and members.
- 12 Jacques Barzun, *From Dawn to Decadence – 1500 to the Present – 500 years of Western Cultural Life* (New York: HarperCollins, 2000), p.784.
- 13 The full quote was as follows: "It has long been recognized, however, that the special status of corporations has placed them in a position to control vast amounts of economic power which may, if not regulated, dominate not only the economy but also the very heart of our democracy, the electoral process ... The State need not permit its own creation to consume it." Justices Byron White, William Brennan, and Thurgood Marshall.
- 14 Scott Turow, "The High Court's 20-Year-Old Mistake," *New York Times* op-ed Sunday, October 12, 1997.
- 15 Jeffrey Goldberg, "Big Tobacco Won't Quit," *New York Times Magazine*, June 21, 1998, pp. 36 (emphasis added).
- 16 Goldberg, *op. cit.*
- 17 "Big Tobacco Wins One," *The Economist*. June 20, 1998, p. 32.
- 18 Jeffrey Taylor & Phil Kuntz, "Despite Polls, GOP Doesn't Fear Voted Heat on Tobacco," *Wall Street Journal*, June 25, 1998, p. A24.
- 19 Richard Kluger, *Ashes to Ashes: America's Hundred-Year War, the Public Health, and the Unabashed Triumph of Philip Morris* (Knopf, 1996), p. 618.
- 20 *Ibid.*
- 21 Common Cause, "Nicotine Fix," in *Return on Investment: The Hidden Story of Soft Money, Corporate Welfare, and the 1997 Budget & Tax Deal*, paper published in Washington, DC, 1997, pp. 30–31.

- 22 Steve Campbell, "Washington Watch," *Maine Sunday Telegram*, June 21, 1998.
- 23 Goldberg, *op. cit.*
- 24 Goldberg, *op. cit.*
- 25 Clifford J. Levy, "Philip Morris Spends Heavily Behind Scenes to Court Albany Lobbyists," *New York Times*, July 27, 1999, p. A19.
- 26 *Ibid.*
- 27 *Congressional Record*, April 17, 1996.
- 28 Kathy Chen, "In Campaign 2000, Local Stations are Winning Big," *Wall Street Journal*, November 9, 2000, p. B1.
- 29 Dean Alger, *Megamedia, How Giant Corporations Dominate Mass Media, Distort Competition, and Endanger Democracy*, (Lanham, MD: Rowman & Littlefield, 1998), pp. 13, 14.
- 30 Jane Meyer, "Bad News – What's Behind the Recent Gaffes at ABC?" *New Yorker*, August 14, 2000, pp. 30, 32.
- 31 Here, we need just note the widespread criticism of Bill Gates and Microsoft in early 1999 for having failed to make the customary lobbying commitment and campaign contributions in Washington, DC – a prudent business expense to assure even-handed consideration by antitrust authorities. No one ever accused Microsoft of being a slow learner. By the end of the Year 2000 election cycles, at \$3.5 million the company was one of the largest donors to political candidates and parties. [Source: Kathy Chen, "In Campaign 2000, Local Stations are Winning Big," *Wall Street Journal*, November 9, 2000, p. B1.]
- 32 As a rather mediocre student at the Harvard Law School, I am perhaps overly impressed by the rather extraordinary coincidence that each of the three most perceptive students of the relationship of corporate power to a free society – Louis Brandeis, David Engel, and James Willard Hurst – shared the distinction of being the finest students in their respective classes. Adolf A. Berle, whose exquisite early work deteriorated into the commonplace, was also a genuine prodigy at both Harvard College and Law School, although not first in his class. James W. Hurst, *The Legitimacy of the Business Corporation in the Law of the United States, 1780–1970*, (Charlottesville: University of Virginia Press, 1970), pp. 162–3.
- 33 Special Report – Executive Pay, *Business Week*, April 17, 2000, pp. 100, 102.
- 34 *Forbes*, May 15, 2000, pp. 213, 214.

- 35 Depending upon what statistics you use, that ratio amounts to an eight-to-tenfold expansion in executive pay relative to the rest of the workforce in just 25 years. *Business Week*, *supra*, at 110.
- 36 I have elsewhere told this story in detail. See *The Emperor's Nightingale* (Reading, MA: Addison-Wesley, 1998), pp. 58–63.
- 37 Charles Gasparino, “Marron’s Job at UBS Has Extra Perk,” *Wall Street Journal*, July 21, 2000.