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**In This Issue: International Corporate Governance**

- |                                                                                                                      |            |                                                                                                                                                                                                                  |
|----------------------------------------------------------------------------------------------------------------------|------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Brand India—Where Next? A Panel Discussion</b>                                                                    | <b>8</b>   | <i>Panelists: Nandan Nilekani, Infosys Technologies; Arun Sarin, Vodafone; Martin Sorrell, WPP Group; Vir Sanghvi, HT Media Ltd.; and Amitabh Kant, Indian Ministry of Tourism. Moderated by Andrew Heyward.</i> |
| <b>U.S. Corporate Governance: Accomplishments and Failings<br/>A Discussion with Michael Jensen and Robert Monks</b> | <b>28</b>  | <i>Moderated by Ralph Walkling, Drexel University</i>                                                                                                                                                            |
| <b>Changes in Korean Corporate Governance:<br/>A Response to Crisis</b>                                              | <b>47</b>  | <i>E. Han Kim, University of Michigan, and Woochan Kim, KDI School of Public Policy and Management</i>                                                                                                           |
| <b>Corporate Governance in India</b>                                                                                 | <b>59</b>  | <i>Rajesh Chakrabarti, Indian School of Business, and William Megginson and Pradeep K. Yadav, University of Oklahoma</i>                                                                                         |
| <b>Sovereign Wealth Funds: A Growing Global Force in Corporate Finance</b>                                           | <b>73</b>  | <i>Shams Butt, Anil Shivdasani, Carsten Stendevid, and Ann Wyman, Citi</i>                                                                                                                                       |
| <b>What Public Company Directors Should Know<br/>About Going Private</b>                                             | <b>84</b>  | <i>Panelists: Robert Kindler, Morgan Stanley, and David Wilson, Graduate Management Admission Council. Moderated by James Gunderson.</i>                                                                         |
| <b>The Corporate Social Responsibility (CSR) Trend</b>                                                               | <b>96</b>  | <i>Barbara Lougee, University of San Diego, and James Wallace, Claremont Graduate University</i>                                                                                                                 |
| <b>Leadership Structure and Corporate Governance in Switzerland</b>                                                  | <b>109</b> | <i>Markus M. Schmid, University of St. Gallen and Heinz Zimmermann, University of Basel</i>                                                                                                                      |
| <b>Who Charges More: Hedge Funds or Mutual Funds?</b>                                                                | <b>121</b> | <i>Mark Kritzman, Windham Capital Management</i>                                                                                                                                                                 |
| <b>Morgan Stanley's Approach to<br/>Assessing Credit Risks in the Microfinance Industry</b>                          | <b>124</b> | <i>Miguel Arvelo, Ju-Lie Bell, Christian Novak, Juliette Rose and Shally Venugopal, Morgan Stanley</i>                                                                                                           |

# U.S. Corporate Governance: Accomplishments and Failings

## A Discussion with Michael Jensen and Robert Monks

Financial Management Association | Orlando, Florida | October 19, 2007



**Ralph Walkling:** Good morning, I'm Ralph Walkling, current president of the Financial Management Association. Both in this role, and as Director of the Center for Corporate Governance at Drexel University's LeBow School of Business, I'm excited—and indeed honored—to be moderating this panel on U.S. corporate governance with Robert Monks and Michael Jensen, two of the most prominent authorities on the subject. The original title for this event, as proposed by Mike Jensen, was just “Failings of the U.S. Corporate Governance System.” But we later decided that, given Mike's and Bob's reputations for plain speaking, we could change the title a bit without dampening people's expectations for a provocative discussion.

And let me say a bit here about our two main speakers:

**Robert Monks** has been a passionate advocate of corporate governance reform for nearly 30 years, and a leader in putting such reform into practice. In 1985, Bob and Nell Minow founded Institutional Shareholder Services, a private firm that advises investors on proxy voting and how to respond to issues of corporate governance generally. In 1992, Bob and Nell sold ISS and started the shareholder activist investment firm called LENS. Much like today's activist hedge funds, LENS bought large stakes in underperforming companies with what Bob and Nell felt were unacceptable governance systems—Sears, Westinghouse, and Eastman Kodak, among others—and then engaged management in a dialogue to bring about change. Bob has served on the boards of directors of at least ten publicly held companies. He is also the co-author, with Nell Minow, of six books on corporate gover-

nance, books that many of us now use in our classrooms.

**Michael Jensen** is the Jesse Isidor Straus Professor of Business Administration Emeritus at Harvard Business School. But Mike's academic career did not start at Harvard. While at the University of Rochester in the 1970s, he wrote a paper with Bill Meckling on “Agency Costs and the Theory of the Firm” that revolutionized the study of corporate finance. It did so by focusing the attention of finance academics on the conflict of interest and incentives between management and shareholders that ends up reducing the value of most if not all public companies. In writing this paper, moreover, Mike and Bill anticipated what was going to become the central corporate governance challenge of the 1980s: getting managers to pursue the interests of their shareholders by maximizing the *value*, and not the size or diversity, of their organizations.

After moving to Harvard in the '80s, Mike became the most prominent academic spokesman for leveraged buyouts, or what is now known as “private equity,” as a way of overcoming this agency problem in public companies. In fact, Mike was so impressed by the private equity model of corporate governance that, in 1989, he published an article in the *Harvard Business Review* called “The Eclipse of the Public Corporation.” There he argued that, at least in the mature sector of the U.S. economy—those companies that no longer had major growth opportunities requiring outside capital—the greater efficiencies of the LBO or private equity model would cause it to replace the public corporation as the dominant organizational form.

Now, if Mike Jensen and Bob Monks

can be thought of as perhaps the pre-eminent spokesmen for the U.S. shareholder activist movement, the other, pro-management end of the U.S. corporate governance spectrum can be represented by Martin Lipton, the inventor of the poison pill and probably the best-known critic of shareholder activism within our borders. And I think it says a lot about our panel that in a speech Marty gave here in Orlando this past February, the title was “Shareholder Activism and the ‘Eclipse of the Public Corporation,’” and the speech began by pointing to Mike's 1989 article: “It was an article,” Marty starts by saying, “that, at the time it was published, I publicly disagreed with. But I now find it has new vitality. I'll return to Professor Jensen in my conclusion.”

Then, in his very next sentence, Marty cites our other panelist as follows: “One can date shareholder activism from the watershed year of 1985...[the year] Bob Monks and Nell Minow started ISS and the City of New York and State of California Pension funds started the Council of Institutional Investors.”

And here are a few representative statements from the rest of the speech:

“The shareholder activism movement is destroying the role, focus, and collegiality of the board of directors... Activist investors create pressure on boards to manage for short-term share performance rather than long-term value.... The key issue for American business is whether the institution of the corporate board of directors as we know it today can cope with shareholder activism and survive as the governing organization.”

At the end of the speech, Marty says, “Now I come back to Michael Jensen. In 1989, Professor Jensen wrote, ‘the publicly

held corporation, the main engine of economic progress in the United States, has outlived its usefulness.’ I now find myself embracing Professor Jensen’s 1989 article, less for the reasons he espoused, and more as a solution to the problems created by rampant, unrestrained, and unregulated shareholder activism.”

What Marty Lipton neglected to mention, of course, is that in the almost three decades since Mike Jensen and Bob Monks began working toward the reform of U.S. corporate governance, the productivity and value of U.S. companies have increased dramatically. And most economists would argue that the kind of shareholder activism advocated by Monks and Jensen has played an important role in these gains. So, again, let me point out once more that we are privileged to have with us this morning two of the country’s leading authorities on corporate governance.

I have organized today’s session around three topical aspects of corporate governance and we’ll address each in turn. The first of the three concerns the wisdom of expanding investor access to the proxy. Does giving shareholders greater ability to nominate directors amount to shareholder democracy, or will it lead to disruption and corporate anarchy? The second question has to do with private equity as a model for public companies. What, if anything, can the successes of LBOs and private equity tell us about how public companies should be managed? And third and last is the perennial controversy over executive pay in public companies: Have we reached a level of pay that is clearly excessive? Or do the even higher rewards now held out to the top managers of private-equity-controlled companies sug-

gest that CEO pay could possibly, in some cases, be too low?

### Expanding the Shareholder Vote

And before turning to Mike and Bob, let me say a word about recent proposals to expand shareholder democracy. Since passing Sarbanes-Oxley, Congress has continued to consider other measures that would give shareholders greater influence in the boardroom. Initiatives relating to shareholder access to the proxy and the procedures by which directors are elected have been debated, and in some cases are pending, in Congress. These measures are designed to transfer power from boards of directors to the investors whose interests the boards are supposed to be pursuing.

So, let me start by mentioning some new evidence on the influence of shareholders in electing boards of directors. In a working paper, my Drexel colleagues Jie Cai, Jacqueline Garner, and I looked at about 2,400 director elections with the aim of answering three questions about shareholder voting: Do shareholders vote as if firm performance matters? Do they vote as if the performance of the directors matters? And, third, do they vote as if the quality of governance matters? Our findings suggest that the answer to each of these questions is yes. Directors received a smaller percentage of the vote under the following circumstances: (1) when firm performance was substandard; (2) when the performance of the individual director was deemed to be substandard; and (3) when the firm’s governance system, as reflected in several indexes of shareholder rights, was viewed as inadequate.

But then we asked a fourth question: Do the votes themselves matter, in the sense of affecting the reputation and labor

market value of directors and influencing the performance of the firm itself? Here’s what we found: Even if you are a poorly performing director in a poorly performing firm with bad governance, you’re still likely to win almost 90% of the votes cast. What’s more, the votes do not appear to affect election outcomes and director turnover. In other words, the voting appears to have no effect on directors’ reputations in the sense that they don’t lose their seats after getting lower votes. The voting also has almost no discernible effect on future firm performance.

At the same time, however, shareholder voting does appear to have two notable positive effects—one on CEO pay and one on antitakeover provisions. In cases where directors—especially members of the compensation committee—get significantly lower votes, the CEOs tend to get lower pay raises the following year, and companies are far more likely to get rid of poison pills and staggered boards.

So, let’s come back to the key question and turn it over to our panelists. How much power should shareholders have in the boardroom, and for what types of decisions? And do you worry about single-issue advocates? Most of the proposals for majority voting, for example, are sponsored by unions. Bob, let’s start with you.

**Robert Monks:** Let me start by telling you that I’m one of the few people in the world who has run as an uninvited candidate for the board of directors of a major U.S. company. And, as we talk about this issue, I think people really ought to understand how important—and restricted—access to the proxy is.

About ten years ago, I analyzed a

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## Ralph Walkling

whole bunch of companies to find one that clearly needed a change in its board. And when I did that, I found Sears. It was 497th out of 500 on *Fortune Magazine's* list of most admired companies. So I ran for the board of Sears. I did everything you're supposed to do. I submitted my papers to their nominating committee—and they duly turned me down. Next I printed up a proxy, at my own expense. Then I had to get access to the shareholder list, which the law says that you're entitled to—but just try and get it.

Then I was sued by Marty Lipton, who was hired by Sears's board to protect themselves against me. Marty sued me on the grounds that I had “an improper reason” for wanting the shareholder list. He said I was trying to get a list to sell my book. The problem here is that even if you're faced with a lawsuit as absurd as this one, you still have to answer it—which costs a good deal of money. Finally, in the

case of Sears, as in many companies, the employee benefit plans owned a lot of the stock. I had to try to prevent the trustee, who is hired by the company, from voting that stock automatically against me and allow the beneficiaries to make some kind of independent judgment.

I could go on, but each one of these steps costs an enormous amount of money. On top of that, if you have five or six hundred thousand shareholders, you're talking \$5 million for a mailing. In the meantime, the management of the company is using shareholder funds to do mailings against you. And they mail not just once, but two or three times, and you have to answer those. So, it can run into very serious money. And that's why very few people have done what I did.

To sum up, then, I had long been interested in the field of corporate governance. And I viewed my experience with Sears as an investment in learning something

about how shareholder democracy actually works in practice in the U.S. What I can tell you is that, under then prevailing practices—and this is still pretty much true today—it is economic folly to do what I did. What I found was not likely to encourage imitators. And while I don't profess to know the answer to Ralph's question about how much power shareholders ought to have, I think that this proxy question is a really important issue that needs to be addressed.

**Walkling:** Bob, do you worry about single-issue activists? You're very much an advocate of value and value creation. But do you worry, for example, about a union with some other agenda acquiring a major influence on corporate decision-making?

**Monks:** I worry about it, but it's way down on my list of worries. The question people really should be asking today is what does

the board of an American corporation actually do—and what is it supposed to be doing. Without wanting to appear cynical, I have to say that there really isn't a consensus in America about what a board is supposed to do. In the United Kingdom, it's pretty clear what a board does. In America, a board does pretty much what the CEO wants it to do.

Now, in principle, American boards are supposed to do a lot. Just take a look at the statutory provisions for board responsibility. The reality, however, is that no one since the book of Genesis has ever been able to do all the things that boards are supposed to do. Therefore, everybody knows it's going to be something less than the complete requirement. And so, the question of which aspects of a company's governance system are in greatest need of reform is very much up for grabs in each company.

But, to come back to your question about single-issue advocacy, it's difficult for me to imagine a union member—or any single member—on a board causing much of a problem. The chairman of the board sets the agenda. When I campaigned for the Sears board, I kept telling myself, “We really ought to have two people running—because I can't even second my own motions.” So, although I can imagine a single union representative being a minor nuisance, I can't see it threatening the foundation of corporate governance.

## More on Corporate Boards

**Walking:** Mike, can you tell us about your experiences as a director?

**Michael Jensen:** As Bob can tell you, I actually got elected to a board of directors in a hostile setting.

**Monks:** That's right, in the case of Armstrong World Industries.

**Jensen:** Right. The Belzberg family had purchased a large minority stake in the company and they invited me to run on a slate of directors. And I was the only one the Belzbergs put up who got elected. So, I was like the fox in the chicken house, I guess. But it was a very interesting experience.

Now, let me say that there were very good people on that board. But what was true at Armstrong—and I would guess that it's still true in almost every major public corporation today—is that even the outside directors basically see themselves as employees of the CEO. That's just the way it is. And the outside directors in this case seemed even more deferential and beholden to the CEO than the managers who actually reported to him.

I was put on the compensation committee. And at the first meeting of that committee, there was a proposal to give the management a substantial bonus for the excellent performance they'd had that year. The problem, however, was that the equity value of the company had fallen by roughly 50% over that period. So I was listening to this discussion—and, by the way, the CEO was there running the meeting whose main focus was his own compensation. And when I pointed out that it was really hard to argue that management had done a great job when the value of the company had fallen by 50%, my fellow members of the compensation committee acted as if they were shocked. The response I got was, “How did you calculate that?”

But again let me assure you that these fellow board members were not bad peo-

ple. In fact, they were fine people. But they were just not accustomed to thinking about things like compensation and performance as being connected in any way to the share price.

Now eventually we did fire the CEO. And I kept asking hard questions. And then the next CEO fired me from the board because, as he put it, I had a tendency to ask “trick questions.” And that, apparently, was inappropriate behavior. A trick question, as I gathered from this experience, is one that the CEO either can't answer or finds it uncomfortable to do so.

But contrary to what Bob just told you, my own experience suggests that one person on a board can make a difference. It took a couple of years, but we did fire the CEO for poor performance. I would show up at every board meeting and say, “We've destroyed \$50 million dollars since the last meeting.” And finally things moved.

Now although things have improved in some ways since then, I would still argue that, under our current system, shareholders are one of the few interests that are really not effectively—or maybe “proactively” is a better word—represented in the boardroom. Even when a company is underperforming, until the market for corporate control—and today that means hedge funds and private equity firms—shows interest in the firm, shareholders really don't have much influence on management and boards. And for that reason, I think there is clearly room for giving shareholders more say in the nomination process.

But when we contemplate such changes, we also need to think hard about special interest groups and unintended consequences. I'm a bit more concerned than Bob about what might happen if we try to regu-

late or legislate changes in the boardroom nomination process. I say that because I believe that attempting to transfer the voting process that goes on in our political sector to board elections in the corporate sector would be a disaster. When Larry Summers came back from Washington a couple of years ago, I heard him describe the political process in Washington as one in which “nobody wants anybody else to succeed at *anything*.” And if you just look at what comes out of Washington, that’s pretty close to being correct.

So, again, I think we want to be very careful about legislating changes in the board nomination process. I find it easy to envision special interests, in a more open nomination system, getting board representation and taking actions to transfer wealth among different parties to the corporate contract. To cite just one example, giving shareholders a voice on executive pay could end up politicizing the corporate decision-making process. Look at what’s happened to the Harvard Management Corporation since the pay of its chief investment officer became the focus of a public debate. The guy quit, went to work for a hedge fund, and got a huge increase in pay. We don’t want that happening to our public corporations.

**Walking:** Well, there is now a proposal in the House and Senate called “Say on Pay” that would allow shareholders to vote directly on executive pay packages, a practice that has been used in the U.K. for some time—and I want to come back to that later in this discussion. But it seems to me that we’re going to need a lot more discussion and evidence to address this issue of the optimal level or form of shareholder democracy. And I do think

that a lot of different forces are coming together on this issue, producing unusual coalitions.

Bob, do you see signs of things changing?

### The U.K. Model of Shareholder Democracy

**Monks:** I think it’s important to make very clear that the problem of shareholder involvement in the process of nominating directors is part of a larger question. And that question is the accountability of U.S. corporate management to anybody. That’s really the issue.

Now, in every developed country in the world but the United States, that problem is solved in a very simple way: a relatively small percentage of shareholders have the right to call what in England is known as an “extraordinary general meeting,” or an EGM. At an EGM, a majority of the shareholders who attend the meeting can remove any or all of the directors with or without cause.

Now that’s a far more efficient and effective solution than the idea of having shareholders nominate people for the simple reason that shareholders are not particularly qualified to pick directors. Even very involved, financially sophisticated fiduciaries are not the best people to nominate directors. They really don’t know the company business that well; that’s not their comparative advantage and it’s not their responsibility. You really want the company to do it—but at the same time, you want accountability.

So, I think we’re going about this problem the wrong way. And this isn’t black magic. As everybody knows, the state of corporation law in America reflects a power struggle and it’s been an unequal power

struggle. “Them that has the power,” as the saying goes, “makes the law.” And the result in this country is that, as a practical matter, shareholders don’t have the power to remove directors. If they did, this problem would go away.

**Walking:** Bob, does your endorsement of these extraordinary general meetings suggest that you think that U.K. companies are better directed and better managed than U.S. companies?

**Monks:** Better directed, but probably not better managed—because the U.K. doesn’t have the same work culture that we have here. In America, for better or worse, there’s a tendency to identify oneself very much with one’s job. The level of commitment to that is huge, and that commitment contributes to effective management. In the U.K., by contrast, there’s no confusion about whether a good life is a competitor with your job; a good life wins every time. So although I think the English have won the governance battle, we manage our businesses better.

But their governance really is a great deal better. For example, in the *Financial Times* this week, you might have read about a company called BAE, the principal British defense contractor. The independent board chairman of BAE, who’d been there about three years, essentially forced the retirement of the CEO. And the same thing happened at British Petroleum with Lord Browne. But, in America, where the CEO is often the chairman, this just can’t happen.

**Jensen:** Well, it can’t happen unless there’s a crisis, unless the troubles are so great they just can’t be ignored.

**Monks:** Right, and Armstrong is a good example of that. But, to go back to my earlier point, there is greater respect for the monitoring function of boards in the U.K. There the directors' sources of information about the company are not limited to just the CEO and the people he chooses to give them access to. The kind of people who serve as chairmen of U.K. companies also tend to be different from their U.S. counterparts. In the U.K. there is a recognized tradition of hiring very experienced executives who are in their second or third careers. And because these people are not afraid of risking their jobs or careers, they have a culture of independent-minded chairmen capable of providing a high level of oversight.

So, in that sense, U.K. companies are better governed. But, as I suggested earlier, if you had to buy stock in two competitive companies, one British and one American, I'd probably take the American.

**Jensen:** My own experience with a handful of U.K. companies suggests that boards there take their monitoring and control function very seriously. They clearly see themselves as separate from the management. And it's very interesting to see American CEOs serving on those boards because the dominant model here is a supportive board. The function of a board member in the U.S. is basically to counsel and support the CEO. In the U.K., by contrast, there's a deep sense of obligation to exercise a control function, to hold management accountable. And that leads to much better governance. But at the same time, I also agree with Bob's suggestion that English companies tend not to be as efficient or well-run as U.S. firms.

Let me give you an example to illustrate

Bob's point about U.K. governance. I was working with a fairly large English company where the outside members—one of whom hired me, by the way—outnumbered the insiders by a large number. And among these outsiders there was not a full-time, but essentially a half-time outside chairman who really ran the agenda independently of the CEO. Now, this is something I had been advocating for years. But until I worked for this U.K. company, I had no idea that any companies were actually doing it. What's more, any outside member of this board had the power to hire any expert or consultant he or she wanted. The only rule the outside board member had to observe was to notify the chairman or the CEO of their intent to hire, and to limit costs to reasonable levels. But there was literally no restriction on the kind of resources they were allowed to hire. And that's unheard of in American companies, at least to my knowledge. Bob, do you know of any U.S. companies that allow that?

**Monks:** No. In fact, I have ended up paying a bunch of pretty hefty legal fees myself because of this practice. In the case of Sears, for example, I submitted them the bill for my legal fees when trying to get on the proxy—and they submitted the bills right back to me.

**Jensen:** Right. And you can imagine the huge difference this makes in the attitude of the outside board members when they know the company is willing to spend money to give the board an independent view. So, again, this kind of independence is very different from the American system, where, as I said, even the outside board members see the CEO as their boss.

They see themselves as employees of the CEO.

And this means that, in American companies, the CEO effectively has no boss. He or she is the boss unless and until there is an outside crisis that threatens the reputations of people on the board. Then the power shifts, the board members become the bosses, and you see people getting fired. But by that time, there's a whole lot of value destroyed that may not be recoverable.

**Walking:** Bob, I want to follow up on your argument that companies in the U.K., although better governed, are not better managed. Can't that be construed as a failure of the U.K. governance system?

**Monks:** Not the way that I look at it. I see governance as concerned primarily with internal processes and accountability rather than performance. On the issue of accountability, if you want to take long lunches at the Grand National, that's a matter of choice. And whereas governance is a matter of process, performance is really a management question. And when people ask me management questions, my response is, "Hire McKinsey, not me." My expertise is in governing a company, not managing it.

**Walking:** But, Mike, before we get off this topic, wouldn't you agree that the kind of discussion that took place at Armstrong is unimaginable today? I think today's boards of directors would be very aware that the stock price had underperformed by 50%. Hedge funds and private equity firms would be all over that board—and they would be forced to respond to that. And I wonder if that isn't an important

In every developed country in the world but the United States, the problem of management accountability is solved in a very simple way: a relatively small percentage of shareholders have the right to call what in England is known as an “extraordinary general meeting,” or an EGM. At an EGM, a majority of the shareholders who attend the meeting can remove any or all of the directors with or without cause. That’s a far more efficient and effective solution than the idea of having shareholders nominate people for the simple reason that even very involved, financially sophisticated fiduciaries are not the best people to nominate directors.

There is also greater respect for the monitoring function of boards in the U.K. The kind of people who serve as chairmen of U.K. companies also tend to be different from their U.S. counterparts. In the U.K. there is a recognized tradition of hiring very experienced executives who are in their second or third careers. And because these people are not afraid of risking their jobs or careers, they have a culture of independent-minded chairmen capable of providing a high level of oversight.



## Robert Monks

part of the explanation for the performance of U.S. companies. Isn't it possible that the outside pressure, if not a perfect substitute, is a reasonably good substitute for effective governance?

**Jensen:** Well, I think you're right to say that the outside pressures and corporate control markets are enormously important in bringing about change. And they were important a decade ago when I served on Armstrong's board. As I said, I was elected to the board as a result of the Belzbergs' acquiring a substantial minority interest. And after we fired the CEO and implemented a new management incentive plan, the value of the company doubled in a year. So, a big chunk of the lost value turned out to be recoverable—though things began to slide after that.

So, I agree with your point that those outside forces—the corporate control markets that today have increasingly taken the form of hedge funds and private equity—play a critical role in maintaining the performance of U.S. companies. But let's not allow the effects of those forces to blind us to the problems that continue to exist in boardrooms, in the *internal* corporate governance system. So, yes, the outside control markets are a very important force—and a partial substitute—for more effective governance. And I don't have any doubt that U.S. companies today are far more efficient as a result of the LBOs and takeovers that took place in the 1980s and 1990s. But in the meantime, people like Marty Lipton continue to work to limit the effectiveness of those forces. And, as I said, most corporate board members continue to act as if they report to the CEOs instead of monitoring their performance and holding them accountable.

**Walking:** One last question on this topic of shareholder voting: In a recent *Harvard Law Review*, the Delaware court's Leo Strine argued that shareholders may not deserve more shareholder democracy because "the majority of them are intermediaries, such as pension funds and mutual funds, which have governance problems of their own"—problems that could lead them to act against the interests of the people whose money they are investing.

Bob, let me put you on the spot by asking a pointed question. I know that you and Nell Minow sold Institutional Shareholder Services for a handsome price, and that ISS is now in the hands of a new owner. Our own estimates suggest that ISS effectively controls about 20% of votes in director elections, and thus can be a dominant factor in such elections. The question I have for you is, what are the potential conflicts inherent in a company that sells its services to the companies it rates?

**Monks:** Oh, there is a conflict; there's no question about it. I sold the venture before it started this practice. But I should also tell you that the Robert Monks who sold the venture is my son. And though he's a better businessman than I am, he is perhaps not as focused on internal governance issues as I would be.

This situation with ISS is a wonderful morality tale for early in the morning. When we started ISS back in 1985, you couldn't expect trustees, no matter how conscientious, to become well informed about all of the thousands of proxy issues that many of them have with regard to their portfolio companies. So we reasoned that if you wanted to have shareholders involved in corporate gover-

nance issues, you had to have some way for trustees to inform themselves about the issues. And ISS began to perform this very valuable function. Over time, it became such a dominant force that we ended up having, as you say, about 20% of the vote. And in addition to our influence on 20% of the vote, many of the clients have simply transferred their fiduciary responsibilities to ISS.

So, you want to be careful what you ask for—because you may get it. Now, as far as I know, ISS has never yet allowed, or been accused of allowing, payments from rated companies to influence its ratings. So far they have been clean. But one day I think that something will happen. It always does, but I hope I'm not around to see it. It isn't right to have a single intermediary becoming in effect the default fiduciary for everybody else.

## The Private Equity Model

**Walking:** Mike, since you just raised the subject of private equity, let's explore the main thesis of your 1989 *Harvard Business Review* article that the LBO represents a superior organizational form, a better model of corporate governance than that provided by the public corporation. What lessons can public companies learn from private equity? And why have they been so slow to learn them? And perhaps even more puzzling to economists, why are the private equity firms themselves becoming public companies? As a practitioner friend of mine, Joe Rizzi, likes to say, "When private equity firms go public, it's time to grab your wallet and run."

And let's start with Bob. What do you make of the recent wave of private equity deals, which now appears on its way down—and maybe even out?

**Monks:** I have long believed that you can increase a company's value by improving its governance system. That was the main premise underlying the kind of activism we practiced at LENS. And it seems equally clear to me that the truth of this proposition has been established by the successes of the private equity industry. Private equity exists mainly because there is a gap between public company governance and the governance structure the new owners plan to put in place once they've acquired the enterprise.

Rupert Murdoch did not pay \$5 billion for the Dow Jones & Company because he wants to put *Wall Street Journal* editorials on his wall. The 60% or so premium he volunteered to pay over the stock's value under its former owners reflects his assessment of the extent of the underperformance—a failure that can be attributed in large part to the company's governance structure, to the dual-class stock ownership that long enabled the family to maintain control while destroying value. That premium can also be viewed as reflecting Murdoch's estimate of the value of the improvements he expects to make.

And private equity, to my way of thinking, plays essentially the same role. It's a form of arbitrage, if you will, between public and private equity markets in which active investors use leverage to acquire assets that, in their eyes, are not being managed to maximize value. Such investors are exploiting what I like to call a "governance value gap" between public and private companies.

**Walking:** Mike, that sounds a lot like the thesis of your 1989 paper on "The Eclipse of the Public Corporation" that got Marty Lipton's attention? Can you tell us what

you were thinking when you wrote that article?

**Jensen:** Well, let's start by thinking back to the beginning of the 1980s, when the shareholders of U.S. public companies were basically the only important stakeholder group that was not well represented in the corporate boardroom. The inefficiencies that resulted from this lack of monitoring and accountability gave rise to corporate raiders and to the formation of these new organizations like KKR, Forstmann Little, and Berkshire Partners. When I started writing about them in the mid-'80s, I called them "LBO associations" or "LBO partnerships." But after LBOs got a bad name, the term "private equity" came into vogue. And let me just mention that what we call "private equity" today encompasses not just LBO firms like KKR but also classic venture capital firms like Kleiner Perkins. While there are important differences between these activities, there are also remarkable similarities between their ownership and governance systems, and that's why we lump them together.

But whatever you want to call them, these new organizations represented to me an important innovation in organizational form, a new model of governance and management, if you will—though I never could get my colleagues in strategy at the Harvard Business School to see it that way. What struck me was that the portfolios of assets put together by the LBO partnerships of the '80s were very similar to those of U.S. conglomerates, with lots of different businesses having no apparent synergies. But the LBO firms were set up very differently from the public conglomerates. Instead of rais-

ing capital from public equity markets, the LBO firms get most of their equity from private limited partnerships, for which the LBO firms serve as the general partners. Each unit or division of the LBO association is funded by debt and equity at the individual business unit or divisional level, not at the corporate level as in the conglomerates.

Now, if you think about how conglomerates operate, this difference in financial structure can make a huge difference. Every business effectively stands on its own, which means that financial problems that affect one operation cannot bring down another. And the level of the debt in these standalone operating businesses is also, of course, significantly higher. As I've argued in a number of papers, the high leverage in these transactions plays an important role, a very important control function. When a highly leveraged firm begins to underperform, the covenants get triggered, decisions rights get changed, and, at the end, you could go into bankruptcy. The control benefit of debt can be seen by recognizing that if a company is leveraged to 90% of its value, management cannot destroy more than about 10% of firm value before these decision rights get substantially changed and outsiders begin to have influence or control. But if the same firm instead has only 10% debt, then management could have the opportunity to destroy as much as 90% of the value of the firm before any covenants get triggered. Reinforcing this control benefit, as I suggested earlier, is the inability of the LBO or private equity firm to use funds from one business or division to subsidize the activities of others.

Also very important, the operating heads of each business have significant

equity stakes *in their own businesses*—as opposed to, say, stock options in a diversified collection of businesses over which they exercise almost no control. And the equity stakes of these operating heads were considerably larger than those of U.S. public company CEOs, especially back then. In a study of executive pay in U.S. public companies in the '70s and '80s, Kevin Murphy and I estimated that the average U.S. CEO in the '80s saw his personal wealth go up by about \$3 for every \$1,000 increase in the value of the firm. By comparison, Steve Kaplan's doctoral thesis found that the CEOs of businesses owned by LBO firms—the people who were previously running divisions inside conglomerates—earned about \$64 for every \$1,000 in shareholder wealth. So that's quite a change in incentives.

Finally, and in some ways most important, under the LBO or private equity governance system, the performance of the operating companies and their top managements is overseen by much smaller boards that consist mainly of the firm's largest investors. Other than the CEO, there are typically no insiders. And, as you can imagine, the kinds of discussions that take place in a room with just the firm's major owners and the CEO are just dramatically different from what goes on in most public company board meetings. In contrast to the public companies we have been talking about, the CEO in a private equity controlled firm does have a boss; he or she clearly reports to the board of directors, who are also the controlling investors. And if the board determines the company is not performing up to expectations, they will remove the CEO far more quickly than a public company board.

Now, there's also one other important

aspect of private equity that I've neglected to mention—and that's the duration or term of the funds. The funds have clearly defined lives, ranging from seven to 13 years. And that means that management has to give the funds back after a definite period of time. So, if you want to continue in operation, you have to ask the capital markets to give you back more money. It used to be a rule of thumb that, if you two of your funds failed to beat the S&P 500 over the life of the fund, you were out of business. You wouldn't be able to raise money again.

That's a very important element of the private equity model, a critical source of discipline on the investment process. But that discipline goes away when a firm like KKR—as they did in Europe recently—raises “permanent” capital, public equity instead of the finite-term capital supplied by limited partnerships. And we all know from looking at closed-end mutual funds what happens when you have permanent capital. The market values the fund at a discount to its net asset value, a discount that I think clearly reflects what we now call “agency costs”—the loss of value from the potential divergence of interests between the fund's managers and its owners. So, when you buy public equity in a private equity firm, what you're essentially buying is a closed-end fund. And, as I said, it's well established that most closed-end funds trade at a discount to the value of the sum of their parts.

Now, when you take the next step, as the people at Blackstone and Fortress have done, and you turn the private equity firm itself into a public corporation, I think you've really put yourself in dangerous territory. I'm giving a talk here later today about the highly counterpro-

ductive game that most public companies are involved in. It's a game called “earnings management” that takes place between managements in corporations and the capital markets. There is a serious lack of integrity in this process and, as I have been arguing for the last few years, it ends up destroying enormous amounts of value.

So, when you take part of the private equity business public, you're putting yourself back into this other game. And I'll be very surprised if the private equity firms don't start to behave very much like other public corporations, with their reliance on earnings guidance and earnings management. So, Ralph, I'm in total agreement with your friend who said, “It's time to grab your wallet and run.”

But, in terms of what public companies can learn from private equity, let me come back to their accomplishments, which have been pretty remarkable. After looking at all the evidence on LBOs—after considering the 30% or 40% premiums that are paid to the shareholders of the public companies that are being taken private, the returns to the limited partners, and the fees that are earned by the private equity firms themselves—there's absolutely no doubt in my mind that private equity has created huge amounts of value for the economy, huge amounts of social wealth.

However, because of the fees paid to buyout sponsors and the premiums paid to public shareholders in the buyout, average returns to private equity investors do not beat the market. Also remarkable is the consistency of the returns produced by the top quartile of firms—which are the best, and generally the oldest, firms in the business. We don't find that kind of consistency anywhere else in the capital markets; for,

Hedge funds and private equity play a critical role in maintaining the performance of U.S. companies. But let's not allow the effects of these forces to blind us to the problems that continue to exist in boardrooms, in the internal corporate governance system. So, yes, the control markets are a very important force—and a partial substitute—for more effective governance. And I have no doubt that U.S. companies today are far more efficient as a result of the LBOs and takeovers that took place in the 1980s and 1990s. But in the meantime, people like Marty Lipton continue to work to limit the effectiveness of those forces. And, as I said, most corporate board members continue to act as if they report to the CEOs instead of monitoring their performance and holding them accountable.

As a consequence, the CEOs of U.S. companies effectively have no boss. He or she is the boss unless and until there is an outside crisis that threatens the reputations of people on the board. Then the power shifts, the board members become the bosses, and you see people getting fired. But by that time, there's a whole lot of value destroyed that may not be recoverable.

## Michael Jensen



example, we don't find it in either our studies of mutual funds or in the work that I've seen to date on hedge funds.

But like all markets, private equity tends to overshoot. When things are going well, you get lots of new, inexperienced firms—Steve Kaplan calls them “tourists”—coming into the market. They will launch a couple of funds, perhaps have a couple of successes, and make a bunch of money. But when the tough times hit, they'll be gone. And thanks to the work of these inexperienced firms, private equity will get a bad rap during the next five or six years as the fallout from the most recent wave of deals begins to settle.

## Public Companies and the Earnings Management Game

**Walking:** Well, since you've brought it up, let's talk a bit more about the earnings management game that public companies either volunteer to play or, according to the managers of the companies themselves, are forced by the markets to play. A Duke University survey reported that almost 80% of some 400 responding U.S. CFOs said they would cut back investment in a project with a positive NPV in order to hit a short-term earnings target. And my question is: Who's really at fault here? Are investors being shortsighted, or are managers failing to understand the markets?

**Monks:** Well, again, I think this question is really one of accountability. A CFO works for a company, and the company is supposed to be run for its shareholders. And the shareholders are represented by the market. Now, does the market speak with a clear voice on corporate investments? Probably not. And even if there

is clearly a market view of a particular project, should it be accepted without question by management? I don't think so. Although I might make an exception for large acquisitions, the precise evaluation of individual corporate projects is generally beyond the competency of the market.

On the other hand, the idea that corporate management should completely ignore the market's expectations in making large capital budgeting decisions is also clearly wrong. The market is the ultimate arbiter of the required return of the collection of corporate projects that make up the company. And that required return is the standard by which we judge what our managers are supposed to do.

But that raises the troublesome issue of net present values and their relevance to today's companies. NPV can take you a long way in valuing basic manufacturing companies, the kinds of companies that are good candidates for LBOs. But for companies whose values consist more of growth opportunities than cash-generating assets, we're going to need a somewhat broader finance vocabulary. We're going to have to understand more about the contributions of intangible assets and so-called real options to corporate values. And we're also going to have to begin to learn the language of sustainability—an area where Europe is well ahead of us, by the way.

If there's one subject on which most financial economists and practitioners agree, it's that the present system of accounting conveys very little information about underlying corporate values. Baruch Lev, one of the pioneering thinkers in this area, has concluded that, for today's companies, the percentage of value captured by corporate income statements and balance sheets has fallen to something like 20%.

In other words, about 80% of corporate values today reflect things that aren't on the financial statements, that aren't picked up by NPV type of arithmetic. On the asset side, this is things like patents and other forms of intellectual property and corporate know-how. On the liability side are the costs of externalities like carbon emissions that are not borne by companies under present law—at least in the U.S.—but are likely to be imposed on them in the future. All of the attention to global warming would suggest that we're not very far away from having a broad social discussion about corporate sharing of the cost of the externalities now imposed on our communities.

So, again, I think that management needs to consider market signals and expectations when making major long-term strategic decisions. But I also think the current “linear” vocabulary of NPV is too limited for this discussion. And, as I said, there are major opportunities for leadership on the creation of a new language of accountability related to sustainability and long-term returns.

**Walking:** I often hear corporate executives complain that they can't manage “for the long run.” They have to hit that earnings target, and that means cutting back on projects that would create maximum value.

**Monks:** I have a good deal of skepticism about this argument. Long term and short term are in the eye of the beholder. While I know there can be a valuable discipline in being forced to meet short-term targets, I've rarely heard managers acknowledge this. But I've heard lots of managers try to justify abysmal performance by argu-

ing that the profits are on the come. As used and abused by corporate managers in practice, “long term” and “short term” tend to be code words with little meaning behind them. The reality, of course, is that long-term performance is just a series of short-term results, and good management is about managing tradeoffs between a dollar of earnings today and a dollar plus tomorrow.

Peter Drucker once described effective management as “muddling through with a purpose.” And I think that’s a good description. The best managers have a pretty good idea of what they’re doing and why. But even their companies are likely to end up somewhere different from where they expected to be—or they may end up in the same spot, but for reasons wholly different from what they anticipated. Marty Lipton ended up agreeing with Mike’s article on the future of public companies, but for wholly different reasons. That’s how our minds work. We begin with a set of priorities and expectations. And then experience causes us to adjust them.

So, to me the important question is whether management has a coherent and compelling explanation for why it is doing what it is doing at a given time. And whether someone characterizes that as short term or long term will depend on his or her expectations and requirements. But my own experience and intuition tell me that a manager with a compelling strategy is likely to find some group of investors who share that vision and are willing to ride out the bumps in performance. At the same time, it also seems clear that the firm that manages earnings to the penny will be abandoned by investors the moment it misses a target.

**Jensen:** I think this evidence of widespread earnings management produced by the Duke survey is very important. It confirms my own beliefs about the system, about this convoluted and distorted discussion of earnings that now tends to dominate at least the public dialogue between corporate management and the capital markets. And it is a corrupt system. It’s a game that nobody can win, and it is reducing the long-run productivity and value of many of our public companies. And this in turn has a lot to do with why so many of our public companies have chosen to go private.

But what continues to puzzle me is the fact that the companies themselves don’t seem to think they have any other options if they want to stay public. Most top managers say that they have to participate in this earnings guidance and earnings management game with analysts. But there are clearly other options. The best example, of course, is the disclosure policy of Warren Buffett, whose Berkshire Hathaway has long refused to provide earnings guidance. Buffett’s success is proof that you can run a public company in pretty much the same way you would run a private firm, provided you do a good job of making clear your strategy and gain the confidence of investors. And the kind of disclosure and relationship with capital markets I’m talking about has nothing to do with earnings guidance. The practice of earnings guidance—and the pressure it puts on organizations to manage earnings to meet the targets—is more likely to undermine a company’s relationship with its investors than to encourage the kind of sophisticated, longer-term holders that most managers claim to want.

**Monks:** That’s right. Buffett doesn’t give guidance and doesn’t even talk to analysts—and his shares trade at a significant premium to the sum of the individual values of the companies that make up Berkshire Hathaway. Buffett’s argument is that it’s not his job to forecast earnings; that’s the job for the analysts. Now if you hold up the example of Warren Buffett to corporate America, most CEOs tend to view Warren as too quirky to follow. But there are a number of successful and highly regarded companies—Goldman Sachs is one—that avoid guidance.

**Jensen:** Progressive Insurance is another good example. It’s a fascinating story of a company that has never given guidance. The board thought about starting guidance when Reg. FD was passed in 2002. But they decided instead to provide monthly releases of their operating P&L—no earnings forecasts, just reports of actual premiums taken in and operating costs for the past month, including expected losses from claims. And since starting that policy, Progressive has seen the volatility of the stock—which many people thought would go up—fall by 50%.

But I will also predict that when Buffett and Charlie Munger are gone, Berkshire Hathaway is likely to revert to a more “normal” corporate behavior with all of the value destruction that will bring about.

So, we have this peculiar equilibrium that looks like collusion between the managers and the analysts and capital markets, but really isn’t. In a market with that many different players, you can’t really have an effective kind of collusion. And when I try to look at the whole picture, it absolutely doesn’t make any sense. Most corporate

managers think they have to engage in this game; if they don't, the capital markets will ignore them and their values will collapse. But I think the exact opposite is true. If they stopped guiding earnings and started a more substantive, forward-looking, strategic dialogue with investors, they would find themselves with a more sophisticated—and probably a more loyal—shareholder base.

### The Issue of Executive Pay

**Walking:** Now let's turn to another major controversy in U.S. corporate governance: the level of executive compensation and its correlation, or lack of it, with corporate performance. Mike has been studying this issue at least since the end of the 1980s; and if it was controversial then, it's even more controversial now.

But before I turn to Mike and Bob, let me mention some new evidence. A bill called "Say on Pay" was passed in the House this spring by a two-to-one vote, and supported by Democrats and Republicans alike. The same day Barack Obama introduced a companion bill in the Senate. Such bills would not limit CEO pay, but instead would allow nonbinding shareholder votes on all public company executive pay packages. So, shareholders would get to say yes or no—either they like the compensation for this firm or they don't. And companies can respond to the votes as they see fit. Let me also add that the Bush White House opposes the bill for essentially the same reason it claims to oppose expanding shareholder access to the proxy—that is, the possibility it creates for special interests to disrupt or distort corporate decision-making.

Now, in devising our study, we came up with three main hypotheses about

how the stock market might respond to the announcements of these bills: The bill could either increase corporate values, reduce them, or have no effect. It might increase values by promising to give shareholders a voice, and perhaps greater influence, on executive pay. Alternatively, it could be viewed negatively by the market as promoting a destructive form of meddling by outsiders. It's not hard to envision a case—like the Harvard Management case Mike cited earlier—where populist voting discourages corporate boards from offering very large rewards for exceptional performance, and thereby causes companies to fail to retain a very effective CEO.

And then there's a third possibility—my own favorite—which is that a shareholder vote on pay could turn out to be what some economists call a "neutral mutation." First of all, even if the measure passes the senate, Bush's opposition is likely to prevent it from becoming law. And even if it passes, it's not binding and therefore doesn't have any teeth. If shareholders vote against a plan, who says the company will take action? And consistent with this third possibility, what evidence we now have on other nonbinding shareholder proposals supports this third hypothesis—not much of an effect.

So, my colleague Jie Cai and I performed the following experiment. We took 1,300 companies and examined the market reaction to the passing of this bill proposing "Say on Pay." And my initial expectation turned out to be right, at least on average: For the average company in our entire sample, there was no perceptible reaction to the bill.

But when we next divided companies into quartiles according to degree of CEO

"overpayment"—we called it "positive unexplained CEO pay"—we found that the stock prices of the quartile of companies with the most overpaid CEOs had a positive reaction to the bill. This positive reaction was also more evident in companies deemed to have poor governance and those with greater ownership by activist investors. So, our findings were consistent with the idea that "Say on Pay" is expected to improve corporate performance and create value.

But now let me turn back to Bob Monks. Bob, in a recent article in the *Financial Times*, you were quoted as describing U.S. stock options as "history's greatest nonviolent transfer of wealth from one class to another." What have we learned about executive compensation and incentives, and where are we headed in this debate?

**Monks:** This has been a truly memorable week with regard to the subject of executive pay. The President of the United States, George W. Bush, publicly professed to be "astounded" by the level of U.S. executive pay. He went on to say that shareholders should get active and do something about it. Now, I don't know whether this is going to be any more of a self-executing decree than some of Bush's military pronouncements, but it is noteworthy that someone who is perhaps as responsible as anyone alive for the current hegemony of the CEO should profess astonishment at CEO pay—and then tell the shareholders to do something about it. So, this has been quite a week on that subject.

I want to say two things on the question of "Say on Pay." First, don't underestimate the idiosyncratic problems, the potential for mischief, stemming from the efforts

of state and local governments in the U.S. to block any Federal initiative. As you know, substantive corporate law is passed by the individual states, which have long been in a race to the bottom to see who can pass the most permissive laws so as to encourage companies to charter there and produce tax revenues.

As a consequence, with one major exception, I don't believe there has been a single piece of substantive corporate law passed by the Congress since 1933. Every time a substantive corporation law comes up, the lobbying of 50 bar associations sees that it gets killed. Corporations are, of course, great clients for lawyers—and every state has lawyers and they're all active in politics. And they do not want to see their corporate law practices moved to Washington D.C. So literally every time some issue would come up, the corporate bar would lobby successfully not to have it passed.

Now, the one clear exception to this is Sarbanes Oxley. It was an extraordinary event, one that could have been produced only by an extreme crisis. Large companies like Enron and WorldCom went bankrupt. And suddenly these bills that Paul Sarbanes had been sitting on for five or six years—which hadn't even gotten out of the Finance Committee—went through with a rush—and grabbed Michael Oxley along the way.

So, I'm not optimistic that this Say on Pay bill will become law in this country any time soon. But I think we should give it serious consideration. Giving investors a say on executive pay has been the practice in England now for about ten years and is widely regarded there as a successful measure. There's a weekly trade publication for governance junkies

called "Global Proxy Watch" that comes out on Fridays. And in this morning's edition, it reports that a new academic study has concluded that, in the U.K., the shareholder votes on pay have had a measurable success in controlling executive compensation.

**Walking:** There are at least two people in this room who are very interested in knowing the results of that study. To my knowledge, Jie and I were the only people who had looked at this.

**Monks:** That's right. According to this article, there had been anecdotal reports of the effectiveness of this measure, but no broad-based statistical evidence until now. But this morning I read that Professors Sudhakar Balachandran of Columbia University and Fabrizio Ferri and David Maber of the Harvard Business School examined 700 U.K. companies while using 1,800 U.S. firms as a control group. The study claims to have found evidence of an increase in the sensitivity of CEO total compensation to negative operating and stock performance following the passage of the new rule. What this means is that the U.K. votes on pay have resulted, as the article's caption puts it, in "markedly fewer rewards for failure." And such findings, as the article goes on to suggest, are expected to put "momentum behind the pending say on pay rise in the U.S. and elsewhere."

This article may well be onto something important. I say that because I think even the most ardent defenders of the U.S. pay system would agree that that some of the packages given to our clearly failing CEOs have been unconscionable, outrageous, a disgrace to our system.

**Walking:** Mike, what are your thoughts on this?

**Jensen:** First of all, compensation matters bring out the worst in human beings, whether you're talking about it across different levels in organizations or at the highest levels. And for that reason, I believe that publicizing and perhaps politicizing that process—and that includes putting executive compensation to a shareholder vote—could turn out to have unintended consequences. In fact, it could be a disaster.

In my paper with Kevin Murphy in the early '90s, we said in a fairly forceful way that, based on the evidence we had found, there was no way you could conclude that CEOs were overpaid. At the same time, it was clear to us that top executives were being paid in the wrong ways. The main determinant of pay was the size of the organization as measured by sales. And we argued that the relationship between size and pay contributed directly to value-destroying corporate behavior—to the pursuit of growth at all cost and, perhaps even worse, the building of conglomerates. Based on estimates of the value created when raiders began pulling conglomerates apart in the '80s, I would guess that U.S. conglomerates were routinely destroying anywhere from 25% to 50% of the total value of their operating companies by trying to run them from a single corporate headquarters.

Now, in the book that Kevin and I are writing today, our message is going to be a little different. We are still not especially troubled by the level of today's pay packages, at least on average. In fact, on that dimension, the rest of the world's companies now appear to be moving rap-

idly in our direction. But what we find disturbing is the way today's CEOs are getting paid enormous amounts of money for failure. Bob Nardelli earned something like \$200 million at Home Depot for increasing earnings per share, even though the stock price fell over his four-year tenure. And making things worse, in fulfillment of the contract he negotiated when coming from GE, he got paid another \$220 million after he got fired. So, as things worked out, he made more by being fired than he would have made had he stayed on board.

Now, to me that is a clear sign that there's something dramatically wrong in the way compensation decisions are being made in these organizations. And Nardelli's deal is not an aberration, by the way. In the process of researching our book, Kevin and Eric Wruck came across this tome produced by compensation consultants that collects, among many other documents, the "for cause" termination provisions in executive compensation contracts. (And, by the way, when we wrote our first article, executive CEO employment contracts were virtually unheard of—they were just coming into use.)

After looking at these contracts, we've come to at least one important conclusion: The near universality today of employment contracts for CEOs can be traced back to federal laws limiting golden parachutes, payments under changes of control. In other words, CEO employment contracts became a standard part of the executive labor market only after the federal government got in the way of the other corporate methods for getting rid of CEOs. And to me it seems very clear that golden parachutes are a far better solution to the problem of removing

entrenched CEOs than today's employment contracts.

One of the major features of those contracts that Kevin and I have focused on are the terms and provisions that surround "for cause" dismissals. What we have found here represents to me an unbelievable failure of corporate compensation committees to fulfill their obligations to the company's shareholders. To cite one statistic, only 4% of the contracts we have examined allow a CEO to be dismissed "for cause" if he or she violates their fiduciary responsibilities. What that means is that 96% of U.S. corporate CEOs are entitled to the full value of their contracts even if they violate their fiduciary responsibilities to the firm and its financial stakeholders. Even more amazing, in the case of around 40% of CEOs, their companies would have to pay them the full values of their contracts *even if they are convicted of a felony*.

So, when I look at the provisions in these contracts, it just makes no sense whatsoever. And if U.S. boards are doing a bad job on obvious stuff like this, then it's not surprising that they're making mistakes elsewhere.

But having made these criticisms, let me also repeat what I've said many times before. There's no doubt in my mind that the shift in U.S. executive compensation during the '90s toward greater pay-for-performance, and away from pay based just on size of the organization, has had a huge impact on the productivity and value of U.S. corporations. And, as I already suggested, the fact that European companies are moving in this direction only lends support to this proposition. So I don't have any doubt that U.S. pay practices have brought about a big—and for the most part positive—change in the

way corporations are run and operated.

But are those practices the best we can do? Clearly not. If Kevin and I were re-writing the paper we published in the early '90s, we would have paid much more attention to ensuring that executive stock options were indexed to the cost of equity capital so that the exercise price grows at the cost of equity capital. To give you an example of what I mean, suppose your company's stock is selling at \$100, and you're going to give the CEO options with an exercise price of \$100. And let's also assume the cost of equity capital is 10%. Given that information, we know that if the price of the stock isn't equal to at least \$110 a year from now, value has been destroyed; the company has failed to provide its investors with the opportunity cost of their capital.

To give management a deal that is consistent with shareholders' interests, then, the exercise price of those options should rise at the end of the year to \$110—or perhaps a bit lower, to reflect the managers' lack of liquidity and inability to diversify. And the exercise price should keep rising in each year thereafter. The problem, however, is that under the current regulations and tax law, there are big penalties for issuing such cost-of-capital-adjusted options; and as a result they have basically not been used.

**Walking:** Mike, shouldn't options also be indexed for overall movements in markets, and perhaps for the performance of their competitors?

**Jensen:** I would argue against that. I know a lot of my colleagues in the business are very fond of these index-adjusted options. But that raises a whole set of complicated

issues, especially if you're talking about industry-specific indexes instead of indexing to the general market. I'm convinced that indexing a firm's performance to its competitors is a bad idea. For example, if you go to competitor-adjusted performance measures, you absolutely have to change the decision rights. You can't let the CEO be deciding what industry he's in; those decision rights have to be taken into the hands of the board.

But, to come back to my earlier point, I think we can do a lot better in designing executive pay packages. We have a system that pays CEOs enormous bonuses for creating value, which I think is a good thing on the whole. But, at the same time, our system pays many executives large bonuses even when they destroy value, and that is something that clearly needs to change. And let me also say that I'm not in favor of the recent substitution by many companies of large restricted stock grants for options. I think that's a very expensive way to provide incentives for managers. And it doesn't provide nearly the incentives that options do. If I simply give you a million dollars' worth of restricted stock (instead of making you pay for it) and the stock price goes down by 20% over the next two years, you've still got \$800,000 worth of stock. So you don't have much downside risk; you end up with a lot of money even if the stock goes down.

Now, options indexed to the cost of capital would take care of this problem. But, as I said, they are not being issued for a variety of legal and tax reasons. So, there's a lot to be untangled here. I don't know how to write rules and regulations that will fix this problem. And I don't think we understand the system well enough to say exactly what ought to

be changed, especially when it comes to the laws. We need to have some people who know a lot more than I do about the long-run effects of legal and regulatory changes thinking about what actual rules one could put in place that would make a difference—changes that stand a better than 50% chance of making things better rather than worse.

More generally, I think we've got a long way to go to really understand the forces that operate in our compensations committees and to understand the incentives that actually get created. I would hate to revert back to the compensation practices we had in the '70s and '80s. In those days, executives had very little incentive to increase shareholder value. But I also believe that there are a lot of compensation rules and practices that have grown up since then that might need some rethinking.

For example, when Kevin and I get our book written, I think boards of directors and compensation committees will think harder about routinely including these for-cause provisions in executive pay contracts. The process by which certain practices become accepted as "best practice" in that industry is a very subtle one—and lawyers tend to do the same thing, by the way. People gather huge amounts of data, which allows them to identify trends or dominant practices. And then—presumably with the assumption that whatever prevails in a market process must be efficient—they go on to interpret them as *best* practices. But in many cases—particularly those involving clear conflicts of interest and unresolved agency problems—they are not best practices at all, nor are they the outcome of a true market process. They are simply summaries of what peo-

ple do when left more or less to their own devices, when they're effectively insulated from market forces. But, as I said, these practices get labeled and sold as best practices—and this is very misleading.

So there are very complicated issues going on here with executive pay. Boards are given a very thick book showing what other executives get paid—and they're given another book on antitakeover devices and other corporate control practices and procedures. And, under the pretext of providing information about the best practices produced by a competitive market systems, these books are viewed as providing protection to both companies and their shareholders.

Now, I haven't finished reading both of those volumes—and before our book gets done, Kevin and I will between us have read every page. But what I will say is that there is not a single example in what I've read so far where the consultants recommend executive compensation, golden parachutes, or antitakeover or corporate control provisions that make shareholders better off by making executives worse off. In other words, in what constitutes today's best practices, executives always win.

So, these findings and practices are sold in a very subtle and yet very powerful way that I believe has a big impact on the outcome of the discussions by compensation and governance committees. And I think that just exposing the methods and assumptions underlying this search for best practices will be very instructive.

Before Sarbanes-Oxley, there was a conflict in which the public accountants that audited companies were making more money from their consulting practices with their clients than from their audits. And that has been addressed by

SOX. But, as Kevin and I have been complaining for years, we've also long had a conflict of interest in the compensation consulting business that is very much like what existed in the accounting business. A compensation consultant might get \$250,000 for designing a CEO compensation contract for a top-level executive while at the same time earning as much as \$10-25 million for actuarial work on rank and file compensation. And, as in the case of auditors, it's very hard to imagine this consultant taking a hard line against CEOs while asking their heads of human resources for \$25 million of additional work. The consulting firms have a clear conflict of interest here.

How do we solve this problem? There are now Congressional hearings on this issue, but I wouldn't jump to passing a law. At the very least, it seems clear to me that the comp consulting industry needs to be reorganized so you don't have people facing that conflict. Towers Perrin and the other major compensation consultants have supposedly split up their practices. And Fred Cook does only top-level management compensation contracts, and no lower-level consulting. But even if this problem gets resolved as has been done in the public accounting sphere, you still have enormous conflicts of interest with outside consultants.

**Walking:** Bob, do you want to respond to Mike on this, or give us any last words?

**Monks:** I have to confess that I feel privileged just to hear Mike talk about executive pay, since he probably has thought and written more about the subject than anybody in the world. And when he tells us that he doesn't have a legal or regulatory

solution to obstacles to the design of better stock options, I find that a wonderful example of concern for getting things exactly right, for avoiding the problem of unintended consequences.

As Mike was just suggesting, it is amazing how little we know about the important factors and forces in setting the compensation of top executives. It's also disturbing to me to see consultants devoting so much ingenuity and effort to comply with the letter of disclosure requirements while flouting the spirit or intent of the regulations. I see it as an abandonment of basic standards of ethics and decency. And I don't see things changing any time soon. I recently asked the head of the SEC why he was so optimistic about the new disclosure requirements on CEO compensation. When I said to him, "I've been a director for 40 years, and the SEC has always had rules about disclosing compensation," he leaned back and said, "Bob, this time we really mean it."

So, let me end by inviting you to draw your own conclusions. What's important to keep in mind about disclosure and the governance of corporations is that they are not matters of law. And they are not matters of economics. They are matters of power. And the fixing of the pay of the top executives is the smoking gun, the indicator, of this power. The mechanisms that will correct this problem, whether they be legal or regulatory or governance, are going to result from investors meeting that power with their own. The difficulty at the moment is that the balance of power is with managements and boards. As we've been discussing at some length, the board views themselves as working for the CEO, so they're not going to be very effective in limiting the power of top management.

And recognizing their limited ability to influence boards or management, many shareholders who ought to participate in corporate governance have chosen not to. A good example of this is Harvard University, Mike's long-time employer and my alma mater. Harvard's endowment fund has long simply declined to involve itself in matters of governance. And why an institution where people take so much pride in teaching ethics refuses to practice effective governance is a question I leave to you.

**Walking:** Well, let's leave it at that. Please join me in thanking our two panelists, Bob Monks and Mike Jensen, for a lively and provocative discussion.

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