

**The American Corporation**  
**At the End of The Twentieth Century**  
**- An Outline of Ownership Based Governance -**

**Summary**

American corporations have achieved world-wide leadership in competitiveness at the same time that their influence over civil government has continued to expand. Through direct involvement in the electoral processes, financing candidates and political parties and lobbying, American corporations have largely succeeded in equating their interests with the public interests and in focusing the resources of government for the primary benefit of business. There is substantial evidence that this process has gone too far. At the present time the private power of American corporations is not accountable to public or private authority in a meaningful way. Recent indications that government will again attempt to fill this gap compels the conclusion that the only system of governance compatible with a free society is one that is based on the effective involvement of corporate owners.\* Effective governance is essential to the healthy growth of capitalism in a democracy.

**1. *Hegemony of the American Corporation***

**Scope - Private Interest Prevails**

As the twentieth century comes to a close, American corporations have once again earned acceptance as the most competitive in the world. The Council on Competitiveness was able to boast in its latest annual report that growth rates in America's standard of living, manufacturing productivity and investment in plant and equipment had been the highest in a decade.<sup>[i]</sup> Even outsiders without star-spangled glasses are reaching the same conclusion. This spring, for the second year running, the Swiss-based World Economic Forum ranked America as the world's most competitive economy."<sup>[ii]</sup>

The present success of American corporate enterprise is a function of the belief that corporate purpose and legitimacy are congruent with market place value. The nuances of "social responsibility" - to other constituencies, employees, customers, suppliers, host communities - are considered to be appropriately reflected in the value accorded to corporations by the market. In other words, if a corporation treats its employees poorly or has a sub-optimal relationship with the communities in which its operations are located, the market is assumed to respond adversely, reducing the value of its stock. The notion that the market place - the deemed ratification by millions of beneficial owners - accurately, appropriately and promptly reflects all aspects of corporate functioning has the further seeming virtue of legitimating the power exercised. This notion of a self-correcting system has enormous appeal. It appeals to corporate managers because it legitimates their use of investment funds from outside sources, while leaving them maximum flexibility to direct the corporation as they wish. And it has appeal to everyone else because it requires no additional attention or energy to make it "work." It is this reliance on a sort of invisible perpetual motion machine of market correction that requires periodic and careful evaluation to see whether it is working.

America's corporate success must be examined in the context of a country that is comfortable with growth and change. We consider them "progress" almost by definition. We point with pride to one moment of our creation, when our founding fathers built into our constitution the mechanisms for changing it. The U.S. population has doubled in my lifetime; there are still vast

portions of the land that have never known human cultivation; relatively free immigration persists and the polity is generally prepared to pay the price extracted by an international market place. As *The Economist* put it: "No other rich country gives companies quite such a free hand to lay off workers and shift resources from declining industries into growing ones. No other country refreshes itself in quite the same way by continuous waves of immigration... the special characteristic of American business as: 'a willingness to reinvent itself and a willingness to see things disappear; an almost intuitive belief in Schumpeterianism.'<sup>[iii]</sup> People do not like it... but by and large they accept it. For as long as Americans are willing to put up with the mass lay-offs and accompanying social dislocation, these are incomparable wealth-creating advantages."<sup>[iv]</sup>

This appears to be one of those periods in American history during which the primacy of private interests (rather than public concerns) is accepted by the populace. The choice here is not between capitalism and socialism, but between capitalism with a short or long term perspective with all costs evaluated up front, explicitly, advertently and accountably.

### · **Legitimacy - Corporate Citizenship**

In all countries, corporations are creatures of governmental act and have no relevance or authority in common or natural law. But in the United States special significance is placed on the written Constitution and laws. In the absence of a common language, culture or value systems in a heterogeneous population, they are as close as we come to an expression of national culture.

Twenty years ago, the United States Supreme Court significantly changed the nature of corporate personhood in the bitterly divided 5-4 decision in *First National Bank of Boston v. Bellotti*, 435 U.S. 765 (1977). *Bellotti* grants corporations the authority to participate as citizens in the core workings of democratic government using the shareholders' money, without suggesting any limitation. It is still not clear how the addition of corporate citizens - **Citizen GE**<sup>[v]</sup> - fundamentally changes the nature of American political life.

### · **Corporate Power - Lobbying**

An entire industry exists in Washington D.C. in order to participate in government business. Business effectively and persistently works to persuade the legislative and administrative branches of government to create new rules, or to amend existing ones, to limit their liability or create barriers to entry for competitors. Both political parties have spoken disparagingly about "corporate pork" (predictably, neither has done very much about it).<sup>[vi]</sup> "The lobbying industry is the largest private sector employer in Washington, accounting for fully one-sixth of the private work force - 67,062 people. These lobbyists were paid more than \$3.2 billion in 1993, an average of \$47,679 each. By comparison, the typical American worker earned \$19,429 in 1993. In addition, the lobbying sector generates more than \$8.4 billion in revenue every year. If the D.C. lobbying industry were its own economy, it would be larger than the economies of 57 countries."<sup>[vii]</sup> "The lobbying industry has grown significantly over the past few decades by any measure. The number of people employed in the lobbying sector has grown from 16,721 in 1964 to 67,062 today. To put it another way, in 1964 there were 31 people working to influence government policy for every member of Congress; today there are 125 lobbyists per congressman."<sup>[viii]</sup>

Through an amalgamation of trade policies, selective tax breaks, and spending programs, the federal corporate welfare state is nearing \$250 billion to \$300 billion a year. This failed welfare empire should be toppled. Because they intermingle government dollars with corporate political clout, business subsidies have a corrupting influence on both America's system of democratic government and our system of entrepreneurial capitalism."<sup>[ix]</sup> An indispensable part of the lobbying effort is the financing of political campaigns. The post-Watergate "reforms" allowed corporations to establish and pay the operating expenses for Political Action Committees (PACs)<sup>[x]</sup> The PACs, virtually all of which are physically located in Washington DC, provide the

easiest and the largest source of funding not only for incumbents but for all candidates for federal office. There is no other way that campaign money can be raised so quickly and in such quantity. Beyond the direct contributions is the murky area of "soft money."<sup>[xi]</sup>

Time Magazine recently devoted its cover article to the power of soft money in both political parties.<sup>[xii]</sup>

**Big Tobacco** - \$2.4 million to Republicans in 1995.

What it wanted: To block a move by the FDA to regulate cigarettes. [The week of June 17, 1996] Dole showed which side he's on -- "I don't think the FDA has the authority to do what they want to do now."

**Lawyers** - \$1.8 million to Democrats in 1995.

What they wanted: To kill a litigation-reform bill. Clinton did veto it -- 4 days after his White House dinner with trial-lawyer honcho Bill Lerach.

### **Externalities - who pays?**

There is no ultimate answer as to which of the expenses related to corporate enterprise should be born by the company and which should be paid for by the public. The economic consequences of achieving standards for environmental protection, product safety liability and industrial health are so enormous that corporate managers will inevitably be trying to transfer them to one public authority or another. One might ask - why isn't it the obligation of a first class management to use all legal means to cause government to allocate responsibility for expenses elsewhere? The extent to which the public pays for particular costs in one country may be an important element in explaining its "competitiveness" with another country having opposite practices.<sup>[xiii]</sup>

### **Summary**

Today's American corporation is a constitutionally empowered active participant in the political<sup>[xiv]</sup> life of the republic. Government is the source of several critical elements of potential wealth, not only direct contractual awards, but through the allocation of "externality" expenses away from the corporation. Corporations have enjoyed great success in persuading government that "competitiveness" is the most important national concern and that, to achieve it, the primacy of corporate concerns need be recognized.

## **2. The Language of Accountability**

It is widely agreed that in a free society those controlling corporations need be accountable to someone.<sup>[xv]</sup> We must look at our language of accountability to understand what it says about our underlying assumptions and further to ask who is the appropriate party to proscribe this language.

### **The Myth of Marketplace Accountability**

A company is held to account in the marketplace. One of the principal elements of marketplace appraisal is its performance as recorded by Certified Public Accountants ("CPA"). Bolstered by the professional education and prestige of accountants, the efforts of self-regulatory standard setting organizations such as the Financial Accounting Standards Board ("FASB") and the oversight of the SEC and non-governmental regulators such as the NYSE, "the numbers" provide a preponderantly honest and consistent picture which is susceptible of sophisticated interpretation.<sup>[xvi]</sup> But no one should be under any illusions that the Generally Accepted Accounting Principle ("GAAP") numbers provide a reliable basis for determining the absolute

value of a company. They are what they say they are - no more, no less - a statement of financial condition based on principles consistently applied. In recent years, the integrity of GAAP numbers has squarely been strained by the continuing proliferation of "restructuring" charges. The pattern of taking a special charge to account for unusual and non-recurring circumstances is doubtless a useful convention. The pattern of taking charges every year in amounts that often dwarf the reported "earnings" makes a mockery of the whole process.[\[xvii\]](#)

With the violent changes in corporate condition reflected by massive charge-offs, anomalies emerge that illumine the limitations of the process. For example, Westinghouse, one of the Dow Jones 30 companies in America with a seemingly sustainable capacity to generate a billion dollars a year of cash flow, has only a nominal net worth according to GAAP. Stone & Webster Engineering was losing money in its principal operating business for over five years, but recorded profits due to an accounting convention that permitted treatment of surpluses in its pension plan as earnings.

A further problem with GAAP is that it places emphasis on traditional assets which have increasingly little to do with the generation of income in a world dominated by new invention and informed by the communications revolution. "A report prepared by Arthur Andersen for 11 large British companies states: 'In successful companies, the value of such [those not reported on the financial statements] assets is growing as a proportion of total shareholder value.' Indeed; Margaret Blair, a Brookings Institution economist, has calculated the relationship between tangible assets (property, plant and equipment) and total market value for U.S. manufacturing companies in the Compustat database. In 1982, she found, hard assets accounted for 62% of the companies' market value; ten years later they made up only 38%. And these were industrials."[\[RAGM1\]](#) [\[xviii\]](#)

#### **Accounting for the Cost of Externality**

While the seeming precision of numerical evaluation is beguiling, we must pause to consider that corporations have wide impact on the society in which they function that extend well beyond those items that are generally included within GAAP. Referred to by economists as "externalities," these range from the costs of training, medical and disability expenses arising from work, unemployment, and impact on the environment. The fundamental question is - will the private sector - the corporation, its shareholders - bear the cost of externalities or will they be born by the public? This is a political question and it has been answered in dramatically different ways in different countries.

In Japan the major companies do not lay off employees in times of recession. In almost all other OECD countries, unemployment costs are largely paid for by public funds (some of which are contributed by employers). In Germany, industry is required to process all atmospheric effluent occurring as a result of its functioning. Most other industrial countries regulate the extent of permissible effluent, thus, in effect, placing an "in kind" tax on the public, but only Germany requires the private sector to be completely responsible for its environmental impact. The United States has developed a massive program of employer financed retirement programs. While these are subsidized through tax advantage, employer responsibility for funding pensions is not the practice elsewhere.

#### **The Extent of Corporate Responsibility**

As corporations became an increasingly large factor in the world, difficult questions need be addressed as to the extent and propriety of expenditures in areas that are not ineluctably tied to profit generation. "How far has business a responsibility to maintain the framework of the society in which it operates and how far should business reflect society's priorities rather than its own commercial priorities? At this level, companies will have to look outwards at the changing terms on which society will license them to carry on their activities... The definition of responsibility moves further out of the hands of companies at this stage,

because business decisions are like stones thrown into a pool, which is society, and companies are asked to take account of the ripples as they move outwards to the shore. This requires companies to envisage the wider consequences of their decisions and to build that awareness into their decision-making processes.”[xix]

### · **Corporate Responsibility of Disclosure**

Accounting statements can only reflect information about corporate impact that is known. To the extent that managements see fit to limit disclosure about what they **know or strongly suspect** about the “costs” of their functioning on society, the financial statements will be defective. We encounter daily newspaper discussion of the research reports of various tobacco companies disclosing harmful impact of smoking over many decades. Should these companies disclose publicly this information? There are laws which proscribe what information is required to be disclosed. When should companies feel a compunction to go beyond what is legally required?

There are occasions when it is plainly in society’s interest that these disclosures be made. One has to question the utility of GAAP if the information on which it is based is incomplete. Are the income statements of a tobacco company misleading if there is no reference to reserves arising out of future liabilities suggested by the company’s own research work? The market cannot work without access to better information than this.

Appalling damage has been done to countless American women through the use of silicone for reconstructive and cosmetic surgery. Dow Corning, the principal supplier of silicone products, has paid over billions of dollars in damages before becoming bankrupt. Will its parent companies - Dow Chemical and Corning - be liable for damages? If so, their own survival would be in question. From a public policy/cost-benefit standpoint, what is the relevance of that risk? At all stages - from the earliest research to the most sophisticated legal pleadings - the question of information disclosure has been paramount. At this point of life and death litigation, no one really is free to say anything without causing unknown consequences. Corporate employees are put in the impossible position of either being silent or of the painful, lonely and expensive choice of becoming “whistle blowers.” The concerned corporations run the risk of further incriminating themselves. What is clear is that this kind of situation should not happen. It is difficult to know how to get from where we are to where we should be, but the goal is clear: “If companies do have any doubts about the effects of their products on people or on the environment, they have a duty to share their concerns with the appropriate authorities as soon as they become aware of them.”[xx]

### · **The Power of CEOs**

A minimum requirement for a healthy governance system is that there be a mechanism to assure that power is in fact exercised in the public good. The problems of concentrated private power reach the level of unacceptability when managements use corporate power in their own - personal, pocket book - interest rather than in the interest of the company or its shareholders, to say nothing of the polity at large.

There has been great concern lately over the extraordinary increase in the level of compensation for the top executives of corporations. The present levels of pay were unimaginable in earlier times; they are utterly out of sync with the pay levels abroad; management pays itself without effective overview by anyone. In recent times, management has even managed to dominate the national accounting system (including the overwhelming 1994 [88-9] Sense of the Senate vote) with the result that the preponderant portion of CEO compensation - stock options - need not be recorded on financial statements as an expense! This particular situation represents a rare insight into corporate power gone amok and we, therefore, linger for a careful look.

*“With the birth of the Roundtable, big business in America may at last be said to have come of political age.”*<sup>[xxi]</sup> Big Business in America was long a clumsy, uncomfortable and ineffective element in American political life. Whether it was General Motors’ getting caught in the ‘60s hiring a private detective to deal with the nuisance of Ralph Nader or a “real Republican” President Richard Nixon going off the gold standard, calling himself a “Keynseian”, and invoking wage and price controls in his first term, evidence abounded of the impotence of the business community in Washington DC. By the mid 1970s several of the Chief Executive Officers (“CEO”) of the largest U.S. companies devised a new kind of organization - the Business Roundtable (the “Roundtable” or “BRT”). Only CEOs could participate (deputies were not acceptable at meetings or in committee work); the organization would have small presence in Washington; and key staff would be provided in large by the CEO who was designated to chair approved projects. Throughout its brief history, BRT has enjoyed the involvement of some of the ablest leaders in the country. The organization has been well led and disciplined. Bruce Atwater, former CEO of General Mills, and his staff were deeply involved in corporate governance questions for much of the last decade. The Roundtable represented a huge commitment of resources by Corporate America to the political arena when one takes into account the true “cost” of the time of CEOs, General Counsels and other top staff. It also meant that some of the best talent in the country was directly committed to achieving “big business” government agenda. Impact was immediate and startlingly effective.

During the mid 1980s, Boone Pickens’ successful “runs” at Phillips and Gulf and Milken financed hostile takeovers of all but the largest U.S. companies raised consternation in corporate boardrooms. “Unable to persuade Congress to pass legislation curbing hostile takeovers,”<sup>[xxii]</sup> the BRT devised an ambitious program to protect its members through control over the processes of corporate governance. There is a fine line between the public interest and a corporation’s interest; the line is even finer between the interests of the corporation and those of its top executives. The Roundtable conspicuously crossed this line in the heated discussions accompanying the meteoric rise in the pay of CEOs over the last dozen years. A very large part of the pay of top executives derives from the grant and exercise of stock options - the preponderance of the hundreds of millions of dollars paid to CEOs like American Surgical’s Hirsch, Coca Cola’s Goizetta and Disney’ Michael Eisner came from option profits. Reflecting a wave of public concern over CEO compensation, the Financial Accounting Standards Board (“FASB”) revived its dormant recommendation that a charge be made of the “fair value” of the option against earnings (like other compensation expenses) at the time of grant. Managements opposed this suggestion with a ferocity never before unleashed with regard to any public proposal. The Roundtable developed a comprehensive and successful strategy to deal with this threat to its members’ compensation. In early 1992, John Reed, Chairman of Citicorp, described as Chairman of the BRT Accounting Principles Task Force, led the charge. He met with FASB executives and rallied BRT members to take suitable steps to deal with the problem:

“We need help from BRT CEOs in the following areas: 1. Communication with and **EDUCATION** of your public accountants. 2. Communication with and **EDUCATION** of your compensation consultants. 3. Communication with FASB now, before their views become solidified. We believe these contacts would be most effective if made by CEO’s.”<sup>[xxiii]</sup>

In plain English, Reed was asking his fellow CEOs, personally, to intervene in relationships between their corporation and certain of its professional advisers so as to “educate” them, presumably, of the consequences of their publicly expressed attitudes about appropriate accounting treatment for stock options. Nor did the resulting activity go unnoticed. The journalist Alison Leigh Cowan reported in length for *the New York Times*: “Corporate America is quietly seeking to muzzle the compensation consultants who routinely provide information about executive pay to the business press or to regulators... Leading the charge are John S. Reed, Chairman of Citicorp, and H. Brewster Atwater, Jr., Chairman of General Mills, with several other members of the Business Roundtable, an influential group of chief executives... the pressure tactics against the half-dozen or so firms that routinely provide this information seem to be working... The Roundtable scored an even bigger coup this summer when some of its members

who are clients of Tower Perrin led that firm to conclude that it was not in its best interest to continue helping the *Wall Street Journal* prepare the executive pay survey it publishes each spring... The sensitivity of the issue became clear on March 31, when four consulting firms and one accounting firm received a technical request from the FASB asking them to demonstrate how they would value five types of stock options. Using computer models, all five responded. But several chief executives said they felt betrayed by the consultants' participation in a demonstration that undermined the executives' contention that values cannot be easily placed on options."<sup>[xxiv]</sup>

That BRT John Reed's "education" program would have impact is a self-fulfilling prophecy. What is of ultimate significance in this unhappy story is the public humiliation of an institution that Americans have traditionally respected. It does not boggle the mind of a sophisticated person to appreciate that large customers will get accommodation from their service providers, but it does make it extremely difficult to base any system of accountability or governance on the independence of accountants. The bullying was so unignorable as to be the subject of a speech by Walter P. Schuetze, Chief Accountant of the Securities and Exchange Commission to the American Institute of Public Accountants<sup>[xxv]</sup> which concluded "...[i]f public companies are pressuring their outsider auditors and the Accounting Standards Executive Committee of the AICPA, to take particular positions on financial accounting and reporting issues, and outside auditors are subordinating their views to their clients' views, can the outside auditor community continue to claim to be independent?"<sup>[xxvi]</sup>

By the time that there was general recognition that the professional community was suborned on this issue, the BRT had successfully disappeared from the scene. Bruce Atwater declined the invitation of the Senate Securities Subcommittee to testify at its Hearings, Senator Bradley conspicuously did not mention the BRT in his speech listing supporters for the Sense of the Senate Resolution of May 3, 1994, and the organization is not mentioned in the articles in recent months that describe FASB's withdrawal of its proposal in mid 1995.<sup>[xxvii]</sup> Substituted for the Roundtable CEOs were venture capitalists, CEOs of growth companies and various Washington lobbying organizations, some of which, like the Coalition for American Equity Expansion, had been cobbled together for this particular project. These proponents were able to change the issue - from one of the very large increase in total compensation of large firm CEOs to the "motherhood" issues of enabling new businesses to be successful and jobs to be created.

Warren Buffet, the premier American investor of the age and a dedicated student of accounting, submitted testimony for the Senate hearings that give some evidence why the annual report of Berkshire Hathaway is considered a literary as well as a financial event. "[S]o the argument proceeds... [new companies] will find new capital too expensive if they must charge against earnings the full compensation costs implicit in the value of the options they issue. In effect, the people making this argument want managers at those companies to tell their employees that the options given them are immensely valuable while they simultaneously tell the owners of the corporation that the options are cost-free. This financial schizophrenia, so it is argued, fosters the national interest, in that it aids entrepreneurs and the start-up companies we need to reinvigorate the economy. Let me point out the absurdities to which that line of thought leads. For example, it is also in the national interest that American industry spend significant sums on research and development. To encourage business to increase such spending, we might allow these costs, too, to be recorded only in the footnotes so that they do not reduce reported earnings. In other words, once you adopt the idea of pursuing social goals by mandating bizarre accounting, the possibilities are endless."<sup>[xxviii]</sup>

The ultimate skill of the Roundtable was in successfully defining the terms of discussion so as to avoid consideration of the reality that options are preponderantly a question of CEO and top executive compensation. Institutional Shareholder Services (ISS) found that, in 1992, the top 15 individuals in each company received 97% of the stock options issued to all employees. *Business Week* wrote for all to read: "[T]he 200 largest corporations set aside nearly

10% of their stock for top executives... in almost all cases, moreover, it's the superstar CEO who takes the lion's share of these stock rewards."[\[xxix\]](#)

Warren Buffett's last word[\[xxx\]](#) to Senator Chris Dodd, Chairman of the Securities Subcommittee of the Senate Committee on Banking, is a refreshing reminder that what was at stake is not a matter of principle - that is long since decided - it is a matter of power. "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 rulemakers, 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 that 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 that the tail is a leg."

What happened in this matter is that a previously respected independent professional organization inadvertently challenged the "right" of American CEOs not only to compensate themselves but to **continue to do so without any impact on the financial statements. "Stealth compensation" won.** The focused leadership of the BRT was able to accomplish this without leaving any fingerprints behind. They were able to demonstrate the inability of the large accounting firms to maintain independence; the enthusiasm of virtually the entire U.S. Senate to adopt a politically popular but commercially mischievous practice; and the fragility of the self-regulatory organizations whose expertise and independence were thought as essential components of a workable system of corporate governance.

In sporting terms this was a game where the players disagreed with the referees, beat them up severely and returned to play the game according to their own rules. The accounting profession with its self-regulatory traditions has always seemed the best hope for those who perceive the utility of independent experts in a system of effective corporate governance.[\[xxxi\]](#)

Notwithstanding the hopes of those like Peter F. Drucker for periodic "audits" to ensure an acceptable level of governance, one is forced to conclude that there is no such thing as an "independent service provider" in today's free market America. Lawyers will give opinions to the taste of those who pay them; virtually every great investment banking firm in America created for their clients huge fortunes in the 1980s by rendering "fairness opinions" that were as "convenient" as they were wrong; compensation consultants are hired by corporate managements - enough said.

### **Corporate Power and Freedom of the Press**

An effective system of governance in the United States depends on the continued existence of a free and energetic press. We must recognize that the continued effectiveness of the press as an independent monitor rests on slender supports. There is always the problem of the power of advertisers and the potential for censorship. The principal national Television Networks are owned by major conglomerates: Westinghouse has recently acquired CBS, Disney owns ABC and **GE** owns NBC. Major business magazines (with the exception of *Forbes*, which has never published an article offensive to advertisers) are also part of publicly owned companies - Time Warner owns *Fortune* and McGraw Hill owns *Business Week*.[\[xxxii\]](#)

Profit considerations will doubtless be accorded great significance when questions of agenda, tone and critical conclusions arise.

### **Pressures for Increased Government Involvement**

The impact of unaccountable chief executive officer power<sup>[xxxiii]</sup> has not gone unnoticed in the national political dialogue. Indeed, CEO pay has been described as the “smoking gun” that proves the impotence of existing governance systems. In 1993, the Congress purported to limit top executive compensation by denying tax deductibility to payments in excess of \$1 million that were unrelated to productivity. Predictably and unhappily the only impact of this law has been further to enrich accountants and compensation consultants. CEO pay continues to increase.

During the presidential primary season of early 1996, the impact of corporate downsizing, plant closings and the according layoff of tens of thousands of employees was politically irresistible. Labor Secretary Robert Reich, Senators Ted Kennedy and Jeff Bingaman, among others, promulgated ambitious programs to reward “good” corporations and punish “bad” ones. President Clinton has so far contented himself with the statesman posture of “jaw boning.”

There has developed the beginning of a public agenda for corporate accountability, the possible implementation of which will depend importantly on the result of the November 1996 election.

“The National Economic Council proposed that companies voluntarily adopt five principles of good corporate citizenship providing [1] “family friendly” workplaces, which recognise the need for flexible work schedules; [2] health care and pension benefits; [3] safe and healthy work environments; [4] investment in employee education and training and [5] giving employees more voice in the workplace.”<sup>[xxxiv]</sup>

### **Factors Limiting Government Effectiveness**

Corporations are able to pay the highest prices for goods and services. The most prestigious professions depend on securing their share of corporate business in order to prosper. This leverage has been compounded in recent times by increasing percentages (over past decades) of the “best talent” entering business related professions.<sup>[xxxv]</sup>

The sheer talent available to business has had vast impact in its relationship with government. Consider a situation where the stakes are high enough to warrant litigation. **GE** recently overwhelmed the government and secured a rare acquittal in a case involving alleged price fixing in the diamond markets. “The government prosecutors were outspent, they were outnumbered, and in the end... they were outlawyered. A de facto 25-lawyer powerhouse firm -- composed of top litigators from 475-lawyer Winston & Strawn, 380-lawyer Arnold & Porter, and Columbus’ 256-lawyer Porter, Wright, Morris & Arthur [the trial was located in Columbus], in addition to **GE’s** Kindler -- opened its doors for two months in Columbus this fall and simply blew away the smaller, less cohesive, seemingly less prepared, and less experienced government team. There is perhaps no better example of the tired advice “get yourself a good lawyer;” the government’s case may have been there, but [**GE**] took it away... **GE** mustered an army, sparing no expense. While a guilty verdict probably would have resulted in a verdict of up to \$10 million, the company spent “approximately \$20 million” on outside costs, according to one knowledgeable **GE** source, and several million more on internal costs, to defend itself against the price-fixing charges and related civil claims.”<sup>[xxxvi]</sup> There must be a serious question as to the capacity of the United States government today to prevail in legal proceeding against a major corporation on an issue that the company decides is essential.

## Corporate Crime - How to Account for It

Then there is that last alternative. If you can't beat them in court, or change the law, just go ahead and pay the fine. From the perspective of company management, the decision whether to obey the law is simply a cost/benefit calculation. Will the costs of disobedience (discounted by the probability of being discovered, prosecuted and fined (there is almost no risk of jail)) equal the costs of compliance. Obeying the law is the duty of every citizen, but is this one of those instances where corporations are not exactly like other citizens? This raises not only the accounting questions of the appropriate level of investigation and reporting of non compliance with law in the financial statements but also the fundamental question as to whether society possesses any effective means of requiring corporations to obey particular societal signals. We need to think seriously as to whether a society so constructed can - or should - long endure.

Some of the greatest of American corporations have found themselves guilty of criminal violation of government contract laws.<sup>[xxxvii]</sup> By creating a category of "crime," government sends an unmistakable signal that the described conduct is incompatible with the interests of society. This is the ultimate expression by civil authority of its right and obligation to provide society with protection against certain unacceptable conduct. Whether or not a person chooses to comply with a criminal statute is immaterial. And yet, laws on corporate crime neither deter repeat offenders nor lower the esteem in which they are held by the public and stock market.<sup>[xxxviii]</sup>

Nor is there any evidence of a public boycott of the products of these "criminals." The scope of the recent spate of criminal convictions obtained from Project Illwind in 1987 extended virtually to the entire defense industry which makes a mockery out of the entire concept of a standard of criminal conduct for defense related corporations: "Investigators reeled off some impressive statistics for him [the Assistant Attorney General, now Governor of Massachusetts, William Weld]: In the end, more than fifteen hundred individuals could be classified as being subject to the probe. **Sixteen of the nation's top twenty defense contractors were under varying degrees of scrutiny.** Seeking clarification, Weld posed some question. "Do you mean to tell me," he probed with a deadpan expression, "if we blackball all these companies at the same time, the government would hardly have any contractors left to deal with?"<sup>[xxxix]</sup> Humor is certainly preferable to anger, but the notion that laws may be unenforceable because nobody complies with them raises the most serious questions. Either the laws are so poorly conceived that they should be amended or repealed, or a different corporate culture needs to be developed.<sup>[xl]</sup> Is a pattern of criminality material to the financial statements of a company? To the re-election of the directors who presided over this activity? Should accountants be obligated to "certify" that to the best of their knowledge the audited company is in compliance with law?

Nor has the marketplace indicated a disinclination by investors to value companies highly whose earnings may derive from sources or conduct that government intends to discourage. We return to **GE**. *Fortune* magazine crowned **GE** and its charismatic leader Jack Welch as the most successful generators of shareholder value of any American corporate management. Little more than fifteen months earlier, *Fortune* characterized **GE's** problems with its brokerage house acquisition: "Most troubling is that ... misdeeds.. are not an isolated case at **GE**. When you put the Kidder scandal together with other transgressions that have sullied **GE's** reputation over the past decade you begin to get a sense that somewhere in the highly successful and celebrated **GE** culture something is not right.<sup>[xli]</sup>

When the market place overwhelmingly approves and supports companies whose activities have been repeatedly branded as "criminal," it seems clear that government does not have any effective means of inhibiting what it characterizes as unacceptable corporate conduct.<sup>[xlii]</sup>

### 3. Conclusion

- Even the most successful corporate systems in the post-Communist era has within it serious threats to the citizens of a free society. Corporate power over the state tends to inhibit appropriate attention to non-profit generating consideration.
- Communism and total government control plainly is a failure, but what will be the nature of government involvement in victorious capitalism has yet to become clear. An indispensable element must be the possession by popularly elected government of power to define the language of accountability of business to society.
- Notwithstanding much talk of government employee, stakeholder and shareholder power, the prevailing governance system in the United States boils down to the CEO acting as a trustee for the public good. Some have proven to have a spacious view, others a more narrow one. The problem remains the inappropriateness of locating so much unaccountable power in a free society otherwise than through general election.
- American competitive success in world business is largely a function of the willingness of the American people to subordinate all considerations to those leading to maximization of profit as defined by CEOs. There may come a time when Americans conclude that they are paying too high a price and change the existing governance system.
- Unhappily, the experience with government involvement in business is virtually one of consistent frustration and failure to achieve satisfactory objectives. The challenge for Americans is to devise an acceptable system of governance that will forestall the necessity (or need, if you prefer) of government involvement.
- This requirement is particularly important due to the increasing internationalization of business and the capacity to relocate domicile in the least intrusive legal and regulatory structure (the familiar "race to the bottom").
- Corporations are capable of focusing so much human talent and resources to the resolution of issues in their favor that one must doubt the capacity of *any* outside force meaningfully to require accountability for management.
- Effective governance is essential to the healthy growth of capitalism in democracies. The present "non system" does not work in the United States. We have little choice. We must use the components that exist. The question can no longer be whether the institutional shareholders want the responsibility of ownership, nor even whether in their present configuration they are capable of exercising it. Our society can no longer afford corporate owners who do not organize themselves to be responsible with the same tenacity and ingenuity they employ to assert rights.
- Institutional owners have a pocket book interest in expending resources to investigate corporate functions; they have the power (over 50% of total shareholding in the United States, more in the United Kingdom) to effect change; they are international in scope (welcome "CalPERS"); they operate with great flexibility under government mandate; and they are trustees for beneficial owners (approximately 100 million people in the United States) comprising a valid proxy for the population as a whole. Institutional shareholders possess the characteristics essential for an effective corporate monitor - a party to whom management can be held effectively accountable.
- Nothing meaningful will occur, however, unless the three most affected parties conclude that it is in their self-interest for the changes to take place. The government must explicitly adopt the policy that commercial competitiveness is a national priority and that an effective governance system is a necessary precondition for such success. Government can view a system in which its guidance significantly provides a framework within which institutional owners effectuate the oversight necessary for legitimacy and competitiveness as one that affords adequate protection

against the threats of excessive corporate power for the citizens. Institutional investors need a government drawn “bright line” delineating the obligations of institutions to act as owner and the limits of permissible conflict of interest in acting as a fiduciary. Conflict has been so rife over the last twenty years that government’s acquiescence has created the impression that the fiduciary rules will not be enforced. So long as government takes this attitude, it is folly to expect commercial enterprises voluntarily to complicate their lives and diminish their profits.

· Most importantly, management of the great American corporations - the leadership of the Business Round Table - will need to adopt the notion that “creative tension” between themselves and their owners is a preferable system of governance than other alternatives, including a continuation of the present one that might be styled “apparent governance.” There have been indications that the necessary statesmanship can be forthcoming.

## ENDNOTES

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\* For reference to extensive further writings on governance based on institutional investor involvement, see <http://www.lens-inc.com/academic.html>

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[i] Adolph A. Berle, *The American Economic Republic*, Harcourt Brace, 1965, xvii. “Compared with the system of any other great nation, the American economic republic is the most successful in the modern world.”

[ii] *The Economist*, “A Survey of American Business, Back on Top?”, September 16, 1995.

[iii] Joseph Schumpeter ended his distinguished career as a professor at Harvard University in 1951. His memorable phrase that “capitalism is a process of creative self-destruction” is doubtless that which is referred to in the text.

[iv] *The Economist*, “A Survey of American Business, Back on Top?”, September 16, 1995. A prominent supporter of NAFTA was Republican businessman William Farley, CEO and owner of Fruit of the Loom, who was nevertheless compelled to relocate over half of his production outside of the United States within six months of the treaty’s passage.

[v] William Greider, *Who Will Tell the People?*, (1992), Chapter 15.

[vi] The Progressive Policy Institute, which was given pre-1992 election credit for defining the “New Democratic” party, proposed reforms that would save \$131.2 billion over five years (Robert J. Shapiro, *Cut-and-Invest A budget Strategy for the New Economy*, Progressive Policy Institute Policy Report No. 23, March 1995, at p 17.) while Cato Institute, a leading libertarian think tank, recommends “getting businesses off the \$80 billion annual dole (Linda Grant and Robert F. Black, *Getting Business off the Dole*, U.S. News & World Report, April 10, 1995, at p 38.)

[vii] Dick Arney, *How Taxes Corrupt*, Wall Street Journal, June 19, 1996, p. A-20.

[viii] Ibid

[ix] Stephen Moore and Dean Stansel, *Ending Corporate Welfare as we Know It*, Cato Institute, Policy Analysis No. 225, May 12, 1995.

[x] Let's pause to consider the functioning of one such PAC in the politically sensitive defense industry: "...Kane's umbrella organization, called the Long Island Aerospace PAC, raised more than \$1.2 million in just a few years. He created it and ran it like one of his family companies. Kane employees provided clerical support. Committee records were stored in his office. The list accountant was his personal accountant... the organization was a coercive instrument of Grumman's political agenda, and some of its methods were branded as a sophisticated form of corporate extortion.... Subcontractors that value Grumman as a customer knew that they had better give Kane the contributions... Grumman purchasing officials were in charge of collecting campaign donations .. The impetus came from the top. Employees who aggressively raised campaign loot were rewarded with promotions and bonuses... Another time the irate chairman ordered Grumman's to stop buying from a valued but politically recalcitrant supplier called Monitor Aerospace. The subcontractor quickly toed the line and rejoined Kane's lobbying association. 'Not to do business with Monitor because [it wasn't] a member ... was insanity' the shocked executive told prosecutors afterward. Andy Pasztor, *When The Pentagon was for Sale - Inside America's Biggest Defense Scandal*, (Scribner, 1995) at p. 343, 344.

[xi] [W]hile special interests have been lavishing soft money on both parties for more than a decade, some experts believe that it's now being used more blatantly to influence the parties and policy makers. Consider the beleaguered tobacco industry, which has long been a big soft-money donor to both parties. The Food and Drug Administration move this year to regulate nicotine as a drug.... Not surprisingly, perhaps, the tobacco industry has been channeling record amounts of soft money to the Republicans. In fact, the three leading soft-money contributors to the Republican party in the first half of 1995 were Philip Morris Cos. Inc. (\$729,749), RJR Nabisco Washington Inc. (\$286,450) and Brown & Williamson Tobacco Corp. (\$260,000). Philip Morris's contributions represent a more than sevenfold increase over its soft-money gifts of \$99,000 to both parties in the same period in 1994... Peter H. Stone, *Labyrinth of Loopholes*, National Journal, 11/25/95, 2912, 2914.

[xii] Time Magazine, June 24, 1996, p. 26.

[xiii] Market forces create substantial pressure on business to decrease costs and increase profits by increasing efficiency. The corporate rationalists fail to mention that one way firms increase their "efficiency" is to externalize more of their costs. As ecological economist Nevi Goodwill observed, 'power is largely what externalities are about. What's the point of having power, if you can't use it to externalize your costs - to make them fall on someone else?' - David C. Korten, *When Corporations Rule the World*, Kumarian Press and Barrett-Koehler Publishers (1995), p. 77.

[xiv] We will later consider its involvement in the social and cultural spheres.

[xv] The idea of a public-private partnership in managing the economy does not win applause in all quarters... Such coordination has its eminent antecedents in the American past. Indeed it calls for the restoration of the spirit in public good, of the general welfare. **The tradition of affirmative government is quite as authentically American, quite as deeply ingrained in our national history, quite as strongly identified with our greatest statesmen, quite as expressive of American ideas and character, as the competing tradition of self-interest and private enterprise.**" (emphasis added). Arthur Schlesinger, op cit supra, at p 225 [quote from article by Frank Rich, *Fear and Favor*, New York Times, November 15, 1995]

[xvi] If there is one subject on which there is world wide agreement, it is respect for the quality of financial disclosure in the United States.

[xvii] Securities & Exchange Commissioner Steven Wallman states flatly: "It is troubling then that financial accounting and disclosure are no longer keeping pace with changes in the business world. Competitive challenges and novel corporate opportunities appear more quickly now than ever before. Stephen M.H. Wallman, *Updating Disclosure for a New Century*, New York Times, September 24, 1995, Section F. at p. 14.

[xviii] Thomas A. Stewart, *Trying to Grasp the Intangible*, Fortune, October 2, 1995, p. 157.

[xix] Sir Adrian Cadbury, *The Company Chairman (2nd Ed.)*, (Director Books, 1995) at p. 146.

[xx] Cadbury, op cit supra, at 318.

[xxi] Kim McQuaid, *Big Business and Presidential Power: From FDR to Reagan*, William Morrow, New York, 1982, p. 308.

[xxii] Tim Smart, *Knights of the Roundtable: Tracking Big Business' Agenda in Washington*," Business Week, October 21, 1988, p. 39.

[xxiii] Letter from John S. Reed on the Letterhead of The Business Roundtable, dated June 23, 1992. Emphasis added twice to the word Education.

[xxiv] Alison Leigh Cowan, *Executives are Fuming over Data on Their Pay*, New York Times, August 25, 1993, Section D, Page 1, Column 3.

[xxv] Walter P. Schuetze, *A Mountain or a Molehill*, Twenty-First Annual National Conference of the AICPA, January 11, 1994, at p. 8.

[xxvi] "In 1984 and 1985, in response to the Invitation to Comment that began the FASB's reconsideration of the existing accounting rules for stock options granted to employees, all of the then Big Eight accounting firms except one wrote to the FASB supporting (a) reconsideration of the accounting rules and (b) a charge to compensation cost/expense for all options granted to employees. But in February 1993, even before the FASB issued its exposure draft on the subject on June 30, 1993, all of the Big Six accounting firms joined forces with certain members of industry and a group of users to recommend to the FASB that there be no formal recognition for the cost of stock options. (I understand that the AICPA's Accounting Standards Executive Committee recently changed its mind and now will recommend to the FASB that there be no recognition for the cost of fixed stock options.) The Big Six accounting firms did not, in February 1993, offer an explanation for their change of mind. I would be the first to say that anyone could change his or her mind. I have changed my mind on several accounting issues over the years. But, I think that the public deserves an acknowledgment of that change of mind by the firms and the reason why. Such a change in position, without a corresponding change in the underlying concepts and issues that led the firms and the AICPA initially to support the FASB's project, has left some members of the public with the impression that the switch was in response to the fear of losing clients or other forms of retaliation. I do not know if this is true.

[xxvii] "Recognizing that the public might see free trade as a special-interest issue if touted by an exclusive club of the country's 200 largest transnationals, the Roundtable created a front organization, USA\*NAFTA, that enrolls some 2,300 U.S. corporations and associations as members. Although USA\*NAFTA claimed to represent a broader constituency, every one of its state captains was a corporate member of the Business Roundtable." Korten, op cit supra, at 145.

[xxviii] Buffet, letter, op cit supra.

[xxix] Business Week, April 24, 1995, p. 93.

[xxx] Letter dated October 18, 1993 included with records of Subcommittee Hearings dated October 21, 1993.

[xxxii] The struggle continues to this day with SEC Chairman Arthur Levitt trying to preserve a measure of independence for FASB over the continuing objections of big business.

[xxxiii] In the current *Columbia Journalism Review*, a troubling behind-the-scenes account of ABC's apology to Philip Morris is followed by an even more alarming article that portrays Disney's new president, the former agent Michael Orvitz, as a ruthless foe and manipulator of news organizations. ... The press isn't perfect, but if anyone doubts that its freedom is essential to democracy, the covering of ABC and CBS before Big Tobacco is a perfect illustration. In 1995, tobacco corporations are by far the biggest contributors to the Republican Party - which is why, for instance, Bob Dole is more likely to attack the cultural industry that poisons children's minds than take on the tobacco industry that poisons their lungs. If bottomless corporate coffers can both buy off elected officials and scare off news organizations as huge as CBS, who will defend the public interest. Frank Rich, *Fear and Favor*, New York Times, November 15, 1995.

[xxxiiii] At a time when several CEOs of very large companies have prematurely been removed from their positions, it may seem inappropriate to describe their power as "unaccountable." In the author's view, however, the continuing capacity of CEOs to compensate themselves at levels without precedent and without reflection on the fate of other corporate constituencies suggest that for the aspect of corporate governance of greatest personal significance -- i.e., their own pay -- CEOs continue to be able to sign their own paychecks.

[xxxv] Nancy Dunne, Financial Times, Monday, June 17, 1996.

[xxxvi] Money also seems to have contributed to the most important set of career changes that took place in the past twenty-five years: the movement of tens of thousands of highly educated students away from teaching and government service into more highly paid jobs in private business law practice. As we have observed, not only did the numbers of young people entering schools of law and business double and treble; their intellectual level also rose significantly. In 1950, law and MBA students were only of average ability; their test scores were far below those of classmates in medical schools, engineering or graduate (Ph.D.) studies, by 1990, the situation had changed; business now rivaled that of applicants to any other graduate or professional school. Derek Bok, *The Cost of Talent How Executives and professionals Are Paid and How It Affects America*, Free Press, 1993, at p. 89.

[xxxvii] William W. Home, *GE Crushes the Trustbusters*, The American Lawyer, January 1995, page 57.

[xxxviii] "What follows is a list of the 22 companies that have signed the lobbying position paper urging that the False Claims Act be weakened. The company name is followed by a number that represents the number of fraudulent activities uncovered by the Project. The survey covers cases publicized just since 1990. The Boeing Company (4); Eaton Corporation (2); FMC Corporation (0), General Electric (16); Grumman Corporation (5); GTE Government Systems (0); Honeywell Inc. (3); Hughes Aircraft Company (9); Litton Industries (4); Magnavox Electronics (3); Martin Marietta Corp. (5); McDonnell Douglas (4); Newport News Shipbuilding (1); Northrop Corporation (4); Raytheon Company (4); Rockwell International (4); Sundstrand Corporation (1); Teledyne Corporation (5), Texas Instruments (3); TRW Inc. (1); Unisys Corporation (20); United Technologies (3), *Corporate Crime Reporter*, Volume 8, Number 9, page 2,3 February 28, 1994.

[xxxix] In annual surveys conducted by *Fortune* magazine, Boeing consistently ranks among the country's most respected corporations. *Fortune's* February 1993 issue, published almost three years after Operation Uncover disappeared from the headlines, showed the firm's resilience. Boeing made the list of the ten "most admired" companies, alongside phenomenally successful consumer-goods marketers such as Procter & Gamble, Wal-Mart Stores, and Coca-Cola. Pindy

Pasztor, *When the Pentagon was for Sale - Inside America's Biggest Defense Scandal*, (Scribner, 1995) at 264.

[xxxix] Ibid. at 318

[xli] One of the frequent comments by corporate leaders is that Congress has so trivialized the concept of Criminality in law - presumably for political reason - that there is *sub silentio* understanding that it will not be enforced.

[xlii] Kidder Peabody is not the only one of **GE's** businesses to be rocked by scandal on Jack Welch's watch. Herewith an unsettling long but incomplete list of **GE's** wrongdoings over the past decade. Only settled incidents are listed.

**1993 GE's** NBC News unit issues an on-air apology to General Motors for staging a misleading stimulated crash test. NBC agrees to pay GM's estimated \$1 million legal and investigation expenses.

**1992 GE** pleads guilty to defrauding the Pentagon of more than \$30 million in the sale of military jet engines to Israel after an employee received bribes. **GE** pays \$69 million in fines.

**1990 GE** is convicted of defrauding the Defense Department by overcharging the Army for a battlefield computer system. **GE** pays \$30 million in penalties for that and other defense contracting overcharges.

**1989 GE** settled four civil suits brought by whistle blowers who alleged that **GE** cheated the government out of millions of dollars by issuing faulty time cards' **GE** pays some \$3.5 million.

**1985 GE** pleads guilty to fraud charges for overcharging the Air Force on its Minuteman missile contract; **GE** agrees to pay \$2 million in criminal and civil penalties. "A Washington, D.C. based public interest group, The Project on Government Oversight, studied the histories of these companies and found that they had been engaged in adjudicated fraudulent activities, some of them criminal, many of them having been convicted three or more times...The study found that General Electric engaged in fraudulent activities 16 times since 1990.." Russell Mokhiber, Soft on Crime. Internet. Note also "General Electric continues its reign as the top U.S. company in market value." [\$120bb] *Business Week*, January 15, 1996, p 6.

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