Careless language or cunning propaganda

By Robert A.G. Monks

Introduction

I am glad to have the opportunity to speak to you about an issue very close to my heart. It is one on which I have spent much of my life's work – and is probably the topic most of you know me for. Of course, I am talking about Corporate Governance. I am both encouraged and troubled by the state of governance. As I look back over the past thirty to forty years I am heartened and proud that the issues we first raised in the eighties are part of common public discourse about publicly held corporations. It is, indeed, a very good thing when governance topics are a major portion of discussion every proxy season. Still, there is something not quite right about this discussion. We seem stalled at a point in our progression and governance resolutions never seem to gain any steam. We can discuss governance provisions until the cows come home but ultimately our goal is (and always has been) to make change in the way corporations function. So why are we stalled? Why do we never get beyond resolutions and stewardship codes? That's what I want to talk about today and I look forward to your response.

Speech

"…empty corporation statutes – towering skyscrapers of rusting girders internally welded together and containing nothing but wind"

– Bayliss Manning

There is a sense that corporate functioning today is not understandable under the law but is best approached as a study of the expression of power. The beginning of power is control over language. At the point at which words are consistently used in a manner contrary to their traditional and commonly understood meanings, we have to ask whether this is careless evolution or whether it is contrived as a mode of acquiring and legitimating power.

Each scholar inclines to speak from his own specialty with little conscience of the need for holistic expression. It is almost as if everyone is so sufficiently comfortable – intellectually and otherwise –that they do not want to upset the status quo. Let me provide a quick illustration (I will write in more detail below) about boards of directors: Directors appear to be utterly incapable of administering the principal conflict of interest – executive compensation – between owner and employee. So how can we believe that they are any more effective in areas where objective evaluation is not possible?

We are tormented with the ever more intricate notions of what a truly “independent” director can assure along with the salvation promised by specialist board committees made up of these “independents.” But at a certain level of consciousness, we know with certainty that the products of a self-perpetuating system can never really be independent of the people and process that created them. Why is this nonsense perpetuated? From the ferocity of opposition to even the most improbable and theoretic reforms, we must understand that there is something highly prized and yet undisclosed in the present system. Our only conclusion can be that this energy has discouraged scholarship and inquiry. Indeed, one of the finest current scholars of corporate law – Melvin A. Eisenberg – has abandoned it to study contracts.

I often muse about a cultural anthropologist of the twenty-second century, who, on encountering a description of the board of directors of the American publicly traded company, asks the question: what could one expect such a body to accomplish? What is the purpose of a self-selected group comprised of part time semi-skilled individuals whose primary concern is loyalty to the “club” rather than a fiduciary responsibility for the owners? If she were very wise she might conclude that “they had this board system because it pleased the leaders of most sectors of society.” The CEOs can piously recite that they are accountable to their board; the board members feel important (while being overpaid); and the government (who is powerless anyway) can say that the problems of corporations should be a private sector concern.

The fundamental dynamics of Corporate Governance have been diluted into virtual meaninglessness. So, to return to the Bayless Manning quote about corporate statutes that contain nothing but wind, I propose to talk about the language, the words that we use when discussing corporate and board function. We all know what these words mean in a literal sense but in the context of governance, of business and of our post-crash world do they still mean the same thing? I sometimes refer to board function as theater but it's really more like a magic show. The performers distract you while performing feats of illusion.

1. **What do we mean when we talk about *electing* directors? What does the word Elect mean in the context of corporations and corporate governance?**

To start, the process by which directors are chosen is described as an *election*. And yet, virtually no one would describe the reality of how individuals accede to board membership as an *election* in the sense that word is generally understood by political scientists – or by the general public. It is at least clear that no individual appears on the company's proxy statement for *election* to the board except with the approval of the chief executive officer and the incumbent board members. It is equally clear that there are only as many individuals enumerated on the proxy card as there are vacancies. In what sense is this *election* in the democratic sense of the word?

All of this compels the conclusion that the *election* is a ritual without meaning in the corporate world. Why then do we insist on using a word that plainly does not describe what actually happens? This evokes the marvelous novels describing "doublethink" – *1984* and *Brave New World* **–**

> "This was where "doublethink" came into play, minds were trained to hold contradictory positions simultaneously and unquestioningly – for example you had to believe at one and the same time that Democracy was impossible and that the Party

was the guardian of democracy." (Orwell, *Nineteen Eighty-Four*)

2. **What does it mean to be a shareholder or "owner" in 2015?**

Over 80 years ago, Adolph Berle wrote about "...the dissolution of the old atom of ownership into its component parts, control and benefit ownership." Very crudely, this means there are owners who only want a return on their investment and there are owners who want to have a say in how their investment is used.

These two very broad umbrella categories cover a myriad of interests held by owners. Ira Millstein's telling metaphor describes shareholders as a garden comprised of vegetables with very characteristics. Like any other cross section of society, owners are a diverse group with diverging (and conflicting) interests. And, since modern *ownership* sometimes amounts to short term holdings managed by computer algorithms, people do not always see themselves as *owners* (indeed, even if they ever know of this "ownership").

The Delaware Chancery Court has identified two different categories of shareholder – arbitrageurs and the rest – in holding that the board acts correctly in serving the interest of the rest (*Air Products v. Airgas*). If a court is at liberty to decide which category of shareholder a director is obligated to serve, the disciplining impact of "hostile takeovers" is diluted significantly.

Under the present conditions where shareholders do not share a common interest – indeed, their interests may be diametrically opposed – and the traditional pillar of corporate law and governance that accountability to ownership is the duty of management must be crumbling. And without the involvement of active and engaged shareholders, the entire corporate system lacks its basic foundation.

Where there is no identifiable group on whom to focus the fiduciary responsibilities of management, a new basis for corporate legitimacy is needed.

3. **Independence & Legal Independence**

Effective governance of corporations requires that the board include individuals and committees independent of the management. Under the current system, in which boards of directors are essentially self-perpetuating, it strains credulity that any individual board member could be considered to be "independent" of the board and the CEO. Directors chosen and endorsed by management inherently have a conflict of interest. Those entrusted with auditing and compensating management cannot be dependent on the favor of management without destroying the legitimacy of the process.

The criteria for independence is defined according to the charter of each corporation, state incorporation statutes and the various Stock Exchanges. In a submission to the Harvard Law School Corporate Governance Forum, Martin Lipton recently wrote: "friends can and should be independent directors. There is absolutely no basis for second-guessing a board's reasonable determination that a friend of the CEO, or a friend of another director, is independent." Plainly, there is such a thing as legal independence but is it that we want or does it operate so as to legitimate a management-based power structure?

Legal independence is a construction that exists outside reality. A legally independent director may or not be independent-minded. People want to be directors, it is a coveted position. If an individual is "gifted" a directorship it seems naïve to believe that he will be independent of the person who offers him the position. The only way to characterize an individual as truly independent is to have him nominated from outside the present power system.

Specific criteria of independence are often painfully wrought, but does compliance with them assure the real independence essential for a system of effective governance? Can the corporate system flourish in reliance on “legally independent” compensation committees, audit committees and their creatures?

4. Trustees

It’s likely that a majority of the voting shares of all publicly traded companies are held by “trustees” – legal creatures with the obligation to responsibly manage trust property for “the exclusive benefit [ERISA terminology]” of “plan participants.” The ancient, unchanging and inveterate requirement of trust law and practice is that the trustee is not permitted to serve his own objectives when they are in conflict with those of trust beneficiaries.

With a few rare and honorable exceptions, trustees – including universities, foundations and even the most enlightened corporations’ pension funds – deliberately decline to take steps as activist shareholders. There is no recorded judicial effort to enforce trust principles; there has been no action by regulators; and there hasn’t been any derivative litigation on behalf of the beneficiaries.

What this means is that mutual funds, employee benefit plans and other relationships styled as trusts are trusts in name only, and not in substance. Truly, a trustee who actively pursues the interests of their beneficiaries is in a precarious position. Good guys can’t be good because they’re at a competitive disadvantage. So we’re left with layers of conflicts. Among them:

- When the trustee is a member of a conglomerate group, pursuing beneficiary interest could put them into conflict with their parent company. If the fiduciary portfolios include tradable shares from other parts of the conglomerate, how do you proceed? On behalf of the beneficiary or the parent company?

- When university or foundation trustees also represent companies in the trust portfolio, which interest takes priority? Engaging such a company raises questions of comity and collegiality within the board and can make for difficult relationships.

- There has long been a rumored "Golden Rule" for ERISA plans: "You leave my company alone and our pension plan will leave your company alone." Whether or not this is hyperbole, there has never been a recorded case of activism by an ERISA plan. When a trustee is serving as fiduciary for a company employee benefit plan, he might well be acting contrary to the commercial interest of the sponsor company (company whose employees join the plan) by raising questions about the management of companies in the pension portfolio.

So long as these important institutional investors can ignore legal fiduciary obligation with respect to portfolio companies, this significant block of shares is effectively sterilized. And, because entire categories of investors decide not to participate, they succeed in trivializing those who do. As a result, critics of shareholder involvement can claim that only a limited group of shareholders are active and that their perspective is skewed.

5. **Directors**

There persists an almost desperate focus on the Board as the primary agent of effective corporate governance. Discussion about boards of directors is always confusing. There is no general agreement on the optimum scope of board responsibility. Indeed, Jay Lorsch and Marty Lipton conclude: "It is not an exaggeration to say that directors operate in a vacuum as to the purposes boards ought to be pursuing."

Peter Drucker has long raised the question as to whether the current standard of board functioning is so unsatisfactory as to require structural change. "Whenever an institution malfunctions as consistently as boards of directors have in nearly every major fiasco of the last forty or fifty years it is futile to blame men. It is the institution that malfunctions." ("*The Bored Board*," in *Toward the Next Economics and Other Essays* (Harper & Row, New York, *1981*)

In the years subsequent to Drucker's characterization, the utter failure to control executive compensation leads me to conclude that the current board model is derelict. If the principal cannot manage his agent's compensation, he has no right to assume that he exercises effective accountability in any other area.

It is time to recognize that a fundamental and irreconcilable conflict exists between the perception of what boards should do and how they should be comprised. Our efforts to achieve functionality within the context of the traditional single board can be understood as the inability to square a circle. We cannot hope to make progress until – once and for all – we face up to the reality that a self-selecting board cannot ever overcome conflicts of interest and achieve the real governance need for independence.

We may have to recognize that there is no single board solution. There are some board functions that absolutely depend on collegiality and confidentiality. There are other board functions that absolutely depend on "independence." Why not design a new board structure based on the very incompatibility of collegiality and independence? A self-perpetuating board might be the optimal instrument for strategy, succession and compliance, while independence is essential in those areas where conflict of interest between agent and principal are apparent. Enabled shareholder involvement could prove the best way to discharge the responsibilities involving conflicts of interest. **Without the involvement of active and engaged shareholders, the entire corporate system lacks its basic foundation**.

One model might be a shareholder proposal I first put to ExxonMobil twenty years ago. In order to incorporate shareholder initiative, I proposed a new Shareholder Advisory Committee at the 1992 Exxon Annual Meeting and the SEC required the company to include it in its proxy. It reads,

"This new committee, authorized by a by-law amendment, would consist of three paid representatives elected by the company's largest institutional shareholders; it would be funded with a penny a share by the company itself, and have a right to meet with the company, propose candidates for director and publish its views annually in the proxy statement. This is one way to deal with the adverse problems of "collective action" or "free riding" and to make possible economically rational involvement by conscientious fiduciaries (It is doubtful if any trust scheme would condone fiduciaries' failure to act pursuant to this by-law) and other shareholders."

6. **States as Laboratory**

When the possibility of a federal provision for shareholder access to the proxy ballot was proposed, the Business Roundtable wrote, "Recent SEC rules on proxy access, however, would impose a "one-size-fits-all" mandate and exacerbate focus on the short-term rather than long-term value creation… Congress should rescind the authority it gave the SEC on proxy access. This responsibility should remain in the purview of states and individual companies and their shareholders."[i]

Throughout American history, whenever the federal government has threatened involvement in areas of regulation – or more particularly, areas governed by state law – the affected parties evoke the beguiling image of state innovation and creativity, and claim state sovereignty to be under attack. This usually worthwhile experiment stimulated by competition among the states is, or has become, seriously flawed in the area of corporate governance. Competition only works if the states must bear the costs of the benefits they provide to entice corporations. Imagine, for example, that a **state** had the authority to exempt corporations from all **federal** environmental laws. Many states would enact this legislation to encourage corporations to incorporate there, while safe in the knowledge that most of the factories would be located elsewhere – along with the pollution, workers issues, health costs, etc. Economists call these costs externalities, and they present a problem with **state** corporation **law**. When a state can collect all of the benefit of corporate domicile but accrue none of the losses then they have no reason to address governance issues.

Are there any reasons that fundamental governance provisions should remain in the province of the states? At the risk of being simplistic, states want to attract corporations to charter (and locate) within their borders. This enhances tax revenue and employment with no correlative costs and is thus a reduction in the taxes for the present citizenry. Citigroup moving to North Dakota to take advantage of the absence of usury laws is an example of this. Corporate domicile is decided as a practical matter by the incumbent management. While statutes recite the need for shareholder approval, a careful reading by management usually provides the view that the capacity to pose the issue for a vote rests elsewhere.

And the same goes for the removal of corporate directors. Outside of the United States, shareholders in all OECD countries have the right (5%) to call a special meeting at which any or all directors may be removed with or without cause. This simple right is denied shareholders in Delaware. Just to be clear, they have the right to remove, but they have no right to call a meeting at which to exercise that right. Delaware corporate law is as flagrantly pro management as possible; stopping just short of raising a level of outrage that would generate support for federalization of corporate law.

And yet, Delaware with an alert, intelligent judiciary and bar is by no means the worst. There is much evidence of the “race to the bottom” in the competition between states. Consider for example the legislative response to Justice Powell’s opinion, reversing prior precedent (*CTS Corp v. Dynamics Corporation of America*) that state anti-trust laws were within the scope of the Federal Constitution. The Commonwealth of Pennsylvania twice broke every known barrier to protect local companies, Armstrong World Industries and Sovereign Bank.

There is precious little evidence that states will enact provisions that threaten the existing corporate power arrangements. And so, the Business Roundtable’s exhortation can be understood as a defense of the status quo. The gap between the glib language of the BRT and the realities of the corporate governance world is large.

7. **Long Term Shareholders**

There are two elements of societal interest in long-term investing: first is the perspective of the profit-making, publicly traded corporation, and second is the perspective of the investors in such companies. A corporation needs long term shareholding in order to permit allocation of resources so as to maximize long term value. Society loses when a corporation forgoes risky, long term commitments because they will reduce current “income” and, therefore, tend to depress valuation in the market place.

And then there is the risk that managers will lose their jobs. Is the focus on long-termism a euphemism for management protection? Long-term shareholders must be sure that corporate management is incentivized to carry out long term goals. Particular attention must be paid to: 1) options that are not indexed, 2) immediate rather than time-staggered vesting of incentive arrangements and, 3) termination incentives.

A corporation doesn’t care whether any particular shareholder is long term or short term, as long as a functional block of ownership – sufficient to control the venture (the “controlling block”) – is long term and effectively active. 90% of the shareholders of public companies are institutions and not flesh and blood human beings and roughly half of ownership is created by mechanical formulae, either a form of index or the result of algorithms. This means that something north of a third of the ownership of public companies is long term. Indeed, ownership is hard wired to be permanent. While there is an active trading market in ownership of index funds, the holdings of the funds in shares of large companies rarely changes very much. So long as there exists a long term “controlling block” in a particular corporation, there need no further concern as to whether the rest of the shareholders are long or short term.

The critical challenge is to develop incentives and structure so that the indexed 33% permanent shareholders can and want to act as stewards of the companies in which they have holdings.

8. **Globalization and the Corporation**

Global corporations have outgrown the limited boundaries of regulating domicile states and countries. Their reach and power are such that, for the time being, there is no regulation, oversight or even penalty effective enough or far-reaching enough to have true impact on how multinational corporations operate.

Corporations have always been creatures of, and indeed were created by, the sovereign state. There has always been an accepted "domicile" for corporations – in the U.S. it is the state which issued their charter. But while they operated under the aegis of one state, corporations have long manipulated their revenue sources between nation states so as to optimize their own net profit and minimize their taxes. Hence, what is arguably the most profitable company in the world – General Electric – pays no taxes in its country of origin. Now, we're seeing the practice of "regulatory arbitrage" become more widespread as companies locate their activities so as to avoid or minimize the impact of labor, environment and human rights regulations. Yet, they still rely on their nation of origin to negotiate on their behalf for favorable trade agreements. What does nationality (or state of incorporation) mean to corporations now – or in the future?

When corporations incur or cause damages– *see British Petroleum in the Gulf of Mexico 2010* – it is clear that the nation in which the harm occurred is the place where damages will be adjudicated and enforced. BP has previously (in Texas City in 2007) been involved in negligent/criminal activity to the level of requiring a special investigation (led by James A. Baker) and a kind of consent decree from the appropriate federal regulator. Even during the investigation into the Gulf Disaster it remained unclear whether the provisions of the earlier consent decree were complied with. There were specific requirements for the company to incur a culture of safety at all levels up to the board of directors. It would appear as if this did not, in fact, occur. Can the law of any one sovereign country have the teeth necessary to enforce change in a global corporation? And, in the case of BP, would the determining factor be UK law, pursuant to which the board of directors of BP is selected, or would it be US law where the incidents occurred and the settlements were negotiated?

What is the “nationality” of a global corporation? For example, it was quite surprising to many to discover the BP had a larger American ownership than British; and, of course, an American has recently been elected CEO. Exxon generates 30% of its earnings from the US; probably a minority of its employees works here. Clearly, it has obligations with respect to the places where facilities are located and employees live. But to what country does it owe loyalty and what shape does that loyalty take? Is the concept of national loyalty misplaced? Doesn’t the corporation owe a good faith undertaking to optimize its value to its owners, irrespective of the place where its headquarters or operations are located? Is it realistic to think of Exxon as an American corporation or BP as a British one? What are the implications if it is not?

Japanese kereitsu corporations are explicitly creatures of public policy and undertake projects in the “national interest.” The government makes the funds available for approved projects and, informally, holds the corporation without loss in situations like Mitsui’s in Iraq. This technique allows entrepreneurial energy to be used for the national interest and the corporate shareholders are not harmed.

There are specific rules governing foreign ownership of communications, banking and transportation facilities. How do we determine what makes a foreign owner or foreign corporation? Both the Business Roundtable and the Chamber of Commerce expressed horror at the notion of shareholders having access to the company’s proxy statement for the purpose of nominating directors – imagine the scene if foreign shareholders are able to take advantage of this, as well! In 2008, Senator Schumer led the opposition to a Dubai company taking control in operating major ports along the U.S. east coast. But very soon after that he was an enthusiastic supporter of Sovereign Wealth Funds investing in Manhattan banks.

9. **Stock buybacks**

One of the dirty little secrets of corporate management referred to (but not focused on) during recent investigations is the dual nature of the CEO's responsibilities: he must run the business but he must also – and this is no less important – run the stock. One reads frequently that management buys back stock because it is a better use of cash from a cost/benefit point of view.

Much scholarship has been devoted to the proposition that stock buybacks are simply a device to transfer wealth from shareholders to senior managers – particularly as the holders of mega grants of stock options. Buybacks provide a way to conceal the dilution that these grants of executive stock would otherwise cause – and be publicly seen as the cause – of shareholder equity.

Some have concluded that buying back stock is a confession of the inadequacy by management when identifying suitable projects for corporate development. In a world that is short of energy resources and where demand is growing predictably, doesn't it seem strange that multinational oil companies barely maintain their hydrocarbon reserves from year to year and yet are among the leaders in size of stock buybacks?

Are stock buybacks fair to the investing public? That is a key question: after all, the management has unique knowledge of the timing of corporate disclosures that will have impact on the market price. No board of directors has yet been found liable for negligence of fiduciary duty in stock buyback deals but consider the circumstance of several major financial companies: In the years 2005- 2007,

- Citigroup repurchased $20.457 billion worth of its outstanding shares;
- Merrill Lynch $18.01 billion;

– and Morgan Stanley $7.2 billion.

Furthermore, during the financial crisis years, each bank struggled to raise new capital – the absence of which was a major factor in requiring the active involvement of foreign investors and subsidy by the U.S. Federal Government. The first TARP tranche (respectively $billions, 20, 10, 10 for the companies named above) in September 2008 was a virtual mirror of the funds these companies had bought back from their shareholders during the previous three years.
We read endlessly about the "turnover" of shares – more than 100% of the outstanding every year – as evidence of the fickleness of shareholders and of their lack of entitlement to be treated as "real owners." On the one hand, we read of the high speed computer-driven trading programs and of the approximately 33% of all shares being held in index funds (or closet index funds). This creates a range from perpetual motion to virtual inertia so the average (or the mean) is virtually meaningless. The question I have is this: what is the turnover rate for shares that are purchased pursuant to the decision of flesh and blood investors?
Management of capital is the single most important responsibility for a financial institution so isn't it careless, or even negligent, of executives and boards to let capital fall dangerously low in a chase for quick returns?

CEO tenure is now briefer than ever before. This is taken as evidence of the fragility of their status, of their high-risk status. Occasionally, the details of the "termination arrangements" for CEOs are made public and some suggest that CEOs make more money by quitting and collecting on the acceleration of various "long term" rights than in continuing to work and taking their chances on stock prices in the future. Should we conclude that these generous provisions are appropriate recognition of the "risks" assumed by a CEO or should we view them as evidence of the asymmetrical power of CEO's and as an important, if inadvertent, force for merger or sale?
There is endless blather about the risks of liability for persons serving as director of public companies. It is the custom for corporations to indemnify directors against liability and it is the practice for companies to purchase Errors and Omissions insurance to fund any such liability. There are cases when both company and insurer become bankrupt and the question of director

liability is real. Over a lifetime of some fifty years, including service on the boards of a dozen publicly companies, I can call to mind only a handful of instances where there was final adjudication of liability. And, I know of only one or two in which the individual director has actually had to pay money out of their own pockets.

"Shareholder rights" may be in competition for the ultimate oxymoron among corporate governance terms. Evidence of this is in the magisterial language of the United States Supreme Court: Justice Kennedy in dismissing concerns of minority shareholders who disagreed with specific corporate political contributions concludes that, "There is little evidence of abuse that cannot be corrected by shareholders 'through the procedures of corporate democracy'." He also speaks of the transparency of political contributions which enables "the electorate to make informed decisions and give proper weight to different speakers and messages." Reality, of course, is that the references to shareholder democracy and transparency are at cruel variance with the observed practice by which management give large sums to intermediate "laundries," like the U.S. Chamber of Commerce, with no indication as to the identity of the ultimate recipient. The Supreme Court has simply ignored reality in concluding that the present practice of corporate governance provides meaningful protection for shareholders from the improper political use of their property.

The complete failure of Dodd-Frank to provide meaningful shareholder reforms stems from government focus on continued functioning of the stock market rather than with the workings of corporate governance. Or, John Cioffi put it this way in a summary of post-crisis reform: "Shareholders were marginalized within corporate governance, their interests framed and protected as participants in the stock market rather than in a firm"[ii]

"Sophisticated investor," "fiduciary duty," "independent director," and "long term investor" are concepts that advertise a mode of conduct that is, for the present, at variance with the practice. Why is there such wide spread and deliberate use of terms contrary to what informed people know to be the truth? Who benefits?

Ultimately, Corporate Governance is a modality in which critical words and categories are accepted in practice, notwithstanding their use contrary to accepted meaning. Why does this practice exist? And, why is there so little effort to confront the unnecessary problems it creates? The answer is the same as it has been throughout history: those with the power to correct misuse of languages and concepts are content with the way things are.

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[i] Business Roundtable, "Roadmap for Growth" (Business Roundtable.org, December 8, 2010).

[ii] John Cioffi, Public Law and Private Power, (Cornell, 2010), at p. 91.