



FIFTH EDITION

CORPORATE GOVERNANCE

ROBERT A. G. MONKS & NELL MINOW

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Robert A. G. Monks and Nell Minow



John Wiley & Sons, Ltd

This edition first published in 2011
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John Wiley & Sons Ltd, The Atrium, Southern Gate, Chichester, West Sussex, PO19 8SQ, United Kingdom

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Library of Congress Cataloging-in-Publication Data

Monks, Robert A. G., 1933–

Corporate governance / Robert A.G. Monks and Nell Minow. — 5th ed.

p. cm.

Includes bibliographical references and index.

ISBN 978-0-470-97259-5 (pbk.)

1. Corporate governance—United States. I. Minow, Nell, 1952– II. Title.

HD2745.M66 2011

658.4—dc22

2011013532

ISBN: 978-0-470-97259-5(pbk) ISBN: 978-0-470-97273-1(ebk)

ISBN: 978-0-470-97274-8(ebk) ISBN: 978-1-119-97773-5(ebk)

A catalogue record for this book is available from the British Library.

Typeset in Bembo Regular 10/11pt by Thomson Digital, New Delhi, India
Printed and bound in Great Britain by TJ International, Padstow, Cornwall

BRIEF CONTENTS

Introduction	1
1. What is a Corporation?	3
2. Shareholders: Ownership	101
3. Directors: Monitoring	251
4. Management: Performance	347
5. International Corporate Governance	415
6. Afterword: Final Thoughts and Future Directions	475

CONTENTS

<i>Cases in Point</i>	xiii
<i>Preface</i>	xvii
<i>Acknowledgments</i>	xxvii
<i>Introduction – How to Use this Book</i>	1
1. What is a Corporation?	3
Defining the Corporate Structure, Purpose, and Powers	5
Evolution of the Corporate Structure	6
The Purpose of a Corporation	9
Satisfying the human need for ambition, creativity, and meaning	9
Social structure	10
Efficiency and efficacy	10
Ubiquity and flexibility	11
Identity	11
Metaphor 1: The Corporation as a “Person”	12
Metaphor 2: The Corporation as a Complex Adaptive System	12
Are Corporate Decisions “Moral”?	14
Are Corporations Accountable?	16
Three Key External Mechanisms for Directing Corporate Behavior:	
Law, the Market, and Performance Measurement	18
Government: legislation, regulation, enforcement	18
What Does “Within the Limits of the Law” Mean?	20
When and how do you punish a corporation?	28
Probation of corporations	29
The problem of serial offenders	31
Securities analyst settlement	32
What is the role of shareholders in making this system work?	33
The market: too big to fail	36
The corporation and elections	40
Citizens united	41
The corporation and the law	45
A Market Test: Measuring Performance	47
Long term versus short term	50
Corporate decision making: whose interests does this	
“person”/adaptive creature serve?	55

Another (failed) market test: NGOs	61
Measuring value enhancement	62
GAAP	62
Market value	69
Earnings per share	70
EVA®: economic value added	71
Human capital: “It’s not what you own but what you know”	72
The “value chain”	73
Knowledge capital	74
The value of cash	74
Corporate “externalities”	79
Equilibrium: The Cadbury Paradigm	79
ESG: Environment, Social Governance – A New Way to Analyze Investment	
Risk and Value	83
Quantifying Nontraditional Assets and Liabilities	87
Future Directions	92
Summary and Discussion Questions	93
Notes	95
2. Shareholders: Ownership	101
Definitions	105
Early Concepts of Ownership	106
Early Concepts of the Corporation	107
A Dual Heritage: Individual and Corporate “Rights”	108
The Reinvention of the Corporation: Eastern Europe in the 1990s	110
The Evolution of the American Corporation	111
The Essential Elements of the Corporate Structure	115
The Mechanics of Shareholder Rights	117
The Separation of Ownership and Control, Part 1: Berle and Means	118
Fractionated Ownership	125
The Separation of Ownership and Control, Part 2: The Takeover Era	129
Waking the Sleeping Giant	134
A Framework for Shareholder Monitoring and Response	140
Ownership and Responsibility	141
No innocent shareholder	141
To Sell or Not to Sell: The Prisoner’s Dilemma	143
Who the Institutional Investors Are	144
Bank trusts	145
Mutual funds	146
Insurance companies	149
Universities and foundations	149
Executive pay from the consumer side – a leading indicator of risk	150
Pension plans	154
The Biggest Pool of Money in the World	154
Pension plans as investors	164
Pension plans as owners	166

Public Pension Funds	169
Divestment initiatives	188
Economically targeted investments	189
AFSCME	195
Federal Employees' Retirement System	197
TIAA-CREF	199
Private Pension Funds	201
The Sleeping Giant Awakens: Shareholder Proxy Proposals on Governance Issues	206
Focus on the Board	212
Hedge Funds	220
Synthesis: Hermes	221
Investing in Activism	222
New Models and New Paradigms	223
The "Ideal Owner"	228
Pension Funds as "Ideal Owners"	233
Is the "Ideal Owner" Enough?	234
Summary and Discussion Questions	236
Notes	238
3. Directors: Monitoring	251
A Brief History of Anglo-American Boards	255
Who Are They?	256
Size	256
Term	256
Inside/outside mix	257
Qualifications	261
Who Leads the Board? Splitting the Chairman and CEO and the	
Rise of the Lead Director	261
Agenda	263
Minutes	263
Diversity	264
Meetings	264
Communicating with Shareholders	264
Special Obligations of Audit Committees	265
Ownership/Compensation	266
Post-Sarbanes-Oxley Changes	266
Board Duties: The Legal Framework	267
The Board's Agenda	281
The Evolution of Board Responsibilities: The Takeover Era	283
The Fiduciary Standard and the Delaware Factor	284
How did boards respond?	287
Greenmail	287
"Poison pills"	288
Other anti-takeover devices	290
The Director's Role in Crisis	291
Limits and Obstacles to Board Oversight of Managers	295

Information Flow	295
Practical Limits: Time and Money	301
The Years of Corporate Scandals – Boards Begin to Ask for More	302
Director Information Checklist	303
Who Runs the Board?	304
Catch 22: The Ex-CEO as Director	306
Director Resignation	308
CEO Succession	308
Director Nomination	309
Limits and Obstacles to Effective Board Oversight by Shareholders	318
Carrots: Director Compensation and Incentives	319
Sticks, Part 1: Can Investors Ensure or Improve Board Independence by Replacing Directors who Perform Badly or Suing Directors who Fail to Act as Fiduciaries?	324
Can Directors be Held Accountable through the Election Process?	324
Staggered boards	327
Confidential voting	328
Sticks, Part 2: Suing for Failure to Protect the Interests of Shareholders – Are the Duties of Care and Loyalty Enforceable?	331
Future Directions	331
Majority voting and proxy access	331
Improving director compensation	333
Increasing the authority of independent directors	333
“A market for independent directors”	335
“Designated director”	336
Board evaluation	336
Executive session meetings	336
Succession planning and strategic planning	337
Making directors genuinely “independent”	337
Involvement by the federal government	338
Involvement by shareholders	339
Summary and Discussion Questions	339
Notes	340
4. Management: Performance	347
Introduction	348
What Do We Want from the CEO?	354
The Biggest Challenge	359
Risk Management	363
Executive Compensation	363
The pay Czar	370
Post-meltdown pay	370
The Council of Institutional Investors	371
Stock Options	374
Restricted Stock	379
Yes, We Have Good Examples	380
Shareholder Concerns: Several Ways to Pay Day	380

The “guaranteed bonus” – the ultimate oxymoron	380
Deliberate obfuscation	381
The Christmas tree	382
Compensation plans that are all upside and no downside	382
Loans	382
Accelerated vesting of options	383
Manipulation of earnings to support bonuses	383
Manipulation of peer groups	384
Huge disparity between CEO and other top executives	384
Imputed years of service	384
Excessive departure packages	384
Backdating, bullet-dodging, and spring-loading options	385
Phony cuts	386
Golden hellos	386
Transaction bonuses	386
Gross-ups and other perquisites	387
Retirement benefits	387
Obstacles to restitution when CEOs are overpaid	387
Future Directions for Executive Compensation	388
CEO Employment Contracts	389
Cause	390
Change of control	391
Half now, half later	391
CEO Succession Planning	391
Sarbanes–Oxley	392
Creation of the Public Company Accounting Oversight Board	392
Section 404	393
Other changes	394
Dodd–Frank	394
Employees: Compensation and Ownership	395
Employee Stock Ownership Plans	399
Mondragón and Symmetry: Integration of Employees, Owners, and Directors	403
Conclusion	409
Summary and Discussion Questions	410
Notes	411
5. International Corporate Governance	415
The Institutional Investor as Proxy for the Public Interest	429
Norway in the driver’s seat	431
The International Corporate Governance Network	433
ICGN: Statement of Principles on Institutional Shareholder Responsibilities	433
The Global Corporate Governance Forum	435
Sweden	435
Canada	437
Singapore	438
Russia	441

Germany	442
China	443
Japan	444
GovernanceMetrics International (GMI)	445
World Bank and G7 Response	458
Azerbaijan	459
Slovakia	460
Jordan	460
Thailand	461
Poland	461
The Global Carbon Project (GCP)	464
A Common Framework for Sustainability Reporting	465
Towards a Common Language	468
Vision	470
Summary And Discussion Questions	471
Notes	473
6. Afterword: Final Thoughts and Future Directions	475
Beyond the Nation State	477
Government as Shareholder: The Institutional Investor as Proxy for the Public Interest	484
Notes	486
<i>Index</i>	489

CASES IN POINT

CHAPTER 1

<i>Shlensky v. Wrigley</i> (1968)	15
Corporate Crime and Punishment	21
A UK Attempt to Redefine Corporate Manslaughter	26
What Happens When You Let Corporations Choose their Own Regulators?	
Just What You Would Expect	33
Chrysler	36
The Voluntary Restraint Agreement in the Auto Industry	38
Corporate Political Donations in the UK and the US	44
“Delaware Puts Out”	45
The Years of Accounting Dangerously	48
Protection, Pennsylvania Style	52
The “Good,” the “Bad,” and the Real	55
Green Tree Financial	64
FASB’s Treatment of Stock Options	66
The Battle of the Theme Parks	70
Daimler-Benz and the New York Stock Exchange	77
Johnson & Johnson	80
Socially Responsible Investing	84
Price Fixing	88

CHAPTER 2

Mis-Trust: The Mysterious Case of the Hearst Will	103
How Much is a Fiduciary Worth – And Can He Charge More than That?	103
Of Vouchers and Values – Robert A.G. Monks Visits Vaclav Havel	110
Standard Oil and the Arrival of Big Business	112
Partnership versus Corporation	116
Annual Shareholder Meetings	118
The Conflicted Owner	121
When is the Employee Stock Plan Obligated to Step in or Sell?	121

Who Owns Hershey?	122
F&C Advises Its Clients to Vote Against Excessive Compensation – At F&C	123
Junior Invests in Boothbay Harbor	126
One Share, One Vote	134
Refco	140
Hermes	144
R.P. Scherer and Citicorp	146
T. Rowe Price and Texaco	147
Director Resignations	151
Interlocking Directors	152
The Alumni Protest Fees Paid to Managers of the Harvard Endowment	152
The Rose Foundation Takes on Maxxam	153
<i>Reader's Digest</i>	153
Eating the Seed Corn: NY's Pension Fund Borrows from Itself	158
Maine State Retirement System	159
CalPERS and Enron	169
Public Fund Activism	173
CalPERS Invests in Activism	177
Institutional Investors Address Climate Change	183
Shareholder Influence on Standardizing and Integrating Corporate Ethics and Sustainability	184
Myners Shifts the Burden of Proof on Activism	186
The Institutional Shareholders Committee	187
AFSCME's Economically Targeted Investment Policy	191
Can a Fiduciary Invest in Volkswagen?	193
Socially Responsible Investing	194
Campbell Soup Company and General Motors	202
"Universal Widget"	205
Honeywell and Furr's	209
Swib and Cellstar	214
Revolt of the Yahoos: United Companies Financial and Luby's	215
Deutsche Asset Management Changes Its Vote	217
From DuPont to Relationship Investing	223
A&P, Paramount, and K-Mart	230
Hermes	231

CHAPTER 3

Warren Buffet on Boards	254
The Worldwide Frustration of Audit Committees	255
The Corporate Library's Interlock Tool	259
The Walt Disney Company and the Magical Kingdom of Executive Compensation	268
The Disney Decision	270

Illicit Backdating: Trends in Illegal Executive Compensation	271
Upper Deck v. Topps: Getting a Fair Chance	274
The Duty of Loyalty – A Race to the Bottom?	276
Further Exploration of the Requirement of Good Faith	278
Trans Union	285
Unocal and Revlon	286
Compaq Computers	293
RJR Nabisco, Lone Star Industries, Tambrands, and Enron	296
A Director Quits	310
A Director Demands More from the Board	311
Two Directors Depart at Emap	315
Director Pay at Coca-Cola	320
Sears	325
Salomon Inc.	338

CHAPTER 4

Merck Creates a Product No One Can Pay For	351
Tony Hayward and BP's Deepwater Horizon Oil Leak	353
AT&T and NCR	355
Beyond the Balance Sheet	356
More About H-P and Hurd	357
E Exxon, AT&T, and General Electric and Creative Destruction – Internal and External	361
Warnaco	367
ICGN on Compensation	373
The Chairman Speaks	376
Borden	378
United Airlines and Employee Ownership	401
The “Temping” of the Workplace	402
Mondragon and “Cooperative Entrepreneurship” or “Cooperation Instead of Competition”	406

CHAPTER 5

Offshore Outsourcing	417
Russia's Hostile Takeover	418
Embraer	419
Capital Flight, Tax Avoidance, and Tax Competition	428

PREFACE

John D. Rockefeller famously sold out of the stock market just before the 1929 crash because of a shoeshine boy. At least according to legend, he knew that when shoeshine boys were giving out stock tips, it was time to sell.

In *The Big Short: Inside the Doomsday Machine*, by Michael Lewis, there are a couple of shoeshine boy moments. In this case, it was not wealthy industrialists or anyone at the heart of the financial world who figured out that there would be a collapse triggered by billion-dollar bets on the subprime mortgages and their derivative securities.

Lewis writes about four outsiders who saw what was coming and bet it would fail while the entire economy was betting the other way. Steve Eisman had a “light bulb” moment when he found out that his former baby nurse had six investment properties. Michael Burry asked if he could buy a security betting a group of the subprime mortgages would fail. He wanted to bet against a group made up entirely of no-doc loans (those where the applicants for the mortgages did not have to submit any documentation to demonstrate their ability to repay). He wanted it to be a group rated A by one of the ratings agencies, the same rating given to groups of mortgages where the applicants had to demonstrate that they could repay. And he got it.

Why were they the only ones who saw that as a problem? And how did that problem get created in the first place?

What went wrong?

In late 2007, the United States economy suffered its worst economic catastrophe since the Great Depression of the 1930s. The American taxpayers found themselves guarantors of the entire financial services industry when almost overnight assets that had been valued at hundreds of billions of dollars turned out to be worth some undetermined amount but much, much less. The entire economy seemed to collapse like a house of cards.

This was not supposed to happen. Just five years before, the most sweeping reform legislation in decades was passed to deal with the then-record-setting scandals of the time. From late 2001 through 2002 spectacular corporate failures at Enron, Global Crossing, Adelphia, WorldCom, and more resulted in the loss of hundreds of billions of dollars and hundreds of thousands of jobs. Front-page news stories were illustrated with photographs of men in suits doing perp walks. CEOs went to prison.

The passage of the Sarbanes–Oxley legislation in 2002 helped to restore confidence in the markets. Perhaps it restored too much confidence because people like Federal Reserve Chairman Alan Greenspan kept insisting that the mushrooming category of derivative securities did not need to be regulated, because he said the efficiency of the market was all that was needed.

He does not think that any more. “Those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity, myself included, are in a state of shocked disbelief,” he told the House Committee on Oversight and Government Reform in 2008.

So, what happened? The failures that led to this collapse were widespread and the fault extends to every element of the system: corporations, regulators, accountants, ratings agencies, securities analysts, politicians, shareholders, journalists, and more. A lot of blame has been assigned, mostly from those trying to deflect it from themselves. The alleged culprits have included “monetary policy,” the government-sponsored entities (Fannie Mae and Freddie Mac), and lax oversight by regulators. Those all played a role, but unquestionably, the primary culprit was a failure of corporate governance.

The proof of that statement will be one of the key themes of this book. The first element of that proof is a sentence that occurs near the end of *The Big Short*. “What’s strange and complicated about [the subprime mortgage market], however, is that *pretty much all the important people on both sides of the gamble left the table rich*.”¹

That tells you everything you need to know – except for how that anomalous situation came about, which is what the rest of this book will cover. The point to keep in mind here is that it is not the market that malfunctioned. On the contrary, the market did exactly what it was supposed to do. It responded to risks and incentives in a rational manner. It was the risks and incentives that were distorted. That is what made it possible – in fact, what made it inevitable – that the people on both sides of the table got rich.

However, if both sides made money, someone had to lose it. The problem is that it was not the buyer or seller or counter-party or insurer who was on the other side of the transaction, it was the rest of us. What happened was a massive shift of costs as Wall Street externalized the risk on to just about everyone else. For example, a hedge fund called Magnetar helped create arcane mortgage-based instruments, made them even riskier, and then bet against them, putting their customers on the other side.

We have seen a fairly consistent cycle of boom and scandal in the financial markets since the savings and loan failures of the 1980s, and the one common theme is the ability of one segment of the economy to externalize its risks. In every case, the system was gamed so that the upside gain was diverted in one direction and the downside losses were diverted in another. The market cannot operate efficiently under those circumstances.

Corporate governance is about how public companies are structured and directed. Every strategy, every innovation in product, operations, and marketing, every acquisition and divestiture, every decision about asset allocation, finance, joint ventures, financial reports, systems, compensation, and community relations – every decision and every one of the thousands of decisions within each one – is determined by some part of the system of corporate governance. Every one of those decisions can be made consistent with long-term, sustainable value creation for investors, employees, and the community or for the short-term benefit of one group regardless of the consequences for the others. When corporate governance operates optimally, the three key players – the executives, the board of directors, and the shareholders – provide through a system of checks and balances a system for a transparent and accountable system for promoting objectively determined goals and benchmarks. When it does not, well, take a look at these examples:

- A very successful CEO had something he wanted to ask his board of directors. He wanted an employment contract. This was not the norm but it was hardly unusual. One-third of Fortune 500 CEOs had written contracts, mostly reflecting the negotiations leading to their employment and

spelling out the terms of their compensation packages and how they would be affected by a merger or termination of employment. What was a little bit unusual was that he was asking after three years on the job without a contract. What was very unusual – what was, in fact, unprecedented – was a particular provision of the contract, which stated that conviction of a felony was not grounds for termination for cause, that is, unless the felony was directly and materially injurious to the corporation.

Huh?

You might think that the board of directors, presented with such a proposal, would ask a few questions. One might be, “Why now – why do you need a written contract now when you did not need one before?” Another one might be, “What exactly prompted this language about the felony – is there something you want to tell us?”

But the board did not ask any questions. The CEO was, as noted above, very successful. Everyone was making a lot of money. Some directors were getting substantial side payments from deals with the company. The board of Tyco signed the contract.

- The board of another very successful company listened to a presentation about a new “special purpose entity” that would allow the company to burnish its financial reports by moving some of its debt off the balance sheet. There was one small problem, however. The deal was a violation of the company’s conflict of interest rules because it permitted an insider, the company’s general counsel, to essentially be on both sides of the transactions. The board was asked to waive the company’s conflict of interest rules to permit the transaction.

Huh?

You might think that the board of directors, presented with such a proposal, would ask a few questions. “Why can’t someone who is not an insider run this thing?” “Is this something that is going to look good on paper or is there some actual benefit?”

But the board did not ask any questions. The company was, as noted above, very successful. Everyone was making a lot of money. Some directors were getting substantial side payments from deals with the company. The board of Enron agreed to the waiver – three separate times.

- A graduate of the United States Military Academy at West Point, which teaches the ideals of “duty, honor, country,” retired from the Army as a general and went to work for a major and very successful corporation. He participated in a tour of the company’s operations for securities analysts that included a fake trading floor where secretaries pretended to be negotiating transactions, peering into computer screens that were not connected to anything, and talking on their telephones to each other. He later admitted that he knew the trading floor was a fake. Yet he did not say anything.

Huh?

Tom White, the former general, was paid more than \$31 million by Enron in that year.

- Angelo Mozillo, founder and CEO of Countrywide, ground zero for subprime mortgages, made \$550 million as his company’s stock went down 78 percent, taking the entire US economy down with it. When the compensation consultant advising the board suggested that the pay plan he wanted might be too high, he hired another consultant – at company expense. They unsurprisingly agreed with his proposal and the board agreed.
- The Lehmann board’s finance and risk management committee, chaired by an 80-year-old director, met only twice in 2007 and twice in 2006. Nine of the company’s directors were retired and one had been on the board for 23 years. Four of the directors were over 75 years old. One was an actress, one was a theatrical producer, another a former Navy admiral. Only two

board members had direct experience in the financial-services industry. Until 2008 it had no one on the board who was familiar with the kinds of derivatives that caused the collapse of the 158-year-old firm that year.

- At Indymac, the CEO's pay was as large as CEO salaries at firms exponentially larger and included \$260,000 one-time initiation fee to a country club, reimbursement for payment of taxes (\$12,650), financial planning (\$15,000), and other perks. It became the then-second-largest bank failure in history.
- The compensation committee at Chesapeake Energy not only paid CEO Aubrey McClendon \$100 million, a 500 percent increase as the stock dropped 60 percent and the profits went down 50 percent, but spent \$4.6 million of the shareholders' money to sponsor a basketball team in which McClendon owned a 19 percent stake, they purchased catering services from a restaurant where he was just under a half-owner, and they took his collection of antique maps off his hands for \$12.1 million of the shareholders' money, based on a valuation from the consultant who advised McClendon on assembling the collection. The board justified this by referring to McClendon's having to sell more than \$1 billion worth of stock due to margin calls, his having concluded four important deals, and the benefit to employee morale from having the maps on display in the office.
- RBS CEO Fred "the Shred" Goodwin said he would consider reducing his £17 million pension (but as of this writing has not done so). His leadership, which included the disastrous acquisition of the Dutch firm Amro, ended with the company laying off 2,700 people and writing down £240 billion worth of assets, resulting in a £20 billion bailout. The board allowed him to characterize his departure as a resignation rather than termination for cause, doubling the size of his severance and retirement package.
- The WorldCom CEO asked his board for a loan of over \$400 million. According to public filings, the loans were to repay debts that were secured by his shares of company stock and the proceeds of these secured loans were to be used for "private business purposes." The board agreed.
- Hollinger CEO Lord Black informed his board that a particular acquisition had been a mistake and offered to take it off the books by buying it for one dollar. The board agreed.
- Linda Wachner told her board she wanted to take a portion of the company private, with herself continuing as CEO of both organizations, being paid separately by each. They agreed. She subsequently offered to sell the private entity back to the public company, taking not only a profit but an investment banking fee. The Warnaco board agreed.
- A CEO made a phone call to a large institutional investor that had voted against her proposed merger, reminding them that her company did significant business with the institutional investor's parent company. Deutsche Asset Management changed their vote.

This is the description of the bailout and the banking industry's response from President Reagan's budget director turned private equity mogul David Stockman:

The banking system has become an agent of destruction for the gross domestic product and of impoverishment for the middle class. To be sure, it was lured into these unsavory missions by a truly insane monetary policy under which, most recently, the Federal Reserve purchased \$1.5 trillion of longer-dated Treasury bonds and housing agency securities in less than a year. It was an unprecedented exercise in market-rigging with printing-press

money, and it gave a sharp boost to the price of bonds and other securities held by banks, permitting them to book huge revenues from trading and bookkeeping gains. Meanwhile, by fixing short-term interest rates at near zero, the Fed planted its heavy boot squarely in the face of depositors, as it shrank the banks' cost of production – their interest expense on depositor funds – to the vanishing point.

The resulting ultrasteep yield curve for banks is heralded, by a certain breed of Wall Street tout, as a financial miracle cure. Soon, it is claimed, a prodigious upwelling of profitability will repair bank balance sheets and bury toxic waste from the last bubble's collapse. But will it?

In supplying the banks with free deposit money (effectively, zero-interest loans), the saviors of America are taking a \$250 billion annual haircut in lost interest income. And the banks, after reaping this ill-deserved windfall, are pleased to pronounce themselves solvent, ignoring the bad loans still on their books. This kind of Robin Hood redistribution in reverse is not sustainable. It requires permanently flooding world markets with cheap dollars – a recipe for the next bubble and financial crisis.²

What is wrong here? How did so many different people in so many different roles make so many bad decisions? How did corporate governance go from being an arcane, almost vestigial topic in scholarly circles to being the source of scandals, headlines, lawsuits, and business school course materials?

The importance of corporate governance became dramatically clear in 2002 as a series of corporate meltdowns, frauds, and other catastrophes led to the destruction of billions of dollars of shareholder wealth, the loss of thousands of jobs, criminal investigation of dozens of executives, and record-breaking bankruptcy filings.

Seven of the twelve largest bankruptcies in American history were filed in 2002 alone. The names Enron, Tyco, Adelphia, WorldCom, and Global Crossing have eclipsed past great scandals like National Student Marketing, Equity Funding, and ZZZZ Best. Part of what made them so arresting was how much money was involved. The six-figure fraud at National Student Marketing seems almost endearingly modest by today's standards. Part was the colorful characters, from those who were already well known like Martha Stewart and Jack Welch, to those who became well known when their businesses collapsed, like Ken Lay at Enron and the Rigas family at Adelphia. Part was the breathtaking hubris – as John Plender says in his 2003 book, *Going off the Rails*, “Bubbles and hubris go hand in hand.” Then there were the unforgettable details, from the \$6,000 shower curtain the shareholders unknowingly bought for Tyco CEO Dennis Kozlowski to the swap of admission to a tony pre-school in exchange for a favorable analyst recommendation on ATT at Citigroup.

Another reason for the impact of these stories was that they occurred in the context of a falling market, a drop-off from the longest, strongest bull market in US history. In the 1990s, we saw billions of dollars of fraudulently overstated books at Cendant, Livent, Rite Aid, and Waste Management, but those were trivial distractions in a bull market fueled by dot-com companies. Those days were so heady and optimistic that you didn't need to lie. Why create fake earnings when an honest disclosure that you had no idea when you were going to make a profit wouldn't stop the avalanche of investors ready to give Palm a bigger market cap than Apple on the day of its IPO?

However, the most important reason these scandals became the most widely reported domestic story of the year was the sense that every one of the mechanisms set up to provide checks and

balances failed at the same time. All of a sudden, everyone was interested in corporate governance. The term was even mentioned for the first time in the President's annual State of the Union address. Massive new legislation, the Sarbanes–Oxley Act, was quickly passed by Congress and the SEC had its busiest rule-making season in 70 years as it developed the regulations to implement it. The New York Stock Exchange and NASDAQ proposed new listing standards that would require companies to improve their corporate governance or no longer be able to trade their securities. The rating agencies S&P and Moody's, who had failed to issue early warnings on the bankrupt companies, announced that they would factor in governance in their future analyses. Then six years later, things were even worse. Even bigger legislation has been passed and more rule-making is underway – and the ratings agencies are still promising to do better.

Corporate governance is now and forever will be properly understood as an element of risk – risk for investors, whose interests may not be protected by ineffectual or corrupt managers and directors, and risk for employees, communities, lenders, suppliers, taxpayers, and customers as well.

Just as people will always be imaginative and aggressive in creating new ways to make money legally, there will be some who will devote that same talent to doing it illegally, and there will always be people who are naive or avaricious enough to fall for it. Scam artists used to use faxes to entice suckers into Ponzi schemes and Nigerian fortunes. Now, they use email – or, sometimes, they use audited financial reports.

The businesses that grabbed headlines with spectacular failures that led to Sarbanes–Oxley were fewer than a dozen of the thousands of publicly traded companies, and the overwhelming majority of executives, directors, and auditors are honorable and diligent. Yet, even in the post-Sarbanes–Oxley world, the scandals continued. Refco had a highly successful initial public offering in 2005, despite unusual disclosures in its IPO documents about “significant deficiencies” in its financial reporting, pending investigations, and potential conflicts of interest. Just a few months later, in the space of a week, the stock dropped from \$29 a share to 69 cents and the company declared bankruptcy. In 2006, widespread undisclosed backdating of stock options at public companies was uncovered not by regulators or prosecutors but through a statistical analysis conducted by an academic. Then came the subprime/too-big-to-fail mess, with an emergency \$700 billion infusion of cash from the government. In the midst of that, the government's taking over of most of the automotive industry, once the flagship of American commerce, hardly seemed worth noting.

If the rising tide of a bull market lifts all the boats, then when the tide goes out some of those boats are going to founder on the rocks. That's just the market doing its inexorable job of sorting. Some companies (and their managers and shareholders) get a free ride due to overall market buoyancy in bull markets. If the directors and executives were smart, they recognize what is going on and use the access to capital to fund their next steps. If they were not as smart, they thought they deserved their success. If they were really dumb, they thought it would go on forever – and kept creating more derivative securities based on increasingly fragile subprime mortgages.

One factor that can make the difference between smart and dumb choices is corporate governance. It is not about structure or checklists or best practices. It is about substance and outcomes. Think of it as the defining element in risk management. **In essence, corporate governance is the structure that is intended (1) to make sure that the right questions get asked and (2) that checks and balances are in place to make sure that the answers reflect what is best for the creation of long-term, sustainable, renewable value.** When that structure gets subverted, it becomes too easy to succumb to the temptation to engage in self-dealing.

This book is about managing the risk of that temptation. Corporate governance is our mechanism for addressing the core conundrum of capitalism, the problem of agency costs. This is the problem that persuaded that great advocate of the free market that the corporate structure could not work. Adam Smith wrote, “People of the same trade seldom meet together but the conversation ends in a conspiracy against the public, or in some diversion to raise prices.”

Corporate governance is our way of answering these questions:

- How do we make a manager as committed to the creation of long-term shareholder value as he would be if it was his own money?
- How do we manage corporate value creation in a manner that minimizes the externalization of its costs on to society at large?

Good corporate governance requires a complex system of checks and balances. One might say that it takes a village to make it work. In the last decade, we have seen a perfect storm of failures, negligence, and corruption in every single category of principal and gatekeeper: managers, directors, shareholders, securities analysts, lawyers, accountants, compensation consultants, investment bankers, journalists, and politicians. In this book, we will discuss the theory and practice of corporate governance with examples from the good, the bad, and the very, very ugly, with reference to theoretical underpinnings and real-life cases in point, and with some thoughts on options for reform, future directions, and the prospects for some kind of global convergence on governance standards.

Our primary focus will be on the three key actors in the checks and balances of corporate governance: management, directors, and shareholders. We begin with some thoughts about the role of the board from a speech given by one of America’s most successful CEOs at a 1999 conference on ethics and corporate boards:

[A] strong, independent, and knowledgeable board can make a significant difference in the performance of any company [O]ur corporate governance guidelines emphasize “the qualities of strength of character, an inquiring and independent mind, practical wisdom and mature judgment” It is no accident that we put “strength of character” first. Like any successful company, we must have directors who start with what is right, who do not have hidden agendas, and who strive to make judgments about what is best for the company, and not about what is best for themselves or some other constituency

[W]e look first and foremost for principle-centered leaders. That includes principle-centered directors. The second thing we look for are independent and inquiring minds. We are always thinking about the company’s business and what we are trying to do We want board members whose active participation improves the quality of our decisions.

Finally, we look for individuals who have mature judgment – individuals who are thoughtful and rigorous in what they say and decide. They should be people whom other directors and management will respect and listen to very carefully, and who can mentor CEOs and other senior managers The responsibility of our board – a responsibility which I expect them to fulfill – is to ensure legal and ethical conduct by the company and by everyone in the company. That requirement does not exist by happenstance. It is the most important thing we expect from board members

What a CEO really expects from a board is good advice and counsel, both of which will make the company stronger and more successful; support for those investments and decisions that serve the interests of the company and its stakeholders; and warnings in those cases in which investments and decisions are not beneficial to the company and its stakeholders.

That speech, “What a CEO Expects From a Board,” was delivered by then-Enron CEO, the late Kenneth Lay. The company’s code of ethics is similarly impressive. The company got high marks from just about everyone for best corporate governance practices.

The board looked good on paper: the former dean of the Stanford Business School was chairman of the audit committee. Another director was formerly a member of the British House of Lords and House of Commons, as well as Energy Minister. In addition, the board included one of the most prominent business leaders in Hong Kong, the co-founder and former president of Gulf and Western, two sitting CEOs of large US corporations, and the former head of the Commodities Future Corporation who was an Asian woman, with an economics PhD, and married to a prominent Republican Congressman. There was also a former professor of economics and a former head of General Electric’s Power Division worldwide, a senior executive of an investment fund with a PhD in mathematics, the former president of Houston Natural Gas, the former head of M.D. Anderson, the former head of a major energy and petroleum company, and a former Deputy Secretary of the Treasury and PhD economist.

That shows the most important point to keep in mind as you consider the challenges of corporate governance: it is easy to achieve the letter of good corporate governance without achieving the spirit or the reality. While it is tempting to engage in checklists of structural indicators, there is no evidence that intuitively appealing provisions like independent outside directors (rather than people whose commercial or social ties might create conflicts of interest) or annual election of directors (rather than staggered terms) have any correlation to the creation of shareholder value or the prevention of self-dealing.

Therefore, keep in mind throughout this book that corporate governance is about making sure that the right questions get asked and the right checks and balances are in place, and not about some superficial or theoretical construct. Every other topic in business school – analysis, strategy, finance, marketing – is developed and executed under a structure that either does or does not address the issues of agency costs and risk management. Strategic planning is overseen by the board who either does or does not have the expertise, information, and authority to make the right decisions. Every incentive program either does or does not link pay to performance. The difference between the does and does not is corporate governance.

William Donaldson, then Chairman of the Securities and Exchange Commission, made this point in a 2003 speech at the Washington Economic Policy Conference:

[A] “check the box” approach to good corporate governance will not inspire a true sense of ethical obligation. It could merely lead to an array of inhibiting, “politically correct” dictates. If this was the case, ultimately corporations would not strive to meet higher standards, they would only strain under new costs associated with fulfilling a mandated process that could produce little of the desired effect. They would lose the freedom to make innovative decisions that an ethically sound entrepreneurial culture requires.

As the board properly exercises its power, representing all stakeholders, I would suggest that the board members define the culture of ethics that they expect all aspects of the company to embrace. The philosophy that they articulate must pertain not only to the board's selection of a chief executive officer, but also the spirit and very DNA of the corporate body itself—from top to bottom and from bottom to top. Only after the board meets this fundamental obligation to define the culture and ethics of the corporation—and, for that matter, of the board itself—can it go on and make its own decisions about the implementation of this culture.

NOTES

1. W.W. Norton & Co., 2010, pp. 256 (emphasis added).
2. David Stockman, "Taxing Wall Street Down to Size," *New York Times*, January 19, 2010.

ACKNOWLEDGMENTS

First and foremost, we want to thank Kit Bingham, former editor of the indispensable magazine *Corporate Governance*, without whom this book would still be just a dream. His tireless, thorough, creative, and even cheerful diligence provided most of the case studies and supporting material in the first three editions, and he made even the more tedious aspects of research and writing a genuine pleasure. Professor emerita D. Jeanne Patterson did a masterful job of reading through hundreds of academic papers, assembling the material for the NYSE (Grasso) case study, and providing assistance throughout the process of writing and editing. David Smith was very helpful with the fourth edition and Zachary Cloyd's superb research skills and good spirits were an essential contribution for the fifth.

We are honored to be able to include case studies from three top scholars and extend our deepest thanks to Beth Young, Jennifer Taub of the Vermont Law School, and John Coleman of NCI Consulting. Dave Wakelin was most generous with his time in bringing us up to date on the Maine State Retirement System. Paul Lee of Hermes allowed us to use his superb case studies of Premier Oil and Trinity Mirror. Paola Perotti and Rolf H. Carlsson gave us outstanding case studies with an insider's perspective. Teresa Barger and Michael Lubrano of Cartica Capital and formerly of the Corporate Governance and Capital Markets Advisory Department International Finance Corporation/World Bank were kind enough to allow us to use their superb Embraer case study. Lynn Turner provided daily email updates on the latest developments in corporate governance. Jackie Cook's pioneering work in applying social networking theory to corporate boards has been of inestimable value.

We are also very grateful to the heroic scholars whose work instructed and inspired us, especially Warren Buffett (special thanks for suggesting a case study on fiduciary obligation and the lack thereof), Sir Adrian Cadbury, David Walker, Robert Clark, Simon Wong, Alfred Conard, Peter Drucker, Melvin Eisenberg, Shann Turnbull, Betty Krikorian, Lucian Bebchuk, Simon Deakin, Margaret Blair, Joe Grundfest, Charles Elson, Bernie Black, Mark Roe, Marcy Murningham, Bob Massie, Jack Coffee, Jeffrey Sonnenfeld, the late Jonathan Charkham, Adolf Berle and Gardiner Means, and James Willard Hurst.

We have also learned a great deal from our colleagues, clients, and friends, including the widely disparate group of institutional investors all joined together by their commitment to the beneficial owners they serve as fiduciaries and the corporate managers they monitor as shareholders. It also includes the corporate managers, lawyers, regulators, commentators, and individual shareholders who care enough about making things work better to make a difference. These are also our heroes. They include Alan Hevesi, Allen Sykes, Tim Bush, Ann Yerger, Kayla Gillan, Anne Simpson, Alyssa Machold, Roger Raber, Peter Gleason, Deborah Davidson, Alan Kahn, Sarah Ball Teslik,

Carol Bowie, Peter Clapman, Brock Romanek, Stephen Davis, William McDonough, Charles D. Niemeier, Rich Koppes, Ned Regan, Olena Berg, Dale Hanson, Tom Pandick, Harrison J. Goldin, Carol O'Cleireacain, Patricia Lipton, Ned Johnson, Dean LeBaron, Dick Schleffer, Keith Johnson, Elizabeth Smith, Ken Bertsch, Janice Hester-Amey, Doug Chia, Adam Turteltaub, Phil Lochner, the late Al Sommer, Cathy Dixon, Martin Lipton, Ira Millstein and Holly Gregory, Vineeta Anand, Luther Jones, Roland Machold, Michael Jacobs, the late John and Lewis Gilbert, Peg O'Hara, Mort Kleven, Alan Lebowitz, Karla Scherer, Bill McGrew, Kurt Schacht, Beth Young, Kimberly Gladman, Abbot Leban, Bill Steiner, Bob Massie, Tom Flanagan, Bill McEwen, David Greene, Alan Towers, and Gary Lutin. We are also grateful for the journalists who have produced exceptionally thoughtful and illuminating stories, especially Mark Gunther, Mathew Bishop, Gretchen Morgenson, Ralph Ward, Mary Williams Walsh, Jim Kristie, Leslie Wayne, John Plender, and Joann Lublin.

We are also especially grateful to our dear friends Ann Yerger, Executive Director of the Council of Institutional Investors, and Ralph Whitworth, of Relational Investors, who provided the leadership, support, and intellectual foundation for most of the developments in this area over the past few years. John M. Nash and the late Jean Head Sisco, former Director and Chair of the National Association of Corporate Directors, and current Chair Barbara Franklin and director Ken Daly deserve special thanks for their labors in the field of governance.

We are grateful to those who permitted us to use their material in this book, which added greatly to its value. Thanks to Chancellor William Allen, Ira Millstein, Shann Turnbull, Marcy Murningham, Martin Lipton, Jay Lorsch, Cyrus F. Freidheim, Hugh Parker, Oxford Analytica, Jeanne Patterson, Aaron Brown, Joe Grundfest, Jamie Heard, Sophie L'Helias, Howard Sherman, Bruce Babcock, and Geoff Mazullo. Cathy Dixon guided us through the thorny securities law issues with patience, good humor, and unbounded expertise. We are deeply grateful.

Our dear friends Beth Young, Kimberly Gladman, Jackie Cook, Annalisa Barrett, Paul Hodgson, Howard Sherman, Gavin Anderson, Jack Zwigli, Jim Kaplan, Rick Bennett and all of the staff of The Corporate Library/Governance Metrics/Audit Integrity were generous, knowledgeable, and completely indispensable in giving us the latest data and analyses. Ric Marshall, our trusted colleague, developed the website that has made it possible for us to include and update the book's supporting materials. Manpower CEO Mitchell Fromstein was most generous not only with useful material but also his own time. Newton Minow and the late Stanley Frankel sent us constant clippings and gave us thoughtful advice.

There is a special section of heaven for those who were willing to trudge through early drafts and provide comments. Thanks very much to Margaret Blair, Alfred Conard, Wayne Marr, Jane Zanglein, and Stu Gillan.

We want to thank our colleagues, including everyone at the three companies we have worked at together: Institutional Shareholder Services, Lens, and The Corporate Library (now GovernanceMetrics International). Barbara Sleasman is the finest professional with whom we have ever worked. Sylvia Aron and Stephanie Philbrick provided crucial support. We would also like to thank the people at Wiley, including Rosemary Nixon, Michaela Fay, Tessa Allen, and Pat Bateson. Alexandra Lajoux was a brilliant (and tactful) editor of the original edition.

Note from Bob Monks: I am long accustomed to being told that "I married above myself." In my work with corporate governance, happily the pattern has been repeated in a different form – "I have partnered above myself" – and am in particular grateful to John Higgins, Ric Marshall, Rick Bennett, Peter Butler, Steve Brown, Simon Thomas, Barbara Sleasman, and, above all, Nell Minow for their willingness to help me along this delightful passage of life.