FIFTH EDITION

CORPORATE GOVERNANCE

ROBERT A. G. MONKS & NELL MINOW

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Robert A. G. Monks and Nell Minow

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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 savers 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.

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