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EXECUTIVE MBA SERIES

CORPORATE GOVERNANCE

BUSINESS, LEGAL, AND ETHICAL CHALLENGES FACED BY BOARDS OF DIRECTORS

METHODS FOR THE SELECTION, PERFORMANCE APPRAISAL, COMPENSATION, AND SUCCESSION PLANNING FOR THE CEO

HOW TO MAINTAIN EFFECTIVE RELATIONSHIPS WITH ALL CONSTITUENCIES

JOHN L. COLLEY, JR., JACQUELINE L. DOYLE,
GEORGE W. LOGAN, & WALLACE STETTINIUS

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PREFACE

Frustrations with the performance of publicly traded corporations abound. Even before the Enron debacle and the other widely publicized scandals in 2002, there was a steadily increasing volume of criticism and complaints regarding the governance of many companies. Awareness of and new stories about dissatisfaction have only intensified over time as the complaints have continued to take many forms and address ever-broader issues. There is the perceived injustice of chief executive officers (CEOs) having made huge fortunes while company shareholders have lost significant portions of their investments and many employees have lost their jobs. Recent payoffs to underperforming CEOs have reached a level that is unacceptable to many people. CEOs whose unsatisfactory performance called for their dismissal have been able to leave with severance payments of $1 to $2 million per year for life. This tendency toward expansive severance payments is even more apparent in mergers. In one instance, the terms of the merger called for the CEO who was leaving to receive $5 million per year for life.

Both the public and regulatory authorities have been seriously misled by accounting irregularities and financial disclosure problems. In addition, a dot-com shell game has been played over the last 10 years or so as analysts hyped stocks whose prices found stratospheric levels from which they inexorably collapsed. There are also problems with the involvement of financial analysts in significant decision making within the firms they recommend. There is the practice of corporations guaranteeing loans to executives and the alleged use of corporate funds for executives' personal expenditures. This situation is compounded by the persistent public perception of corporate irresponsibility with regard to environmental issues. Add to all these problems the uneasy sense of big business' buying access to political influence in search of special-interest corporate subsidies, and we see a dark picture of senior corporate America indeed.

It is certainly tempting and easy for those of us in business to lay blame for this irresponsibility and greed at the feet of a few renegades. We like to think that the vast majority of businesspeople are honest and conscientious, trying to do the right thing. For the most part, this is fortunately true. Yet there seems to be entirely too many renegades in the corporate realm, and their indiscretions are damaging to us all. The pendulum apparently has swung too far toward the side of excess and willful nondisclosure, and our economic system has suffered as a result.

The collective problem of business today is coming to be seen as a failure of corporate governance, meaning that far too many boards are failing to execute their duties responsibly, both collectively and individually.

The critics are many. A number of reputable business-related publications have even begun to publish lists of the "worst corporate boards in the United States." Individual shareholders, investment fund managers, large state employee pension funds, lawmakers, government regulators, and a variety of activist groups are publicly and stridently questioning board judgments on a wide range of issues. These discontented critics invariably include employees who have invested portions of their 401(k) plans as well as other retirement assets in the shares of their employers.

Sustaining and fueling the criticism is the fact that investors have better access to more detailed information than ever before, enabling them to assess readily not only the performance of a company relative to its peers but also the lucrative agreements between boards and CEOs, conflicts of interest, and a host of other issues that historically have remained within the confines of the boardroom, largely unknown to the shareholder group. It is particularly in the absence of healthy corporate financial performance, however, that pressure is mounting against boards and their CEOs. In addition to scrutiny in the media, boards find themselves frequently facing questions from federal, state, and local governments, as well as federal and state regulatory agencies. The oversight of these groups reaches from the smallest company to the giants of our economy, many of which have felt the sting of legal and regulatory bodies. Consider the pressure brought to bear throughout the economy by the U.S. government's lawsuit to break up Microsoft, the successful effort by European regulators to halt the merger of GE and Honeywell in 2001, and the 2002 congressional investigations into Enron's collapse. According to the *Wall Street Journal*, the Securities and Exchange Commission (SEC) opened 570 investigations in 2001, which was more than in any year of the previous 10 years but, interestingly, just 10 more than in 1994.[1]

Adding further complexity, the laws and regulations governing business are by no means static over time. The rules of the game are in a state of constant revision, from Equal Employment Opportunity Commission (EEOC) regulations governing sexual harassment, equal employment opportunities, and age discrimination, to SEC regulations affecting corporate financial reporting and tax policies, to Environmental Protection Agency (EPA) environmental regulations and Occupational Safety and Health Administration (OSHA) safety rules. Parenthetically, these shifting standards have created a perpetual cottage industry for the legal and accounting professions both in the United States and abroad. This state of flux greatly complicates a board's best intentions to oversee completely ethical and legal operations. Some corporate actions that meet all contemporary regulatory requirements may be subject to critical scrutiny years later as a result of some event that focuses new attention on product safety or competitive standards.

These very public complaints about board performance have led many thoughtful people to a newly awakened interest in the subject of corporate governance and its critical importance to the U.S. and world economies. Likewise, such criticism has made corporate boards of directors more introspective. Many boards are rethinking their approaches to governing their corporations. The gradual increase in sophistication and power of financial analysts, large institutional investors, and other pressure groups also has forced boards to be far more sensitive to their firms' financial performance and its impact on stock prices. These pressures in the aggregate have prompted boards to wake up to the responsibilities for which they were elected, lest they find that events have outrun their ability to control them.

Despite growing interest, there is a general lack of understanding of the principles of effective corporate governance in most quarters, even those including many directors themselves. Evidence of this lack of understanding is the superficiality of the comments and analyses on the part of both the media and politicians with regard to the Enron scandal and other cases. For some parties, this lack of depth results from an absence of knowledge and/or experience. For others, it stems from a simplistic, single-issue focus on operations rather than governance. In any case, this lack of understanding can lead to poor policy decisions by boards and regulators alike, with potentially very adverse and unintended consequences. In extreme cases, complex issues become political, and passions overwhelm reason.

Consider the dilemma every company faces in determining a fair yet competitive level of compensation for its CEO. Few aspects of corporate governance are more likely to draw criticism from interested parties than the level of CEO compensation. Keep in mind that there is a free market for the services of CEOs and that at any specific time numerous companies are hard at work recruiting effective CEOs. For many years, CEO salaries had followed a pattern of steady increases, along with the costs of most goods and services, reflecting the competitive market for truly outstanding CEOs. The compensation for the majority of CEOs consists primarily of a salary, with an opportunity to earn bonuses for outstanding short- and long-term performance. While such salaries may appear large relative to that of a wage-earning person, these salaries are generally much lower than the compensation of small business owners/operators, professional athletes, actors, and media personalities. Yet CEOs of large companies are responsible for billions of dollars of shareholder assets and the livelihood of thousands of families of employees, and the effective ones can demonstrate that they make a difference in creating shareholder value in the hundreds of millions or even billions of dollars. In our opinion, the compensation of most good, effective CEOs is well earned.

We have observed the growing importance of corporate governance during many years of collective service on more than 70 public and private for-profit and not-for-profit boards. The ongoing immediacy of these governance issues and their importance to business managers, students, and investors confirmed for us the need for education on the subject of corporate governance. We are now in our fourth year of offering an elective MBA course at the Darden Graduate School of Business of the University of Virginia on the topic of corporate governance. The success of the course has been both rewarding and instructive. Through our own board experience and the experience of our teaching, we recognize that corporate governance decisions require analysis from several perspectives. These perspectives include

- *The legal issues.* What does the law require?
- *The ethics.* How does the organization define and fulfill its obligations to its constituencies or stakeholders in view of conflicting interests?
- *Effectiveness.* How does the board ensure that it and its management make effective decisions in an efficient and timely manner?
- *The board's relationships.* How does the board maintain effective relationships with its constituencies, particularly shareholders and management?
- *The group dynamics.* How well does the board function as a group or team?

We wrote this book with these multiple perspectives in mind. We also drew on our mutual experience base to fashion this book to address the many topics of primary import to current and future board members, as well as those who are likely to interact with boards of directors. These topics include the critical importance of the corporate form of business organization to our system of free enterprise and capitalism, the legal obligations of directors, the nuances of board selection, the most effective methods of board and corporate organization, and how boards could operate most effectively. We also have sought to provide a clear exposition of the methods employed for the selection, performance appraisal, compensation of, and succession planning for CEOs. We provide coverage of the board's role in strategy formulation, related business plans, and the means employed to finance a corporation and examine how the board should deal with external events, such as hostile takeover attempts, shareholder activism, proxy fights, and class-action lawsuits, to name a few. Additionally, we present a treatise on how directors get into trouble. Curiously, we have found a lack of coverage of this issue the most significant gap in the literature on governance. Finally, we consider the principles previously addressed for the context of the nonprofit or not-for-profit board.

Our goal has been to produce a book that would be informative for aspiring and active board members, managers, students of business, and individuals who want to understand the numerous facets of the governance process more clearly and are looking for useful insights into how they might do their work more effectively. This book focuses primarily on the governance of U.S. for-profit, publicly-owned companies, and as a result, we use the terms *shareholder* and *stockholder* throughout the book. Other names of constituencies would be appropriate for other forms of incorporation, such as *member* or *trustee*, for example, in the case of a mutual company.

In the end, we hope to contribute to raising the quality of the public debate surrounding corporate governance as we all strive to improve corporate performance.

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CONTENTS

CHAPTER 1

Capitalism, Free Enterprise, and the Corporation

The societies of the developed countries of the twenty-first century live in unprecedented prosperity. These nations have produced the highest standard of living for the most people in the history of the world. How has this happened? We believe that the origin of this prosperity lies in the development of an economic system that embraces, for the most part, free enterprise, capitalism, and competition. Free enterprise brings to the economies of developed countries the sustained energy of competition, in which the creative minds of countless individuals are unleashed to pursue their individual best interests, the more unfettered by regulation the better. Adam Smith first wrote in 1776 that "an invisible hand of self-interest" moved to create a total environment in the best interests of "the many" when each of us acts to maximize our own individual interests.[1] The initial step in this amazing journey of economic development was thus the realization that the greater good would be served by each of us diligently seeking to optimize our own best interests. While counterintuitive in some respects, this remains an astonishing idea.

The concept of the efficacy of the invisible hand led logically to a second notion that as individuals attempt to pursue their separate interests, the intersections of their interests and objectives result in a natural state of competition. Specifically in the realm of business, we mean by this competition for raw materials, labor, customers, and investment capital. This competitive environment leads to a "survival of the fittest" regimen that, over time, weeds out the weakest competitors and promotes survival of the most successful. While some people may fear this relentless ferreting out of the less efficient, it is perhaps the most energizing aspect of our system of free enterprise and competition. The third key aspect of our economic system has been the development of modern capitalism, in which the capital of many investors can be united to provide the large amounts of investment capital needed to fund extensive projects and massive enterprises. It is axiomatic that the greater the freedom of our corporate enterprises to compete in search of expansive returns, the greater is the inclination of individual and institutional investors to provide the capital sought. The three cornerstones of our economic system, therefore, are free enterprise, competition, and capitalism.

With the development of this economic system, enterprises of a size and complexity not previously thought possible flourished. The obvious question was, How could these enterprises be managed in the best interests of shareholders? Our premise in this book is that governance, as we know and practice it, has made the difference both at the macro levels—political, social, and economic—and at the level of the individual enterprise—corporate governance. Without an effective system of governance, there would be chaos in human affairs. It is governance that brings order out of the chaos. When individuals live together in communities, there must be rules and laws about how they relate to each other because conflict among individuals and groups is inherent in the human condition. Most of these conflicts result from different personalities and beliefs and from a natural competition for limited resources. Some have more serious moral implications, however, because they are rooted in a lack of respect and concern for the lives and property of others, inspired by the basest of human motives.

Moral conflict nakedly reveals the two sides of human nature—the good and the evil. We see the good in acts of love and selflessness, acts of courage, acts of genius in the arts and sciences, and acts of integrity, honor, and duty. We see the evil in acts of hate, greed, tyranny, oppression, cowardice, and dishonesty. Such struggles between the forces of good and evil have been at the core of the human drama since the beginning of time. The battle takes place within every individual of conscience, as well as between individuals and groups. We also see these conflicts playing out in the various forms of government prevalent around the world and, naturally, in the realm of modern business.

THE EVOLUTION OF GOVERNANCE

Early on in antiquity, the hard labor of subsistence living was transformed gradually by the invention of tools—the beginnings of technology. With the development of new sources of energy—first the steam engine and then electricity and the internal combustion engine—came machines that dramatically increased productivity. In the past 50 years technological advances in practically every field have exploded, nearly all traceable to the invention of the transistor. With the subsequent development of digital technology, we have seen revolutions in electronics, communications, transportation, medicine, and all forms of manufacturing, leveraged by an exponential increase in our ability to gather and disseminate information. A requisite driver of these evolutionary forces has been the advent of universal education. The breakthrough that made education more readily available to the masses was the invention of movable type by Gutenberg in 1438, and the evolution of printing that followed ushered in growing literacy that became the foundation for an educated populace. We recognize the impact of this innovation in the axiom, "We learn to read so that we can read to learn."

As widespread literacy spawned education that has driven technology, there has been a comparable evolution in how we govern our affairs. People have been living in groups from the beginning, first as hunters, gatherers, and fishermen and then in agricultural societies and eventually in industrial societies. From the outset, humankind has sought to discover the best ways to make decisions for its groups—to find ways to govern so as to resolve disputes, control destructive behavior, and achieve goals that advance the mutual welfare of the members of the society. The effectiveness of a given approach to governance has determined, to a large extent, the survival and prosperity of that society. In the beginning, groups of people were small, simple, and located in one place. Their governance processes could be equally simple. Over time, these groups have become large, complex, far-reaching organizations. Tribal and feudal fiefdoms have evolved into nation-states. Small, local proprietorships have evolved into large corporations. Their decision-making processes likewise have matured to reflect the more complex governance issues.

Among the seminal breakthroughs in this journey from simplicity to complexity in governance were the social revolutions of the eighteenth and nineteenth centuries—particularly the American and French revolutions and their accompanying periods of enlightenment. Prior to that time, as societies grew, they became progressively more stratified, with smaller ruling classes accumulating greater wealth generated by the labors of the subservient masses. Rich nations became ever more powerful and, by force, colonized weaker nations, particularly those endowed with an abundance of natural resources. For centuries, governance was exercised by a privileged few who had gained power over the many. The powerful ruled until they were overthrown by a revolt from within or defeated by a conqueror from outside. However, the nature of the society seldom changed; it was simply a case of one monarchy or dictatorship replacing another. Some were competent and benevolent, and the people benefited. More typically, there was incompetence, corruption, and oppression of the citizenry.

The prevailing system of governance resulted from the actions of individuals, not from the evolution of legal principles. As individuals gained power, however, they increasingly ruled by oppressive force, often creating a backlash of revolution. The social revolutions that followed were fueled by a hunger for individual freedom and by a sense of moral imperative of how people should treat one another. Out of these revolutions grew the modern concept of democracy—a rule of the people, by the people, and for the people—a concept implied in the Constitution of the United States and articulated in Lincoln's Gettysburg Address.

THE DEMOCRATIC EXPERIMENT

Government as we know it today in the United States actually had its beginning with the Greeks and Romans. Their examples influenced the development of the English rule of law, of which the Magna Carta, written in the thirteenth century, is surely the cornerstone, and most of American jurisprudence is rooted in English common law. During the Renaissance, the seeds for representative government were sown. They sprouted in the American Revolution in the eighteenth century and resulted in the Constitution that was painstakingly hammered out by our Founding Fathers to create a truly democratic form of government.

The evolution of democracy in the United States has been neither easy nor painless. Born of the idealism of the Declaration of Independence, it continued with the Articles of Confederation that lasted roughly a decade before they had to be discarded. Our democracy then came to life in a Constitution that had the near-fatal defect of tolerating slavery, in stark contradiction to the original concept in the Declaration of Independence that "all men are created equal." There was even confusion as to whether the Constitution created a nation. In fact, many preferred to think of it as a federation of sovereign states, thereby leaving unresolved the issue of federalism—the reaches and limits of the federal government (centralized authority) versus that of the states (decentralized authority). In the minds of some revolutionary leaders, the federal government actually was subordinate to the states, except in very limited and well-defined functions.

The Constitution obviously was not perfect when first written, and it was soon amended to include a Bill of Rights, which conferred a mix of individual rights, states' rights, and constraints on federal power. Those legal constructs acknowledged the potential for a tyranny of the majority and the need to protect the rights of minority groups. Even with its deficiencies, the

Constitution created a more representative government than had previously existed and clearly defined the separation and balance of power among the legislative, judicial, and executive branches of government. The process of amending the Constitution established early on that the document would be a work in progress, adapting to changing conditions and mores as times passed, as evidenced by its current 27 amendments.

Nonetheless, just 85 years from the founding of the Republic, one of the bloodiest civil wars in world history was fought to resolve two issues: to make the United States "one" rather than "many" (essentially to further define the rights of the states and the federal government) and to remove the blight of slavery that contradicted the basic premise of the Declaration of Independence that "all men are created equal." Another hundred years and the nonviolent civil rights movement were required to remove the legal barriers of segregation, which had resulted from a culture of white supremacy. On the way, as the new nation became, ultimately, a world power, it was forced to fight many wars to preserve freedom in the world, assuming the leadership role in defending and extending the democratic form of government. This great experiment in governance continues to this day as Americans struggle to harmonize the domestic differences of a pluralistic society and to live peacefully with their neighbors in an ever more tightly knit world community.

GOVERNANCE HAS MADE THE DIFFERENCE

The American experience with governance has been a great yet fragile experiment. It did not have to succeed. South America began its development into a number of individual countries (states) at about the same time as the United States. South America has had great difficulty establishing stable and democratic regimes, even to this day. The twentieth century also saw the growth and failure of totalitarian regimes in Germany, Japan, and Russia, with great personal suffering. The end of colonial rule in Africa following World War II has resulted in almost continuous political instability and bloodshed, as it has in other areas of the world. These experiments in self-governance around the world have not yet succeeded. It is worth noting that peace and prosperity in today's world tend to correlate with stable and democratic governments. Nations ruled by authoritarian regimes of one type or another appear to fall short of achieving both of these goals.

Thus in nation-states, governance indeed does make a difference in the success of a society, but good governance cannot be taken for granted. Without effective political and economic systems, it is virtually certain that no society can achieve sustained peace and prosperity.

CAPITALISM

A fundamental chapter in the evolution of governance was the concurrent development of a free-market economic system that spawned the prosperity that continues to this day. Democracy created a context in which this free-market economic system, called *capitalism,* could evolve. There is a clear and logical connection between the concept of individual political freedom and the freedom of individuals to pursue their economic self-interests. As mentioned earlier, Adam Smith, in his classic *Wealth of Nations,* written in 1776, described "the invisible hand of self-interest" as at the center of human behavior. Rather than seeing it negatively in moral terms, he saw it positively as the principal driving force for economic and social development.

A paradox resulting from the development of capitalism is that the collective pursuit of individual self-interest has created a prosperity that benefits us all. A concept that remains at issue, though, is "the tension between accumulating goods and cultivating goodness, which appeared early in the American experience and has lingered long."[2] The role of the economic system is to provide goods and services that meet the needs of the people and in the process provide the jobs that create the wealth with which people buy the needed and/or desired goods and services. In a poor economy, people are reduced to struggling for survival, often falling prey to disease and starvation. Surviving does not, by definition, create an attractive standard of living. Conversely, an economy that creates wealth does not necessarily meet high moral standards, depending on how the wealth is created, how it is distributed, and for what purposes it is used. Finding the right balance between "goods and goodness" is an ongoing debate. It is not our purpose here to resolve it, nor could we. However, we do want to acknowledge its importance and relevance to contemporary society. Most certainly, moral and ethical considerations must enter into the governance not only of nations but also of commercial enterprises, as we are sadly relearning as this is being written.

THE GAME

Businesses function in complex economic systems, each with its own characteristic ecology. We can view these systems using the analogy of a game, where participants typically compete within the rules of the game to get ahead. Such games have been played throughout recorded history and have developed in complexity and reach, with most changes having occurred within the past two centuries. Initially, though, the games were mostly local, confined to villages, townships, and small geographic regions. In the last several hundred years, they have expanded and grown to encompass whole nations. Currently, the games are becoming more global, with nations banding together to form economic unions. For the most part, though, the rules of the economic systems we describe are determined predominantly at the level of national governments, with trade restrictions eased or eliminated for member countries of economic alliances.

The nature of the game in each nation reflects a number of variables: the culture, the education of the population, the political system, the geography, and the available capital and natural resources. These attributes influence the creation of an infrastructure that supports the game. Of particular importance in this infrastructure are national defense and public safety, the nation's transportation system, and its legal system, both criminal and civil. The criminal system protects people and property and ensures domestic social order. Likewise, a strong military protects the nation from attack. The civil system arbitrates and enforces contracts and personal property rights. We find that within the context of the resulting organizational infrastructure, the game is influenced and substantially determined by three distinct institutions: the government, regulatory and law-enforcement agencies, and finally, those individuals or groups who choose or are forced to operate outside the rules of the game.

The Government and the Game

Federal, state, and local legislative bodies and various governmental agencies write, approve, and interpret the rules of the game. Governmental executives, particularly the president and state governors, also have a role in this process, primarily through the use of vetoes and executive orders. In a democracy, individual constituents as well as various interest groups try to influence the writing of the rules in their favor. Thus part of the game itself involves the efforts to modify the rules of the game.

The game's rules in the United States have centered on seven main goals:

- To maintain competitive markets via antitrust and fair-trade laws
- To regulate noncompetitive markets
- To maintain a balance of power between capital and labor
- To ensure orderly capital markets
- To protect consumers from unsafe products and fraud
- To ensure equal access to employment, education, housing, and public accommodations
- To protect the environment