Corporate Governance 101: Who's in Charge?

How does something like Enron or WorldCom happen, a corporate scandal where every safeguard fails? Chalk it up, in part, to a failure of corporate governance. Corporate governance is the relationship between shareholders, directors, and management. The way it works is that shareholders (mostly passive investors) are the technical owners, but since they are such a diffuse group, they exert little control. Instead, they "elect" a board of directors to look out for their interests (making money). But board elections are barely elections. Usually, there is one slate of candidates, nominated by management. These directors naturally tend to be very friendly to management, happily increasing executive salaries regardless of performance. They also tend not to ask the tough questions about what's really going on. And as long as the stock price keeps going up, everybody's happy. But what about the employees whose jobs depend on what goes on in the boardroom? What about the communities where the companies operate, where a plant closing or accident could have devastating consequences? In most cases, none of these stakeholders are represented under the current corporate governance set-up.

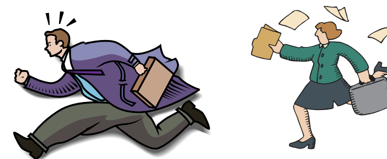
Directors

The board of directors is, in theory, elected by and accountable to the shareholders. But in actuality, most board elections offer only one slate of candidates, a slate pretty much hand-picked by management. And that's the problem — few directors are "independent." Instead, they are often chosen by the executives they are supposed to be overseeing. This makes them less likely to stand up to management on issues such as fraudulent accounting or even salary increases. In most U.S. companies, the CEO is also the chairman of the board. So essentially directors are serving at the behest of management, not the other way around. Many directors also serve on several the boards of several other corporations, meaning their attention is split. But directors do have to make sure that the company is working to maximize profit for shareholders — that is their legal responsibility. In most cases, however, they don't pay much attention to how the company is making money. That is up to the managers, who are paid to deliver profit by whatever means possible.

Shareholders

Shareholders are the true owners of publicly-traded corporations. They are the more than 100 million Americans who own stock. But shareholders are primarily investors looking to make some money. Most feel no particular responsibility for the corporation's behavior. They decide to buy and sell based primarily on the company's earning potential. Although owning stock gives them a right to vote at shareholder meetings, most own such a small percentage of oustanding shares that their influence is indeed tiny. Institutional investors, such as mutual funds and large pension funds, own larger chunks of stock, but most also take a passive role in corporate governance. However, a growing number of socially responsible funds and state pension funds (most notably California) are taking an increasingly active interest in corporate governance, using their weight to press for governance reform and social responsibility. In 2003, A record of at least 862 shareholder proposals have been filed at 2,000 widely held U.S. companies, according to the Investor Responsibility Research Center

Passing the buck: Nobody takes responsibility



Management

The executives theoretically serve at the pleasure of the board of directors, but since few directors watch them closely, most executives do as they please.Their primary directive is to maximize profit for shareholders. To accomplish this, they often cut jobs and pay workers less, reduce long-term research and development investments, and sidestop environmental and safety regulations — anything to make an extra buck. But that's what they have to do — executives are, after all, under tremendous pressure to maximize shareholder profit (i.e., "deliver the numbers"). But increasingly, executives are becoming major shareholders as well. During the '90s, executives were given boatloads of stock options, a move designed to align the executives' interests with the shareholders' interests. But what actually happened was that many executives focused more on doing whatever they could to boost the short-term stock price, forsaking the long-term health of the company. Then, because they knew the true financial situation, the executives were able to cash out before the stock crashed, usually with the complicity of directors.

For more information, visit Citizen Works at http://www.citizenworks.org or call 202-265-6164.

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CITIZEN WORKS

Profiles in Cronyism

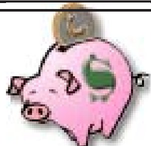
Tyco: Where was the board when former CEO Dennis Kozlowski was stealing $600 million from Tyco through stock fraud, unauthorized bonuses, and falsified expense accounts, using company money to buy a $17,100 travelling toilet kit and a $15,000 dog umbrella? Some were allegedly taking bribes from Kozlowksi.

Enron: So shouldn't somebody on Enron's audit committee have raised questions about the company's accounting? Well, committe member John Mendelson didn't speak up. But, Enron had given $1.6 million to Mendelson's M.D. Anderson Cancer Center at the University of Texas. Why would he cause trouble? The same goes for committee member Lord John Wakeham, who was also earning $72,000 a year as a consultant to Enron? You get the picture.

Gap: How's this for cronyism? Chairman Donald G. Fisher scored a deal for his brother to build and remodel Gap stores and his wife to serve as a consultant. Two directors sit on the board of Charles Schwab Corporation, while Charles Schwab sits on the Gap board.

Tyson: Ten of 15 board members have ties to the company. Seven have extensive business dealings. CEO and board chairman John Tyson got a $2.1 million bonus in a year when net income fell 42%. Meanwhile, the company is charged with smuggling workers from Mexico into its U.S. poultry plants.

Resources



US Investors: www.usinvestors.org
Corporate Governance: www.corpgov.net
Council of Institutional Investors: www.cii.org
The Corporate Library: www.thecorporatelibrary.com
Shareholder Action Newtork: www.shareholderaction.org
The Stakeholder Alliance: www.stakeholderalliance.org
The Conference Board: www.conferenceboard.org
The New York Stock Exchange: www.nyse.com
Standard and Poors: www.standardandpoors.org

Books:
The Divine Right of Capital, by Marjorie Kelly
Corporate Irresponsibility, by Lawrence Mitchell
The Tyranny of the Bottom Line, by Ralph Estes
The New Global Investors, by Robert Monks
The End of Shareholder Value, by Allan A. Kennedy

Making corporations accountable:

some corporate governance solutions

Almost everybody recognizes the need to improve corporate governance, even most corporate managers. At the most basic level, there is a call for more director independence and more shareholder involvement as checks against corporate corruption. But the "Enron moment" should result in much more. The interests of all stakeholders — workers, communities, and even customers — need to be placed on equal footing with the proft-hungry investors who currently dominate the corporate governance process. Below are a number of others corporate governance reforms.

Make sure directors are independent: Directors who have close ties to executives often act as rubber stamps for accounting fraud and excessive compensation, willfully failing to ask the tough questions. Only independent directors who have no ties to the company and its executives can prevent insider cronyism and represent shareholders. Audit and compensation committees also must be composed entirely of independent directors. The size of boards needs to be limited. The number of boards individual on which directors can serve needs to be limited as well. The SEC has taken a step in the right direction by requiring the audit committee directors do not have consulting relationships or other ties to the corporation. But that same rule should apply to all directors.

Activate the shareholders: Shareholders are often uninvolved in the major decisions of the corporations they own. Some decisions that should be brought to shareholders for a vote: the sale of major corporate assets; executive compensation packages, including options; all takeovers and mergers. Director elections should be done by cumulative voting, so that a director doesn't need a straight majority to get elected. Shareholders should be guaranteed a choice of at least two directors for every opening, not just one slate chosen by management. Minority shareholders should be able to nominate directors. And finally all election ballots should be confidential.

Give all stakeholders a voice: Even if boards of directors were more independent and shareholders were active, only a small slice of people affected by a company's actions would be involved in the decision-making process. What say would communities have when plant closures were being discussed? What say would workers have when their benefits were about to be cut? However, if workers, communities, consumers and other stakeholders are given a participatory voice in corporate governance, corporations would become more responsive to all parties, not just profit-driven investors. This could be accomplished by placing all stakeholders on the boards of directors. It could also be accomplished by changing the law to broaden the corporation's duty from just making profits for shareholders to serving the interests of all stakeholders. One proposal is The Code for Corporate Responsibility (see www.citizenworks.org)