ONE

Introducing corporate governance

Case: Lehman Brothers and the subprime crisis

In November 2008, Richard Fuld was called to testify before a US Congressional committee investigating the sudden collapse of Lehman Brothers, the investment bank he had headed for many years. Its deep involvement in the markets for asset-backed securities – bonds developed from what were called 'subprime' mortgages and derivatives contracts associated with them – had brought the bank to a crisis two months before. When the US government refused to bail it out, credit markets around the world seized up, accelerating the growing slump of the world economy. The next day, perhaps realizing the mistake of allowing Lehman Brothers to fail, the US Treasury pumped money into the American Insurance Group (AIG), a company that had become the biggest player in a gigantic global market for credit default swaps – tradable securities that initially served as insurance against corporate borrowers, individual mortgage-holders and the banks who lent to them being unable to meet their commitments. As credit dried up around the world, almost any credit default swap might have to pay out. There was insufficient money to pay them all at once. The US Treasury saved AIG, but it proved too little and too late to prevent a string of calamities of varying degrees of severity in Italy, France, Japan, Thailand, Germany, the UK and even Switzerland.

By the end of November, several major commercial banks in a variety of countries had, in effect, been nationalized. Citigroup, the world's largest bank, had been propped up with new equity supplied by US taxpayers, and the entire banking system of a whole country – Iceland – was on its knees. Investments made by Icelandic banks – especially in the retail sector across Europe – were threatened as other banks refused to lend the retailers money to pay their suppliers for merchandise in the run-up to the busy Christmas sales.

The problems in the system were not entirely of Lehman Brothers' making, of course. It had been only one of many intermediaries in the complex web of transactions that collapsed in on itself that month. In the preceding months, Britain had been forced to nationalize a mortgage lender, Northern Rock, after other banks had lost confidence in its ability to repay loans it had taken from other banks to fund its activities. America's biggest stockbroker, the venerable Merrill Lynch, had been impelled into a takeover by Bank of America, the country's second largest commercial bank. Wachovia, the fourth largest, was salvaged by Wells Fargo. On Wall Street, the model of investment banking that had dominated capital markets – from mergers and acquisitions advice, to stock and bond trading, commodities futures and lending to the burgeoning hedge fund industry – had come to an end. After Lehman filed for bankruptcy, its rivals Goldman Sachs and Morgan Stanley, the last two large investment banks, turned themselves into commercial banks, subjecting themselves to a myriad of new regulations in exchange for the right to borrow the money they needed to stay afloat directly from the Federal Reserve, America's central banking system (for background, see Economist, 2008a, 2008b, 2008c).

The legislators wanted to hear from Fuld just what he had done to earn the $500 million he had take home from Lehman Brothers over the last nine years. (It was not that much, he protested, something closer to $250 million.) But they also wanted to know: how did the board of directors – the people charged with watching over the policies and practices of the company known as Lehman Brothers Holdings Inc. – how had they so completely failed in their duties to the shareholders, that is, the owners of the business they had pledged to serve? How had they failed to see that the business had gone bad, that the assets of the bank had become so 'toxic' – the word that had become an emblem of the banking crisis – that it had afflicted with global financial system, spreading the discomfort throughout the world economy? Were they simply asleep on the job? And what of the directors of all the other banks, brokers and businesses now threatening the wealth of their shareholders, the jobs of their employees, the pensions of their retired workers and of all those whose savings were locked up in other pension funds that invested in stock, debt and property markets now threatened with one of the greatest collapses of value in the modern history of finance? How could these smart people get things so catastrophically wrong?

This was not, to be sure, the first time that directors of public companies had presided over massive destruction of value, despite widespread use of mechanisms of corporate governance – ranging from auditors to credit rating agencies, voluntary codes of conduct to stringent laws on liability and listing requirements of stock exchange – to prevent just that. In the first few years of the twenty-first century, the Italian dairy company Parmalat failed under allegation of fraud and misdealing, and Ahold, a Dutch supermarket group, reeled under a scandal of false accounting. In America, the names of Enron and WorldCom, once among the largest and most respected companies in the country, became synonymous with corporate greed, arrogance, fraud and deception. Aided and abetted by their auditors, the venerable firm of Arthur Andersen, these two colossuses proved to be only two of a string of companies that had exploited every loophole in the US regulatory system to pump up their financial statements well beyond a true reflection of the state of the business. The first wave of internet-related euphoria in financial markets – the dot-com bubble – burst about the same time, wiping trillions of dollars off the nominal value of stock markets in America, Germany, France, Italy, the UK and just about every developed economy in the world.

A decade earlier in the UK major three companies failed in spectacular fashion, the Bank of Credit and Commerce International, better known as BCCI, Polly Peck International, a trader in fruit and textiles, and Maxwell Communication, a newspaper publisher run by a larger-than-life proprietor and one-time member of parliament whose apparent suicide led to the unravelling of his business empire in the US and UK alike.

These were massive failures in the practice we know of as corporate governance. But the lessons we learn from corporate governance extend into almost all areas of life in organizations. How do family-owned companies cope when the founder of the business retires? How do small, private companies deal with the interests of people who provided capital – the initial funding – to get the business started in the first place? When a business floats shares on a public markets, how do its directors look after the interests of those outside shareholders, those not directly involved in the business, too numerous and perhaps too widely spread around the country and the world to consult individually for their views and whose interests will not, anyway, all be the same? How do other organizations – charities, government agencies, clubs and trade associations – look after the interests of their donors, taxpayers, members and beneficiaries? What structures and processes will help the people entrusted with running them remain accountable to their interests? While this book will focus on the affairs of quoted companies drawn mainly from the major western economies, it will do so knowing that readers will be seeking lessons as well about the affairs of other organizations in other parts of the world whose aim is to create value for those whose interests they represent.

Questions arising

Let's remember, for the moment, that the subprime mortgage market benefited many people in society, had the system not crashed. Poorer people got a chance at home ownership, by virtue of the way this market – initially, at least – held the promise to distribute risk more widely than ever before. And remember that Lehman Brothers was only one of many banks and corporations that become entangled in the crisis.

1 What approaches might the Lehman board or the US government have used to prevent a disaster?

   a) Which are external to the company?
   b) Which are internal to the company?
   c) Which external to the profession/industry?
   d) Which internal to the profession/industry?
   e) Which have force of law?
   f) Which have force of custom and practice?
   g) Which have ethical force?
   h) Which draw their force from politics and power?

2 What power did Richard Fuld have to prevent a disaster?
3 What power did the board of Lehman Brothers have?
4 To whom were they responsible?
5 To whom were they not responsible? What were the limits of their responsibility?

What is corporate governance?

Seeking a tidy definition of any subject presents difficulties, but few are less tidy than corporate governance. Corporations create employment for many if not most people in the advanced economies around the world. Their profits fuel wealth creation, through the payment of dividends they pay to their shareholders or the money they invest in research and development to create new products or to reduce the costs of creating the goods and services that people around the world want to buy. Much of the improvement we have seen in living standards in the last 200 years can be attributed to corporate activity, since the industrial revolution made mass production possible and with it made products available to the masses. Governing such entities involves overseeing strategy, human resources, financial accounting, marketing, external communications, factories and organizational structures and deciding how they all fit together.

Corporations – the large businesses operating on a scale that one individual person could easily control and only a few could ever dream of owning – also operate in ways unlike other entities, other 'economic actors'. Unlike individual people, corporations are difficult to hold to account. You cannot imprison a corporation. Their owners claim property rights over them, but in a very peculiar way. Owners' rights over the corporation scarcely justify using the term 'ownership' at all.

Corporations occupy an odd place in the political systems in which they reside. Even the word 'reside' is odd: to create the structures we know of as corporations, nineteenth-century political and legal theorists decided to treat them as though they were people. Companies – groups of people working as an economic unit – were allowed to incorporate and in so doing become 'legal persons', entitled in law to enter into contracts with people and other corporations, and given the protection of law as though they were people. But unlike people – or, until the past few decades, partnerships between people – corporations, received in law the recognition that their members, that is, their shareholders or 'owners', were not personally liable for their debts or if something went wrong. This protection in law allowed corporations to amass the large amounts of capital needed to build large enterprises using large machinery and employing large numbers of people. Through that protection, they grew throughout the twentieth century into the enterprises we know today (for background, see McCraw, 1997).

Many large corporations, the ones we sometimes call multinational enterprises or 'transnational' companies, have more income and produce more wealth than many countries. Their employees may well be citizens of a country – or of more than one – but their expatriate managers may have a greater sense of allegiance to the corporation than to any single nation-state. Their actions – if nothing else through threatening to move their legal seat from one political jurisdiction to another – can prompt governments to change policy. A few have conspired to overthrow governments, so great is the potential of their power (for the case of ITT and Chile, see Sampson, 1973).

Most corporations, of course, do not enjoy such power let alone use it. But neither are they easy to subsume under law in any one jurisdiction. Particularly in the liberal democracies that fostered the growth of corporations and the economic welfare they allowed, governments claim legitimacy through their right to govern the people who live under their jurisdiction. Corporations cannot claim such legitimacy, yet they can govern, in many ways, the lives and activities of the workforces and the companies and individuals who supply them or buy the products and services they create. The scope of this power sits ultimately but uncomfortably under the jurisdiction of law and society. But the power they possess puts them and the managers who lead them in a position to do much damage as well as much good.

How, then, do we govern these corporate entities? In the narrow sense, corporate governance looks at the mechanisms put in place inside companies to guide their actions and monitor their performance. Most writing and thinking about corporate governance focuses on the role of the board of directors, the group of people who sit at the top of the enterprise, deciding what direction it should take, what strategies it should adopt, hiring a team of managers and then holding them to account for the performance they deliver. Another aspect of corporate governance looks at how those boards of directors relate to their owners, the investors who bought shares in the corporation and claim, through the legitimacy of their property rights, to have some sort of say over the affairs of the corporation. These two areas – the relationship between boards and managers and the relationship between investors and boards – form what we will call the classical agenda of corporate governance, which has dominated the thinking and writing about corporate governance (Cadbury & Millstein, 2005;

Charkham, 1994; MacAvoy & Millstein, 2003; Millstein & MacAvoy, 1998; Monks & Minow, 2003). Despite the difficulties associated with looking into the private and often highly confidential affairs of private entities, scholars have attempted to describe how these processes work, in part so that other directors on other boards can see, if only through a glass darkly, how they might conduct their business. Even more scholars have attempted to prescribe how boards ought to conduct their relationships – with managers and investors – even in absence of definitive information about how the complex interaction of all the factors that come together at the board really works.

There is, however, another range of issues that have increasingly come to be seen as forming a new agenda in corporate governance: how corporations relate to their broader society. Whether we call it corporate social responsibility, sustainability, ethics or just corporate responsibility without the 'social', this stream of thinking (Benn & Dunphy, 2007; Crowther & Rayman-Bacchus, 2004; DesJardins, 2007; Elkington, 1999) involves a consideration of how boards and the top management teams they employ relate to their employees, suppliers, customers, and even their competitors and those who might seek to compete against them. It seeks to take into account as well how the corporation relates to the community in which it operates, the people who live near the factories and office buildings the corporation operates, local governments, and even national governments and supranational organizations. It seeks as well to examine how and even whether corporations have a responsibility to non-governmental organizations, even those that are not particularly part of a local community in which the global corporation just happens to work. It seeks to identify the role of the corporation and its board in preserving the environment in which we all live, a larger and more prominent part of the agenda as the consensus of scientific opinion has built around the impact of global warming and the role corporations play in it. This second agenda has been widely studied in descriptive ways as well, often with even less access to definitive information that would lead to conclusions we might consider robust. It, too, has developed a large academic literature of a prescriptive nature, and one with perhaps even more vigour of opinion than we see in the literature of the classical corporate governance agenda.

Both streams of thinking seek to address simultaneously two issues:

- How are corporations directed and monitored, and what mechanisms can we use to make them perform better?
- What mechanisms can we put in place to ensure that corporations, their managers and directors do not destroy the value that the corporation was meant to create and destroy the value of others with whom it conducts its affairs?

Inside corporations, however, corporate governance has another aspect: how can we create value? That was, after all, why the corporation was formed; indeed, why society created the institution of the corporation in the first place.

In that sense, running a corporation is a bit like sailing a ship or driving a car. The term governance traces its roots to the Latin word *gubernare* – to steer – as in directing a ship towards its destination, overcoming whatever vagaries the wind and tides might inflict on the crew's intended course of action. Governance is, therefore, the job of setting the direction. When kings were truly sovereign, governance referred to the instructions that the leader had set out for his subjects to follow, come what may. But over the centuries other definitions have come into play. Democracies govern not by edict, but rather by systems of checks and balances, by negotiating a settlement between competing interests. The role of governance is not merely to set direction, but rather to mediate between the various parties contesting for control of resources.

Box 1.1 Agenda point 1: Operating the controls

Governance involves steering, yes, but in a modern economy, one powered by engines rather than wind, it also involved stepping on the brakes and limiting the throttle. In mechanical engineering, a governor prevents engines from generating too much power, from propelling the mopeds faster than a speed limit deemed appropriate to keep their riders and other users of the road safe. Corporate governance also concerns slowing things down, avoiding disasters, protecting something of value, preventing one party from scaring others off the road.

Strategy, when the driver uses the steering wheel the accelerator pedal, and is also a part of corporate governance. But both the classical and the new corporate governance agendas involve thinking about how we should apply the brakes. People who drive use all three controls – the steering wheel, the accelerator and the brakes – hopefully at the right time and in the right circumstances. We use brakes, as the presenter of a British television programme on motoring once said, *to make the car go faster*.

Agenda point 1 suggests we can think of governance as involving three controls: the steering wheel, the brake and the accelerator. This book considers all three and their purpose. We will look a bit at direction, though it more often than not is the subject of books on strategy and its use tends to be specific to each company. We will look at the importance of speed in creating value, too; how corporations innovate and bring ideas to market quickly to remain competitive and to add value. But the main focus of this book is examining the brakes, not because they should be applied at all times – quite the contrary. This book is intended to help us be sure, when we do go into a sudden change of direction or we're just gaining speed as we cruise straight ahead downhill, we can take the actions necessary to avoid a crash and get to the destination faster.

How this book is organized

Chapter 2 explores some of the background to the two questions that have dominated the corporate governance agenda: 1) the disasters that have led to massive destruction of wealth and of trust in the role of corporations in society, and 2) the smaller, day-to-day grievances that are piled at the doorstep of the board of directors, whether in complaints about excesses in executive pay, the role of corporations in philanthropic activities, or any of a variety of other issues the board may need to decide. The three sections that make up the rest of the book explore the principles of corporate governance, the governance issues facing boards of directors, and how companies account for their activities and what that holds for the future.

Principles of corporate governance

Chapter 3 examines those issues through the lens of theory, showing how *agency theory* can help us understand the actions of managers and boards and their relationship to owners. We will look at alternative views as well: what scholars call *resource dependency theory* concerning the way boards facilitate access to key resources, contributing to the company's creation of value, and how that invokes *stewardship* and its implication for board performance. We will look as well as what has come to be called *stakeholder theory* helps illuminate competing claims to the resources that the corporation controls, whether they come from workers, suppliers, customers or the public at large.

Chapter 4 sets corporate governance in a wider context, looking at the range of mechanisms that constrain how corporations function – from the ways that markets and competition play a role in applying the brakes to corporate greed and personal ambition, to the role of law and regulation in setting a framework that prescribes what corporations, their boards and managers must and must not do.

This leads us, in Chapter 5, to a discussion of the approaches taken in different countries to the way corporations are organized, the roles boards of directors play, and the tensions that result. We will also see how that situation is changing, in large part under pressure from markets themselves: global markets for products and services and the increasingly global market for capital and investment.

Chapter 6 brings us to the attempts to reconcile these pressures: the ones that led to disasters in corporate governance like those sketched out in the opening section of this chapter, and the ones that look at those smaller, day-to-day issues that confront corporations of all sizes, industries and nationalities – if corporations really can be said to have nationalities any more. We will look at how codes of conduct have developed around the world, though with a heavy focus on Europe and the United States, whose measures came first and were copied in many other parts of the world, whether or not they were appropriate to local conditions.

Issues on the board's agenda

The next four chapters explore the key issues on the classical corporate governance agenda of monitoring and control, those examined in the main through agency theory. Chapter 7 considers how codes have sought to address these issues through the structure and composition of the board. The chapter also looks at the limitations that formal measures have. That leads to a discussion of board processes and how the characteristics of board members can work against the twin aims of corporate governance – performance monitoring and value creation.

In Chapter 8 we look at the issues of executive pay (which can involve paying too little as well as too much), its more sinister extensions into fraud and self-dealing by top management, and how accounting has been used to cover it up. The solution to these types of issues rests in increasing the independence of the board of directors and in modifying the structure of the boards.

Chapter 9 considers the relationship between boards and their owners, and in particular two aspects: the role of founding families and other large shareholders who can exert decisive power in board decisions, and how institutional investors, like pension funds, insurance companies and the companies that create collective investment vehicles like mutual funds, seek to influence corporate affairs.

Chapter 10 explores the trend in these ownership issues, and in particular the role that non-traditional investors – like hedge funds, private equity houses and sovereign wealth funds – are changing the investment landscape, raising new issues about the nature of the classical corporate governance agenda.

Chapter 11 then turns to what we have called the new corporate governance agenda, looking first through the lens of a particular type of specialized investment activity: the growth of what is sometimes called *socially responsible* or *ethical investment*, approaches that can in some ways challenge the assumptions which underpin traditional institutional investment, and indeed the non-traditional world of hedge funds and their kindred spirits. In this context we will also consider issues of sustainability in the face of the uncertain science of climate change as well as the uncertainties of markets for goods and services and the resulting uncertainties about the sustainability of strategy and the profits it aims to create.

Reporting, rebalancing and the future

Chapter 12 revisits the some of the issues raised about *how* we conduct corporate governance, but with a special focus on the roles of transparency and disclosure as alternatives to detailed rules, regulations and enforcement.

Chapter 13 makes a modest attempt to link these themes to the debate over what private companies, charities and public sector bodies have to learn from the emerging consensus – as we will see, even orthodoxy – about what corporate governance entails.

The book concludes in Chapter 14 by returning to the question of whether all this attention to the brake pedal means that we have slowed the enterprise down too much and lost momentum towards value creation. We consider the board's role in strategy and provision of resources, before ending with a few tentative thoughts about the issues we are likely to face in these unsettled and unsettling times, when global economic integration is proceeding even as the banking and regulatory issues rised in the discussion at the start of this chapter pose questions about whether the governance mechanisms we have implemented so far are capable of doing the job we designed them to perform.

Further readings

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