Institute for governance
of private and public organizations

Corporate Governance:

Looking backward, looking forward

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Yvan Allaire, PhD (MIT), FRSC

Executive Chair
Institute for Governance (IGOPP)

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Once upon a time, the governance of publicly listed corporations was a friendly, fraternal affair with few requirements and little risk. Then, during the 1980s, a group of funds (leveraged buyout funds) sprouted up claiming that this sort of governance deprived shareholders of the full economic value of the business they had invested in. Cozy boards and complacent management, these funds claimed, were not motivated to maximize value for shareholders.

Their solution was a dramatic one: this system must be changed by a “revolution” in governance made possible only by the full privatization of these companies. Having access to large pools of funds and the borrowing capacity of the targeted companies, these LBO “revolutionaries” carried out a wave of hostile takeovers of companies and their subsequent privatization. That period was unusual for the large number of transactions – nearly always hostile – to privatize public companies.

This “revolution”, which was to some degree successful and did leave a lasting impact on corporate governance, eventually faded away as a result of two events at the end of the 1980s and beginning of the 1990s:

1. The financing of these LBO transactions relied heavily on another “innovation”, namely junk bonds, whose principal protagonist was Michael Milken. However, at the end of the 1980s, a series of financial scandals implicated several major actors in the financial world, including Milken himself who was charged and eventually served jail time. This criminal turn of events had the effect of immediately drying up the junk bonds market as a source of financing for LBOs;
2. Legislators in 30 or so U.S. states, prompted by an electorate that was shocked and outraged by the impact on their communities of these hostile “privatizations”, adopted laws giving boards of directors increased authority and leverage to repel any unwanted takeover bids.

However, stung by the arguments of LBO funds, boards of directors would henceforth set compensation of senior executives in a way that would motivate them to create economic value for shareholders. That meant, *inter alia*, generous helpings of stock options so that management would work hard to push up the stock price, pleasing shareholders and *ipso facto* enriching themselves.

This radical change in executive compensation was strongly supported, and even instigated, at the time by institutional investors. As executive compensation shot up, public companies, beginning in 1992, were obliged to disclose detailed information about the compensation of their five best-paid executives.

Thus, during the 1990s, hostile takeover bids quickly dried up and were replaced by transactions that had become "friendly"[1]. The aggressive, "hostile" LBO funds morphed into "gentle" Private Equity Funds (PEF).

Board governance reverted to the quiet, collegial nature of the old days, but failing inexcusably to factor in the increased risk of management misbehaviour brought about by a system of compensation now loaded with stock options. This risk went unforeseen until the tornado known as ***Enron***, ***WorldCom***, ***Global Crossing***, ***et alia*** caught boards of directors by surprise in 2001.

The American political and regulatory system, sensing that accusations of laxity were forthcoming, adopted the Sarbanes-Oxley (SOX) Act in short order in July 2002. Thus, having interpreted the ***Enron/WorldCom*** scandals as being largely attributable to accounting flaws and management malpractices resulting from overly generous incentives, SOX imposed new safeguards, including the following:

- Independence requirement for audit committee members;
- Responsibility of audit committees for the quality of internal controls;
- Explicit responsibility of the CEO and CFO to certify that the financial statements adequately represent the corporation's financial position;
- Full disclosure of off-balance sheet transactions;
- Creation of the Public Accounting Oversight Board;
- Severe restrictions on other services that audit firms can provide to corporations for whom they assume audit responsibility;
- More expeditious filing of insider trading reports;
- The reimbursement of any variable compensation obtained according to financial statements that were subsequently restated;
- The prohibition of loans to senior management and directors;
- Longer prison terms for financial fraud.

1 An argument also proposed by the recent recipient of the Nobel Prize in economics, Bengt Holmstrom, in an article entitled "*Corporate Governance and Merger Activity in the U.S.: Making sense of the 1980s and 1990s*" by Bengt Holmstrom and Steven N. Kaplan, SSRN, February 19, 2001

Not only did the bankruptcies of ***Enron*** and ***WorldCom*** lead to unusually long prison sentences for the officers of these corporations but board members were required to pay *out of their own pockets* fines of $13 million and $18 million respectively. Although there was no equivalent jail time or monetary fines in other cases, the Enron/WorldCom sagas triggered a shock wave among the officers and board members of U.S. public corporations.

Having to comply with the SOX requirements, worried about the risks they now ran for any laxity in governance, submerged under an avalanche of measures, standards and principles of "good governance" put forth by committees of experts, security commissions and the stock exchanges, boards of directors engaged in a sweeping reform of the governance of public corporations. Boards would henceforth play their role fully and assert a new (or renewed) fiduciary authority over corporate management.

This phenomenon, which first appeared in the U.S., spread like wildfire to Canada and the United Kingdom, and then more slowly to other developed countries.

Then the 2008 financial crisis happened! While it was rooted in financial firms and institutions,[2] the conflagration came close to engulfing all industrial economies. The resulting trauma had several consequences:

- Despite the obsessive quest for "good" governance and the frenetic agitation to implement the best governance practices, boards of directors were incapable of foreseeing or anticipating events and controlling corporate management. The determination, in the post Enron-WorldCom episode, *to assert a new (or renewed) authority over corporate management* proved to be a pipe dream. Clearly, the fundamental issue of governance has never been resolved: the huge gap in information, knowledge and experience at running a particular firm which management enjoys over the board;
- Shareholder confidence and public trust in boards of directors plummeted;
- The rich, often extravagant compensation of executives in the financial sector, now apparent to all, was quickly, and quite properly, identified as one of the main causes of this crisis. Are the boards of directors not responsible first and foremost for setting executive compensation and ensuring that it does not encourage conduct that could ultimately damage the firm? The media, the governance industry and other parties certainly thought so and claimed that boards had too often failed in this fundamental task;

2 It escaped many American observers (and others) that all the companies involved were listed on exchanges and widely-held.

- Once again, the political system had to act quickly and it did. The Dodd-Frank Act, numbering 848 pages, was adopted in July 2010. There were numerous aspects to this sweeping legal text. Among others, and despite being aimed primarily at the financial sector, this Act mandates universal changes. For example, advisory votes on compensation have become mandatory for all companies listed on a U.S. exchange. All U.S. listed companies will be required to disclose the ratio between the CEO's compensation and the median compensation of the company's employees[3];
- There were multiple interventions by the ***European Union***, the ***Bank for International Settlements*** and the ***Financial Stability Board*** (FSB), a creation of the G20. All these bodies, like Dodd-Frank, either formulated directives or made recommendations aimed at controlling compensation in the financial sector and requiring a demonstrable relationship between performance and variable compensation. All these organizations expressed a limited and uncertain confidence in the ability of boards to properly handle this task, but their concrete proposals on compensation were often misguided and revealed a limited understanding of the issues;
- The 2008 financial crisis made a fetish of "risk management"; yet an examination of the failed companies in 2008-2009 shows that it was not so much inadequate risk awareness and measurement that were at the root of the problem, but a surging complexity of financial firms, which quickly overwhelmed the board's ability to "govern" the corporation. Among the lessons to be drawn from this episode, one should include the requisite self-assessment by the board of its own ability to govern the corporation when the complexity of its operations has ballooned as a result of new strategic initiatives;

3 The Securities and Exchange Commission (SEC) encountered numerous difficulties in implementing this measure mandated by Dodd-Frank, but it has now been adopted (supported by a 192-page explanatory document) and will take effect in 2018. Canadian corporations listed in the U.S. will be exempted from this requirement.

- The gradual, initially latent, erosion of the legitimacy of boards became more tangible after 2008. The conventional structure of a management overseen by a board of directors has lost much of its credibility and has triggered a frontal assault by institutional funds to take over the historic and legal powers and responsibilities assigned to boards. The phenomenon is apparent, *inter alia*, in the following developments:
    - Shareholders' vote on compensation, which is initially advisory, but may soon be binding;
    - Proxy access by important shareholders wishing to propose their own candidates for the board;
    - The undeniable influence of proxy advisory firms on institutional shareholders;
    - The emergence of activist funds convinced that their strategic and financial wisdom is clearly superior to that of board members;
    - Majority voting for the election of board members, without granting safeguards to the board (Bill C-25 in Canada);
    - The decisions of U.S. courts permitting shareholders to circumvent the provisions (Rule 14a-8(i)(7)) that give management the authority to reject any shareholder proposal which represents an attempt to "micromanage" the corporation (S. Bainbridge, ***Fordham Law Review***, Vol. 85, 2016);
    - The suggestion, which might yet be confirmed, to create shareholder committees for public corporations; this practice is already common in France and other European countries, but, in these cases, takes a generally harmless form. Indeed, advisory committees made up of individual shareholders – who are kept on a short leash by management – hold meetings two or three times per year to deal with "lighter" topics. However, the bill put forward by British legislators, inspired by the role of the nomination committee in Sweden, goes much further: *Concretely, new committees composed of shareholders could take their place next to the existing audit, nomination, or compensation committees created by the board. These shareholder committees would consist of i**nstitutional investors holding a large share of the capital** such as, for example, the five largest shareholders. They could express their opinion on sensitive points and even review certain decisions of the corporation. This could include the salary*

> *of the CEO, the amount of which could be subject to ratification, and even appointments to the board.* ***This new power would provide a counterbalance to the power of the directors.*** (Les Échos, October 9, 2016, our emphasis).

In essence, shareholders, particularly the institutional ones, have all, in some fashion, become "activists".

Some funds make it their mission to push aggressively on boards of directors to implement measures that they (the activists) deem likely to boost stock prices. Other funds may be less vocal and less aggressive but will support the "activist" funds as well as put forth their own expectations in private meetings with management and the boards.

In this day and age, the CP Rail/Pershing Square saga teaches us that no matter its size or the nature of its business, a company is always at risk of being challenged by dissident shareholders, and most particularly by those funds which make a business of these sorts of operations, the activist hedge funds.

Of course, a *widely held* company with weak financial results and a stagnating stock price will inevitably attract the attention of these funds. But the puzzling question and it is an unresolved dilemma of corporate governance remains: how come the board did not know earlier what became apparent very quickly after the Ackman/Harrison takeover at CP Rail? Why would the board not call on independent experts to assess management's claim that structural differences made it impossible for CP to achieve a performance similar to that of other railroads? How could the board have known that performances far superior to those targeted by the CEO could be swiftly achieved?

Lurking behind these questions is the fundamental flaw of corporate governance: *the asymmetry of information, of knowledge and time invested between the governors and the governed, between the board of directors and management. In CP's case, the directors, as per the norms of "good" fiduciary governance*, relied on the information provided by management, believed the plans submitted by management to be adequate and challenging, and based the executives' lavish compensation on the achievement of these plans. The Chairman, on behalf of the Board, did *"extend our appreciation to Fred Green [then CEO of CP] and his management team for aggressively and successfully implementing our Multi-Year plan and creating superior value for our shareholders and customers"*. That form of governance is being challenged by activist investors of all stripes.

Their claim, a demonstrable one in the case of CP, is that with the massive amount of information now accessible about a publicly listed company and its competitors, it is possible for dedicated shareholders to spot poor strategies and call for drastic changes. If push comes to shove, these funds will make their case directly to other shareholders via a proxy contest for board membership.

Cases of boards surprised by events or shocked by the misbehaviour of management abound. From Lehman Bros to SNC-Lavalin, boards of directors faced the same conundrum:

After some 15 years of tweaking and polishing the theory and practice of "good" governance, board members, through no fault or inadequacy on their part, remain surprise-prone, estranged from the goings-on in the company, partially informed and lacking the wherewithal to challenge management. In the current form of governance, corporate directors are too often akin to skaters making intricate arabesques on a frozen lake, largely unaware of the teeming life underneath [4].

Corporate boards of the future will have to act as "activists" in their quest for information and their ability to question management's strategies and performances.

The overarching theme emanating from all these goings-on points clearly at a loss of legitimacy and credibility of boards and a push by shareholders for a greater influence in the governance and the running of corporations.

Obviously, in this context, the interests of stakeholders other than shareholders will receive short shrift and the board of directors will be unable to set a proper trade-off between the various stakeholders. Disappointing shareholders and pursuing objectives other than short-term performance will put the board at risk of sparking an insurrection. However, managing and governing the corporation in the interests of short-term shareholders entail a less immediate, but very real, risk that the corporation will lose its social and political legitimacy.

Of course, all these outcomes are the lot of widely-held corporations. Companies with a different ownership structure may well be capable to plan and manage their affairs with a longer term perspective and an appropriate sensitivity to the expectations of critical stakeholders.

4 Allaire, Yvan "Lessons from SNC-Lavalin", *Financial Post*, July 2013.

To summarize where corporate governance stands at this point:

- The gradual loss of board legitimacy from the onslaught of institutional shareholders will possibly accelerate in years to come; the notion of a "shareholder-centric" governance replacing a "board-centric" governance is gaining currency;
- The fundamental dilemma of the information and knowledge asymmetry between the board and management is still unresolved;
- The Gordian knot of executive compensation has still not been cut; the lingering, simmering discontent with executive compensation among investors and in the broader society remains in spite of all efforts at corrective measures;
- Governance of corporate complexity remains an important issue, more important than the issue of risk management because the former is surreptitious, often undetected before it's too late;
- Short-term pressures from shareholders are on the rise in publicly listed, widely-held firms;
- Boards are increasingly expected to play the role of fair-minded arbitrators between the interest of various stakeholders and factor in the corporation's social responsibility for environmental and ethical issues.

This context of corporate governance, if plausible, points to several avenues of fruitful research and interventions in the coming years:

- How do we shift from impeccable fiduciary governance to a more "activist" form of governance, one that shores up the legitimacy and credibility of boards of directors, creates value for the firm and for society, is less vulnerable to the information and knowledge asymmetry between the board and management?
- Despite the remarkable convergence of corporate compensation programs (or because of it), and despite all the efforts to establish a clear relationship between compensation and performance, the Gordian knot of executive compensation remains to be cut; what innovative forms of executive compensation could be suggested to eliminate or shrink the flaws of the current system?
- How is the board to play its role of arbitrator among the demands of stakeholders and the expectations of society at large? What is the responsibility of the board to shareholders and to other stakeholders of the company?
- These previous issues are highly salient for widely-held, publicly listed corporations. Other forms of ownership (controlling shareholders with or without multiple voting shares, cooperatives and privately held corporations), though also affected by these issues, have peculiar governance challenges; what adjustments to the corporate governance of publicly listed corporations will ensure that boards can play a useful role in companies with these alternative forms of ownership?

About IGOPP

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Created in 2005 by two academic institutions (HEC Montréal and Concordia University – The John Molson School of Business) and the Stephen Jarislowsky Foundation, the Institute for governance (IGOPP) has become a centre for excellence about governance of public and private organizations. Through research, training programs, policy papers and participation in public debates, IGOPP has become a key reference on all issues of governance in the private and public sectors.

OUR MISSION

- Strengthen fiduciary governance in the public and private sectors;
- Make organizations evolve from a fiduciary mode of governance **to a value creating governance**®;
- Contribute to debates, and the solution, of governance problems by taking positions on important issues and by a wide dissemination of information and knowledge about governance.

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1000 De La Gauchetière St. West, Suite 1410, Montréal (Québec) H3B 4W5

Telephone 514.439.9301 | **Fax** 514.439.9305 | **E-mail** info@igopp.org | www.igopp.org