Roger Martin versus Michael Jensen:

much ado about nothing

JANUARY 13TH, 2012
FINANCIAL POST

Yvan Allaire, Ph.D. (MIT), FRSC

Emeritus Professor of Strategy,
UQAM

Executive Chairman,
Institute for governance of private and public organizations (IGOPP)

In a profanity-laden interview with Terence Corcoran of the National Post (January 6th 2011), Professor Michael Jensen rejects the accusation in Roger Martin's latest book that he is the spiritual father of the shareholder-value maximization movement. True enough; in the seminal Jensen-Meckling article of 1976 that Martin singles out as the source of this abomination, the authors never make the argument that maximizing shareholder value should be the aim of corporate management.

But, Jensen does protest too much. His contribution to the field of finance, very influential in the 1980s and 1990s, consisted in two main arguments:

1. The theory of agency costs and the nexus of relationship between principals and agents; in his view, shareholders (and debt holders) are the principals of the board of directors, and the latter, the principals of management. If shareholders are indeed the principals of the board of directors, for whose benefits should the agents (the board) act in all circumstances; fairly or not, the conclusion drawn broadly and widely from this article was that boards should urge and prod management to do whatever is necessary to maximize shareholder value. Marx might not have liked what Lenin did with his theory but he still bears the blame for its contents.

2. In two famous articles in the Harvard Business Review (September-October 1989), Jensen wrote of the "Eclipse of the Public Corporation" and in May-June 1990 (with Kevin J. Murphy) about "CEO Incentives: It's not How Much You Pay, But How", Jensen argued that the CEOs of the public corporation got too small a share of the value they created for shareholders. That is why "*so many CEOs act like*

> *bureaucrats rather than value-maximizing entrepreneurs*". That insight triggered a search for ways to let senior management get a larger share of the wealth created for shareholders. Lo and behold, stock options were the perfect device to accomplish that, it was thought at the time. So Jensen may not have advocated directly for the widespread use of stock options as an effective means of incentivizing management but that was the inference drawn from his theoretical musings.

After the collapse of Enron, WorldCom, Global Crossing and others in 2001-2002, Jensen took some distance from his own earlier writings. He may claim, and rightly so, that he has proposed alternatives to the shareholder-value model as well as the stakeholder model. He is right to argue that the stakeholder model proposed by Roger Martin and a host of writers before him never provides any clarity as to how the trade-offs between the interests of various stakeholders would be set and resolved.

Jensen (as well as Allaire and Firsirotu in books published 1993, 2004, 2009) proposes "value-maximization" as an alternative model, by which he merely means the maximization of the long-term interest of the corporation. *That happens to be the fiduciary responsibility of boards of directors under Canadian law.*

The argument here is that this objective cannot be achieved without careful consideration of the interest of all stakeholders who have an influence on the long-term survival and success of the company. It does not entirely avoid the issue of trade-offs among stakeholders but puts in a manageable framework.

As for the elimination of stock options, Jensen, unlike I and Roger Martin, may not have proposed this measure but, in a long piece (again with Kevin J. Murphy) published in 2004, he points out the flaws and limitation of stock options as a form of incentive compensation. His solution at the time, options indexed by the cost of capital of the firm, would have created more problems than the flawed stock option system he subjected to virulent criticism.

Indeed, most boards of large corporation have come to agree, gingerly and slowly, that stock options are a deeply flawed system of compensation. For the CEOs of the S&P 500 companies, stock options represented 49% of their total compensation in 2000 but only 25% in 2008. For the Canadian CEOs of the TSX 60 companies, stock options represented 35% of total compensation in 2000 and merely 22% in 2010.

So, far from a far-fetched, leftist proposal, the elimination of stock options is happening gradually as boards of directors come to terms with the severe limitations of that form of compensation but are careful to proceed slowly, lest it should lead to some inopportune CEO exit.

Institute for governance of private and public organizations

1000 De la Gauchetière St. West, Suite 640, Montréal (Québec) H3B 4W5

Telephone 514.439.9301 **Fax** 514.439.9305 **info@igopp.org** **www.igopp.org**

This article is available online in PDF format at www.igopp.org

Design: KarineBellerive.com