the coming corporate revolt

by Roger Martin

BUSINESS IS IN THRALL TO THE MYTH OF "SHAREHOLDER VALUE." NOW IT'S UP TO SHAREHOLDERS TO BREAK THE SPELL.

"What has happened to us is that our execution and processes have broken down under the white-hot heat of driving for quarterly revenue growth."

— LUCENT TECHNOLOGIES CEO HENRY SCHACHT,

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It was the autumn of 2000, and Henry Schacht had been on the job only a couple of weeks when he spoke those words to his senior managers. His predecessor, Richard McGinn, had just been ousted by the Lucent board. No suggestion of wrongdoing accompanied McGinn's departure, but it soon became clear that execution and processes were not all that had broken down on his watch. Two months after McGinn's ouster, Lucent revealed that in the third quarter of 2000, while McGinn was still CEO, the company had concocted $700 million in fictitious revenue.

No prosecutor or regulatory authority has charged McGinn with any sort of impropriety. But current and former Lucent employees confirm that McGinn relentlessly pressed them to deliver ever-higher revenue. He wasn't leaning on them for the fun of it, of course. As Schacht, his successor, told Lucent's managers, employees resorted to falsifying revenue because the company was "driven by Wall Street expectations that were beyond the capacity of the company to meet."

Schacht was speaking of Lucent, but he could just as easily have been referring to Worldcom, Enron, or any other company caught up in the recent round of corporate scandals—or many other firms that managed to escape the headlines. His comments raise as many questions as they answer. How did "Wall Street expectations" come to call the tune in corporate America? Is meeting Wall Street's expectations good business? Is it good for society? Is pleasing "the Street" sufficient motivation for corporate employees? To attempt to answer those questions is to discover the deep flaws in the concept of "shareholder value," a concept that at many corporations has achieved the status of holy writ—a faith so strongly held that believers literally cannot imagine another way to orient and motivate a corporation and its employees.

In response to business's long season of scandal, Congress passed the Sarbanes-Oxley Act in 2002. Additional proposals for repairing corporate accounting and governance fill bookstores, business magazines, and op-ed pages. The proposed reforms, which are largely technical and structural in nature, may be necessary to change corporate conduct, but I will argue that they are not sufficient. In this article I call for a new set of business principles and priorities—and for a special breed of shareholder, a genuine change agent who can lead a radical reorientation of the business organization.

Radical change is needed, I believe, because the governance of public corporations is fundamentally flawed. Corporate managers and independent directors alike have neither the incentives nor the capabilities to protect the interests of outside shareholders—the incentives all run the other way, *against* the interests of outside shareholders. To improve the quality of governance, publicly traded companies will need to significantly alter the structure of monetary and non-monetary incentives and capabilities for managers and directors, as well as the auditing firms and investment bankers they hire. But no alteration will be feasible without the participation—the leadership, in fact—of shareholders.

At first blush, it seems nonsensical that shareholders should lead a revolution in corporate governance. Why would they want to overhaul a corporate value system that recognizes continual increases in their wealth as the highest good? Therein lies the paradox at the heart of the shareholder-value creed: if the recent spate of corporate scandals proves anything, it is that organizations explicitly

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dedicated to the maximization of shareholder value are in fact inimical to the long-term interests of shareholders.

A TALE OF TWO MARKETS

The typical business enterprise has become a community that venerates shareholder value—a value assigned by a market (the stock market) whose prices are based not on real, current results but on expectations of future performance. Corporations that enshrine shareholder value no longer consider producing or delivering a product or service to be their central mission. Instead, they become dedicated to stoking expectations that by definition cannot be satisfied. That is not the only damage done: when shareholder-value maximization is placed at the heart of the corporate value system, an unbridgeable rift opens between the mission of the corporation and the capabilities of employees, who have direct control only over real, current corporate performance (what I call the Real Market); their connection to the expectations of equity investors (or what I term the Expectations Market) is tenuous at best.

In a bid to close the rift, corporations offer stock-based compensation, which purports to align the incentives of employees and shareholders. But in reality, stock-based compensation merely gives owner-employees—who are most often owner-managers—a nearly irresistible incentive to influence the Expectations Market. And not just to influence it, but to deliberately create expectations that are out of line with the real market.

In investing parlance, an attempt to capitalize on price disparities between different markets is known as arbitrage. Stock-based compensation creates a strong incentive among corporate employees, especially senior managers whose compensation consists largely or stock or stock options, to arbitrage between the Real Market and the Expectations Market. The greater the disparities between expectations and reality, the greater the profit opportunities when owner-managers cash out of their stock-based compensation. (Compounding the imbalance between owner-managers and other shareholders, the cashing-out often goes undetected, thanks to derivatives designed to permit owner-managers to liquidate their holdings while avoiding public disclosure.)

Owner-managers, then, have a strong motive to skew expectations. They also have the means: their superior access to company information—what business theorists Michael Jensen and Bill Meckling termed "specific knowledge"—which affords them, by a significant margin, the best understanding of how expectations relate to reality. Self-interest being what it is, we can expect that as owner-managers increase their share ownership, they will tighten their grip over information about the relation of expectations to reality. That relation, after all, is the most precious form of inside information, and those outside the tight circle of owner-managers should not expect those within the circle to share it willingly.

In theory, corporate directors, especially "outside" or "independent" directors (usually executives of other corporations, or academics or political figures; executives who sit on the board of the company that employs them are known as inside directors), are supposed to champion the interests of outside shareholders. But outside or independent directors have neither the motive nor the means to protect shareholders. Consider first the means: compared with senior management, independent directors are at a distinct knowledge disadvantage. Senior management is bound to know more about the company's operations and prospects, and they can—and do—cherry-pick the information that independent directors see. No matter how smart and diligent they are, independent directors will never match the specific knowledge of management.

The conventional governance wisdom says that independent directors can overcome their knowledge deficit by renting professional experts, chiefly financial auditors, to advise them. In the end, however, all important audit decisions come down to judgment, and management always has more data to support its case than the auditors have to argue theirs. Congress has attempted to create a cadre of bold and skeptical auditors by legislative fiat, but no law can erase the specific knowledge deficit.

Independent directors lack more than the means to protect shareholders. They also lack the motivation. After all, many directors are compensated primarily in stock or stock options—the better, theoretically, to align their interests with those of ordinary shareholders. But stock-based compensation has the same effect on directors as it has on senior management: it shifts their focus from producing goods and services of value—the only lasting source of shareholder wealth—toward encouraging ever-greater expectations. Independent directors also have nonmonetary incentives to shirk their duty to shareholders. One incentive is social: the fewer uncomfortable questions they ask, the better their relations will be with other

directors and senior management. And whom do directors see more often: other directors and senior management, or ordinary shareholders? What's more, as long as shareholder-value maximization remains the corporate creed, any director's attempt to align expectations with reality will be regarded as an attack on the sanctity of ever-higher stock prices.

This is, of course, a generalization. There will always be, as exceptions to the general rule, boards and managements that are committed to good governance. Those directors who are vigilant about protecting outside shareholders will gravitate to those companies, where they will have an insignificantly positive impact on an already good situation. Meanwhile, the mass of corporations will continue to march under the banner of shareholder value, even as it leads to further scandal and failure.

WANTED: A MID-COURSE CORRECTION

The fundamental problem with corporate governance, then, is that it is ineffective by design. And as long as business maintains its present course, there is little hope for improved corporate governance. Enthusiasm for stock options has diminished, it's true, but stock-based compensation is as popular as ever—it's just that outright stock awards have supplanted options grants. Moreover, shareholder-value maximization remains the overriding corporate mission. This focus encourages managers to maximize their own personal monetary benefit by arbitraging schisms between the Real Market and the Expectations Market. They're aided in this effort by increasingly sophisticated capital market tools. Today, an owner-manager can sell the upside of his or her corporate holdings and protect against the downside in an extremely tax-efficient manner and avoid having to disclose the transaction in any way.

To be fair, business and government have taken a couple of steps in the direction of better governance. Equity analysts now have to disclose far more about their own and their firms' relationships with the companies they cover. And Sarbanes-Oxley requires CEOs and chief financial officers—the two managers most likely to serve on the board of directors—to certify their firm's financial statements. This requirement sharply ratchets up the potential penalties for deliberately misleading outside shareholders.

At the end of the day, though, corporate boards after Sarbanes-Oxley have no more ability or incentive to protect outside shareholders than they did before the law was passed. The detailed rules of procedure governing audit committees and auditors won't do a thing to weaken management's specific knowledge advantage.

Improved corporate governance will come about only if managers, directors, and above all shareholders commit to altering their present course. Three fundamental changes are necessary. First, the stock-based compensation for managers and directors must be reduced or, preferably, eliminated. The bulk of managerial compensation must be based on results in the Real Market, not the Expectations Market, and payable in cash. This will necessitate changes in U.S. tax law, which now penalizes large, cash-based pay packages. Second, owner-managers (and to a lesser extent, directors) must be stripped of the ability to profit from their specific knowledge advantage. This can be accomplished by requiring owner-managers and directors to pre-announce intentions to sell and buy stock. Moreover, they can complete the transaction only after the Expectations Market has had time to react to the information inherent in the announcement. Currently, stock sales and purchases by officers and directors are announced after—often long after—the transactions have closed. The delay allows owner-managers and directors to exploit specific knowledge at the expense of shareholders without such knowledge. A mandatory pre-announcement will give the market time to react to the information and close the gap between the Real and Expectations Markets. That wipes out the arbitrage opportunity as well as the incentive to create such opportunities in the future.

The third necessary change—fundamental cultural change—is the most difficult and the most crucial. As I mentioned earlier, owner-managers and directors don't always take advantage of outside shareholders, even though they have the means and opportunity to do so. They may, in the face of powerful monetary and nonmonetary incentives, exert self-control because they think that taking advantage of outside shareholders is wrong, just as each of us would like to think that if we found a cash-laden wallet on a park bench, we would return it to its owner, even if we could "get away" with keeping it. This self-control is strongly influenced by the norms of the communities where we live and work. Yet somehow those norms, which we wouldn't think of violating in our nonworking lives, are often discarded or inverted once we step inside the corporate walls. There, cultural norms promote self-aggrandizement and self-enrichment, not self-control, which is regarded only as a means to greater wealth and not an end in itself. The simple and nearly impossible task facing business is to upend the regnant norms that dictate how most corporations—and most corporate employees—now govern themselves.

THE SEARCH FOR A HIGHER PURPOSE

The first norm that will have to go, of course, is the exaltation of shareholder value. Shareholder-value appreciation is simply not motivational for employees of a firm. There is no community to be had with shareholders. They are nameless and faceless and under no obligation to hold their shares more than an instant. They are also, by definition, never satisfied. If employees do something that produces a great bump in shareholder value, then that bump was created by a new shareholder buying the stock at the appreciated value. The new shareholder's first question is: What are you going to do for me next? There is no sense of basking in the warm glow of appreciation from the shareholders because they want more, more, more. And if shareholders don't get more, they exit the firm's community by selling the stock.

Although shareholder-value appreciation does not inspire employees, it does encourage them to think that maximizing their financial well-being is a legitimate goal—in many cases, the only goal. After all, isn't that what shareholders want, to the exclusion of all else? And doesn't the corporation bend over backwards to satisfy them? Why shouldn't employees also look at the corporation as nothing more than an instrument for maximizing their personal economic benefit?

Firms need to stop focusing on something they can't control anyway—the Expectations Market—and stop pandering to shareholders who can never be satisfied. Their focus should be on defining a moral purpose for the firm that will motivate and excite employees. That purpose should be the cornerstone of a community—the firm—of which employees are proud and happy to be valued members. And if the defining purpose involves making the broader community a better place, then the firm, and its employees, will be valued and respected by those outside the community. This configuration has the potential to create a culture in which service to the customer, service to fellow-employees, and service to the firm provide strong nonfinancial benefits of respect and community to employees. The new community norms, in

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turn, will buttress employee self-control and in the process, ameliorate the governance problems created by the owner-manager role.

This approach, ironically, is more likely to produce shareholder-value appreciation than an explicit and central goal of pursuing shareholder-value appreciation. A defining moral purpose will help produce motivated, self-controlled employees, which will in turn improve the odds of a firm's developing a competitive advantage—the only thing that produces long-term shareholder-value appreciation.

But how can this kind of defining moral purpose take root in a widely held, publicly traded corporation? The din from the capital markets insisting on the primacy of shareholder-value maximization is so loud, it is easy for corporate leaders to fall into the trap of attempting to produce shareholder-value appreciation and by the very effort actually failing.

This is where a particular breed of shareholder—the major or controlling shareholder—has a vital leadership role to play. Because they hold a large or majority portion of a given firm's equity, major or controlling shareholders are immune to many of the pressures faced by owner-managers and directors. When they demand that a firm find a defining moral purpose, majority shareholders aren't declaring that they will settle for diminished returns. After all, they're shareholders too. But they're in a position to demand that the enterprise create shareholder value not by gaming the Expectations Market but by training the organization's sights on sustainable competitive advantage and defining moral purpose.

The power of shareholder-leaders should not be underestimated. Recent history has shown how much the attitude and behavior of a major shareholder can influence the culture of a firm and the behavior of its managers. Consider the contrast between Philip Anshutz and Ken Thomson. Philip Anshutz is the biggest shareholder by far of Qwest Communications International and until recently its chairman. He came to define the culture of Qwest when he took advantage of wildly inflated expectations to sell almost $1.5 billion in corporate stock at prices much closer to the August 2000 high of $54 than the August 2002 low of $1.07. Twelve other insiders followed Anshutz' lead, clearing $543 million before the bottom fell out. Between August 2000 and August 2002, the stock shed $88.2 billion in value. The market now values the company at a paltry $1.8 billion—less than the $2 billion reaped by Anshutz and his twelve high-ranking colleagues. The company is now struggling to stay afloat, but Anshutz and his senior managers cannot devote all their attention to corporate financial issues—not with various prosecutors and regulators investigating the firm.

In contrast, Ken Thomson, controlling shareholder of Thomson Corp. and until recently its chairman, has maintained his family's dominant stake in Thomson over a long period of time. He has committed his family to plow 50 percent of their Thomson dividends back into Thomson stock, regardless of the prevailing price, and he encourages senior management to invest for the long-term good of the firm, not to please shareholders in the short term. During his chairmanship, the shareholder value of Thomson increased forty-fold, from around $500 million to $20 billion.

That shareholders like Ken Thomson are the exception, not the rule, is prima facie evidence of a fundamental structural problem with corporate governance. In the current governance system, neither managers nor independent directors have an incentive to protect outside shareholders. To the contrary, managers have both the incentive and the means to profit at shareholder expense. Independent directors, meanwhile, are well-positioned to protect outside shareholders only when they don't need protection and ill-equipped to protect them when they need protection most.

For a good-governance culture to take root within a corporation, the Real Market must be disentangled from the Expectations Market. That means reducing or eliminating the stock-based compensation of firm managers and directors and neutralizing their ability to exploit specific knowledge for their own gain.

Most important, the cultural norms that support the present governance regime must change. The community's highest value must be not wealth accumulation but self-control. This change will require publicly traded firms to reorient themselves dramatically and find a higher, more compelling mission than mere shareholder value appreciation. The payoff: enhanced shareholder value. Counterintuitive as it may sound, corporate governance will reach its goals of protecting outside shareholders when it stops putting them first. Now it's time for major shareholders to step up and commit themselves and their companies to that proposition. ■

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