The New Challenge for Corporate Governance

Nawshir H.Mirza
Independent Director

In the last twenty year, since the topic of the governance of corporations came into the public eye, all debate has raged around only one aspect of it – the misuse of power by the managements and the controlling shareholders of companies in which the public has invested. The misuse of power has not necessarily been outside the framework of the law. An example of that is the packing of company boards by supposedly independent directors who are, in reality, controlled by management or the controlling shareholder, leading sometimes to another "legally acceptable" misuse – that of management compensations far in excess of what is fair. Corporate history has countless examples of the other kind of misuse, that of criminal or other illegal conduct by these stakeholders in a corporation. Quite rightly, the different aspects of this issue have agitated the capital markets the most. Most debate is by participants in these markets – company managements, independent directors, business promoters, regulators of the capital markets and academics who are concerned with capital markets. The regulators who are charged with the responsibility for good corporate governance are those that are also concerned with the healthy regulation of the capital markets – stock exchanges or regulators of the stock markets. All corporate governance is directly or indirectly concerned with protecting the interests of minority shareholders against the depredations of managements and controlling shareholders. This is too narrow a view of the responsibility that boards and managements bear for good governance: it should have a much broader purpose; that of respecting the rights and claims of all stakeholders in a corporation and of enabling a harmonious interaction between them. Recent developments bring to the fore the need for such a view of governance and the need for it being the subject of much wider public discussion.

Early in June 2010, a court in India sentenced the non-executive chairman of a company to two years' imprisonment for a corporate crime. He was not a director who lacked backbone or who viewed his position to be that of a mere figurehead. He did his duty as the law required but never-the-less, faces two years in jail. I refer to Mr. Keshub Mahindra, chairman of the board of Union Carbide India at the time the Bhopal gas tragedy. The official death toll immediately from inhaling the poison gas emitted by Union Carbide's plant was over 3,000. Eventually many others died because of the long term effects of the gas – a number put at anywhere between 8,000 and 25,000. 26 years after the event, the first court decision was that the Chairman of the company at that time was also guilty, even if he was non executive and was not deputed from the parent company in the United States of America. Mr. Mahindra is a highly respected Indian industrialist with an impeccable record for doing the right thing. Even in today's activist climate, many believe that such a sentence was manifestly unfair. He had no control over or responsibility for ensuring that the plant functioned safely. Unfortunately for him and for many other corporate directors, the law determined otherwise. But the court of public opinion is furious with the mild punishment awarded by the judgement. It believes that this is naught but a slap on the wrist for the murder of thousands of innocent people. It would like to see a far more severe penalty meted out to the guilty, including the CEO in the USA. Take another instance. The recent disaster in the Gulf of Mexico on BP's deep water oil drilling platform has dealt such a blow to the company as to threaten its survival. In a totally different context, over two decades ago when depositors in BCCI lost their money with the bank's collapse, they could fairly ask what the board was doing. As could those who bought unaffordable mortgages from pushy salesmen of American banks. From the community to the environment to customers, when major corporate disasters occur, the question being asked is, where was the board?

The corporate governance debate is moving from the effects of bad governance on minority shareholders to the effect on all stakeholders. And this is rightly so. Many global corporations today are far more powerful than most national governments. Even those strong governments in the developed world, who may be perceived as bigger than the biggest corporations, are controlled by politicians who are beholden to those big corporations. In India, property developers are said to be major donors to political parties, thereby having the power to influence the rules that regulate their business. The oil and gas industry and Wall Street are known to have very strong influence over both, The Hill as also the White House. In the US, corporations have a keen interest in nominations of judges to the bench of their Supreme Court, judges who are nominated and approved by politicians. While it would be an exaggeration to say that even the USA has been reduced to a banana republic, it is correct to state that business has a disproportionate influence over national governance. Business also has great influence over the pools of thought in the form of universities, economists and

business schools, all of whom are beholden to business for their survival. Without a doubt, the capitalist system has entrenched itself deep within democracy; so deep that sometimes it subverts democracy in its own interests. Half a century ago a Noble laureate, Milton Friedman, wrote, “Few trends could so thoroughly undermine the foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible”. This was a preposterous view but influenced American business ethos for all of these fifty years and still has a stranglehold over the way businesses perceive their roles in society. This ideology lies at the heart of American business schools teaching and is therefore perpetuated in that country as also in those many others where its graduates work. Indeed, the reality is that free society has been undermined by businesses that push a single agenda of profit maximisation. Witness the lag-jam over climate change. Industry and commerce has ensured that the world’s politicians do not reach any deal that would significantly reduce their ability to generate profits, by curbing the consumption of the goods and services that they produce. Even as this change threatens the very survival of humankind, these companies put profits before that danger. Democracy has now been subverted.

This brings me to the topic of democracy. It is instructive to compare the evolution of democracy in political governance with how it has evolved in corporate governance. Modern political democracy owes its origins to the Magna Carta; an agreement forced upon the autocratic King John of England by his rebelling barons in 1215. The King was forced to concede his absolute right over the lives and liberty of his peoples as also the absolute power to tax them, to a Parliament. In that Parliament, members were elected to one of the chambers from amongst the barons. The right to stand for election to that chamber, as also the right to vote, vested only in those who gave to the King. The barons gave to the King in the form of men and taxes. When the King went to war, it was these barons who supplied him with the soldiers to fight it. And they paid a land tax to the King, the main form of revenue for his Treasury. The serfs and the women got no vote because they, apparently, gave the King nothing in return. In other words, it was clearly accepted that if you wanted the King to give you a say in determining the governance of the land, you were required to give him something in return. Those who gave nothing to the King had no right to demand a say in England’s governance. This structure of democracy endured for several centuries till it was challenged at the end of the eighteenth by the revolutions in France and America. For the first time, the concept that the power to determine governance must require some corresponding return was questioned and found wanting. The US constitution decreed that the right to determine governance should not be given only to those who give in return but to those who are affected by the governance. In other words, for the first time universal adult franchise became the accepted norm. As we know, the definition of a stakeholder is anyone who is affected. So, stakeholders got the vote.

Long before this happened, the first modern corporation was chartered into existence. In 1601 the East India Company received its charter from Charles II. The structure of governance for the company required it to have a governor and a committee elected annually by its shareholders. The governor and the committee were charged with overseeing management. By-laws were to be approved by the members in general meeting and those governed the working of the corporation and the relationship between its members inter-se. Each member’s vote was proportionate to his shareholding. In other words, the corporate governance of the East India Company was based on a concept borrowed from the then prevailing form of political democracy. Shareholders gave capital in return for the right to determine its governance. Those were times when the concept of other stakeholders, the affected, was beyond the ken of many of its founders. The need to be concerned with the effect of their conduct on millions of natives in a far-off land and on its own traders, soldiers and administrators would not have occurred to its founders. 250 years after this conceptualisation of corporate governance, the first company law in the world was legislated, also in England. It copied the structure of corporate democracy from the East India Company’s charter. Another 150 years brings us to modern times. And company law remains unchanged. Shareholders elect the board who appoint management. Shareholders have a vote equal to each of their shareholdings. The Articles & Memorandum of Incorporation are determined by those same shareholders. Those who give have the power, not those who are affected by the conduct of a company. Four centuries has seen no evolution in company governance. The recent developments that require independent directors, audit committees, etc. are all aimed at minority shareholder protection. The concept that shareholders, as a body, determine how a company is governed remains unchanged.

The people of Bhopal and of the Louisiana coast had no say in the governance of Union Carbide or of BP. The 10% of Americans who remain out of a job even as the US economy recovers had no say in the way their respective employers ran their businesses. Nor for that matter have the millions of people who lost their money or their homes investing in questionable schemes sold to them by clever bankers. The vendors to those businesses too have suffered, often worse than the misgoverned companies they sold to; many have ceased to exist, others have lost big chunks of business. None of them had any say in the governance of those businesses. Their relationship is deemed to be contractual or regulated by the law (in the case of the community or the environment or the government). Never has it been viewed in the context of a responsibility of the governors of corporations, even if many of the ills that have caused those problems would have been avoided if the

governance of those companies was right. Is it right for the oil and gas industry to drill in extreme environments for which it has not developed the technology to remedy serious failures? Was it right to continue to operate a factory that used deadly poisons in a location that became surrounded by new shanty-towns? These are matters of corporate strategy and the responsibility of the board.

Boards, even though they continue to be elected by the shareholder, need to give recognition to the legitimate expectations of all other stakeholders. There is a belief that in the long term all of these expectations should coincide. That every stakeholder is benefited from the survival of the corporation and that each should concede what-ever is needed to ensure that. But as the saying goes, in the long term we are all dead. Or have retired. Company boards and managements are concerned with the near term – often as near as the next 90 days. As are many shareholders in companies; ironically the minority rather than the controlling party. Boards that ignore the longer term consequences of their behaviour on other stakeholders now do so at their peril. For them lies the difficult task of balancing the interests of different stakeholders, interests that can be in conflict. Should a company increase prices in a monopolistic situation? Should a company invest in new technologies that are not economically viable but which will reduce the adverse environmental impact of its operations? Should a company replace long loyal workers with out-sourced services that are cheaper? Should a company make durable products versus those that do not last, giving it the opportunity for high repeat sales? Should a company add and charge for unnecessary extra features to its products aware that only a tiny minority of its customers will ever use them?

I believe that as a responsible citizen, every company must behave in the way expected of it. Just as individuals should not behave in a manner that would maximise their personal pleasure regardless of the effect on others, so should companies not focus exclusively on maximising shareholder value. They must develop techniques to evaluate the effect of their decisions on all concerned stakeholders. Companies need to supplement IRR, DCF valuations, RoCE, profit ratios and other financial measures with quantitative measures for other stakeholders and to work out a system of trade-offs between conflicting decisions. These tradeoffs would need to be made both, for each decision as also cumulatively. Some systems such as the Global Reporting Initiative attempt this but suffer from using too many measures that are not reduced to one common number. The Malcolm Baldrige system does come up with a single score but is highly subjective. Regardless of what is used by a company, a start has to be made by beginning to look at important decisions from several perspectives. This is a discipline that will stand companies in good stead as the public's expectations of them changes. No doubt, it is a challenge to make any decision that may reduce short term shareholder value but as the directors and managers of Union Carbide and BP would have learnt at the cost of millions of lives of men and animals, this is a false trade-off.

But an even more fundamental conflict is caused by capitalism: the focus on maximising shareholder value by increasing consumption of goods and services. This has been done increasingly successfully till the developed world has a life-style that can only be described as hedonistic. The cost of this on the environment has been immense with emissions of greenhouse gases exceeding all safe measures. The resultant change in climate threatens the very existence of the world as we know it and of the continuance of humankind. But business continues to stymie any efforts to reduce consumption. It has also been unsuccessful at developing technologies that would allow high levels of consumption with reduced GHG emissions. The system is working overtime to confuse people and to deflect attention from the fundamental conflict between maximisation of shareholder value and the long term viable survival of our species. For the system to respect value creation other than for shareholders will need much more than new measurement methodologies. It will need a replacement of the capitalist system by a model that encourages the harmonious teaming of all stakeholders for the common weal of all of God's creations. But we are very, very far from that. Will we invent a new system to replace the current one while there is still time?