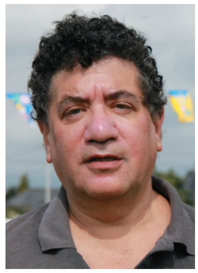
Corporate Governance



By Richard P. Greenfield

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The First Test Question

Pay attention, as they say, for this will be or already is on the final exam at many business schools:

You are chosen to be president of XYZ Co., a publicly listed company. Within your first weeks of employment, a small tabloid magazine runs an article alleging that XYZ is hiding billions of dollars of undocumented losses that are not on the books. When you check and find that these allegations are true, you:

A) Check to see if the name of XYZ Co. has been changed to Corleone Enterprises;
B) Jump out the window in your high-rise office;
C) Call in all the directors who were involved in the corrupt transactions and demand your cut; or
D) Realize that this is why you are getting paid a large salary and put together a playbook on how to root out the problem.

The correct answer, of course, is D. But no one who has been in a corporate boardroom or close to one will say it is the easiest choice.

This situation, which seems to come straight out of a corporate thriller novel, is exactly the one Michael Woodford faced when he became president of Olympus. His account of the entire sequence of events recently published in both English and Japanese is titled *Exposure: Inside the Olympus Scandal* (Portfolio-Penguin, 2012).

Woodford's tale is a true life thriller. A boy from a hardscrabble background makes good, works his way up through the ranks, and is chosen to lead one of the most famous, and up until then respected, companies in the world. Then things began to unravel, and Woodford gives the reader a long deep look that rings true to anyone who has ever had to ask "How did I get here? Can I just walk away?"

Woodford did not, though he makes clear how tempted he was, and how trapped he felt, in a bubble that he had not created, had no idea existed, and wanted only to pop, even, and ultimately, at the price of his own position.

Yet the dilemma Woodford faced is far from new, nor is it even the most egregious in corporate history.

Quis Custodiet?

In Rome the question was "*Quis custodiet ipsos custodes?*" — literally "Who guards the guards themselves?"

The question is still relevant today. Corporations are in business to make money in the most convenient, popular formulation. But corporations have an equally important function to create, and enhance, long-term value for their investors.

Simply put, in the terms of corporate governance, the job of managers is to manage the necessary daily functions of a company (e.g. quality control, human resources). Directors, on the other hand, have the responsibility to oversee the larger questions of corporate behavior (e.g. if XYZ Widgets wants to merge with ABC Tools, does that fit with XYZ's existing business, does it provide value for XYZ's shareholders, and are there any groups of company insiders, particularly managers, who would benefit personally from such a merger?).

It is tactical versus strategic, both having their place, and both being necessary but very discreet functions.

When those fail, as they did with Olympus, the entire corporation is compromised. What Olympus did, in brief, was to hide losses it had incurred through an ever more byzantine system of phantom acquisitions which had to be made through ever more irregular channels. While the scheme was exposed, much of the money has never been recovered and cannot even be traced, and many of those who aided and abetted the corrupt transactions are beyond the reach of Japanese law. The losers were the employees who had worked for a company they believed in, with brand name recognition throughout the world, and of course investors, large and small.

Of course, corporations must take risks — the introduction of a new product, modification of an existing product, research and development itself is a risk. Not all research will work out or prove to be profitable, and it is very easy to find examples of mergers and acquisitions that have failed.

In one way, that is precisely the point. Failure is an option, or at least a possibility, when the decisions leading up to it have been made by different groups, overseeing different objectives, who together believed this or that product or merger would be successful.

Tell It to the Judge

One way to look at governance systems is to look at the legal systems that govern them. Until recently in Japan, with the introduction of lay judges, civil and criminal cases in law were decided by judges. In the United States, unless specifically waived, jury trial is mandatory.

In a civil case, the standard for guilt is determination by a majority of jurors based on "preponderance of evidence". In a criminal case, the standard for guilt is a unanimous vote by 12 jurors of guilt "beyond a reasonable doubt".

Of course, the process is not perfect. Evidence can be withheld and jurors can be bribed, but both are serious offences.

What the jury system captures is an interesting truth about people. Convincing 12 people who should be more or less chosen randomly from a given population that anything is true "beyond a reasonable doubt" or even a majority that the "preponderance of evidence" shows X or Y is not an easy task.

But compare it to either of the two possibilities: the judge, the prosecutor and the defense attorney all know each other, go to the same clubs, perhaps went to the same schools, and see each other all the time (the situation in Japan prior to the introduction of lay judges) or, a jury where all the jurors were friends and/or related. The effects of either could, in any particular case, corrupt an objective outcome of a trial (civil or criminal).

Comparing the US and Japan may seem in one way to be unfair. There are many Western countries, such as Britain, France and Germany, at various stages where judges (as well as prosecutors) had all the advantages, and a defense attorney, to say nothing of a defendant, was extremely unlikely to prevail save in the most extreme circumstances. It is worth noting that more than a century after Alfred Dreyfus was convicted in France of treason he was innocent of, the conduct of the government, the prosecutors, and the military is still the object of historical soul searching, while the novelist Emile Zola, who famously wrote "*J'accuse*" in pointing out the flaws in the prosecution and sentencing of Dreyfus, had to flee to England to avoid prosecution by the French government. Yet the government that sought to imprison him collapsed and Zola was buried in the Pantheon to rest among the most honored of his nation.

All countries have known scandal, treason, misuse of power and wrongdoing at the highest levels. It is the ability to recognize it, to recognize those who speak up against it, and to protect their right to do so that is at issue. Corporate governance is, as all things, a part of the system it is derived from.

Judges are not, in Europe or the US, untouchable figures. Another system that exists in the US that does introduce an element of stability to the judicial system is the legal doctrine of *Stare decisis* (to stand by that which is decided). This does not mean a court always accepts the reasoning of a prior decision of a different court, or a legislative decision. What it means is that when a court rejects a decision (and some of the most famous rulings are such rejections) it must state clearly why it rejects it — for example, a piece of legislation may be found unconstitutional, or an earlier court decision may not have taken into account certain factors. And these arguments will be scrutinized and criticized at great length.

Judges in Japan are under no such compunction and thus may decide each case as though it has no precedent, and no relationship to any case that has gone before it. This does not mean the courts will always make an arbitrary or inconsistent ruling, but it is indicative of the level of scrutiny and criticism of a particular institution. Japan does not have the same level of scrutiny of the judiciary, to say nothing of particular rulings, and that adds a level of uncertainty to the process.

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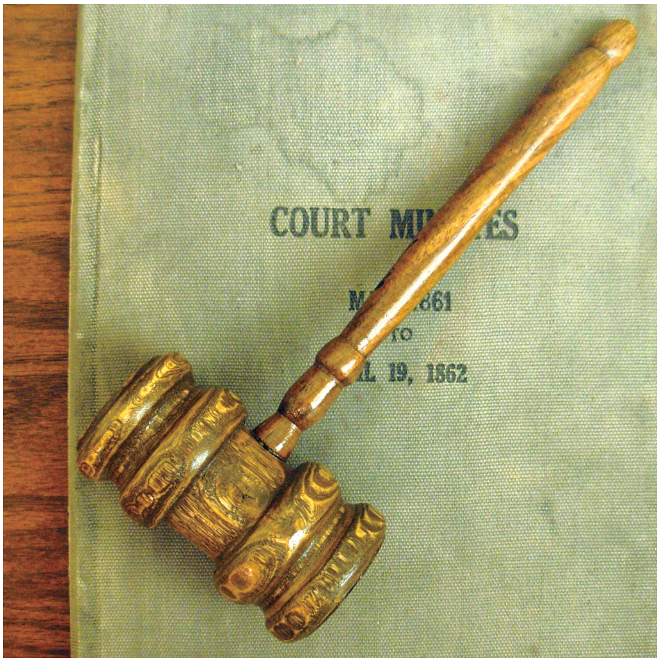

Using the jury trial illustration as above, would you prefer to be tried by a jury of yes-men only looking to the jury foreperson (or company president) for a thumbs up or thumbs down, or would you prefer a rigorously chosen random jury with no inside ties? In which system would you feel more comfortable investing, where insiders with vested interests predominate or where accountable outsiders are the dominant factor?

The Boardroom or the Boredroom

Faced with the above legal mechanisms, moving to the boardroom is not simply a matter of a nice table, comfortable chairs, and men (mostly in suits); it is a question of who decides and how decisions are reached and by whom. Recall that when directors are promoted from within a corporate structure, they are inherently part and parcel of that structure and their self-interest, whether direct, legal or corrupt, resides in that structure. When the majority of directors are from outside (as is currently the status in the US), their legal obligations (they can be sued for illegal or even ill-advised transactions) can offset the self-interest of any particular management faction.

Sidebar

What Is to Be Done?

Nicholas Benes is the founder of BDTI, the Board Directors Training Institute (www.bdti.or.jp), the only group certified by the Japanese government as a non-profit "public interest" organization offering training for and working in the field of corporate governance. He listed the top five things Japan needs to do to raise corporate governance to the current global standard.

1) Require disclosure of company policy (if any) about training for all directors and orientation for all new directors.
2) Require the same disclosure with respect to training policy (if any) for all Statutory Auditors, who conduct "accounting audits" and "legal audits".
3) Enable all types of listed companies to form legally valid committees ("Special Boards") composed of independent directors to make decisions with regard to nominations, compensation, MBOs, defenses, investigations, and any other matters where internally-promoted "executive directors" are inherently self-interested.
4) Provide incentives to use such committees by shifting the burden of proof with regard to the duty of due care in shareholder lawsuits about decisions regarding such matters.
5) Enable all types of listed companies to appoint "executive officers" (e.g., CEO, CFO, COO, CIO) who need not be board directors but whose fiduciary duties are set forth in the Company Law.

This is not the case in Japan, where there is, at present, no requirement for outside directors (in the US the majority must be outside directors). Most Japanese companies nominate directors from within their management structures. Not only does this encourage inherent conflicts of interest, it also prevents boards from having the widest possible perspective on their business. Moreover, in the US directors are subject to shareholder lawsuits and have fiduciary duties (enhanced under the new Dodd-Frank Act, and the subject of several court decisions). In Japan, directors have no direct fiduciary duties.

US companies are also required to disclose their training policies and requirements for directors. Japanese companies are not required to do so.

No One Knows Anything

With some simplifications, Hollywood provides a very good way to look at the models of what a company must do. A movie is a story; it can be generated from a script, adapted from a novel, a comic book, even a Disney Ride ("Pirates of the Caribbean"). But if it is adapted and current, the rights must be purchased, and if it is in the public domain (e.g. Shakespeare) it may need to be adapted for current use. So, long before the cameras roll, money is being spent (and there are always back stories to scripts, the best unproduced scripts, or those like "Skyfall" that took longer to write than it took to film the movie). Stars and film directors have to be signed and scheduling has to be arranged for filming, as well as for release (more and more films are released on the same day around the world). Studios look for other factors — for example, does a film lend itself to sequels ("Spider-Man" does, "Lincoln" does not), or what ancillary sources of revenue can a production bring? (The legendary story on this is that George Lucas kept the merchandising rights on the first three "Star Wars" films, and those rights in total were worth over three times the box office and rental fees that the movies made).

A movie in production is also a temporary medium-sized enterprise (in the past, without as much technology, the personnel numbers were larger). These are people with job descriptions as varied as lead actor/actress all the way to caterers and make-up artists.

In this same way Hollywood studios, most started by entrepreneurs, have experienced (and in many cases experienced earlier) the very same problems that corporate governance is meant to address: misuse of company funds by executives (one case involved a studio executive and the late actor Cliff Robertson), copyright infringement and misuse of intellectual property (the case of Art Buchwald and the film "Coming to America"), the same problems in reverse (first surfaced with videotape), and the continual need to adjust to changing technologies (television, videotape, cable delivery, DVDs, streaming video).

This is a very simplified schemata of a very complex business, but it goes directly to the point of a company being in many businesses and developing many products. It is also worth noting that for every 100 projects that are optioned for film, approximately seven make it to actual filming. And of those, a few will make money, a few will break even, and a few will not even come close to covering their production costs. A studio makes money on the films that break out, from the studio's end, hopefully more than they have lost on the films that tanked, or on the films that barely made back their costs of production.

That is why, on any given day, studio personnel will be considering cartoons and adventure, an adaptation of a crime or detective novel, and any number of domestic comedies. Some sure-to-be-hits will vanish, a week or two after release, while some that someone had to argue for or take a pay cut to make will blow out beyond any possible measure. When they say no one knows anything, it is more than cynicism — it is hard learned wisdom.

It is very easy to see the pressure studios face — the entertainment industry is spotlighted and highlighted enough (not least by itself) — but it also is very useful to focus on why the day-to-day management of a company (the release schedules for a slate of films, the post-production status of the soon-to-be-released, etc.) can and should be separate from the larger questions (acquisitions of other companies, mergers, strategic cooperation).

The insiders who came up through the ranks might know more on the day-to-day operations, but they also have relationships and vested interests. Another famous Hollywood case that bears on this is when Michael Ovitz, who had been head of a very large talent agency in Hollywood, was chosen to be head of Disney. His tenure was a disaster and it cost Disney financially and in goodwill. Ovitz had not come up through the ranks but he was considered a consummate insider.

Insiders need outsiders, yes men need no men. There is simply too much evidence (most of it, sadly, recent) to back this up. Olympus, TEPCO, the Lehman shock — in each case, it was not that no one saw the possibility of an iceberg (any more than the captain of the *Titanic* himself was unaware of that possibility), it was not heeding the warnings, not listening to the lookouts. The stokers in the engine room of the *Titanic* were doing their jobs, to keep the ship moving. The captain and officers and one company official on board were the ones who did not do theirs (or did theirs rather poorly).

It's a Hard Job & Someone Has to Do It

Looked at differently, for an Edison, a Disney, a Jobs (each representing owner/founders of companies that still exist), board meetings and for that matter boards themselves must have seemed like nothing so much as an intrusion into the inventive/creative process.

This is an attractive image but it is a simplification. Thomas Edison was an inherent tinkerer, and he did have his own lab and there were many inventions that flowed out of it. Walt Disney started as a talented illustrator. And before there was even an Apple, Steve Jobs and Steve Wozniak made money selling Blue Boxes, which enabled users to spoof the tones used by the existing hard-line phones and call for free. And they really did work out of a garage in Silicon Valley.

Thomas Edison was, however, not simply an inventor, but also a very clever promoter and lobbyist for his inventions. Without a supporting cast of investors (starting with Western Union which funded his initial laboratory in Menlo Park, New Jersey, J.P. Morgan and members of the Vanderbilt family) as well as a talented research staff, Edison might have remained a backyard tinkerer.

Walt Disney, of course, started as an animator (and the original voice of Mickey Mouse). Going from short cartoons (which were the introduction to many feature movies well into the late 1960s) to a full length feature animated film was a serious gamble. "Snow White and the Seven Dwarves" was called "Disney's Folly" but it made money. Two successors, "Pinnochio" and "Fantasia" did not, though "Fantasia" enjoyed a revival on the midnight/weekend circuit through the 1960s and 1970s. But in the immediate sense, it was a hit and two misses, and they were misses at a time when making a full-length film was extremely labor and time intensive since all cells had to be hand drawn. Later came television and theme parks, the latter almost counter-intuitive — America, like Europe, Asia and the rest of the world has its festivals and carnivals — with rides, sweet/salty food, gambling (even if the games are rigged), and other exotica set up for a few days and then taken down. Disney's take was that people would pay for a sanitized (some would say sterile) but visually exciting experience, on the edge of what was ordinary technology, but above all predictable and safe. Looking back, it seems obvious, but *it had never been done*, and the era of mass travel was just beginning when the first Disneyland opened in 1955. Cheap airfares, even across the US, were more than a decade away.

The Steve Jobs story is far better known and more recent, but it is still telling that Apple was very much an also ran to Microsoft until the company (and Jobs was a driving force in the move) embraced entertainment "content" — the easiest of which was music because the format existed, Apple had more experience in graphical user interfaces, and the music industry was itself being steamrolled. Jobs was an unlikely savior because Apple had earlier resisted involvement with the entertainment industry (though Jobs, of course, had separately funded Pixar, and in an irony worthy of Hollywood became a huge shareholder in Disney when Pixar was sold).

We began with an exam question, so it is fitting to close with a close approximation of one. Imagine yourself in a room with any of these three kinds of men: geniuses, visionaries, but also, arguably, megalomaniacs. Your situation is not the one that opened the article, dealing with corruption or breach of ethics. It is much more complex than that. What you are being asked to approve is something that, however much market testing has been done, is unproven. Your job is, if not to say no (and who would want to be remembered as the man who said no to Edison, Disney or Jobs?) then to manage the risk that the total investment in this "new new" thing, this new line of business will not, if it fails, bring the entire company down with it.

That is the final question on the final exam. JS

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