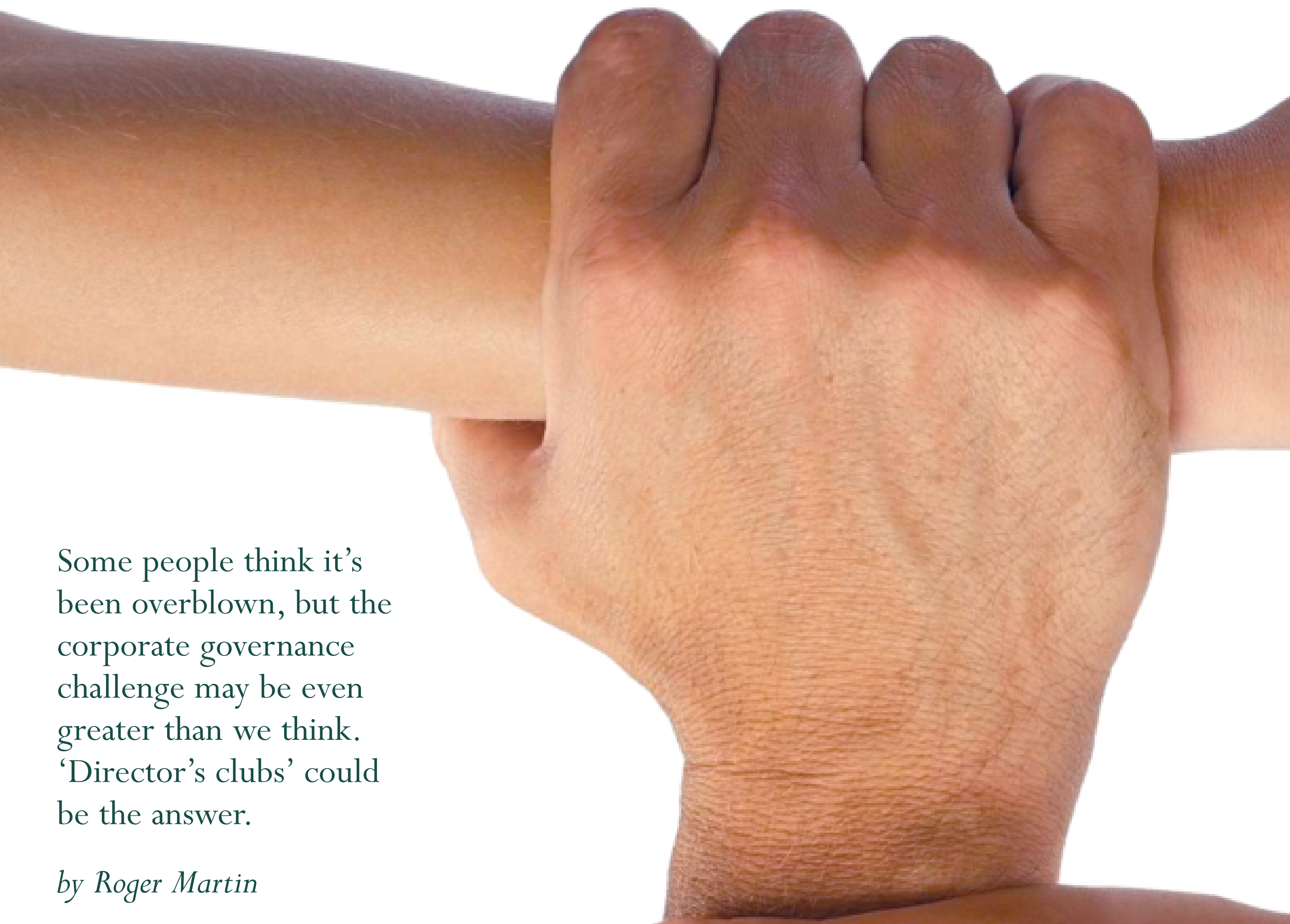
Prosperity:
A FUNCTION OF TRUST



Some people think it's been overblown, but the corporate governance challenge may be even greater than we think. 'Director's clubs' could be the answer.

by Roger Martin

Peter Sibbald for *BusinessWeek*

There is no question that corporate governance has become a 'big deal'. The great scandals of our day have left many of us asking, even years later, "Where were the directors?" And everywhere you look, there is active debate around key issues such as accountability, standard-setting, monitoring, disclosure and enforcement.

Whether or not you think the impact of a few big scandals has been overblown, I think most of us would agree that there is a lot at stake here. As we collectively search for ways to fix what is broken, scholars of economic development and prosperity have lessons buried in their work – not necessarily aimed explicitly at corporate governance – to which we would be wise to pay attention.

First, let us scroll back to **Douglass North**, the 1993 Nobel Laureate in Economics. Like most Nobel Laureates, he received his award for a lifetime of work, in his case for creating a field that became known as 'The New Economic History'. North challenged the neoclassical view in economics that prosperity was a rather simple function of the quantity and quality of basic resources – labour, capital and resource endowments. Like a proper scholar, he explored the data to answer the fundamental question of why some countries are rich, and others poor.

In his landmark book, *Institutions, Institutional Change and Economic Performance*, North argues that, "Institutions provide the basic structure by which human beings throughout history have created order and attempted to reduce uncertainty in exchange. Together with the technology employed, they determine transaction and transformation costs, and hence the profitability and feasibility of engaging in economic activity."

The worse-functioning the institutions, the greater the institutional uncertainty, the greater the transaction costs, and the greater the difficulty of entering binding contracts. The consequence, according to North, is economic stagnation, as evidenced in most developing countries and many former socialistic states. North's identification of the importance of political, legal and administrative institutional structures opened up a rich vein of research and thinking about how important institutions can be to the prosperity of countries.

This vein has been mined impressively by two other important scholars whose work bears on the issue of corporate governance. The first is Peruvian **Hernando de Soto**, winner of the 2004 Friedman Medal for Advancing Liberty and called by folks as diverse as **Bill Clinton** and **George Bush** "the most influential economist in the world today." In 2000, he wrote *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, in which his core thesis is that only in the developed west do we have land registry systems and real-estate law practices and procedures – i.e. institutions supporting real estate – that allow owners to establish and enforce clear title to their property. This, he argues, enables owners to go to banks and finance property ownership, which creates massive amounts of capital with which to improve real estate, build factories, and create economic wealth.

De Soto shows that in Egypt, obtaining clear title to a piece of property on which to open a store requires exactly 77 procedures, 31 agencies, and a minimum of five years working 250 days a year, eight hours a day – if you are lucky. If you are less than lucky, it can take up to 19 years, and even after all that work, it is unclear whether this clear title will be enforced. Hence, de Soto calculates that more than of 80 per cent – and in some countries as much as 95 per cent – of the potential capital in these countries is essentially 'dead' and unusable.

For me, the most interesting part of the book is de Soto's description of the painful 150-year process that America went through to develop its now-robust system of land registry and legal protection of title. In his view, the functioning of these intricate and sometimes arcane institutions is as responsible for American prosperity as anything else, because real estate is the biggest source of capital in the U.S., by far. Notwithstanding the current real estate bubble, equity in one's home is the largest asset for the majority of Americans at their death. De Soto reinforces North in underscoring the fact that the functioning of certain key institutions determines not just small nuances in prosperity, but rather the not-so-fine line between prosperity and poverty.

How does all of this tie-in to corporate governance? To get closer to the topic, we need to look at a third great scholar, **Francis Fukuyama**, who was a senior analyst at the U.S. State Department when he wrote the article that made him famous – "The End of History" – in *The National Interest* in the summer of 1989. He went on to write a fabulous book called, *Trust: The Social Virtues and the Creation of Prosperity*, in 1995. Richly researched and powerfully argued, the book makes a central point: the prosperity of nations is a direct function of the broad institutionalization of trust in their economies. For example:

- economies in which you can only trust your immediate family have the lowest prosperity – e.g. sub-Saharan Africa and Russia;
- economies in which you can trust the broad-extended family are next more prosperous – e.g. China;
- economies with primitive stock markets and commercial legal institutions are the next most prosperous – e.g. Indonesia, Thailand; and
- the economies in which there are robust legal institutions, an independent judiciary, advanced contract law, and tightly regulated capital markets are the most prosperous – e.g. the major OECD countries.

So, why are the countries in the fourth category so prosperous? Because capital formation can take place at a broad level. Individuals can trust people they don't even know with their capital, because institutions provide protection and recourse for them. At the opposite end of the spectrum, where trust is low, capital cannot be gathered and deployed, and widespread poverty ensues.

While none of these scholars was specifically studying or talking about corporate governance (and all wrote their treatises long before the recent wave of scandals), nevertheless, their work holds a powerful but simple message: weak governance undermines trust, and anytime trust is undermined, prosperity suffers fundamentally. These scholars help us understand that the institutions that provide trust for investing in our economy are fundamental to our standard of living. Indeed, they represent the difference between prosperity and poverty.

De Soto warns that in the West, we totally take for granted that these institutions are dependably in place and operating smoothly. And for that reason, we don't always nurture and protect them. And so it was with boards of directors and corporate governance as the millennium came to a close: we took for granted that they would do perfectly-adequate jobs, without understanding the magnitude and trickiness of that job, or the downside of not having these institutions 'work'.

It isn't as though we weren't warned: all the way back in 1932, **Adolf Berle** and **Gardiner Means** pointed out in *The Modern Corporation and Private Property* that because professional managers were now running corporations, a fundamental schism had been created between owners and managers. In 1976, **Mike Jensen** and **Bill Meckling** (in the third most-cited article in the history of Economics, "Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure", *Journal of Financial Economics*) – warned of significant 'principal-agent problems' in the modern corporation, and that managers cannot be trusted completely to act in the interests of shareholders. Despite these warnings, we soldiered on, assuming that directors could straightforwardly fulfill the role assumed by Berle, Means, Jensen and Meckling.

Why Do Directors Join Boards?

Let's do a quick reality check and look at directors as the human beings they actually are, rather than the idealized saints that the shareholders of the modern widely-held, publicly-traded corporation assume they have at the helm. When you get right down to it, why would a person join the board of a public corporation?

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I can think of only six reasons: two of them are really bad, three of them are pretty bad, and just one of them is honourable (albeit unlikely.) On the 'really bad' front, a person joins the board of a public corporation:

1. In order to garner favours from the organization in question. This is patently wretched for the shareholders and detrimental to trust. You may believe this just doesn't happen; but remember, until relatively recently, it was historically a core rationale for the CEOs of big companies to sit on the board of their lead bank, in part to ensure that their firm wouldn't get cut off in the next credit crunch.

2. As an opportunity to learn about an interesting industry. This is also dreadful for shareholders, who certainly deserve to be served by someone with better qualifications than a motivation to learn about their industry. If and when shareholders need the help and expertise of their directors, they aren't going to get it from a director that is simply in 'learning mode'.

On the 'pretty bad' front, a person joins the board of a public corporation because:

3. The compensation is highly attractive. This is a bad reason because it means the director will be conflicted in the event that he or she objects to something management says, and will be inclined to be quiet rather than risk losing a lucrative board seat.

4. Being on a board is prestigious. Again, this is a bad reason, because the director will fear a loss in prestige if he or she is kicked off the board for being 'argumentative'.

5. The board community is socially enjoyable. If this is his or her motivation, a board member will be disinclined to say anything that might create discord with the rest of the board members, because disagreeing with the prevailing view creates unpleasantness – the opposite of what they're after.

If any one or a combination of the above is the motivation for a director to join a board, then that director will be highly unlikely to serve the role of ensuring that the institution of corporate governance produces the level of trust that is conducive to prosperity. It won't automatically mean disaster; fortunately for the world's shareholders, many management teams actually *want* to do the right thing and act as if they are principals themselves; but if a director decides to join a board specifically for one or more of the above reasons, he or she will let shareholders down at the very time they need to be protected.

What, then, is the one honourable reason to join a corporate board?

6. Public service. The recognition of a well-intentioned citizen that the very prosperity of his or her country depends on the institution of board governance, and depends in a most serious way, as shown by North, de Soto and Fukuyama.

The Judge Analogy

In essence, modern directors need to think and act a lot more like judges: on the whole, judges get crummy pay and have a largely thankless task, with more hardship than exhilaration. But nevertheless, they do it because in the legal profession, there is a strong sense that the highest form of public service is to become a judge and apply your wisdom to ensuring that the judicial institution serves its country well. By and large – at least at the higher levels – this is the case for judges, and it is seen to be the case by the public.

The question is whether this is the case with corporate directors. Are they drawn to directorship as an important public service, *and* are they seen by the public primarily as public servants? The two parts of this question are inextricably linked, and the answer to the latter is a definitive "no." If anything, the public sees directors as highly-paid 'fat cats' who smoke cigars, drink martinis and line their pockets with big pay packages. And the answer to the second question tends to influence the answer to the first: it is rare, in any field, for those in it to view it as public service when nobody else does. By definition, public service requires that the public feels it is being served.

There are two important implications of this analysis of director motivation and public opinion. The first is that for the sake of our country's prosperity, we need to migrate to a state of affairs where directorship of our public companies is motivated first and foremost by public service; is seen as a valued public service; and is widely respected as such.

The problem with these complaints is that directorship shouldn't be an attractive financial proposition; if anything, it should be financially unattractive, as is the case with all public service. Otherwise, it is necessarily bad for shareholders, as I have argued. As long as directors continue to complain about directorship being 'not worth' the compensation involved, the public will never view their work as public service, and consequently, neither will directors. And that will leave directors to be motivated by one of the other five reasons listed earlier, which in turn is automatically bad for governance, bad for the quality of our institutions, and bad for prosperity.

The second thing directors should stop complaining about is Sarbanes-Oxley, and the liability concerns turning board meetings into long bureaucratic 'check-the-boxes' exercises. It is incumbent upon directors not to let this happen in their board meetings: checking boxes and following procedures is not their job, and those who let it become their job will be conspiring with the often wrong-headed folks who created many of the most knee-jerk regulatory reactions to the scandals to drive good governance into the ground.

A Modest Proposal: The Director's Club

So what would be the model for such a public-service-oriented board? I believe that directors who care about the integrity

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The second implication is that everyone who is currently a corporate director should stop complaining about two things if they want improved corporate governance: the first is director fees. The complaints are legion: "It's getting so hard"; "The liability is getting greater"; "With Sarbanes-Oxley, the meetings are getting longer and longer" Believe me, I have heard them all, and heard them often.

of boards should form a global 'director's club', whose members contractually obligate themselves to give 15 per cent of their annual director compensation to a registered charity, with the donations made through the club so that they can be audited. Fifteen percent is a meaningful amount, but not so great that it would turn directorship into a charity. It does leave the standard directors fees at something close to market rate, but ensures that 'club members' are publicly accepting a marginally unattractive compensation – a prerequisite of service.

Club membership would conspicuously demonstrate a director's commitment to public service while offering the social benefits of being perceived as a good corporate citizen. It would also provide entry into a self-reinforcing support structure for good governance, where club members would have the social support needed to make difficult, disinterested decisions that might be unpopular with management, but in the best interest of shareholders.

Smart investors would want to know how many club members sit on which company boards, because the more club members, the greater the boards' public-service orientation and the less potential there is for conflicts of interest. A high ratio of club members to non-members would indicate management's commitment to integrity, as club directors would have little tolerance for self-interested or corrupt management, and if they encounter it, would take their public service elsewhere. And because having club members on boards would make companies more attractive to investors, corporate reports might eventually declare the number of club members on a board, just as they now indicate the number of women and minority directors.

Such a director's club would be good for shareholders, managers, and directors themselves. But as long as directors seek their positions for the wrong reasons and continue to complain about how hard their job is and how underpaid they are, they'll remain deluded about their power to protect the interests of shareholders.

Think once again about the judge analogy, whereby the director's 'job' is to serve as an underpaid public servant who exercises their best judgement and thinking capabilities to protect and uphold democratic capitalism – and with it, our prosperity, and that of our children and grandchildren.

I'm sure we can all agree that this is something worth fighting for.

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