Rethinking

Lynn Paine and Joseph Bower
make the case for an alternative to the agency-based model of governance

Corporate governance has evolved from a topic of concern to a few specialists to a matter of broad public interest with good reason. How corporations are governed has consequences for our economies and our societies, and ultimately for all of us as individuals.

But what is “good governance”? In recent decades, it has come to mean that corporations should be managed to maximize shareholder value (understood as total returns to shareholders), and that the duty of corporate boards and managers is to make sure that happens.

“Shareholder value should be seen as an important consequence of good governance, rather than an objective”

This idea is grounded in what economists call agency theory – the notion that managers are agents of the shareholders who own the corporation and that the manager’s job is to carry out the wishes of shareholders which is presumed to be maximizing the price of their shares.

Within this model, the board is charged with putting in place goals and incentives that will align the interests of management with those of shareholders. The theory posits that in the absence of such arrangements, managers would not apply themselves—or would apply themselves incorrectly—to the task of maximizing shareholder value. The board, in this view, is mainly a mechanism for monitoring management and controlling what is known as agency costs.

This approach may sound plausible on the surface, but it rests on fuzzy legal grounds and involves a serious problem of accountability. It also has a tendency to skew corporate strategy and resource allocation to the near term, and to favor shareholders with shorter time horizons. In many situations, managers can drive up a company’s share price simply by cutting expenses aimed at meeting future needs, such as investments in people, R&D, innovation, and brand building.

Short-term investors can sell their stock and pocket the gains, while shareholders with less flexibility or longer time horizons are left to bear the consequences as they play out over time. And it’s not just long-term shareholders who bear the cost. Research has also shown that some of the high-powered incentives put in place to align management’s interests with those of shareholders are also associated with environmental misdeeds and harm to consumers, not to mention the damaging effects on the public.

In our recent Harvard Business Review article “The Error at the Heart of Corporate Leadership”, we examined these and other problems with the agency-based model of governance and sketched an alternative that we see as more consistent with the realities of managing for the long term and better aligned with the corporation’s functions in society. In that article, we wrote:

“The agency model’s extreme version of shareholder centrality is flawed in its assumptions, confused as a matter of law, and damaging in practice. A better model would recognize the critical role of shareholders but also take seriously the idea that corporations are independent entities serving multiple purposes and endowed by law with the potential to endure over time. And it would acknowledge accepted legal principles holding that directors and managers have duties to the corporation as well as to shareholders. In other words, a better model would be more company centered.”

The model we have in mind puts the ongoing health of the enterprise at its core, and views shareholder value as an important consequence rather than an objective unto itself. That may not sound like much of a difference, but consider a few of the practical implications:

Boards would act as stewards of the company accountable for ensuring its performance over time and, with a broader view of their purpose, approach a number of tasks differently. When allocating resources, they would employ strategic criteria rather than relying on narrow financial metrics such as net present value, which has been shown to undervalue future opportunity. They would also
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invest more heavily in developing the next generation of leaders and ensuring that executive succession occurs in an orderly way—an area that boards themselves say they handle poorly today.

Shareholders would adopt a nuanced view of staggered boards recognizing that they help ensure institutional and strategic continuity and allow for more careful evaluation of directors since fewer candidates are up for election each year. The agency perspective teaches that staggered boards are little more than “entrenchment” devices designed to protect managers and impede takeovers. But the additional time required to replace a staggered board also acts as a buffer against ill-advised takeovers and ensures that unsolicited bids are given adequate scrutiny.

Although the academic debate about staggered boards is far from resolved, recent research has found that they can have beneficial effects on managerial behavior, investment decisions, and firm value in R&D-intensive and early-stage companies.

Boards would develop more customized executive pay plans tailored to the strategy and circumstances of the company rather than to generic standards promulgated by compensation consultants and proxy advisors. That means putting more time into setting appropriate targets and time lines and relying less on short-term shareholder return metrics. In assessing performance, boards would also be mindful of the difference between creating value and merely transferring it from other constituencies, such as its employees or customers, recognizing the long-term repercussions of such practices for the company.

As a corollary, shareholders would be more skeptical of activist campaigns that call on managers to take quick action to increase the company’s share price, recognizing that such gains may come at the expense of the company’s longer-term prospects. As noted, earnings and in turn share price can often be increased by cutting costs aimed at meeting future needs, and academic studies have found that a significant portion of hedge fund interventions involve just that. To be sure, each campaign must be evaluated on its merits and the task of identifying managers who are in fact wasting resources is important, but shareholders should be wary of programs to eliminate uncertain investments—in research, renewal, innovation, people—as companies cannot achieve sustained growth without them.

With a company-centric view of accountability, shareholders, boards, and managers would all pay more attention to the fundamental economic impact of corporate activities. Elsewhere (in our book Capitalism at Risk) we have written at length about the dangers of ignoring the negative externalities produced by corporate activities and shown how this indifference feeds into a chain of forces—natural, social, political, and economic—that can over time become quite destructive. Most simply, if wages are too low, there are no consumers. A broader and more forward-looking view of managers and their boards as company stewards would provide a foundation for attending to those longer-term threats, help build more robust companies, and contribute to a more sustainable economy.

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Those are just a few of the implications that we see flowing from our proposed model of corporate governance. Although it is hardly radical—the model tracks current law—it is a far cry from the standard agency-based view.

The governance model we have in mind seeks a more balanced view of time and harkens back to the reason for creating corporations in the first place: to mobilize capital for the large-scale, long-term projects needed to develop society. The model will gain traction, however, only if it is developed further and embraced by investors, boards, and managers, and used to guide their investment and engagement activities. We invite you to join us in rethinking “good governance.”