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# Notes on Governance and Corporate Control

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## 1. Introduction

These notes comprise the basis of several "foundational" lectures for a 30-session, case-discussion course on *Governance and Corporate Control* offered at the Harvard Business School. This course, like the theory-building and case-writing that preceded it, was largely created before the Enron debacle and similar stories involving the abuse of owners and investors sparked the current review of corporate governance practices. Thus, while the substantive research addressed in these notes have direct relevance to recent breakdowns in corporate governance, they represent the fruits of many years of research, observation, and active involvement in the governance and controls of major U.S., European, Japanese, and, more recently, Russian corporations.

The abuse of equity holders (as well as debt holders and employees) can result either from fraud and theft by corporate executives or from inept behavior on the part of corporate executives and boards of directors. The latter is generally known as a failure of internal governance and control. Without minimizing the importance of fraud and other forms of unethical behavior in the abuse of shareholders, these notes and the lectures drawn from them can contribute to the necessary review of corporate governance practices by focusing on the second, less fraudulent but equally destructive abuse.

In addressing the effective practice of internal governance and control, I draw heavily upon contemporary organizational economics, relevant management research on the behavior of executives in the conduct of corporate affairs, and many years of personal experience as an advisor to some of the world's largest corporations. Where appropriate, I also incorporate ideas and principles drawn from corporate law and ethics, but these notes present a

1. The James J. Hill Professor Business Administration, Harvard Business School, and President, Mars & Co, an international consultancy with offices in New York, London, Paris, San Francisco, and Tokyo.

predominantly economic and managerial perspective. In particular, I concentrate heavily on internal "rules of the game" that the board of directors sometimes set for the CEO and that the CEO sets for the rest of the organization.[2] These rules serve to regulate managerial decision-making. They also contribute directly to the performance of the firm as a whole - for better or for worse.

Sections 2 to 8 of these notes, which summarize the intellectual foundations of the *Governance and Corporate Control* course and constitute the substance of several introductory and summary lectures, address the challenges of managing for sustained value creation in today's business environment. This environment, in my view, is characterized by intensifying capital market pressures to generate above-average or super-normal returns, shrinking asset life-cycles that create great pressures to make new capital investments pay for themselves in a short period of time, and increasingly large scale investments in technology and corporate infrastructure that carry proportionally greater levels of financial risk.

For the purpose of these notes, I assume that there is not a major mismatch between a firm's competitive strategy and its current market environment, and that the most pressing management task is to devise an internal *modus operandi* that ensures both effective strategy execution and timely strategy redefinition as the need arises. This leadership task gets to the heart of effective internal governance and control - by which I mean a set of rules and processes by which the interests of equity holders are served by the behavior and administrative practices of the board of directors, the CEO, and other senior executives responsible for the conduct and performance of the enterprise.

Sections 9 to 11 address the question of how board composition and governance behavior can also affect corporate performance. Section 12 concludes by addressing the question of what kind of leadership behavior is required to complement the kind of value-focused governance and control structure laid out in these notes.

## 2. Foundations of Effective Governance and Control

Governance and control practices directly affect the manner in which management decisions are formulated, debated, ratified, and implemented. They also directly affect corporate performance - by their impact on the costs

2. Where the chief executive officer also serves as chairman of the board, it is not always clear how the board actually sets and enforces expectations and rules for the CEO - but that in itself constitutes a major corporate governance problem for companies without non-executive chairmen. In some cases, "lead" directors together with other outside directors can provide the necessary rule-making and monitoring function, but many U.S. companies have yet to adopt this structural arrangement.

of collective decision-making, the costs of monitoring managers, and the costs of poor decisions taken by ill-disciplined managers. In addition, a firm's internal governance and control regime can affect its access to capital by the confidence (or lack thereof) that it offers suppliers of equity capital or collateralized debt. Finally, corporate governance practices can also affect investor premiums. Recent research has shown that institutional investors are willing to pay a markup of more than 20% for shares of companies that demonstrate good corporate governance.[3]

An appropriate metric for assessing the effectiveness of corporate governance and control practices is the extent to which firms can earn their cost of capital on a sustained basis and at least meet the average returns of firms in their competitive set, many of which may be quite a bit smaller than they are. Companies like General Electric pride themselves on their economic record and their ability to build an enterprise that combines the reach and resources of a big company with the learning abilities and bias for action of a small company.[4] Companies with the capacity to create and blend these large and small company advantages together successfully do so in a wide variety of ways—by imposing strict disciplines on which businesses to support, by minimizing bureaucratic interference and simplifying business processes, by empowering executives imbued with shared values (and, thus, carefully nurtured decision premises), by conducting endless searches for best practices, and by playing serious attention to management selection and incentives. But whatever the unique mix of tools and techniques perfected by successful companies, they must also meet two fundamental challenges of governing complex organizations: the minimization of conflicts of interest and their related costs, and the effective utilization and creation of knowledge.[5]

## 3. Conflicts of Interest and the Agency Problem

From a corporate governance point of view, the most important conflicts of interest arise between owners and managers - or, more generally, between so-called principals and their economic agents. The sometimes conflicting

3. Premiums vary from country, with the size of the premium reflecting the extent to which institutional investors believe there is room for improvement. McKinsey & Co study done in collaboration with the World Bank and Institutional Investors, reported in *The Wall Street Journal,* June 19, 2000, p. B6.
4. General Electric Company, 1995 Annual Report, pp. 7-11.
5. This formulation of the governance challenge reflects the collective thinking of the CCMO Teaching Group at the Harvard Business School of which I have been an active member. See, for example, Michael C. Jensen, William A. Meckling, Carliss Y. Baldwin, George P. Baker, and Karen W. Wruck, "Course Notes for Coordination, Control and the Management of Organizations," Fall 1995.

interests between principals and agents are referred to as "the agency problem" in the economics literature.

The agency problem has its roots in the separation of the financing and management of firms.[6] When suppliers of capital invest in a business venture, they of course want to be sure that managers will be working in their interests and providing adequate returns. In a simple world, financiers could be assured of such outcomes by signing a straightforward contract stipulating what managers should do with the invested funds and how the returns are to be divided between both parties. But in the real world it is hard to describe and foresee all future contingencies, thereby creating what can be called an "incomplete contract" between financiers and managers.[7]

In a world of incomplete contracts, financiers cannot expect to retain the right to control decisions not stipulated in advance. These so-called "residual rights of control" typically end up with managers since financiers are usually neither qualified nor sufficiently informed to decide what to do in the domain of everyday operations.[8] Here is where the agency problem is born and why corporate governance is a day-to-day concern.

Many managers (as economic agents) have objectives that diverge, at least in part, from those of the owners of the enterprise (the principals). This divergence of interests stems from the fact that is nearly impossible for anyone to be a perfect agent for anyone else due to self-interested behavior. Most rational men and women systematically make calculated decisions that increase their comfort or decrease their pain and otherwise provide personal gains.[9] This aspect of human nature led Adam Smith, well over two hundred years ago, to recognize that managers as agents for shareholders will tend to be less vigilant in pursuing owners' interests than if they themselves were the owners financing the business venture.[10] The resulting agency problem can lead to managers maximizing their own comfort or personal opportunities through such activities as slacking off, sitting on unproductive cash to insure themselves against unforeseen events, giving favorable prices to friends, underinvesting or even selling assets to make their ROA performance look good, and pursuing growth over profitability to maximize their own tangible

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6. Berle and Means, in their now- classic study of the modern corporation, refer to this phenomenon as the as the separation of ownership and control. Adolf Berle and Gardner Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932).
7. Andrei Shleifer and Robert W. Vishny, "A Survey of Corporate Governance," *Journal of Corporate Finance,* Vol. 52, Issue 2, June 1997, p. 740-741. Much of their language is reflected in this summary of the agency problem.
8. Sanford Grossman and Oliver Hart, "The Cost and Benefits of Ownership: A Theory of Vertical and Lateral Integration," *Journal of Political Economy,* 1986, Vol. 94, pp. 691-719.
9. Michael C. Jensen and William H. Meckling, "The Nature of Man," *Journal of Applied Corporate Finance,* Summer 1994, pp. 4-19.
10. Adam Smith, *An Inquiry Into The Nature and Causes of The Wealth of Nations,* Edwin Cannan ed. (Chicago, ILL: University of Chicago Press, 1976) [1776].

and intangible rewards. Some of the worst agency problems of this sort occur in firms with poor investment opportunities and excess cash that managers invest in ever-declining rates of return rather than return the cash to shareholders.[11]

Given the ubiquity of agency problems in organizations, much of the subject of corporate governance deals with constraints that managers put on themselves, or that investors put on managers to minimize these agency problems. To this end corporate boards and CEOs (via their delegated authority) must devise internal administrative practices that minimize self-interested behavior and personal opportunism and foster cooperative behavior and compliance with organizational objectives and policies. Designing and institutionalizing such practices is costly to an organization (and its principals). These "agency costs" are summarized in the table below.

*Table 1:* Agency Costs

| **Source of Agency Costs** | **Components of Agency Costs** |
|---|---|
| • When a principal delegates decision rights to an agent to take some decision on his or her behalf, the agent will not generally have an objective function identical to the principal.<br><br>• Because individuals are self-interested, the delegation of decision rights generates a control problem associated with temptation of individuals to use the decision right to make themselves better off. | • Costs of devising and writing contracts - costs of devising "rules of the game".<br><br>• Monitoring costs - expenditures by the principal to encourage proper decisions of the agent.<br><br>• Bonding costs - expenditures by the agent to help assure the principal that he or she will not behave inappropriately.<br><br>• Residual loss - costs due to the fact that contracts are seldom perfectly enforced and thus a reduction in the welfare of the principal. |

Source: Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure, *Journal of Financial Economics,* Vol. 3 (1976), p.310.

11. Michael C. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," *American Economic Review,* 1986, Vol. 76., pp. 323-329.

## 4. The Knowledge Problem: Its Effective Utilization and Creation

Knowledge is extremely valuable in "seeing" opportunity and making related strategic and operational decisions. It comes in two forms: general knowledge and specific knowledge.

General knowledge is knowledge that is inexpensive to transmit and specific knowledge is knowledge that is costly to transmit. Indeed, "the more costly knowledge is to transmit, the more specific it is, and the less costly the knowledge is to transfer the more general it is."[12]

General knowledge is information that can be aggregated and communicated easily, such as prices, wages, quantities, product costs, industry growth rates, and the profitability of a business. Specific knowledge is on-the-spot, idiosyncratic knowledge - of machines, customers, particular organizations, and the competitive dynamics of distinct markets.

General and specific knowledge is very different from opinion, speculation, or personal belief. Knowledge is information that has been validated through some tests of correctness and includes both codified intellectual products such as written studies and blueprints, and tacit knowledge such as uncodified routines.[13]

A knowledge advantage exists for firms when they have greater access to specific knowledge about market opportunities and risks than either their competitors or other economic actors in the marketplace or when their accumulated experience results in well-tested competitive concepts or theories enabling an efficient and effective use of firm resources. Such knowledge can result in the design and manufacture of superior products, the development of highly productive work systems, or the reduction of risk through accurate forecasting - just to mention a few ways in which knowledge can create competitive and financial advantages for firms.

Unfortunately, the ability of individual managers to access, analyze and absorb specific knowledge is quite limited despite recent advances in information technology. Top managers typically live under conditions of "information impactedness" where their ability to act is limited by their difficulties in processing large amounts of information.[14] In addition, many top managers are far removed from the actual phenomena in which they are interested and often must rely on secondhand, previously interpreted data.

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12. For a detailed discussion of knowledge and the costs of transferring knowledge in organizations, see Michael C. Jensen and William H. Meckling, "Specific and General Knowledge, and Organizational Structure," in Lars Werin and Hans Wijkander, eds. *Contract Economics* (Oxford: Basil Blackwell Ltd., 1992), pp. 2 51 and 254, and *Journal of Applied Corporate Finance,* Vol. 8, No. 2, Summer 1995, pp. 4-18.
13. Julia Porter Liebeskind, "Knowledge, Strategy, and the Theory of the Firm," *Strategic Management Journal*, Vol. 17, 1996, p. 94.
14. Herbert A. Simon, *Administrative Behavior* (New York: The Free Press, 1965, second Edition), p. xxiv.

They thus lose many of the advantages of their own analytical faculties[15] and often end up relying on automatic decision rules that minimize data manipulation needs[16] - a risky proposition in dynamic operating environments.

Conceptual models such as Michael Porter's well-known framework for industry and competitive analysis or any number of valuation models that are routinely used to assess investment options can be very useful to general managers in overcoming these information and knowledge barriers.[17] They make it possible to compress and simplify large quantities of information and to convert it into widely applicable forms of knowledge. When managers can rely on general frameworks or conceptual schemes, rather than having to work through an analysis of raw data from scratch every time a decision is called for, far less intellectual energy and analytic time are required for problem-solving. The result is reduced information impactedness, making it possible to undertake ever more complex problems.[18]

While conceptual aids can help minimize barriers to knowledge utilization and creation, they cannot completely eliminate them. Another pernicious knowledge barrier is what Argyris has termed the "skilled incompetence" of successful managers. Skilled incompetence refers to the inability of successful managers and others professionals to learn how to learn from failure. Having spent much of their lives mastering a broad range of skills and applying them successfully in the real world, they rarely experience failure and therefore do not know how to learn from it.

Such skilled incompetence also shows up where controversial choices about the future have to be made. Argyris has found that the more highly trained such professionals become, the less likely they are to challenge past policies and practices. Sticking to a proven formula enables successful professionals to remain in unilateral control of their destinies, to avoid the conflict and emotional pain associated with changing the old way of doing things (and, perhaps, the embarrassment of making personal errors along the

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15. Man's consciousness or rationality, for instance, enables individuals to deal remarkably well with uncertainty and ambiguity in the physical environment. Our social structures, on the other hand, have remarkable difficulty in coping with environmental change. Similarly, markets (uncoordinated exchanges) are relatively fluid and quickly internalize information about the environment, while organizations (consciously coordinated sets of exchanges) accept and internalize new information only reluctantly.
16. Richard M. Cyert and James G. March, *A Behavioral Theory of the Firm*, op. cit.
17. Michael E. Porter, *Competitive Strategy* (New York: The Free Press, 1980).
18. Since World War II, the business community has lived through several waves of conceptual approaches designed to accommodate the expanding knowledge needs of business: discounted cash flow analysis, product life cycle theory, systems analysis, S.W.O.T. analysis (assessment of a firm's strengths, weaknesses, opportunities, and threats), risk-return analysis, portfolio analysis, industry and competitive analysis, competitive cost analysis, QWL, time-based competition, resource-based competition, corporate re-engineering, and EVA (economic value added) analysis, just to mention some of the most prominent.

way), and generally to appear as "rational" as possible by setting easily understood goals and working to meet them.[19] The purpose of this behavior, Argyris claims, is to protect professionals from feeling vulnerable or incompetent.

This behavioral program turns out, of course, to be profoundly defensive. Argyris points out that such defensive reasoning encourages individuals to keep private the premises, inferences, and conclusions that shape their behavior and to avoid testing them in a truly independent, objective fashion. When an organization's leaders behave in this manner, it develops severe learning disabilities - meaning that it becomes incapable of openly debating how best to adapt to changes in the external environment. The great irony is that that the more successful the manager, the less skilled he or she may be in helping an organization access and utilize important information and knowledge.

Another related impediment to knowledge utilization and development is rooted in the pathology of defensive behavior. Defensive behavior is not limited to an organization's leadership. It is widely observable at all organizational levels and in virtually all human settings.

People behave defensively when they cling to beliefs in the face of overwhelmingly contrary evidence. Defensive behavior is thus essentially non-rational behavior. An instructive example is receiving negative feedback. Most people say that they welcome negative feedback which typically involves identifying and discussing one's errors or weaknesses. But then many actively resist such feedback - either by denying responsibility or attacking the provider of negative feedback. By ignoring or denying evidence that reveals personal mistakes, people often end up making themselves worse off than they were before. This is why defensive behavior is non-rational.

Non-rational behavior of this sort should not be considered "random." For example, not only do people commonly refuse to welcome feedback on their errors, but they also systematically tend to overrate themselves in rankings of their peers.[20] Neither should such behavior be considered "unexplainable." Jensen and Meckling explain this behavior as "pain avoidance" - one of two competing behavioral regimes that people are in at any point in time.[21] When we are in a non-rational regime (or PAM for Pain Avoidance Model), we are frightened; we fear the pain of losing our self-esteem; we make decisions that generally make us worse off; and we learn too slowly. We are unable to

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19. Chris Argyris, "Teaching Smart People How to Learn," op. cit., p. 103.
20. Large sample surveys show that almost no one ranks themselves below the 50th percentile of their peers. For discussion of this phenomena see George P. Baker. Michael C. Jensen, and Kevin J. Murphy (1988), op. cit.
21. Michael C. Jensen and William H. Meckling, "The Nature of Man," *Journal of Applied Corporate Finance* (Summer 1994) and Michael C. Jensen, "Self-Interest, Altruism, Incentives, and Agency Theory," *Journal of Applied Corporate Finance*, Summer 1994.

confront problems early because we cannot get ourselves to put aside something pleasant or *less painful* for something *more painful*. Brain scientists tell us that this behavior is grounded in such biological foundations as the flight-or-fight mechanism that has contributed to human survival for millions of years.[22]

While behaving as PAMs, we typically deny that we are acting to avoid pain and fail to recognize responsibility for our own errors or mistakes. In addition, we fool ourselves that things are going just fine, then we deny that we are fooling ourselves, and we perpetuate this state of mind by failing to encourage any testing of whether we are fooling ourselves.[23] Since we often don't realize when we are in a state of pain avoidance, we are often unable to understand that our behavior is self-defeating and to change our non-rational behavior.

When we are in a rational regime (or behaving as REMMs for Resourceful, Evaluative, Maximizing Man), pain avoidance is not part of our personal calculus. We become creative enough to find new ways to get around any new constraints on our plans. We are willing to make calculated trade-offs or substitutions of benefits as we attempt to maximize our self-interest. And while we make mistakes, we are able to learn from them and reduce them in the future. While behaving as REMMs, we generally think things through in a calm, reasoned way enabling ourselves to learn as we go forward.

*Table 2:* Dualistic Nature of Human Behavior

| **Rational (REMM) Behavior** | **Non-Rational (PAM) Behavior** |
|---|---|
| • Willing to make calculated trade-offs or substitutions that serve our self-interest. | • Denying the need to change personal beliefs and behaviors in the face of overwhelmingly contrary evidence. |
| • Sufficiently resourceful and creative to work around contraints on our ability to act in our self-interest. | • Afraid to face the emotional pain of admitting (and taking responsiblity for ) our personal errors. |
| • Able to think things through clearly in a calm, reasoned way. | • Unable to learn from past experience and understand why our behavior is self-defeating. |

22. Daniel Goleman, *Emotional Intelligence* (New York: Bantam Books, 1995), pp. 13-65 and Joseph LeDoux, *The Emotional Brain,* (New York: Simon & Schuster, 1996), Chapter 6.
23. Chris Arygyris and Donald A. Schon, *Organizational Learning II: Theory, Method, and Practice* (New York: Addison Wesley Publishing Co., Inc., 1996).

Normal people learn how to achieve a balance between these competing behavioral regimes. But when defensive, pain-avoiding behavior dominates in either personal or organizational life, massive mistakes inevitably follow - leading, in the case of organizations, to massive value destruction. The recent histories of GM, Kodak, ATT, and Westinghouse - just mention a few - all demonstrate the difficulties that the leaders of many major corporations have in utilizing and creating sufficient knowledge to reform themselves in the absence of a major crisis in the product or capital markets. In each of these cases, the process of recasting management's views of reality was apparently too painful to be implemented in a timely fashion.

A final knowledge barrier worth noting in this review involves organizational structure rather than human behavior. It concerns the degree to which decision-making authority is collocated with specific knowledge important to those decisions. The less decision rights are collocated with specific knowledge, the greater knowledge barrier and the greater the risk to organizational performance. This is a basic insight first articulated by F.A. Hayek, an early proponent of the importance of knowledge and its distribution to a well-functioning economy. Hayek argued that the distribution of knowledge in society called for decentralization because in a society undergoing rapid adaptation to particular circumstances of time and place, "decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them." Hayek argued that we could not expect that adaptation to proceed successfully by first communicating all the relevant specific knowledge to some central office which, after integrating all the knowledge, would issue its orders.[24]

Hayek's thesis, intended as an argument against centralized economic planning in post-WWII Britain, has been widely and wisely applied to the functioning of firms.[25] But its application in firms tends to create an agency or control problem because individual managers with allocated decision rights are not always perfect agents for owners. As a result, decentralization decision authority risks being used to promote the personal welfare of decision agents rather than the welfare of the firm's principals.

24. Freidrich A. Hayek, "The Use of Knowledge in Society," *American Economic Review,* Vol. 35, No. 4, pp. 519ff.
25. Michael C. Jensen and William H. Meckling, "Specific and General Knowledge, and Organization Structure," in Lars Werin and Hans Wijkander, eds., *Contract Economics* (Oxford: Basil Blackwell, Ltd., 1992) and *Journal of Applied Corporate Finance*, Vol. 8, No.2., 1995.

## 5. Solution to the Agency and Knowledge Problems

Given these human and organizational realities, a key task of CEO's and their boards is designing and overseeing an internal governance and control system that regulates how the interrelationships and exchanges between individuals will take place, and how knowledge embedded in the organization can be productively mobilized to inform decision-making and drive organizational adaptation when required. Such governance and control systems have three key components that comprise the firm's internal *rules of the game:*[26]

- A system for allocating decision rights among individuals
- A performance measurement and evaluation system for those holding decision rights
- A reward and punishment system.

### 5.1. Allocating Decision Rights

To understand how the allocation of decision rights within an organization is central to its internal governance and control, we need to first define what a decision right is and then understand how decision rights are efficiently allocated in markets and what the management challenge becomes as these decision rights are internalized within the boundaries of firms.

A decision right is "the right to decide on and to take action."[27] It is the basis for saying that individuals have the power to decide how resources will be used.

In a private property capitalist system, decision rights are assigned to individuals or organizations rather than to the state as in a socialist or communist system. The ownership of decision rights includes not only the power to decide how specific resources will be used, but also the right to sell the resource (more accurately, the rights to the resource) and capture the

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26. The most contemporary and detailed treatment of internal rules of the game, reflecting concepts drawn from organizational economics, is presented in Jensen and Meckling (1992), op. cit. and George P. Baker, Michael C. Jensen and Kevin J. Murphy, "Compensation and Incentives: Practice vs. Theory," *Journal of Finance,* July 1988. The study of performance measurement and reward systems has long been at the core of the general management literature, starting in 1938 with Chester Barnard, op. cit. and continuing with Edmund P. Learned, C. Roland Christensen, Kenneth R. Andrews and William D. Guth, *Business Policy: Text and Cases* (Homewood, IL: Richard D. Irwin, Inc., 1965), pp 684-704 and Kenneth R. Andrews, op. cit., pp. 97-113.
27. Jensen and Meckling (1992), op. cit., p. 257.

proceeds of the sale. In this sense, decision rights are "alienable."[28] Alienability is the right to buy and sell, the right to choose what to do with a resource, and to capture the benefits offered in the exchange.

In market economies those individuals who know how to best maximize the value of a resource tend to acquire the right to decide how that resource will be used by paying the most for it. The prices that are determined for alienable rights in markets measure the value of the right and provide a benchmark for evaluating the performance of the owner. Since the owner of an alienable right captures the benefits and/or incurs the costs of its use or misuse, there is a strong performance measurement and reward (or punishment) system at work.[29] Alienability of decision rights thus serves as a powerful control mechanism for the economy as a whole.

For example, if I decide to sell a decision right (say, the right to use my car), the proceeds of this sale constitute a clear reward or punishment for my involvement in this transaction. If I have acted in ways that lower the value of my decision rights, I bear all the costs. More generally, since the owner of a decision right bears the capitalized value of the effects of his or her decision, strong efficiency incentives are in place.

In organizations, alienability is absent. Decision rights must be allocated or partitioned among individuals in the organization by administrative fiat rather than by market forces. This creates two problems: (1) determining a basis for allocating decision rights and (2) designing control mechanisms governing the exercise of decision rights in the absence of market discipline.[30]

Jensen and Meckling provide powerful insights to the first problem.[31] In allocating decision rights within firms so that organizational costs are minimized, CEOs need to balance the costs of their making bad decisions owing to poor information with so-called "agency costs" or the costs of delegating decision rights to largely self-interested individuals with inconsistent objectives.

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28. Ibid.
29. Ibid., p. 259.
30. Jensen, Meckling, Baldwin, Baker, and Wruck (1995), op. cit. p. 26.
31. Jensen and Meckling (1992), op. cit.

*Table 3:* Decision Rights and Alienability

- A decision right is the right to decide how an asset or other resources will be used.
- Alienabilty is the right to transfer a decison right and capture the benefits offered in exchange. Alienable decision rights are commonly called "property rights".
- In markets, alienabilty automatically solves the control problem (using resources efficiently) since the owners bear the capitalized value effects of their decisions.
- In organizations, where alienablility is not delegated along with decision rights to managers, substitute mechanisms for solving the control problem must be found.

Source: Michael C. Jensen and William H. Meckling, "Specific and General Knowledge, and Organization Structure," in Lars Werin and Hans Wijkander, eds. *Contract Economics* (Oxford: Basil Blackwell Ltd., 1992), pp. 257-260 and *Journal of Applied Corporate Finance*, Vol. 8, No. 2, Summer 1995, pp. 4-18.

### 5.1.1. Information Costs

The costs of poor information at the top of an organization are the costs of making decisions without the requisite specific knowledge: expanding a product line without appreciating all the attendant risks, focusing on selected channels of distribution without understanding shifting consumer purchasing behavior, making bets on new technology without a detailed understanding of its competitive limitations. The larger and more complex a firm becomes, the less the CEO possesses the specific knowledge to make informed decisions on many issues facing the firm. The costs of poor information can be reduced, however, by collocating decision rights with those individuals at lower levels in the organization who posses the relevant specific knowledge.

Andrew Grove, the founder and chairman of Intel Corp., has long advocated this policy in building his company. In businesses that deal mostly with information and know-how, Grove argues, there tends to be a rapid divergence between knowledge-based power and position power. Under these conditions, concentrating decision rights at the top of the organization guarantees decisions by those unfamiliar with the technology of the day. "In general, the faster the change in the know-how on which a business depends, the greater the divergence between knowledge and position power is likely to be."[32] Grove's remedy is to include junior members of the organization to participate in joint decision-making with senior managers - in effect, allocating (sharing) significant decision rights to those with specific knowledge critical to the business.

### 5.1.2. Agency Costs

Yet there are definite limits to the decentralization of decision rights. Agency costs tend to increase with decentalization as the probability of inconsistent objectives between owners and their decision agents increases.[33] Agency costs also tend to increase when holders of assigned decision rights (or agents of the CEO) do not bear a major share of the wealth effects of the decision.

### 5.1.3. The Tradeoff Between Information and Agency Costs

In the absence of alienable decision rights, organizations must tradeoff information costs with agency costs. As shown in Figure 1 opposite, the optimum location of decision rights for a firm occurs at the point where the costs of poor information (associated with centralized decision-making) and agency costs (associated with decentralized decision-making) are minimized. This point occurs where the marginal reduction in cost due to poor information is just equal to the marginal cost of inconsistent objectives that are generated by moving decision rights further away from the CEO. Finding that optimum point in practice requires a good deal of judgment, not only because it is difficult to calculate the optimum trade-off between the declining costs of poor information and increasing agency costs associated with decentralization, but also because factors other than cost also influence the degree of decentralization: the degree of environmental uncertainty, the desirability of innovation, and the state of information technology.[34]

Given all the ambiguities and difficulties involved in designing an efficient and effective decision-making structure, the CEO shoulders considerable personal risks. Just as the suppliers of equity capital bear the risks of volatile economic conditions, CEOs assume the risks of both high information costs and high agency costs.

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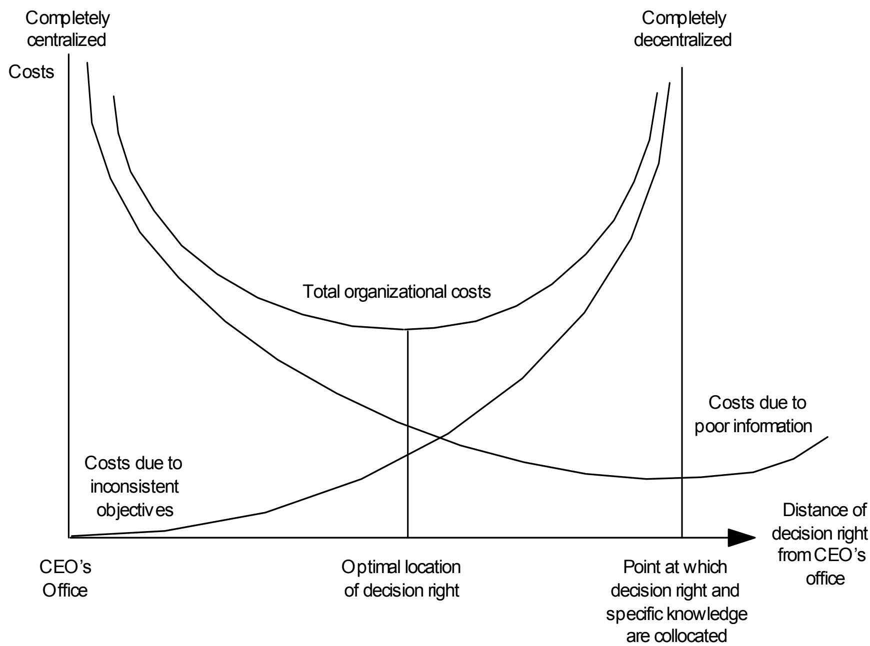
32. Andrew S. Grove, *Newsweek,* October 3, 1983, p. 23.
33. This is an especially acute problem in the conduct of headquarters-subsidiary relationships in diversified, global firms which will be discussed below.

*Figure 1:* The Tradeoff Between Costs Due to Inconsistent Objectives (Agency Costs) and Costs Due to Poor Information as a Decision Right Is Moved Farther from the CEOs Office in the Hierarchy




Source: Michael C. Jensen and William H. Meckling, "Specific and General Knowledge, and Organization Structure," in Lars Werin and Hans Wijkander, eds. *Contract Economics* (Oxford: Basil Blackwell, Ltd., 1992) p.263 and *Journal of Applied Corporate Finance,* Vol. 8, No. 2, Summer 1995, pp. 4-18.

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34. My colleague, Carliss Y. Baldwin, has pointed out that there is no technology available with which we can measure the information and agency costs described in the Jensen-Meckling model. Without such a measurement technology, Baldwin argues that the model cannot be tested (or refuted) and therefore should not be used as a basis for action. While I certainly agree with Baldwin that the utility of economic and management theory increases as the measurement of expected outcomes becomes increasingly credible, I also see the tradeoffs described in the Jensen-Meckling model as providing important new insights to the age-old, unresolved debate regarding the centralization/decentralization of organizations. These insights, focusing on the need to balance the costs owing to poor information and those owing to the inconsistent interests of an organization's membership, help us think more precisely than before about how best to allocate decision rights within firms. What is left unattended in the model, however, are the personal competencies and attitudes of the agents at work in any given organization. This is an important omission. I would argue that the competency level of individuals and their "the willingness to cooperate" (in Chester Barnard's language) will affect both the likelihood of head office personnel making poorly informed decisions and the risks of local personnel acting in conflict with overall organizational purposes. Like the Jensen-Meckling model, this hypothesis is a difficult one to test.

If agency costs, for example, are not contained in an effective manner, CEOs face either dismissal by an attentive board or a take-over by an attentive entrepreneur. The personal incentives to minimize these agency costs by designing effective governance mechanisms or organizational rules of the game in the absence of market discipline are therefore high. These rules, expressed in the design of both performance measurement and reward systems, form the backbone of the firm's organization. Setting these rules of the game is one of a CEO's most important jobs.

### 5.2. Performance Measurement and Evaluation Systems

As suggested above, the heart of the internal governance and control problem in firms is the conflict of interest among self-interested individuals that can lead to high agency costs. When self-interested individuals have been allocated significant decision rights, there are few incentives to maximize the value of those rights for the firm as a whole in the absence of a strong culture reinforced by a set of internal rules of the game. These rules involve not only who reports to whom, but also how individual performance is measured, rewarded, and punished.

The ultimate performance measure for managers needs to reflect the overall organizational objective. In market economies, maximizing total firm value is generally the most common organizational objective. In the absence of monopoly and violations of human freedoms, and assuming that private benefits and costs equal social benefits and costs (no pollution, for example), this objective maximizes society's welfare by focusing human activity on wealth creation. Even in economies where redistributive social policies are being pursued, wealth must be created before it can be redistributed.

There is another important advantage of focusing on total firm value as an ultimate performance measure: in well developed financial markets, firm value best captures the capitalized value of all future effects of current business decisions, as well as industry-specific and economy-wide risks and reward. There may be situations, of course, where a firm (say, a highly leveraged firm) might choose to designate cash flow as its principal measure of outstanding performance, but the market translates current and expected cash flow into firm value very readily. The current shift in performance measurement toward EVA, and away from EPS and ROA, suggests an increasingly wider acceptance of this logic and the fact that earning the cost of capital is increasingly considered a "break-even" outcome.

But, even where there is general agreement on a firm's overall objective, performance measurement is a problem for many firms.[35] Simply passing down top-level objectives to lower-level decision makers is usually not a very good solution. First, there is a potential free-rider problem. Each employee captures the benefits, and bears the costs, of only a small portion of his or her actions, and the work of others often overwhelms the impact of any individual's contribution. This problem gets more severe as the firm gets larger.

In addition, many employees find it difficult to understand how their actions relate to measures like the firm's market value. It takes a significant amount of management effort to make these organization-wide performance measures meaningful to employees and to develop less aggregated measures of performance that are relevant to individual employee' assignments.[36]

Finally, there is the "controllability and distortion" problem elucidated by Baker in his work on pay-for-performance.[37] The issue is whether decision makers should be held responsible for uncontrollable business risks, such as unexpected increases in raw material costs or random events like a hurricane, or whether these risks are best borne by shareholders. One school of thought argues that it is extremely demotivating for managers to be held accountable for events that are beyond their control and that they shouldn't be asked to do so. Baker disagrees. He argues that although many events are indeed beyond the control of managers, it is rarely true that managers have no influence over the *consequences* of these events. According to Baker, backing out the effects of uncontrollable events in performance measurement distorts incentives for managers to confront and be creative in dealing with the unforeseen - whether it means making the best of bad situation or taking advantage of a favorable turn of events. Thus, the more "inclusive" a performance measurement, the more uncontrollable it is, but the less it distorts managerial incentives to be resourceful in unexpected circumstances.

### 5.2.1. Tension Between Managerial Controllability and Distorted Incentives

Baker is correct in pointing out that the trade-off between controllability and distortion is at the heart of many performance measurement problems. A quick review of cost centers, revenue centers, profit centers, and investment centers as performance measurement systems reveals why.[38]

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35. See Jensen, Meckling, Baldwin, Baker, and Wruck (1995), op. cit., pp. 51-54 for a more detailed overview of the performance measurement problem.
36. For a detailed discussion of this point see Robert S. Kaplan and David P. Norton, *The Balanced Scorecard* (Boston: Harvard Business School Press, 1996), Chapters 1 and 2.
37. George P. Baker, "Pay-for-Performance for Middle Managers: Causes and Consequences," *Journal of Applied Corporate Finance,* Vol. 3, No. 3, 1990, pp. 50-61.
38. See Michael C. Jensen, *Foundations of Organizational Strategy* (Cambridge, MA: Harvard University Press, 1998), Chapter 12 for a detailed discussion of choices of performance measures for a firm's organizational subunits. Ideas developed by both Baker and Jensen are reflected in this discussion.

Cost (and expense) centers are used to measure the performance of production facilities and overhead departments, respectively. Their objective is to minimize costs while meeting the quantity and quality expectations of their internal customers. Costs and expenses can be considered reasonably "controllable" performance measures since managers are not accountable for the revenues of the products or services sold. As focused as these performance measures may be, there is nevertheless potential for a distortion of managerial incentives: cost centers provide few, if any, incentives for managers to worry about product/service quality or customer demands for quick delivery.

Setting the budget for cost and expense centers can complicate the managerial incentives problem. In theory, setting the budget should be easy - just decide on the quantity and quality of the desired product or service, calculate the costs of producing the output, and give the cost center a budget of this size. In practice, complications abound. Headquarters personnel rarely understand either the precise value of the products or services provided or the minimum cost way of delivering these products and services. It is thus difficult for headquarters to resist pressures to increase the size of budgets. Unit managers typically want bigger departments, while customers typically demand increased quantity and quality without wanting to pay for it. Within the structure of a cost-based measurement system, such managerial behavior is almost inevitable.

Revenue centers have their own set of controllability and distortion problems to resolve. The objective of a revenue center is to maximize and measure sales volume. Revenues can be considered a reasonably controllable measure in that managers are isolated from production costs. But, like managers of cost centers, managers of revenue centers face distorted managerial incentives - in this instance, the lack of incentives to make *profitable* sales. The price that maximizes revenues is, of course, rarely the price that maximizes profitability.

One way to resolve the problem of distorted managerial incentives is for headquarters to set constraints on levels of product quality, delivery, and price and then track performance accordingly. This, in turn, requires a high degree of specific knowledge at headquarters. Where absent, however, non-optimum quantity and quality levels will be pursued by the firm.

Profit centers eliminate much of the requirement for centrally located specific knowledge. Setting up an organizational unit as a profit center allows more decision rights to be allocated to the manager of the unit. Because profit centers measure performance more broadly than either cost or revenue centers, there are fewer distortions in managerial incentives and thus a reduced need for detailed oversight by headquarters. A profit center manager not only has discretion over cost, quality, delivery, service, price and profitability but also full accountability. Profit centers naturally become centers of deep specific knowledge about the business at hand. At the same time, profit centers tend to decrease the "controllability" of the manager's performance measure.[39]

The controllability problem is particularly acute when plants rather than complete, multi-functional business units are set up as profit centers. While a plant manager may have complete authority over plant operations, the sales force may report to a manager who is the plant manager's boss somewhere up the line of command. This typically leads to considerable frustration over the "level of control" that the plant manager has over sales. Nevertheless, there are good reasons for using a profit center measure of performance in this situation. The profit center system gets the plant manager to pay attention to the revenue consequences of decision on product quality and delivery. It removes headquarters from making many decisions where it lacks requisite specific knowledge and collocates decision rights with the specific knowledge possessed by plant personnel. We know from our previous discussion that this is a value creating solution.

Investment centers are created by allocating decision rights over capital expenditures to profit centers. The performance of investment center managers can be measured in two ways. They can be measured (and rewarded) according to return on investment (ROI) or some residual income measure such as economic value added which is basically profit minus the cost of capital used to produce that profit (EVA). ROI is usually a poor choice because it can provide distorted managerial incentives. For example, it is easy to increase ROI by decreasing investment and to *maximize* ROI by selling off all but one's most important assets. In fact, all accounting measures used in performance measurement raise the possibility of distortion. One of the unintended consequences of flexible accounting rules, designed to give firms discretion in making their financial reports realistically reflect their particular situation, is that they also give managers the power to manipulate the numbers to their advantage.[40]

However organizational units are defined for performance measurement purposes, the tension between controllability and distortion can never be completely eliminated or resolved - whether it result in underinvesting in product or market development to meet short-term profit goals, or overspending relative to competitive need because performance is measured by not exceeding a fixed monetary budget, or reducing individual effort when performance targets are increased in response to superior performance in a prior quarter or year, or expropriating resources for personal use in the absence of productivity measures. Firms are created by parties with both shared and *separate* interests to exploit the economies of their joint economic efforts. No group or organization can count on a complete overlap of personal interests or

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39. Jensen, Meckling, Baldwin, Baker, and Wruck (1995), op. cit, p. 62.
40. Ibid., p. 65.

the absence of self-serving behavior on the part of its various members. Thus, wherever the performance measurement system presents opportunities to promote one's self-interest, many managers will do so.

### 5.2.2. Subjective Performance Measurement

*Objective* or quantitative performance measurement, such as what we have been discussing, is particularly vulnerable to distorted incentives. This is why more *subjective* or qualitative performance evaluation is such a useful tool of general management, although one not without its own limitations.

Consider, for example, the situation where a manager's bonus is tightly linked to a financial performance measure that varies widely on an on-going basis with uncontrollable events. The resulting variations in pay will be large, and the manager will bear a large share of the risk - so much so that the firm may have to pay the manager a higher base salary to compensate for the added risk or tolerate the manager pursuing some risk-minimizing strategy. The first outcome would be inefficient; the second could jeopardize the long-term interests of the firm.

An alternate solution is to supplement objective performance measures with subjective ones. Unlike objective, quantitative measures that can be completely specified before the evaluation period begins, more subjective and qualitative performance measures allow evaluating managers to use knowledge of what actually happened to distinguish between the effects of an employee's decision and the effects of unforeseen events. Qualitative performance evaluation thus asks for judgment on the part of the evaluating manager in assessing how well an employee performs given the situation that actually confronted him.[41] Even when there are no unforeseen events to confound an assessment of a non-quantifiable aspect of individual performance, judgment on the part of the evaluating manager will typically be required. In many instances - ranging from quality assessments of on-going research to evaluations of management development programs - this judgmental approach can contribute to a more meaningful measurement of employee performance than the sole use of quantitative measures.

Despite its obvious advantages, subjective performance measurement can lead to problematic outcomes. If, for example, a CEO evaluates the quality of subordinates' decisions using information about what happened *after* the decision was made, subordinates may make decisions in the future that minimize the possibility of anything bad happening, even if it this also eliminates the possibility of good things happening. Under this scenario, they

41. Baker (1990), op. cit., p. 58.

would tend to become risk-averse as they try to avoid being second-guessed in the performance evaluation process.[42]

A second problem with more subjective and qualitative performance measurement is the tendency of evaluators to give everyone good or outstanding reviews in the absence of quantifiable results. This tendency has been well documented in both business and academic settings. In a well-known study of performance ratings for 7,629 managers in two large manufacturing firms, Medoff and Abraham found that the percent of the sample receiving performance ratings of good or outstanding (as opposed to acceptable, or unacceptable) was greater than 94.5% in both cases.[43] A similar pattern exists in universities. At Harvard College, for example, 91% of undergraduate grades were B- or higher in 1993. D's and E's were virtually extinct. At the high end, A and A- made up 43% of all grades.[44] There is considerable speculation as to why this pattern exists. One hypothesis is that the costs imposed on the evaluator are high and getting higher. These costs include the fear of rejection by the reviewed individual ("You don't appreciate my efforts! You don't understand! It's your fault anyway! Boy, are you a jerk!") and, for some reviewers, the fear of hurting a recipient's feelings. To complicate matters, the costs of giving negative feedback may actually be going up as evaluators are increasingly being held accountable for their evaluations. In academia, more complete feedback is being requested by ambitious and anxious students, some of whom feel few inhibitions in challenging their professors' assessments. While students have every right to a complete explanation of their course grades, some professors find it extremely unpleasant to face angry students in their offices. ("This is not why I chose a career of scholarship!") Perhaps it is professors' aversion to giving negative feedback and facing angry students that has led to granting of 43% A's in 1993 versus 22% in 1966-67 at Harvard College. Whatever the explanation, such behavior by evaluators results in a smoothing over of performance differences that, in turn, makes ranking impossible and blunts the motivational power of any evaluation system.[45] This is why a few educational institutions such as HBS and firms such as McKinsey and GE have adopted the forced curve in evaluating individual performance and providing feedback to their students, consultants, or operating managers.

Despite these problems with subjective or qualitative performance measurement, any quantitative measure - whether one uses sales, margins, various return ratios, cash flow measures, productivity measures, EVA or

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42. Ibid., p. 59.
43. James Medoff and Katherine Abraham, "Experience, Performance, and Earnings," *Quarterly Journal of Economics,* December 1980.
44. Craig Lambert, "Desperately Seeking Summa," *Harvard Magazine,* May-June 1993, p.36.
45. The "forced curve" at the Harvard Business School is one response to "grade inflation" in university settings.

market value - can never be more than a partial perspective on the success of an organization. The art of effective internal governance and control is to use the right balance of quantitative and qualitative performance measures and to develop skills in giving negative feedback to subordinates. On the latter point, Argyris' extensive research on organizational learning is directly relevant. According to Argyris, the only feasible way for evaluators to break through the defensive routines that we all possess with respect to feedback is for evaluators to craft feedback in a way that illustrates the data or behavior that have been observed, encourages inquiry into the evaluations offered, and encourages recipients of feedback to test and question both the data and the conclusions. Only by testing observations against data, encouraging others to test one's reasoning and use of data, and stressing that questioning is not a sign of distrust but rather an opportunity to learn can subjective performance measurement and feedback be a productive process.[46]

### 5.3. Reward and Punishment (Compensation) Systems

Few instruments of management evoke more powerful and complex emotions in an organization's membership than its system of allocating rewards and punishments. The source of these emotions are feelings of fairness about how individual contributions are valued and compensated. By definition, a compensation system contains a scheme of pay differentials that attempts to scale the value of individual contributions, thereby forcing the company - and the individual - to answer questions about the value of his or her work. What is fair pay for the position the individual holds - what are the standards or norms for his or her job? Does his or her performance warrant additional compensation, is he or she getting paid just about the right amount, or is he or she being overpaid, by any chance? In short, is the company treating the individual in an equitable fashion? When an individual is dissatisfied with his or her pay, this can only exacerbate the principal-agent problem.

#### 5.3.1. Perspectives on Equitable Pay

While managers and employees may have a general feeling for what constitutes a square deal, it is extremely difficult for all to agree on a specific concept of equity or fairness which can serve as a uniform standard for judging the motivational impact of various pay practices. Social scientists who have done work in this area have not been able to agree on any single theoretical

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46. Chris Argyris, "Teaching Smart People How to Learn," *Harvard Business Review,* May-June 1991, pp. 99-109.

approach, but they have been able to agree on one important point: namely that compensation should be perceived as equitable by affected employees if they are to commit fully to their jobs. Table 4 below summarizes three ways of thinking about individual perceptions of equitable pay.

*Table 4*: Three Perspectives on Equity (or Fairness)

- The individual's preconceived, unconscious ideas of what constitutes equitable payments in specific cases.
- Comparisons of the total strengths - social as well as professional - that the individual brings to his or her job and the total satisfactions he or she takes away from it.
- Relationships between the individual's performance and reward.

According to Elliot Jaques - who ran a 10-year study of compensation for the Glacier Metals Company in Great Britain during the 1950s and then replicated this study in a larger sample of British manufacturing firms - a company has a better chance of creating a perception of equitable pay for individuals in organizations when it can match the pay for various levels of decision-making (or "time spans of discretion") to individuals' ideas of what is fair (or, as he put it, to "intuitively held norms of equitable pay").[47] Jaques found that where an individual's pay fits with these norms, he or she will feel that the pay is equitable; and where pay does not fit with these norms, he or she develops job dissatisfaction and dysfunctional work behavior such as debilitating forms of rivalry and hostility. More specifically, Jaques discovered that executives who saw their jobs as having a time span of discretion of about one year tended to agree on what was a fair rate of pay - £980 (as of April 1954). Similarly, executives who saw their jobs as having a maximum time span of two years tended to agree that £2,000 was a fair salary.

Jaques concluded that because of universal norms of equity, people working at all levels can agree on what constitutes a fair level of pay for their jobs when defined in terms of degrees of discretion in decision-making. This idea was novel at the time, suggesting, as it did, that managerial compensation by consensus is desirable. It also differed dramatically from more established views of compensation - held by Adam Smith and Karl Marx alike - which held

47. See his books, *Measurement of Responsibility* (London: Tavistock, 1956) and *Equitable Payments* (London: Heineman, 1961). See also Malcolm S. Salter, "What is 'Fair Pay' for the Executive?" *Harvard Business Review,* May-June 1972, p. 6 ff. for detailed discussion of internal and external equity and the relationship between concepts of equity and compensation policy.

that pay differentials typically reflect a market-oriented process of bargaining between the individual and the corporation along with owners' judgments of what constitutes useful hierarchical distinctions.

A second, more practical approach to thinking about equitable pay was developed by J. Stacy Adams at the General Electric Company in the 1960s.[48] While both Jaques and Adams view the problem of equity in psychological terms, Adams' notion of equity focuses on (1) what an individual brings to his or her job and what is gained from it and (2) the social comparisons by which an individual contrasts his or her total contribution and rewards with those of his or her social or cultural peers.

In Adams' terms, inequity exists for an individual whenever "perceived job inputs" (such as effort, education, experience, skill, seniority, and job status) stand psychologically in an unequal relation to the benefits derived from his or her job (such as salary, perquisites, prestige, and personal fulfillment). The individual derives his or her notion of what this relation ought to be by comparing his or her own situation with the situations of others considered to be equals, in an all-around sense. In making this comparison, the individual usually has in mind another specific individual or "referent."[49]

In thinking about this definition of inequity, it is important to note that the absolute level of inputs (personal investments) and outcomes (personal rewards) for either the individual or the referent is quite irrelevant. What determines the equity of a particular input-outcome balance is, according to Adams, the individual's *perception* of what he or she is giving and receiving. This, of course, may or may not correspond to another's view, or to reality, as perceived by top management.

Adams' model predicts a wide range of actions an employee can take (quite apart from resigning) if he or she perceives a lack of equity. He can decrease his job inputs, if they are high relative to another's inputs and to his own outcomes; he can force others to alter their inputs; he work to beat out competitors and force them to "leave the field"; he can ask for more money; he can willfully distort the perceptions of his own inputs and outcomes, increasing or decreasing them as the case requires.[50] Not all of these results have necessarily negative implications for the success of an organization, but the first one clearly aggravates the agency problem.

From an administrative point of view, one of the intriguing implications of Adams' model is the notion that inequities in pay for an individual can be resolved not only by changing the actual ratio of job inputs and outcomes, but also by influencing the individual's perceptions of that ratio. For instance, in

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48. J. Stacy Adams, "Toward an Understanding of Inequity," *Journal of Abnormal and Social Psychology,* Vol. 67, 1963, p. 422.
49. J. Stacy Adams, "Injustice in Social Exchange," *Advances in Experimental Social Psychology,* Vol. 2, edited by L. Berkowitz (New York: Academic Press, 1965), p. 27.
50. "Toward an Understanding of Inequity," op. cit., p.427.

situations where an imbalance between an individual's contribution and reward seems to exist, top managers can augment perceptions of future outcomes - say, by explicitly relating future payments or promotions to the achievement of specific corporate goals. Where such outcomes have a real present value for an individual, and where that individual feels confident that his or her performance will finally and tangibly determine pay and other rewards, a company can directly alter the individual's perception of the balance between job inputs and its rewards in this manner.[51]

The work of Jaques and Adams suggests that an equitable approach to compensation should contain the following elements: (1) a policy on pay differentials that reflects the dominant norms of equity of the management group as a whole, as well as the requirements of the industry in which the company operates; and (2) a policy of relating pay to individual performance, whatever the selected performance measure may be. The first element is by far the most troublesome to implement in practice, especially where norms of equity are used to justify egalitarian reward systems.

Egalitarian reward systems compensate all individuals at comparable positions in the management hierarchy at roughly the same level - Oxford tutors, for example. Such systems typically rely heavily on seniority as well as hierarchical position as a basis for determining salary, bonus, and other aspects of employment affecting an individual's welfare and status.

There are two problems with egalitarian reward systems in business organizations. The first is the adverse impact on individual performance. Managers who do not discriminate between high and low performers under their supervision when allocating pecuniary and non-pecuniary rewards put risk-taking and personal effort directed at innovation and change at serious risk. While group welfare may provide some incentive, extraordinary breakthroughs usually require extraordinary effort. Sustaining such a level of personal effort without recognition is difficult for most people.

The second problem with egalitarian pay is that different parts of an organization may systematically earn widely differing rates of return, making uniform compensation practices a barrier to organization cohesion. In the case of U.S. colleges and universities, who would ever suggest paying football coaches and humanities deans at the same level? (Many coaches get paid the higher amount!) Another illuminating case in point was the struggle by the Salomon Brothers investment bank to preserve its old partnership ideal of equal compensation across the firm.

In the mid-1980s Salomon sought to streamline top management and commissioned an internal study of its operating policies. Rather than introducing a pay-for-performance scheme as some had hoped, Salomon's

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51. See K. W. Weick, "The Concept of Equity in the Perception of Pay," *Administrative Science Quarterly,* Vol. 2, 1966, p. 414.

chairman introduced a new bonus plan that was designed to calm the growing resentment between the departments that were doing well (bond sales and trading) and those that were not (the rest of the bank, mainly the investment bankers). This decision reflected the notion that not all businesses did well in any one year, but that their performances were similar over longer periods of time.[52] This move produced open conflict when the traders, who felt that they were the only consistent high performers in the firm, objected. Private side deals were made between the chairman and the firm's arbitrage desk to keep that side of the house intact, but when word leaked out, there was an uproar in the rest of the house - leading, unfortunately, to a scandal when the newly appointed head of government bond trading broke rules to boost his profits to a level comparable with that of the arbitrage desk. In the aftermath of this scandal, Warren Buffett, Salomon's largest shareholder, insisted that the bank overhaul the way it paid its star traders by tying their pay much more closely to the bank's *overall* performance. Over the following months many of Salomon's key traders resigned as their compensation plunged. Shortly thereafter Buffett's compensation scheme had to be abandoned. What Buffet missed in this instance was that highly skilled traders could command significantly higher prices in the labor market than most investment bankers could.

### 5.3.2. Pay-for-Performance

The design of pay-for-performance systems can be characterized by several attributes: (1) the types of rewards or payoffs used (salary, bonus, stock options, fringe benefits, quality of the working environment, time off), (2) the size or potential range of rewards paid (the total value of the reward package available), (3) and the variability of rewards over time (how the realized level of compensation relates to performance and how that performance is measured). Baker, Jensen, and Murphy refer to these three basic elements of compensation as *composition, level,* and *functional form*.[53]

The composition of a pay-for-performance system can be varied to attract certain types of employees. Plans that offer low salaries with potentially high bonuses, for example, will tend to attract persons with a different risk profile, energy level, and, perhaps, entrepreneurial spirit than plans offering a higher salary with no contingent payoffs. Alternatively, organizations that offer full medical coverage for families will tend to attract more heads of families than those without such a plan.

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52. "Paying For Performance: The Case of Salomon", *The Economist* , September 5, 1992.
53. George P. Baker, Michael C. Jensen, and Kevin J. Murphy, "Compensation and Incentives: Practice and Theory," *The Journal of Finance*, Vol. XLIII, No. 3, July 1988, p. 612.

The level of pay and contingent payoffs can also determine the quantity and quality of employees an organization can attract. In order to hire and retain an employee, a firm must offer at least the employee's opportunity cost. This is a lesson that professional service firms - such as investments banks, consultancies, and law firms - have learned and mastered in their efforts to recruit "the best and the brightest" from elite universities and the world of practice. The similarities in compensation packages offered by many leading firms is not an indication of collusion or administered pricing, but rather a fierce competition for talent based on a clear understanding of prospective employees' other career options and opportunity costs.

It is the functional form of a reward system - that is, the specific relationship between performance measures and rewards - that provides incentives.[54] This stems from the fact that that strong performance incentives help motivate people to do what they are asked to do, such as working in ways that create value for organization as a whole. This should not be misinterpreted as a cynical statement about human behavior. Wherever we work, we face a variety of complicated incentives that can either weaken or strengthen an organization. Thus the issue for top managers is not whether to introduce incentives to motivate employees. There are always incentives affecting human behavior, and the management issue is simply which incentives one wants to encourage or to suppress.[55] In addition, we know from the preceding discussion that pay-for-performance is perceived as being equitable or fair by most managers.

The issue of pay-for-performance lies at the core of any organizational strategy designed to achieve the greatest possible good for its members. Strong pay-for-performance or financial incentives help people to focus on the most important priorities for the firm and to "work smarter" not just "harder". Depending on the types of rewards used and the relationship between performance measures and rewards that is built into an incentive system, different time horizons can be emphasized, different degrees of risk-taking encouraged, and different levels of teamwork and internal cooperation promoted.[56] Annual cash bonuses tend to reward current performance, while stock options and deferred compensation tend to reward employees for actions taken today whose results are only observable in the future. Completely

54. Rewards can of course take many different forms - ranging from praise and public recognition to promises of future promotions or cash rewards. This discussion focuses on monetary rewards "because individuals are willing to substitute nonmonetary rewards for monetary rewards and because money represents a generalized claim on resources and is therefore in general preferred over an equal dollar-value payment in kind." Ibid., pp. 594-595.
55. Michael C. Jensen, "Self-Interest, Altruism, Incentives, and Agency Theory," *Journal of Applied Corporate Finance*, Vol. 7. No. 2 (Summer 1994), p.42.
56. See Malcolm S. Salter, "Tailor Incentive Compensation to Strategy," *Harvard Business Review*, March-April 1973, pp.94-102 for a detailed discussion of this point.

discretionary or highly personalized bonuses that fail to clarify the rules of the game tend to discourage risk-taking behavior. To reinforce risk-taking, top managers can introduce incentive systems with large payoffs for attaining some predetermined quantitative goal. Alternatively, top managers can rely on systems where the inclusion of qualitative measures of performance will assure employees that total performance will be evaluated for the purposes of bonus awards. (This is critical in organizations whose CEOs urge their executives to have the courage to make mistakes, but never to repeat the same mistakes.) Incentive systems based on sub-unit or team performance tend to reinforce group rather than individual accomplishments.

Pay-for-performance systems, when properly designed, encourage firms to give decision rights to the people who have the relevant knowledge, and to encourage people to gather relevant information, both general and specific, and to use it.[57] Indeed, one of the strengths of incentive plans is that they empower employees to take actions and reap the rewards of their initiative, innovativeness, and risk-taking. This is the essence of entrepreneurship. For all these reasons, strong performance incentives can be an extremely valuable tool for creating economic value.

Not all organization theorists agree with this argument. Critics of pay-for-performance and other incentive plans argue that money is nowhere near the top of lists of factors contributing to extreme job satisfaction or dissatisfaction,[58] that incentives to increase productivity do not address underlying problems and bring about meaningful change,[59] and that incentives undermine intrinsic motivation and job interest. The latter claim assumes that the more one feels controlled, the more one loses interest in what one is doing and the more likely performance will decline.[60]

Each of these claims raises as many questions as it purports to answer. How does the relatively low ranking of money as a source of extreme satisfaction or dissatisfaction (sixth or seventh in Herzberg's study)[61] eliminate its motivational power? Why does money need to be the most important priority in life in order to retain its standing as an effective motivator of individual performance? If financial incentives are failing to motivate employees to correct fundamental operating problems of the firm, is that a problem with incentives per se or a problem with the performance measures used or the way the plan is administered? Why would financial incentives

57. Jensen, Meckling, Baldwin, Baker, and Wruck (1995), op. cit., p. 106.
58. Frederick Herzberg, "One More Time: How Do You Motivate Employees?" *Harvard Business Review,* January-February, 1968, p. 57.
59. Research cited in Alfie Kohn, "Why Incentive Plans Cannot Work," *Harvard Business Review,* September-October 1993.
60. Edward L. Deci, and Richard M. Ryan, *Intrinsic Motivation and Self-Determination in Human Behavior* (New York: Plenum Press, 1985).
61. Frederick Herzberg, B. Mauser, and B. Snyderman, *The Motivation to Work* (New York: Wiley, 1959).

undermine intrinsic motivation or the innate drive of individuals to do a good job even in the absence of external rewards? Isn't it possible that external or extrinsic rewards reinforce rather than replace intrinsic motivation?[62]

At best, the research underlying many of the critics' claims is suggestive of potential problems with pay-for-performance rather than definitive evidence of why incentive plans cannot work. Indeed, research on employee behavior and compensation preferences suggests quite another perspective on the power of incentive pay. One consistent finding of research dating back to the early years of this century is that "when individual pay is clearly dependent on individual performance, job performance is higher than when pay and performance are not related."[63] Research has also shown that managers prefer to have their pay tied to performance.[64] And while poorly administered pay-for-performance plans can promote gaming behavior to make individual performance look better than it actually is, it is precisely because incentives are so powerful that we see so many unintended and unwanted side effects of many incentive plans. The behavioral assumptions underlying pay-for-performance may be controversial, but they are neither untested nor unsubstantiated by a serious stream of social science research.

### 5.3.3. A Comment on Promotion as an Incentive

It should be noted that performance-based, contingent rewards, such as bonuses and stock options, are typically used hand-in-hand with promotions as an incentive for managers. In fact, promotion is often the most important source of incentives. With promotion-based rewards individuals can be carefully matched to jobs for which they are best suited, and knowledgeable and valuable employees at lower levels in the organization are more likely to stay with the firm if they know they can advance. But there are significant (and obvious) disadvantages of relying *totally* on promotions as an incentive device. Promotion incentives are weak for employees who have been passed over for promotion recently and whose future promotion is doubtful. Similarly,

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62. Osterloh and Frey argue that extrinsic motivation is not simply additive to intrinsic motivation but often crowds it our altogether, and that under certain conditions (where tacit forms of knowledge need to be transferred seamlessly within an organization) the use of intrinsic rewards or other market-like elements like profit centers is counter-productive to organizational success. See Margit Osterloh and Bruno S. Frey, "Motivation, Knowledge Transfer, and Organizational Forms," *Organizational Science,* Vol. 11, No. 5, September-October 2000, pp. 538-550.
63. Edward E. Lawler, III, *Pay and Organizational Effectiveness: A Psychological View,* (New York: McGraw-Hill Book Company, Inc., 1971), p. 132.
64. I. R. Andrews and M. M. Henry, "Management Attitudes Toward Pay," *Industrial Relations*, vol. 3, 1963, p. 29; and Edward E. Lawler, III, "Managers' Attitudes Toward How Their Pay Is and Should Be Determined," *Journal of Applied Psychology,* vol. 50, 1966, p. 273.

promotion incentives are non-existent for many general managers and CEOs with nowhere else to go within the firm. Promotion also provides a weak incentive in many smaller firms where the existing executive role constellation can accommodate significant growth. Finally, promotion incentives require larger firms to keep growing just to feed the reward system.[65] his can be a definite problem for firms in slow growth industries or firms pursuing downsizing strategies in the name of increased competitiveness and profitability.[66]

## 6. Impact of Changes in Corporate Financial Policies

A firm's internal rules of the game - defined by its system of allocating decision rights to individuals and then measuring and rewarding those individuals holding decision rights - can be profoundly influenced by changes in a firm's capital structure, its dividend payout policies, and the distribution of its ownership claims. In recent years there has been a flood of research explaining how changes in financial policy can greatly influence what performance standards are set for the firm and what mechanisms are adopted to monitor and control organizational performance.[67]

Consider, for example, the impact of buyouts and leveraged recapitalizations on an organization's internal rules of the game. Both strategies involve substituting debt for equity in an organization's capital structure, and are pursued for a variety of reasons. Some corporate boards and CEOs have seen an opportunity to leverage returns available to equity holders (as in the case of O.M. Scott's leveraged buyout discussed above); some have been motivated by the need to defend against an invited tender offer or takeover threat (as in the case of Goodyear's leveraged recapitalization in response to Sir James Goldsmith's tender offer); and some have sought to motivate a radical change in organizational performance (as in the case of Dermot Dunphy at Sealed Air Corporation). Whatever the motivation, each of these restructurings involved much more than a financial transaction. The financial transactions were part-and-parcel of a new approach to internal governance and control, including changes in the allocation of decision rights and new performance measurement and reward systems that tied managers' pay to value creation through cash-flow bonuses and stock-based compensation.[68]

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65. Baker, Jensen, and Murphy, op. cit. pp. 599-605.
66. Deci and Ryan, op. cit. pp. 559-606.
67. For the most complete discussion of the impact of financial policy on the process of organizational change, see Karen. H. Wruck, "When Organization Strategy Fails: Financial Policy, External Discipline and the Process of Change," 5/20/98 Draft.

The use of debt can be a particularly powerful change agent in such financial restructurings.[69] Many general managers are often driven to grow their firms beyond the optimal size - by the increased power that accompanies an expanding resource base under their control, by growth-related financial payoffs, and by promotion-based reward systems for middle managers that create organizational biases towards growth and the creation of new management positions. In such situations, the incentive to pay out free cash flow (that is, cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital) in dividends is low. As a result, cash tends to be invested in increasingly low-return projects, some below the cost of capital, or otherwise wasted on organizational inefficiencies. We have already noted that this agency problem is especially common in firms that generate large cash flows but have low growth prospects. It is also common in firms that must downsize due to competitive pressures.

Enter debt creation. When debt is issued in exchange for stock, general managers are "bonding their promise to pay out future cash flows" and giving shareholder recipients of the debt the right to take the firm into bankruptcy court if they do not make their scheduled payments of principle and interest. Debt reduces the agency costs of free cash flow by reducing the cash flow available for spending at the *discretion* of top managers.[70] Issuing large amounts of debt to buy back stock also sets up organizational incentives for managers to behave more efficiently. Both the inviolate debt repayment schedule and restrictive loan covenants force top managers to develop a deep understanding of their investment opportunities; they force organizations to know where they excel and where they do not; they force companies to realize that growth is not always coincident with value creation; they provide increased discipline as the monitoring of performance shifts from insiders to outside lenders uninvolved with the social life of the organization; and most importantly, it makes it difficult for an organization to insulate itself from market forces.[71]

In her work on the ownership, governance and control of organizations, Wruck provides a dramatic example of how debt was used as a catalyst for organizational change at Sealed Air Corporation.[72] Sealed Air was a company with substantial free cash flow during the mid-1980s, and its CEO became concerned that resources were being used inefficiently and that the firm would be unprepared for an increasingly competitive environment. The firm

68. Karen H. Wruck, "The Ownership, Governance and Control of Organizations," HBS Course Module Overview Note, April 1997, p. 2.
69. Michael C. Jensen, (1986) op. cit., pp. 323-329 and Shleifer and Vishny, op. cit., pp. 761-766.
70. Jensen (1986), op. cit. and Jemsen, "Eclipse of the Modern Corporation," *Harvard Business Review,* September/October, 1989.

embarked on a program to improve manufacturing efficiency and product quality, but after nearly a year of serious efforts progress was slow. In an effort to create a watershed event or crisis that would disrupt the status quo and promote internal change, the company borrowed almost 90% of the market value of its common stock and paid it out as a special dividend to shareholders. Consistent with the need to payoff this debt, cash flow replaced earnings-per-share as the *top* priority, a new executive bonus plan was tied to EBDITA (earnings before depreciation, interest, taxes, and amortization) rather than EPS, and the capital budgeting system was reorganized as bankers now ratified all spending decisions. The recapitalization also knocked down the price of Sealed Air's stock to a sufficiently low level where it would provide an opportunity for younger managers to receive stock awards at a low tax cost and with the opportunity for the kind of considerable gains that older managers had received in earlier periods. The subsequent redesign of the executive compensation system and refocusing of attention towards highly productive investments, efficient manufacturing and growing cash flow returns, coupled with a strong equity market that rewarded sustained improvements in operating earnings, led to an annual post-recapitalization return of 40% from 1989 through 1996.

While Sealed Air was successful in improving organizational productivity, the aggressive use of debt can of course be a risky tactic when cash flows are highly unpredictable and variable. As Warren Buffett is reported to have observed, "High debt is like a spear at the center of a steering wheel. It certainly focuses the mind, but can also be lethal if you make mistake." In Sealed Air's case, however, the riskiness of the recapitalization was less than what might otherwise be imagined. The company's market leadership and predictable cash flows placed it in a position to go into a highly leveraged mode with relatively little risk. By overpowering competitors in mundane market niches with technology, the company was able to insulate itself from an unexpected technological sideswipe and a precipitous decline in cash flow. With negligible risks of bankruptcy, Sealed Air was free to use financial policy

71. From corporate governance point of view, Shleifer and Vishny point out that "the defining feature of debt is the ability of creditors to exercise control." For example, a failure by a borrower to adhere to previously agreed upon debt repayment schedules or the violation of any loan covenants automatically transfers some control rights from the borrower to the lender. These rights include the right to investigate the books of the firm and to grab cash before the borrower can waste more of it (or steal it) and the right to repossess collateral in case of default. Because the rights of creditors are clear, violations of those rights are easy to verify in courts - thereby providing creditable protection to all outside investors, including equity holders. The rights of creditors are typically more clear than those of equity holders whose primary right is to elect directors (an even this right is obscure in many industrial nations). Shleifer and Vishny, op. cit., pp. 761-763.
72. The following description appears in Wruck (1997) op. cit., p. 6. See also Karen H. Wruck, "Financial Policy, Internal Control, and Performance: Sealed Air Corporation's Leveraged Special Dividend," *Journal of Financial Economics,* Vol. 36, 1994, pp. 157-192.

as an instrument of organizational renewal and change. (Sealed Air's favorable operating environment does not always hold, however, as exemplified by the most notable buyout failure of the 1990s, the insolvency of Regal Cinemas. In this case KKR and Hicks Muse - two experienced buyout sponsors - destroyed over $1 billion of value in a leveraged roll-up of the movie theatre business which coincided with a major expansion of industry capacity (with so-called megaplexes) backed by competing buyout sponsors pursuing a similar consolidate-and-grow strategy. In the end, debt flowed freely onto Regal's and other company's balance sheets before the industry's inevitable "death spiral" became visible to the leading players. Most of the majors were filing for bankruptcy by Spring 2001.[73]

Changing a firm's dividend payout policies can have a similarly dramatic impact on how performance is measured and rewarded within firms. By shifting to a more aggressive payout policy, a firm's board of directors forces the firm to tap into the external equity markets on a more frequent basis than before. As in the case of a leveraged buyout or recapitalization, the organization ends up externalizing major parts of its capital budgeting and control systems. Rather than requesting resources from headquarters and being governed by headquarters staff, the firm now relies more heavily on external sources of funds and externally defined performance measures and disciplines. A similar transformation in measuring and controlling performance is typically associated with equity carveouts and spinoffs.

## 7. The Problem of Headquarters Influence and Corporate Control

The governance of relationships between corporate headquarters and subsidiary business units often fits the predictions of the agency theory model of governance outlined above - that is, the basic problem is inducing an "agent" to behave as if he were maximizing the "principal's" welfare. In the context of diversified firms, headquarters acts as the principal and delegates decision authority to the managers of subsidiary business units. Agency problems exist where subsidiary or divisional managers make decisions that are not in line with those desired by headquarters due to a lack of goal congruence between the two levels of management and self-interested behavior on the part of subsidiary managers. The solution to this problem is to rely on *monitoring*, which limits the ability of decision agents to engage in self-interested behavior, or *incentives*, which serve to align the goals of the principal and agent.[74]

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73. See Malcolm S. Salter and Dan Green, "Regal Cinemas (A) and (B)," HBS Cases N9-801-401 and N9-801-416.
74. Jensen and Meckling (1976), op. cit.

A variety of bureaucratic monitoring mechanisms are available and used by diversified firms to obtain information about the behavior and decisions of subsidiary managers - including the assignment of headquarters personnel to subsidiary units to directly monitor subsidiary management behavior (in the role of a divisional controller, for example) and the use of rules, programs, and procedures related to allocation and management of critical resources. However, headquarters monitoring becomes more difficult as agents in subsidiary operations are delegated increased decision-making discretion or autonomy and as the information asymmetry between headquarters and subsidiary operations increases.

Subsidiaries or divisions may be given more autonomy because they are in a better position than headquarters to evaluate the demands of particular markets and the resources needed to exploit available opportunities. Under these conditions, subsidiary management typically develops specialized information that headquarters does not have. Hence the asymmetry of information between levels of management. This information asymmetry poses challenging monitoring tasks for the headquarters of large firms, especially multinationals where a foreign subsidiary has worldwide responsibility for a complete set of activities associated with a particular product or product line. Under these circumstances, corporate headquarters typically tries to coordinate and monitor activities worldwide, but the bulk of decision-making information is held at the subsidiary level, not at headquarters. O'Donnell refers to this as the challenge of "lateral centralization."[75]

There are also monitoring challenges where the decision structure involves vertical interdependencies between operating units as well as lateral interdependencies. In vertically independent units decision rights are distributed among parties that need to coordinate tightly their activities within a value chain. Here the governance challenge is maximizing coordination through the value chain while minimizing the costs of coordination. The costs of information asymmetries (and simply poor information) at any stage in the value chain include inadequate monitoring and coordination of operations

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75. S. Watson O'Donnell, "Managing Foreign Subsidiaries: Agents of Headquarters, or an Interdependent Network?" *Strategic Management Journal,* Vol. 21, No. 5., p. 531. For a detailed discussions of the governance of intra-firm relationships in global enterprise see also Y.L. Doz and C.K. Pralahad, "Headquarters influence and strategic control in MNCs," *Sloan Management Review,* 1981, (Fall), pp. 15-29; C.A. Bartlett and S. Ghoshal, *Managing* Across Borders (Cambridge, MA: Harvard Business School Press, 1989*);* S. Ghoshal and N. Nohria, "Internal differentiation of within multinational corporations," *Strategic Management Journal*, 1989, Vol. 21, pp. 323-337; S. Ghoshal and C.A. Bartlett, "The multinational corporation as an inter-organizational network," *Academy of Management Review*, 1990, Vol. 15, pp. 603,-625;; and S Ghoshal, H. Korine and G. Szulanski, "Inter-unit communication in multinational corporations," *Management Science,* Vol. 40, pp. 96-110.

leading to such "show stoppers" as the inability to deliver product to customers and expensive build-ups of inventories at various stages in the value chain.

Where information asymmetry between headquarters and interdependent subunits is high, making it costly for headquarters to monitor subunit management behavior, incentives can play a key role in reducing goal incongruence and promoting cooperation and integration. From an agency theory perspective, the use of incentives as a supplement to monitoring is desirable when the outcomes of subunit management behavior can be specified and quantified. But where desired outcomes are difficult to specify and quantify precisely in advance (due to an extremely uncertain competitive environment or the subtlety of outcomes desired, such as customer perceptions of product quality), the effectiveness of incentives as a governance and control tool diminishes. In its place, social control methods are often used along with traditional incentives to facilitate collaboration and learning and to enhance subunit managers' sense of belonging to a larger corporate system. These methods include increased on-site interaction between headquarters and subunit managers via training and other visits or assignments at headquarters, headquarters mentors for subunit managers, inter-unit committees, temporary task forces, or permanent teams.

Headquarters influence and control faces a different set of problems with autonomous subunits. In these subunits, especially those at the periphery of the firm (such as internal startups), managers tend to interact and compete more directly than their colleagues in the interdependent core with the value propositions in the marketplace. Where these *external* value propositions are easily compared with the *internal* bureaucratic value proposition, firms are more vulnerable to double-cross or defection than to the kind of self-serving, non-maximizing behavior widely discussed by agency theorists. As the governance challenge changes, so too do the applicable governance tools. The corporate challenge is to balance entrepreneurial rewards with incentives and oversight mechanisms to promote cooperation, where necessary, with the rest of the organization. This can be done through a tailored ownership arrangements and the introduction of internal boards of directors - such as GMAC's board within General Motors.

Whatever the composition and role of subunits comprising a firm, it is a mistake from a governance perspective to assume a simple, dyadic, hierarchical relationship between headquarters and subsidiary business units. Modern firms are complex precisely because of the interdependencies of their parts. In a corporate world of rich interdependencies, it is tricky business encouraging entrepreneurial subunit manager behavior while simultaneously expecting and guarding against opportunistic managerial behavior. In this real world of organizational complexity, there will often be multiple principals and many agents, the mix depending upon which set of relationships are being considered.[76] For internal governance and control, the implications are clear.

Headquarters monitoring and incentives are insufficient tools; they must be supplemented with the promotion of mutual interdependencies and learning through social as well as bureaucratic means.

## 8. Governance in "New" versus "Traditional" Firms

Throughout this discussion of internal governance and control we have made no distinctions between the histories and ages of firms. This stems in part from a conviction that the perspective on corporate governance developed so far in this paper has broad applicability and generality. Without completely reversing field on this point of view, there are important distinctions to be made between what Luigi Zingales has termed "traditional" firms and "new" firms - where the governance challenges are somewhat different.[77]

Traditional firms have four features that influence its governance agenda. First, traditional firms are organized to exploit economies of scale and scope, and tend to be both asset-intensive and vertically integrated. In traditional firms, many transactions are governed by power and internal rules rather than prices and end being conducted within the legal boundaries of the corporation.

Second, traditional firms have a high degree of control over their employees, especially where competitors are few in both the intermediate and output markets. Where alternate uses for the employee skills developed on the job are few and far between, corporate headquarters effectively control employment opportunities for their specialized employees - thereby giving top management enormous power.

Third, both size and asset-intensity of traditional firms, along with their inherent riskiness, has forced management to seek financing from outside sources. Where management controls critical assets, outside ownership by dispersed investors becomes feasible and, indeed, a defining characteristic of this type of firm.

Finally, the concentration of power at the top of the organizational pyramid, together with the separation of ownership and control, makes the agency problem between top managers and shareholders the principal governance problem. The objective of corporate governance is to maximize the protection of outside investors by reducing or removing all obstacles to shareholders' control. At the same time, power in the traditional firm often rests with persons controlling critical assets, so the corporate governance problem also centers on how to prevent persons holding this power from abusing it. For these reasons, transparency, accountability of directors,

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76. O'Donnell, op. cit., p. 542.
77. See Zingales (2000), pp. 28-39 for a detailed discussion of traditional and new firms, much of which is reflected in this section of the paper.

contestability of corporate control, and managerial compensation aligned with wealth maximization are key steps in the battle for effective corporate governance.[78]

Over the past decade, however, many of these characteristics of traditional firms have faded in importance. First, physical assets in many industries have become less unique and are no longer commanding large rents. Continued developments and innovation in the capital markets have also made it easier for newly formed firms to finance expensive assets. Similarly, the radical decline in communication costs has reduced the grip of expensive distribution channels on the consumers - again favoring new entrants.

Second, the increase in global competition has put an enormous premium on process innovation, quality improvements, and talented employees who make this all happen. As the drive for innovation has increased, so too has the importance of human capital increased.

Finally, as the importance of human capital has increased, corporations' control of it has weakened. Easier access to financing has increased specialized employees' outside options, and the explosion of employment opportunities accompanying the implementation of new technologies and the expansion of world trade expansion has generated many alternate employment opportunities. At the same time, increased competition throughout the value chain has reduced the specificity of human capital to current employers and led to the disintegration of formerly vertically integrated firms (such as the spin-off of Delphi Automotive Systems from General Motors). Under these conditions, the ability of many current employers to restrain specialized employees from defecting has declined radically.

In sum, new firms tend to be non-vertically integrated, human-capital intensive organizations in highly competitive markets where the exercise of authority by top management is severely limited by the ability of employees to quit, taking valuable human capital with them. Equally as important, the boundaries of new firms are becoming increasingly fuzzy. Where control of physical assets was the main source of value and control, it made sense to define the firm by its physical assets. But with human capital becoming the most valuable asset, employee defections becoming more common, and growth options up for grabs by internal and external talent pools, the boundaries of firms are less clear cut. As market contracting increases between firms and outside talent, not only may the authority of the traditional hierarchy over human capital becoming more limited, but it is also becoming less clear in the new firm who is actually a participant in the enterprise called a firm.[79]

78. Ibid. p. 29 and 37.
79. Ibid., pp. 30 and 31.

New firms thus have a different mix different governance challenges than traditional firms. In traditional firms, the focus of governance is empowering shareholders by reducing the costs of collective action. In new firms, where human capital is crucial and highly mobile, an important goal of corporate governance is protecting the integrity of the firm. This can only be accomplished by creating a system where employees believe that their rewards will be greater if they make firm-specific investments rather than defecting. The firm can reinforce such a belief by giving key employees privileged access to critical resources so they have power within the firm if they specialize and can produce more at the firm than a competing defector or entrepreneur starting from scratch.[80]

In order to maintain the incentive to specialize in firm-specific work, employees must have a credible expectation of a certain level of returns in the future. Growth is central to making the expectation of future returns credible.[81] For this reason, the exploitation of growth opportunities must be a central concern of corporate governance in the new firm. While we need to understand more about what determines the ability of firms to capture new growth opportunities, a good place to start is ensuring alignment between the ability to capture growth opportunities and the rewards stemming from them.[82] This is not a simple question of decentralizing or sharing equity with talented employees. It also involves determining the relationship between de facto control rights held by persons with critical firm-specific knowledge and *de jure* control rights held by owners. Further analysis of this evolving relationship will certainly lead to new ideas about the optimum allocation of ownership and the optimum capital structure in what we call the new firm.

## 9. Board Effects on Corporate Performance

An active and independent board of directors working for shareholders can be thought of as a principal means of controlling agency costs arising from the separation of financing (or ownership) and management (or control) in the modern corporation. According to this view, the board is the agent for shareholders and monitors management to make sure that management runs the enterprise in the best interests of the shareholders.[83]

An active board is an organization that oversees the formulation of strategy in the interests of shareholders, develops appropriate incentives for the CEO

80. Ibid. p. 34.
81. Ibid.
82. Ibid, p.34 and 39.
83. Ira M. Millstein and Paul W. MacAvoy, "The Active Board of Directors and Performance of the Large Publicly Traded Corporation," *Columbia Law Review*, Vol. 98, No. 5, June 1998, pp. 1291-1292.

and other employees to harness their energies in the service of the agreed-upon strategic plan, and judges the performance of management against this plan. An independent board is one that is capable of acting under the leadership of either a non-executive chair or lead director without relying on initiatives from management, that holds periodic meetings of independent directors to evaluate management against the strategic plan, and has formal rules or guidelines for the relationship between the board and management.[84]

Whether or not such a regime leads to improved corporate performance is difficult to prove. No fewer than 40 major studies probing the link between board characteristics and corporate behavior and performance have been published in leading journals over the past twenty-five years.[85] This link has proven difficult to isolate because of the multitude of factors that more directly impact company profitability and market value - such as industry, market position, corporate strategy, organizational life cycle, and internal coordination and control. As a result statistical analysis applied to the question of whether or not good corporate governance helps or hurts the bottom line often leads to incomplete (and sometimes contradictory) results.

For example, most board governance studies focus on discrete variables and discrete events to determine the effect of these variables on corporate performance - such as the relationship between current directors' share holdings and subsequent corporate performance,[86] the link between directors' holdings and the adoption of "poison pill" anti-takeover provisions,[87] and the likelihood of outsider-dominated boards to remove a CEO when the firm is performing poorly versus insider-dominated boards.[88] In these and many similar studies, researchers have been able to create tractable data sets that lend themselves to regression analysis. The resulting studies are impressive and rigorous but ultimately provide a woefully incomplete picture of the impact of board governance practices in corporate performance. There are simply too

84. Ibid., pp.1298-1299. Even if these conditions are met, board independence can be compromised by board composition. In his comprehensive study of corporate boards, Lorsch points out that it is the CEO who most often selects candidates for board approval and election by shareholders and that many CEOs feel entitled to select not only people of judgment but also directors who will feel sympathy with him. While such practices do not automatically destroy board independence, they do compromise it. See Jay Lorsch, *Pawns or Potentates: The Reality of America's Boards* (Boston: Harvard Business School Press, 1989), pp. 20-22.
85. See Sidney Finkelstein and Donald Hambrick, *Strategic Leadership* (Minneapolis: West Publishing Company, 1996 ), pp. 238-240 and Millstein and MacAvoy, op. cit., pp. 1296-1297) for a review of these studies.
86. Carey Bhagat and C.M. Elson, "Director Ownership, Corporate Performance, and Management Turnover," *The Business Lawyer,* Vol. 54, 1999, pp. 885-919.
87. P. Mallete and K.L Fowler, "Effects of Board Composition and Stock Ownership on the Adoption of Poison Pills," *Academy of Management Journal,* Vol. 36, 1992, pp. 1010-1035.
88. Michael S. Weisbach, "Outside Directors and CEO Turnover," *Journal of Financial Economics,* Vol. 20, 1988, p. 431.

many intervening variables to be adequately controlled, and from a practical point of view as long as investors *believe* that a company's future is bright (for whatever reasons) its present day stock price will be a self-fulfilling prophecy until people change their minds (for whatever reasons). What this means is that we need to apply a healthy skepticism to statistical results and double check what we really know and do not know from all the studies and surveys on board governance.

## 10. Board Governance as an Evolving Phenomenon

One of the points that most students of corporate governance *can* agreed upon is that board governance is an evolving phenomenon.[89] During the early years of the 20th century, corporate boards were powerful, active monitors of corporate performance since directors were almost uniformly owners. But by the middle of the century, the rise of "professional managers" led to major changes in the governance regimes of large, publicly owned corporations. Corporate boards, comprised of an increasing number of inside director/ managers possessing insignificant financial stakes financial stakes in the enterprise, stripped themselves of one traditional basis of board power - namely, owner/directors providing arms-length, detailed oversight of both policy and operations. The dynamics of the relationships between directors and managers thus changed dramatically. One commentator described the dynamics of many mid-century boards as follows:

> Board service was largely viewed as honorific and responsive to management concerns; the arms-length relationship implied in the board's monitoring role over management was replaced by a collegial relationship between the two - closer to that implied by membership in a Yale secret society than to oversight.[90]

Through the 1970s and 1980s this general state of affairs began to change. Following a series of spectacular corporate collapses and the subsequent failure of legislative attempts in Congress during the late-1970s requiring that corporate boards conform to certain structural characteristics, the Delaware court handed down a series of landmark cases in the 1980s that firmly established directly liability for boards that wholly shirked their oversight duties.[91] This development was sufficiently threatening that by the late 1990s

89. A good summary of this point appears in Bradley A. Helms with Richard H. Koppes, "Statistical Alchemy", *Business Law International,* Issue 3, June 2000, pp. 207-211.
90. Ira Millsten and Paul MacAvoy (1998), op.cit. Also quoted in Helms, op. cit. p. 207. This description is consistent with the findings of a broad survey and clinical study of board behavior conducted by Myles L. Mace during the during the 1070s, See *Directors: Myth and Reality* (Boston: Division of Research, Harvard Business School, 1971).

a substantial majority of large, publicly traded corporations had converted themselves to a majority of outside-independent directors (although there remains today a difference of opinion over what distinguishes between inside and outside directors). In addition, a majority of these boards had audit and compensation committees with a majority of outside directors.

But the hostile takeover boom of the 1980s and 1990s revealed that the evolution of board governance practices was not over. Whatever the composition of the board, in many instances a "bunker mentality" among directors and corporate managers developed which, in turn, led to an entrenched management protected by takeover defenses - such as the poison pill - that were typically passed by the board without shareholder approval. While these defenses were almost uniformly legitimate uses of the board's legal powers, this practice dramatically diminished the board's capacity to play a powerful monitoring role. CEOs, increasingly concerned about keeping their jobs in a hostile environment, were careful to curry the favor of their directors. Fees for board service also increased, and simultaneously golden parachutes and extraordinarily large option bonuses became common features of executive compensation packages. Corporate governance under these conditions developed into a largely "inside" affair despite the majority of non-management directors. Not surprisingly, many boards were criticized for a lack of rigorous monitoring of corporate affairs, leniency towards management in the face of continuing poor performance, and a lack of passion for the protection of shareholder interests.

Criticisms of this board governance regime became more strident as extraordinarily large CEO compensation packages received board approval at companies, such as for Michael Eisner at The Walt Disney Company; as lapses in management accountability became more widely reported in the press, such as GM's Roger Smith convincing the board to pay Ross Perot what amounted to a $700 million bribe to relinquish his board seat; and as the persistent inability of many leading firms to earn their cost of capital revealed an apparent lack of urgency of many boards about deteriorating performance and a failure to exercise control rights delegated to them by shareholders. By the early 1990s, then, significant pressure was building up for further changes in board governance. Activist institutional investors like CalPERS, TIAA-CREF, NYCERS, and others picked up this challenge.

At first, during the 1980s, activist institutional investors focused on reinvigorating the market for corporate takeovers that had been weakened by the widespread adoption of the poison pill. By the 1990s, their focus shifted to the promotion of active, engaged boards that took their responsibilities

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91. For a review of the landmark Delaware cases in the 1980s on director liability. See Ralph D. Ward, *21st Century Corporate Board* (New York: John Wiley & Sons), p.48. Cited in Helms, op. cit. p. 207.

seriously - which involves a willingness and freedom to challenge management from a position of equality.[92] This, in turn, requires a culture of open debate and many other subtle, interpersonally sensitive changes in board decision-making. Like any cultural revolution or transformation, introducing meaningful changes in established behaviors will take time to accomplish. In this effort, activist institutional investors are not acting alone. In recent years they have been aided by the press such as *Business Week* and *The Wall Street Journal* which, starting in 1992, has routinely been publishing CalPERS "top-ten" under-performing companies in its portfolio - thereby bringing public attention to laggards in board governance and performance.

One of the threshold cases in board governance reform is the story of GM's board's transformation from a complacent ally of management to what activists would agree is a good model of board governance. After years of snubbing CalPERS, most notably during the 1990 succession process following Roger Smith's retirement, the board fully asserted itself in 1992 by dismissing Smith's hand picked successor. As described by Helms, and validated by my own personal experience with the corporation, the behavior of GM's board was the result of a combination of outside activist forces and an internal self awakening.[93] Using the firing as a platform of self-renewal and conversion to an activist board, the GM board spent two years developing a new set of board governance principles or "GM Guidelines" including such "radical" features as separate Chair/lead director, formal CEO evaluations, and separate meetings of independent directors. The GM guidelines sent a message to the rest of the world that board governance in large corporations could change and was changing. What the message could not convey was whether or not the new provisions had in fact changed the attitudes and behaviors of board members.

If we accept the notion that individual and group behavior is key in implementing activist board principles effectively, we then have a clue as to what kind of research method is most persuasive in demonstrating that good board governance can indeed benefit the bottom line. The problem, however, is that the obvious resort to large-sample clinical research would be an overwhelming effort, even assuming that unprejudiced access to the boardroom was possible. Fortunately, one recent scholarly work has attempted to deal with the behavioral complexity of corporate boards and the associated question of the value of good corporate governance.

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92. Helms, op. cit. p. 210.
93. Ibid.

## 11. Board Behavior and Corporate Performance

Relying on the presence or absence of certain board characteristics as a proxy for identifying boards with active and engaged directors, two highly experienced advisors to corporate boards and students of corporate governance - Ira M. Millstein and Paul W. MacAvoy - attempted to judge how active behavior of the board generated organizational behavior that improved earnings. Their study is an important one, worthy of review here, not only because of its methodology but also because each of the boards in their study were committed to active governance and set out to improve their company's performance.[94]

In designing their study, Millstein and MacAvoy realized that they could not gain access to direct observation of 200 or more boards in operation - how they participated in strategic planning, monitored management, and rewarded and punished top executive performance. They thus chose three documentable surrogates for the observed behavior of professional boards:

- Independent board leadership, whether through a non-executive chair or lead director,

- Periodic meetings of the independent directors without management present, and

- Formal rules or guidelines for the relationship between the board and management.

The researchers assumed that when one or more of these indicia were present the board was independent and thus able to influence corporate performance favorably.

Data related to these three indicators of board behavior was culled from a CalPERS survey of 300 large corporations aimed at identifying the extent to which the nation's largest corporations conformed to the board governance principles that GM established for itself after it fired GM's CEO and president in 1992 and installed a new management team. Responses from this survey were graded from "A" to "F" based upon, for example, whether or not companies provided a comprehensive list of guidelines ("A+"), responded with a minimal list of guidelines but indicated they were still currently active in the self-evaluation process (B), or sent a letter indicating no need to

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94. "The Active Board of Directors and Performance of the Large Publicly Traded Corporation," op. cit. For an extension of this initial research and commentary, see Paul W. MacAvoy and Ira Millsten, *The Recurrent Crisis in Corporate Governance* (London and New York: Palgrave, McMillan Press, 2003).

formalize governance guidelines (F+). Non-responders received an "F." In addition to CalPERS's graded responses to the standardized survey, Millstein and MacAvoy graded non-standard letters to CalPERS from 300 companies (setting forth their board practices in detail) according to whether or not they represented active or non-active boards. The governance profile for a final, usable sample of 154 large publicly traded domestic corporations was compared with the economic returns of each company in the sample. Economic return was defined as earnings in excess of the cost of capital (ROIC-WACC).

Because board composition and practices are not the sole determinant of economic performance, Millstein and MacAvoy also sought to identify the effect of other determinants and attempted to control for them - specifically, the economic performance of a firm's industry and the life-cycle position of the firm within that industry. (Many of the most successful companies in the CalPERS sample were early in their lifetimes of development, such as Home Depot, Wal-Mart, and Intel).

The results of this study showed that the set of companies receiving an "A+" grade from CalPERS was the only set to demonstrate a positive average spread between their return on invested capital and their cost of capital. For companies committed to anything short of total board participation in a clearly identified set of governance protocols, no such association between board governance and corporate performance existed. This leaves, of course, a wide range of board practices that cannot be linked to corporate performance.

The analysis of non-standardized letters submitted to CalPERS along with the standardized survey yielded more interesting and clear-cut results. Specifically, those companies identified as having active, independent boards showed an excess return of nearly 4% over their average industry peers while boards self-identified as less than active or independent performed slightly over 1% worse than their average industry peers. Taken together, these findings show a statistically significant relationship between an active, independent board and superior economic performance. These findings certainly make sense in light of the unmonitored conflicts of interest, abusive accounting practices, and lapsed board oversight that led directly to Enron's economic collapse and the subsequent flurry of legal proceedings against Enron's remarkably inattentive and compromised board of directors.

The Millstein-MacAvoy study offers presumptive evidence that in large publicly traded corporations the link between the behavior of an active and independent board and the performance of large publicly traded corporations is worth careful attention. For smaller private companies the role of the board in corporate governance takes on a different pattern and may therefore have a different impact on corporate performance.

As summarized in Table 5 opposite, the role and behavior of the board in start-ups and buyouts is typically more "active" than the active boards described by Millstein and MacAvoy. And the directors are hardly independent observers since they themselves tend to be owners having significant financial stakes in the enterprise, and their fingerprints show up all over the strategy, financing, and recruiting of key personnel. In addition, some of these directors are agents for other owners such as those representing institutional investors (e.g., venture capital and buyout firms) and their general and limited partners. Typically these agent-directors intervene without hesitation in operations on a direct and sustained basis whenever business plans go awry or other signs of trouble appear. The price of effective intervention by agent-directors is often quite high (represented in the percent of company ownership given up to private equity firms in the course of early round financings) because it requires special effort by very skilled agent-directors who represent major investors standing to gain or lose significant amounts of venture capital or personal equity.

*Table 5:* Role of Corporate Directors

| **Traditional Public Corporation** | **Corporate Start-Ups and Buyouts** |
|---|---|
| • Set goals and terms of employment | • Extension of mangement |
| • Hire, fire, and monitor management | • Active participant in creation of strategy |
| • Set compensation, options and perks | • Build management team |
| • Ratify corporate strategic initiatives | • Improve access to capital |
| • Approve major capital transactions | • Exercise contingent intervention |

To the extent that corporate directors - in start-ups, buyouts, or even large public companies facing a crisis - behave as a supra-top management team, their role as vigilant monitors and disciplinarians of top management is of course compromised. From an agency perspective, once board members representing equity holders participate in both “decision management” (the *initiation* of investment or resource utilization proposals, and the *implementation* of approved proposals) and “decision control” (the *ratification* of proposals or choice of which proposals to be implemented, and the *monitoring* of results including the performance measurement and reward of decision agents) it becomes more difficult for them to protect equity holders against opportunistic actions of managers. It's the bureaucratic equivalent of letting the fox into the chicken coop, and such a practice can lower the value of unrestricted claims on cash flow available to equity holders. Where the separation of decision management and control cannot be completely separated due to crisis or other factors, the solution to the resulting agency problem is to make sure that the wealth effects of decisions weigh heavily upon the shoulders of important decision agents (through the ownership requirements and compensation of decision agents). In brief, they must live or die by their decisions.[95]

Despite the strong normative implications of agency theory and the vast body of research addressing board behavior in executive succession and CEO selection, setting executive pay, and conducting takeover attacks and defenses, there is much that we still do not understand about how vigilant boards actually influence to management to "do the right thing." Indeed, we may know more about the behavior of inert boards than the behavior of effective active boards. The investigations and legal proceedings surrounding the collapse of Enron will surely add to this body of clinical evidence.

The theory of internal governance and control outlined in these notes provides some help in this regard. It argues for active board involvement in setting internal "rules of game" under which CEOs and their top management teams operate and, equally as important, for active board oversight and monitoring as well. Nevertheless, what is now left to do is to describe empirically how active, independent boards actually monitor and influence management once rules have been designed and put in place - and how this board *behavior* can leverage the influence that a carefully designed internal governance and control *system* promises.

## 12. Corporate Governance and Leadership Behavior

One of the principal themes of these notes is that the capacity of CEOs and their boards to create value for equity holders is largely based upon their ability to minimize the agency costs and information costs that inevitably arise when economic transactions are internalized within the boundaries of firms. The question of how best to think about and design internal rules of the game (or internal governance and control structure) that serve to minimize these costs and create value for owners has thus received considerable attention.

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95. See Eugene F. Fama and Michael C. Jensen, "Separation of Ownership and Control," *Journal of Law and Economics,* Vol. 26, June 1983 for a detailed discussion the separation of decision management, decision control, and residual risk bearing.

What we have not discussed so far is what kind of leadership behavior is required to complement the kind of value-focused governance and control structure laid out above. Since value-creating policies need to be accepted (or at least tolerated) by those participants whose interests are affected by policy decisions, successful leadership of large corporations generally requires continual communication and negotiations with these participants the terms, responsibilities, and rewards of their affiliation. (Some of these participants - owners, employee associations, suppliers, and, of course, customers - operate outside the formal, day-to-day decision hierarchy, while others are part of the bureaucracy.) When corporate leaders fail in their communications and negotiations with interested parties, the voluntary coalitions that comprise their firms may disintegrate or, at a minimum, undergo some change in participants' commitment. Commitment to corporate purposes and policy, not just passive compliance, is required if an organization's participants are to coordinate their activities efficiently.[96]

Managerial failures in building a widely shared commitment to corporate purpose often leads to the kind of maladaptive behavior that characterizes most low-performing organizations. As Kotter and Heskett point out in their extensive study of corporate culture and performance in more than 200 firms, managers in low-performing firms tend to care more about themselves, their immediate work group, and some product (or technology) associated with that work group rather than about their organization's basic purposes - serving customers and rewarding shareholders. They tend to behave somewhat insularly and bureaucratically. And, because they are internally focused, they fail to see new business opportunities and risks as they arise and cannot change strategies quickly.[97] When the inevitable crisis in corporate performance occurs, such organizations can become immobilized by corrosive internal political conflict, which shifts energies away from the substance of policy.

Due to the inevitably self-interested behavior of individuals, there will always be some degree of conflict of interests and political activity in all organizations - and especially in large diversified corporations. Multiple factors determine how the firm will operate as a political structure how corporate purposes change to reflect the shifting interests of the enterprise's various members; how authority is distributed within the firm; where staff,

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96. This notion holds for enterprises in both start-up and more advanced phases of development. To be sure, new ventures have more flexibility than established firms in selecting their constituencies (and therefore the mix of resources used in pursuing business opportunity). But once multiple constituencies have become involved, they are legitimate participants in business decisions that affect their interests. See Howard H. Stevenson and J. C. Jarillo-Mossi, "A New Paradigm for Entrepreneurial Management," in *Toward a New Synthesis*, edited by P. R. Lawrence and A. Etzione (Armonk, NY: M.E. Sharpe, 1991), p. 11.
97. John P. Kotter and James L. Heskett, *Corporate Culture and Performance* (New York: The Free Press, 1992), p. 51.

who quickly become power centers of their own, are located; how efficiency is traded off against broad participation in corporate policy making; how tightly the allocation and use of resources is controlled; how cooperation and competition within the management hierarchy are balanced; how rewards are allocated; and so on. The resolution of these issues will be based in part on the CEO's analysis of technical factors discussed in these notes. It will also reflect a less ordered amalgam of feelings, instincts, and attitudes towards the exercise of personal power.

Personal power is the ability to influence the opinions and behavior of others. CEOs and other top managers can tap the economic surplus of firms to improve the well being of various interest groups or individuals (via contingent payoffs or rewards), thereby influencing opinion and behavior within the enterprise. A CEO who has a plausible vision of the future and enjoys the trust of other organization members can also play on expectations of future benefits to shape current behavior. Such trust is usually established on the basis of a history of distributing satisfactory benefits.

How CEOs and other top managers mobilize personal power is one of the most fascinating, open questions in the long history of organizational research. Smart managers with political savvy know that they can maintain their influence (however mobilized) only so long as they serve the interests of the coalition that makes up the firm. Thus, a CEO who intends to direct a process of change in operating policies or corporate strategy must first identify the direction in which he or she wishes to lead the firm, decide which parties should be courted or ignored, and then begin a process of adjusting the benefits of continued cooperation so that the relevant parties maintain their commitment to the enterprise. This decision-making process can be described as a continuing negotiation among coalition members. A primary role of the CEO is thus to be the chief negotiator among negotiators, one who tries to steer the firm in the direction that most effectively furthers its interests.[98]

Negotiating the purposes and policies that drives corporate performance requires the subtle trading of quid pro quos with participants in the enterprise - trading political support for various policies and projects; offering enhanced career opportunities in exchange for corporate loyalty, or high rewards for parties running high risks; offering labor a measure of job or income security in exchange for a radical restructuring in work rules; or giving suppliers longer-term contracts in exchange for price concessions. While no single exchange need be very significant in itself, a full set of coordinated exchanges of quid pro quos among a firm's members adds up to a course of action that

98. Robert James, "Corporate Strategy - The Management of People" (mimeo, undated). See also Fama, "Agency Problems and the Theory of the Firm," op. cit. and Joseph L. Bower, *Managing the Resource Allocation Process* (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1-970).

has the support of relevant, interested parties. In this sense we can think of corporate strategy and performance as resulting from multiple decisions negotiated at all levels within the firm. We can also see CEOs as custodians of this negotiating process and the corporate strategy that it shapes over time, rather than as unconstrained decision makers.[99]

Such a conception of leadership behavior raises many practical questions that can only be addressed when the specific circumstances of an individual firm are known: What elements of policy or strategy need to be negotiated now? Who are the relevant negotiating partners? What constitutes a negotiated "agreement?" What should be the nature of the negotiating process? In what forums should these negotiations take place? Successful CEOs will discover answers to these questions that best serve their current needs. Future research is required to increase our understanding of their negotiating successes (and failures).

In addition to these questions, several objections might be raised to our description of the CEO's task. One might argue that its emphasis on negotiation could compromise the competitive strength of the firm; that "bargaining-oriented firms" are likely to find themselves immobilized by conflict;[100] or that CEOs who see themselves as negotiators may inadvertently undermine the personal charisma and institutional power upon which the legitimacy of their leadership ultimately depends.

These potential criticisms cannot be ignored, for they represent the risks of negotiating failures. These risks can be minimized or accommodated, however, by CEOs keenly aware of the demands of creative political leadership. Political leadership in the private sector requires a talent for defining an organization's mission and role in terms that both include and go beyond the minimum conditions for ensuring institutional survival discussed in this paper. It requires an ability to manage internal conflict by allowing parties with either high stakes or relevant specific knowledge a wide degree of representation, while maintaining a balance of power appropriate to the fulfillment of realistic economic commitments. It means nurturing thoughtfully planned alterations in the internal and external commitments of the enterprise, but resisting temporary pressures to make opportunistic changes in policy or to expropriate for oneself the rewards due other participants in the enterprise.

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99. This vision of the CEO as chief negotiator runs counter to many orthodox beliefs about managerial authority. It envisages senior managers of established firms as custodians of corporate purpose who preside over, but do not totally control, the intensely political process of formulating policy and allocating resources. The conception of the general manager or chief executive as a "custodian of corporate objectives" was originally put forth by Kenneth R. Andrews in *The Concept of Corporate Strategy*, op. cit., pp. 12-13.

100. For a description of the "politicized organization" and the political games that contribute to intense organizational politics, see Henry Mintzberg, *Power in and Around Organizations* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1983), Chapters 14 and 23.

This vision of effective leadership and the governance of corporate affairs by no means implies that the role of CEOs is simply to be passive mediators of the interests of others. Rather, it suggests that once the purposes of the corporation have been defined by its owners, then it would be fatal to ignore the intensely political work of building commitment and administering an authority structure distinctly adapted to these ends. CEOs who shirk the political tasks involved in this kind of organization building may find themselves without the capacity to act upon a promising strategic initiative.

In the final analysis the creation of value and sustaining of above-average returns for the benefit of owners is largely dependent upon the nature of the relationship between the parties comprising the firm. Corporate performance fixes the context within which each party can achieve its objectives, but it is also limited by the relationship existing between those parties.[101] How the relationships between management and other parties with legitimate claims on the corporation can dramatically affect the firm's long-run performance and its strategic management practices is the subject of another paper in this series of notes on corporate governance.[102]

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101. This notion is at the core of the collective bargaining model of industrial governance. We have argued, in effect, that it has applicability in multilateral as well as bilateral contexts. See Neil W. Chamberlain and James W. Kuhn, *Collective Bargaining*, 2nd edition (New York: McGraw-Hill, 1965), p. 428 ff.
102. Malcolm S. Salter, "Industrial Governance and the Strategic Management of Firms," Harvard Business School Working Paper, #95-008.