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Chapter 1

What is corporation

The first challenge is defining what we mean by the corporation. There is a legal definition that covers the requirements for obtaining articles of incorporation and the obligations of the resulting entity. However, corporations always seem to have more vitality and more complexity than can be constrained by definitions or laws. They even seem to take on personalities that go far beyond the way we feel about their products. Think of the reputations of Apple, of Enron, of General Motors, of Google, of BP.

The variety of definitions set some parameters but are most useful in what they tell us about the assumptions and aspirations of the people who propose them. They remind us of the blind men who tried to describe an elephant – one feeling the tail and calling it a snake, one feeling the leg and calling it a tree, one feeling the side and calling it a wall, one feeling the tusk and calling it a spear. All definitions of the term corporation reflect the perspectives (and the biases) of the people writing the definitions. Some lawyers and economists neutrally describe the corporation as simply “a nexus (bundle) of contracts,” arguing that the corporation is nothing more than the sum of all of the agreements leading to its creation.1 Some speak of it with admiration. Ayn Rand wrote, “Capitalism demands the best of every man – his rationality – and rewards him accordingly. It leaves every man free to choose the work he likes, to specialize in it, to trade his product for the products of others, and to go as far on the road of achievement as his ability and ambition will carry him.” Historians John Mickelthwait and Adrian Wooldridge lauded the flexibility of the corporate form: “Nowadays, nobody finds it odd that, a century after its foundation, the Minnesota Mining and Manufacturing Company makes Post-it notes, or that the world’s biggest mobile-phone company, Nokia, used to be in the paper business.”

According to Dean Robert Clark of Harvard Law School, the four characteristics essential to the vitality and appeal of the corporate form are:

1. limited liability for investors;

2. free transferability of investor interests;

3. legal personality (entity-attributable powers, life span, and purpose); and

4. centralized management

The metaphors for the corporate role and structure are reviewed: the corporation as “person,” as “complex adaptive system,” as “nexus of contracts.”

Chapter 2

SHAREHOLDERS: OWNERSHIP

This chapter introduces the role and responsibilities of the shareholder – legal, theoretical, practical, actual, philosophical, and even cultural/anthropological. Analysis of recent proxies issued by public companies and proxy voting policies published by” institutional investors can be instructive.

The chapter also discusses the traditional “Wall Street rule” – “vote with management or sell the shares.” The theory was that shareholders could send a powerful message to a company’s management by selling out, ideally in enough of a block to depress the share value. Ultimately, the theory continues, the stock price would fall enough to make the company an attractive takeover target. This risk would then keep management acting in the interest of shareholders.

One of the most critical elements in understanding corporate governance is recognizing the various inhibitions and obstacles to the theoretical elements of shareholder oversight that legitimize the corporate structure.

The takeover era of the 1980s, when the seismic impact of junk bonds and the growth of institutional investors jolted every aspect of the corporate structure, is comparable to the increasing appeal and power of private equity in today’s markets. This is part of a cyclical corrective force in the markets; the nomenclature and vehicles may change (raiders become hedge fund managers) but the incentives and consequences are the same, as the forces push companies to combine, break up, and recapitalize. The lawyers and investment bankers make money no matter what.

A key theme of this chapter is how investors can make possible the kind of effective oversight and market check that is the foundation of both the credibility and the viability of the capitalist system despite the collective choice problem, the separation of ownership and control, the impediments that make it almost impossible for shareholders to locate and communicate with each other, and the economic conflicts of interest that affect institutional investors.

Chapter 3

DIRECTORS: MONITORING

Unless there is a crisis, the board is almost universally overlooked. This chapter makes it clear that, whether they are a positive force, a negative force, or completely neglectful and ineffective, they play a crucial role in corporate strategy, reputation, and sustainability.

The single major challenge addressed by corporate governance is how to grant managers enormous discretionary power over the conduct of the business while holding them accountable for the use of that power. This is the function of the board of directors – at least in theory. In reality, as this chapter shows, directors have too often behaved as – and been treated as – an operating division of the company.

In the context of the post-Enron reforms, it is important to make a distinction between regulatory/legislative/compliance-related changes and best practices that developed as a reaction to market forces. The chapter spends some time on the duties of care and loyalty to understand what they mean in theory and in practice and how standards are evolving.

In the Disney/Ovitz case, what were the most significant factors that led the court to uphold a pay package that was universally agreed to be unjustifiable in business or market terms? (Note the judge’s proviso that the leeway granted to the Disney board reflected the standards of behavior expected at the time and that courts may look at things differently in the future.)

Control of information is a key issue in board effectiveness. “I didn’t know” is a frequent defense” offered in cases of corporate fraud and other meltdowns.

If directors have a duty of care and a duty of loyalty, how do they meet the duty of care in making sure that they get the information they need? When, if ever, is an ‘I didn’t know’ defense sufficient for ad the biggest challenge for a board is often CEO succession planning, because it is there that the CEO/chairman’s control of the agenda, information, and access to senior staff can provide an impenetrable barrier to independent oversight. The traditional control by the CEO over the selection of directors has also led to a self-perpetuating closed circle of failure of oversight more attributable to the process than to the ability or lack of goodwill on the part of the board members director? How can directors make sure they do not get ‘spun’?

Chapter 4

MANAGEMENT: PERFORMANCE

The best way to think about the CEO in the context of his or her relationship to boards, directors, and other constituencies is through the problem/conundrum of executive compensation, both the symptom and the cause of misalignment of shareholder and management interests.

When a company is failing, it will try almost anything, but when a company is successful, it ” generally does not know why it is successful, and so, like an athlete on a lucky streak who won’t change his socks, it will fall into an almost superstitious pattern of not changing anything. The best way to make sure that the right questions are asked of the right people is to create a structure that aligns the interests of the CEO with the long-term interests of the shareholders as much as possible. Indeed, it is just this alignment that gives managers the expertise and the credibility to do their job effectively. Here again, compensation packages play a key role.

What kinds of compensation plans, in which kinds of circumstances, motivate what kinds of managers to guide a company to maximum total shareholder returns over the long run? Which plans have consistently led to the best long-term performance? What are the indicators of a good plan, and, maybe more important, what are the indicators of a bad one?

The challenge for all of the participants in corporate governance is to make sure that there is ” enough of a balance between pay and performance so that, overall, the decisions made are in the long-term interests of the shareholders (and thus, by definition, all other constituencies). The board should also talk about the “for cause” provisions of CEO employment contracts that make it all but impossible to terminate a CEO’s employment without calling it a “resignation” and paying departure costs that can total in the hundreds of millions. The Boeing, Raytheon, and Radio Shack cases in point show us cases where bad behavior by the CEO that was not directly related to performance on the job became an issue for the board.

Scholars from law and economics, and, more recently, from management theory, have shown” that giving employees more authority over their work and more of an ownership interest makes companies stronger and more productive. Many times, each day, every employee is faced with a choice between performing the job to maximize benefit for the company or performing it to benefit himself.

If we accept that the advantage of the corporate structure is that it enables different groups to” combine capital and labor for the benefit of all of them, we must recognize that one of the core issues is how those benefits are divided.

Chapter 5

INTERNATIONAL CORPORATE GOVERNANCE

As discussed in the previous chapters, majority stock ownership is managed by fiduciaries and the exercise of ownership rights has been compromised by conflicts of interest and the collective choice problem. While, in theory, these funds are directed by fiduciaries whose sole obligation is to the beneficial owners, the trustees are most often conglomerate financial service institutions with many important commercial relationships with those companies whose shares are held in their trust departments.

Public and private entities have failed to enforce the legal obligation of the trustees to act as owner of portfolio companies “for the exclusive benefit” of plan participants; the result has been the neutering of a substantial portion of the ownership spectrum. The Nathan Cummings Foundation is one of the few institutional investors that takes a holistic approach, managing its grants and the ownership rights attached to its portfolio in support of the same principles. It explicitly ties its investment decisions, including proxy voting and shareholder proposals, to the investment risk of poor long-term corporate strategy, including perverse incentive compensation and bad management of climate change.

There are initiatives like the 2010 climate change statement from 259 investors from North” America, Europe, Asia, Australia, Latin America, and Africa with collective assets totaling more than $15 trillion – more than one-quarter of global capitalization. Signatories included Allianz, HSBC, APG, and a dozen US public pension funds and state treasurers. The statement cited potential climate-related GDP losses of up to 20 percent by 2050 and the economic benefits of shifting to low-carbon and resource-efficient economies.

The accompanying release explicitly recognized that investors could have more power to address the issue than governments. Similarly, the UN has undertaken an in-depth multijurisdictional project investigating the role of corporate and securities law and human rights, with the understanding that corporations and governments must both be involved to make sure that human rights are protected throughout the world.17 The Social Investment Forum’s 2010 Trends Report found that sustainable and responsible investment (SRI) assets in the US now stand at $3.07 trillion, and have a market share over 12 percent. Assets under some form of SRI management grew 13 percent over the last three years of market uncertainty, far outpacing the 1 percent growth in the broader universe of professionally managed assets. The SRI asset categories included issues relating to Sudan and tobacco and governance.