

Rebuilding Corporate Leadership: How Directors Can Link Long-Term Performance with Public Goals

Executive Summary

The financial crisis, which became evident in September 2008, transformed U.S. financial markets and provided a painful reminder of the conflict that can occur between private-sector actions and public goals. A root cause of the crisis was the excessive risk taken by almost all market participants—corporate executives, money managers, rating agencies, investment intermediaries, bankers, and investors—to achieve short-term results that temporarily benefited their businesses and themselves at the expense of their own long-term interests and those of their shareholders, employees, other linked businesses, and the nation as a whole. Of course, government regulators, some home buyers, and others who overextended credit purchases also share responsibility.

Although the crisis started in the financial services sector, our focus in this report is not on financial services or capital markets as such. Our focus is on corporate governance and the vital role directors can play in mitigating the types of pressures that created the crisis. “Rebuilding Corporate Leadership” is best understood in the context of our previous reports on regaining public trust in the wake of Enron and other scandals and how corporate directors could promote the enduring qualities of their enterprises.*

It is clear to us that the underlying patterns of behavior—rooted in short-sighted and self interested behaviors—exist across all industries. A well-functioning board can govern the corporation and its management by supporting a CEO who is doing the right thing for the sustainability of the business, while checking the excesses and other mistakes of one who is overly short sighted, self interested, or conflicted.

Starting in 2002, the CED Subcommittee on Corporate Governance and Capital Markets has met to propose ways by which to restore confidence and trust in American corporations and their leaders by

encouraging enlightened statesmanship in accounting, corporate governance, other board and management practices, and, as important, the strategic thinking of corporate leaders. Public corporations are the driving force of the U.S economy. They are the core of a system unsurpassed in creating jobs, income, and wealth, and in delivering a wide choice of goods and services. Corporate leaders should understand it is in their self interest to engage responsibly with the society around them. They must find an appropriate balance between generating short-term profits and building for the future, because sustainable profits come only from long-term investment and strategy.

This statement is meant to promote discussion; its recommendations are advisory. We encourage corporate leaders to put the long-term health of their enterprises at the forefront of their numerous priorities, by paying greater attention to how their business strategies interact with the societal environment that shapes their corporations’ long-term performance and sustainability. Aligning the interests of the corporation and its shareholders with the long-term interests of society will generate vibrant and successful entities that will help to regain the public’s trust.

Our focus is on the potential contributions boards of directors can make to improve corporate strategy and long-term performance. Directors generally have been reluctant overseers of their corporations. Before the corporate scandals associated with Enron, WorldCom, and others, directors too frequently deferred to “imperial CEOs.” The Sarbanes-Oxley Act and other reforms put greater emphasis on the responsibility of independent directors to counter the CEO’s inherent power. But many directors have interpreted those reforms solely in terms of fiduciary loyalty to shareholders and, consequently, to the maximization of short-term share value, despite the diversity of shareholder interests and the transitory membership of that group. For many

* *Private Enterprise, Public Trust: The State of Corporate Governance After Sarbanes-Oxley; and Built to Last: Focusing Corporations on Long-Term Performance*

directors, the daily share price has come to represent the success or failure of a board's ability to represent shareholders' interests. But shareholders will not prosper long when other groups linked to the health of the corporation—broadly, society—do not also thrive.

Directors have a legal obligation and duty to address the long-term performance of the corporation. Directors' fiduciary duties include broader societal concerns that affirmatively affect the corporation's performance and long-term sustainability. To meet that duty, directors must consider the concerns of all—not just current shareholders, managers, or other powerful constituents—who are in a position to affect a company's long-term performance. In today's environment, boards must know that they are empowered to reject actions that produce only short-term financial results at the expense of the long-term interests of the corporation. Compensation policies, for example, should not be designed to promote purely short-term share price enhancement.

Many corporate leaders—directors and CEOs—have found that a principled, long-term view fosters greater appreciation of the interdependence between the corporation and the society in which it operates. These individuals are leading the development of business strategies that take account of societal challenges as a means to ensure their corporations' and society's long-term prosperity. Although many boards remain behind the curve, a number of forward-thinking directors seem willing if not eager to consider shareholder resolutions that encourage action to abate climate change, disclose environmental risks, or incorporate human rights best practices. As important, some are speaking out to urge U.S. political leaders to repair *their* broken systems so they can begin to solve long-term societal problems that hamper business as well as society's other constituents. But too few business or political leaders are following these paths, and talk about business and society interaction far outpaces action.

Our central conclusion is that corporate boards and the leaders they select must integrate relevant societal concerns, such as environmental and human rights considerations, into corporate strategy to strengthen long-term competitiveness and the sustainability of both the corporation and the society in which it exists. A successful framework requires that societal and business leaders view and treat each

other as partners, not adversaries. Their actions and public communications should recognize their interdependence and shared goals.

Recommendations

This report is addressed primarily to America's corporate directors. Individual directors and the boards they compose can make an enormous difference by motivating management to identify and execute long-term value solutions to the economic and social pressures their businesses face.

In summary, our major recommendations are as follows:

- ♦ **The board of directors has ultimate responsibility for the performance of the corporation. Directors have an obligation to act as stewards of the corporation's long-term economic health. They should widen the purview of their deliberations to give weight to societal issues that impact the firm's longer-term performance.** (p. 26)
- ♦ **Our basic recommendation with regard to societal issues is not a "one-size-fits-all" solution. As each corporation is unique, each will have unique societal issues that may impact its performance. These should be the board's concern. Our recommendation is simply that boards should play an active role in encouraging company management to evaluate the options available and to decide explicitly what it ought to do, based on sound business grounds that incorporate a longer-term view. Once a decision has been made and justified, the board should monitor implementation and continue to evaluate the company's strategy on the basis of long-term costs and long-term benefits.** (p. 32)
- ♦ **Directors regularly should consider how the company plans, manages, and communicates its interaction with society. The board should insist that management report regularly to it and to the public on non-financial performance, including social performance.* To institutionalize the process, the board may want to establish a special committee or empower its governance committee to take responsibility for oversight. That committee should report to the full board and appear regularly on its agenda.** (p. 28)

- ♦ **Directors should recognize the value of corporate communication with shareholders and the public on issues that bear on the company’s reputation and brand value, even when such communication may not be required by regulation or fit neatly into financial disclosure formats. Boards that have a non-executive chair or lead director may want to consider a communications role for that person on such issues and topics. (p. 32)**
- ♦ **Directors should promote honesty in reporting not only on financial results and other non-financial aspects of their company’s operations, but also on the risks, opportunities and results of its social interactions. Such reporting should show how the company evaluates the long-term impact of potential costs and benefits. But aside from mandated environmental and labor reporting to government regulatory agencies, corporate “sustainability” reporting should remain within the purview and at the discretion of individual companies (as they exercise their responsibility for honest and full communication with shareholders). Directors should use their authority to help their companies find a firm-specific way to communicate effectively with shareholders and the public—through the regular annual report to shareholders, in a separate public report, or in some other way. (pp. 33-34)**
- ♦ **The CEO is mainly responsible for carrying out the board’s directions. When choosing a CEO, the board’s selection committee should be mindful of the role that person will play in setting the tone and direction of the company with regard to ethics, integrity, and engagement with shareholders and other interested parties. Boards should tie a portion of CEO and senior management’s performance compensation to metrics based on the corporation’s performance on such concerns. (pp. 28 and 29)**

Interdependence of Business and Society

The current paradigm that shapes the way that many business and political leaders and the general public think about the relationship between business and society is overly narrow and oppositional. This conven-

tion views the role of business solely as the maximization of profits. While those engaged in business understand the good that comes from the profit motive, many in the public and in politics see the pursuit of profit as feeding individual greed at the expense of society. They perceive private and public interests to be engaged in a zero-sum contest for resources and power. The recent turmoil and government intervention in financial markets has exacerbated these perceptions.

Our preferred framework recognizes that the interests of society and business are not mutually exclusive: they are interdependent; their goals are linked; and they should be seen in positive-sum terms. Our society depends on corporations to innovate and invest, thereby improving living standards, creating jobs and wealth, and providing social goods. Corporations, too, depend on society. At the most fundamental level, society establishes and secures property rights and provides the environment in which businesses can exist. An excellent and equitable education system is needed to provide a productive and innovative workforce. Intelligent policies towards land, water, energy, transportation, communication, health care, and other concerns are needed to sustain the environment, improve commerce, and maintain a vibrant society. An effective and equitable system of justice keeps all parties productively engaged in the pursuit of the common good and protects property and other economic rights. It is without question in each corporation’s interest to sustain the society in which it operates.

We recognize that there are practical limits to any corporation’s ability to fulfill societal needs—individual companies cannot do everything. Neither can they ignore their profit-making responsibilities. Surely government must play a prominent role in setting the public agenda and rules of fair competition that support, rather than undermine, far-sighted business statesmanship (as discussed below).

Yet, failure of corporations to shift to an approach—based on substance, not image—that recognizes their interdependence with the societies around them will further increase public cynicism toward business, erode society’s already diminished trust in, and support of, corporations and their leadership, and invite more burdensome regulation. Such results are in the interests of

^{*} Of course, these need not be the same reports, but public reporting must be truthful and easily understood.

neither business nor society. Society overall is already poorer and less able to address its needs because business has not been sufficiently engaged in helping to find solutions to problems culminating in the late-2008 financial crisis. Business risks losing its “license to operate,” imperils its access to needed physical, human, and financial resources, and invites ever greater scrutiny and more stringent regulation through excessive attention to short-term self interest.

The Role of the Board of Directors

Boards should spend more productive time considering long-term sustainability, which means finding practical ways—through production, research and development, investment, marketing, communications, human resources development, and other processes—of carrying out a strategy that includes the interaction between the corporation and society.

Many directors are uncertain about the validity of societal and other non-shareholder concerns and how such concerns interact with corporate performance. But recent research indicates that how a corporation engages societal issues is a significant factor in a company’s performance. Investors and analysts are increasingly using such evaluations to allocate capital. That does not mean that other corporate constituents any more than shareholders should determine company policies; that social considerations should trump hard-headed business analysis; or that the corporation should be viewed as an arm of government or an instrument of social policy. It does mean, however, that boards must pay greater attention to how societal concerns affect the corporation while continuing to keep an eye on traditional financial criteria.

Boards are uniquely positioned to make sure that the long-term interests of the corporation are not lost or sacrificed to the pressures of daily business activity. Successful boards will help the CEO to balance short-term and long-term goals. Boards can serve as a buffer between the CEO and market forces that make unhealthy short-term practices difficult to resist. They should support—and protect—CEOs and other senior managers who take the long-term view.

Because each corporation has a stake in the health and welfare of the society in which it operates, its directors

cannot afford to ignore that social environment. Nor can they ignore the welfare of key groups, such as employees, whose interests bear on the wealth-creating potential of the corporation.

Additional Considerations

In the course of our deliberations, we examined several related critical issues.

First, we examined some practical cases where corporations have had to confront directly environmental and human rights issues. The examples we analyze, in the oil industry with respect to climate change and in internet technologies with respect to human rights, illustrate the difficult problems companies face and the types of responses they have developed. These examples demonstrate that companies cannot avoid confronting hard questions regarding environmental, human rights, and other societal concerns, and that no one answer fits every circumstance. Whether decisions are made after considerable deliberation or in the heat of a moment, business decisions that intersect with societal interests can reverberate in unexpected ways. **The importance of such decisions both to the society in which a business operates and to the business itself should command the attention of corporate directors.**

Next, we addressed the question of whether privately held corporations that are owned by private equity companies face the same societal pressures as their publicly held counterparts. We found, unsurprisingly, that the actions of private firms are subject to the same market forces and bound by the same social considerations (including government regulation) as large, public corporations. Of course, private-equity-owned firms differ from public corporations on a number of accounts: disclosures, access to funding, executive compensation, shareholder/ownership rights, and investors’ liquidity, to name a few. But these differences neither protect private firms from market competition nor free them from exposure to societal concerns. In fact, like their public counterparts, market forces, pressure from non-governmental organizations, and “enlightened self interest” work to nudge some of these private firms toward a more operational and sustained integration of social issues with company strategy. Others, of course, remain resistant to change or fly under the radar of social monitors.

We conclude that both publicly held and private-equity-owned businesses must become more adept at incorporating societal concerns into strategic frameworks and business plans. For private firms, which currently are not compelled to disclose as much information as public firms, greater voluntary disclosure of their activities might serve as a starting point.

Finally, what is the proper division of responsibility between business and government? Shouldn't governments take primary responsibility for addressing societal concerns?

Government plays many economic roles in market capitalist systems. Among them are: promotion of macroeconomic growth and stability; maintenance of social equity in the distribution of income; and regulation of market competition. Most relevant to the issues addressed in this report, governments generally supplement markets by providing public goods and compelling private entities to account for the costs they impose on society—the two primary concerns that corporations are increasingly called upon to address.

Clearly, government must establish and enforce social policies in these areas. Normally, the business role is to obey local laws and regulations. But laws and regulations typically set minimum standards. Many businesses, especially global corporations, often exceed these minimum standards. In advanced economies, like the United States, the pressure to exceed regulatory minimums is strongest when it appears that government policies lag behind societal attitudes. For example, U.S. environmental policy, to many observers, has not caught up with societal concerns about the risks of climate change.

In the U.S. context, a lack of trust in political institutions undermines social progress and shifts public demands from political leaders to business leaders. A better outcome would be one where political institutions could be relied upon to address intelligently public concerns and close the gap between social expectations and government policies. Elsewhere, CED has

addressed the problem of Washington's broken policy process.* **Our conclusion and recommendation, adapted from that analysis, is that political leaders should understand the costs they impose on business and society at large if they do not take action to improve political governance and policymaking. They need seriously to address reforms in ethics, lobbying, redistricting, earmarks, and other legislative procedures and executive practices to break the logjam holding back policy reforms in substantive areas such as global climate change.**

We also reiterate conclusions and recommendations from CED's previous policy statement on government regulation.† That analysis pointed to what some now term "smart regulation," which draws from an array of ideas linked to performance- and principles-based regulation. Smart regulation seeks to strike an appropriate balance between flexibility and efficiency, relying more on markets than on commands.

Conclusion

CED was founded by a group of business statesmen who had strong views on the direction of public policy and the role of the business community in helping to advance our society as a whole. A key, if not critical, contribution of the business community to overcoming societal problems may lie not only in individual corporate policies but in business statesmanship—the willingness of business leaders to speak out on pressing public concerns, such as unsustainable cost increases in federal entitlement programs, the lack of universal health care, environmental damage from climate change, and the threat to human rights.

It is not an either-or choice. U.S. business leaders should consider both how their business strategies interact with societal issues and how they personally can make a difference by supporting sound public policies that address society's key concerns.

* "Washington Is Broken" So What Are You Going To Do About It?

† *Modernizing Government Regulation: The Need for Action*