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No Substitute for Good Judgment

The agency theory of corporations always has been an oversimplification. Recently, it has become a dangerous one. Proponents of this theory take the view that science and statistics can explain management behavior; they combine this view with a general pessimism about human nature. The net result is a belief that self-interested opportunistic behavior by managers is to be expected and must be controlled with suspicion and supervision. The late Sumantra Ghoshal, of the Advanced Institute of Management Research (UK) and the London Business School, in a recently released article,* provides numerous compelling reasons for rejecting the negative view of management behavior that has become unquestioned doctrine over the last several decades in business schools around the world.

Ghoshal attributes the prevalence of the agency theory to a desire by academics to turn management studies into a science such as physics, complete with elegant mathematical models and accurate predictions of events. But as Ghoshal points out, theories in the social sciences, unlike theories in the physical sciences, can affect the behavior of their subjects. Treating people as untrustworthy makes them less trustworthy, not more so; assuming that people will behave opportunistically to maximize only their own enrichment often results in them doing so. Academics have preferred to ignore human nature in all its complexity and variety — including morality, common sense, judgment, effectiveness, leadership and experience — in favor of neat mathematical models. To the extent this view results in corporate governance regimes that emphasize suspicion, surveillance and liability for corporate actors, at the expense of the authority and autonomy necessary to manage effectively, the consequences for our corporations and the broader economy will be increasingly negative.

Even the "agency" aspect of agency theory is based on questionable assumptions. Whence the certainty, asks Ghoshal, that the job of managers is solely to maximize *shareholder* value? Shareholders have chosen a limited liability form in which to invest their capital, entitling them to the residual cash flows of the corporation but not to its actual assets or resources, which are owned by the legal entity of the corporation itself. They are not the only investors in a company; management and employees generally have much more invested in terms of personal and financial risk than the average shareholder. Ghoshal posits that the only advantage of the agency model — of shareholders as "principals" whose interest is paramount and managers as "agents" who are trying to use company resources for their own benefit — is that it is a simple one for academics to structure and solve.

In recent months, the agency theory has been pushed to its logical limits and beyond. Some prominent commentators are now arguing for the extreme version: that shareholders should have the right to govern a company virtually by referendum. Activist shareholders are pushing proposals such as majority election of directors, proxy access for shareholder nomina-

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* Bad Management Practices are Destroying Good Management Practices (Academy of Management Learning & Education, 2005, Vol. 4, No. 1, 75-91; available at http://aom.pace.edu/AMLE/AMLEVolume4Issue1pp75-91.pdf)

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tions of directors, limits on the form and amount of executive compensation and shareholder votes on key corporate events. They intend to turn directors, and to some extent management, into passive executors of shareholder will. This would be a grave mistake.

The prosperity of the American corporation long has been the envy of the world. We owe this success in no small measure to the institution of the board of directors and to the common sense, integrity and good judgment of corporate officers and directors. Though there have been scandals in recent years, they are the exception and not the rule. Treating them as the rule risks imposing impractical and onerous restraints that stifle entrepreneurial activity and hobble our competitiveness.

If agency theory began with the notion that shareholders take risks and are entitled to rewards, it is becoming the idea that shareholders are entitled to reap rewards while management and the board shoulder the risks. After the upheaval caused by the large-scale corporate crises of the past few years, some activist shareholders now seem to believe that they are entitled to as close to all of the financial gains of a company as possible in exchange for a minimal amount of risk, yet they expect directors to assume daunting personal liability for almost no reward. In the current corporate governance climate, board members are reluctant to accept meaningful payment for their efforts for fear of creating a "conflict." At the same time, the efforts of activist shareholders — frequently motivated by political considerations — to punish directors who did not benefit from corporate misfeasance but only failed to ferret it out, such as in the recent WorldCom settlement, cause even the most steadfast and reliable directors to fear for their personal assets. In the end, however, it is the shareholders who may be the losers if the current trend in risk-reward division continues. As Treasury Secretary John Snow recently observed, directors and management are growing less willing to take business risks that, on the whole, would produce benefits for investors and society, for fear of personal liability if something goes wrong. The irony is that in trying to eliminate all possible conflicts for directors, the regulators and activist shareholders may be creating the most substantial conflict of all.

Recent laws and regulations have done much that is good. Legislators and regulators have succeeded in improving communications between companies and their shareholders and in reminding directors of their responsibility to be active, engaged participants in the life of the corporation. Ultimately, though, the success of an enterprise depends not on the stringency of applicable laws and constraints, but on human competence, experience, integrity and many other qualities that the agency model ignores. Studies have shown time and again that the proportion of independent directors on the board has no significant effect on corporate performance. Neither does the separation of the roles of chairman of the board and CEO. It may well be time to accept the limitations of the agency theory, rein in our regulatory impulses and consider an alternative.

Ghoshal urges us to acknowledge that companies prosper when they simultaneously consider the interests of their customers, employees and shareholders and perhaps even the local community. Interestingly, after long study and debate, this principle has been adopted in the Company Law Reform legislation submitted this month by the English government to Parliament: "the basic goal for directors should be the success of the company for its members as a whole; but to reach this goal, directors would need to take a properly balanced view of the implications of decisions over time and foster effective relationships with employees, customers and

suppliers and in the community more widely." In the United States, we have recognized this in the past. Beginning in the 1980s, over half of the states adopted statutory provisions specifically allowing or requiring boards to consider factors other than shareholder profit — e.g., the interests of customers, suppliers and local communities and the long-term interests of the company — when facing a takeover bid. At that time, courts rejected the idea of board passivity and indeed expanded the arena in which boards were urged to exercise their business judgment. This understanding of the vital role of the board of directors is threatened now by advocates of shareholder "empowerment" and expanded director liability. It is crucial that we preserve the basic principles underlying the American corporation. There is no substitute for sound judgment, common sense and a fundamental faith that American business, when invested with responsibility and trust, will continue to do great things.

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