

Insiders and Directors : Symbiosis or Incest ?

One of the definitions of "symbiosis" is "the intimate living together of two dissimilar organisms in a mutually beneficial relationship." I don't think that's a bad description of the relationship of corporate directors with the officers, who are considered "insiders." After all, one group is responsible for running a business, whereas the other group is there to represent shareholders and to keep an eye on the CEO and the other senior officers to make sure they stay within the bounds of reason in the exercising of their functions. The relationship is not one of incest. Incest is a crime under Section 155 of the Criminal Code of Canada and the corresponding statutes of the various States of the Union. It is of the utmost importance to realize that the recent scandals in the Enron, WorldCom, Xerox, etc., cases did not involve criminal behavior on the part of the corporate directors. They relied on the outside auditors who were themselves part of some gigantic frauds. But this does not mean that the director-insider relationship is healthy and that the various scandals are a temporary aberration. On the contrary, the relationship is one of "Systemic Corruption." This means that without any criminal or even overtly unethical behavior of the directors, the system stinks from a public policy and shareholders' point of view.

In the column "Death of Edwin Land's Dream" I reported that the directors doubled the CEO's salary as the company was sliding into bankruptcy, and even after that, efforts were undertaken to provide the officers with 19 million dollars in "Retention Bonuses."

In my column "Should I be more Gruntled?", I discussed my anger as a shareholder of Verizon Communications Inc. for the princely pay and benefits lavished on the directors, including stock options, which when exercised, dilute the value of my shares.

While the directors, in my view, were not involved in the frauds mentioned above, they were completely responsible for the obscene pay and benefits which, during the last several years, greedy CEOs extracted from the corporations for which they were responsible. A Time magazine article about the "WorldCom Ripoff" reports that the corporation had loaned its CEO, Ebbers, \$366 million "most of which he ostensibly used to purchase WorldCom shares." Any loan of this magnitude to a CEO, for any purpose whatsoever, is scandalous. The article also states that when he was fired, he received a golden handshake worth \$1.5 million dollars a year for life. In an earlier issue, I read that Tyco's "Dennis the Menace" Kozlowski received more than \$300 million in compensation during the last three years. The same article also says that Enron's CEO, Ken Lay, received \$ 200 million from 1999 up to his recent resignation. Another shaky corporation, Adelphia, guaranteed \$3.1 billion in loans to partnerships owned by founder John Rigas' family.

These are the extremes. But for a number of years, directors as a group have been falling all over each other to boost the salary and other compensation of insiders. This was explained in an article in the Business Section of the New York Times about six months ago. The Compensation Committee of the Board pays an outside consulting firm to survey what comparable enterprises are paying their CEOs. Then they instruct them to arrive at a figure above the average, or say, in the upper third. Consequently, the salaries are leapfrogging all the time. This

tendency leads to the practice of the directors granting options to the insiders with great abandon. The underlying rationale is that the officers' salaries reflect in considerable part on how well the corporation is doing under the direction of the optionees. In fact, options based purely on the stock price of a corporation, can have very negative consequences as David Wessel of the Wall Street Journal wrote recently: "One culprit was stock options which gave executives huge incentives to boost near-term share prices regardless of long term consequences..... These incentives helped turn the widely practiced art of earnings management – making sure profits meet or barely exceed Wall St. expectations – into a gross distortion of reality at some companies." To top it all off, there is little evidence that directors in general seriously question takeover or merger strategies of their CEOs.

The "corporate culture" of the symbiosis is easy to understand. The insiders "nominate" the directors who are then "elected" by the shareholders at the annual meeting. In the event that there is any funny business on the part of corporate gadflies, the insiders are armed with thousands, and sometimes millions of proxies to make the "election" a success. Even this process, a kinder version of the "elections" in former Communist countries, might not be disastrous if the directors looked at their function as an honour and were paid at the rate of professionals on a per hourly basis. But the fact is that they get big bucks for being quiescent. I expect to get outraged letters from M.I.T. deans and other worthies telling me how much time they put into studying the piles of materials which are supplied to them. Of course there are serious-minded directors, probably hundreds, but this does not argue against the fact that the system as a whole is corrupt.

This is what has to be done to change the "culture":

1. Some, but not much, carefully considered, legislative and regulatory intervention.
2. Much more importantly, the creation of a non-profit corporation which would supply professional directors to the shareholders who could write in their names on the yearly proxy statements. In order to bring about change in an orderly fashion, it would probably be advisable not to elect more than two of these men and women at a time. These individuals would be accountants, lawyers, former security regulators and others who are truly knowledgeable and of an independent mind. At first blush it sounds as if the new model might be a prescription for conflict. Not so. These directors would not hesitate to defend vigorously the insiders against ridiculous demands on the part of mutual fund and pension fund managers that the corporation produce continuously growing profits year in, year out. In fact these new directors paid on an hourly basis by the non-profit corporation, and returning any extra compensation to their employer, would be a help to the traditional executives who looked at their position as one of trust. These kinds of executives, some of whom I have encountered personally, were well-paid and keen to prove themselves, but did not look at their job as an opportunity to build enormous personal fortunes.

Author : The Editor

Date of publication : November 2002