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The Real Reason Why Businesses Make Bad Decisions

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Speaking volumes

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Corporate Governance: Promises Kept, Promises Broken

By Jonathan R. Macey
Princeton University Press
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Jonathan Macey's new book, *Corporate Governance: Promises Kept, Promises Broken*, provides insight into how corporations are run, and, in so doing, takes aim at some traditional theories of governance. Given the governance failures in our post-Enron environment, now is a particularly good time to read this book.

I started paying attention to corporate governance issues when we began to study the failures of Enron, WorldCom, and the other fiascos of the early 2000s. As I read about the mistakes that the Enron board made, I wondered why so many very smart people could make so many really dumb decisions. How difficult is it to say "no" to a chief financial officer who wants to engage in self-dealing with his own company? Apparently, the Enron board found it impossible to say "no" to Andy Fastow, Enron's own CFO (who made a personal profit of over $40 million in his deals with Enron, and who's now serving time for his crimes). Enron waived its own ethics rules to allow Fastow to sit across from Enron at the bargaining table and to let Fastow help Enron hide poorly performing deals from easy discovery. (Here's a clue, board members: if what you're considering involves waiving an ethics rule at all, just don't do it.)

Some good things came out of Enron's governance failures, although not very many good things. Probably the most important good thing was that more people started to pay attention to corporate governance—and to what distinguishes good governance from bad governance. I've noticed that board membership has started to become less decorative (although most boards are still not very diverse in terms of gender or skill sets). People have started to take their board responsibilities more seriously. Board members are paying more attention to financial statements. All of these developments are good.

But we still have a long way to go. Boards continue to overcompensate their officers and award bonuses for short-term behavior that can ruin companies in the long run. They're still allowing their companies to engage in short-term, high-risk ventures without necessarily understanding exactly the level of risk that those ventures involve. Macey's book helps to explain why, despite our best efforts, we really haven't learned all that much from Enron.

What I admire most about this book is that he comes out swinging about whether even smart boards actually do any good at all. I wish I'd written this book, although I could never have done it with the same flair and wisdom that Macey has done. So I'm glad he's said what I'd been thinking: that no amount of brains or talent can fix this system by assuming that boards can really govern.

This book really is too chock-full of good points to do it justice in a short book review, so this review will focus on his discussion about boards (Chapters 4 and 5). He highlights the difference between managing and monitoring:

> The intuition that directors add value is strong and deeply held. That intuition is not challenged here. What is challenged is the deeply held assumption that traditional directors add value by serving shareholders as independent monitors of managers. It is more likely that directors nominated and elected through traditional board processes serve managers by supporting them. Sometimes, particularly when managers have useful and constructive strategic advice for management, directors add value for shareholders. At other times, however, such as when managers need directors to approve managers' aggressive salary requirements or when managers need insulation from the market for corporate control or pesky institutional investors, so-called independent directors at best do not reduce shareholder value, and at worst they destroy it. (Macey at 51.)

That's a strong statement, but is there anyone who has read the financial news over the past year or so who can really disagree with it?

Part of Macey's strength in this book comes from his willingness to debunk

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the traditional notion that corporate governance comes not from a contract (real or imagined) between shareholders and the company, but from the "investors' legitimate investment-backed expectations." Those expectations, which include the expectation that the company's managers won't steal from the corporation or lie to the public, just aren't monitored well by directors who have been handpicked by the managers themselves. There's nothing nefarious in this assertion. People tend to prefer to be in collegial groups, and it's difficult to be a naysayer who slows down a group's decision making.

But Macey also shows us what happens when these collegial groups have to make some hard decisions. Pointing to such common problems as board capture, Macey explains that "it is virtually impossible to identify, much less to monitor and control, the myriad ways that board independence can be compromised." In Chapter 5, he gives us examples of what I call big, boneheaded board mistakes. The Disney board's hiring and firing of Michael Ovitz and the Enron board's willingness to opt out of any use of common sense—two of the best-known examples of big, boneheaded mistakes in recent U.S. corporate law—demonstrate just how easily smart people can, subconsciously, force each other to make bad decisions.

There is a lot of solid social science that explains why smart people end up doing some very dumb things. What Macey's book demonstrates so convincingly is that blindly putting our trust in any governance structure (whether it's boards, or regulations, or derivative suits), without understanding that humans have certain cognitive biases, will result in us leaving the lessons of corporate fiascos on the table. The best laws, the most conscientious directors, and the most favorable dispute resolution climate still can't overcome human nature. Any governance system that doesn't understand that humans can be pressured into groupthink, and that humans can talk themselves into walking on the wrong side of the ethical line, is a governance system that's doomed to fail.

I was in a cab the other day, riding to a lecture and talking with the cabdriver about the economy. "You know," he said, "the really sad thing is that, when Enron went down, we thought that that was the worst thing in the world. Too bad we didn't realize that Enron was part of the good times, compared to what we have now." We're suffering now in large part because businesses have continued to make bad decisions—decisions blessed by their boards—without some sort of "loyal opposition" (perhaps a new officer—the Chief Naysayer?) to slow down the groupthink. Now that we have a good new book that gives us more insight into how boards work (or how they don't), let's take that next step.