Curtains for the Corporate Veil

Sydney Morning Herald,
April 18, 2009

Treating corporations as 'legal persons' is one thing, asking them to act with humanity quite another, writes David Ash.

APRIL FOOLS' EVE just past was the 96th anniversary of the death of John Pierpont Morgan, the granddaddy of corporate finance. But in the pulpit of London's St Paul's Cathedral, prime ministers Rudd and Brown were interring Mammon. Markets need morals, they preached. Fair but not laissez-faire.

In the Great Financial Meltdown, a particular target has been the executive payout. When it was revealed last month that the former head of the Royal Bank of Scotland was entitled to a £700,000 ($1.44 million) annual pension, his house and car were attacked by a group calling itself Bank Bosses Are Criminals.

And so it was, the day after April Fools', the prayer became a commandment. In its declaration, the G20 required that "stakeholders, including shareholders, should be adequately informed on a timely basis on compensation policies to exercise effective monitoring". The accompanying communique spoke of "corporate social responsibility".

I have nothing against regulation as such. Freedom is best enjoyed with a soupcon of constraint. Anyway, if everything else is being globalised, why not globalise regulation, too?

The problem with the communique is its presupposition that corporations are independent adult beings, moseying through life alongside the rest of us. Who, pray tell, will do the informing demanded by the communique? Who, pray tell, is to be socially responsible?

Corporations are and need to be what lawyers call "legal persons". As persons, they can sue or be sued. But that is a legal invention, a sleight of hand, a convenience. Should it follow that a corporation can be required to exhibit humanity? Regulation is one thing. Regulating a fictional person to feel ashamed of itself is another.

The Meltdown is as good a time as any for our leaders—along with the rest of us—to go back to basics and ask what a corporation should be. Since Adam and Eve, societies have recognised a relationship between rights—in particular the right to hold property—and responsibilities, a relationship of benefit and burden. If you want to bite the apple, you have to accept that it might bite back.

This is not a relationship ever much disputed. Our most influential economic philosophers—Adam Smith, Karl Marx, J.M. Keynes, Friedrich Hayek and so on —did not seek to question the relationship. For them, the debate was merely about the best way to ensure the fecundity of the apple tree and the fair splitting of its fruit.

The existence of the relationship meant, necessarily, that people interested in acquiring property needed tools to assess the risk of responsibility. The most important tool was and is information.

These days, information imbalance in the market goes by the highfalutin' title of "asymmetric information"; its study was the subject of the 2001 Nobel Prize in Economics. In the field of corporate management, the buzz term for how to make sure the managers do not use information against owners is "agency costs". For the rest of us, it's simply "who guards the guards?"

The two most popular tools used by principals to guard themselves against the guards are the well-known "As" of audit and alignment.

Audit is good, but no guarantor. Witness its weakness in the hands of an infamous double-A entity, Arthur Andersen, accountant and sometime auditor to Enron.

Alignment is the attempt to co-ordinate the interests of principal and agent. It can work beautifully. When asked why he wouldn't get rid of J. Edgar Hoover as head of the FBI, Lyndon Johnson explained: "I'd rather have him inside pissin' out than have him outside the tent pissin' in".

The trouble with the modern tools of alignment, the tools by which corporations keep their own agents—a large salary, millions of stock options, huge bonuses, and Byzantine termination payments—is not so much the pissing in or the pissing out, but the pissing off. The executive is the pisser, the shareholder the pissee.

The G20 communique suggests that the remedy for the trouble—a realignment of alignment, if you like—lies in corporate regulation. It seems to me that this is destined for failure unless we use the exercise to remind ourselves that dogs should wag tails, and not vice versa.

A basic rule of agency law is that a principal is liable for his agent's debts. If you want the benefit of an agent, you take the burden of his errors. While this was fine in a static feudal economy, it hampered expansion. People were reluctant to invest in enterprises where they had exposure but not control.

Enter the limited liability corporation, where the investor could only lose the amount he put in. Leaving to one side the occasional exception, such as the BrisConnections debacle, that remains the case today.

So while the buzz term may be "agency costs", the one thing we do know is that a limited liability corporation is not the agent of its owners. That has the profound consequence that the executives, from the CEO down, owe duties only to a legal invention.

It is this distinction which has created much of the difficulties uncovered in the Meltdown. A shareholder cannot say to any particular executive: "You are my agent. Please account to me for your actions." The executive is entitled to say: "I am not your agent. I am answerable to a completely separate legal person."

The traditional policeman is the board of directors. The directors, after all, are voted in by shareholders and not by executives. But the difficulty is the same. Directors themselves, just like executives, are not agents of the owners, but officers of the corporation. Merely providing for non-executive or independent directors is not, we are seeing, a complete safeguard against that consequence.

The law has made some ameliorating moves, with judges in some cases prepared to make directors accountable directly to shareholders and not merely to the company. But this is necessarily on a case-by-case approach.

What to do? For the executive, the fair answer may be "nothing". If we were happy to break the link between ownership and responsibility, we should be happy to live with the consequences. And for the regulator, the fair answer may be "lots and lots". If there is no link between ownership and responsibility, then government is the only person able to fill the gap. For the rest of us, the answer is thankfully somewhere in between. In Australia, the Government has flagged a cap on termination pay for executives to one year's pay unless shareholders agree to more. The well-regarded Allan Fels and the Productivity Commission have been charged with further investigation.

We can hope that Professor Fels will be looking at a number of things. One possibility is the continental model of directorship, with more representation for rank-and-file employees. There would be something deliciously post-Marxist about owners having workers save them from managers.

Another possibility is looking at the concept of ownership itself. If a shareholders' meeting goes to a poll, the power is in the number of shares you hold and not in the number of shareholders on your side. Even in the case of serious matters—so-called "special resolutions"—the measure is the same, it just happens to be 75 per cent and not 50 per cent.

But this is not the only way to weigh votes. As Australians, we know that when it comes to constitutional change, we require a majority of states as well as a majority of people.

Creditors' votes in bankruptcies can be similar. Important matters must be passed not merely by a majority of creditors. Those creditors must also hold three-quarters of the bankrupt's debts in value. In this way, abuse of creditors generally by larger creditors is more easily policed.

Larger shareholders of corporations are likely to be corporations themselves. Managers managing managers. It is impractical to give smaller shareholders much say in the day-to-day running of a corporation, but I wonder whether there may be justification for preferring smaller shareholders on the meeting floor. Something for Professor Fels to consider, perhaps.

The limited liability corporation is the most celebrated example of the law's contribution to capitalism. Today, we are finding out that the greatest boon of the corporation—releasing owners from the responsibility of ownership—is also its greatest danger.

With corporations, there is by definition no such thing as "ownership capitalism". There is only "management capitalism". The manager is the controller. Here, as in all things, possession and not ownership is nine-tenths of the law.

One of JP Morgan & Co's ventures was the White Star Line, owner and operator of the *Titanic*. Morgan had a private suite and promenade deck. In April 1912 he was booked to leave, but he cancelled.

If Morgan had sailed and drowned, one can't imagine much good press. If he had sailed and survived, one can't imagine any good press at all. In fact, when he died less than a year later, flags on Wall Street flew at half-mast and the market closed for two hours.

Managers, as a species, are no more responsible for the Great Financial Meltdown than the rest of us. Moreover, we can be thankful that the bulk of them managed our money and continue to manage it well and modestly.

But even those managing well must be interested in avoiding the epitaph that Morgan might have had, had he taken the fateful voyage in 1912. And they could do worse than reminding themselves every morning that they are risking other people's money and that no amount of alignment relieves them of that responsibility.

David Ash is a Sydney barrister and writer.
http://business.smh.com.au/business/curtains-for-the-corporate-veil-20090417-aa6p.html?page=-1