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Business Should Act for All Its Stakeholders – Before "The Feds" Do

by Richard J. Mahoney

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The publicly held American corporation is a work in progress — and always has been. From the earliest days of the republic with the New York Curb Exchange, to the great market expansion of the late 1800s which financed the railroad trusts, to the 1920s expansion for the automobile industry consolidations, to the conglomerates of the 1970s, and the leveraged buyout craze of the 1980s — change of corporate structure has been a regular occurrence. The only constant has been the fundamental purpose of publicly held corporations: the development of wealth for shareowners.

Today, that narrowly defined purpose is being questioned. Increasingly, voices are asking, "What about all those others whose fortunes corporations affect?"

To be sure, no corporation can sustain itself without appropriate attention to all those who hold a stake in its performance: customers certainly, but also suppliers, creditors, neighbors, society in general and, of course, those most directly affected — employees. Indeed, the fate of employees has moved to the headlines in the wake of well-publicized corporate downsizings. While there never was "lifetime employment" promised or delivered in American corporations, the general sense was that layoffs came only as a result of sales downturns or outright business failure — not, as is the case today, during times of relatively good profitability and at least moderate growth.

The *New York Times* reported recently that "nearly three-quarters of American adults say that they or someone close to them have been touched by layoffs in the last 15 years." While we don't have an equivalent bench-

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mark from 10 or 15 years ago, reports of concern are escalating, perhaps ignited by well-publicized "CEO pay" stories. What are often considered excessive compensation amounts for CEOs are largely the results of stock-option program expansions urged on companies during the 1980s to "link executive compensation to shareowner results." Those option values soared in the bull markets of the 1980s and 1990s — and not just for well-run companies. Most companies benefited. Indeed, many stocks rose on the announcement of layoffs, because stock watchers factored the resulting cost savings into future earnings.

Out of all this came a cry for "fairness." Some, like Secretary of Labor Robert Reich and Senator Ted Kennedy, proposed legislative solutions — rewards for corporate behavior *they* liked.

But they are not alone. There is a growing sense that rank-and-file employees, as well as middle-level management, disproportionately share the risk, but not the gains, of corporate success.

The anger caused by executive stock-option gains will no doubt dissipate in the inevitable next stock market decline when "out-of-the-money" option values reflect the bear market as they did in the 1970s.

But the fundamental issue of employee and other "stakeholder" rights versus just shareowner rights is not likely to go away soon. The reason is that the questioning goes well beyond the matter of executive pay. With increasing deficit problems, government has seen a power shift away from *themselves* and toward employers. The power to tax has been severely challenged and with it comes constraints on the age-old political purpose — to move resources from one group to another, from the wealthy regions and wealthy people to those less so — or vice versa, depending on who is in position to decide.

Government Reacts

The reaction by government to this shift in power when it first appeared in the 1970s and 1980s was to legislate desired social programs "tax-free" by imposing regulations on companies. Much of this new emphasis and its related oversight function is reflected in the tripling of federal regulatory agencies' budgets from about $5.2 billion in 1970 to $16 billion in 1996 (measured in constant 1995 dollars). These programs ranged from hiring and promotion practices, directed benefits and worker safety rules, to minority purchasing standards, and a host of others. The results were felt by industry and the public — for example, effectively even dictating the size of automobiles based on fuel economy standards.

A degree of this regulatory outburst may well have represented an appropriate response to the wishes of the public. But much was wasteful and often counterproductive. Of course, it was ultimately paid for by the people themselves, in higher prices — presumably more palatable than higher taxes. In any case, affecting governmental social policy through regulation has been with us at this increased level now for some two decades, and business has more or less adapted to it, however grudgingly. Weighing costs versus benefits for these regulatory thrusts generally received only lip service, although striking this balance is now a legislative priority for many.

We should now expect even more pressure on corporations to achieve social program objectives if government's ability to tax continues to be restricted and if the freewheeling regulatory power of the 1970s and 1980s begins to be challenged effectively with cost-benefit analysis and other obstacles.

As Secretary Reich said in January 1996, "Even if we could turn the clock backward and enlarge on the CEOs' former discretion in balancing the interests of shareholders against those of employees and communities, it is far from clear that society should vest such power in unelected officials." He added, "If we want them (corporations) to put greater emphasis on the interests of their workers and communities, society must reorganize them to do so. In this era of smaller government, such steps seem warranted."

A recent *Business Week* editorial said, "New conservative and liberal philosophies also challenge the corporation's role in America. Reviving the civil society is the motivating idea driving conservatives these days." The editorial went on to say, "Voices from the left are also calling for changes in the way corporations operate. The motivating idea in liberal circles is to build a stakeholder society, which calls for a wider collection of corporate groups to join shareowners and chief executives in reaping the rewards of higher productivity and profits. As *Business Week* concluded, "One thing is certain: U.S. corporations may have to strike a new balance between the need to cut costs to be globally competitive and the need to be more responsible corporate citizens."

Why should we pay attention to the views of *Business Week* or Secretary Reich? Quite simply, opinions at this level often escalate into policy as others take up what can be made into an appealing populist cause.

How Should Business React?

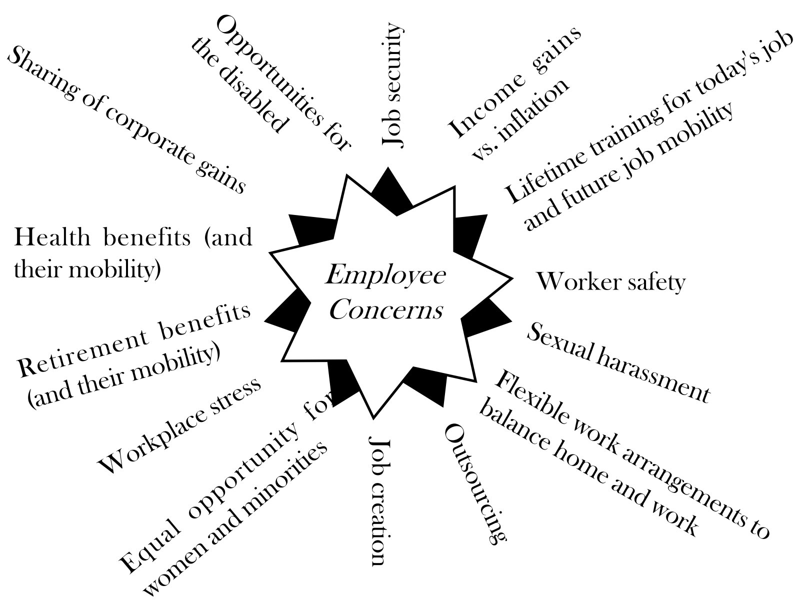
The real questions are, "Where is this discussion likely to lead if it *does* result in policy?" "How can corporations position themselves for this potential new development?" Should they simply acquiesce and get ready — or should they take steps to modify corporate behavior *now* to forestall the enormous potential implications which such governance policy changes could have?" I argue for the latter response. To paraphrase hockey great Wayne Gretzky's advice on goal scoring, I believe that corporations should "skate to where the puck *will be*, not where it is now."

Before attempting to outline elements of this preemptive approach, let's examine the underlying stakeholder issues.

First, the major *employee* concerns that today dominate the debate both for individual workers and for workers in aggregate are familiar ones:

Added to those already on the table, tomorrow's *new* employee issues may include:

- Unionization of middle management. This activity today is only a fledgling effort, but the target population size is irresistible to unions with declining opportunities in their traditional organizing areas. The unease over job security and pay and benefits issues in middle management makes many susceptible to an organizing effort.
- Tax-induced incentives (or mandates) to cover training, layoffs, ben-



efits, and other issues along the lines of the Reich proposals and the Kennedy Senate bill, "American Workers Economic Security Act" floated in April 1996.

- Increased opportunity for community service during working hours. Most major companies encourage a degree of this, but needs in society and the coming devolution of social programs to state and local communities will significantly increase the need for skilled managerial volunteers.
- Dramatically reduced work weeks. Social gadfly Jeremy Rifkin, in a recent appearance on C-SPAN proposed a 30-hour week with an eventual decline to 20 hours. The audience was not laughing!
- Pressure to shrink the pay disparity between low- and top-level employees. The recent attempt by Congress to cap executive pay at $1 million through tax policy failed, not in its ardor, but in the clumsy legislation it produced. One can never underestimate the populist appeal of this issue in both political parties.

But Who's Minding the Corporation?

Beyond these and other employee issues lurk broader corporate *governance* questions. It is not difficult to visualize some of them. We have already seen dramatic increases in involvement by institutional shareowners, especially pension funds, which now control some 30 percent of all corporate equities. While "social investment" groups have been mostly unsuccessful, the large institutional investors *have* had a good deal of success in more appropriate areas of interest, like board of directors governance. Other "stakeholders" have doubtless observed the pressure that can be brought to bear on corporations under the "governance" banner. Just consider the clout of retirees and those nearing retirement. Collectively this group owns some two-thirds of corporate equities both as individual owners and through pension funds — and the number is climbing. Could they organize to enact legislation to have corporations pick up the full burden of the future bankrupt social security system? These are not the "Little Sisters of the Poor" at a shareowners' meeting with their 100 shares of stock. The retirees could be a powerhouse.

Among other possible interventions:

- We could see federal involvement in countering what politicians see as the "short-term view" taken by corporations. This might range from expensive, but relatively harmless, locally targeted R&D tax "pork" to even more damaging mandates. Corporate America is making massive investments in R&D (today about $100 billion of the $170 billion a year spent totally) and major investment in long-payout capital equipment. Nevertheless, the perception persists that if only the corporate "quarterly income mentality" could be reversed, all would be well. This perception shows no sign of changing, and legislative opportunities abound.

- Constraints on "internationalization." This could take many forms — all of which would be intrusive and likely, in aggregate, to be destructive of growth in this country. Local-content laws, tax policies, and other attempts in this area were only door-openers. The possibilities are endless for imaginative legislators.
- Incremental, but steady movement to a "single payer" (government) health-care system with mandated employee benefits. This has its supporters not only in the "progressive" (formerly "liberal" groups), but also in certain business sectors burdened with expensive labor union-mandated employee health programs.
- Demands for "public interest" or "constituent" corporate directors in the style of the German Workers' Council (Betriebsrat). While this concept has never taken hold in this country, it could easily develop, with increasing concern over the social power shift away from governments to corporations.
- Federal, rather than state, chartering of corporations, especially if the so-called "rush to the bottom" occurs in social and employee matters as a result of devolution of these programs to the states. Federal chartering would bring politics to the boardroom in ways limited only by the resourcefulness of legislators and regulators. The insurance industry, now chartered and regulated by the states, has been hearing and responding to threats of federal chartering for some time. It is not a remote possibility.

Can *any*, *all* — or even *more* than this happen? Consider what has already occurred in the regulation of business over the past two decades. Almost all of the federal regulatory agencies and major social legislation was "sparked" by outrage fueled by the perceived political need to act. Today's increasing dissatisfaction with the direction of the power shift from government to employers — should that dissatisfaction continue to grow — could well be the "spark." Legislators are not in the habit of sitting idly by. Legislators legislate when they believe (or *want* to believe) the public calls for it. *They* will provide the "fuel."

How then, can corporations "skate to where the puck will be"? How can they help alleviate the underlying issues that could drive unwanted government intrusion into corporate governance?

Of course, employers by themselves, *whatever* they do, cannot prevent the "socialization of corporate America" if a sudden national shift to the left were to occur. But that kind of economic policy has been so discredited around the world that the prospects here seem unlikely.

What is *not* unlikely, however, is massive government tinkering around the edges — and business *can* take steps to prevent *that*. But not with "business as usual" — not in view of the dissatisfaction that is becoming increasingly evident.

Corporations Should Move into Action

Here are some of the things that can be done by corporations to try to head off government intrusion in corporate governance. This is by no means an all-inclusive list nor is it necessarily an appropriate list for all corporations. But it is worth considering, nonetheless.

- Start at the top. *Install demanding "performance-based" stock options.* End the argument that executives get a free ride to riches in a booming stock market. Options would vest only when the corporation meets tough targets relevant to its circumstances. These performance-based options should be part of the annual proxy statement for shareowner approval. Some companies have done this — but they often install them *in addition* to normal options.
- Broaden stock-option participation to increase employee "buy-in" to corporate objectives as well as bringing opportunity for sharing corporate gains. Several companies have extended modest numbers of options to all employees, with positive effects. But compensation guru Frederic W. Cook of Frederic W. Cook Co., a 30-year consultant in the field, suggests going much further. He argues that, "Since 1981, the average total shareholder return for the S&P 500 stocks has been 17 percent, while the average increase in pay and benefits has been 4 percent. He asks, "How long can a significant gap between returns to shareholders and to employees continue without negative social consequences that would be detrimental to all"?

  Cook's answer is to double — to 20 percent — the shareowner's normally "accepted" level of up to 10 percent dilution from stock options. The first 10 percent would be for new "all-employee" options on top of the historically acceptable second 10 percent for top executives. Cook argues that by balking as they do at more than 10 percent dilution from employee options, "shareowners are applying old standards to new situations. By being unwilling to share more than a limited portion of the returns they (shareowners) are receiving with the employees who help create them . . . they risk the creation of conflict between employees and investors that will hurt investors' returns in the long run." Of course, compensation gurus may be somewhat more courageous than the CEO who has to sell this program to shareowners. But directionally, his idea makes sense. And imagine how much better it would be than a proposal one day by Congress for something called "The Fairness in Options Act," which might provide that all options approved by shareowners must be distributed proportionally, or even equally, to all employees.

- *Increase opportunities for decentralized entrepreneurism* by carving out *real* financial rewards for outstanding group performance by lower-level employees. The rather modest sums made available today in most companies won't get the job done. Most profit-sharing plans have just token payments, even when individual or group results are extraordinary.

What is not *unlikely is massive government tinkering around the edges — and business* can *take steps to prevent* that.

- *Develop much greater attention to lower- and middle-level management issues.* Install "lifetime-training" programs to make the employees more valuable within the company — but also more valuable to themselves if circumstances require them to look for work elsewhere. Pay much greater attention to lifestyle issues like flex and free time. A significant increase in opportunities for "during work hours" community service might be another worthwhile lifestyle accommodation. These voluntary programs are extremely popular with many employees who may increasingly see them as a way to help restore today's diminished sense of community. They may also see them as an outlet for relief of work stress, without further impinging on limited free time for working parents. Most basic of all, consider increased pay levels — higher salaries as a quid pro quo for the greater responsibilities people have taken on in de-layered organizations. Higher salaries also indicate recognition of the loss of hierarchical advances, which are fast disappearing in these new streamlined organizations.

- *Develop diversity programs that really work* for moving people into top management. The modest aggregate numbers of advances to senior levels clearly demonstrate that the efforts of the past decade or more haven't produced. Women and minorities are underrepresented in top management.
- *Increase corporate involvement in public education.* While this issue didn't make it to the list of federal interventions to watch out for, in the long run this is the only answer to providing quality work opportunities in a competitive international environment. And it is desperately needed to ensure adequate numbers of future domestic customers with real purchasing power. This is hardly a new idea — but despite years of corporate effort, the schools seem little improved. Few would tolerate these results in their own business. Increasingly, education *is* our own business.

At the board of directors level:

- *Bring increased attention to societal needs.* Directors might consider establishing an active "Social Responsibility Committee" of the board that goes well beyond the usual focus of these kinds of committees on corporate philanthropy. Instead, the committee would regularly assess the impact of the corporation on *all* its stakeholders and be a voice to urge balance.
- *Consider board establishment of a "nonexecutive chairman."* While this move is likely to be "more form than substance," it could go a long way to silencing critics of alleged passive boards.
- *Move to truly independent directors on compensation and related committees.* Most companies have already done this — but just enough have not, thus keeping this issue alive. It is easily remedied.

In the public policy and communications areas:

- *Increase political activity at all employee levels* — not just for legislative crises — but, rather in the early formative stages of issues. The voice of business is too often missing when ideas for action are just beginning to percolate in government.
- Change the "conversation" on the so-called corporate quarterly earnings syndrome. *Publicize the long-term actions that the firm is taking — every day.*
- *Speak out on the already heavy and expensive intrusion of government*

in excessive regulation and social mandates placed on corporations. Help the public understand that these costly impositions share some of the blame for the shift of jobs outside this country.

- *Develop and publicize data on the hundreds of thousands of jobs created* by outsourcing staff services and other functions. Many of these jobs go to small businesses and start-up companies, the kind of firms generally credited as job creators. Outsourcing does not necessarily mean job killing.
- *Remind the public and government that corporations are not impersonal and monolithic entities.* Point out that, increasingly, corporations take inputs, add value to them, and pass the gains to the *real* owners — retirees, who own some two-thirds of publicly traded stocks.

Rewards of a Preemptive Strike

Imposition of social policy on corporations is not free. It is better debated openly in the tax arena than imposed in burdens on retirees' security or hidden in consumer taxes called price increases.

Install "lifetime-training" programs to make the employees more valuable within the company — but also more valuable to themselves.

These and many other ideas can help forestall major new government intervention in business. Much on this list has a moderate price tag and can bring several-fold returns. Indeed, *all* of this preemptive menu is currently practiced in varying degrees by some American corporations, but obviously, not enough to defuse the issue.

However, it is the *widespread and voluntary* adoption of employee and governance-improvement practices and improved public communication that can bring the real impact. Groups such as the Business Roundtable, the Business Council, the Chamber of Commerce, and others can be useful forums for bringing the issue of potential new federal intervention and ideas like these to the table for consideration.

Companies are infinitely better equipped to respond sensibly to today's pressures on behalf of all the stakeholders — before the "one-size-fits-all" feds do it for them.

There is a certain justifiable logic to the idea now taking hold — that if employers, more than ever, will be defining society's well-being, then with it comes added responsibility. And in the end, embracing voluntary changes in corporate governance is nothing more than enlightened self-interest. Taking action now can pay off for the shareowners and *all* the stakeholders.

Just consider the alternatives!

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