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Corporate Governance Matters

A Closer Look at Organizational Choices and Their Consequences

Third Edition

David Larcker
Brian Tayan

Pearson
To Sally, Sarah, and Daniel,

Jack, Louise, and Brad,

Michelle and Rita

Nick
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Contents at a Glance

Preface ................................................................. xviii

Chapter 1  Introduction to Corporate Governance ................. 1
Chapter 2  International Corporate Governance ..................... 19
Chapter 3  Board of Directors: Duties and Liability .................. 55
Chapter 4  Board of Directors: Selection, Compensation, and Removal ... 79
Chapter 5  Board of Directors: Structure and Consequences ........... 109
Chapter 6  Strategy, Performance Measurement, and Risk Management ........ 151
Chapter 7  CEO Selection, Turnover, and Succession Planning ........... 181
Chapter 8  Executive Compensation and Incentives .................. 211
Chapter 9  Executive Equity Ownership ............................. 251
Chapter 10 Financial Reporting and External Audit .................... 285
Chapter 11 The Market for Corporate Control .......................... 319
Chapter 12 Shareholders and Shareholder Activism .................... 351
Chapter 13 Stakeholders and Stakeholder Activism .................... 391
Chapter 14 Corporate Governance and ESG Ratings .................. 425
Chapter 15 Alternative Models of Governance ....................... 449
Chapter 16 Summary and Conclusions .............................. 473
Index ..................................................................... 481
# Contents

<table>
<thead>
<tr>
<th>Preface</th>
<th>xvi</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Chapter 1</strong> Introduction to Corporate Governance</td>
<td>1</td>
</tr>
<tr>
<td>Self-Interested Executives</td>
<td>4</td>
</tr>
<tr>
<td>Defining Corporate Governance</td>
<td>8</td>
</tr>
<tr>
<td>Corporate Governance Standards</td>
<td>9</td>
</tr>
<tr>
<td>Best Practice or Best Practices? Does “One Size Fit All”?</td>
<td>12</td>
</tr>
<tr>
<td>Relationship between Corporate Governance and Firm Performance</td>
<td>13</td>
</tr>
<tr>
<td>Endnotes</td>
<td>15</td>
</tr>
<tr>
<td><strong>Chapter 2</strong> International Corporate Governance</td>
<td>19</td>
</tr>
<tr>
<td>Capital Market Efficiency</td>
<td>19</td>
</tr>
<tr>
<td>Legal Tradition</td>
<td>22</td>
</tr>
<tr>
<td>Accounting Standards</td>
<td>23</td>
</tr>
<tr>
<td>Enforcement of Regulations</td>
<td>25</td>
</tr>
<tr>
<td>Societal and Cultural Values</td>
<td>26</td>
</tr>
<tr>
<td>Individual National Governance Structures</td>
<td>28</td>
</tr>
<tr>
<td>United States</td>
<td>29</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>31</td>
</tr>
<tr>
<td>Germany</td>
<td>35</td>
</tr>
<tr>
<td>Japan</td>
<td>37</td>
</tr>
<tr>
<td>South Korea</td>
<td>40</td>
</tr>
<tr>
<td>China</td>
<td>41</td>
</tr>
<tr>
<td>India</td>
<td>43</td>
</tr>
<tr>
<td>Brazil</td>
<td>44</td>
</tr>
<tr>
<td>Russia</td>
<td>46</td>
</tr>
<tr>
<td>Endnotes</td>
<td>47</td>
</tr>
<tr>
<td>Interlude</td>
<td>53</td>
</tr>
<tr>
<td><strong>Chapter 3</strong> Board of Directors: Duties and Liability</td>
<td>55</td>
</tr>
<tr>
<td>Board Responsibilities</td>
<td>55</td>
</tr>
<tr>
<td>Board Independence</td>
<td>56</td>
</tr>
</tbody>
</table>
Contents

The Operations of the Board ......................................... 57
  Board Committees ..................................................... 60
Duration of Director Terms ............................................ 64
Director Elections ....................................................... 64
Removal of Directors ................................................... 66
Legal Obligations of Directors ......................................... 66
  Fiduciary Duty ........................................................... 67
  Environmental, Social, and Governance (ESG) ......................... 70
  Disclosure Obligations under Securities Laws ........................ 71
  Legal Enforcement of State Corporate Law (Fiduciary Duties) ...... 72
  Legal Enforcement of Federal Securities Laws ......................... 73
  Director Indemnification and D&O Insurance ........................ 73
Endnotes ................................................................. 75

Chapter 4  Board of Directors: Selection, Compensation, and Removal .... 79

Market for Directors .................................................... 79
  Criteria for Director Recruitment ..................................... 80
  Active CEOs ............................................................. 81
  International Experience ............................................... 82
  Special Expertise ....................................................... 82
  Diverse Directors ...................................................... 84
  Professional Directors ............................................... 85
  Disclosure Requirements for Director Qualifications ................. 86
Director Recruitment Process .......................................... 87
Director Compensation .................................................. 90
  Ownership Guidelines ............................................... 95
  Board Evaluation ...................................................... 96
Removal of Directors ................................................... 98
Endnotes ................................................................. 102

Chapter 5  Board of Directors: Structure and Consequences ............... 109

Board Structure .......................................................... 110
  Chairman of the Board ............................................... 113
  Lead Independent Director .......................................... 116
  Outside Directors ..................................................... 119
  Board Independence .................................................. 122
Chapter 6  Strategy, Performance Measurement, and Risk Management

Organizational Strategy ......................................................... 151
Strategy Implementation Process ........................................... 154
Business Model Development and Testing .............................. 156
  Example 1: Fast-Food Chain and Employee Turnover ............ 156
  Example 2: Financial Services Firm and Investment Advisor Retention ........................................... 158
Key Performance Measures ................................................... 159
How Well Are Boards Doing with Performance Measures and Business Models? .......................... 162
Risk and Risk Management .................................................. 164
Risk and Risk Tolerance ....................................................... 165
Risk to the Business Model .................................................. 166
Risk Management ............................................................... 169
Oversight of Risk Management ............................................ 172
Assessing Board Performance on Risk Management .............. 174
Cybersecurity ...................................................................... 175
Endnotes ............................................................................. 177

Chapter 7  CEO Selection, Turnover, and Succession Planning ..................................................... 181

Labor Market for Chief Executive Officers ............................. 181
# Labor Pool of CEO Talent

- [CEO Turnover](#) ............................................. 186
- [Newly Appointed CEOs](#) ................................. 191
- [Models of CEO Succession](#) ............................ 193
  - External Candidate ........................................... 193
  - President and/or Chief Operating Officer ............. 195
  - Horse Race .................................................... 196
  - Inside–Outside Model ....................................... 197
- The Succession Process ..................................... 197
- How Well Are Boards Doing with Succession Planning? 201
- Executive Search Firms ..................................... 203
- Endnotes ....................................................... 205

## Chapter 8 Executive Compensation and Incentives 211

- The Controversy over Executive Compensation ......... 212
- Competing Theories of CEO Pay ........................... 213
- Components of Compensation ............................. 214
- Determining Compensation ................................ 218
- Compensation Consultants ................................. 221
- Compensation Levels ....................................... 221
- Ratio of CEO Pay to Other Top Executive Pay .......... 226
- Ratio of CEO Pay to Average Employee Pay .......... 229
- Compensation Mix. .......................................... 230
- Short-Term Incentives ....................................... 233
- Long-Term Incentives ........................................ 235
- Benefits and Perquisites ................................... 237
- Compensation Disclosure ................................... 238
- Say-on-Pay ..................................................... 239
- Competing Theories of CEO Pay ........................... 242
- Endnotes ....................................................... 243

## Chapter 9 Executive Equity Ownership 251

- Equity Ownership and Firm Performance ................ 251
- Equity Ownership and Risk ................................ 254
- Equity Ownership and Agency Costs .................... 259
- Accounting Manipulation ................................... 260
Manipulation of Equity Grants ........................................... 261
Other Examples of Value Extraction through Timing .............. 263
Equity Sales and Insider Trading ...................................... 264
Rule 10b5-1 .................................................................. 267
Hedging ...................................................................... 269
Pledging .................................................................. 273
Repricing and Exchange Offers ........................................ 274
Endnotes .................................................................. 277

Chapter 10  Financial Reporting and External Audit ............... 285
The Audit Committee ...................................................... 285
Accounting Quality, Transparency, and Controls ................. 286
Financial Reporting Quality ............................................. 288
   Non-GAAP Reporting .................................................. 290
Financial Restatements .................................................. 291
Models to Detect Accounting Manipulations ....................... 297
The External Audit ........................................................ 299
Audit Quality .............................................................. 302
Structure of Audit Industry ............................................. 302
Impact of Sarbanes–Oxley ............................................... 305
External Auditor as CFO ............................................... 307
Auditor Rotation .......................................................... 308
Endnotes .................................................................. 310

Chapter 11  The Market for Corporate Control ....................... 319
The Market for Corporate Control ..................................... 320
Stock Market Assessment of Acquiring and Target Firms ...... 324
   Who Gets Acquired? ..................................................... 324
   Who Gets the Value in a Takeover? ............................... 327
Antitakeover Protections ................................................ 330
Antitakeover Actions ..................................................... 331
   Poison Pills ............................................................. 333
   Staggered Board ....................................................... 335
   State of Incorporation ............................................... 337
   Dual-Class Shares .................................................... 339
Warding Off Unwanted Acquirers ...................................... 341
Endnotes .................................................................. 344
Chapter 12  Shareholders and Shareholder Activism .......................... 351
The Role of Shareholders .............................................351
Blockholders and Institutional Investors ...........................354
Institutional Investors and Proxy Voting ..........................357
Activist Investors ......................................................359
Pension Funds ..........................................................361
ESG and Socially Responsible Investing ...........................363
Individual Activist Investors ........................................364
Activist Hedge Funds ..................................................366
The Rise of Index Investing ...........................................370
Shareholder Democracy and Corporate Engagement ..........371
Majority Voting in Uncontested Director Elections ...............371
Proxy Access ..............................................................372
Proxy Voting ..............................................................372
Corporate Engagement .................................................374
Proxy Advisory Firms ..................................................375
Endnotes ......................................................................381

Chapter 13  Stakeholders and Stakeholder Activism ......................... 391
Pressure to Incorporate Stakeholder Interests .....................392
Legal and Economic Implications ..................................397
Director and CEO Views on Stakeholders .........................401
ESG Metrics and Disclosure .........................................402
External Assessment of ESG .........................................407
Endnotes ......................................................................417

Chapter 14  Corporate Governance and ESG Ratings ....................... 425
Third-Party Ratings .....................................................425
Credit Ratings ..............................................................426
Commercial Corporate Governance Ratings .....................428
   ISS: Corporate Governance Quotient ..........................428
   ISS: Governance Risk Indicators ...............................430
   ISS: QualityScore ....................................................430
MSCI ESG Governance Metrics ....................................431
Testing the Predictability of Corporate Governance Ratings ..432
Governance Rating Systems by Academic Researchers ........433
The Viability of Governance Ratings ......................... 438
ESG Ratings .................................................. 439
MSCI ESG ...................................................... 440
Sustainalytics ................................................... 441
Vigeo Eiris ....................................................... 442
HIP (Human Impact + Profit) ................................. 442
ISS E&S Disclosure QualityScore ............................. 442
TruValue Labs .................................................. 443
Evaluation of ESG Ratings ..................................... 443
Endnotes .......................................................... 444

Chapter 15  Alternative Models of Governance ................. 449
Family-Controlled Corporations ............................... 449
Venture-Backed Companies .................................... 452
Private Equity-Owned Companies ............................. 458
Nonprofit Organizations ....................................... 462
Endnotes .......................................................... 466

Chapter 16  Summary and Conclusions ........................... 473
Testing Remains Insufficient. .................................. 474
The Current Focus Is Misdirected ............................. 475
Important Variables Are Clearly Missing .................... 476
Context Is Important ......................................... 477
Rights of Shareholders and Stakeholders .................... 478
Endnotes .......................................................... 478

Index ..................................................................... 481
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Additional resources and supporting material for this book are available at:

- Stanford Graduate School of Business
- The Corporate Governance Research Initiative
- www.gsb.stanford.edu/cgri-research
Preface

This is a book about corporate governance, written from an organizational perspective. It is intended for practitioners and aspiring practitioners who are interested in improving governance systems in their organizations. Unlike many other books on governance, this book is not written primarily from a legal perspective. Although we describe the legal obligations of selected organizational participants, our objective is not to rehash legal constructs. Books written by trained lawyers are much better for that purpose, and many fine works explain these obligations for the practitioner. Instead, our purpose is to examine the choices that organizations can make in designing governance systems and the impact those choices have on executive decision making and the organization’s performance. This book is therefore relevant to corporate directors, executives, institutional investors, lawyers, and regulators who make organizational decisions.

Corporate governance is a topic that suffers from considerable rhetoric. In writing this book, we have attempted to correct many misconceptions. Rather than write a book that is based on opinion, we use the knowledge contained in the extensive body of professional and scholarly research to guide our discussion and justify our conclusions. This approach does not always lead to simple recommendations, but it has the advantage of being grounded in factual evidence. As you will see, not every governance question has been the subject of rigorous empirical study, nor is every question amenable to a simple solution. There are gaps in our knowledge that will need to be addressed by further study. Still, we hope this book provides a framework that enables practitioners to make sound decisions that are well supported by careful research.

In each chapter, we focus on a particular governance feature, describe its potential benefits and costs, review the research evidence, and then draw conclusions. Although the book is written so that it can be read from cover to cover, each chapter also stands on its own; readers can select the chapters that are most relevant to their interests (board structure, CEO succession planning, executive compensation, and so on). This book—along with our set of associated case studies and teaching materials—is also suitable for undergraduate and graduate university courses and executive education programs.

We believe it is important for organizations to take a deliberate approach in designing governance systems. We believe this book provides the information that allows them to do so.
The governance mechanisms discussed in this book so far have been considered from a shareholder-centric perspective. A fundamental premise throughout is that the primary purpose of a corporation is to create value for shareholders and the obligation of a board is to ensure this purpose is achieved. Chapter 3 outlines board operations and fiduciary duties from this standpoint. Chapter 6 evaluates strategy development and risk management with this objective in mind. Chapter 11 accepts the premise that an effective market for control facilitates the transfer of corporate assets to owners who will derive the highest value from them. Many of the empirical studies discussed in this book measure the effectiveness of governance mechanisms by their impact on shareholder value and corporate profitability, and the central definition of corporate governance that we employ—that a separation between the ownership of a company and its management creates opportunity for self-interested managers to take actions that benefit themselves at the expense of shareholders—is rooted in the premise that preserving shareholder value is a primary objective.

An alternative viewpoint, however, exists—that a corporation should exist not only to increase value for shareholders but also to address the needs of other (non-shareholder) stakeholders. These stakeholders include employees, trade unions, customers, suppliers, local communities, and society. In this chapter, we turn to this issue. We start with an overview of the pressures that corporate managers face to incorporate stakeholder objectives into their planning, including pressures that come from their own shareholder base. We discuss the legal and economic implications of a stakeholder-centric governance model, including its potential impact on strategy, risk, and value creation. Then we examine how corporate managers and directors view their obligations to stakeholders, and discuss the recent trend of CEO activism on social issues. We end with a discussion of the metrics used to track a corporation’s progress toward achieving social goals—including those developed by third-party rating providers—and their effectiveness.

As we will see, managing a corporation from a stakeholder perspective is not a simple undertaking and highlights a fundamental tension that has long existed in corporate
boardrooms: how to balance competing interests to ensure the success of the organization over the long term.

**Pressure to Incorporate Stakeholder Interests**

In 1970, economist Milton Friedman famously argued that a company’s only social responsibility is to maximize shareholder value. He argued that corporate executives are employed by the owners of the firm (shareholders) and their obligation is to manage the business in accordance with the wishes of their employer—that is, to increase its value under the constraints of the law and accepted ethical standards. When other purposes are added to the equation, they require trading off this objective by diverting resources to a purpose that the owners of those resources have not approved, with the cost borne by shareholders through lower profit, customers through higher prices, and workers through lower wages and employment.\(^1\)

Despite Friedman’s argument, pressure has grown on large, publicly traded firms to incorporate stakeholder interests into their long-term planning. Without providing an exhaustive list, *stakeholders* include employees of the firm, customers, suppliers, creditors, trade unions, local communities, and society at large. The interests of these groups are broad and include environmental sustainability, reduction in waste or pollution, higher wages, workplace equality, diversity, providing access to groups who cannot afford products or services, and being a responsible counterparty or local citizen. Because companies operate in different industries, stakeholders and stakeholder interests differ across corporations. When we talk about stakeholder interests, we generally refer to the most directly relevant issues—such as climate change for energy producers, product waste for goods manufacturers, or affordability for healthcare providers. In some cases, the social interest is assumed to be common across companies, one example being diversity.

Various labels have been applied over time to describe corporate and investor efforts to address stakeholder needs. These include *socially responsible investing (SRI), corporate social responsibility (CSR), and environmental, social, and governance (ESG).*

Pressure for corporations to address stakeholders’ interests has come from multiple fronts:

- **Money flowing into sustainable investment funds**—In 1995, less than $1 trillion was invested with money managers and institutional investors dedicated to sustainable, responsible, and impact investing in the U.S. By 2018, that number exceeded $12 trillion (see Figure 13.1).\(^2\)
13 • Stakeholders and Stakeholder Activism

Figure 13.1  Sustainable and responsible investing in the U.S.

- **ESG-related proxy proposals**—The number of shareholder-sponsored proxy proposals relating to ESG considerations has generally increased in time and the percent of shares voted in favor of these proposals has also increased (see Figure 13.2).³


Figure 13.2  Shareholder-sponsored proxy proposals on ESG-related topics.

Note: The decline in shareholder-sponsored proxy proposals in 2018 was the result of higher direct engagement between companies and sponsoring shareholders.

Source: FactSet. Calculations by the authors in David F. Larcker, Brian Tayan, Vinay Trivedi, and Owen Wurzbacher, “Stakeholders and Shareholders: Are Executives Really ‘Penny Wise and Pound Foolish’ About ESG?”

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• **Institutional investors**—Large institutional investors that had previously taken passive stances on ESG-related issues have become more assertive. For example, each of the “Big Three” index funds—BlackRock, Vanguard, and State Street Global Advisors—have engaged in advocacy campaigns in recent years to shape the governance practices of their portfolio companies in areas relating to social responsibility. (We discuss this more fully later.)

• **ESG metrics**—Data providers use survey data and publicly observable metrics to rate companies along a variety of stakeholder dimensions. This data is sold to institutional investors to inform investment decisions or is used in magazine rankings. Examples of data providers include MSCI, HIP (“Human Impact + Profit”), and TruValue Labs. Examples of published indices include Barron’s 100 Most Sustainable Companies, Bloomberg Gender Equality Index, Ethisphere Institute’s Most Ethical Companies, and Newsweek Top Green. The Sustainability Standards Board (SASB) has tried to standardize the reporting of these metrics. (We discuss ESG measurement more fully later and in Chapter 14.)

• **Employee activism**—Employees of some companies have become more vocal expressing their views to management on environmental or social issues. Social media and internal corporate communications platforms have facilitated this process. Employee activism has forced companies to change corporate policy, withdraw from commercial activities, and take public stances on societal issues about which the company might traditionally remain silent (see the following sidebar).

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### Employee Activism

**Microsoft**

In 2018, more than 100 employees protested the company’s work with U.S. Immigration and Customs Enforcement (ICE), writing in a letter to management that “Microsoft must take an ethical stand and put children and families above profits.” The company, which provided data processing and artificial intelligence capabilities to ICE, said that it was not aware of its products being used for unethical purposes. Still, it expressed “dismay” over U.S. immigration policy, and CEO Satya Nadella called certain border enforcement practices “cruel and abusive.”

---
Amazon
In 2019, more than 4,000 employees signed a letter to senior leadership calling on Amazon to take a more aggressive stance in combatting climate change. The letter asked management to make firm commitments to reduce its carbon footprint. It also asked the company to support a shareholder-sponsored proxy resolution on climate reporting. The company responded by highlighting initiatives underway to reduce carbon emissions in its distribution network. The company did not support the proxy resolution, which did not pass.  

Google
Over the years, Google has faced multiple instances of employee activism. In 2018, employees protested work the company performed for the U.S. Defense Department, causing Google not to renew the contract. That same year, employees staged a walkout over reports that Google had paid severance to senior executives accused of harassment. Workers have also engaged in internal debate on social and political topics, and some have protested speakers invited to speak in company offices. Google developed guidelines to moderate internal discussion groups, saying it would discipline employees whose discussions are “disruptive to a productive work environment.”

Of these sources, institutional investors have played a particularly prominent role promoting stakeholder interests. Beginning in 2014, Vanguard launched a program of direct engagement with portfolio companies to discuss governance-related topics. It dubbed this program “quiet diplomacy.” Vanguard subsequently included ESG criteria in this effort. In 2017, State Street Global Advisors launched what it called the “Fearless Girl” campaign to advocate that its portfolio companies increase the number of women on their boards.

BlackRock has been the most vocal of the Big Three investors to advocate that companies give greater consideration to stakeholder interests. For the last several years, BlackRock CEO Larry Fink has written an annual letter to the CEOs of the companies in BlackRock’s investment portfolio, encouraging them to address a variety of stakeholder-related issues. In 2016, he advocated they lay out “a strategic framework for long-term value creation” and stated that “generating sustainable returns over time requires a sharper focus not only on governance, but also on environmental and social factors.” The next year, he encouraged greater attention to “long-term sustainability” and discussed such topics as globalization, wage inequality, tax reform, and a more secure retirement system for workers. In 2018, he argued that a company needs to have a “sense of purpose” that...
serves all stakeholders and that “to prosper over time, every company must not only deliver financial performance but also show how it makes a positive contribution to society.” In 2019, he argued that “purpose and profit are inextricably linked” and that purpose is “the animating force” to create stakeholder value. In 2020, he announced that BlackRock was putting “sustainability at the center of our investment approach” and asked companies to disclose more information on their sustainability efforts, including climate change.

Because of BlackRock’s size and ownership stake, it is positioned to influence corporate practice: In 2018, it held more than 7 percent of the equity value of the Russell 3000 Index and had an ownership position greater than 5 percent in almost every company in the S&P 500 Index (see the following sidebar).

Is BlackRock the New ISS?

The evidence presented in Chapter 12 demonstrates the influence that Institutional Investor Services (ISS) has on shareholder voting and corporate practices. Because of BlackRock’s size and ownership position across U.S. companies, is BlackRock similarly positioned to influence corporate decision making?

In his 2020 letter, CEO Larry Fink makes clear that his firm “will be increasingly disposed to vote against management and board directors when companies are not making sufficient progress on sustainability-related disclosures and the business practices and plans underlying them.”

This advocacy raises several questions: How does BlackRock determine whether its advocacy stances on stakeholder issues are value increasing to shareholders? Does empirical evidence support this conclusion or is it driven by normative assumptions about how companies “should” behave? Are the company’s advocacy positions consistent with its fiduciary responsibilities, given that it does not own shares in these companies itself but instead on behalf of beneficial owners? How should the views of the CEO of an investment company with more than $7 trillion under management influence the voting behavior across a firm’s entire investment portfolio?

Despite Fink’s advocacy of stakeholder issues, the firm has made investments that conflict with some of the positions put forward in his annual letter. For example, in 2019, BlackRock invested in a $12 billion inaugural bond offering by Saudi Arabian oil company Aramco, despite that company’s contribution to carbon emissions. Of the bond offering, Fink said “We wanted [it] to be much bigger.” Regarding investment in Saudi Arabia, he said, “The region is not perfect, no region is perfect. The fact that there are issues in the press doesn’t tell me I should run from a place, it tells me we should run to a place.”
In response to pressure from these sources, more than 180 CEOs affiliated with the Business Roundtable agreed to revise the association’s statement on the purpose of a corporation, to emphasize a commitment to all stakeholders and not just shareholders. According to the association:

Since 1978, Business Roundtable has periodically issued Principles of Corporate Governance that include language on the purpose of a corporation. Each version of that document issued since 1997 has stated that corporations exist principally to serve their shareholders. It has become clear that this language on corporate purpose does not accurately describe the ways in which we and our fellow CEOs endeavor every day to create value for all our stakeholders, whose long-term interests are inseparable.

Under the revised statement, association members commit to:

- Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.
- Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.
- Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.
- Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.
- Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.\(^\text{17}\)

We discuss the implications of this commitment next.

**Legal and Economic Implications**

It is not clear what tangible impact a commitment to stakeholders has on the manner in which a corporate director advises and oversees management and the corporation. Fiduciary duty under Delaware law requires that shareholder considerations be primary. The adoption of ESG-related principles does not change this.\(^\text{18}\) According to Delaware Supreme Court Chief Justice Leo E. Strine, Jr:

[A] clear-eyed look at the law of corporations in Delaware reveals that, within the limits of their discretion, directors must make stockholder welfare their sole end, and that other interests may be taken into consideration only as a means of promoting stockholder welfare.\(^\text{19}\)
Similarly, former Chancellor William B. Chandler III of the Delaware Court of Chancery wrote:

I cannot accept as valid … a corporate policy that specifically, clearly and admittedly seeks not to maximize the economic value of a for-profit Delaware corporation for the benefit of its shareholders.\(^{20}\)

Nevertheless, Delaware law does allow stakeholder considerations to be taken into account to the extent that they protect the value of a firm or decrease its long-term risk. According to Skadden Arps:

The shareholder primacy path does not preclude a for-profit company from taking social issues into account in the conduct of its business. What is required to stay on the path is that the company’s consideration of those social issues have a sufficient nexus to shareholder welfare and value maximization.\(^{21}\)

In evaluating a stakeholder’s need, the board is expected to gather reasonably available material, evaluate the costs and benefits, and make a decision in a disinterested manner in the best economic interest of shareholders—just as it does all other business decisions. The board’s decision then falls under protection of the business judgment rule.\(^{22}\)

As such, it is not clear that the board of a company that explicitly adopts ESG-related principles can or would make substantially different economic decisions than a corporation that does not. In order for a board to make a decision that reduces economic outcomes for shareholders to benefit other stakeholders, a fundamental change to corporate law would have to occur. (Some politicians have advocated such a change.)\(^{23}\) If the decision does not reduce outcomes, then it could be argued that the decision-making framework of a board that adopts ESG-related principles is no different than the standard decision-making framework that directors currently and have historically employed. ESG is just a different strategic approach to achieving similar economic ends. (The Business Roundtable statement cited earlier appears to walk this line when it says that the long-term interests of shareholders and stakeholders are inseparable. Many ESG-related initiatives also appear to walk this line. See the following sidebar.)

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**Is It Really ESG?**

Corporations tout public initiatives to demonstrate their commitment to environmental and social issues. Many initiatives, however, are closely aligned with the company’s existing business model. Are these examples of management willing to invest in costly initiatives to address a stakeholder need, or do they represent decisions under a standard framework to increase shareholder value by mitigating potential risk?
The Coca-Cola Company

In 2018, Coke announced a sustainability initiative called “World Without Waste.” The company, which has been criticized by environmental groups for generating plastic waste, set a goal of collecting and recycling the equivalent of 100 percent of its packaging by 2030. According to its CEO, “The world has a packaging problem—and like all companies, we have a responsibility to help solve it.”

Republic Services

In 2019, management company Republic Services announced aggressive goals to reduce its climate footprint, reduce waste, and increase safety and charitable giving as part of its 2030 Sustainability Goals. The company has been recognized by third-party rating associations for its progress on these measures. According to its CEO, “We actually think so much about this that we formed an additional committee in our board of directors called sustainability and corporate responsibility to look at things like sustainability, things like safety, things like environmental impact. … Sustainability matters, and we think it’s good for business, and our customers are telling us that they will pay more for a company that actually takes this seriously.”

Gilead

Like many pharmaceutical companies, Gilead offers a payment assistance program to make the company’s products affordable to low-income patients. In 2013, the company received approval to market and sell Sovaldi, the world’s first treatment to cure Hepatitis C. Under Gilead’s payment assistance program, “Most eligible patients will pay no more than $5 per co-pay.” The list price of the drug charged to payment providers, however, was $1,000 per pill, or $85,000 for the full regimen.

Corporate executives need to make rational strategic and investment decisions for both the short and long term. The debate about the importance of ESG hinges on the time horizon that public company executives use to make those investment decisions (and, by extension, the board of directors that approves those decisions). ESG advocates contend that companies, motivated by compensation incentives and shareholder activism, are too short-term oriented and do not make sufficient investment in important stakeholder groups (such as employees, customers, suppliers, or environmental preservation) because they are overly focused on quarterly profit maximization to increase the current share price. As a result, their business model is presumed to be unsustainable: At some point in the future, this lack of investment will either lead to a deterioration in performance or contribute to a societal ill that the company is forced to redress through government action (an externality). An important assumption underlying these claims is that shareholders do not notice the damage being done to the company today and will bid the stock price
up based on current earnings without accurately pricing in the long-term risk created by foregone investment.

The solution to the problem, when framed this way, is to create more sustainable companies. This explains in part the advocacy of BlackRock and its emphasis on “sustainable, long-term growth.” It also explains the support for ESG-related initiatives by prominent corporate law firms such as Wachtell, Lipton, Rosen & Katz, which urges companies to reject a “short-term myopic approach” and embrace “sustainable improvements … [that] systematically increase rather than undermine long-term economic prosperity and social welfare.”

Unfortunately for those who want to resolve the issue, robust empirical evidence does not exist to evaluate the claim of whether CEOs are too short-term oriented. (We discuss the viewpoints of executives and directors on this question in the next section.) Denis (2019) reviewed research evidence on shareholder investment horizon, shareholder activism, corporate investment, and shareholder reaction to corporate investment over a three-decade period and concluded that “there is little systematic evidence to suggest that short-termism is a pervasive problem plaguing U.S. companies.”

Ioannou and Serafeim (2019) found that sustainability initiatives are adopted first by market leaders and then spread over time to become common industry practice. Sustainability initiatives contribute most positively to corporate performance when environmental and social issues are relatively more important in the industry. They concluded that sustainability initiatives are strategic choices.

The impact of a stakeholder orientation on corporate governance is also uncertain. Jensen (2002) argued that stakeholder theory allows managers to design their own objective functions and run firms in their own interests. That is, a stakeholder orientation has the potential to increase agency costs by replacing a measurable objective (shareholder value) with a less measurable objective (stakeholder value). Mehrotra and Morck (2017) argued that shareholder value maximization constitutes a bright line to evaluate performance, “whereas stakeholder welfare maximization is an ill-defined charge … that gives self-interested insiders broader scope for private benefits extraction.” Similarly, Bebchuk and Tallarita (2020) contended that a stakeholder orientation insulates management from shareholders, reduces accountability (by lessening financial performance as a disciplining mechanism), and harms economic performance. They concluded that a stakeholder orientation has the potential to be costly to shareholders, stakeholders, and society alike, and counterproductive to the objective of advancing the very interests that ESG advocates embrace.

Note, these are theoretical arguments. It is likely that companies that adopt a stakeholder orientation do so out of a variety of motives and experience a variety of outcomes from their initiatives. The impact of requiring a stakeholder orientation on all firms through a change to corporate law, however, is likely negative. We return to this question at the end of the chapter.
Director and CEO Views on Stakeholders

We have seen the pressures that companies face to adopt stakeholder-friendly initiatives and the legal and economic implications of these initiatives. What are the viewpoints of corporate directors and executives on this issue? Survey data suggests that they embrace the concepts behind advancing stakeholder interests and generally are satisfied with the decisions their companies make to address stakeholder needs within the constraints of maximizing shareholder value.

A survey of corporate directors from PricewaterhouseCoopers found that many directors accept, at least in part, the concept of a stakeholder orientation. Four out of five directors believe that social purpose and corporate profitability are not mutually exclusive. Three-quarters believe that companies should have a social purpose. A lower but still significant percentage (58 percent) believe that stakeholder needs should be prioritized alongside shareholder needs in making company decisions.

Many directors also believe stakeholder needs should be incorporated—again, in part—into strategic planning and investment. Approximately half believe ESG-related issues should be part of strategic formulation. Slightly more than half (57 percent) say they should be part of the company’s risk management framework. However, as we discussed in Chapter 3, corporate directors believe that some of the external focus on ESG is excessive. Approximately 60 percent believe shareholder focus on board diversity is excessive, 56 percent that the focus on environmental sustainability is excessive, and 47 percent that the focus on corporate social responsibility is excessive.

Corporate executives also appear to embrace the concept of addressing stakeholder needs and claim that they currently do so as part of their long-term planning. They do not agree that increasing shareholder value requires that stakeholder needs be ignored or disregarded. A 2019 survey of more than 200 CEOs and CFOs of companies in the S&P 1500 Index found that almost 90 percent believe stakeholder interests are critical to their long-term planning. Furthermore, very few (23 percent) believe that shareholder interests are significantly more important than stakeholder interests; instead most (77 percent) believe that shareholder interests are only slightly more important or that some level of parity exists between the two. Almost all (96 percent) are satisfied with the job their company does to meet the interests of their most important stakeholders.

The most surprising result of this survey is that very few executives accept the central premise that incorporating a stakeholder orientation into corporate planning requires a trade-off between short-term costs and long-term benefits. In fact, only 12 percent of CEOs and CFOs hold such a view. Instead, most believe either that investing in ESG-related initiatives is costly in both the short and long terms (37 percent)—in which case it is not worth doing at their company—or that ESG initiatives are beneficial in both the short and long terms (28 percent)—in which case the decision requires no trade-off and is not difficult to make.
Finally, many CEOs and CFOs do not believe their largest investors see stakeholder considerations as being in conflict with their financial interests as owners (see the following sidebar).42

These are perception data, but they suggest that in the eyes of corporate decision makers, most companies try to strike an appropriate balance in pursuing shareholder value without imposing harm or cost on stakeholders. Most companies believe they are sustainable.

**BlackRock Speaks. Does Anyone Listen?**

Earlier in the chapter, we described the advocacy efforts of BlackRock CEO Larry Fink who urged companies to pay greater attention to the “long-term sustainability” of their businesses. What is the reaction of CEOs?

A 2019 survey by the Rock Center for Corporate Governance at Stanford University found that 67 percent of CEOs report receiving Larry Fink’s letter. Sixty-eight percent agree with the ideas expressed in his letter—in particular, the notion that companies have an obligation to address broad economic and social issues. Half discussed this letter with the board. However, almost none (87 percent) say the letter led them to evaluate or implement new ESG initiatives.42

These results do not necessarily suggest that shareholders like BlackRock are ineffective in their advocacy efforts. Dimson, Karakas, and Li (2015) studied shareholder engagement activity over the ten-year period 1999–2009. They found that successful engagement on environmental and social issues is followed by positive abnormal returns; unsuccessful engagement has no impact on returns. It is interesting to note that the rate of successful engagement in the study (18 percent) is not significantly different from the percent of CEOs motivated by Fink’s letter (13 percent).43

**ESG Metrics and Disclosure**

The absence of reliable reporting metrics is a considerable obstacle to assessing the degree to which a company invests in stakeholder initiatives and to measuring their effectiveness. A 2020 survey by the National Association of Corporate Directors (NACD) found that lack of uniform disclosure standards was the single greatest challenge directors face in providing oversight of ESG matters. If directors, who have access to nonpublic information, struggle with this challenge, then external observers no doubt struggle even more so.
To increase transparency, some companies are disclosing information about their stakeholder-related initiatives through supplemental reports to their required financial disclosure. Examples include:

- **Sustainability report**—A report that describes the economic, environmental, and social impact of a company’s activities, and describes the link between corporate strategy and sustainable outcomes.

- **Human capital report**—A report that includes qualitative and quantitative information about a company’s workforce, critical skills and expertise requirements, workforce development initiatives, diversity initiatives, training, human resource policies and practices, and trends within the company.

- **Climate change impact report**—A report that enumerates the potential impact of climate change on a company’s governance, strategy, and risk management including metrics and targets to assess and manage climate-change risk. These reports are often developed in accordance with the recommended guidelines of the Financial Stability Board Task Force Recommendations (TCFD).\(^\text{44}\)

In addition to these, some companies voluntarily disclose ESG-related initiatives in the annual proxy. The NACD reports that approximately 23 percent of Russell 3000 companies make a statement on sustainability in their proxy statement, 6 percent on human capital management, and 6 percent on climate change.\(^\text{45}\) ESG disclosure is more prevalent among large corporations. For example, Ernst & Young found that half of the Fortune 100 voluntarily highlight workplace diversity initiatives, and between a quarter and third highlight workplace compensation, culture initiatives, or workplace health and safety initiatives.\(^\text{46}\) Some companies disclose the use of ESG-related metrics in their executive compensation programs (see the following sidebar).

### ESG Disclosure

**Chevron: Corporate Responsibility Report**

Chevron’s corporate responsibility report provides an overview and metrics about its ESG initiatives:

- **Environment**: Protecting the environment, addressing climate change, and managing water resources

- **Social**: Valuing diversity and inclusion, creating prosperity, contributing to the United Nations sustainable development goals, and respecting human rights

- **Governance**: Getting results the right way, prioritizing our culture and operational excellence, operating safely and reliably, and engaging our stakeholders
Examples of performance data in the report include greenhouse gas emissions, water usage, gender and ethnic diversity at different levels of the organization, and safety data.

**IBM: Proxy Disclosure on Climate Risk**

“IBM considers risks as identified by the Financial Stability Board Task Force on Climate-related Financial Disclosures (TCFD) in its risk management process. IBM senior management assesses the significance of environmental and climate-related risks. In addition, they manage these risks and provide regular updates to the Board and to the Directors and Corporate Governance Committee. Furthermore, IBM has established internal objectives and targets for energy conservation, procurement of renewable energy, carbon dioxide (CO2) emissions reduction and other key environmental performance indicators. Performance against these objectives and targets is routinely monitored, and results are reviewed annually by the Board’s Directors and Corporate Governance Committee. Details on IBM’s performance against key environmental performance indicators can be found in our annual IBM and the Environment Report.”

**Clorox: Proxy Disclosure on Product Sustainability**

“We strive to be a leader in responsible product stewardship with a focus on progressive actions to enhance the practices of our company and the consumer packaged goods industry overall.

- We surpassed our product sustainability goal two years early, having made sustainability improvements to 58% of our product portfolio versus our goal of 50% by 2020.

- Across our portfolio, 92% of our primary packaging is recyclable and 85% of our domestic retail sales volume carries the How2Recycle label.

- We’ve eliminated 100% of polyvinyl chloride (PVC) in our U.S. packaging and are on track to achieve our goal to eliminate PVC in packaging globally by the end of 2020.

- In May 2019, leaders from our Burt’s Bees and Glad businesses participated in the inaugural Ocean Plastics Leadership Summit, a forum for developing innovative solutions to the causes of plastic waste.

- Our new IGNITE Strategy furthers our commitment to sustainable products and packaging and includes goals of reducing virgin packaging by 50%, and using 100% recyclable, reusable or compostable packaging and also plastic post-consumer recycled content in packaging.”
Vermilion Energy: Sustainability Skills Matrix

Vermilion Energy lists the experiences required for sustainability oversight and highlights how the skills and experiences of each director map to these requirements.

**Environment:** Greenhouse gas emissions, air quality, waste and wastewater management, ecological impacts, renewable energy

“Larry J. MacDonald: As Chief Operating Officer of Anderson Exploration, had direct responsibility for health, safety and environment, including cold bitumen production; helped initiate an experimental project to re-inject produced sand into existing wells.”

**Social and human capital:** Human rights and indigenous relations, community relations and development, employee health and safety, people management, labor rights

“Robert B. Michaleski: As CEO of Pembina, was responsible for human resources, corporate philanthropy, community engagement and Indigenous relations; personal volunteering as Co-Chair of the Energy section of United Way Cabinet for three years, and a member of United Way Board of Directors for five years, including role as Chair.”

Microsoft: Executive Compensation

Microsoft assigns a 33.3 percent weight to the achievement of culture and organizational leadership goals in awarding executive bonuses.

“Mr. Nadella continued to demonstrate his commitment to evolve Microsoft culture, where his successes include achieving aspirational goals for diversity goals in hiring and retention. In fiscal year 2019, nearly 80% of employees and managers surveyed indicated they understand how to leverage a new core priority for inclusion to contribute towards building a more diverse and inclusive workplace. Moreover, 90% of employees said their managers created an inclusive environment. Work remains to be done to provide additional training and resources for the Company’s mid-level managers and address the needs of the millennial workforce.

Surveys of employee sentiment and Senior Leadership Team feedback show strong support for Mr. Nadella’s cultural push for One Microsoft and Growth Mindset initiatives.”
A lack of rigorous, quantitative, and uniform metrics makes it difficult to assess the quality of stakeholder-related efforts across large samples of companies. Without uniform metrics, companies effectively can choose what variables to report and how to calculate them.

To address this challenge, a nonprofit organization called the Sustainability Accounting Standards Board (SASB) developed a set of standards for companies to make consistent and comparable disclosure about ESG-related issues. These standards are organized into five dimensions: environment, social capital, human capital, business model and innovation, and leadership and governance. Each dimension is further organized into three to seven general-issue categories. Additionally, SASB provides a materiality map to identify the dimensions and general-issue categories that are relevant to each industry. For example, the general-issue category “greenhouse gas emissions” is considered material to the transportation industry but the category “water and wastewater management” is not.51

SASB standards are therefore tailored to each industry and, as a result, a sustainability report compiled by a company in the commercial banking industry would include different metrics from one compiled by the casinos and gaming industry. A commercial bank SASB report includes metrics and disclosure language on financial inclusion through the availability of lending and savings products in underserved communities.52 By contrast, the casino SASB report includes metrics on responsible gaming.53

Despite the similarity of its name to the Financial Accounting Standards Board (FASB) and International Accounting Standards Boards (IASB) that develop the accounting standards used to prepare public financial statements, SASB standards are not officially endorsed by the SEC. As a result, few companies include SASB metrics in their Form 10-K disclosure. Instead, companies that report SASB metrics do so through separate sustainability reports on their website.54

Furthermore, sustainability metrics are generally not audited by a public accounting firm. In some instances, companies will engage independent third-party organizations to certify their report, although the verification procedures of these organizations are not overseen by Public Company Accounting Oversight Board (PBAOC).55 As a result, some shareholder groups are skeptical of the quality of the ESG-related information they receive from companies. PricewaterhouseCoopers found that only 29 percent of investors are confident in the quality of ESG disclosure.56

The research on sustainability reporting is mixed. Christensen, Hail, and Luez (2019) provided a literature review on corporate social responsibility (CSR) reporting. They found that CSR information can benefit capital markets through greater liquidity, lower
cost of capital, and better capital allocation. At the same time, CSR disclosure might also be associated with higher litigation risk. The authors found large variations in disclosure (length and quality) across firms, which likely reflect heterogeneity in firms’ business activities, the materiality of CSR to firms’ activities, and the perceived cost and benefits of disclosure. Because most CSR initiatives and disclosure are voluntary, it is difficult to measure the impact of these on performance and valuation. The authors concluded that mandatory CSR reporting standards “have the potential to improve information to investors and other stakeholders” but the “net effects of a CSR mandate are not a priori obvious.”

**External Assessment of ESG**

Shareholder and stakeholder demand to better understand corporate ESG initiatives has spawned a cottage industry of third-party organizations that publish rankings and ratings of companies on various environmental and social dimensions. Examples of rankings include:

- **Bloomberg Gender-Equality Index**—Measures how companies “invest in women in the workplace, the supply chain, and in the communities in which they operate.”
- **Corporate Responsibility Magazine Best Corporate Citizens**—“Recognizes outstanding environmental, social and governance (ESG) transparency and performance among the 1,000 largest U.S. public companies.”
- **Ethisphere Institute Most Ethical Companies**—“Recognizes [companies] for setting the global standards of business integrity and corporate citizenship.”
- **Fortune Best Workplaces for Diversity**—Ranks companies that “create inclusive cultures for women and people of all genders, people of color, LGBTQ people, employees who are Boomers or older, and people who have disabilities.”
- **Newsweek Green**—Compiles “environmental performance assessments of the world’s largest publicly traded companies.”

Examples of ratings include:

- **FTSE Russell**—“Allows investors to understand a company’s exposure to, and management of, ESG issues in multiple dimensions.”
- **HIP Investor Ratings**—“Derived from quantitative performance measures that demonstrate positive social, environmental and economic outcomes. Higher HIP Ratings also correlate with lower future risk and greater future return potential.”
• **MSCI ESG**—“Helps investors identify environmental, social and governance (ESG) risks and opportunities within their portfolio.”\(^{64}\)

• **Sustainalytics**—“Helps investors identify and understand financially material ESG risks at the security and portfolio level.”\(^{65}\)

• **TruValue Labs**—“Applies artificial intelligence to uncover opportunities and risks hidden in massive volumes of unstructured data, including real ESG behavior that has a material impact on company value.”\(^{66}\)

These ranking and rating organizations employ diverse methodologies. Some rely on information publicly disclosed in financial statements or sustainability reports. Some rely on proprietary surveys distributed to the company or its employees. Others incorporate information derived from the media and event-related press releases. Multiple sources of information are sometimes combined to arrive at the assessment.

We examine the methodologies of selected firms and the predictability of their ratings in greater detail in the next chapter. However, several issues are worth noting here. The first one is the availability of information. Disclosure of ESG data is primarily voluntary, and more information is available about large corporations than small ones—because of their more extensive disclosure practices, larger investor relations departments, and greater media coverage. As such, an ESG rating firm must determine how to evaluate companies with different disclosure practices.

The second issue is how to assign weightings to ESG dimensions to generate an overall score. The concept of ESG includes a broad array of somewhat disparate environmental, social, and ethical issues. A ranking such as the Bloomberg Gender Equality Index makes an assessment of one ESG dimension and so weightings are less of an issue. *Corporate Responsibility Magazine* Best Corporate Citizens, on the other hand, takes a broad view and has to decide how to incorporate difficult-to-relate variables into a single outcome. This includes a determination of how to compute an overall score when an individual data element is not publicly available.

The third challenge is materiality. As discussed earlier in reference to SASB standards, various ESG dimensions have different relevance to different industries. How should the environmental stewardship of an energy or manufacturing company be compared to that of a technology or service company, given their different exposure to environmental challenges (carbon emissions, pollution, waste, and so on)? Should a company be compared only against its industry peers to determine which ones handle the matter better, or can companies in different industries be compared against each other?
Each ranking or rating firm makes choices on these questions. Because of this, the ratings assigned to companies vary considerably depending on the firm that assigns them. For example, MSCI gives Tesla Motors one of its highest ratings for environmental performance, but FTSE Russell gives Tesla a low score on environment because the FTSE Russell model does not take into account emissions from a company’s cars and only includes emissions from its factories. FTSE also penalizes Tesla in its social rankings because Tesla discloses little information about its practices, whereas MSCI assumes that if a company does not disclose information on a dimension that its performance is in line with industry averages. In another example, Sustainalytics gives ExxonMobil a relatively high ranking because it puts a 40 percent weight on social issues whereas MSCI ranks it lower because it puts a 17 percent weight on social issues. 

Still, on average, we see that large U.S. companies tend to receive high scores across providers. Whether this is due to greater availability of information about these firms, their willingness to engage with rating providers to supplement information, their embrace of and willingness to invest in stakeholder initiatives, or methodological biases by the rating firms is not known.

An analysis of 11 prominent rankings of companies based on environmental, climate-related, human rights, gender, diversity, and social responsibility factors shows that 68 percent of the Fortune 100 companies are recognized on at least one ESG list. The combined market value of these companies is $9.4 trillion, which comprises 84 percent of the market value of the entire Fortune 100. Cisco Systems appears on the most lists (eight); Microsoft on seven; and Bank of America, HP, Procter & Gamble, and Prudential Financial each appear on six lists. Even companies that are widely criticized by advocacy groups for their business practices are rated highly by third-party observers for ESG factors. For example, Chevron appears on the Dow Jones sustainability index and the Forbes list of best corporate citizens. Walmart is on Bloomberg’s gender equality Index. Comcast is on DiversityInc’s top 50 corporations for diversity. General Electric is named to Ethisphere Institute’s list of most ethical companies. (Perhaps unexpectedly, Berkshire Hathaway is not named to this list nor does it appear on any of the 11 lists reviewed. See Table 13.1.)
## Table 13.1  Fortune 100 Companies Appearing on the Most ESG Rankings

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<th># Lists</th>
<th>Companies</th>
<th>Barron's Most Sustainable</th>
<th>Bloomberg Gender Equality</th>
<th>CDP – Climate Change A List</th>
<th>CDP – Water Management A List</th>
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Based on rankings published between 2017 and 2019.
Research generally shows a modest relation between sustainability scores and firm performance and risk. Lins, Servaes, and Tamayo (2017) studied the performance of companies with high CSR scores during the financial crisis. They found that firms with high CSR ratings from MSCI experienced higher returns, profitability, growth, and sales per employee than firms with low ratings. However, there were no significant associations between CSR rating and performance in the periods before or after the crisis. Deng, Kang, and Low (2013) studied the relation between CSR and firm value by examining stock price returns around acquisition announcements. They found modest evidence that firms with high CSR ratings exhibit higher announcement returns and higher long-term operating performance post-acquisition. Performance differences were largely the result of below-average performance by low-rated CSR firms; highly rated firms did not exhibit above-average performance. Ferrell, Liang, and Renneboog (2016) studied the relations between CSR, agency problems, and firm value. They found that firms with low agency problems have higher MSCI ratings. They also found a positive association between firms with both low agency problems and high MSCI ratings and firm value.

Margolis, Elfenbein, and Walsh (2009) conducted a meta-analysis of the research on CSR and firm performance. Their sample included 251 studies between 1972 and 2007. They found a small, positive association between CSR and performance but also that the positive association declines throughout the measurement period (that is, the effects of CSR were stronger in earlier studies and less so in later studies). They concluded:

> After thirty-five years of research, the preponderance of evidence indicates a mildly positive relationship between corporate social performance and corporate financial performance. The overall average effect … across all studies is statistically significant, but, on an absolute basis, it is small.

Finally, Gerard (2018) conducted a literature review on the relation between ESG scores and stock and bond price performance. He found that high ESG scores are related to higher profitability and firm value. He also found that positive performance differentials observed in the 1990s decreased in the early 2000s and disappeared in the 2010s, suggesting that any financial benefit of ESG is priced into securities markets.

In general, research on ESG suffers from a problem of causality. Does a commitment to environmental or social goals make a company more profitable, or are more profitable companies able to spend more on these activities?

Despite pressure on companies to engage in ESG-related activities and corporate efforts to disclose their commitment to these initiatives, our ability to assess ESG quality remains limited. Inconsistent metrics, voluntary disclosure, and lack of comparability across firms account for much of the problem. Furthermore, it is not clear that the metrics that third-party firms develop to measure companies on ESG dimensions are accurate or reliable. (We turn to this question in the next chapter.)
As such, requiring all companies to incorporate a stakeholder orientation into their corporate planning—beyond the extent to which they already do so—would likely have unintended consequences with the potential to harm shareholders, employees, and outside stakeholders alike. Governance systems today—with an emphasis on shareholder returns, accountability of management to a board of directors, clearly defined performance metrics, and a capital market that disciplines companies for poor performance—might have their shortcomings, but the objective nature of stock price and operating returns are effective gauges for measuring performance and risk.

One solution (and one which many companies currently embrace) is to include ESG factors as key performance indicators in the same manner as other qualitative or nonfinancial information is used today to measure performance and award compensation—such as customer satisfaction, employee engagement, and product innovation (see the following sidebar). This gives discretion to companies and allows their shareholders and stakeholders to advocate for the adoption of policies most relevant and tailored to their situation and interests. It does not solve the problem of comparability of metrics across companies, particularly when a company chooses not to disclose proprietary information for competitive reasons, but it lessens the risk that management is held accountable to measures without a proven correlation to value, thereby weakening board oversight. (An interesting, related question is whether CEO activism—the practice of CEOs taking a personal stance on social, environmental, or political issues—is in the interest of a company. See the subsequent sidebar.)

The greatest challenge, and greatest opportunity, for ESG advocates is to incorporate a stakeholder orientation within a shareholder mandate, without disrupting the positive benefits that the current system accrues to shareholders and stakeholders alike.

### ESG Compensation Incentives

According to Glass Lewis, 35 percent of S&P 500 companies use ESG-related metrics in their executive compensation programs, primarily in their short-term rather than long-term bonus plans. This statistic is somewhat misleading in that Glass Lewis categorizes metrics such as safety, customer satisfaction, and production waste management that historically have been considered nonfinancial operating metrics as ESG metrics.74 According to Equilar, the overall prevalence of nonfinancial metrics has not increased over the last five years.75 This raises the question of whether ESG-related metrics in compensation plans are serious goals or window dressing (see Figure 13.3).
Examples of ESG-related metrics in the annual bonus include the following:

**Clorox**

Clorox ties the annual bonus of named executive officers to corporate ESG initiatives relating to diversity, packaging, and environmental goals:

- “We have exceeded the 20% reduction goals we set in our 2020 Strategy for greenhouse gas emissions (33% reduction), solid-waste-to-landfill (21% reduction), and water use (21% reduction).
- “We have cut energy usage by 18% and are on track to meet our reduction goal by the end of 2020.
- “100% of our Glad facilities worldwide achieved zero waste-to-landfill status in the 2019 fiscal year, bringing our total to 13 global company sites versus our goal of 10.”

The company does not disclose the weighting of ESG targets in the overall bonus calculation.

**Alcoa**

“We continued to link 30% of our incentive compensation goals to non-financial metrics relating to sustainability—safety, gender representation in the workforce, and reductions in greenhouse gas emissions due to process improvements.”

---

**Figure 13.3** Prevalence of nonfinancial performance metrics related to ESG

Source: Equilar
Walmart

“The performance evaluation of each of our NEOs and most other management associates includes performance with respect to culture, diversity, and inclusion. The [compensation committee] considers performance evaluations, along with other factors, when making pay decisions. Additionally, any associate’s annual cash incentive payment may be reduced by up to 30% if they engage in behavior inconsistent with our discrimination and harassment policies.”

Are these difficult targets? How much would the board reduce an incentive award if the CEO achieved revenue, earnings, and other operating metrics but did not meet an ESG objective?

CEO Activism

In recent years, we have seen CEOs take a personal stance on social, environmental or political issues. Examples include the following:

- Apple CEO’s opposition to Indiana’s religious freedom law on the basis that it was discriminatory to gay rights.79
- Citigroup CEO’s restriction on financing to companies that sell certain categories of firearms.80
- Costco CEO’s call for an increase in the federal minimum wage.81
- Goldman Sachs CEO’s criticism of U.S. immigration policy.82
- NRG Energy CEO’s call for a tax on carbon emissions.83
- Salesforce CEO’s advocacy for the homeless.84
- Starbucks CEO’s activism on race relations.85

One review found that CEOs are most likely to take a public stance on diversity, including gender, racial, or sexual-orientation diversity or equality. They are next most likely to take public positions on environmental matters, followed by immigration and human rights, other social issues, and politics. Still, the overall rate of CEO activism is low (between 4 and 12 percent of CEOs), and incidents of CEO activism are concentrated among the largest U.S. companies.86

CEO activism raises several questions. One is whether it is appropriate for a CEO to leverage their public position to advocate for an issue that might be divisive to their shareholders, employees, or customers. A second question is whether a board should intervene if the public expression of a personal belief has the potential to impact the company’s reputation or performance. A third is how to distinguish between a company’s official position on an ESG-related issue and a CEO’s personal belief.
Research shows that CEO activism can be a double-edged sword. A 2019 survey found that, by a two-to-one margin, the public believes CEOs should use their position to advocate on ESG issues. The public’s view of advocacy, however, varies considerably by topic. They are most in favor of advocacy about the environment, healthcare, poverty, and taxes. Support is more mixed about diversity and equality. Contentious issues—such as gun control and abortion—and politics and religion garner the least public support (see Figure 13.4). 87

Note: Net favorability calculated as the percent of respondents who select “thank you for speaking up” minus the percent of respondents who select “keep your mouth shut.” Excludes respondents who select “no opinion.”


**Figure 13.4** Public reaction to CEO activism by topic

The survey found that Americans claim to change their purchasing behavior depending on their agreement with an activist CEO’s position. In a warning to companies, respondents are significantly more likely to remember products they stopped using or use less because of the position the CEO took than products they started using or use more. Specifically, 35 percent of the public could think of a product or service they use less, while only 20 percent could think of a product they use more.
If true, this suggests that CEOs who take positions to build loyalty with employees, customers, or constituents might also inadvertently alienate segments of these populations.

The actual impact of CEO activism on purchase behavior is essentially unknown. Chatterji and Toffel (2018) found that CEO activism can “increase consumers’ intentions to purchase the company’s products” but only to the degree that there is “alignment between the CEO’s message and individuals’ policy preferences.” Korschun, Aggarwal, Rafieian, and Swain (2016) found that CEO activism is viewed positively by consumers if the company is considered “values-oriented” but negatively otherwise. The authors argue that the impact of CEO activism on purchase behavior is driven by the degree of “perceived corporate hypocrisy.”

Endnotes


15. Larry Fink (2020).


19. Ibid.

20. Ibid.

21. Ibid.

23. In 2018, Sen. Elizabeth Warren of Massachusetts proposed federal regulation that would require the federal charter of large corporations and provide that corporate directors consider the interests of all major stakeholders—not only shareholders—in company decisions. Her proposal would also require employee representation on public boards, limit political contributions, and place broad restrictions on equity grants to executives and directors. See Elizabeth Warren, “Companies Shouldn’t Be Accountable Only to Shareholders,” Wall Street Journal (August 15, 2017, Eastern edition): A.17.


31. Economists refer to this as an externality problem. An externality is the cost of a commercial activity that is not incorporated in the cost of goods or services provided and is borne by third parties. Externalities are generally redressed through taxation, lawsuits, or regulatory intervention.


40. The remainder believe ESG-related initiatives have little financial impact one way or the other.


42. Ibid.


89. They cite Patagonia, the outdoor apparel company, as an example of a values-oriented company because it associates itself with conservation and environmental issues. They contrast this example with Footlocker, which does not associate itself with particular issues. See Daniel Korschun, Anubhav Aggarwal, Hoori Rafieian, and Scott Swain, “Taking a Stand: Consumer Response When Companies Get (or Don’t Get) Involved,” *Social Science Research Network* (July 2016). Accessed July 19, 2017. See https://ssrn.com/abstract=2806476.
Index

Numbers
$1 Dollar CEOs, 226
737 MAX airliner, 266, 432
1940 Investment Company Act, 357, 366
2008 financial crisis, 174–175, 256–258

A
Abbott Laboratories, stock prices and CEO wealth, 255
Abercrombie & Fitch, pay differentials, 226–227
abnormal accruals, 297–298
abnormal returns, 14–15
academic researchers, governance ratings systems
corporate governance index, 434
E-Index, 436–439
G-Index, 434–436, 437–438
accountability, board evaluations, 97
accounting
abnormal accruals, 297–298
AGR, 298
American Institute of Certified Public Accountants and Chartered Institute of Management Accountants, risk management, 174
audit committees, 296–297
audits. See audits
country-specific standards, 24
disclosures, 299–300
dismissals, 309–310
estimates, 299–300
external audits, 299, 301
FASB, 29

IASB, 24
IFRS, 24–25
international corporate governance, 23–25
linguistic-based analysis, 298–299
manipulation
agency costs and equity ownership, 260–261
detecting, 297–299
principles-based accounting, 24–25
rules-based accounting, 24
SASB, 406
acquirers (bidders), 320
myopia, 330
unwanted acquirers, 341–344
acquisitions
antitakeover defenses, 320
antitakeover protections, 320, 330
classified boards, 331, 335–337
incorporation, 337–339
poison pills (shareholder’s rights plans), 331, 333–335
staggered boards, 331, 335–337
bargaining power, 330
diversification, 321
dual-class shares, 331, 339–341
financial synergies, 321
friendly acquisitions, 320
golden parachutes, 325, 326
hostile takeovers, 320, 328–329
impact of, 321
mergers, 320–325
proxy contests, 320
tender offers, 320
long-term value, 330
mergers, 321–325
compensation incentives, 322–324
empire building, 322–323
herding behavior, 322–323
hubris, 322–323
ownership changes, 321
reasons for, 321
targets, 320, 324–327
tin parachutes, 343
value, determining, 327–330
active advisors, outgoing CEO behaviors, 199
active CEOs, recruiting directors, 81–82
active investors, 352
activism
activist hedge funds, 366–369
activist investors, 11, 359–361, 364–366
behind-the-scene activism, 364, 231–232, 415–417
employees, 394–395
individual activist investors, 364–366
activity levels, shareholders, 352
ad hoc committees, 60
advantage, organizational strategies, 152
advisors, financial services firm/investment advisor retention business model, 158–159
advisory capacity (boards of directors), 55
advisory directors, 83–84
Aegon, risk management, 173
AFL-CIO (American Federation of Labor and Congress of Industrial Organizations), proxy voting, 361–363
agency costs, 4
equity ownership, 259–260
accounting manipulation, 259–260
equity grant manipulation, 261–263
insider trading, 264–267
stock option backtrading, 262–263
insider trading, 264–269
agency problems, 4
family-controlled corporations, 450
nonprofit organizations, 466
agendas, boards of directors, 59
aggressors, outgoing CEO behaviors, 200
AGR (Accounting and Governance Risk), 298
agreements, contractual, 216
AIG (American International Group), governance ratings, 432
Alcoa, ESG compensation incentives, 414
Allergan, hostile takeovers, 328–329
alphas, 14–15
Amazon
CEO to employee pay differentials, 229
employee activism, 395
American Airlines, “extreme” compensation, 226
American Electric Power, CEO severance agreements, 204
American Institute of Certified Public Accountants and Chartered Institute of Management Accountants, risk management, 174
Ameriprise Financial, compensation disclosures and risk management, 258–259
Ameren, shareholder feedback on executive compensation, 239
Analog Devices, recruiting directors, 87
analysts (UBS), HealthSouth Corp., 2
Anderson Exploitation, sustainability skills matrix, 405
Anglo-Saxon model, 31
annual bonuses, 215
annual incentives, 234–235
annual salaries, 215
antitakeover defenses, 320
antitakeover protections, 320, 330
classified boards, 331, 335–337
incorporation, 337–339
poison pills (shareholders’ rights plans), 331, 333–335
staggered boards, 331, 335–337
venture-based companies, 457–458
Apple
CEO activism, 415
“extreme” compensation, 226
appropriate/reasonable compensation, recruiting directors, 92–93
Aramco, stakeholder interests, 396
Arthur Andersen, structure of audit industry, 303
A-shares, 42
Ashton and employee representation, Joseph, 130–131
assessing risk, 170
assets, target acquisitions, 325
Association of Certified Fraud Examiners, 7
audit committees, 61
external audits, 300
financial experts, 286
financial reporting, 255–256, 288
accounting quality, 286–287
internal controls, 287–288
transparency, 287
internal controls, 296–297
U.S. boards of directors, 112
auditor opinions, external audits, 301
audits
auditor resignations, 309–310
Big Four audit firms, 302–305
dismissals, 309–310
external auditors
as CFO, 307–308
HealthSouth Corp., 2
external audits, 299, 301
accounting estimates/disclosures, 299–300
audit committees, 300
auditor opinions, 301
fraud, 300–302
internal controls, 300
preparing for, 299
GAAS, 305
industry, structure of, 302–305
internal audits, risk management, 171
nonprofit organizations, 465
opinion shopping, 309–310
PCAOB, 305–306
quality of, 302
auditor dismissals, 309–310
auditor resignations, 309–310
auditor rotations, 308–310
external auditors as CFO, 307–308
GAAS, 305
opinion shopping, 309–310
PCAOB, 305–306
Sarbanes-Oxley Act of 2002, 305–307
structure of audit industry, 302–305
Aufischtrat (supervisory board), 35
autovoting, 378
awards
performance awards, 236–237
target awards, 233
Bank of America, CEO/chairman of the board
separation, 114–115
banking
boards of directors, 126–127
German corporate governance, 36
bankruptcies, 5
bargaining power, takeovers, 330
Bausch Health, hostile takeovers, 329
Bayer AG, entlastung (vote of discharge), 35–36
Becker, Gary, 5
behavioral discipline, managers, 21
behind-the-scene activism, 364
benchmarking executive compensation, 220
benefit corporations (B Corps), 69–70
benefits, 216, 237–238
Berkshire Hathaway, 450
Bernanke, Ben
2008 financial crisis, 257
stock prices and CEO wealth, 257
best practices
Cadberry Committee Code of Best Practices, 32–34
corporate governance, 12–13
testing, 474
bidders (acquirers), 320
myopia, 330
unwanted acquirers, 341–344
Big Four audit firms, 302–305
Binder, Alan
2008 financial crisis, 257
stock prices and CEO wealth, 257
black swans, 165
blackout periods, 264–267
BlackRock
CEO views on stakeholders, 401–402
stakeholder interests, 395–396
blockholders, 354–356
Bloomberg Gender-Equality Index, 407
board evaluations, 96–98
board meetings, 58, 111
agendas, 59
NACD, 58–59
Sarbanes-Oxley Act of 2002, 58
boards of directors
ad hoc committees, 60
advisory capacity, 55
advisory directors, 83–84
agendas, 59
attributes of, 112
B Corps (benefit corporations), 69–70
backgrounds, 184–185
backtrading stock options, 262–263
Bair and independence of boards of directors,
Shelia, 57

B
alert committees, 61, 112
bankers, 126–127
benefit corporations (B Corps), 69–70
board meetings, 58, 111
business models, 162–164
busy directors, 131–133
CEOs, 57–58, 111

  chairmen of the board/CEO separation, 113–116

  succession planning, 198–199, 201–202

chairmen of the board

  characteristics of, 113

  independence, 111

  role of, 113

classified boards, 64

codetermination, 129

committees

  creating, 61

  fees, 91–92

  meetings, 112

  nominating committees, 62

compensation, 90–91

compensation committees, 61–62

constituencies, 68–69

contested elections, 65–66

current directors as CEOs, 202

D&O insurance policies, 74–75

data, sharing information, 59–60

directors

  duration of terms, 64

  qualifications, 79–80

  removing, 66, 98–102

  women directors, 111, 138–139
disclosure obligations under securities laws, 71
diversity, 136–137
elections, 64–66
employee representation, 129–131

ESG, 70–71

EVA, 94
evaluating, 96–98
executive sessions, 58, 116–117

federal securities laws, 73

fiduciary duties, 67–70, 72

Finance Committees, 63

financial experts, 127

first time directors, 111
governance committees, 62
groupthink, 136–137

HealthSouth Corp., 2

indemnification of directors, 73–74

independence, 56–57, 122–125

  independent committees, 125–126

  independent directors, 110–111,

  113–119, 122–124

interactions, 62

interlocked (connected) boards of directors, 134–135

lead directors, 58

lead independent directors, 116–119

legal enforcement, state corporate law, 72

legal obligations of directors, 66–70

management, 59–60

market for directors, 79–80

Netflix, 60

nominating committees, 62

nonprofit organizations, 463–465

nonshareholders

  duties to, 69

  ESG, 70–71

observers, 83–84

operations, 57–60

outgoing CEOs, 89

outside (nonexecutive) directors, 119–121

overlapping committees, 135–136

oversight capacity, 55–56

ownership guidelines, 95–96

performance, 139–141, 162–164

performance-based director pay, 93–94

politically connected boards of directors, 127–128

Principles of Corporate Governance, 55

private equity firms, 460–461

proxy contests, 360–361

Public Responsibility Committees, 63–64

quality of, 476

recruiting directors. See recruiting directors

removing directors, 66, 98–102

Research Committees, 63

resignations, 99–100

responsibilities, 55–56

retirement, 111–112

Risk and Compliance Committees, 63

risk management, 172–174

SEC enforcement, 73

shareholders, duties to, 68–69

size of, 136

specialized committees, 62–64
staggered boards, 64
stakeholders, views on, 401–402
standing committees, 60
state corporate law, 72
structure of, 110–112
supplemental pay, 91
tokenism, 139
Toyota Motor Corp., 38
transparency, 60
uncontested director elections, majority voting, 371
venture-based companies, 454–455, 457
women directors, 111, 138–139
written consent, 58
Boehner and politically connected boards of directors, U.S. Speaker of the House John, 128
Boeing
737 MAX airliner, 267, 432
CEO succession planning, 198
governance ratings, 433
large-scale executive stock sales, 266
Bohle and context of governance systems, John, 477
Bonthu and large-scale executive stock sales, Sudhakar, 267
bonuses, annual, 215
Bostock and unwanted acquirers (bidders), Roy, 343
Bovespa, 45–46
“brain drain,” CEOs, 183
Brazil
Bovespa, 45–46
international corporate governance, 44–46
national governance structure, 44–46
Novo Mercado, 45–46
breaches, data, 175–176
Bristol-Myers Squibb, financial restatements, 293
B-shares, 42
Buffett, Warren
proxy advisory firms, 376–377
re-election of, 376–377
Bull-Dog Sauce, poison pills (shareholder’s rights plans), 335
bullet-dodging, 263
Burt’s Bees, product sustainability and proxy disclosures, 404
Bush and politically connected boards of directors, U.S. President George W., 128
business judgment rules, 72
business models, 155–156
boards of directors, 162–164
casual business models, 155, 161–162
development process, 156
fast-food chain/employee turnover business model, 156–158
KPI
corporate performance metrics, 160–162
defined, 159
financial KPI, 160, 162
nonfinancial KPI, 160, 162
risk management, 166–169
Business Roundtable
Principles of Corporate Governance, 397
stakeholder interests, 397
business setting factors, corporate governance, 19
busy directors, 131–133
buyouts (leveraged), private equity firms, 460
C
Cadberry Committee, Code of Best Practices, 32–34
Calhoun and CEO “brain drain” to private equity firms, David, 184
CalPERS (California Public Employees’ Retirement System), proxy voting, 361, 362–363
candor, duty of, 68
Canopy Growth, 128
capital market efficiency

corporate discipline, 20
economic growth across countries, 20
family-controlled business groups, 20–22
foreign investments, 21
managerial behavior, 21
pricing, 19–20
capitulators, outgoing CEO behaviors, 200
care, duty of, 67
career/status benefits versus compensation, 225
Cargill, 450
CAS (Cost Accounting Standards), FAS/CAS pension adjustment, 234–235
cash flows, target acquisitions, 325
casual business models, 155, 161–162
Cavanagh and CEO “brain drain” to private equity firms, Michael, 183
central risk, risk management, 171
CEOs (Chief Executive Officers)
$1 Dollar CEOs, 226
activism, 415–417
backgrounds, 184–185
boards of directors, CEO role, 57–58
“brain drain,” 183
chairmen of the board/CEO separation, 113–116
compensation, 182–183, 186, 204–205
$1 Dollar CEOs, 226
activism and CEO compensation, 231–232
annual incentives, 234–235
benefits, 237–238
compensation paid in United States, 221–222
competing theories on compensation, 242
disclosures, 238–239
equity ownership, 251–258
“extreme” compensation, 225–226
Harley-Davidson, 223–224
long-term incentives, 235–237
management entrenchment, 228
mixing, 230–231
optimal contracting, 213
pay differentials, 226–229
pensions, 234–235
performance awards, 236–237
perquisites, 237–238
rent extraction, 213–214
say-or-pay policies, 239–242
shareholder feedback on compensation, 239–242
short-term incentives, 233–235
stealth compensation, 237–238
stock options, 236
stock prices and CEO wealth, 254–258
target awards, 233
theories, 213–214
tournament theory, 228
current directors as CEOs, 202
equity ownership, 251–253
experience, 184–185
factory firms, 185–186
failure, paying for, 204
firm performance, 186
ideal characteristics of, 186
labor market, 181–183
labor pools of talent, 184–186
misconduct, 190–191
newly appointed CEOs, 191–193
outgoing CEOs, positions on boards of directors, 89
paying for failure, 204
performance, 183, 186, 188–189
personality of, 186, 190–191, 476
private equity firms, 183
Push-Out Scores, 188–189
recruiting directors, 81–82
risk management, 166
severance agreements, 204–205
stakeholders, 401–402
succession planning. See succession planning
talent development/retention, 183
tenure, 184, 205
turnover, 186–190
U.S. boards of directors, 111
CFOs (Chief Financial Officers), external auditors as, 307–308
CGQ (Corporate Governance Quotient), 428–429
chaebol (South Korea), 40–41
chairmen of the board
CEO/chairman of the board separation, 113–116
characteristics of, 113
independence, 111
role of, 113
U.S. boards of directors, 111
Chandler III, William B., 397–398
Chapek and CEO succession planning, Bob, 196
Chattem, zero-cost collars, 270
Cheney and politically connected boards of directors, U.S. Vice President Richard, 128
Chesapeake Energy, pledging, 273–274
Chevron, corporate responsibility reports, 403–404
China
A-shares, 42
B-shares, 42
Company Law of the People's Republic of China, The, 42
H-shares, 42
international corporate governance, 41–43
national governance structure, 41–43
publicly traded companies, 42
Chubb, benchmarking executive compensation, 220
Cisco, Finance Committees, 63
Citigroup
   CEO activism, 415
   clawbacks/deferred payouts, 217–218
class action lawsuits, 6
classified boards, 64, 331, 335–337
Clause 49, 43
clawbacks, 217–218, 261
cclimate change impact reports, 403
Clorox
   ESG compensation incentives, 414
   proxy disclosures, product sustainability, 404
Coca-Cola Company, The
   ESG, 399
   performance-based director pay, 93–94
   re-election of Warren Buffett, 376–377
Code of Best Practices (Cadberry Committee), 32–34
codetermination, 28, 129
Comcast, 450
committees
   ad hoc committees, 60
   audit committees, 61, 112
      accounting quality, 286–287
      external audits, 300
      financial experts, 286
      financial reporting, 285–288
      internal controls, 287–288, 296–297
      transparency, 287
   compensation committees, 61–62
   COSO, risk management, 169–170
   creating, 61
   director committee fees, 91–92
   Finance Committees, 63
   governance committees, 62
   independent committees, 125–126
   nominating committees, 62
   overlapping committees, 135–136
   Public Responsibility Committees, 63–64
   Research Committees, 63
   Risk and Compliance Committees, 63
   risk management, 172–173
   specialized committees, 62–64
   standing committees, 60
   U.S. boards of directors, 111–112
Companies Acts, 31–32
Company Law of the People’s Republic of China, The, 42
company size, executive compensation, 224
compensation
   81 Dollar CEOs, 226
   activism and CEO compensation, 231–232
   annual bonuses, 215
   annual incentives, 234–235
   annual salaries, 215
   benchmarking, 220
   benefits, 216, 237–238
   CEOs. See CEOs (Chief Executive Officers), compensation
   clawbacks, 217–218
   company size, 224
   consultants, 221
   contractual agreements, 216
   contractual restrictions, 217–218
   deferred payouts, 217–218
   determining, 218–219
directorships, 90–91
disclosures, 224, 238–239, 258–259
earned (realizable) compensation, 223
employees, CEO to employee pay differentials, 229
ESG compensation incentives, 413–415
executive compensation. See executive compensation
expected compensation, 223
“extreme” compensation, 225–226
hedging restrictions, 217
incentives
   ESG compensation incentives, 413–415
   long-term incentives, 235–237
   mergers, 322–325
levels of compensation, 221–226
long-term incentives, 235–237
management entrenchment, 228
market forces, 224–225
mixing, 230–231
nonprofit organizations, 464–466
oversight, 225
pay differentials
   among executives, 226–229
   CEOs to employees, 229
peer groups, determining executive compensation, 218–219
pensions, 234–235
performance, 225
performance awards, 236–237
performance share awards, 216–217
Index

performance shares (units), 216
perquisites, 216, 237–238
planning, 214–216
pledging restrictions, 217
private equity firms, 461
ratcheting effect, 219
realized compensation, 223
retirement, 216–218
“right” measure of pay, determining, 223–224
risk management, 258–259
say-or-pay policies, 239–242
shareholder feedback on executive compensation, 239–242
short-term incentives, 233–235
status/career benefits versus compensation, 225
stealth compensation, 237–238
stocks
  ownership guidelines, 217
  restricted stocks, 216
  stock options, 215, 236
target awards, 233
tournament theory, 228
venture-based companies, 457
compensation committees, 61–62
Competitive Strategy, 153
compliance, Risk and Compliance Committees, 63
compliance risk, 167
comply-or-explain system, U.K. Corporate Governance Code, 34
composition, board evaluations, 97
Computer Associates, financial restatements, 293
concerns, external audits, 301
connected (interlocked) boards of directors, 134–135
Connecticut Retirement Plans and Trust Funds, pay differentials, 226–227
consent (written), boards of directors, 58
constituencies (boards of directors)
  nonshareholders
    duties to, 69
    ESG, 70–71
  shareholders, duties to, 68–69
consultants, compensation, 221
contested elections, 65–66
context, governance systems, 477
Continental Resources, pledging, 274
contracting, optimal, 213
contractual agreements, 216–218
control activities, risk management framework, 170
controlled corporations, 340–341
conventionally independent, 123–124
COO (Chief Operating Officers), CEO succession planning, 195–196
Cook and “extreme” compensation, 226, Tim
Corporate control, market for, 319
  acquisitions. See acquisitions
  mergers, 321–325. See mergers
  private equity firms, 322
  takeovers. See takeovers
Corporate governance
  activist investors, 11
  best practices, 12–13
  business setting factors, 19
  defined, 4, 8–9, 19
  empirical research, interpreting, 14–15
  ESG, 11
  firm performance and corporate governance, 13–14
  “one-size-fits-all” approach, 12–13
  as organizational discipline, 476–477
  Principles of Corporate Governance (Business Roundtable), 397
  private equity firms, 11
  proxy advisory firms, 12
  ratings. See ratings
  shareholders, 8–9
  stakeholders, 8–9
  standards, 9–12
Corporate Governance Code
  Japan, 40
  United Kingdom, 34, 151, 374–375
Corporate Responsibility Magazine Best Corporate Citizens, 407
corporate strategies, 151
advantage, 152
  boards of directors, 162–164
  business models, 155–156
    casual business models, 155, 161–162
    development process, 156
    fast-food chain/employee turnover business model, 156–158
    financial services firm/investment advisor retention business model, 158–159
    KPI, 159–162
defined, 152–153
development process, 153
environments, 153
implementation process, 154–156
markets, 152
mission statements, 151–152
performance
  KPI, 159–162
  metrics, 160–162
resources, 153
scope, 152
stakeholders, 153
corporations. See also nonprofit organizations
controlled corporations, 340–341
family-controlled corporations, 449
  agency problems, 450
  earnings, 452
  largest family-controlled businesses in United States, 449–450
  negative effects, 450–451
  positive effects, 451
  succession planning, 451–452
  transparency, 452
performance. See performance responsibility reports, 403–404
shareholder democracies. See democracies, shareholder
corporate engagement, 371, 374–375
majority voting in uncontested director elections, 371
proxy access, 372
proxy advisory firms, 375–380
proxy voting, 372–374
dimension, corporate performance, 161
Dimon, Jamie, 183
Directors’ Remuneration Report Regulations (United Kingdom), 35
directorships
  ad hoc committees, 60
  advisory capacity, 55
  advisory directors, 83–84
  agendas, 59
  attributes of, 112
  audit committees, 61, 112
  bankers, 126–127
  benefit corporations (B Corps), 69–70
  board meetings, 58–59, 111
  busy directors, 131–133
  CEO/chairman of the board separation, 113–116
  succession planning, 198–199, 201–202
chairmen of the board
  CEO/chairman of the board separation, 113–116
cumulative voting, 65
current directors as CEOs, 202
Currie, John, 167
cybersecurity, 175–176
D
D&O insurance policies, 74–75
damages, paying, 72
data
  gathering, boards of directors, 59–60
  theft, cybersecurity, 175–176
Day and risk management, Christina, 167
debt, target acquisitions, 325
decentralization, risk management, 170, 296–297
defered payouts, 217–218
Delaware Court of Chancery, 397–398
Dell Technologies, 450
Delta Airlines, hedging policies/disclosures, 272
democracies, shareholder
corporate engagement, 371, 374–375
majority voting in uncontested director elections, 371
proxy access, 372
proxy advisory firms, 375–380
proxy voting, 372–374
dimension, corporate performance, 161
dimension, corporate performance, 161
dimensions, corporate performance, 161
dimensions, cultural, 170–171
cultural fit, CEOs, 194–195
cultural fit, CEOs, 194–195
cultural risk, 170–171
cultural/societal values
codetermination, 28
Hofstede Model of Cultural Dimensions, 27
international corporate governance, 26–28
shareholder-centric view, 28, 31
stakeholder-centric view, 28, 37–39
Cumulative voting, 65
Current directors as CEOs, 202
Currie, John, 167
Cybersecurity, 175–176
D
D&O insurance policies, 74–75
Damages, paying, 72
Data
  gathering, boards of directors, 59–60
  theft, cybersecurity, 175–176
Day and risk management, Christina, 167
Debt, target acquisitions, 325
Decentralization, risk management, 170, 296–297
Deferred payouts, 217–218
Delaware Court of Chancery, 397–398
Dell Technologies, 450
Delta Airlines, hedging policies/disclosures, 272
Democracies, shareholder
  corporate engagement, 371, 374–375
  majority voting in uncontested director elections, 371
  proxy access, 372
  proxy advisory firms, 375–380
  proxy voting, 372–374
dimension, corporate performance, 161
Dimon, Jamie, 183
Directors’ Remuneration Report Regulations (United Kingdom), 35
directorships
  ad hoc committees, 60
  advisory capacity, 55
  advisory directors, 83–84
  agendas, 59
  attributes of, 112
  audit committees, 61, 112
  bankers, 126–127
  benefit corporations (B Corps), 69–70
  board meetings, 58–59, 111
  busy directors, 131–133
  CEO/chairman of the board separation, 113–116
  succession planning, 198–199, 201–202
Chairmen of the board
  CEO/chairman of the board separation, 113–116
characteristics of, 113
independence, 111
role of, 113
classified boards, 64
codetermination, 129
committee fees, 91–92
committee meetings, 112
compensation, 90–91
compensation committees, 61–62
constituencies, 68–69
contested elections, 65–66
creating committees, 61
current directors as CEOs, 202
D&O insurance policies, 74–75
data, sharing information, 59–60
disclosure obligations under securities laws, 71
dissent slate, 360–361
diversity, 136–137
duration of terms, 64
elections, 64–66
employee representation, 129–131
ESG, 70–71
EVA, 94
evaluating, 96–98
executive sessions, 58, 116–117
federal securities laws, 73
fiduciary duties, 67–70, 72
Finance Committees, 63
financial experts, 127
first time directors, 111
governance committees, 62
grouphink, 136–137
HealthSouth Corp., 2
indemnification of directors, 73–74
independence, 56–57, 122–125
  independent committees, 125–126
  independent directors, 110–111, 113–116, 122–124
interactions, 62
interlocked (connected) boards of directors, 134–135
lead directors, 58
lead independent directors, 116–119
legal enforcement, state corporate law, 72
legal obligations of directors, 66–70
management, 59–60
market for directors, 79–80
Netflix, 60
nominating committees, 62
nonprofit organizations, 463–465
nonshareholders
duties to, 69
ESG, 70–71
observers, 83–84
operations, 57–60
outgoing CEOs, 89
outside (nonexecutive) directors, 119–121
overlapping committees, 135–136
oversight capacity, 55–56
ownership guidelines, 95–96
performance, 93–94, 139–141, 162–164
politically connected boards of directors, 127–128
Principles of Corporate Governance, 55
private equity firms, 460–461
proxy contests, 360–361
Public Responsibility Committees, 63–64
qualifications, 79–80
quality of, 476
recruiting directors. See recruiting directors
removing directors, 66, 98–102
Research Committees, 63
resignations, 99–100
responsibilities, 55–56
retirement, 111–112
Risk and Compliance Committees, 63
SEC enforcement, 73
shareholders, duties to, 68–69
size of, 136
specialized committees, 62–64
staggered boards, 64
stakeholders, views on, 401–402
standing committees, 60
state corporate law, 72
structure of, 110–112
supplemental pay, 91
terms, duration of, 64
tokenism, 139
Toyota Motor Corp., 38
transparency, 60
uncontested director elections, majority voting, 371
venture-based companies, 454–455, 457
women directors, 111, 138–139
written consent, 58
discharge, vote of, 35–36
discipline, capital market efficiency
  corporate discipline, 20
managerial behavior, 21
disclosures
accounting, 299–300
board of director obligations under securities laws, 71
compensation disclosures, 238–239, 258–259
director qualifications, 86–87
executive compensation, 224
hedging, 272
proxy disclosures
climate risk, 404
product sustainability, 404
stakeholders, ESG, 403–407
dismissals, auditors, 309–310
Disney
chairmen of the board, characteristics of, 113
state corporate law, 72
dissident slate, 360–361
diversification of acquisitions, 321
diversity
boards of directors, 136–137
recruiting directors, 84–85
Dodd-Frank Wall Street Reform Act of 2010, 10, 30, 366
board of director elections, 66
clawbacks/deferred payouts, 217
executive compensation, 212–213
financial reporting, 288
hedging, 271
hedging restrictions, 217
proxy access, 372
risk management, 164–165
say-or-pay policies, executive compensation, 240
uncontested director elections, majority voting, 371
donor support, nonprofit organizations, 466
Dow Chemical, removing directors, 100
Doyle and PVF, David, 271
dual-class shares, 65, 331, 339–341
Duke Energy, risk management, 173

economic growth, international corporate governance, 20
economic implications of stakeholder commitments, 397–400
efficient capital markets
  corporate discipline, 20
economic growth across countries, 20
  family-controlled business groups, 20–22
  foreign investments, 21
  managerial behavior, 21
  pricing, 19–20
E-Index, 436–439
elections
  boards of directors, 64–66
  contested elections, 65–66
  Dodd-Frank Wall Street Reform Act of 2010, 66
  proxy access, 66
Ellison and pledging, Larry, 274
emergency basis, CEO succession, 202
empire building, 322–323
empirical research, interpreting, 14–15
empirical tests, 14–15
employees
  activism, 394–395
  boards of directors, representation in, 129–131
  compensation, CEO to employee pay differentials, 229
  fast-food chain/employee turnover business model, 156–158
  representation, German Code of Corporate Governance, 36
  right of codetermination, 129
  unions, employee representation, 130–131
enforcement (regulatory), international corporate governance, 25–26
Enron, 1
  accounting manipulation, 260
  structure of audit industry, 303
enterprise risk, 171
entlastung (vote of discharge), 35–36
environments, organizational strategies, 153
Equifax
data breaches, 176
large-scale executive stock sales, 267
Equilar, ownership guidelines, boards of directors, 95

Economic Approach to Human Behavior (1976), The, 5
equity
control group profits, incorporation, 338
ownership, 251
private equity firms, 11, 322
Ernst & Young, HealthSouth Corp. audits, 2
ESG (Environmental, Social and Governance), 11, 70–71, 392, 398–399
CEO activism, 415–417
compensation incentives, 413–415
CSR ratings, 412
external assessments, 407–413
Fortune 500 companies, ESG rankings, 409–411
FTSE Russell ratings, 407
HIP Investor Ratings, 407
MSCI ESG, 408
ratings, 439
evaluating, 444–445
Fortune 500 companies, 409–411
HIP Investor Ratings, 407
ISS E&S Disclosure QualityScore, 442–443
MSCI ESG, 408, 431, 434, 440–442
Sustainalytics, 408, 441–442
TruValue Labs, 408, 443
Vigeo Eiris, 442
SRI funds, 363–364
stakeholders
disclosures, 403–407
metrics, 394, 402
proxy proposals, 393
Sustainalytics, 408
TruValue Labs, 408
estimates, accounting, 299–300
Ethisphere Institute Most Ethical Companies, 407
Etsy, as a benefit corporation (B Corp), 69–70
EVA (Economic Value Added), director compensation, 94
evaluating boards of directors, 96–98
event identification, risk management framework, 169
event studies, 15
excess returns, 14–15
excessive risk taking, 256–257
exchange offers, 274–277
executive compensation, 211, 405, 475
$1 Dollar CEOs, 226
2008 financial crisis, 256–258
activism and CEO compensation, 231–232
annual bonuses, 215
annual incentives, 234–235
annual salaries, 215
benchmarking, 220
benefits, 216, 237–238
clawbacks, 217–218
company size, 224
competing theories on compensation, 242
components of, 214–216
consultants, 221
contractual agreements, 216
contractual restrictions, 217–218
controversy, 212–213
deferred payouts, 217–218
determining, 218–219
disclosure of, 224
disclosures, 238–239
earned (realizable) compensation, 223
expected compensation, 223
"extreme" compensation, 225–226
Harley-Davidson, 223–224
hedging restrictions, 217
large-scale executive stock sales, 266–267
levels of compensation, 221–226
long-term incentives, 235–237
management entrenchment, 228
market forces, 224–225
mixing, 230–231
optimal contracting, 213
oversight, 225
pay differentials
among executives, 226–229
CEOs to employees, 229
peer groups, determining executive compensation, 218–219
pensions, 234–235
performance, 225
awards, 236–237
share awards, 216–217
shares (units), 216
perquisites, 216, 237–238
planning, 214–216
pledging restrictions, 217
ratcheting effect, 219
realized compensation, 223
rent extraction, 213–214
retirement, 216–218
"right" measure of pay, determining, 223–224
say-or-pay policies, 239–242
shareholder feedback on compensation, 239–242
short-term incentives, 233–235
status/career benefits versus compensation, 225
stealth compensation, 237–238
stocks
  ownership guidelines, 217
  restricted stocks, 216
  stock options, 215, 236
target awards, 233
theories, 213–214
tournament theory, 228
United States, 31
executive search firms, CEO succession planning, 203
executive sessions, 58, 116–117
Exelon, ComEd stock prices and CEO wealth, 255, 256
exercise backdating, 263
expected compensation, 223
experience, CEOs, 184–185, 200–201
expressed opinions (auditors), 301
external audits, 299, 301
  accounting estimates/disclosures, 299–300
  audit committees, 300
  auditor opinions, 301
  external auditors as CFO, 307–308
  fraud, 300, 301–302
  HealthSouth Corp., 2
  internal controls, 300
  preparing for, 299
external candidates, CEO succession planning, 193–195
externalities, 399–400
“extreme” compensation, 225–226

F
factory firms, CEOs, 185–186
failures
  corporate governance
    Enron, 1
    HealthSouth Corp., 1–3
    international corporate governance, 4
    self-interested behavior, 4–7
    Tyco, 1
    U.S. corporations, 4
    WeWork, 3
  paying for failure, 204
  risk management, 170
fair value, stock repricing/exchange offers, 275
family-controlled business groups, international corporate governance, 20–22
family-controlled corporations, 449
  agency problems, 450
  earnings, 452
  largest family-controlled businesses in United States, 449–450
  negative effects, 450–451
  positive effects, 451
  succession planning, 451–452
  transparency, 452
FASB (Financial Accounting Standards Board), 29
FAS/CAS pension adjustment, 234–235
fast-food chain/employee turnover business model, 156–158
FCPA (Foreign Corrupt Practices Act), 7
Federal Reserve, The, risk management, 168
federal securities laws, enforcement, 73
fees, director committee fees, 91–92
female directors, 111, 138–139
Fidelity
  proxy voting, 352, 358
  shareholders, 352
fiduciary duties, boards of directors, 67, 72
Fifth Third Bancorp, Risk and Compliance Committees, 63
Finance Committees, 63
financial crisis of 2008, 174–175, 256–258
financial experts
  boards of directors, 127
  defined, 286
financial KPI (Key Performance Indicators), 160, 162
financial reporting
  accounting
    abnormal accruals, 297–298
    AGR, 298
    audit committees, 286–287
    detecting manipulation, 297–299
    external audits, 299–302
    linguistic-based analysis, 298–299
    audit committees, 285–286, 288
    accounting quality, 286–287
    external audits, 300
internal controls, 287–288
transparency, 287
audits
auditor resignations, 309–310
external auditors as CFO, 307–308
GAAS, 305
opinion shopping, 309–310
PCAOB, 305–306
audits, quality of, 302
auditor dismissals, 309–310
auditor resignations, 309–310
auditor rotations, 308–310
external auditors as CFO, 307–308
GAAS, 305
opinion shopping, 309–310
PCAOB, 305–306
Sarbanes-Oxley Act of 2002, 305–307
structure of audit industry, 302–305
decentralization and internal controls, 296–297
dischassals, 309–310
external audits, 299, 301
accounting estimates/disclosures, 299–300
audit committees, 300
auditor opinions, 301
fraud, 300–302
internal controls, 300
preparing for, 299
financial restatements, 291–297
fraud, 296
non-GAAP metrics, 290–291
quality of, 288–290
whistleblowers, 288
financial restatements, 6, 291–297
financial risk, 166–167
financial services firm/investment advisor retention business model, 158–159
financial synergies, acquisitions, 321
Fink, Larry
CEO views on stakeholders, 401–402
stakeholder interests, 395–396
firm performance
CEO personality and, 186
corporate governance, 13–14
equity ownership, 251–253
first time directors, U.S. boards of directors, 111
focus of governance systems, 475–476
Ford Jr. and CEO succession planning, William, 198
Ford Motor Company, 198–199, 450
Foreign Corrupt Policies Act of 1977, audit committees, 287–288
foreign investments, international corporate governance, 21
Form N-PX, 357
Fortune
Best Workplaces for Diversity, 407
Fortune 500 companies, ESG rankings, 409–411
fraud
Association of Certified Fraud Examiners, 7
external audits, 300–302
financial restatements, 296
red flags, 7
free rider problem, 352
friendly acquisitions, 320
FTSE Russell ratings, 407
G
GAAS (Generally Accepted Auditing Standards), 305
Gamble and large-scale executive stock sales, John, 267
Geithner, Timothy
2008 financial crisis, 257
stock prices and CEO wealth, 257
Genchi Genbutsu, 38
General Board of Pension and Health Benefits of the United Methodist Church, behind-the-scene activism, 364
General Mills
Public Responsibility Committees, 63–64
stock prices and CEO wealth, 254, 255
General Motors, employee representation, 130–131
Gephardt and CEO succession planning, Richard, 199
Germany
Aufsichtsrat (supervisory board), 35
banking, corporate governance, 36
codetermination, 28
employee representation, 36
entlastung (vote of discharge), 35–36
globalization, 37
international corporate governance, 35–37
national governance structure, 35–37
shareholders, 36
Vorstand (management board), 35
Gilead, ESG, 399
G-Index, 434–436, 438–439
Glad, product sustainability, proxy disclosures, 404
Glass Lewis & Co.
ESG compensation incentives, 413–414
proxy advisory firms, 375, 377, 379
Glencore, sovereign wealth funds, 357
Globalization
Germany, 37
Japan, 39
going concerns, external audits, 301
golden parachutes, 325, 326
Goldman Sachs, CEO activism, 415
good faith, state corporate laws, 72
Google, employee activism, 395
Gorsky and large-scale executive stock sales, Alex, 266
governance
AGR, 298
corporate governance
activist investors, 11
best practices, 12–13
business setting factors, 19
defined, 4, 8–9, 19
empirical research, interpreting, 14–15
ESG, 11
firm performance and corporate governance, 13–14
“one-size-fits-all” approach, 12–13
as organizational discipline, 476–477
Principles of Corporate Governance (Business Roundtable), 397
private equity firms, 11
proxy advisory firms, 12
ratings. See separate entry
shareholders, 8–9
stakeholders, 8–9
standards, 9–12
failures
Enron, 1
HealthSouth Corp., 1–3
international corporate governance, 4
self-interested behavior, 4–7
Tyco, 1
U.S. corporations, 4
WeWork, 3
family-controlled corporations, 449
agency problems, 450
earnings, 452
largest family-controlled businesses in United States, 449–450
negative effects, 450–451
positive effects, 451
succession planning, 451–452
transparency, 452
nonprofit organizations. See also corporations
agency problems, 466
audits, 465
boards of directors, 463–465
compensation, 464, 465–466
by count/activity, 463
donor support, 466
Sarbanes-Oxley Act of 2002, 465
tax-exempt status, 463
trustees, 463–464
United States nonprofits, 462
private equity firms, 458–459
boards of directors, 460–461
compensation, 461
leveraged buyouts, 460
NYSE standards, 460
returns, 461–462
summary statistics, 459
ratings. See ratings
venture-based companies. See venture-based companies
governance committees, 62
governance systems
context, 477
focus of, 475–476
grants (equity), manipulating, 261–263
GRI (Governance Risk Indicators), 430, 434
groupthink, boards of directors, 136–137

H
Halliburton, politically connected boards of directors, 128
Hamm and pledging, Harold, 274
Harley-Davidson, CEO compensation, 223–224
Hastings and sharing information with boards of directors, Reed, 60
HealthSouth Corp., 1–3
  external audits, 301–302
  fraud, 301–302
hedging, 269
  activist hedge funds, 366–369
  disclosures, 272
  examples of, 270–271
  policies, 272
  PVF, 270–272
  restrictions, 217
  wolf pack strategies, 367
  zero-cost collars, 270
herding behavior, mergers, 322–323
Hershey Company, insider trading, 265
Hill and lead independent directors, Bonnie, 118
HIP Investor Ratings, 407, 442
Hockaday Jr. and busy directors, Irving, 132
Hofstede Model of Cultural Dimensions, 27
Holliday and CEO/chairman of the board separation, Charles, 114–115
Home Depot, lead independent directors, 118
hopeful saviors, outgoing CEO behaviors, 200
horse races, CEO succession planning, 196
hostile takeovers, 320, 328–329
  impact of, 321
  mergers, 320–321
    compensation incentives, 324
    empire building, 322–323
    herding behavior, 322–323
    hubris, 322–323
    targets, acquisitions, 324–325
  proxy contests, 320
  tender offers, 320
H-shares, 42
hubris, mergers, 322–324
human capital reports, 403
Human Resources (HR), risk management, 171

I
IAB (International Advisory Board), Toyota Motor Corp., 38
IASB (International Accounting Standards Board), 24
Ibbotson and director resignations, Steven, 99
IBM, proxy disclosures and climate risk, 403
Icahn and unwanted acquirers (bidders), Carl, 343
ICE (Immigration and Customs Enforcement), employee activism, 394
Iger and CEO succession planning, Robert, 195–196
IGNITE Strategy, 404
incentives
  annual incentives, 234–235
  compensation incentives, ESG, 413–415
  long-term incentives, 235–237
  mergers, 322–325
  short-term incentives, 233–235
incorporation, antitakeover protections, 337–339
indemnification of directors, 73–74
independence
  boards of directors, 56–57, 122–125
  chairmen of the board, 111
  conventionally independent, 123–124
  independent committees, 125–126
  independent directors, 113–116
    lead independent directors, 116–119
    NYSE, 122–124
    U.S. boards of directors, 110–111
  socially independent, 123–124
index (passive) investing, 370
India
  Clause 49, 43
  international corporate governance, 43–44
  national governance structure, 43–44
individual activist investors, 364–366
information, board evaluations, 97
information communication systems, risk management framework, 170
inside-outside model, CEO succession planning, 193–195
insider trading, 264–267
  hedging, 269–273
  Rule 10b5-1, 267–269
institutional investors
  activist hedge funds, 367
  blockholders and, 354–356
  proxy voting, 357–359
  stakeholders, 394–395
insurance, D&O insurance policies, 74–75
interlocked (connected) boards of directors, 134–135
internal audits, risk management, 171
internal controls
    audit committees, 287–288
    decentralization, risk management, 296–297
    external audits, 300
internal environment, risk management framework, 169
international corporate governance, 28
    accounting standards, 23–25
    Brazil, 44–46
    business setting factors, 19
    capital market efficiency
        corporate discipline, 20
        economic growth across countries, 20
        family-controlled business groups, 20–22
        foreign investments, 21
        managerial behavior, 21
        pricing, 19–20
    China, 41–43
    codetermination, 28
    corruption, 23
    failures of, 4
    Germany, 28, 35–37
    Hofstede Model of Cultural Dimensions, 27
    IASB, 24
    IFRS, 24–25
    India, 43–44
    Japan, 37–40
    legal systems, 22–23
    regulatory enforcement, 25–26
    Russia, 46–47
    shareholder-centric view, 28
    societal/cultural values, 26–28
    South Korea, 40–41
    stakeholder-centric view, 28, 37–39
    United Kingdom, 31–35
    United States, 29–31
international experience, recruiting directors, 82
interpretation, corporate performance, 161
Investment Company Act of 1940, 357, 366
investments
    active investors, 352
    activist investors, 11, 359–361
        activist hedge funds, 366–369
    blockholders, 354–356
    ESG, SRI funds, 363–364
    externalities, 399–400
financial services firm/investment advisor retention business model, 158–159
foreign investments, capital market efficiency, 21
index (passive) investing, 370
institutional investors, 394–395
    activist hedge funds, 367
    blockholders and, 354–356
    proxy voting, 357–359
passive investors, 352
sovereign wealth funds, 356–357
SRI funds, 363–364, 392
sustainable investment funds, 392–393
IPO (Initial Public Offerings)
    pre-IPO companies, 455–457
    venture-based companies, 453–455
ISS (Institutional Shareholder Services), 428
    BlackRock, 396
    CGQ, 428–429
    GRId, 430, 434
    ISS E&S Disclosure QualityScore, 442–443
    predictive ability of ratings, 433
    proxy advisory firms, 375, 377, 380
    QualityScore, 430–431, 434
    stakeholder interests, 396
ITP (Insider Trading Policies), 264–265

J
Japan
    Corporate Governance Code, 40
    globalization, 39
    international corporate governance, 37–40
    keiretsu, 37, 39
    Ministry of Justice, 39
    national governance structure, 37–40
    Olympus Corporation of Japan, 4
    poison pills (shareholder’s rights plans), 335
    stakeholder-centric view, international corporate governance, 37–39
    Stewardship Code, 40
    Toyota Motor Corp., board of directors, 38
    zaibatsu, 37
Jefferies and pay differentials, Michael, 227
JOBS (Jumpstart Our Business Startups) act, 30
Johnson & Johnson
    large-scale executive stock sales, 266
    stock prices and CEO wealth, 255
JP Morgan Chase
CEO “brain drain” to private equity firms, 183
executive compensation, 212–213
risk management, 173

K
KBW Bank Index, risk management, 168
keiretsu, 37, 39
Kerr and lead independent directors, Sir John, 118
Kikukawa, Tsuyoshi, 4
Kilts and CEO “brain drain” to private equity firms, James, 183
Knight and CEO cultural fit, Phil, 194–195
Koch Industries, 450
Korn/Ferry Institute, outgoing CEO position on boards of directors, 89
Kozlowski and Tyco, Dennis, 1
KPI (Key Performance Indicators)
corporate performance metrics, 160–162
defined, 159
financial KPI, 160, 162
nonfinancial KPI, 160, 162
Kraft, stock prices and CEO wealth, 255
Krispy Kreme, financial restatements, 294

L
labor market for CEOs (Chief Executive Officers), 181–183
labor pools of CEO talent, 184–186
large-scale executive stock sales, 266–267
law
boards of directors, state corporate law, 72
federal securities laws, enforcement, 73
securities laws, board of director disclosure obligations, 71
state corporate law
boards of directors, 72
business judgment rules, 72
damages, paying, 72
good faith, 72
incorporation, antitakeover protections, 337–339
Walt Disney Company, 72
lead directors, 58
lead independent directors, 116–119
legal implications of stakeholder commitments, 397–400
legal obligations of directors, 66–70
legal systems
corruption, 23
international corporate governance, 22–23
risk management, 171
securities laws, board of director disclosure obligations, 71
Lehman Brothers
lead independent directors, 120
outside (nonexecutive) directors, 120
levels of compensation, 221–226
leveraged buyouts, private equity firms, 460
Lewis and CEO/chairman of the board separation, Ken, 114
Liberty Tax, director resignations, 99
linguistic-based analysis, accounting, 298–299
Lockheed Martin, value statements, 152–153
long-term incentives, 235–237
long-term plans, stakeholder interests, 392–397
long-term value, takeovers, 330
losers, succession, 196
loyalty, duty of, 67–68
Lululemon Athletica, risk management, 167

M
MacDonald, Larry J., sustainability skills matrix, 405
majority voting, 65, 371
management
behavioral discipline of management and capital market efficiency, 21
boards of directors, 59–60
entrenchment, pay differentials, 228
risk management. See risk management venture-based companies, 453, 457
Vorstand (management board), 35
Manne and market for corporate control, Henry, 320
MAO (Material Adverse Outcomes), 218
market efficiency (capital)
corporate discipline, 20
economic growth across countries, 20
family-controlled business groups, 20–22
foreign investments, 21
managerial behavior, 21
pricing, 19–20
market for corporate control, 319
  acquisitions. See acquisitions
  mergers, 321–325
    compensation incentives, 322–324
    empire building, 322–323
    herding behavior, 322–323
    hubris, 322–323
    targets, acquisitions, 324–325
private equity firms, 322
  takeovers. See takeovers
market forces, executive compensation, 224–225
market organizational strategies, 152
Mars, 195, 450
“massaging” earnings, 7
material information, board of director
disclosure obligations, 71
McCallister and large-scale executive stock
sales, Kevin, 267
McClendon and pledging, Aubrey, 273–274
meetings
  board evaluations, 97
  board meetings, 58
    NACD, 58–59
    Sarbanes-Oxley Act of 2002, 58
Merck & Co., Research Committees, 63
mergers, 320, 321
  compensation incentives, 324
  empire building, 322–323
  herding behavior, 322–323
  hubris, 322–323
  targets, acquisitions, 324–325
metrics, corporate performance, 160–162
Michaleski and sustainability skills matrix,
Robert B., 405
Microsoft
  employee activism, 394
  executive compensation, 405
  unwanted acquirers (bidders), 343
Miller and director resignations, James, 99–100
Ministry of Justice (Japan), 39
misconduct of CEOs, 190–191
misdirected focus of governance systems,
475–476
mission statements, 151–152
mixing compensation, 230–231
monitoring, risk management, 170
Monsanto, entlastung (vote of discharge),
35–36
Moody’s Investor Services, credit ratings, 426–428
Morphic Therapeutics, observers (boards of
directors), 84
Morris and CEO severance agreements,
Michael, 204
Moynihan and CEO/chairman of the board
separation, Brian, 114–115
MSCI ESG, 408, 431, 434, 440–442
Mulally and CEO succession planning, Alan,
198–199
Musk and “extreme” compensation, Elon, 225
myopia (acquirers), 330

N
NACD (National Association of Corporate
Directors), 151
  board meetings, 58–59
  recruiting directors, 59
  risk management, 174
Nadella and employee activism, Satya, 394
Nappier and pay differentials, Denise,
226–227
Nardelli and lead independent directors,
Robert, 118
national governance structures
  Brazil, 44–46
  China, 41–43
  Germany, 35–37
  India, 43–44
  Japan, 37–40
  Russia, 46–47
  South Korea, 40–41
  United Kingdom, 31–35
  United States, 29–31
Netflix, board of directors, 60
Neumann and WeWork, Andrew, 3
new CEO skills-and-experience profiles,
200–201
newly appointed CEOs, 191–193
Newsweek Green, 407
Nike, 450
  behind-the-scene activism, 364
  CEOs, cultural fit, 194–195
nominating committees, 62
nonexecutive (outside) directors, 119–121
nonfinancial KPI (Key Performance
Indicators), 160, 162
non-GAAP metrics, financial reporting, 290–291
nonprofit organizations. See also corporations
agency problems, 466
audits, 465
boards of directors, 463–465
compensation, 464, 465–466
by count/activity, 463
donor support, 466
Sarbanes-Oxley Act of 2002, 465
tax-exempt status, 463
trustees, 463–464
United States nonprofits, 462

nonshareholders
board of directors duties, 69
ESG, 70–71
Northern Trust, proxy voting, 358
Northrup Grumman, annual incentives, 234–235
Norway Government Pension Fund, 356–357
Novo Mercado, 45–46
N-PX, Form, 357
NRG Energy, CEO activism, 415
NYSE (New York Stock Exchange), 29–30
controlled corporations, 340–341
independent directors, 122–124
private equity firms, 460
risk management, 173

O
objective setting, risk management framework, 169
objectivity, corporate performance, 161
observers (boards of directors), 83–84
Ocean Plastics Leadership Summit, 404
OECD (Organization for Economic Cooperation and Development), 55, 151
Olympus Corporation of Japan, 4
“one-size-fits-all” approach, corporate governance, 12–13
operational risk, 166, 171
opinion shopping, 309–310
opinions (auditors), 301, 309–310
opportunity costs, directorships, 92
optimal contracting, 213
Oracle
financial restatements, 292–293
pledging, 274
organizational culture, 476
organizational design, 476
organizational discipline, corporate governance as, 476–477
organizational strategies, 151
advantage, 152
boards of directors, 162–164
business models, 155–156
casual business models, 155, 161–162
development process, 156
fast-food chain/employee turnover
business model, 156–158
financial services firm/investment advisor retention business model, 158–159
KPI, 159–162
defined, 152–153
development process, 153
environments, 153
implementation process, 154–156
markets, 152
mission statements, 151–152
performance
KPI, 159–162
metrics, 160–162
resources, 153
scope, 152
stakeholders, 153
outgoing CEOs
behaviors, 199–200
position on boards of directors, 89
outliers, risk management, 165
outside (nonexecutive) directors, 119–121
overhang, stock, 457
overlapping committees, 135–136
oversight
executive compensation, 225
oversight capacity (boards of directors), 55–56
risk management, 172–173
Ovitz and state corporate law, Michael, 72
ownership
changes in ownership, acquisitions, 321
guidelines
boards of directors, 95–96
effective compensation, 217
P
parachutes
golden parachutes, 325, 326
tin parachutes, 343
Parker and “extreme” compensation, Doug, 226
Parker and cultural fit of CEOs, Mark, 195
passive (index) investing, 370
passive aggressors, outgoing CEO behaviors, 200
passive investors, 352
pay differentials among executives, 226–229
CEOs to employees, 229
paying for failure, 204
payouts, deferred, 217–218
PCAOB (Public Company Accounting Oversight Board), 305–306
Pearson and hostile takeovers, Michael, 329
peer groups, executive compensation, 218–219
Peltz, activist hedge funds, 369
Pembina, sustainability skills matrix, 405
pensions
FAS/CAS pension adjustment, 234–235
pension funds, 356–357, 361–363
sovereign wealth funds, 356–357
Pepper and characteristics of chairmen of the board, John, 113
Perez and cultural fit of CEOs, William, CEOs, 194–195
performance
abnormal returns, 14–15
alphas, 14–15
awards, 236–237
boards of directors, 139–141, 162–164
CEOs, 183, 186, 188–189, 251–253
corporate performance metrics, 160–162
corporations, lead independent directors, 117
directorships, 93–94, 162–164
event studies, 15
excess returns, 14–15
executive compensation, 225
firm performance
  corporate governance, 13–14
equity ownership, 251–253
KPI
corporate performance metrics, 160–162
defined, 159
financial KPI, 160, 162
nonfinancial KPI, 160, 162
lead independent directors, 117
performance-based director pay, 93–94
Push-Out Scores, 188–189
risk management, 174
share awards, 216–217
targets, acquisitions, 324
Tobin’s Q, 15
performance shares (units), 216
perquisites, 216, 237–238
Pershing Square, hostile takeovers, 328–329
personalities of CEOs, 186, 190–191
Pfizer, stock prices and CEO wealth, 255
Pitney-Bowes, board of directors ownership guidelines, 95
planning
  compensation plans, 214–216
  long-term plans, stakeholder interests, 392–397
  poison pills (shareholder’s rights plans), 331, 333–335
target ownership plans, 253
pledging, 217, 273–274
plurality of votes, board of director elections, 64
poison pills (shareholder’s rights plans), 331, 333–335
polities, boards of directors, 127–128
power blockers, outgoing CEO behaviors, 200
precision, corporate performance, 161
predictive ability, ratings, 425–426, 432–434
pre-IPO companies, 455–457
president/COO, CEO succession planning, 195–196
pricing, capital market efficiency, 19–20
Principles of Corporate Governance, 55, 397
principles-based accounting, 24, 25
private equity firms, 11, 458–459
  boards of directors, 460–461
  CEOs, 183
  compensation, 461
  leveraged buyouts, 460
  market for corporate control, 322
  NYSE standards, 460
  returns, 461–462
  summary statistics, 459
private-company exchanges, venture-based companies, 453–455
Procter & Gamble (P&G), activist hedge funds, 369
product sustainability, proxy disclosures, 404
professional directors, recruiting, 85–86
proposals, shareholder, 359–360
proxy access, 66, 372
proxy advisory firms, 12, 375–380
proxy contests, 320, 360–361
proxy disclosures
  climate risk, 404
  product sustainability, 404
proxy proposals, ESG, 393
Public Responsibility Committees, 63–64
publicly traded companies, China, 42
Push-Out Scores, 188–189
PVF (Prepaid-Variable Forward), 270–272
Pyot and hostile takeovers, David, 328–329

Q
Q (Tobin’s), 15
Qatar Investment Authority, sovereign wealth funds, 357
qualified opinions, external audits, 301
QualityScore (ISS), 430–431, 434
Quest Software, 271

R
Rasulo, Jay, CEO succession planning, 195
ratcheting effect, executive compensation, 219
rating agencies, 10–11
ratings, governance
  corporate governance index, 434
  credit ratings, 426–428
  CSR ratings, 412
  E-Index, 436–439
  ESG ratings, 412, 439
  evaluating, 443–444
  HIP Investor Ratings, 407, 442
  ISS E&IS Disclosure QualityScore, 442–443
  MSCI ESG, 408, 431, 434, 440–441
  Sustainalytics, 408, 441–442
  TruValue Labs, 408, 443
  Vigeo Eiris, 442
G-Index, 434–436, 437–438
ISS, 425–426
  CGQ, 428–429
  GRIId, 430, 434
  predictive ability of ratings, 433
  QualityScore, 430–431, 434
Moody’s Investor Services, 426–428
MSCI ESG, 431, 434
predictive ability, 425–426, 432–434
third-party ratings services, 425–426
viability of governance ratings systems, 438–439
rational self-interest, 5
ratios of pay
  among executives, 226–229
  CEO to employees, 229
realizable (earned) compensation, 223
realized compensation, 223
recruiting directors, 80–81
  active CEOs, 81–82
  Analog Devices, 87
  appropriate/reasonable compensation, 92–93
  committee fees, 91–92
  compensation, 90–91
  Covidien, 87
  disclosure of director qualifications, 86–87
  diversity, 84–85
  EVA, 94
  international experience, 82
  opportunity costs, 92
  performance-based director pay, 93–94
  process of, 87–89
  professional directors, 85–86
  Regulation S-K, 86
  special expertise, 82–84
  supplemental pay, 82–84
red flags (fraud), 7
Regulation S-K (SEC), 86
regulatory enforcement, 25–26
Reinhard on removing directors, J. Pedro, 100
relations, board evaluations, 97
removing directors, 66, 98–102
rent extraction, 213–214
reporting
  climate change impact reports, 403
  corporate responsibility reports, 403–404
  CSR reports, 406–407
  human capital reports, 403
  sustainability reports, 403, 406–407
reporting, financial
  accounting
    abnormal accruals, 297–298
    AGR, 298
    audit committees, 286–287
    detecting manipulation, 297–299
    external audits, 299–302
    linguistic-based analysis, 298–299
audit committees, 285–286, 288
  accounting quality, 286–287
  external audits, 300
  internal controls, 287–288
  transparency, 287
audits, quality of, 302
  auditor dismissals, 309–310
  auditor resignations, 309–310
  auditor rotations, 308–310
  external auditors as CFO, 307–308
  GAAS, 305
  opinion shopping, 309–310
  PCAOB, 305–306
  Sarbanes-Oxley Act of 2002, 305–307
  structure of audit industry, 302–305
decentralization and internal controls, 296–297
dismissals, 309–310
  external audits, 299, 301
  accounting estimates/disclosures, 299–300
  auditor committees, 300
  auditor opinions, 301
  fraud, 300–302
  internal controls, 300
  preparing for, 299
financial restatements, 291–297
  fraud, 296
  non-GAAP metrics, 290–291
  quality of, 288–290
  whistleblowers, 288
repricing stocks, 274–277
  Republic Services, ESG, 399
reputational risk, 167
Research Committees, 63
resignations
  auditors, 309–310
  directors, 99–100
resources, organizational strategies, 153
responding to risk, 170
responsibilities, boards of directors, 55–56
restatements (financial), 6, 291–297
restricted stocks, 216
retirement
  boards of directors, 111–112
  executive compensation, 216–218
returns
  abnormal returns, 14–15
  excess returns, 14–15
  private equity firms, 461–462

Reuters, large-scale executive stock sales, 266
  “right” measure of pay, determining, 223–224
rights of
  codetermination, 129
  shareholders, 478
  stakeholders, 478
Risk and Compliance Committees, 63
risk management, 164, 475
  2008 financial crisis, 174–175
  accounting manipulation, 261
  AGR, 298
  American Institute of Certified Public
    Accountants and Chartered Institute of
    Management Accountants, 174
  assessing risk, 170
  black swans, 165
  boards of directors, 172–174
  business models, 166–169
  central risk, 171
  CEOs, 166
  climate risk, proxy disclosures, 404
  committees, 172–173
  compensation disclosures, 258–259
  compliance risk, 167
  cultural risk, 171
  cultural shortcomings, 170
decentralization, 170
defined, 169
  Dodd-Frank Wall Street Reform Act of 2010, 164–165
even enterprise risk, 171
equity ownership, 254–259
  excessive risk taking, 256–257
  failures, 170
  financial risk, 166–167
  frameworks, 169–170
  GRId, 430, 434
  Human Resources (HR), 171
  internal audits, 171
  legal systems, 171
  Lululemon Athletica, 167
  MSCI ESG ratings, 431, 440
  NACD, 174
  NYSE, 173
  operational risk, 166, 171
  outliers, 165
  oversight, 172–173
  performance, 174
  reputational risk, 167
  responding to risk, 170
risk, defined, 165
structural shortcomings, 170–171
tolerance for risk, 165
“transactional” risk management, 170–171
venture-based companies, 453
Wells Fargo, 168
robovoting, 378
Roche on cultural fit of CEOs, Gerry, 194–195
rotating auditors, audit quality, 308–310
Royal Dutch Shell
accounting manipulation, 260
lead independent directors, 118
Rule 10b5-1, 267–269
Rule 14a-8 (SEC), 372
rules-based accounting, 24
Russia
international corporate governance, 46–47
national governance structure, 46–47
shareholder-centric view, international corporate governance, 46–47
S
salaries, annual, 215
Salesforce, CEO activism, 415
Salix Pharmaceuticals, hostile takeovers, 329
Sarbanes-Oxley Act of 2002, 9–10, 30
audit committees, 287–288
audits, quality of, 305–307
boards of directors
board meetings, 58
lead directors, 58
structure of, 110
clawbacks/deferred payouts, 217
committees, creating, 61
financial reporting, 287–288
independent committees, 125
nonprofit organizations, 465
stock option backtrading, 263
SASB (Sustainability Accounting Standards Board), 406
say-or-pay policies, 35, 239–242
scope, organizational strategies, 152
Scrushy and HealthSouth Corp., Richard, 1
Seagate Technologies, observers (boards of directors), 84
searching, executive search firms, 203
SEC (Securities and Exchange Commission), 29
decentralization and internal controls, 296–297
enforcement, 73
financial restatements, 291
Form N-PX, 357
insider trading, 264–266
Investment Company Act of 1940, 357, 366
proxy advisory firms, 378
proxy voting, 357, 372–373
Regulation S-K, 86
Rule 10b5-1, 267–269
Rule 14a-8, 372
securities laws
board of director disclosure obligations, 71
federal securities laws, enforcement, 73
security, cybersecurity, 175–176
self-interested behavior
evidence of, 5–7
failures of corporate governance, 4–7
rational self-interest, 5
sensitivity, corporate performance, 161
severance agreements
incorporation, antitakeover protections, 338
CEOs, 204–205
share awards, performance, 216–217
shareholder-centric view, international corporate governance, 28
Russia, 46–47
United States, 31
shareholders
active investors, 352
activist investors, 359–361
activist hedge funds, 366–369
individual activist investors, 364–366
activity levels, 352
bases
composition of, 353–354
size of, 352
behind-the-scene activism, 364
blockholders, 354–356
board of directors duties, 68–69
coordinating, 352
corporate governance, 8–9
democracies
corporate engagement, 371, 374–375
majority voting in uncontested director elections, 371
proxy access, 372
proxy advisory firms, 375–380
proxy voting, 372–374
dissident slate, 360–361
ESG, SRI funds, 363–364
feedback on executive compensation, 239–242
free rider problem, 352
German corporate governance, 36
incorporation, antitakeover protections, 337–339
index (passive) investing, 370
influence of, 351, 353
objectives of, 352
passive investors, 352
pension funds, 361–363
perspective of, 351
poison pills (shareholder’s rights plans), 331–333
proposals, 359–360
proxy access, 372
proxy contests, 360–361
proxy voting, 352, 357–359
removing directors, 100
rights of, 478
role of, 351–353
say-or-pay policies, executive compensation, 239–242
sovereign wealth funds, 356–357
SRI funds, 363–364
TSR, 154–155
uncontested director elections, majority voting, 371
voting rights, incorporation, antitakeover protections, 338
sharing information, boards of directors, 59–60
short-term incentives, 233–235
Side A (D&O insurance policies), 74
Side B (D&O insurance policies), 74
Side C (D&O insurance policies), 74
skills, new CEO skills-and-experience profiles, 200–201
Smith and HealthSouth Corp., Weston L., 1
socially independent, 123–124
societal/cultural values
codetermination, 28
Hofstede Model of Cultural Dimensions, 27
international corporate governance, 26–28
shareholder-centric view, 28, 31
stakeholder-centric view, 28, 37–39
Solso and employee representation, Tim, 130
Sorkin and 2008 financial crisis, Andrew Ross, 175
South Korea
chaebol, 40–41
international corporate governance, 40–41
national governance structure, 40–41
Southern Company, Georgia Power division, stock prices and CEO wealth, 255, 256
sovereign wealth funds, 356–357
special expertise, recruiting directors, 82–84
specialized committees, 62–64
spring-loading, 263
SPX Corporation, performance-based director pay, 94
SRI (Socially Responsible Investment) funds, 363–364, 392
staggered boards, 64, 331, 335–337
Staggs and CEO succession planning, Tom, 195–196
stakeholder-centric view, international corporate governance, 28, 37–39
stakeholders, 391–392
CEO views on, 401–402
commitments to
economic implications, 397–400
legal implications, 397–400
Principles of Corporate Governance (Business Roundtable), 397
corporate governance, 8–9
CSR, 392, 406–407
director views on, 401–402
employee activism, 394–395
ESG, 392, 398–399
CEO activism, 415–417
CSR ratings, 412
disclosures, 403–407
external assessments, 407–413
Fortune 500 companies, ESG rankings, 408
metrics, 394, 402
proxy proposals, 393
incorporation, antitakeover protections, 337–339
institutional investors, 394–395
organizational strategies, 153
pressures incorporating interests in long-term plans, 392–397
proxy proposals, ESG, 393
rights of, 478
SRI funds, 392
sustainability reports, 406–407
sustainable investment funds, 392–393
standing committees, 60
Starbucks
CEO activism, 415
exchange offers, 275
state corporate law
boards of directors, 72
business judgment rules, 72
damages, paying, 72
good faith, 72
incorporation, antitakeover protections, 337–339
Walt Disney Company, 72
status/career benefits versus compensation, 225
stealth compensation, 237–238
Steel, Myron, 474
Steel Partners, poison pills (shareholder’s rights plans), 335
Stewardship Code (Japan), 40
stocks
backtrading, 262–263
dual-class shares, 331, 339–341
equity ownership, 252, 254–258
exchange offers, 274–277
insider trading, 264–267
large-scale executive stock sales, 266–267
overhang, 457
ownership guidelines, 95–96, 217
repricing, 274–277
restricted stocks, 216
stock options, 215, 236, 262–263
prices and CEO wealth, 254–258
Strategic Management, 153
strategies, organizational, 151
advantage, 152
boards of directors, 162–164
business models, 155–156
casual business models, 155, 161–162
development process, 156
fast-food chain/employee turnover business model, 156–158
financial services firm/investment advisor retention business model, 158–159
KPI, 159–162
defined, 152–153
development process, 153
environments, 153
implementation process, 154–156
markets, 152
mission statements, 151–152
performance
KPI, 159–162
metrics, 160–162
resources, 153
scope, 152
stakeholders, 153
structural shortcomings, risk management, 170–171
Stumpf and risk management, John, 168
succession planning
CEOs, 183, 193, 475
boards of directors, 201–202
board-led searches, 198–199
cultural fit, 194–195
current directors as CEOs, 202
emergency basis, 202
executive search firms, 203
external candidates, 193–195
horse races, 196
inside-outside model, 193–195
losers, 196
new CEO skills-and-experience profiles, 200–201
outgoing CEO behaviors, 199–200
president/COO, 195–196
process of, 197–201
transition period, 201
family-controlled corporations, 451–452
supervisors, Aufischtstrat (supervisory board), 35
supplemental pay, directorships, 91
Surge Components, director resignations, 99–100
sustainability
investment funds, 392–393
product sustainability, proxy disclosures, 404
reporting, 403, 406–407
skills matrix, 405
Sustainalytics, 408, 441–442
T
takeovers
acquirer myopia, 330
antitakeover defenses, 320
antitakeover protections, 330
classified boards, 331, 335–337
incorporation, 337–339
poison pills (shareholder’s rights plans), 331, 333–335
staggered boards, 331, 335–337
bargaining power, 330
dual-class shares, 331, 339–341
hostile takeovers, 320, 328–329
impact of, 321
mergers, 320–325
proxy contests, 320
tender offers, 320
impact of, 321
long-term value, 330
mergers, 320–321
compensation incentives, 324
empire building, 322–323
herding behavior, 322–323
hubris, 322–323
targets, acquisitions, 324–325
proxy contests, 320
tender offers, 320
value, determining, 327–330
venture-based companies, 457–458
talent, CEOs
development/retention, 183
labor pools of talent, 184–186
target awards, 233
Target Corporation
data breaches, 176
ownership guidelines, boards of directors, 95
target ownership plans, 253
targets, acquisitions, 320, 324–327
tax-exempt status, 463
Taylor and activist hedge funds, David, 369
Taylor II and zero-cost collars, Alexander, 270
tender offers, 320
tenure, CEOs, 184, 205
Tesla, “extreme” compensation, 225
testing
best practices, 474
predictive ability, ratings, 432–434
theft of data, cybersecurity, 175–176
third-party ESG ratings, 412
third-party ratings services, 425–426
Thornton and CEO succession planning, John, 199
timing, value trading through, 262–263
tin parachutes, 343
Tobin’s Q, 15
tokenism, boards of directors, 139
tolerance for risk, 165
Too Big to Fail (2009), 175
tournament theory, executive compensation, 228
Toyota Motor Corp.
board of directors, 38
Genchi Genbutsu, 38
IAB, 38
trading
blackout periods, 264–265
hedging, 269–273
insider trading, 264–267
Rule 10b5-1, 267–269
“transactional” risk management, 170–171
transition period, CEO succession planning, 201
transparency
audit committees, 287
boards of directors, 60
family-controlled corporations, 452
stakeholders, ESG disclosures, 403–407
Travelers, benchmarking executive compensation, 220
Treadway, Jr. and decentralization and internal controls, James, 296–297
Trian, activist hedge funds, 369
trustees, nonprofit organizations, 463–464
TruValue Labs, 408, 444
TSR (Total Shareholder Returns), 154–155
turnover, CEOs, 186–190
Tyco, 1
Tyson Foods, 450

U
UAW (United Auto Workers), employee representation, 130–131
UBS analysts, HealthSouth Corp., 2
unions, employee representation, 130–131
United Kingdom
Anglo-Saxon model, 31
Cadberry Committee Code of Best Practices, 32–34
Companies Acts, 31–32
comply-or-explain system, 34
Corporate Governance Code, 34, 151, 374–375
Directors’ Remuneration Report Regulations, 35
international corporate governance, 31–35
national governance structure, 31–35
say-or-pay policies, 35

United States
Boehner, U.S. Speaker of the House John, 128
Bush, U.S. President George W., 128
CEO compensation, 221–222, 230–231
Connecticut Retirement Plans and Trust Funds, pay differentials, 226–227
corporate boards of directors, structure of, 110–112
Delaware Court of Chancery, 397–398
Dodd-Frank Wall Street Reform Act of 2010, 30
executive compensation, 31
family-controlled corporations, 449–450
FASB, 29
FCPA, 7
Federal Reserve, The, risk management, 168
ICE, employee activism, 394
international corporate governance, 29–31
JOBS act, 30
equity ownership, corporate governance, 31
national governance structure, 29–31
nonprofit organizations, 462
NYSE, 29–30
Cheney, U.S. Vice President Richard, 128
Sarbanes-Oxley Act of 2002, 30
SEC, 29
shareholder-centric view, international corporate governance, 31
United Way, sustainability skills matrix, 405
UnitedHealth Group, hedging policies/disclosures, 272
units (performance shares), 216
unqualified opinions, external audits, 301
unwarranted acquirers (bidders), 341–344

V
Valence Pharmaceuticals International, hostile takeovers, 328–329
value
assets, targets, acquisitions, 325
long-term value, takeovers, 330
statements, 151–152
takeovers, determining, 327–330
trading through timing, stock option backtrading, 262–263
Vanguard
corporate engagement, 374
proxy voting, 358
venture-based companies, 452–453
antitakeover protections, 457–458
boards of directors, 454–455, 457
compensation, 457
IPO, 454–455
management, 457
positive effects, 457–458
pre-IPO companies, 455–457
private-company exchanges, 453–455
public offerings, 453
risk management, 453
stock overhang, 457
summary statistics, 453
takeovers, 457–458
Verifiable, corporate performance, 161
Verizon, unwanted acquirers (bidders), 343
Vermillion Energy, sustainability skills matrix, 405
viability of governance ratings systems, 438–440
Vigeo Eiris, 442
Vorstand (management board), 35
voting
autovoting, 378
board of director elections, 64–66
cumulative voting, 65
dual-class shares, 65
incorporation, antitakeover protections, 338
majority voting, 65, 371
plurality of votes, 64
proxy access, 66
robovoting, 378
vote of discharge (entlastung), 35–36

W
Wall Street Journal
corporate engagement, 374
stock option backtrading, 263
Walmart, 415, 450
Walt Disney Company
CEO succession planning, 195–196
chairmen of the board, characteristics of, 113
president/COO, 195–196
state corporate law, 72
wedges, dual-class shares, 339
Wells Fargo
  clawbacks/deferred payouts, 218
  risk management, 168
WeWork, 3
whistleblowers, 288
Whole Foods, CEO to employee pay
differentials, 229
Williamson on interpreting empirical research,
Oliver, 14
Wilson and risk management, Chip, 167
wolf pack strategies, 367
women directors, 111, 138–139
Woodford and Olympus Corporation of Japan,
Michael, 4
WorldCom, accounting manipulation, 260
Wrigley and cultural fit of CEOs, 195
written consent, boards of directors, 58

X–Y
Xstrata, sovereign wealth funds, 357
Yahoo!
  data breaches, 176
  unwanted acquirers (bidders), 343
Yang and unwanted acquirers (bidders), Jerry,
343
Ying and large-scale executive stock sales, Jun,
267

Z
zaibatsu, 37
zero-cost collars, 270
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