The critical difference

Business leaders and investors more than ever believe that companies with the best governance will be the best-performing companies. The foundation for corporate governance is a commitment to ethical behavior. **BY STEVE ODLAND**

I'M TOLD THAT when the Lord was driving Adam and Eve out of paradise into the brutal world before them, Adam turned to his mate and observed, "Eve, I think things are going to change." And things have been changing ever since.

Because of constant change and dynamism, the American corporation is alive and well, although we need few reminders that we've been through a difficult period of business history. But it's interesting to note that this same period was also accompanied by ethical scandals by political leaders, lawyers, journalists, and even the clergy. What does it say about our whole society when few of our hallowed institutions are free from scandal? The corporate ethics lapses seem to correlate with an ethics shift in our society as a whole.

The financial frauds shook the trust and confidence of Americans who rely on business for their jobs, their savings, and their retirement security. Public outrage followed sensationalized stories of misdeeds, and federal and state officials followed in turn with new regulations on corporations. All responsible business leaders were embarrassed by these scandals. We could not content ourselves with blaming a few bad apples, assuring the public that the rest of us were just fine, and going back to business as usual. Given an appreciation of how corporations came to play such a strong role in the human experience (see sidebar on page 20), let's review where the American business corporation and its system of governance stand today.

We can rightly regard the costs of complying with the new standards as investments in public trust and confidence.

It was clear that our governance processes needed improvements and that we needed to demonstrate a commitment to reform and a commitment to restoring investor confidence.

Taking the initiative

My company, AutoZone, a Fortune 500 company, is committed to corporate governance, customer service, and profitable growth. With my strong personal interest in corporate governance, I was delighted to become chair of the Business Roundtable's Corporate Governance Task Force. I was proud that the Business Roundtable took the initiative to strengthen corporate governance guidelines for the rights and responsibilities shared among the various corporate participants, especially the management, the board, and the shareholders.

The Roundtable also supported the landmark Public Company Accounting Reform and Investor Protection Act — better known as the Sarbanes-Oxley Act. This is the most far-reaching corporate reform legislation in 60 years. It was a moment of rare bipartisan action in response to the breakdown in corporate checks and balances that cost investors hundreds of billions of dollars in losses.

Two years after its passage, we can say that the reforms are taking hold. Many Roundtable member corporations had already adopted reforms in advance of regulations or since have gone beyond required standards — to fundamentally change how we govern ourselves and conduct business. For example, in a survey of its members the Roundtable found that:

- Eight in 10 of our members have boards that are three-quarters or more independent.
- Virtually all of them have closed meetings of independent directors without the CEO present. More than half expect to have five or more closed meetings a year of independent directors.
- Nine out of 10 members reported increased involvement by the board of directors, especially by directors on audit, compensation, and nominating committees.

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• Two out of three have a process for nominating new board members that responds to shareholder proposals and nominations.

• And, even though not required by law, more than half our members have an independent chairman, lead director, or presiding outside director.

In other words, corporate leaders are responding to and going beyond the letter and the spirit of the new laws and regulations.

Danger of collateral damage

But we must be careful. Policymakers run the risk of not knowing when enough is enough — and of falling victim to unintended consequences. We cannot strive so hard to legislate away every last problem that we ignore the very real possibility of collateral damage to our corporations, and, more important, economic prospects.

For example, we have to be careful not to criminalize honest mistakes. Everybody makes mistakes — and I've made my share — but that's inherent in risk-taking. And risk-taking is vital to winning the competition in world markets. We would harm ourselves greatly if the threat of criminal sanctions became so pervasive that corporations simply stopped taking risks. Without risks we wouldn't have innovation, new products, or scientific breakthroughs. Other countries like China could overtake the U.S. in terms of economic growth and job creation. Capital investment flows could go to other parts of the world. We must be careful not to overreact.

It's also important to remember that corporate decision-making is not a sort of corporate New England town meeting — a legal democracy in which shareholders put up candidates and raise issues and vote on them whenever they want. Instead, shareholders are represented by boards of directors. Those directors now are independent from management but must work in more of a team with management to ensure shareholder value is created.

The new regulatory requirements don't come cheap. The average large corporation expects to spend more than $6 million to reach and maintain compliance, with all the laws and regulations passed in just the last two years. But in the long term, the costs of not complying — and losing the trust of investors and the public — far outweigh the costs of complying with these new standards. We can rightly regard these as investments in public trust and confidence. In general, CEOs and companies agree that the reforms were the right ones at the right time.

A move to values-based behavior

All of these voluntary and required changes in corporate governance (see sidebar on page 22) raise the question: *Have we finished the job?* The answer clearly is: No, there's plenty of unfinished business, and there probably always will be. And just when we think we've put yesterday's scandals to rest, something new comes up.

But we won't solve these and similar problems only by adding more laws and regulations or by voluntary corporate governance changes. We can and should continue to refine needed regulations, of course. But real, lasting change can come only from improving every corporate culture with a genuine commitment to ethical behavior.

Knowing what's right is a constant learning process for business leaders.

— Steve Odland

That involves moving beyond corporate "rules-based" behavior to "values-based" behavior. Or to put it another way, for people in corporations to do the right thing even when the rules don't precisely cover it or when they don't think that anyone's watching. In a word, they need to act ethically.

Ethics are motivation based on ideas of right and wrong. They are the rules or standards governing conduct. Ultimately good corporate governance is driven by the ethics of the individuals in the company. We must focus on the ethics of the individual and ensure those ethics translate into the corporation.

To that end, we established the Business Roundtable Institute for Corporate Ethics, with the leading business schools in the country, to help strengthen the link between ethics and

business practices. The institute will conduct research, create a cutting-edge business ethics curriculum, lead executive seminars on business ethics, and develop best practices in corporate and business ethics.

In developing this institute, we polled Roundtable CEOs for their insights about the ethical questions they face and their priorities. In responding, a majority of CEOs stated that establishing a framework for business decision-making that integrates ethics is their top priority — followed by encouraging open discussion by subordinates and a culture for addressing potential bad news early and decisively.

A $500 million hit to earnings

Underlying these and other efforts to strengthen corporate governance and ethics is the recognition that these are crucial for long-term business success.

For example, observers usually cite the Johnson & Johnson recall of Extra-Strength Tylenol in 1982 as a public relations success. When eight people died of deliberately poisoned Tylenol tablets, the company responded by withdrawing all Tylenol products immediately — putting customer safety first — even though it caused, by one estimate, a $500 million hit to corporate earnings. But that decision went much deeper than a public relations judgment. From the CEO on down, Johnson & Johnson had embraced a values-based ethics that stated that the company's first duty was to its customers.

J&J's demonstration that it was serious about upholding those values reassured the public that Tylenol was safe when reintroduced a few weeks later, and Tylenol quickly regained its sales leadership. J&J not only saved one its most valuable brands but also became the leader in tamper-proof packaging, and continues to enjoy the trust of its customers. Most of all, it set a reassuring standard of ethical conduct. Especially when contrasted with companies that try to shift blame or take half-measures to meet similar challenges, this is a classic example of values-based leadership.

Business leaders and investors more than ever believe that companies with the best governance will be the best-performing companies, they will be in business longer, and they will lead to more stable markets. In a review of 42 studies of the subject, Professor J.D. Margolis of Harvard found a strong correlation among corporate social responsibility, high ethical standards, and financial success.

A rabbi's story

Moshe Kranc, in a new book *Jewish Mysticism for Managers,* relates an old story about an ancient rabbi's trip to heaven and hell:

> His first visit to see hell was horrifying. Row after row of tables were laden with platters of food, yet the people around the tables were suffering hunger pain. Every person held a full spoon, but both arms were in splints so they could not bend either elbow to bring the food to their mouths. The food was so close, but they could not eat.

Roots of a nation's wealth

In his landmark book, *The History of the Corporation,* Bruce Brown noted the roots of the modern corporation reach back to the guilds of the eighth-century B.C. Roman kingdom. It later attained its first known written form in St. Benedict's organizational rules for his monastic order at Monte Casino in the sixth century A.D.

In fact, it was the early Christian Church that established the corporation as a central organizing principle — and even many of its aspects we regard as modern. For example, in the 12th century, Cistercian monks held the first corporate convention on record. There were even early versions of the leveraged buyout phenomenon, resulting in a complaint by the Dominican bishop of the ill effects of borrowing against the assets of a corporation to gain control of it.

By the Renaissance, secular corporations expanded, with merchant guildsmen in Italy using such business devices as compound interest, double-entry bookkeeping, and even expense accounts.

Two centuries later, the joint-stock company became the earliest means of the British colonization of North America — Virginia by the Virginia Company and New England by the Massachusetts Bay Company — selling stock to numerous investors who expected to earn a tidy profit.

Barely nine years after they landed at Plymouth Rock, the Puritans bought enough stock in the Massachusetts Bay Company to take control from London shareholders — probably the first recorded corporate takeover on our soil. The Puritans later transformed it into the Commonwealth of Massachusetts — established by contract with the British Crown.

By the 19th century, corporations became the established way to organize businesses in America. Chief Justice John Marshall gave it legal prominence in the Supreme Court's landmark *Dartmouth College* case, which upheld the legal standing of its corporate charter. As Justice Marshall wrote, "A corporation is an artificial being, invisible, intangible and existing only in the contemplation of the law. Among its most important qualities are immortality, and individuality; properties by which a perpetual succession of many persons may be considered the same, and may act as a single individual...."

Aided by such legal protections, 19th century America corporations propelled our nation to industrial supremacy. We went from a small agricultural nation clinging to the Atlantic coastline to a continental economic and military powerhouse that overtook and passed its European rivals in those brief 100 years.

One of the great historic ironies was that this agrarian nation literally had to steal the technology for the world's first industry, textiles, to begin our own industrial revolution. British law made it a crime to export textile machinery or even for skilled machinists to leave the country. But Samuel Slater memorized the plans, left England surreptitiously, and re-created cotton spinning equipment in America's first textile mill in 1790.

By 1900, America accounted for more indus-

The rabbi then went to heaven and found the same setting — row after row of tables with platters of food, and every person also had both arms in splints. But the people were well fed and contented.

So how did they manage to eat? Well, each person picked up a spoon, dug into a dish, and then stretched across the table to feed the person across from him or her. The recipient of this kindness thanked him and returned the favor.

The rabbi concluded that the circumstances and conditions were the same in heaven and hell. The critical difference was the way people treated each other.

"The way people treat each other" — that's a good way to measure a corporation's commitment to ethical behavior. I believe that such a commitment is attainable with a values-based approach that includes five practices:

• First, people should know *what you stand for* — both as CEO and as a corporation. That involves a clear statement of ethical principles.

• Second, employees and officers *can push back* — they can report wrongdoing and propose improvements without fear of retribution.

• Third, there is *access to management* by everyone from customers to shareholders.

• Fourth, the *organization is transparent* and open.

• Five, everyone understands how we in the corporation *should treat each other.*

Principles into practice

These are governance principles that AutoZone put into practice three years ago, soon after I became CEO.

We made some highly visible changes that included replacing a board dominated by insiders with a board of independent directors. We required board members to have at least $100,000 invested in AutoZone stock — to make sure they had a significant personal stake in our long-term success. We required that they could serve on no more than a few corporate boards, and we set a retirement age of 70.

We also repealed our poison pill clause in our corporate charter, put in place years before to discourage hostile takeovers. Our poison pill would have fended off unwelcome takeovers by granting to incumbent shareholders the rights to purchase more stock at a low price to increase the hostile bidder's acquisition cost so much as to make it uneconomic.

The poison pill device became a popular way to protect companies throughout corporate America, but we came to believe that continuing it could become a drag on shareholder value. We concluded that the threat of a takeover could be a useful external discipline to ensure success, and we decided to take our chances in the marketplace.

We also stress company-wide compliance with our code of ethics. Every new hire signs this code, and every employee signs again every year. We encourage every employee to check with our legal counsel if there's any doubt about ethical behavior — or "just don't do it," if they have any doubts.

Moreover, we stress to our sales staff that they treat every contact with customers as the opportunity to win their repeat business. We stress to them that we don't sell customers things they don't need.

Finally, I began a practice of constantly speaking to groups of employees. I stress that everyone must do the right thing every day. In short, I do everything I can to get that message across clearly.

The behavior of every employee is important to AutoZone's success. And because we can't look over their shoulder every hour of the day, we have to depend on them to do what's right and to know that doing that is good for them and our company.

Constant learning process

Knowing what's right is a constant learning process for business leaders. That often involves venturing into uncharted territory as new choices present themselves. Like other business leaders, I have to manage my life and business with imperfect foresight in a world that judges other people based on perfect hindsight, but all too often imperfect information.

trial output than Great Britain and Germany combined — due to a competitive advantage far more important than rich natural resources. This was the ability to organize businesses into ever-far-reaching corporations that achieved great marketing and distribution reach, economies of scale, and access to capital. We also enjoyed a uniquely low level of government regulations or artificially limited resources that burdened our European competitors by distorting markets and discouraging competition.

As editors of *The Economist* magazine put it in their book, *The Company,* the central good of the corporation is that "It is the key to productivity growth in the private sector: the best and easiest structure for individuals to pool capital, to refine skills, and to pass them one. We are all richer as a result."

Today, corporations form the underpinnings of most things we know about America, including our economic power. Four of the five largest corporations in the world are American. The largest is Wal-Mart with more than a quarter-trillion dollars in sales and 1.4 million employees last year.

There is no official figure for the number of U.S. public companies, but the number usually quoted is about 15,000. Investments in these companies form the basis for most pension funds, mutual funds, and retirement plans, and collectively form most of the U.S. private net worth. Of the $10.7 trillion U.S. GDP, 82% comes from the private sector — American corporations are our economy, not the government.

This wealth has led to creation of the greatest superpower ever known to mankind. The late Ronald Reagan said, "Individual freedom and profit motive were the engines of progress that transformed an American wilderness into an economic dynamo that provided the American people with a standard of living that is still the envy of the world."

Adam Smith very wisely observed in the 18th century that wealth was not driven by accumulation of commodities or exploitable natural resources. Rather, the true source of a nation's wealth exists in the productive knowledge of its people and their ability to efficiently transform resources into desired goods and services.

— *Steve Odland*

That's where a values-based approach comes in — to help guide us in new situations.

It is the dynamism and openness of our markets that has sustained our nation as the world's strongest economy for more than a century now — that has provided work and rewards like no other nation — and that has enabled us as a people to confront civilization's greatest moral and ethical challenges, from racism to poverty.

I'm convinced that effective corporate governance — free from conflicts of interest, corruption, and unethical behavior — is essential for the long-term success of any business. Ultimately, the bad actors in the corporate world are found out and stand revealed as failures. And while it affects us all, these failures ultimately give the ethical companies even more of a chance to gain. So there are natural checks and balances in the system even though in the short run, violations can lead to the destruction of wealth.

While not perfect, the U.S. has the best corporate governance, financial reporting, and securities markets systems in the world. These systems work because of the adoption of best practices by public companies within a framework of laws and regulations. While there have been exceptions to the overall record of success, generally the system has worked very well.

A corporation and a society based on strong governance principles and high ethical standards are in the best position to face unexpected challenges, overcome them, and prosper. And as long as we can keep that idea central, we can continue to look forward to a 21st century of greater prosperity and human progress. I believe that we can indeed accomplish that task. ■

BRT + SOX: Strengthening of governance standards

The Business Roundtable's involvement in corporate governance reforms is not new. It goes back a quarter century with our first report and recommendations. This was followed by several refinements and culminated in our guidelines two years ago, titled *Principles of Corporate Governance.*

The Roundtable guidelines spelled out six major principles:

- First, the majority of corporate boards of directors must be independent both in appearance and reality, should choose its CEO, and ensure the competent and ethical operation of the corporation.
- Second, senior management must produce value for shareholders and never put personal interests ahead of the interests of customers, employees, or shareholders.
- Third, directors and senior managers must produce financial statements and timely disclosures that fairly present to investors the financial condition and results of the corporation.
- Fourth, the directors and their audit committee are responsible for hiring an independent auditor to approve financial statements prepared by management and to ensure the independence of that outside auditor.
- Fifth, the auditor must be independent in fact, apply the highest standards to its work, and report any concerns to the directors and their audit committee.
- Sixth, the corporation must deal with employees in a fair and equitable manner.

The Roundtable followed up those recommendations last year by spelling out principles of executive compensation, detailing some very sensible ways to link executive pay to results and to have independent committees of directors determine the appropriate level of pay.

First among those responsibilities was that directors should understand the pay packages presented to them, including the maximum payout under every scenario. Despite the glaringly obvious need for that, the fact remains that even many members of compensation committees didn't understand the financial consequences of complex pay packages they are supposed to approve.

Moreover, our recommendations included that pay be linked to performance, that only independent directors be members of compensation committees, that they use outside experts to develop pay packages, and that they disclose to shareholders all significant elements of those packages. Again, these may seem obvious but were not consistent practice by companies.

Besides these voluntary standards, the Roundtable also strongly supported regulatory reforms that made constructive business practices the law of the land.

We supported changes to the listing standards for New York Stock Exchange and Nasdaq-listed public corporations that significantly strengthened financial and governance standards. More important, the Roundtable supported the Sarbanes-Oxley Act (SOX) that was signed into law two years ago. The act established an overarching public company accounting board and also set a number of deadlines for compliance. The Securities and Exchange Commission has been moving with uncommon speed to implement its major provisions.

There are six major provisions of SOX:

- It established the Public Company Accounting Oversight Board (PCAOB) to regulate accounting firms and audit standards.
- It prohibits conflicts of interest for auditing firms and requires that companies change auditors at least every five years. It also prohibits conflicts of interests for research analysts used by investment firms.
- It requires that only independent directors can serve on corporate audit committees.
- It prohibits personal loans by corporations to their executives or directors.
- It increases criminal sanctions for numerous violations and protects corporate whistleblowers.
- And finally, it requires that chief executives personally sign their annual corporate income tax return.

Even many private corporations exempt from these reforms are making governance changes — such as prohibiting company loans to officers. This is especially so among private companies expecting some day to go public, to be acquired by a public corporation, or just to satisfy major lenders.

— *Steve Odland*