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# Welcome, "Stateholder"

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# Welcome, "Stateholder"

The newest corporate stakeholders — government representatives — must learn to become effective agents for reform.

**by Robert Gogel and Ludo Van der Heyden**

Since 2008, the world's governments have injected an unprecedented amount of capital into what used to be known as the private economy. The United States and United Kingdom have led the way, but the governments of many other countries have moved into similarly uncharted waters, taking huge equity stakes and purchasing warrants and senior debt positions in financial institutions and corporations. To be sure, bailouts for such companies as AIG, Northern Rock, General Motors, and Fortis Bank were necessary evils. They protected both financial and nonfinancial industries, as well as the wider public, from the excessive negative aftershocks that would have occurred if the failed organizations had simply gone bankrupt.

But what now? Unlike sovereign wealth funds, which make long-term commitments in many of their investments, governments have made only temporary investments, according to government officials. Nonetheless, although some banks are beginning to repay their investments, government ownership will continue for many companies, if only because it will be difficult to sell the shares at attractive prices. The global economy must first recover, and that won't happen before mid-2010. The ways in which governments assume their novel responsibility will remain at center stage; they could have a significant effect on the quality and speed of the recovery itself.

To many capitalists, the prospect of "governments running companies" instantly generates visions of socialism. They regard this phenomenon as a de facto nationalization and fear a general turn toward protectionism and more government interference in free markets. But it is more accurate to think of this new wave of government intervention as heralding a new kind of stakeholder in corporate governance.

So welcome, "stateholder." You have means you did not have before to reform corporate governance and bring this function to a new standard. You will be with us for some time, and you may as well learn to do your job effectively.

Questions remain unanswered about whether public monies are and will be wisely invested and spent, whether stateholders will act differently in their board member role than private individuals or institutional shareholders do, how financial performance will be affected, whether these companies will emerge stronger or weaker, and whether such companies will be equipped to operate effectively or constrained by a heritage of bureaucratic shackles.

Unfortunately, the track records of most state-run, state-owned, and state-supervised institutions — such as Sallie Mae and Amtrak in the U.S., British Leyland in the U.K., Sabena in Belgium, and Alitalia in Italy — have not been very good. These companies have failed in the public eye and have also failed to achieve any nonsubjective economic or effectiveness benchmark.

Fortunately, counterexamples exist. They include major French utility Électricité de France, former national airlines Air France and Lufthansa, and Chrysler after its U.S. government rescue in 1979. These examples demonstrate that government stateholders can perform well in their shareholding functions if they have a clear purpose and execute their responsibilities well.

The large sovereign wealth funds of China, Singapore, and the Gulf states may provide another positive example. Sovereign funds do not have the same short time horizon that other stateholders face because they have not been "forced" to become rescuers of last resort. But they face the same duality of public–private interests, and finding the right balance is still daunting.

Although this new global experiment of stateholding is still in its early stages, four simple guidelines ought to steer the behavior of stateholders. Getting those four elements right will contribute to making the challenge surmountable. Getting them wrong will further erode public trust in both business and political leadership.

**1. Commit to systemic governance.** The root cause of the financial crisis was not a flaw of capitalism. It was a failure of governance — not just by corporate leaders, but by corporate boards and regulators as well. Former Federal Reserve chairman Alan Greenspan admitted as much in October 2008, when he testified to a U.S. congressional committee that his major mistake was "in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms."

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The failures within the corporate sector (such as Enron and Tyco) are well known, but the extent of the government's failure to properly supervise the financial sector is still underreported. Regulators allowed managers to pursue higher returns without properly adjusting for the risk incurred or setting appropriate prices, and in some cases they were simply inattentive: Bernard Madoff's Ponzi scheme should become a topic in any security regulatory agency's induction program for new recruits, a case study for business schools, and a semester-long course in law schools. It is simply unfathomable that Madoff was able to perpetrate such a level of fraud for so many years.

Many regulators — and the board directors they oversaw — apparently did not understand the risks that banks were taking in their borrowing and lending practices. Nor did the regulators make managers accountable for results by forcing reductions in commissions and bonuses, or aligning such bonuses more closely with delivered results (as is the case in commodities trading). At no other time in history has so much been paid in short-term commissions in the face of such medium- and long-term value destruction.

An essential tenet of capitalist systems should never be forgotten: Markets and their actors need to continuously earn the public's trust to operate in the public interest. The ultimate accountability for the financial system rests with government. Someone needs to monitor the system not only to identify bubbles but also to pierce them as early as possible. Governments are uniquely well suited to manage this task; no other single actor has the requisite systemic interest.

Let us underline how difficult the task of reforming government practice is, however: We have just emerged from a long period of market deregulation and government dis-intervention. Rather than letting the pendulum now swing excessively to the side of overregulation (as it has in the past), we should find a proper balance by agreeing on a clear vision of the new order, and then taking multiple small steps to achieve it.

This is far from current practice. Consider, for example, the European Union. The economic crisis of 2008–09 has provided a unique opportunity for European governments to tackle reform together and steer the system with a common approach. After all, it's only logical to assume that the countries of the E.U. should act in concert to prevent bubbles that affect its currency. Yet there has been no single concrete action in this regard. Instead, European governments have largely acted independently from one another, protecting their own national interests.

**2. Hold boards responsible.** The market for corporate control is quite different from the market for goods and services. If a buyer is displeased with the goods or services provided by a supplier, the response is easy and immediate: Buy from someone else. Shareholders can also easily disengage when the prospects of investment returns deteriorate. But when a corporation becomes insolvent, it may very well not recover at all. And that can irreversibly damage communities, employees, business partners, and the regions and nations that governments are elected to serve.

The central justification of stateholder governance is to take control of corporate destinies so that if a company goes south, there is a reasonable promise of its returning north at some point, when it can continue its journey without direct state guidance. When and to what extent government should intervene by taking equity positions will always be a delicate question, as there will always be tension between intervening and letting the corporation die or restructure on its own. Governance will remain a complex act, distinct from execution and distinct from regulation and policymaking. But just as corporate boards can temporarily intervene in corporate execution (for example, when nonexecutive board members become managers), so can governments temporarily intervene in the governance of private corporations by taking stakes in them.

Improving the governance system by delegating this job to regulatory authorities is not sufficient. In 2002, the U.S. witnessed its biggest modern-day corporate governance reform with the passage of the Sarbanes-Oxley Act. These rules, which are onerous and expensive to comply with, and are enforced by the SEC and an agency that oversees the auditors called the Public Company Accounting Oversight Board, appear to have done little to prevent the 2008–09 crisis.

The Sarbanes-Oxley regime forced U.S. corporations to provide more information to shareholders (with the intent of allowing them to make more informed decisions), but some executives continued to collectively mislead shareholders (and employees as well). If they did this knowingly, they ought to be pursued in the courts for fraudulent behavior; the trouble is that such judicial action typically comes too late and does not cure the larger problem. Sarbanes-Oxley has the flavor of providing forensic evidence once a governance crime has taken place. The justification for stateholding is to allow preventive intervention when larger economic interests are at play — actions that can be put in place sooner and increased gradually as needed.

The first preemptive step is for governments to hold corporate boards responsible not just for financial results and for providing information to shareholders, but more generally for proper governance, which reduces the risk that any corporate crime will occur at all. Too many boards, particularly in the U.S., have been obsessed with short-term execution and results (even at the risk of survival), and have not been attentive enough to longer-term value creation and sustainability. Boards must be required to embrace their fiduciary responsibility to the company as well as to the share price, and to ensure that good governance becomes an integral part of the corporate culture. This should be enforced through legislation, regular prodding, and — crucially — through the threat of stateholder intervention. Governments and regulatory authorities ought to have the means to regularly audit companies to ensure that governance standards are being upheld.

It is no coincidence that certain countries have come out of the recent crisis relatively unscathed, such as Canada, Denmark, and Australia. These countries have reinforced the role of the board chairman by giving that position an explicit responsibility for good governance. The chairman has a primary duty of ensuring that clear responsibilities are established for both managers and their supervisors, so that the firm follows and can benefit from a robust system of checks and balances.

In countries where the chairman and CEO roles can still be held by a single individual, the separation of roles must be encouraged, if not required for companies of a certain size. It is one more safeguard to help us avoid many of the abuses that have led to the current crisis. One person ought to be primarily responsible for execution, and the other for effective governance; when there is a conflict, the chairman should rule — because that is the only way to restore an effective balance between these two corporate functions.

Stateholder representatives on boards will have to be exemplary representatives of the company's long-term interests. They must in-

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sist on training board members (including themselves) in governance capability, as well as improving board processes, including succession. The real lack of capability on many boards has become a blight in the wake of the recent meltdown; the presence of stateholders provides the corporate world with an unparalleled opportunity for systemic improvement in this domain. To be sure, there will be cries of government interference, and for that reason there should be frameworks and processes that establish restraint. The very fact that the stateholder has intervened should be seen as a signal of corporate malfunction. It should be triggered only by predefined parameters and initiated by a government agency.

As stateholders acquire governance expertise, they will (and should) seek out new ways of sharing knowledge without violating corporate confidentiality. Boards and executives will also find new forums for discussing governance. One excellent model is the Canadian Coalition for Good Governance. It was formed to promote good governance practices in the companies owned by its members, which include a wide range of institutional investors — pension funds, mutual funds, and third-party money managers.

**3. Enforce transparency.** Secrecy is a tradition dear to the financial-services industry and most of the corporate world. It will take vigilance to prevent stateholders from embracing it as well.

Why is transparency necessary? Where there is no broad awareness of the priorities and practices of government-owned corporations, stateholders will be vulnerable to lobbyists and predators. Indeed, dominant shareholders have often used their power at the expense of minority stakeholders. The public desires information and accountability. As shown by the initial debate in the U.S. on the crisis and on the Troubled Asset Relief Program (TARP), a small group of people at the top of a company or even at the top of government can no longer make critical decisions by themselves. Extensive, honest communication (not "spin") is required: The stateholder can act much more freely in this regard, with a greater accountability to the public.

For example, if stateholders plan to sell a company, they should make explicit the rationale, conditions, and expectations for the sale, and then leave open the date and the corporate acquirer. If the government's desire to sell becomes known in advance, the sale could be executed in a way that avoids unhealthy stress on the organization. Sufficient time must be taken for the best match to be found, and the appropriate acquirer may not necessarily be the highest bidder.

There are many examples of what not to do. The takeover by the Belgian government of Fortis Bank

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in October 2008, and the decrease in shareholder value, led to months of legal disputes and ambiguity. The TNK–BP joint venture, founded in 2003, appears to have been a play by three Russian shareholders to eliminate their BP partner with the (silent) consent of the Russian government. The onerous controls implemented by Swissair on airlines it acquired in the 1990s (Air Liberté, AOM, and Sabena) represented an abuse of minority shareholders that ought to have been identified earlier and stopped.

These examples suggest that interventions by the stateholder should be governed by a neutral body — not governed directly by ministers or officials who are political appointees. In that sense, supervisory authorities must have total independence and should function more like a central bank than a government department.

**4. Choose board members carefully.** Stateholders will need to select competent and experienced board representatives for the companies they own. Because not all shareholder-selected board members add value, one can assume that not all government appointees will necessarily do so — at least not without better training, selection, and oversight. Opportunities for conflicts of interest abound in a context where ambiguity is pervasive and where feedback takes a long time to arrive and is difficult to evaluate. Yet training may be hard to come by, because compared to management training, governance training is still in its infancy — if not in gestation.

There is now a great opportunity for experienced and professional bankers to volunteer to represent the stateholder stake. Such sufficiently independent government representatives would truly take a long-term view in rebuilding former or still-great institutions. To find them and provide a structure for them, governments should call upon civil society, giving some institutions (like the previously mentioned Canadian Coalition for Good Governance) a clear mandate and a healthy dose of independence to help take on the task.

One area in which stateholders will need to be very careful is the structure for compensation. As institutional health is restored, governments will reap the benefits by selling part or all of their stateholding. Bankers who have a sense of public service and are eager to redeem their industry in the eyes of the public will embrace this noble and delicate challenge. Remuneration ought to follow, but without the excessive bonuses that boards previously awarded their managers (and even themselves). The foremost reward for public service ought to be public recognition, not financial gain. Again, this points to the difficulty: Without a proper framework and adequate guidance, few people will venture to undertake the task.

The crisis thus does offer a surprisingly positive public-service opportunity for financial executives. Working for a stateholder represents a contribution that will help the banking and corporate sector find redemption. These are new roles in business and in society. They will be training grounds for future leaders in governance and business. And they can also provide a direction for emerging leaders. Our business and law schools might rethink parts of their curricula and begin to develop coursework and cases around the stateholder position and best practices in this domain.

### Welcoming the Stateholder

Paradoxically, governments' failures as regulators have now led to their massive presence as stateholders. Having reached this point, governments now represent our greatest hope for corporate reform. They have an opportunity to enter the system as a governor, make effective changes, and then exit. Furthermore, they have a chance to be active players in governance when normal market conditions no longer apply. They ought to develop frameworks and methods for guiding their intervention.

This will not be easy, and governments will need to tread carefully in a domain where knowledge is limited and ambiguity abounds. Yet the biggest mistake would be to engage in wishful thinking that this is the final economic crisis of capitalism, and that the current crisis simply ought to be managed. Our point is to insist that one lasting impact of the crisis to be hoped for is the introduction of the stateholder, which works for the good of the capitalist system, as a supervisor as well as occasional intervener in cases of massive corporate destruction and governance failure, and also as an advisor and preemptive actor in cases that appear to be on their way to failure.

We believe that all stakeholders ought to actively support the stateholders in the definition and execution of their mission. We may not get another chance like this for a long time. +

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