So, why be public?

This is a question more and more companies have been asking. Many of the traditional advantages of being public are no longer valid, and the mounting costs all the more obvious. **BY JOSEPH FULLER**

IT HAS BEEN over two years since the Enron scandal broke and well over a year since Congress passed its sweeping reform legislation, the Sarbanes-Oxley Act. Enough time, perhaps, to gain some perspective on a series of scandals that continue to shock the senses of even the most jaded business observer.

Look carefully at the recent accounting scandals, and you will see a pattern writ large. A faltering company is unable to meet earnings targets fully endorsed by management and set to fulfill analysts' expectations. Staring down the barrel of an earnings gun they locked and loaded, management sets out to meet those targets using every means possible — including, at the extreme, resorting to fraudulent accounting methods. And, while pundits have written much about the causes and consequences of infamous cases such as Enron and WorldCom, one thing stands out. They all involved a fundamental breakdown in what economists call agency — the persistent, inherent problem all corporations face in aligning the interests of those who manage the company (executives) with those who own the company (shareholders).

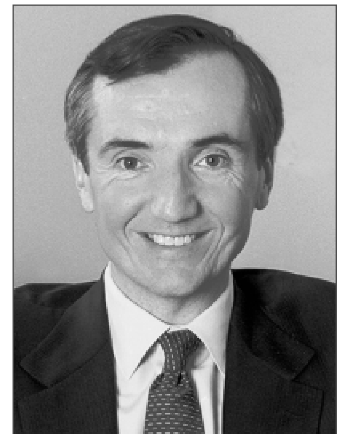
Once considered primarily an academic issue, agency costs arose prominently in the aforementioned cases when the interests of managers and the interests of the shareholders diverged dramatically. While the dry ruminations of academics are of little interest to board members, mastering agency costs must stand at the top of any board's agenda. As the duly elected representatives of a dispersed and varied group of shareholders, directors must arbitrate between the shareholders' interest and the very real market constraints executives contend with daily. Indeed, boards sit at the intersection of this historic conflict. Managing — or, at the very least, understanding and accounting for — agency costs, then, becomes a priority for all boards.

The origins of agency costs

The public corporation, almost by definition, carries a fragmented set of owners. This continues to be one of its great advantages as well as an unavoidable, structural weakness. Public ownership spreads the entrepreneurial risk inherent in any particular venture. And it allows shareholders to diversify their portfolio efficiently and tailor that mix to reflect their appetite for different types of risk at different points in time.

However, a dispersed shareholder group brings with it its own inherent risks. In all but the rarest circumstances, no individual shareholder possesses the stature to command management's attention. Moreover, none has the incentive to invest substantially in a detailed understanding of any individual company's risk profile. (See sidebar, "Erosion of the Power of Large Shareholders.") Indeed, the evolution of the public accounting industry and the criticality attached to the integrity of corporate financial reporting reflects the supposition that most shareholders require a limited amount of accurate data to inform them in making investment choices.

As Andrew Carnegie once said, "Anybody's business can become nobody's business" with public ownership. Today even sophisticated institutional shareholders find themselves at a loss to explain the apparent ineptitude or even criminality of once lionized executives



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and the evaporation of value in once feted companies. Why? Because large corporations are so complex, the transactions they consummate so sophisticated, and the markets in which they compete so vast as to bewilder even sitting board members. As a result, even the best-equipped investor cannot possibly hope to understand much of what goes on inside a company beyond a superficial level.

Uninformed owners, deceptive metrics

That complexity not only affords desperate executives and fraudsters the opportunity to obscure reality for extended periods, but also undermines the flexibility of the best-intentioned managers. The lack of informed owners can restrict management's ability to act on the owners' long-term behalf. Uninformed owners prefer easily understood, often deceptive metrics of corporate success, such as sales growth or earnings per share growth rates. Their capacity and willingness to invest in their understanding of the vagaries of markets and the nuances of risks inherent in any strategy is limited. Take the example of a pharmaceuticals company in the late 1980s, struggling to overcome a weak product pipeline. It staunchly refused to cut its research and development budget in favor of short-term earnings, as the capital markets feted its rivals. While things ultimately turned out well for the company in question — Pfizer, the darling of today's industry — it had to overcome the market's predilection for the immediate and observable.

Mastering 'agency' costs must stand at the top of any board's agenda.

Few management teams or boards demonstrate that constancy of purpose; therefore, their vulnerability remains great. Andrew Carnegie and John D. Rockefeller had both the means and the opportunity to understand fully the companies they owned, just as Warren Buffett and Charlie Munger have done in recent years. John Q. Public has no such opportunity, most likely lacks the necessary technical skill, and will likely exercise no such patience.

So because shareholders cannot, will not, or simply do not police managers, boards have become more and more responsible for doing the work that owners once did routinely. That is, they must act as watchdogs ensuring that a company reflects the shareholders' interests as it makes strategic decisions and incurs business risks.

Board's role in principal/agent problems

For any board, the fundamental issue in resolving the principal/agent dilemma revolves around how to prevent the careerism and innate self-interest of executives from expressing themselves at the expense of shareholders. The recent heated debates over compensation reflect the public reemergence of that issue. It is, however, far from new.

As far back as 1932, Berle and Means explored agency costs and noted their centrality in the design of the modern corporation. "The management of a corporation was thought of as a set of agents running a business for a set of owners." Managers are not owners, and developing mechanisms that cause them to act like owners has proved frustrating. This intractable challenge has given rise to a vast array of economic literature that addresses the issue, formally known as the "principal/agency problem" or, more simply, as "agency costs."

While Berle and Means set out the dilemma, it was Michael C. Jensen and William Meckling who developed agency theory as we know it today. Jensen and Meckling wrote about agency costs throughout the 1970s. Jensen, in particular, wrote about the need to consider a full range of strategies in mature industries, including exit. More importantly, he noted, along with other scholars, the propensity of management to invest in marginal businesses or projects in order to grow their companies, retaining cash beyond the clear reinvestment needs of the corporation in the interest of preserving managerial flexibility. Jensen dubbed this the "free cash flow" problem. For a time in the late 1980s, the threat of hostile takeovers and leveraged buyouts served to discipline managers who hoarded the shareholders' cash. However, those financial techniques were blunt remedies, used primarily to cudgel the most obtuse or recalcitrant executives into submission. Shareholders had to rely upon the integrity of managers and wisdom of boards to offset the all too real pull of managerial self-interest.

It was not until the advent of stock options — a virtual ownership mechanism designed to encourage managers to act like owners by rewarding them like owners — that many informed observers declared the principal/agent dilemma all but resolved. Options provided a clear incentive for executives to build shareholder value by giving them virtual equity stakes that might generate the vast majority of their net worth. The upside embedded in options dwarfed the value of salaries and cash bonuses. Options did suffer from visible flaws, such as occasionally generating mind-boggling windfalls for executives — as happened in the case of Disney's CEO, Michael Eisner. Moreover, they seldom required executives to put their own capital at risk — a hazard that Jensen and others pointed out before the recent implosion.

Encouraged recklessness

Without question, some options programs contributed to material improvements in corporate performance. Executives invested in building their own understanding of what contributed to share price appreciation and that of their organizations. But, in too many instances, the disproportionate gains available from the leverage options provided encouraged managers to become reckless. Regrettably, even tragically in some cases, recent scandals have revealed substantial flaws in the implementation of many option-based pay packages. As commonly instituted, options packages gave executives significant upsides with little associated downside. Far too often, ill-designed options packages rewarded managers who resorted to all sorts of manipulative practices to ensure their company's short-term earnings growth. Fulfilling analysts' earnings expectations led to share price appreciation, even when the strategies employed ultimately suborned a company's long-term prospects.

Despite their inherent complexity, options presented executives with a relatively simple calculus: If they succeeded in raising share prices, they benefited; if share prices fell, the managers had lost an opportunity but suffered no direct negative consequence. Indeed, since boards occasionally helped managers recoup their lost opportunities by repricing "underwater" options plans, some executives found themselves in the enviable position of having what amounted to "all upside" plans.

In some instances, it is arguable that options proved less effective than old-fashioned salary and bonus schemes. In that old world of compensation, experts feared that managers acted too conservatively. Systems based on salary and bonus were believed to encourage executives to take too great an interest in preserving their managerial flexibility and growing the company, irrespective of the incremental impact of those strategies on the marginal returns for shareholders. While hardly an attractive proposition, it compares favorably with the worst of the options schemes, in which executives received rents usually reserved for entrepreneurs taking extraordinary risks, while assuming few actual risks themselves.

Microsoft's decision to begin awarding restricted stock, instead of options, to eligible employees brought new attention to the now familiar problem of agency costs and the difficult task of aligning the interests of owners and managers. *The Wall Street Journal* recently revisited this issue, citing Jensen's work on the subject. It described one of Jensen's most recent proposals — to structure options in such a way that they prove valuable only if a company's share price appreciates at a rate higher than its cost of capital. Acknowledging that the use of options "backfired" during the bubble, the paper concludes that Jensen's ideas for structuring options to avoid their misuse and maximize their impact are "sensible."

Back at square one

Still, boards have many reasons to remain cautious. As we have so painfully learned, assuming such solutions will authoritatively address the failings of a complex system would appear naive. With the limitations of stock options, at least as generally conceived and implemented, now laid bare, we find ourselves back at square one. No instrument has emerged that consistently causes executives to bring a perspective similar to that of owner/operators to the stewardship of assets or the management of risk. In short, the agency dilemma remains unresolved.

Many, many observers have offered potential solutions. Some seek to address the issue of agency directly. Other prescriptions, including those embed-

A short history of the modern corporation

Public companies first arose as a vehicle to raise capital for entrepreneurial ideas that conservative 19th-century bankers balked at funding. Most historians point to the Boston Manufacturing Co., founded in 1813 in Waltham, Mass., as the first public company in the United States.

Scholars have estimated that two-thirds of the industrial wealth of the country was transferred from private ownership to public shareholders in the early part of the 1900s. During that period, public ownership became the norm for large companies and the aspiration for emerging companies. Perhaps more important, it became the form that most capitalist constituencies came to assume any legitimate company should adopt.

Small and medium-sized companies aspired to public status for reasons beyond merely raising capital for expansion. The status associated with public ownership and, eventually, the enticements of compensation based on equities encouraged executives to go public. The creation of new stock exchanges and the competition emerging between them fanned those flames.

As the process of going public became easier, a host of interested parties — ranging from investment bankers to corporate lawyers, public relations and advertising firms to the exchanges themselves — all proffered arguments for public ownership. Companies began to think less about whether they genuinely benefited from public status and needed the high cost capital associated with it and more about the management of shareholders and the prestige and liquidity afforded by being listed on different exchanges. This trend reached almost a fever pitch in the rush to take many dotcoms public before they had established a true earnings stream or demonstrated a viable business model.

— Joseph Fuller

ded in the recently passed Sarbanes-Oxley bill, seek to increase transparency in financial reporting and strengthen the supervision of executives by boards. Although most of these provisions have merit, they raise more fundamental and often unasked questions: Can we solve the agency problem definitively and, if not, why do we remain so wedded to the form of the public corporation? In short: Why be public? And why, when we have witnessed so much innovation in business practice, has the corporate form itself been so static?

The reasons for posing these questions go beyond the problems posed by agency. Over the past several decades, the costs of being public have risen steadily. Sarbanes-Oxley adds another tranche of substantial new costs to being publicly traded. New rules and restrictions relating to audits and accounting firms, enhanced reporting obligations, new standards on qualifications for board membership, and other regulations add to the already high costs associated with being public. Add those to many other costs — some direct, some hidden — associated with public status that have emerged in recent years, such as the costs associated with fending off the trial bar. The cumulative costs of being a publicly traded company have mounted steadily.

At the same time, we have seen little of the dynamism in corporate forms that one witnesses in other domains in which costs have mounted for large companies. That reflects both a lack of originality and a welter of regulations meant to stop the accrual of wealth by fraudulent means that greatly limit the corporate form. Sarbanes-Oxley is only the most recent of a number of reforms that, cumulatively, greatly restrict things like holding companies as an investment form. For reasons that may have made sense in the past, the ability of investors to hold large stakes in companies was limited (as discussed in the sidebar below). However, in many cases, those accreted prescriptions for preventing harm have created inflexibility and resulted in stagnation in the way we fund companies. In short, while many things have changed around the corporate form, the form itself has changed little.

So, why be public?

This is a question more and more companies have been asking. Take as evidence a report in *The Wall Street Journal* that shows a record number of companies, over 400 at the time of the story in 2003, have "deregistered" their stock — freeing themselves from the burdensome corporate reporting requirements of Sarbanes-Oxley and other regulations.

Indeed, for these companies, many of the traditional advantages of going public are no longer valid, and the mounting costs all the more obvious. When one reviews the historical rationales for companies being public in the first place, however, one finds that the evolution of the capital markets, compensation policy, and other factors render most mute:

• *A Shortage of Risk Capital Motivated the Formation of Publicly Owned Corporations.* As manufacturing companies requiring substantially more initial capital than banks or individuals could or would provide began to emerge, the need for a new means of raising funds and spreading the associated risks arose. Capital is no longer scarce — witness the rush of VC money into dot-coms. Nor is it as risk averse. Professional investors have access to unprecedented amounts of information relevant to weighing the risks of any given investment, ranging from a huge, real-time business press to information services on specific global markets. And, despite recent, glaring shortcomings of auditors in specific situations, the extent and timeliness of financial information within companies are unprecedented. Legitimate invest-

Erosion of the power of large shareholders

At one point in the recent past, large shareholders had the naked economic incentive to develop a textured understanding of the operations of companies they own. Moreover, they had the standing to demand access to information about a company's actual performance.

Over the last 50 years, significant impediments were created to major shareholders exercising any meaningful control over companies — and not without good reason. Concerns about substantial shareholders exploiting their power at the expense of smaller holders are hardly theoretical. The late 19th and early 20th centuries are rife with all-too-real examples of insider trading, asset stripping, and other frauds. Indeed, it took the appointment of one of the masters of some of those techniques, Joseph Kennedy, as head of the SEC, to put an end to most of them.

Recent legislation has continued down a path blazed in the New Deal era and, once again, for good reason. The SEC's Regulation FD — for "fair disclosure" — put an end to major investors gaining preferential access to management. It banned private briefings on the firm's performance and forced companies to share data, in the same form and at the same time, with all investors. That was a great step forward to making the market fairer.

But, as is so often the case when righting a wrong, the opportunity for some new ill was inadvertently created. By eroding the role of larger, more sophisticated investors in corporate governance over a 50-year period, these regulations gradually eliminated an important check on misguided, incompetent, or crooked executives. This left the policing function to the representatives of the fragmented population, i.e., the board.

— *Joseph Fuller*

ment hypotheses do not go begging for capital in today's environment. Do most companies truly require access to the public markets to fund themselves? No.

• *Public Ownership Provided Liquidity in Several Senses.* First, it serves as a means for an entrepreneur (such as Bill Gates) to gain liquidity and diversify his or her holdings. Floating stocks will always offer that important benefit. Second, stock exchanges provide easy mechanisms for individuals and institutions to adjust their portfolios. In an era with fewer, larger, and more widely held stocks, all companies benefited from such a system.

Today, however, a two-tier system of public companies has emerged. Large companies with significant floats and, especially, certain "star" companies, such as GE, continue to benefit from the liquidity afforded them by the market and the associated coverage from analysts. The second tier consists of a large percentage of mid-market companies, left struggling for market-making attention. Analyst coverage of that second tier — particularly those companies with no prospect of generating meaningful investment banking fees or requiring brokers to sell anything other than the hottest current investment hypotheses — has simply disappeared in recent years. The vast majority of mid-cap companies find themselves dropped from the coverage of major banks, leaving second- and third-tier banks with modest resources to provide coverage. They often provide little more than limited commentary attached to cursory forecasts and earnings bulletins. That, in effect, leaves a large, absolute number of companies in public "purgatory," unable to generate enough interest to reap the presumed benefits of the liquidity and with too small a float to attract the investment of institutional investors who fear that they will set a higher price for a stock from which they will be unable to escape.

The growing inability of many public companies to attain any relevance in the public markets raises the real costs and real risks of being public for those companies. Are most companies enjoying the type of liquidity for their shareholders they assumed came with public status? Probably not.

• *Public Status Provided Both Prestige and the Prospect of Wealth Creation for Top Talent.* Historically, public companies made the market for executives. And public companies still possess the size and prestige to attract such executives. Nonetheless, public company executives have taken a beating recently. Whether or not you subscribe to the view that such a beating was justly administered or the "outrage industry" has made scapegoats of an entire class for the sins of a few and for problems beyond their control, the cost of being a public company executive has skyrocketed — both in terms of personal legal liability and in terms of risk to personal reputation. Many executives will wish to avoid both the limelight and the liability that come with public ownership. One can see that preference in the flight of distinguished executives to executive-in-residence positions in private equity firms.

• That brings us back to the original problem that resurfaced when options failed: *How will public companies attract executives with the capability of entrepreneurs, if no means exist to pay them as such?* That challenge will become more profound in coming years, since so many of today's industries have become increasingly intensive in terms of human, rather than financial, capital. They rely on the knowledge and innovation of a highly skilled and mobile employee base, not access to hundreds of millions of dollars, to create wealth. As the dot-com craze showed, when talented employees left large public companies in droves for speculative start-ups, many employees no longer wished to be agents. Most prefer the risk/return trade-off associated with principal status. And, lest one confuse the collapse of most of the Internet sector with a refutation of this trend, note that the trend toward entrepreneurship continues in fields ranging from biotechnology to professional services.

We have witnessed so much innovation in business practice, yet the corporate form itself has been so static.

Reinstilling dynamism: What will it take?

For a remarkably innovative economy, very little innovation has occurred in the fundamental form of structuring and running public enterprises over the past 100 years or so. Most of the attention of policymakers, academics, and business executives has focused on "perfecting" the form of the public corporation. But, in so doing, they have lost track of its original purpose, and that it still remains plagued by structural problems, specifically the agency problem.

Recent controversies should lead us to go beyond a debate as to how to "perfect" the model further. We ought to have a much more active debate about new forms of enterprise ownership. We need to bring the same level of innovation to corporate forms that we have to financial instruments. That will require that executives, board members, and

policymakers revisit some of their assumptions as to the status and evolution of public companies.

• *The Costs of Being Public:* Business leaders, regulators, and politicians must make the mounting direct and indirect costs of being a publicly held enterprise a focus of discussion. Over the last several decades, public companies have become magnets for costs imposed by regulation and legislation. The accretion of those costs reflects the importance society places on public ownership and their centrality to our national life. But we must acknowledge an unintended consequence — a growing unattractiveness to being public — and consider how to prevent those costs from getting out of hand.

• *Reporting on Risks, Not Just Results:* The degree to which large numbers of individual investors took on risks they did not understand constitutes one of the revelations of the last several years. That many of them did so in order to fund their retirement represents an enduring tragedy. In retrospect, it is hard to imagine why any individual investor might have held shares in Enron, a company incurring risks of such complexity that it has required forensic accountants to fully understand them. While new reporting requirements will enhance the timeliness and integrity of financial reporting, they do little to speak to the fundamental problem shareholders confront in understanding public companies — evaluating the risk/return trade-offs that underlie any company's strategy.

We ought to have a much more active debate about new forms of enterprise ownership.

• *Rethinking Executive Compensation by Rethinking Tax Treatments:* Many factors contributed to the adoption of option programs by so many companies. The reasonably favorable tax treatment options receive contributed significantly. Compensation committees face a dilemma in granting compensation in the form of equity that creates immediate tax liabilities for the executives in question. It makes little sense to give someone a tranche of equity in order to help ameliorate the agency problem, only to have them sell 55% of the award in order to meet their cumulative tax obligations. By deferring gains, options provided an elegant solution to the friction that occurs on the intersection of the corporate and personal tax codes. We have special tax treatments to solve anomalies related to partnerships, real estate transactions, etc. Why not extend that logic to executive compensation?

• *Reducing the Barriers to Exit from Public Status:* Executives, lawyers, and policymakers have invested incalculable hours refining the process through which companies become public. Few individuals, other than corporate raiders and private equity investors, have spent time considering how to make exiting public status efficient if not convenient. But, the aversion private equity firms have for transactions involving privatizing companies suggests that sufficiently material and costly barriers exist in the process of bidding for a company as to scare off even the most sophisticated investors. Companies in capital markets purgatory need to have their path out of that unfortunate state eased.

• *Eliminate Dated Restrictions on Financial Holdings:* When one studies the literature on corporation strategy and compares it to actual performance, an anomaly emerges. The literature says that highly diversified companies will systematically underperform focused corporations. But, when one asks even casual students of corporate America to name the best-managed large companies, they invariably get the same answers: General Electric and Berkshire Hathaway. Those companies share several things in common, one of which is that both remain unrepentantly diversified, defying strategy pundits.

Perhaps more important, they speak to the effectiveness of professionally managed holding companies, as does the success of private equity investors like Clayton, Dubilier & Rice, and Thomas H. Lee. Holding companies of various types provide professional governance motivated by an owner's or principal's motives — a combination that helps defuse the agency dilemma. In the early 20th century, trust-busting administrations and financial regulators moved aggressively to inhibit the growth of such holdings and the ability of banks to invest directly in and maintain substantial stakes in unrelated commercial enterprises. While the underlying concerns motivating those actions were appropriate to that time and place, those barriers deserve reconsideration. Relaxing certain restrictions should stimulate new types of vehicles, less vulnerable to problems of agency and less afflicted with the direct and indirect cost of public ownership status.

Showing its vulnerability

As in all things, change to the corporate form will come slowly and in fits and starts. We would be wise to remember that famous quote from Mark Twain, who cautioned that reports of his death had been greatly exaggerated. So, too, have been reports of the demise of the public corporation. Still, the form is showing its age and its vulnerability. ■