Executive Looting of Companies: A note for the Kay Review

David G. Green, Civitas, March 2012

The American economy has now grown beyond its peak before the 2008 crash, while our GDP languishes about 4% below its previous high point. One cause has been low business investment, so much so that George Osborne used his Budget speech to urge business leaders to have the confidence to invest. But weak investment is not only because confidence is lacking, there is a deeper structural problem: the looting of companies by executives.

As Martin Wolf, chief economics commentator at the Financial Times, recently argued, the 'core institution of contemporary capitalism' the limited liability shareholder corporation has 'inherent failings', the most important of which is that companies are not effectively owned. As a result they are vulnerable to 'looting' by executives. Shareholder control, he said, was often an illusion and maximisation of shareholder value 'a snare, or worse'.

To make this claim is not to say that the free-market system as a whole is flawed. There is no viable alternative to a market economy, but we need to confront the fact that some characteristics of the prevalent institutions of the day – above all the shareholder corporation and modern equity markets – are undermining our hopes for economic growth.

Consider the example our largest manufacturer, BAE Systems. In September 2011 it announced nearly 3,000 redundancies, mainly because of falling defence orders. A couple of months earlier, in July 2011, the company had announced a share buy-back of up to £500m. Investors welcomed the move, pushing the share price up over 5 per cent. There had been an earlier buy-back in 2010. The BAE website shows that it had cash of about £2.8bn on its balance sheet at the end of 2010 and that during the year it had used £520m to buy back shares, making a grand total in 2010 and 2011 of £1.2 billion spent on buy-backs. Why did it not use its reserves to develop new products to take advantage of the proven capabilities of its workforce? Because buying back shares allows senior executives to increase their bonuses. Companies that buy back their own shares cancel them in order to increase earnings per share, without adding to real profitability. A recent Citigroup research note quoted in the Sunday Times said: 'BAE management is, indirectly, incentivised to continue share buybacks ... We would argue that buybacks are the easiest and least risky way to boost earnings per share.' Responding, BAE Systems claimed that executive pay was 'performance-related and aligned to the interests of shareholders'. The 'long-term incentive plan for senior executives covers a three-year period and includes a range of measures such as total shareholder return as well as earnings per share.'

These protestations are not very convincing. As a study by Simpson Associates has revealed, BAE also under-invests in research and development compared with the most successful companies, such as those entering for the UK and German Manufacturing Excellence Awards. They spend about 6% of operating revenue on research and product innovation, whereas BAE spends about 3%, the general level in the UK. Outstanding German companies like Bosch spend over 8%.

Boardroom short-termism has long been criticised but the real problem is not the time scale of investment decisions but the extraction of cash from companies by executives – looting in Martin Wolf's terminology. Using cash reserves to buy back shares in the hope of artificially inflating earnings per share is especially indefensible. Britain urgently needs economic growth if we are to avoid years of relative decline, but the resources that might achieve economic growth are in the hands of company executives with very different priorities. These characteristics are not found in all companies and are rather rare in private limited companies, chiefly because shares cannot be sold in public markets. The ultimate cause lies in the pressures generated by secondary equity markets.

Could we encourage a new kind of private enterprise corporation committed to long-term prosperity? Based on developments already under way in America, reform could take two beneficial directions. First, corporate articles of association could be changed so that executives can lawfully take into account interests other than those of shareholders, including the interests of employees and the long-term interests of the company. The second possibility is to use corporation-tax rules to discourage arms-length shareholding and promote proprietorship.

Under the 2006 Companies Act the interests of shareholders are assumed to be dominant. To take one example, Sir Roger Carr, the chairman of Cadbury during the recent takeover by Kraft, told the Kay review of UK equity markets in 2012 that the board had believed it was under a legal obligation to accept the Kraft offer. Even if it had considered that an offer was not in the long-term interests of the company, the board believed it was bound to accept any bid that reflected the value of the business. The legal position in America is similar, but some states are now introducing a new type of corporation, the 'benefit corporation' or B corporation.

This is how the legal obligations of directors are framed in some US states. When running a company the directors are permitted to take into account 'the long-term prospects and interests of the Company and its shareholders, and the social, economic, legal, or other effects of any action on the current and retired employees, the suppliers and customers of the Company or its subsidiaries, and the communities and society in which the Company or its subsidiaries operate.' Specifically, when considering takeover offers, directors can accept the lower of two offers if they think it best serves the interests of all stakeholders.

When UK company law was reformed in 2006 a great opportunity was missed to amend the duties of directors. We urgently need to revisit the 2006 Companies Act.

It is sometimes said that the shareholders' interests should be paramount because they bear the ultimate risk in the event of failure, but this claim overstates their vulnerability, especially compared to employees. Consider young people who commit to a company apprenticeship scheme. Their fortunes are tied to those of the company, but if the specific skills are later considered to be surplus to requirements it may be very difficult to find new work. The more specific the skills are to the company, the greater the risk to the employee. By comparison, the risk taken by shareholders rarely threatens the very means by which they earn a living.

The vast majority of shareholders have no real commitment to the company whose shares they own. They value shares primarily because they can easily be turned into cash. According to the Bank of England's Andrew Haldane, the average duration of equity holdings in the UK fell from about 5 years in the mid-1960s to two years in the 1980s. By 2000 it was slightly over 12 months and just before the crash in 2007, it was nearer 7 months.

A second remedy for irresponsible ownership has also been attempted in the USA. For several decades, the American tax regime has tried to encourage responsible company ownership.

Since 1958 US companies have been able to register with the tax authorities as either a 'C corporation' or an 'S corporation'. The chief difference is that a C corporation pays corporation tax, while an S corporation does not. In the latter case, all profits and losses 'pass through' to the shareholders. Ordinary income tax is paid when individual owners take money out of the company, for example when dividends are received, but if profits are retained in the company they are not taxed. To qualify, an S corporation must have no more than 100 shareholders. The small number of shareholders makes it more feasible for owners to know one another face to face, but is not so small that it prevents investors other than the executives from taking an equity stake. Shares cannot be sold in public markets but they can be sold privately, without the pressures prevalent in secondary equity markets. The measure has proved very effective, and by 2007 there were twice as many S corporations (4.5 million) as C corporations. The proprietorship encouraged by American tax law is what gives its small-company sector its vibrancy.

The B corporation laws permit companies to take other interests into account, not only those of shareholders, but should we go a step further? It would be preferable to create companies whose objects obliged directors to serve the interests of the locality, the workforce and the nation, as well as those of shareholders. Let's call such companies productive enterprise companies. In return for registering as a 'productive enterprise company' and accepting the obligations to the workforce and the wider public, there would be no corporation tax and no capital allowances, so that investment was just another business expense. Any profits taken out of the company would be taxed as individual income at the highest marginal rate, but earnings retained for investment would be tax free.

Under such a regime decision making in a company like BAE would no longer be distorted by conflicts of interest, such as those between executives and shareholders, executives and employees, and large shareholders and small shareholders. Instead, directors could pursue the long-term interests of the company. Such companies would be more likely to see that their main business asset was the capabilities of the workforce. Faced with declining orders for one product, they would not judge some of their workforce to be 'surplus to requirements', but the solid foundation on which the business rests. Instead of sacking people, a productive enterprise company would find new products that could be made with the skills already in house. It's what good companies already do, but not those driven by the frivolous buying and selling of modern stock markets.

There is no real alternative to a market economy. Few want a return to the collectivism of old, but the institutional shape of capitalism can take many forms. Above all, there is nothing inevitable about the limited-liability shareholder corporation. As the great economist Hayek remarked, corporations are the result of 'special conditions which the law has created and the law can change'.
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