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"The Corporation as Complex Adaptive System"

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The canton of Zurich has proposed that English replace French as the second language taught in school; Citicorp and Traveler's have agreed to merge notwithstanding legal prohibition; according to George Soros, the legal profession has transmogrified into a business; sports are no longer principally concerned with personal accomplishment but with entertainment; press standards are subsumed into sales and away from quality of research and writing. The common factor in all of these developments around the industrialized world is the hegemony of corporations and corporate values.

Corporations are a system of power. It is difficult to find a language to describe how they function. It follows that it is even more difficult to proscribe a regime under which their functioning can be accommodated to the broader interests of society. Usually, we are introduced to corporations in the language of law: lawyers form corporations, and corporate disputes are usually resolved in courthouses. And yet the language of the law is oftentimes plainly – even deliberately – misleading. The law describes a static institution when corporations are dynamic. Legal terminology appears to be chosen for political or public relations reasons rather than for the purposes of straightforward communication. How else could we account for the description of a director selected by a self-perpetuating board as "independent"? Whatever else, such a person is, they are surely not independent.

The "legitimacy" of corporations – that is the conferral by society of so much power on non-elected officials – is based on the accountability of officers and directors to the shareholders. Corporation law recites – "The shareholders elect the directors." Everyone knows that this is not true in any meaningful sense. The fact is indisputable that the Chief Executive Officer either acting alone or in concert with a Nominating Committee "selects" those individuals whose names will appear on the proxy. They are then circulated as a ballot among all shareholders. On receipt of the ballot with X nominees for X vacancies on the board, a shareholder has four choices – he can destroy the card; he can write in the name of a candidate of his choice; he can vote for some of the nominees; he can vote for all of the nominees – in all events, the result is the same. Those persons whose names were put on the card by the incumbents are "elected" to the board. Rather than voting, the shareholders' role in the directoral election process could more appropriately be described as "coerced ratification". If this deception is at the core of the legal construct of the corporation, it is apparent that we need to look elsewhere for a language that can reliably give insight into its functioning.

Economists conceive of a corporation as being comprised of actors who can be predicted to function rationally in their own self-interest. This begs the interesting question as to whether there is ever adequate information on which one could divine one's optimal interest. It also misconceives the nature of man. People do not function out of concern uniquely with economic considerations. A CEO who is being paid five million dollars a year is considered by economists to be "incentivized" by pay increases, absurd as it may appear on the face of it. This use of corporate apparatus for the purpose of enriching the principal officers is described by economists as an "agency cost" which plainly derogates from the long-term enrichment of shareholders. Human beings simply are more complex than "homo economicus". While long-term value maximization can be taken as a generally accepted corporate goal, there is no existing academic discipline or language which provides a satisfactory definition of "value".

There is much talk about "good" corporations and the supposed obligation of their managers to take into account non-profit maximizing allocations of corporate resources. Warren Buffett, the great Nebraska investor, put it best in his annual appeal to shareholders to tell him what charitable contributions they wanted him to make with their money. He says simply: "I would no more think of giving away your money to a charity than I would think of going into your house and using your telephone." This talk of the "good" is an indication of how uncomfortable society is with corporate power and the need for some formulation that will better rationalize it. Is there such a thing as a good corporation? Many years ago in New England, everyone knew what was the best corporation in the world. It was Polaroid located in Cambridge, Massachusetts. Edwin Land, to whom more patents were issued than any American other than Thomas Edison owned and operated a business that created pleasure for customers, put no one out of work, used all the most modern techniques for educating employees, was a model in being located in depressed areas and in training the unemployed. Then one day, it was discovered that Polaroid's nifty process for making ID badges with laminated color photographs was being used as an enforcement tool for apartheid in South Africa. Polaroid went from being the best company in the world to Public Enemy No. 1.

Fredric Hayek, the Austrian economist, raises the further question whether society can tolerate corporate functioning beyond the profit maximization definition. In his view, society allows a realm of economic activity for corporations but this realm must be strictly monitored so as not to involve any further infringement on the political liberties of society than necessary.

Corporations involve individuals, property and a legal structure. We often talk of corporations in human terms – Ma Bell was the beloved American Telephone Company for most of the twentieth century. It is tempting to think that a corporation is simply a human, writ large. While human energies and instincts significantly affect the operation of corporations, there are important aspects of their being that cannot be understood anthropomorphically. Nor can corporations be simply understood as machines with an ineluctable mode of functioning.

The new "science" of complexity provides a language that helps understand corporations and their impact on modern society. By thinking of corporations, either literally or metaphorically, as "complex adaptive systems", we can benefit from the work that has been done in the fields of particle physics, genetic biology and economics. The underlying theme to all of these fields is that they have a connecting characteristic – they are based on the existence and functioning of complex adaptive systems. These systems, whether in physics, biology or economics, can be analyzed as patterns and modes of behavior that can inform activity in other fields. One cannot literally find in corporate behavior a repetition of the interaction of sub atomic particles; one can, however, notice living patterns that seem to replicate in corporate experience – tendencies towards immortality, for unlimited size, unlimited power, unlimited license.

Only when one understands that corporations have adaptive characteristics does it become clear that modification of their behavior must come from within the organizations. It has not been convenient for society to recognize the general ineffectiveness of external restraints on corporate activity. Neither government nor marketplace has the capacity to require corporate functioning to conform to society's interests. Large corporations retain the services of the most talented professionals, the most persuasive lobbyists (consider for a moment that the genuinely great George Mitchell, "hero" of the Irish peace talks, is the principal lobbyist for the tobacco industry). They control the most influential newspapers, TV (all three American networks are owned by diversified conglomerates – GE, Disney and Westinghouse) and magazine outlets and the best lawyers. With such competitive strength, it is difficult for the widely dispersed elements that comprise society, to effectively assert a contrary view. The only way in which to attempt societal harmony with corporations is to understand that they are complex adaptive systems and change must come from within.

Over the last century, several theories of corporate compatibility with society have been promulgated – none of them are satisfactory in light of the place we have presently arrived at. They range from considering the chief executive officer to be a kind of "philosopher king", to considering boards of directors or other experts as effective moderators to the "free press", to the cumulative monitoring capability of the functioning free market. There are only two conclusions that can be drawn. It is generally agreed that unlimited corporate power is unacceptable and that some seemingly plausible theory of moderation is essential. It is likewise agreed that no harm is done if the theory has only superficial plausibility and, in reality, there is no constraint on corporate power. At the risk of confusing the matter further, we are glad to note that there are many (maybe most) corporations today that act as good citizens. The problem is at the margin.

Economists suggest that the fear of takeover constitutes a discipline assuring acceptable corporate conduct. While this ultimate weapon may provide dissidents with theoretical control, it is too expensive, too legally intricate, and too violent to have more than nominal appeal. What is needed is continuing effective involvement in the process of monitoring managements. Ultimately, only the owners can perform this difficult function and this, only with great difficulty. The "free rider" problem consigns activist owners to all of the risk and cost of information and action while limiting them only to their pro rata share of any incremental value. Beyond this, many owners suffer from conflicting interests. The great institutional money managers – J. P. Morgan, Merrill Lynch – not only serve as significant fiduciary owners, but they also offer a whole range of services to the managements of these portfolio companies. Plainly, there is inhibition on the part of trustees to exercise managerial oversight that is offensive to their potential customers. While trust law plainly requires the trustee responsibilities take precedence over all other considerations, the law is not enforced. Until it is, shareholder activism will be the work of entrepreneurs, public pension funds and the few institutions who are not in the business of selling their services to large corporations, such as the College Retirement Equity Fund in the United States and Hermes in the United Kingdom.

There is need for informed and involved owners to assure that the corporate system can coexist with a free society. The challenge is to create incentive for shareholders to undertake the burden of monitoring. Again, the great American investor, Warren Buffett, has provided an answer. Frequently, he invests in companies through the medium of a special class of stock which protects him with a current dividend and a preferential position in liquidation, as well as being convertible into common stock on the upside. Buffett's involvement plainly increases the total value of companies in which he invests; he simply has placed a price on this involvement and has found a way to be paid. Few investors are as scrupulous, few are as powerful, and virtually no one else has Buffett's reputation for intervening when such is necessary to protect shareholder values (the case of Salomon Brothers comes to mind). Possibly, the Buffett model could be extended to other shareholders or groups of shareholders.

The excesses of corporate power manifest in today's world require resolution if the system is going to be able to continue. Otherwise these excesses will bring down such counter productive remedies as nationalization or over regulation. The time-honored legal, economic and ethical solutions demonstrably are not effective, in large measure because they fail to understand the nature of the corporation itself. The species itself – a complex adaptive system involving legal structure, talented people and large resources – needs to be informed by an energy that places priority on the transcending importance of a free society.