Originally published in French in *La Tribune*, 15 January 2007

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Bob Nardelli's Governance Lessons

Bob Nardelli has made big headlines in the United States in the past two weeks. On 3 January, the media-hungry CEO of Home Depot was forced to resign by his board following an energetic campaign by activist investment funds. His authoritarian management style has left employees demoralised, customers frustrated by an apparent drop in the quality of service, and investors unconvinced. In spite of good financial results, Home Depot's stock price remains lower than when Nardelli was hired in December 2000. In spite of this, the ousted CEO goes home with a record severance payment: 210 million dollars in total. There could be more twists in the turmoil at Home Depot. All the same, this case already brings three useful lessons to the debate about corporate governance.

First lesson: don't despair of the Stock Exchange. It has now become conventional wisdom that family-owned or unlisted companies are better managed than listed, dispersed-ownership corporations, because the latter are subject to the market's collective myopia and bring no checks to the powers of the 'imperial CEO'. But Home Depot tells a different story. Its stock price has stagnated even while its earnings per share have increased by more than 20% every year. Far from being short-sighted, the markets have paid attention to the long-term risks resulting from lack of care for employees and customers. Moreover, minority investors are far from powerless. Relational Investors, the fund that was most active in dismissing Nardelli, had only 1.2% of Home Depot's shares. The boundary between listed and unlisted is certainly shifting with the growing skills and acumen of private equity investors. But the idea that listed companies are structurally less well-governed than unlisted ones is not backed by hard evidence.

Second lesson: don't despair of the US governance framework. In spite of all its flaws, it has preserved a remarkable ability to adapt and self-correct. The much-reviled Sarbanes-Oxley Act has improved internal controls. Disclosures about executive compensation are more transparent. Minority investors have more possibilities to act. By contrast, Continental Europeans are complacent in allowing more poison pills than in the past (with France setting a bad example), and tolerate glaring distortions between different categories of shareholders. Perhaps because of this, the potential for rapid corporate growth remains higher in the US. Home Depot is a spectacular example. Founded in 1978, it developed a market capitalisation of $80bn, among America's 40 largest, almost solely through internal growth. In spite of the stock price stagnation under Nardelli, it is still worth twice as much as Carrefour, the Continental European retail leader. In France, no company in the top 40 is younger than forty years.

Third lesson: the problem of executive compensation is political rather than economic. Controversial as they may be, incentives at Home Depot can be described as having functioned relatively well. Had Nardelli’s 2000 contract not foreseen a big severance payment, it is likely that he would have put up more resistance to leaving his job, and caused more harm by digging himself in. The aim of corporate governance being to maximize long-term economic performance, it can be justified for companies to provide substantial golden parachutes for disappointing executives, even if this sounds unfair.

Thus, pay packages may be at the same time efficient from a governance point of view and unacceptable to the wider public. So it is misleading to say, as did Medef (France’s employers’ association) last week, that self-regulation has to be “the sole reference” in executive compensation. This issue is hotly debated in the United States. France adds two aggravating factors to the political controversy: tax avoidance by many of its richest citizens, and a perception that CEOs are chosen not on merit but rather on relationships. Not least because the French higher education system advantages children from privileged backgrounds. These issues cannot be tackled without the help of public action. To fight tax avoidance, at least some yet-to-be-defined sort of European coordination is needed. And enabling fairer competition among talents, especially through higher education, is one of the key issues of the incoming presidential election. If France fails in this, it is sure to slide.

The market provides models for corporate governance, but does not relieve policymakers of their responsibility to respond to wider societal challenges, including those created by high executive pay packages. This is perhaps another of the lessons involuntarily taught by Bob Nardelli.