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1 DEVELOPMENTS IN CORPORATE GOVERNANCE

1.1 Corporate governance: origin and evolution
1.2 Corporate governance: corporate law and regulation
1.3 Corporate governance: ethics and corporate social responsibility
1.4 Corporate governance: does it matter nowdays?

Learning objectives

- to explain the cornerstones of evolution of corporate governance
- to describe the role of law and regulation in corporate governance
- to conclude on the importance of corporate social responsibility in corporate governance
- to explain why corporate governance matters nowdays

Key concepts and terms

- the corporation
- stock exchange
- Securities and Exchange Commission
- mergers and takeovers
- pension funds
- corporate governance
- corporate law and regulation
- code of best practices
- corporate ethics
- corporate social responsibility

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1.1 CORPORATE GOVERNANCE: ORIGIN AND EVOLUTION

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1. Introduction

The financial crises of Enron, WorldCom and Parmalat have heated up the discussion about the proper governance of companies. Under the buzzword of corporate governance a lot of issues borne by the separation of ownership and control (see Berle and Means, 1932) are treated.

The term "Corporate Governance" derives from an analogy between the government of nations or states and the governance of corporations, whereas - according to James Wolfensohn, former president of the World Bank - the governance of corporations is now as important in the world economy as the government of countries.

Corporate governance in the academic literature seems to have been first used by Richard Eells (1960) to denote "the structure and functioning of the corporate polity". But how to manage companies and the question for the best structure to achieve an optimal allocation of resources is as old as the history of companies. Nevertheless, the term corporate governance is inescapably connected with (listed) corporations, as here the separation of ownership and control and the therefore arising agency conflicts are obvious. Therefore it is instructive for the further work to begin with a brief historical origin of the corporation.

2. The corporation

The corporation, as we know it today, is the product of a process that began in England as early as the 17th century (Mueller, 2003). In those days, ownership was divided among a few individuals who often also participated in management. At this time no organized markets existed for the transfer of ownership claims (Larner, 1966). As a consequence, shares were only transferred to friends or relatives, and control was therefore characterized by "voice" rather than by "exit" (Hirschmann, 1978). This means that shareholders unhappy about the corporate performance invested effort and patience into the company (voice) rather than selling or transferring shares (exit).

Corporate control was therefore characterized by "voice" rather than by "exit"

2.1. History of corporations

Until the beginning of the 17th century, the partnership was the dominant form for organising jointly owned business firms. In fact, the partnership was the only form available for most types of business. Partners bore unlimited personal liability for the contractual obligations of the firm.

One of the first corporations that came into existence was the British East India Company, sometimes referred to as "John Company". It was a joint-stock company, which was granted an English Royal Charter by Queen Elizabeth I at the end 1600, with the intention of favouring trade privileges in India. The company had 125 shareholders, and a capital of £72,000. At the time, the concept of a corporation was quite different than today. Corporations were small, quasi-governmental institutions chartered by the crown for a specific purpose like the above mentioned trade privileges. This was one of the first companies established as well to gather together investors to satisfy the huge capital demand of large projects. Not only Queen Elizabeth I but other kings and queens closely watched these corporations and didn't hesitate to revoke charters if they weren't happy with the way they were being run.

One of the first corporations was the British East India Company founded in 1600

But being more the exception than the rule, corporations in general remained small institutions for the next 200 years or so to come. Most of them were chartered for specific purposes, such as banking. Corporations could only exist for a limited time, were not allowed to make any political contributions, and could not own stocks in other companies.

The start of the industrialisation changed this picture heavily. Industrialisation was connected with the huge capital demand of new giant firms, especially in the railroad industry (Mueller, 2003). At the same time legislators also began to take corporations more into consideration: corporations were allowed to write broader and less restrictive charters (Hopt and Leyens, 2004). The doctrine of limited liability, allowing corporate owners and managers to avoid responsibility for harm and losses caused by the corporation, made this business form even more interesting.

The growing industrialisation in the 19th century also meant that more citizens left the countryside to look for jobs in the cities. A wave of immigration created a new class of society which was depended on factory jobs to earn a living. Between 1895 and 1904, the first great merger wave in the US consolidated companies into mega corporations. In other words, the corporation was transformed from state-controlled organisations to unlimited private organisations with limited responsibility and limited accountability.

Corporation was transformed from state-controlled organisations to unlimited private organisations

Due to the growth and importance of corporations, markets for the exchange of shares opened in New York and some European capital cities (Pistor and Xu, 2002) at this time.

As share trading became easier the shareholders as capital providers increasingly relied on the exit option to express their pleasure or displeasure with "their" managers' decisions. Thus, considerable authority was granted to management. Control via voice shifted to the boards of directors, which in turn were dominated by managers.

Corporate control via voice shifted to the boards of directors, dominated by managers

In other words, at the end of the 19th century and beginning of the 20th century, control of corporations shifted more and more into the hands of the managers and therefore ownership and control separated. As the 20th century unfolded and corporations continued to grow while the descendants of the founding families increasingly reduced their share of the ownership, the extent of the separation of ownership from control - and therefore the agency problem – deepened.

2.2. Key features

The law typically views a corporation as a fictional person, a legal person, or a moral person. In other words, a corporation is a person in its own rights. The owners of the company are the shareholders (also called members). In return for money they put into the company they are getting shares. Corporations are managed by directors, which may be members of the company or not.

A corporation is typically characterised by the following four key features presented in exhibit 1.

EXHIBIT 1.1

Key features of a corporation

KEY FEATURE	DESCRIPTION
Separate Legal Personality	A company has its own legal personality. Consequently it can be a party to contracts and the subject of rights and liabilities. Furthermore, the existence of a corporation may continue indefinitely unless and until it is liquidated.
Separation of Management from Ownership	There is a formal separation of the company's management (under the board of directors) from the shareholders. The latter are sometimes termed “the owners” of the company. They share the company's profits. As they are collectively entitled to appoint and remove directors from the board, they exercise ultimate control over management. Berle and Means (1932) argued that a company does not behave in accordance with the classical model. They argued that the shareholders would not act as “owners” and that this would exacerbate “the agency problem” to which all firms are vulnerable. The shareholders’ perceived limited liability and the shareholders’ inability in practice to control management contribute to this problem. Despite this problem, the separation of the function of management from the function of shareholding, i.e. equity capital provision (together with the subsequent "risk-bearing"), enables these functions to be performed more efficiently by specialists. Directors and other managers do not have to possess capital (and risk-bearing expertise) and shareholders do not have to possess managerial expertise. Management can be performed more efficiently by a relatively small and cohesive group of people whereas the risks associated with providing equity capital can be borne more efficiently when shared among a large number of people, who in turn can protect themselves by holding diversified portfolios of investments.
Limited Liability	Starting point for this feature is the company’s responsibility for its own debts and liabilities. In other words, the shareholders share the company's profits, but they are not responsible for its losses. They are only liable to the company to pay up their share capital and have no further liability. So limited liability actually shifts the risk of business failure from the company's shareholders to its creditors. This appears to give the company's owners and managers too much of an incentive to take risks and can lead to an inefficient use of resources.

KEY FEATURE	DESCRIPTION
Transfer-ability	A share in a company carries rights against the company to receive dividends and (usually) to vote at shareholders meetings. Furthermore it carries any remaining liability to pay up capital. A share can be transferred to a new holder and this transfers the associated rights and liabilities. Shares in a public company are usually traded on a stock exchange, facilitating transfer and making shareholding a more flexible kind of investment.

3. Definitions of corporate governance

The term "Corporate Governance" is susceptible of both narrow and broad definitions, related to the two perspectives of shareholder- and stakeholder orientation. It therefore revolves around the debate on whether management should run the corporation solely in the interests of shareholders (shareholder perspective) or whether it should take account of other constituencies (stakeholder perspective).

The term "Corporate Governance" is related to the two perspectives of shareholder- and stakeholder orientation

Narrowly defined corporate governance concerns the relationships between corporate managers, board of directors and shareholders. But it might as well encompass the relationship of the corporation to stakeholders and society. More broadly defined, corporate governance can encompass the combination of laws, regulations, listing rules and voluntary private sector practices that enable the corporation to attract capital, perform efficiently, generate profit, and meet both, legal obligations and general societal expectations.

The different national systems of corporate governance articulate the primary objective of the corporation in different ways. Some nations - predominately in Continental Europe and Asia focus on the need to satisfy societal expectations. These are in particular the interests of employees and other stakeholders, variously defined to include suppliers, creditors, tax authorities and the communities in which corporations operate. Other nations - typical examples are the Anglo-Saxon countries - emphasise on the primacy of ownership and property rights and focus on returning a profit to shareholders over the long term. Under this view, employees, suppliers and other creditors have contractual claims on the company. As owners with property rights, shareholders have a claim to whatever is left after all contractual claimants have been paid. The corporate focus is on shareholder value. Exhibit 2 with some chosen definitions including their origin and perspective illustrates this.

4. The prominent role of corporate governance

Becht et al. (2002) identified five reasons why corporate governance became so prominent in the past two decades: i) the world-wide privatisation wave, ii) pension fund reform and growth of private savings, iii) the takeover wave of the 80s, iv) deregulation and integration of capital markets, and v) crises.

EXHIBIT 1.2

Definitions of corporate governance

DEFINITION	ORIGIN / PERSPECTIVE
Corporate governance describes ways of ensuring that corporate actions, assets and agents are directed at achieving the corporate objectives established by the corporation's shareholders	Sternberg (1998) gives a definition very much in favour of a shareholder perspective.
The approach of corporate governance that social, moral and political questions are proper concerns of corporate governance is fundamentally misconceived. Expanding corporate governance to encompass society as a whole benefits neither corporations nor society. Because management is ill-equipped to deal with questions of general public interest.	Lipton and Lorsch (1992) clearly speak for the shareholder perspective as management is not "well-equipped" enough to deal with multiple constituencies.
Corporate governance is the process of control and administration of the company's capital and human resources in the interest of the owners of a company.	Hess (1996) about the general position within the US. The shareholder is the focus of the company.
Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment	Shleifer and Vishny (1997). This definition is broader than a pure shareholder perspective, as other creditors in addition to the shareholders are mentioned.
Corporate governance is the whole system of rights, processes and controls established internally and externally over the management of a business entity with the objective of protecting the interests of all stakeholders.	Centre of European Policy Studies (CEPS, 1995); The objective of protecting the interest of all stakeholders is clearly a sign of a Continental European definition.
Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.	The Cadbury Report (1992), para 2.5 gives a quite neutral definition of corporate governance, highlighting the importance of shareholders and boards of directors.
Corporate governance defines a set of relationships between a company's management, its board, its shareholders and other stakeholders	The OECD Principles of Corporate Governance (2004) are trying to give a very broad definition as it should serve as a basis for all OECD countries.

4.1. The privatisation wave

Privatisation has been an important phenomenon not only in Western Europe and Asia but especially in the former communist countries, some of which joined the EU recently. The US are an exception as state ownership of companies has always been very small. This privatisation wave has its origin in the UK which was, for example, responsible for 90% of EU privatisation proceeds in 1991. Since 1995 Australia, Italy, France, Japan and Spain alone have generated 60% of total privatisation revenues worldwide.

The privatisation wave raised the question of ownership and control of the former state companies. In the countries of Continental Europe great care was given to ensure the transfer of control to large shareholders. The UK, on contrary, created a form of "shareholder democracy". Privatisation boosted the development of the stock markets as most OECD sales have been conducted via public offerings.

4.2. Pension funds and other institutional investors

The private provision for one's old age is common in the US and due to the demographic development in Europe as well. That made pension funds and other institutional investors into large and powerful institutions which can influence corporate governance. Institutional investors in the US alone command more than 60% of total equity investment in the OECD, raising to 76% when UK institutions are added. A significant proportion is held by pension funds (approx 40% for the US and UK and 15% for Germany). These investors therefore play an increasingly active role in global corporate governance.

INSIGHT 1.1

The California Public Employees' Retirement System

Background

The California Public Employees' Retirement System manages pension and health benefits for approximately 1.5 million California public employees, retirees, and their families. As of June 30, 2006, CalPERS provided benefits to 1,048,895 active and inactive members and 441,277 retirees. CalPERS membership is divided approximately in thirds among current and retired employees of the state, schools, and participating public agencies.

History

CalPERS was established by state law in 1932 to provide retirement benefits for state employees. In 1939, public agency and classified school employees were allowed to participate. In 1962, state law authorized CalPERS to provide health benefits to state employees. The health benefits program was expanded in 1967 to include public agency and school employees. In 1995, CalPERS began offering a supplemental deferred compensation retirement savings plan to members of public agencies that contract for it, and long-term care insurance on a not-for-profit basis.

Mission
Mission of CalPERS is to advance the financial and health security for all who participate in the System. CalPERS will fulfill this mission by creating and maintaining an environment that produces responsiveness to all those CalPERS serves.

CalPERS executive compensation plan
CalPERS is pursuing major pay-for-performance initiatives, including:
- Engagement of the executive compensation consulting industry on the practice of employee stock option backdating and spring-loading, which is causing dozens companies to come under investigation by the Securities and Exchange Commission;
- Urging the compensation consulting industry to adopt practices that better align corporate boards and management with shareowners.

CalPERS seeks disclosure on environmental liabilities
CalPERS Board approved a plan that calls for greater disclosure of corporate environmental liabilities, improve transparency and timely disclosure of environmental impacts. Under the plan, we have launched a number of initiatives aimed at improving environmental data transparency.

CalPERS backs UN principles for responsible investment
CalPERS Board signed the United Nation Principles for Responsible Investment, a menu of possible global actions on environmental, social, and corporate issues. The six guidelines, published in April 2006, were drafted by representatives of as many as 20 investment organizations from 12 countries.

CalPERS seeks majority vote for corporate directors
CalPERS is advocating majority vote election procedures for corporate directors. Currently, a plurality vote system is used in most corporate elections, in which directors can be elected by the vote of a single share unless they are opposed by a dissident candidate.

Data source: www.calpers-governance.org

For further analysis of institutional investors in context of a monitoring device we refer to section 4.

4.3. Mergers and takeovers

The hostile takeover wave in the US and Europe has influenced the public debate on corporate governance

The hostile takeover wave in the US in the 1980s and in Europe in the 1990s in addition to the recent merger wave (eg AOL-Time Warner, DaimlerChrysler, or Acelor-Mittal Steel recently) has influenced the public debate on corporate governance. The 200 billion dollar cross-boarder hostile bid of Vodafone for Mannesmann in 2000 was the largest ever to take place in Europe. This takeover together with the recent hostile takeovers in Italy (Olivetti for Telecom Italia) and in France (BNP-Paribas) have changed the corporate world in Continental Europe. Since these events takeover regulations are political agendas of the European Union (EU).

4.4. Deregulation and capital market integration

The greater integration of world capital markets through the introduction of the Euro and mergers of stock markets (Euronext and the endless merger rumours for London Stock Exchange) and the growth in equity capital throughout the 1990s increased the interest in corporate governance in the last few years. In addition, increasingly fast growing corporations in Europe have been raising capital from different sources by cross listing on multiple exchanges (Pagano et al. 2002).

4.5. Economic crises

The East Asia crises 1998 highlighted the weak corporate governance practices in emerging countries and led to a reassessment of the Asian model characterised by centralised and hierarchical industrial groups. There has been similar reassessment of mass insider privatisation and weak shareholder protection in other transition economies as well.

Corporate governance is a relatively new area and its development has been affected from a number of disciplines including finance, economics, accounting, law, management and organizational behaviour. The main theory which has affected its development, and which provides a theoretical framework within which it most naturally seems to rest, is the agency theory. However, stakeholder theory is coming into play as soon as companies become aware that they cannot operate in isolation but need to have regard to other stakeholders. This and many other ideas got well known over the last few years with the term "Corporate Social Responsibility (CSR)" which will be dealt with in section 3.

Questions

- Explain how the history of corporations influenced corporate governance issues?
- What are the key features of a corporation?
- Describe the different perspectives which can be retrieved from the different definitions of corporate governance.
- Explain the reasons why corporate governance became so prominent in the past two decades.

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Selected Internet Resources

- Cadbury Report - www.ecgi.org/codes/documents/cadbury.pdf
- OECD Principles of Corporate Governance: www.oecd.org/dataoecd/32/18/31557724.pdf
- Social responsibility - www.business-ethics.com/
- Society of Corporate Compliance & Ethics - www.corporatecompliance.org
- Business Ethics.Ca - www.businessethics.ca
- CalPERS - www.calpers.ca.gov
- Employees Retirement System of Texas (ERS) - www.ers.state.tx.us
- Corporate Social Responsibility Europe - www.csreurope.org