

# CORPORATE GOVERNANCE: AN INTERNATIONAL COMPARISON

Vernon P. Dorweiler\*, Mehenna Yakhou\*\*

## Abstract

Commerce has reached a global basis. Either trade regulation has eased, or deployment of production facilities has been adopted. Laws and regulations limit commercial practices in individual countries. Below the level of commerce is control of corporations, internally and externally; that is corporate governance. This research is to explore corporate governance, as laws and regulations enforcing control of corporations on a comparative global basis with commerce. While the scope of the research is broad, descriptions are specific to corporate purposes.

**Keywords:** corporate governance, corporate law, owners, managers

\* Michigan Technological University, U.S.A

\*\* Georgia College and State University, U.S.A

## 1. Introduction

The work of Berles and Deakin (1948) was the initial effort to research corporate governance. That work was descriptive of the area, not normative or prescriptive, leaving implementation and enforcement to legal affairs.

The key rationale for corporate governance is to resolve the separation of owners and managers in a corporate structure. That resolution must facilitate decision-making that maximizes the value of the corporation. This is clearly separate from a legal system, which is based on standards to be met, and enforced on corporate officers. This also relates to "codes of good governance". Codes are enforced internally by the Board of the corporation.

## 2. Duality of Corporate Governance Systems

The main corporate governance systems are two: Anglo-Saxon, and Continental Europe (Ooghe and DeLanghe, 2002). The Continental Europe system is based on size of shareholders (particularly large shareholders); Anglo-Saxon is based on market-orientation (Cuervo, 2002).

### 2.1 Systems of Corporate Governance

Characteristics of the Continental European system are:

- (1) Ownership is limited;
- (2) Control exercised by large owners;
- (3) Board of Directors, controlled by either internal or external directors;
- (4) Capital markets with limited actual ability;

- (5) Close personal trust, in relationships among managers;
- (6) Long-term, lender-ownership relationship; and
- (7) Linked actors' roles in corporate governance.

Characteristics of the Anglo-Saxon system are:

- (1) Diffuse ownership, except institutional investors;
- (2) Control within the Board, with directors playing an extended, important role;
- (3) Liquid capital markets;
- (4) Protection of ownership rights, over debt holders.

Dealing with former Communist States requires another system of corporate governance (Dragneva and Simons, 2001). As Braendle and Noll (2005) point out:

*Interest in corporate governance is not a new phenomenon in the transition economies of Central and Eastern Europe (CEE).....*

*Before the fall of the iron curtain accompanied with the collapse of the Soviet Union there was no need to discuss corporate governance issues as all companies were owned by the state. All this has changed and corporate governance codes as a measure of dealing with each country's specific governance problems have been adopted by most of the CEE markets.*

Hence, the "hand of State" is now being replaced by the stakeholders approach of the Western sphere of commerce. The corporate-governance mechanisms in Central and Eastern Europe are described by Berglof and Pajuste (2005) [see Table II]

## 3. Corporate Actors

Comparison of corporate actors is another way to determine the extent of change, on an international

basis. Most countries have the same list of actors in the corporation's leadership (Salacuse, 2003): shareholders (owners); employees; creditors; suppliers & customers; and community. The communist regime is based on the "hand of State". This is more than revision, but it comparable to stakeholder in the Western business environment.

These actors are identified through business technologies: computer, communication avenues, health & safety, and environmental regulation (Salacuse, 2003).

There are three views of companies:

- (1) historical; (2) human rights; and (3) efficiency.

All three have a traditional role in directing and controlling the corporation (Fairfax, 2002). Shareholders are the only ones with a claim on profit, and hence are mainly concerned with profit maximization.

The role of corporation in society is defined as "corporate social responsibility" (Salacuse, 2003). It was this concept that introduced the view of stakeholders in the 1970s. Development of the broader theory of constituencies was based on critical law theory, political science, management science, and sustainable development.

#### 4. Corporate Governance

Corporate governance is defined (Cuervo, 2002) as to control management of the corporation, and to facilitate maximum value to the firm. Further, corporate governance provides some protection for minority shareholders. Pursuit of these goals must fit within corporate governance. More, specifically, the Board relationship between shareholders and the internal management of the firm (Board and managers) must fit.

Corporate governance is an organization structure

- (1) to determine the integrity of a transaction; and
- (2) to fit with external policies re: capital & labor markets, competition and bankruptcy.

Internal identifies organization, rules and relationships.

#### 5. Sources of Corporate Governance

Corporate Governance, with its powers, must be authorized. It is recognized that economy and culture of a country have a direct effect on the outcome. The law sources are state law, and federal law, including the securities laws of 1933 and 1934. A private source is within the corporation. These all limit relationships between officers and with the corporation.

In Europe, Corporation Governance is found within corporate laws of individual countries (Leermakers, 2003). The European Union has exceptional authority, but not the uniformity of corporate governance. Individual countries have

legislated on Corporate Governance. Thus, there is more divergence on Corporate Governance law & regulation, than in the states of the United States.

#### 6. Special Forms of Corporate Governance

In Eastern Europe, this is the first generation of corporate governance (Dragneve, 2001). This is also a new experience for owners and managers. As noted below, the corporation is a new entity in the freed countries. The underlying theory is found in the following: sustainable development, political science, and critical law. Beyond theory are the practice duties: fiduciary, loyalty, and care.

An unusual entity in corporate governance in Eastern Europe is the "work council" (Drageneva and Simons, 2001). That entity is controlled by employees and employers. It appears in Germany and Netherlands of Western Europe. Dragneve and Simons indicate that:

*the work council is entitled to information on general economic and social matters. In France, Germany and the Netherlands, they can be consulted on certain major economic or financial issues, i.e., major restructuring or winding up the company specified in the respective statutes. In addition to information and consultation, in some countries such as Germany, the Netherlands and Belgium, work councils are granted co-decision making functions with regard to specific social issues. The importance of work councils becomes even more obvious in considering the sanctions for failure to observe its participation. In France, a failure for a director to observe work council rights does not make the decision void but can result in criminal liability.*

#### 7. Codes of Corporate Governance

The method to overcome national rules of Corporate Governance is to develop codes of best practices (Barnard and Deakin, 2002). The American Law Institute, in the U.S., has researched and published a comprehensive statement of Corporate Governance. The European Union has also published a code of business practices (Salacuse, 2003). More than 107 codes have been introduced since 1992 in 35 countries. In Europe alone, more than 55 codes have been introduced in 19 countries (Maassen et al. (2004). The United Nations (2006) also published guidance on good practices in corporate governance disclosures. Table I provides a comparison summary.

#### 8. Direct Impact on Corporate Governance

The most direct impact on Corporate Governance is the manner of corporate officers complying with their fiduciary duty. This duty indicates a standard to

- (1) monitor corporate affairs, including delegations; and
- (2) remain informed about corporate affairs, including probing into business affairs.

To comply with the fiduciary duty, officers are entitled to rely on others, to perform, monitor and ensure reliability of the information.

Misconduct can be proven if officers' decision-making did not diligently seek in good faith, in all aspects of corporate affairs (Tonge and Lawton, 2003). Compliance is not an easy matter, as the corporation's business may be very broad.

## 10. Corporate Governance Mechanisms

From the description above, the corporation is a valuable framework for grouping corporate governance mechanisms, while accounting for the diversity of actors involved. The relationships are the following (Cuervo, 2002):

- a. internal-vertical, addressing the relationships between those in control and all other constituents;
- b. internal-horizontal, directly regulating the relationships among the various constituencies;
- c. external rules and regulations, imposed upon the corporate entity, to address concerns beyond the direct interests of the corporation; and including policies re: competition, anti-trust, export policy, health & safety.

As noted above, internal identifies organization, rules and relationships within the corporation. Cuervo (2002) describes the characteristics of each systems as follows:

*Continental European Systems of Governance. Characterised by:* (1) ownership is concentrated; banks, companies, and families are large shareholders; (2) control is assumed to be exercised by large shareholders; (3) the board of directors is controlled by internal directors or external directors linked to large shareholders. (4) capital markets are relatively illiquid and have limited control ability; (5) there exists implicit contracting and close personal trust relationships among managers; (6) long-term lender-borrower relationships and bank ownership of equity are maintained; (7) there is no active market for control; that is, management does not face hostile bids; and (8) banks play a major role in corporate governance..

*Anglo-Saxon System of Governance: characterised by:*

(1) ownership is diffuse except for institutional investors; (2) control is vested in the board of directors, with external directors playing an important role; (3) capital markets are very liquid and there is a developed market for corporate control and takeover markets; and (4) there is more defence of the ownership rights of shareholders over the rights of debtholders than in the Continental European model....

The various stakeholder initiatives differ in their expectation in particular ways, and the extent to which stakeholder constituencies are integrated in corporate life.

Shareholder inclusion depends on the degree to which relationships between shareholders and stakeholders should be balanced (Salacuse, 2003). Also, inclusion depends on coherent views appropriate to balance corporate affairs. Regulatory, company law, and other restrictions are adopted in Western European countries, in line with corporate governance.

Individual States encourage particular director behavior, to consider other constituencies' interests (Salacuse, 2003). Some States simply permit such consideration, and underline that none of the factors obliges the directors to give preference. Other States limit the scope of instances considered as situations where challenge to corporate control is present.

### 10.1 Work Council

In European countries, a special form, the Work Council, is provided. These are regulated by special statutes. (Dragneva and Simons, 2001). So it differs considerably from country to country.

The European Union mandates a minimum number of working employees, in these countries: Belgium, France, Germany, Netherlands, and Spain. In some States, only employees make-up the Council.

This close relationship entitles the Work Council to information on general economic and social matters of the corporation; this is specific in France, Germany, and Netherlands (Dragneva and Simons, 2001). The Work council is also consulted on major economic or financial issues, and has co-decision making functions re: social policy issues. Employers are subject to sanctions for failing to observe Work Council participation.

## 11. Corporate Culture

The culture of society shapes the corporation, its institutions and rules. Culture has been analyzed as (1) behavior, (2) attitudes, (3) norms, and (4) values (Salacuse, 2003). These components are connected, with the more express (1-3) showing externally and values internally, to the corporation. Note that behavior is observed, and is judged as proper or subject to correction.

Culture gives way to the purposes of the corporation, that is, to make profit. Salacuse states that values form the sequence of preferences, and consequently are the core of the other segments of culture.

### 11.1 Developing Corporate Culture

Corporate culture is developed in several ways (Reberious, 2002). A base level is by officer conduct of duties. As each business function has its own set of

duties, the officer is responsible for function, with standards for that function.

The external level is comprehensive, as an officer conducts external duties. This includes an officer performing internal functions that are externally reported

These segments are intertwined. One way is to determine the cultural performance of the Board and committees, viewed on various criteria:

- (1) composition of the Board, and the committees;
- (2) performance of officer's duty aligned with the best interest of the corporation, and
- (3) compensation of Board members.

Independence is key, so the changes to the Board and to committees may be essential to comply with that criteria.

A product of culture is the values set by the Board, as a "tone at the top" (Carpenter et al., 2004). Culture is imposed on officers and managers of the corporation. Culture then becomes active, as the enforcing action is indirect but is effective. A clear demarcation is to prohibit conflicting activities, such as consulting.

### **11.2 Set by Statues: The Sarbanes-Oxley Act**

A driving force for application of culture (cultural standards in functions of the corporation is the Sarbanes-Oxley Act. That Act provides the effect of law to the standards, and has been used in that way, by:

- increased Board independence;
- change in officers compensation, including stock option grants;
- increase in audit on verification of corporate reports, particularly financial reports;

The most direct impact of the Act is on Corporate Governance, and focused on the manner of corporate managers complying with their fiduciary duty (15 USC 7201). The Sarbanes-Oxley Act imposes extensive duties and obligation, specifically on the Chief Financial Officer. The importance of financial reporting is of highest significance. The Act imposes detailed requirements, and transaction-based audits, on the Chief Financial officer (Carpenter et al., 2004).

Complying indicates standards are met as a duty to:

- (1) monitor corporate affairs, including delegation;
- (2) remain informed about corporate business., including probing into corporate business (Carpenter et al., 2004). The Act entitles officers to rely on others to perform, in monitoring and ensuring reliability of the information. Note that the Sarbanes-Oxley Act enforces the duties of directors and officers of the corporation.

Misconduct can be proven if officers in decision-making did not diligently seek, in good faith, those aspects of corporate affairs (Ooghe and DeLanghe, 2002). Compliance is not an easy matter, as the corporation and its business may be far-reaching.

### **12. Eastern Policy Re: Corporate Governance**

The fall of Communism left the business economy as a mixture of "hated-capitalism" and modern corporate and technological approaches (Dragneva and Simons, 2001). Still the socialist environment is found expressly in corporate purposes:

1. run the corporation, to stakeholder principles, according to the social tradition;
2. ignore profit maximization for social wealth, but focus on profit maximization for the firm; and
3. focus on raising a new generation of managers.

So the corporation operates in Western style, in use of the following:

- (1) stakeholder principles;
- (2) economic principles versus social traditions;
- (3) application of profit maximization; and
- (4) mature development of business managers.

The European Union has proposed, through a directive, a special type of corporation: Societa Europea. The purpose of that form is to include both employment policy and competition policy, in the structure (Dragneva and Simons, 2001). This puts the corporation into an extended form, from corporate social responsibility, into the reality of commercial policy. Clearly this remains as a proposal and has not been introduced into commerce, in Europe.

The Societa Europea form includes the social concept of "negotiation" (Barnard and Deakin, 2002). The outcomes of negotiations are

- (5) rejection by a majority but internationally open to further negotiation;
- (6) accepted according to procedures of negotiation, and
- (7) dealing with default of the decision.

The outcome is announced by a representative of the negotiations, to the affected parties.

### **13. Comparison**

The Table presents a detailed comparison of the differences of corporate governance in Western versus Eastern spheres of influence.

### **14. Summary**

The corporation is a new entity in the newly free countries. It's reach is broad, introducing shareholders, and recognizing stakeholders.

This is the first generation of corporate governance in Easter Europe. Relinquishing from State Control is a new experience for owners and

managers. Beyond theory of governing are the practice duties: fiduciary, loyalty and care. The corporation is proceeding along a commercial path.

## References

- Barnard, C. and S. Deakin, Reinventing the European corporation? Corporate governance, social policy and the single market, *Industrial Relations Journal*, 202, Vol. 33, No. 5, 484-499.
- Berle, A. A. Jr., and G.C. Means, *The Modern Corporation and Private Property* McMillan Publishers, N.Y., 1948.
- Berglof E., A. Pajuste. What Do Firms Disclose and Why? Enforcing Corporate Governance and Transparency in Central and Eastern Europe. *Oxford Review of Economic Policy*. Vol. 21, No. 2, 178-198.
- Braendle C. U., and J. Noll. Enlarged EU: enlarged corporate governance? Why directives might be more appropriate for transition economies. *Corporate Governance*. 2006. Vol. 6, No. 3, 296-304.
- Carpenter, T. D., M.G. Fennema, P. Z. Fretwel, and W. Hillison, A changing Corporate Culture, March, 2004, *AICPA Journal of Accountancy: Online Issues*, 1-11 *Accountancy: Online Issues*, 1-11
- Cuervo, A., Corporate Governance Mechanisms: a plea for less code of good governance and more market control, *Corporate Governance*, April 2002, Vo., 10, No. 2, 84-93.
- Dragneva, R. O., and W. B. Simons, Corporate Governance Revisited: Can the Stakeholder Paradigm Provide A Way Out Of 'Vulture' Capitalism in Eastern Europe. *Review of Central and East European Law*, 2001, Vol. 1, 93-111.
- Fairfax, L. M., The Sarbanes-Oxley Act as Confirmation of Recent Trends in Director and Officer Fiduciary Obligations, *St. John's Law Review*, 2002, Vol., 76
- Leermakers, D., Is Luxembourg losing time in Europe's governance race?
- International Financial Law Review*, July 2003, Vol. 22, No. 7, 65-69.
- Maasen G. F., A.J. van den Bosh, and H. Volberda. *International Journal of Disclosure and Governance*. March 2004. Vol. 1, No. 2.146-159.
- Oohge, R. and T. DeLanghe, The Anglo-American versus the Continental European corporate governance model: empirical evidence of board composition in Belgium, *European Business Review*, 2002, Vol. 14, No. 6m 437-449
- Reberious, J. W., European Style of Corporate Governance at he Crossroads: The Role of Worker Involvement, *Journal of Common Market Studies*, 2002, Vol. 40, No. 1, 111-134.
- Salacuse, J. W., Corporate Governance, Culture and Governance: Corporate American Style or with a European Touch, *European Review of Private Law*, Oct. 2003, Vol. 11, Np. 4, 471-496.
- Tonge, A. Greer, L. and A. Lawton, The Enron story: you can fool some of the people some of time...A *European Review*, Jan. 2003, Vol. 12, No. 1, 4-20.
- Unites Nations, New York and Genova, 2006. *Guidance on Good Practices in Corporate Governance Disclosure*.

## Appendices

**Table 1.** International comparison of corporate governance (Multiple sources)

	<u>United States</u>	<u>International</u>
Owners	Shareholders Stakeholders	Employees as Shareholders Stakeholders for Society
Type	dispersed manage for shareholders	large block: concentrated board of Directors link large shareholders represent Society
<u>Sale of Ownership</u>	public trade determines price	Society / Community ownership
<u>Governance</u>	Board of Directors public policy 1-tier level control insider	Systems: Cont' Europe and Anglo-Saxon protect minority shareholder 2-tier level
<u>Authority</u> Policy	Legislation re: Economic power Professional managers	State Ownership
<u>Special Forms</u>	Closed-held corporation	Work Council proposed Societa Europe National laws
<u>Control</u>	State laws Federal law, as securities laws	National laws

**Table 2.** The Corporate Governance Mechanisms In Central and Eastern Europe

Corporate Governance Mechanism	Relative importance in Central and Eastern Europe	Scope for policy intervention
Large Block Holders	Likely to be the most important governance mechanisms; leads to concentrated ownership	Strengthen rules protecting minority investors while maintaining incentives to hold controlling blocks
Market for corporate Control	Unlikely to be important when ownership is strongly concentrated	Remove some managerial defences; disclosure of ownership and control; develop banking system
Proxy fights	Unlikely to be effective when ownership is strongly concentrated	Technology improvements for communicating with and among shareholders; disclosure of ownership and control
Board activity	Unlikely to be influential when controlling owner can hire and fire board members	Introduce elements of independence of directors, training of directors, disclosure of voting; use cumulative voting
Executive compensation	Less important when controlling owner can hire and fire and has private benefits	Disclosure compensation schemes; conflicts-of-interest rules
Bank monitoring	Important, but depends on health of banking system and the regulatory environment	Strengthen banking regulation and institutions; develop credit bureau and other informative intermediaries
Shareholder activism	Potentially important, particularly in large firms with dispersed shareholders	Encourage interaction among shareholders; strengthen minority protection; activate institutional investors
Employee monitoring	Potentially very important, particularly in smaller companies with mobile high skilled human capital	Disclosure of information to employees possibly require board representation; assure flexible labour markets
Litigation	Depends critically on quality of general enforcement environment, but can sometimes work	Facilitate communication among shareholders. Encourage class-action suits (safeguards against excessive litigation)
Media and social control	Potentially important, but depends on competition among and independence of media	Encourage competition in and diverse control of media; active public campaigns can empower public
Reputation and self-enforcement	Important when general enforcement is weak, but more powerful when environment is stronger	Depend on growth opportunities and scope for rent-seeking; encourage competition in factor markets
Bilateral private enforcement mechanisms	Important, as they can be more specific, but do not benefit outsiders and can have downsides	Relies on well-functioning civil and commercial courts; institution-building in this area helps
Arbitration, auditors, other multi-lateral Mechanisms	Potentially important, often the origin of public law; But the enforcement problem often remains. Audits sometimes abused; watch conflicts of interest	Facilitate the formation of private third-party mechanisms (sometimes avoid forming public alternatives); deal with conflicts of interest; ensure competition

Source: Adapted from Berglof and Pajuste (2005), Figure 1, page 181.