The SAGE Handbook of

Corporate Governance

Edited by

Thomas Clarke and

Douglas Branson

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Contents

	About the Authors	ix
	Preface *Sir Adrian Cadbury*	xx
	Introduction: Corporate Governance – An Emerging Discipline? *Thomas Clarke and Douglas Branson*	1
PART 1: ORIGINS AND DEVELOPMENT		**37**
1	The Evolution of Corporate Governance *R.I. (Bob) Tricker*	39
2	In the Best Interest of the Corporation: Directors' Duties in the Wake of the Global Financial Crisis *Margaret M. Blair*	62
3	Limited Liability Companies *Mark J. Loewenstein*	81
4	Theoretical and Methodological Perspectives *Joan MacLeod Heminway*	96
PART 2: MARKETS AND REGULATION		**111**
5	The Juridical Nature of the Firm *Simon Deakin*	113
6	The Ascent of Shareholder Monitoring and Strategic Partnering: The Dual Functions of the Corporate Board *Michael Useem*	136
7	An Economic Analysis of Fair Value: A Critique of International Financial Reporting Standards *Vincent Bignon, Yuri Biondi and Xavier Ragot*	159

PART 3: BOARDS AND DIRECTORS: LEADERSHIP AND ACCOUNTABILITY **181**

8 Boards and Board Effectiveness 183
Hans van Ees and Gerwin van der Laan

9 Between the Letter and the Spirit: Defensive and Extensive Modes of Compliance with the UK Code of Corporate Governance 196
John Roberts

10 Boards' Contribution to Strategy and Innovation 217
Alessandro Zattoni and Amedeo Pugliese

11 Board Leadership and Value Creation: An Extended Team Production Approach 233
Morten Huse and Jonas Gabrielsson

PART 4: BOARDS AND DIRECTORS: NEW CHALLENGES AND DIRECTIONS **253**

12 Changing Scenes in and around the Boardroom: UK Corporate Governance in Practice from 1989 to 2010 255
Annie Pye, Szymon Kaczmarek and Satomi Kimino

13 Board Evaluations: Contemporary Thinking and Practice 285
Gavin Nicholson, Geoffrey Kiel and Jennifer Ann Tunny

14 Women and the Governance of Corporate Boards 325
Ruth Sealy and Susan Vinnicombe

15 Diversity among Senior Executives and Board Directors 345
Sabina Nielsen

PART 5: COMPETING GOVERNANCE REGIMES **363**

16 Global Convergence in Corporate Governance? What a Difference 10 Years Make 365
Douglas M. Branson

17 A Bundle Perspective to Comparative Corporate Governance 379
Ruth V. Aguilera, Kurt A. Desender and Luiz Ricardo Kabbach de Castro

18 Family-Owned Asian Business Groups and Corporate Governance 406
Marie dela Rama

19 The Limitations of Corporate Governance Best Practices 428
Shann Turnbull

PART 6: DILEMMAS OF CORPORATE GOVERNANCE **451**

20 Executive Compensation, Pay-for-Performance and the Institutions of Executive Pay Setting 453
Martin J. Conyon and Simon I. Peck

21 In the Name of Shareholder Value: How Executive Pay and Stock Buybacks are Damaging the US Economy 476
William Lazonick

22 Governance, Innovation and Finance 496
Ciaran Driver

23 The Governance and Regulation of Complex Conglomerates 520
John H. Farrar

PART 7: EMERGING ISSUES: GOVERNANCE AND SUSTAINABILITY **531**

24 Markets, Regulation and Governance: The Causes of the Global Financial Crisis 533
Thomas Clarke

25 Corporate Governance and the Global Financial Crisis: The Regulatory Response 556
Alice Klettner

26 International Corporate Responsibility 585
Paul Redmond

27 Governance for Sustainability: Challenges for Theory and Practice 612
Suzanne Benn

Name Index 628

Subject Index 634

About the Authors

Ruth V. Aguilera is an associate professor and the Fellow at the Center for Professional Responsibility in Business and Society at the College of Business at the University of Illinois at Urbana-Champaign. Her research interests fall at the intersection of economic sociology and international business, specifically in the fields of comparative corporate governance and corporate social responsibility. She currently serves as an Associate Editor of *Corporate Governance: International Review* and is a member of the Editorial Boards of the following peer reviewed top tier journals: *Academy of Management Perspectives*, *Administrative Science Quarterly*, *Global Strategy Journal*, *Journal of International Business Studies*, *Journal of Management Studies*, *Management International Review*, *Organization Studies* and *Strategic Management Journal*. She also serves in the board of IMDEA Social Sciences (Madrid) and CSR IMPACT Project (Brussels).

Suzanne Benn is Professor of Sustainable Enterprise in the School of Management, UTS Business School. In this position she provides leadership within the Business School and across UTS, working with other disciplinary areas and external stakeholders to promote sustainability. She was previously Professor of Education for Sustainability, Director of ARIES and Head of the Graduate School of the Environment at Macquarie University, Sydney. Suzanne has a background in the sciences and the social sciences. She has had wide experience working across the range of educational sectors and as a research and industrial scientist. Her current research interests range across corporate sustainability and corporate social responsibility, business education for sustainability and organisational change and development for sustainability. Among her publications are *Organizational Change for Corporate Sustainability* (2007) London: Routledge (edited with Dexter Dunphy and Andrew Griffiths) and *Corporate Governance and Sustainability: Challenges for Theory and Practice* (2007) London: Routledge (edited with Dexter Dunphy).

Vincent Bignon is visiting lecturer at the Graduate Institute for International and Development Studies, Geneva and at EconomiX, University of Paris, Nanterre. He has research interests and publications in economic history, monetary economics, search models, accounting and financial information and new institutional economics.

Yuri Biondi is a research fellow at the CRNS, Paris and affiliated professor at CNAM, Paris. He is the Editor in Chief of *Accounting, Economics, Law – A Convivium*, Bepress, and convenor of the Society for the Advancement of Socio-Economics (SASE) network for Accounting, Economics and Law. He is the chairman of the American Accounting Association *Financial Accounting Standards Committee.* He has conducted research looking beyond the narrow boundaries of neoclassical economics to an interdisciplinary approach that integrates accounting to law and economics. His work includes a synthesis and a critique of the current state of the different economic theories of the firm, and further develops them through new insights and neglected lessons from different traditions of thought looking at the firm as a whole: as an institution and an organization, which has special functions and a distinct role in the economy and society. Among his publications is *The Firm as an Entity*: *Implications for Economics, Accounting and the Law* (2007) Routledge, edited with Arnaldo Canziani and Thierry Kirat.

Margaret M. Blair joined Vanderbilt University's law faculty in 2004 as part of the team supporting the Law and Business Program and was appointed to the Milton Underwood Chair in Free Enterprise in fall 2010. She is an economist who focuses on management law. Her current research focuses on four areas: team production and the legal structure of business organizations, legal issues in the governance of supply chains, the role of private sector governance arrangements in contract enforcement, and the problem of excessive leverage in financial markets. Before joining Vanderbilt's faculty, Margaret taught at Georgetown University Law Center and has also been a senior fellow in the Economic Studies Program at the Brookings Institution, where she wrote about corporate governance and the role of human capital in corporations. She served on the board of directors of Sonic Corp. from 2001 through 2006. Among her published work is *Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century* (1995) Brookings.

Douglas M. Branson is the W. Edward Sell Chair in Business Law, University of Pittsburgh. He is the author of a pioneering work in this field, *Corporate Governance* (1993) Charlottesville, Virginia: Michie & Co. Douglas was professor at Seattle University School of Law, before he joined the Pitt Law faculty in the fall of 1996. He has been a visiting professor or lecturer at several law schools, including: the University of Alabama, as Charles Tweedy Distinguished Visiting Professor; the University of Oregon; Cornell University; Arizona State University; and universities in New Zealand and England. He also holds a faculty appointment at the University of Melbourne, Australia, in its Master of Laws program. He has played an influential role in framing the American Law Institute's recommendations for corporate governance. Among his recent publications are *No Seat at the Table: How Governance and Law Keep Women Out of the Boardroom* (2007), New York University Press, and *The Last Male Bastion: Gender and the CEO Suite at America's Public Companies* (2009) Routledge Press.

Adrian Cadbury was the Chairman of the UK Committee on *The Financial Aspects of Corporate Governance* (1991–95) established by the London Stock Exchange, which influenced the development of codes of corporate governance throughout the world. He was chairman of the Cadbury Group from 1965–69; Managing Director 1969–74; and chairman of Cadbury Schweppes plc 1975–89. He was a director of the Bank of England 1970–94; IBM (UK) Ltd 1975–94; and chairman of the West Midlands Economic Planning Council 1967–70; and chairman of the Confederation of British Industry (CBI) Economic and Financial Policy Committee 1974–80. He was Chancellor of Aston University 1979–2004, and President of the Birmingham Chamber of Industry and Commerce 1988–1989. He was knighted in 1977, and received the International Corporate Governance Network Award 2001, and the Corporate Governance Laureate Medal 2005. He was a member of the OECD Business Sector Advisory Group on Corporate Governance, and advised the World Bank on corporate governance policy. He is a former British Olympic rower, competing in the coxless fours in the Helsinki Olympics. Among his publications is *Corporate Governance and Chairmanship: A Personal View*, (2002) Oxford: Oxford University Press.

Luiz Ricardo Kabbach de Castro is completing his PhD in the Department of Business Economics at the Autonomous University of Barcelona (Spain), from which he holds a MSc. in Economics, Management and Organization. He is a research associate in Strategy and Corporate Governance at the Balearic Islands University where he teaches Strategic Management. His research interest include international and comparative corporate governance, corporate strategy, and comparative corporate law and regulation. Previous to his scholarly career he was a managing consultant at Capgemini (Spain), Andersen (Brazil) and Symnetics (Brazil).

Thomas Clarke is Professor of Management and Director of the Key University Research Centre for Corporate Governance at the University of Technology, Sydney. Formerly he was Professor of Management at the China Europe International Business School (CEIBS) in Shanghai. His research has included being a member of the task force for the UK Royal Society of Art's *Tomorrow's Company Inquiry* into the sources of sustainable business success; assisting with the development of the OECD Principles of Corporate Governance in Paris; conducting a major ARC funded survey of *The Changing Roles of Boards and Directors* in Australia; and research with the Federal Treasury on *The Regulation of Small Corporations.* He has conducted corporate governance reviews for a number of organizations including PRS Ltd the intellectual property company for the UK music business. He works closely with professional bodies including the Chartered Secretaries Australia (CSA); CPA; and Australian Institute of Company Directors. Among his publications are included: *Rethinking the Company* (1994), London: Financial Times; *Theories of Corporate Governance* (2004) London: Routledge; *Corporate Governance and Globalisation* (2006) London: Sage (with Marie dela Rama); *European Corporate Governance* (2009) London: Routledge (with Jean-Francois Chanlat); *International Corporate Governance: A Comparative Approach* (2012) London: Routledge, 2nd edn. He is the Corporate Governance and Sustainability section editor of the *Journal of Business Ethics* (Springer), and a founder member of the Editorial Board of Corporate Governance: An International Review (Wiley).

Martin J. Conyon is Professor of Corporate Governance and Finance at Lancaster University Management School, UK in the Accounting and Finance Department, and Senior Fellow at the Wharton School (Center for Human Resources) and a Fellow at Cornell University (Institute for Compensation Studies). He has held faculty posts at the Wharton School, University of Pennsylvania and the Queen's College, University of Oxford. He was a professor at Warwick University in the UK and ESSEC Business School in Paris and Singapore. Martin's research is in applied microeconomics, and recent publications have appeared in the *Review of Financial Studies*, *Vanderbilt Law Review*, the *Journal of Corporate Finance*, *Journal of Business Finance and Accounting* and the *British Accounting Review*. He has written over seventy articles, book chapters or reports in applied economics, focusing on compensation, corporate finance and governance issues. He serves on the editorial board of a number of journals including the *Strategic Management Journal*, the *Journal of Business Finance* and *Accounting*, and *Strategic Organization*.

Simon Deakin is Professor of Law at the University of Cambridge, specializing in labour law, private law, company law, law and economics, and European Union law. He is a programme director in the Cambridge Centre for Business Research, and a Fellow of the Judge Business School. In 2003 and 2008 he was a Visiting Professor of Law at Columbia University and in 2004 a visiting fellow in the Department of Law, European University Institute, Florence. Since 2004 he has been Omron visiting fellow at Doshisha University, Kyoto. His books include *Tort Law* (2008) Oxford: Clarendon Press, 6th edn. with Basil Markesinis and Angus Johnston), *Labour Law* (2009) Hart Publishing, 5th edn., (with Gillian S. Morris) and *The Law of the Labour Market*: *Industrialization, Employment, and Legal Evolution* (2005) OUP, (with Frank Wilkinson). He is a editor of the *Industrial Law Journal* (UK) and a member of the editorial board of the *Cambridge Journal of Economics*. He was elected to a Fellowship of the British Academy in 2005.

Marie dela Rama is a research associate at the Centre for Corporate Governance, UTS Sydney. She holds a PhD in corporate governance from UTS and received an Endeavour Research Fellowship from the Australian Government to complete her doctoral thesis on corporate governance reform in the Philippines. Her research interests include international *corporate* governance, board performance, corporate social responsibility and governance in the voluntary and aged care sectors. Among her publications are *Fundamentals of Corporate Governance* (2008) London: SAGE (with Thomas Clarke and *Corporate Governance and Globalization* (2006) London: SAGE). She is completing a monograph on family-owned business groups and corporate governance.

Kurt A. Desender is an assistant professor of Accounting at the Department of Business Administration at Carlos III University, Spain. He holds a PhD. in Business Economics, a MSc. in Economics, Management and Organizations from Autonomous University of Barcelona (Spain) and a MSc. in Applied Economics from the Catholic University of Leuven. His main research interests lie in the area of corporate governance and finance. His research focuses on understanding the influence of the firm's internal organisation on its objective setting, managerial behaviour and performance.

Ciaran Driver is Professor of Economics and Head of the doctoral programme in the Department of Financial & Management Studies of the School of Oriental and African Studies, University of London. He has held visiting posts at the Australian National University and has worked as consultant to government organisations on investment and innovation. He has broad research interests including macro and microeconomics; capital investment, finance and corporate governance; and industrial economics. His main current interests are in corporate governance theory and the empirical effects of governance forms on investment and R&D. He has published recently in journals such as the *Cambridge Journal of Economics*, *Oxford Economic Papers*, *Oxford Bulletin of Economics and Statistics*, *Journal of Economic Behavior & Organization*, *International Journal of Industrial Organization* and the *Journal of Macroeconomics*.

Hans van Ees is professor in the Faculty of Economics and Business, International Economics and Business of Groningen University, Netherlands. His research deals with corporate governance, theory of business groups in emerging markets, board of directors, sustainable corporate performance and building trust within and between organizations. He is regularly involved in executive teaching, training, consultancy and contract research for private companies and the Dutch government on issues related to good governance, executive compensation and industrial democracy. He has published recently in the *European Management Journal*, *Journal of Business Ethics*, *Corporate Governance: An International Review*, *Journal of Development Studies*, and *Journal of International Business Studies*.

John H. Farrar is Emeritus Professor of Law at Bond University and Professor of Corporate Governance at the University of Auckland. John has extensive experience in commercial law reform, having, for example, acted as a consultant to the New Zealand Treasury, the Law Commission, the Business Council of Australia and the UK Department of Trade and Industry. He was a member of the Legal Committee of the Australian Institute of Company Directors from 1992–2004 and was a member of the Legislation Advisory Committee in New Zealand which monitors new legislation from 2004–2008. He is a member of the editorial boards of a number of journals dealing with corporate and commercial law and is the author of many books and articles in this field in New Zealand, Australia and the UK. He was Dean of Law at the University of Canterbury (1985–1988), Bond University (1993–1996) and University of Waikato (2004–2008). He was Acting Vice Chancellor of Bond University (1995–1996) and Chair of Senate (2000–2003).

Jonas Gabrielsson is associate professor at Lund University in the Centre for Innovation, Research and Competence in the Learning Economy (CIRCLE), a multidiscplinary research centre. He is also affiliated with the CIEL research milieu at Halmstad University. His research interests include corporate governance and value creation from entrepreneurial and strategic management perspectives. He has published recently in *Corporate Governance: An International Review*, *Entrepreneurship Theory and Practice*, *International Small Business Journal*, *International Studies in Management and Organization*, and *Venture Capital*.

Joan MacLeod Heminway is College of Law Distinguished Professor of Law at The University of Tennessee (UT) College of Law in Knoxville and a fellow of the Center for Business and Economic Research, the Center for the Study of Social Justice, and the Corporate Governance Center at UT-Knoxville. Her research focuses on securities disclosure law and policy (especially under Rule 10b-5) and corporate governance issues under federal and state law. She has written numerous law review articles and book chapters, coauthored (with Douglas M. Branson, Mark J. Loewenstein, Marc I. Steinberg and Manning G.Warren, III) a business law casebook, *Business Enterprises: Legal Structures*, *Governance*, *and Policy* (LexisNexis, 2008), and edited and coauthored *Martha Stewart's Legal Troubles* (Carolina Academic Press, 2007).

Morten Huse is Professor of Organization and Management, Norwegian School of Management BI, and President European Academy of Management (EURAM 2011–2012). He has held visiting professorships at a number of universities including Tor Vergata University, Rome, University of St. Gallen, Switzerland and Bocconi University, Italy. He is the project leader of various research projects including the *Value Creating Board* project. He has written or co-authored more than 15 books and over one hundred scientific articles. Areas of research include boards and governance (actual board behaviour and behavioural perspectives; governance in SMEs and family firms; boards, innovation and entrepreneurship; women directors; new paradigms of governance); stakeholder issues (CSR; ethics; stakeholder perspectives on corporate governance; environmental management); and entrepreneurship and regional development (small firms; venture capital backed firms; financing small firms; entrepreneurship and resources; corporate entrepreneurship). Among his recent publications are *The Value Creating Board: Corporate Governance and Organizational Behaviour* (2010) London: Routledge; and *Boards*, *Governance and Value Creation: The Human Side of Corporate Governance*, (2007) Cambridge University Press.

Szymon Kaczmarek is a Lecturer in Strategic Management and International Business at Newcastle Business School, Northumbria University, the UK. He received his Ph.D. from the University of St. Gallen, Switzerland, and after that was holding a post of a research fellow at the University of Exeter, the UK. His research interests are on problems of corporate governance, and especially composition and dynamics on boards of directors, and on processes of internationalization of upper echelons in the context of a firm's internationalization strategy.

Geoffrey Kiel has had an extensive career as a management educator, academic researcher, management consultant and senior manager. He was Senior Deputy Vice Chancellor and Dean of Business at the University of Notre Dame, Australia. Prior to Notre Dame Australia, for many years he was Professor of Management at the University of Queensland and headed the Graduate School of Management at that university. He is an emeritus professor of the University of Queensland. Geoff has completed pioneering work in corporate governance and board evaluation. He has been one of the major presenters on director education throughout Australia for the Australian Institute of Company Directors. He has published over 100 research papers and numerous books including *Boards that Work* (2002) McGraw Hill and *Board Director and CEO Evaluation* (2005) McGraw Hill. He is currently Chairman of Effective Governance Pty Ltd which is the successor organisation to Competitive Dynamics. Geoff has been a director of several other organisations and is a fellow of the Institute of Company Directors and has been a member of the MMRI board since 2006.

Satomi Kimino a Lecturer of International Business and Strategic Management at Northumbria University. Previously she was a research fellow at the University of Exeter Business School. Her research interests are multinational enterprises, network of corporate grouping, foreign direct investment, technology transfer, knowledge spillovers, and corporate governance.

Alice Klettner is a research associate at the Centre for Corporate Governance, University of Technology, Sydney. She is a lawyer admitted as a solicitor in England and Wales in 2000 and in New South Wales in 2004. Alice managed a three year research project *The Changing Roles & Responsibilities of Company Boards and Directors* from 2005 to 2007. This was funded through an Australian Research Council grant with Dibbs Abbott Stillman Lawyers as linkage partner. More recently she has conducted research with the Australian Council for Superannuation Investors on board performance evaluation and with Catalyst Australia looking at the governance of sustainability. Her research interests include the role of regulation in promoting board effectiveness and corporate social responsibility.

William Lazonick is professor at the University of Massachusetts Lowell and Director of the UMass Center for Industrial Competitiveness. He is also affiliated with the University of Bordeaux and the University of Ljubljana. He has been on the faculties of Harvard University, Columbia University, Tokyo University, and INSEAD. His research has been funded by numerous governmental agencies and private foundations in Europe, the United States, and Japan. He is the author or editor of twelve books, including *Competitive Advantage of the Shop Floor* (1990) Harvard University Press; *Business Organization and the Myth of the Market Economy* (1991) Cambridge University Press and *Sustainable Prosperity in the New Economy? Business Organization and High-tech Employment in the United States* (2009) Upjohn Institute (winner of the 2010 Schumpeter Prize). In recent years he has published articles in I*ndustrial and Corporate Change, Research Policy, Capitalism and Society, Enterprises et Histoire, Business History Review*, *Comparative Social Research*, *European Management Review*, *and Industry and Innovation*.

Mark J. Loewenstein is Monfort Professor of Commercial Law at the University of Colorado Law School. Formerly he was a member of a mergers and acquisitions practice in a Chicago law firm. His research interests center on business associations and securities law, with a particular interest in corporate governance, and he has had articles published in a variety of law reviews, including the *Duke Law Journal*, the *Southern California Law Review*, and the *Georgetown Law Journal*. Mark was a visiting professor of law at the University of Michigan Law School. During his career, He has actively served both the Law School and the state of Colorado. At the University of Colorado Law School he was associate dean for academic affairs, and the associate dean for research. From 1995 to 2000, he served as a member of the Colrado's Securities Board. He has also been an active member of the Colorado Bar Association's Corporate Law Revision Committee, including the subcommittee that drafted the 1994 Colorado Business Corporation Act. He co-authored the comments to that Act. From 1999 to 2005 served as a delegate to the American Bar Association House of Delegates and is an active member of the ABA's business law committee.

Gavin Nicholson is associate professor in the Queensland University of Technology Business School. In addition to researching, lecturing and developing materials in the areas of governance policy and practice, Gavin is an experienced director, governance researcher and board consultant. He has published extensively in the leading journals of his field and currently overseas several large research projects aimed at understanding how boards operate. Gavin has provided advice on corporate governance and strategy to listed and large public companies, government owned corporations, statutory authorities, not-for-profit organisations and local government. He has published extensively in the area of corporate governance, co-authoring two books *Boards that Work: A New Guide for Directors* (2002) McGraw Hill and *Board, Director and CEO Evaluation* (2005) McGraw Hill and a manual for boards seeking to implement the ASX Corporate Governance Principles. His research interests include board dynamics and teamwork; identity and boards of directors; board decision making; and corporate governance. He has published recently in *Long Range Planning*, *Organization Science* and *Corporate Governance – An International Review*.

Sabina Nielsen is associate professor in the Department of International Economics and Management of the Copenhagen Business School, Denmark and Research Associate at University of Technology Sydney, Australia. Her primary research areas include top management teams and board composition and behaviour, top management team internationalisation, and diversity in multinational corporations. She has published extensively on top management teams and strategic decision making, and on board diversity in journals including the Strategic Management Journal, Strategic Organization, Journal of Management Studies, Journal of Organizational Behavior, *Journal of World Business*, *Corporate Governance An International Review*, *and Management International Review.* She has won many best paper awards, and her article with Morten Huse on 'Women Directors' Contribution to Board Decision-Making and Strategic Involvement: The Role of Equality Perception' won the *European Management Review* best paper prize for 2010.

Simon I. Peck is associate professor at the Weatherhead School of Management, Case Western Reserve University. His work examines the link between the actions and accountability of the company; characteristics of the board of directors and top management; and the firm's competitive advantage. Simon's work looks closely at the topics of executive compensation contracts, board composition and structure, and how top executives do strategic planning. He has published recently in *Academy of Management Perspectives*, *Journal of Management*

Studies, *Strategic Management Journal*, *Long Range Planning*, *Organization Science* and the *Academy of Management Journal.* He is an editorial review board member of the *Journal of Management Studies*, and associate editor, *Long Range Planning*.

Amedeo Pugliese is a lecturer in Queensland University of Technology Business School. He completed his doctorate at the University of Naples Federico II with a thesis on *Evolutionary Patterns in Corporate Governance: the role of Boards of Directors*. He is a member of the editorial board of the *International Journal of Business, Ethics and Governance.* He has published in the *Family Business Review*, *Corporate Governance: An International Review* and the *Journal of Management and Governance* on family ownership and the quality of accounting information, and boards of directors contribution to strategy.

Annie Pye is professor and Director of Research at the Centre for Leadership at the University of Exeter Business School. Her research includes three interrelated ESRC-funded projects, each ten years apart, into how small groups of people effectively 'run' large companies, each predominantly underpinned by a sensemaking perspective. She has also researched topics such as non-executive director development, network leadership, learning and change and has carried out numerous research and consultancy assignments in and for private and public sector organisations. Her work is primarily qualitative and is published in a range of journals including *Organization Science*, *Journal of Management Studies*, *Human Relations*, *British Journal of Management*, *Management Learning*, *Corporate Governance: An International Review* and the *Financial Times*. Currently, she is researching senior managers leading change in procurement practice to achieve low carbon consumption, in a project funded by the European Social Fund.

Xavier Ragot is a senior economist at the Banque de France and research fellow at CNRS, Paris School of Economics. He has research interests in monetary economics, incomplete markets, theory and computation and macroeconomics. He has published in *The Economic Journal*, *Economics Studies*, *Review of Economic Dynamics*, *Economic Theory* and the *Louvain Economic Review*.

Paul Redmond is the foundation Sir Gerard Brennan Professor in the Faculty of Law at the University of Technology, Sydney. He is an Emeritus Professor in the Faculty of Law at the University of New South Wales and a former Dean of the Faculty. He has research interests in corporate law, corporate governance and conceptions of corporate responsibility.

John Roberts is Professor and Chair of Discipline at the University of Sydney Business School. His recent research has focussed on corporate governance and, in particular, on understanding the dynamics of roles and relationships both within boards and between boards and institutional investors. He is a qualitative researcher who typically uses interview based research with executive and non-executive directors, CEOs and chairmen in FTSE companies, as well as with fund managers and investors to explore the actual processes through which corporate governance is effected and effective. He has published widely from this work both in academic journals and practitioner reports. His wider research interests include corporate social responsibility, organisational processes of control and accountability, narcissism and ethics. He has recently published in *European Accounting Review*, *Accounting Organizations and Society*, *Competition and Change*, *Human Relations*, *The Journal of Interdisciplinary Economics*, *Advances in Public Interest Accounting*, *Organization*, *British Journal of Management*, and *Journal of Corporate Ownership and Control.*

Ruth Sealy is Senior Research Fellow, and Deputy Director of the International Centre for Women Leaders at Cranfield School of Management. Ruth's research interests cover many aspects of women in leadership, including board composition and corporate governance. Her doctoral research considered the importance of role models for female directors in investment banks, and how the lack of them may affect their work identity formation and career aspirations. Building on contemporary literature on the cognitive construction of role models, organizational demography and work identity formation, her research explains the importance of relational identification for women in a male-dominated workforce. Ruth has been the lead researcher of the annual Female FTSE Report since 2007. Sponsored by government and major organizations, the report analyzes the demographic composition of the FTSE 350 corporate boards and executive committees. Ruth has presented the report's findings to both academic and practitioner audiences. The annual report has a considerable reputation and research impact, with the findings cited in approaching 100 broadsheet newspapers, radio and television channels, and practitioner journals across the world each year. She has recently published in *International Journal of Management Reviews*, *Gender in Management: An International Journal*, and *Corporate Governance – An International Review.*

R.I. (Bob) Tricker was the founder-editor of *Corporate Governance: An International Review*, and holds Honorary Professorships of The University of Hong Kong, where he served as Professor of Finance in the Business School from 1986 to 1996, the Open University of Hong Kong and the Hong Kong Baptist University. He was Director of the Oxford Centre for Management Studies (now the Said Business School associated with Green Templeton College, Oxford) and a Research Fellow of Nuffield College, Oxford, where he undertook the research that led to the first book to use the title *Corporate Governance* (1984). His original research study on aspects of corporate governance was *The Independent Director* (1978). Subsequently, he wrote *International Corporate Governance – text, cases and reading*s (1994) and many theoretical and practice related papers and cases. He wrote the briefing paper on corporate governance around the world for the United Nations Development Programme project in South Korea and another for the development of corporate governance in Africa. He has been involved in developments of corporate governance in Hong Kong and China. He edited *Corporate Governance* (2000) in the Ashcroft series on the History of Management Thought. He is also the author of *The Economist Pocket Director* (1996, 1998, 2000) published in 2003 as *The Economist Essential Director*). The fifth edition was published in 2009 as the *Economist Director*. His most recent work is Corporate Governance - principles, policies and practices (2009, 2nd. edition 2012).

Jennifer Ann Tunny is a senior research advisor with Effective Governance, a privately-owned consulting firm that provides advice on corporate governance, strategy, risk management and corporate sustainability to clients in Australia and New Zealand. Since joining the firm in 2001, Jennifer has assisted in the preparation of books and academic and practitioner articles and has played a key role in research and in the development and preparation of teaching materials used in Australian Institute of Company Director courses. She has assisted in a number of board reviews and workshops to assist clients evaluate and improve their governance processes. Jennifer has also broadened her expertise into the area of strategic management has been involved in a number of strategic planning projects.

Shann Turnbull is the Principal of the International Institute for Self-Governance. He researches and teaches corporate governance in Australia at the Macquarie University Graduate School of Management where he obtained his PhD in 2001. His PhD thesis showed how the science of control and communication in the animal and the machine could be extended to organisations to create a science of governance as presented in his articles. His thesis built upon his education as an electrical engineer in Tasmania, BSc from the University of Melbourne and an MBA from Harvard. From 1966 to 1974 he was a founding partner in a private group that gained control of over a dozen publicly traded corporations in Australia. This gave him experience as a controlling shareholder, company director, chairman of one company, and CEO of two others. As a serial entrepreneur founding new enterprises, some of which became publicly traded, he gained further experience as a Chairman and CEO. He also became joint CEO/owner of a mutual fund management company. Among his publications are *Democratising the Wealth of Nations* (1975); *A New Way to Govern; Organisations and society after Enron* (2002) London: New Economics Foundation. He has written many papers downloadable from SSRN on corporate governance.

Michael Useem is the William and Jacalyn Egan Professor of Management, and Director, Wharton Center for Leadership and Change Management, at the Wharton Business School. University of Pennsylvania. His research Interests include leadership, decision making, and governance; corporate change and restructuring; catastrophic and enterprise risk management. Among his recent publications are *The Leader's Checklist: 15 Mission-Critical Principles* (2011) Wharton Digital Press; *The India Way: How India's Top Business Leaders Are Revolutionizing Management* (2011) Harvard Business Press, with Peter Cappelli, Harbir Singh, and Jitendra Singh; *Learning from Catastrophes* (2010) Pearson, with Howard Kunreuther; and Four Lessons in Adaptive Leadership, *Harvard Business Review*, November, 2010; *The Go Point: When It's Time to Decide* (2006) Crown Business/Random House. Michael has articles on leadership, management and decision making appearing in *Administrative Science Quarterly*, *American Sociological Review*, *California Management Review*, *Chicago Tribune*, *Corporate Governance*, *Fast Company*, *Fortune*, *Financial Times*, *Harvard Business Review*, *McKinsey Quarterly*, *New York Times*, *Sloan Management Review*, *Washington Post*, and the *Wall Street Journal.*

Gerwin van der Laan is currently a post-doctoral researcher at the University of Antwerpen, Belgium, and an assistant professor at Utrecht University, The Netherlands. He is trained as a (business) economist, and his research focuses on corporate governance including executive compensation, corporate governance codes, power, independence), and corporate social responsibility. He has published articles in *Corporate Governance: An International Review*, *European Management Journal* and the *Journal of Business Ethics.*

Susan Vinnicombe is Professor of Organisational Behaviour and Diversity Management, Director of the Leadership and Organisation Development Community, and Director of the International Centre for Women Leaders at Cranfield University. Susan's particular research interests are women's leadership styles, the issues involved in women developing their managerial careers and gender diversity on corporate boards. Her Research Centre is unique in Europe with its focus on women leaders and the annual Female FTSE 100 Report is regarded as the global premier research resource on women directors. Susan has written ten books and over one hundred articles, reports and conference papers. Her most recent book is, *Women on Corporate Boards of Directors – International Research and Practice* (2009) Edward Elgar (with R. Burke, D. Bilimoria, M. Husen and V. Singh). The book reviews the position of women on corporate boards in the USA, Canada, UK, France, New Zealand, Australia, Norway, Iceland and Spain. Susan has consulted for organisations in over twenty countries on how best to attract, retain and develop women executives. She has advised the government in the UK, New Zealand, Australia, Finland and Spain on how to increase the number of women on their corporate boards.

Alessandro Zattoni is currently Professor of Management at the Parthenope University of Napoli, and Professor of Corporate Governance at Bocconi University, and Professor of Strategy and Governance at the SDA Bocconi. He graduated at Bocconi University in 1993 and he received a doctoral degree in Management from the same University in 1998. He was visiting scholar at the Wharton School of the University of Pennsylvania (Philadelphia) in 1996. He attended the International Teachers Programme (ITP) at the Manchester Business School in 2001. He is fellow of the Academy of Management and of the Italian Academy of Management (AIDEA – Accademia Italiana di Economia aziendale). His publications include books and articles, in Italian as well as international journals, on many topics relating to corporate governance, such as corporate groups, stock option plans, ownership structure and board of directors. He is a screening editor for *Corporate Governance – An International Review.*

Preface

It is a privilege to be invited to write a foreword to the *Handbook of Corporate Governance*. It is a modest title for a work of international scholarship and of fundamental significance. Entitling it a “handbook” emphasises its practical value as a relevant and accessible store of reference. It is to sit beside us, on the desk ready to hand, not left to gather dust on a shelf. The hallmark of the *Handbook* is the reputation of those who have agreed to contribute to its pages. All are recognised authorities in their fields. Their chapters explain the origins and development of corporate governance, the governance role of boards of directors and the governance challenges of the future. The essential aim of the *Handbook* is therefore to provide a source of up-to-date thinking on the issues facing those with responsibilities for managing and regulating institutions of all kinds. While the *Handbook*’s substance and analyses will be invaluable to governance practitioners, whether they be company directors, gatekeepers or regulators, they will be of equal value to those teaching or studying in the field of corporate governance.

The practical usefulness of the *Handbook* is exemplified by the coherence of approach of those writing in it. Each essay follows a common form, starting with the theoretical underpinnings of the aspect of corporate governance being addressed. The governance issues which arise in that particular context are then tested against the logic and research on which they are based. This leads on to the direction which corporate governance in a particular field is taking and to outlining areas of research which could usefully be developed. Every such analysis highlights issues which are as yet unresolved and since each chapter follows a common structure, it facilitates reading across the different themes to trace the connections between them.

The comprehensive coverage of the *Handbook* provides an opportunity to consider the way in which corporate governance thinking as a whole has developed. Clearly changes in one element of governance influence changes in other elements. If regulation becomes stricter in one jurisdiction, this has its impact on the role of regulation more generally. A recent example of the part played by the international flow of ideas on governance has been the response to the under-representation of women on boards, an issue which is being addressed in different countries in different ways. All those involved in governance in their own country follow developments in their field elsewhere in the world. Investors, in particular, have an interest in promoting governance standards across national boundaries and their role as corporate monitors is discussed. The *Handbook* thus makes an important contribution to comparative thinking on the development of corporate governance and leads to a better understanding of the part played by these cross-connections.

There are two further ways in which the *Handbook* illuminates our thinking on corporate governance as well as providing pointers to the future. The first is to underline the present breadth of the subject and the degree to which its boundaries have become extended. The early discussions on corporate governance centred on the structure within which publicly-quoted companies directed their businesses. Companies acted within a framework which was set by law, by regulation, by the market and by public opinion. The framework itself and the influence of its constituent parts varied between countries and through time, but the concept of corporate governance was essentially a limited one. It was a technical study, seen mainly through the lenses of law and economics. It took for granted the purpose of companies and was primarily concerned with the legitimacy and effectiveness of the manner of their governance.

Contrast that earlier, narrow view of the nature of corporate governance with the range of disciplines and perspectives from which the chapters in this *Handbook* have been drawn. Clearly the framework within which businesses are governed remains central, but it is now assessed in the context of the role of companies in society. The emphasis on the vertical dimension of corporate governance has now been complemented by a greater concentration on its horizontal dimension. Corporate purpose and board responsibilities to the society of which they are an essential part are firmly on the governance agenda. Moral and ethical issues take their place beside economic and legal ones. The philosophical basis of governance is no longer a given but open to argument. Just as the study of corporate governance has broadened to reflect the complexity of its reach and impact on society, so has it broadened internationally in line with the way in which markets have become global. This is brought home by the array of countries from which the contributors to the *Handbook* have been drawn.

The second lesson which the *Handbook* brings home is the rapidity with which corporate governance has grown from a specialist subject, confined to lectures on law and accounting, to a mainstream discipline in every business school. All this has occurred in a space of around thirty years. It is hard to think of another discipline which has established itself so fast in the academic curriculum. The pace with which the study of corporate governance has grown leads to two conclusions. First, that further experience, study and research will refine or alter present judgments on the subject and second that its development will continue, even if not at the same speed. As a consequence, the *Handbook* should be seen and used for what it is; it is a mine of practical and relevant thinking to be quarried by all with an interest in the governance of corporations. It is monumental in scope, but it looks to the past only as a guide to the future. In essence, the *Handbook* represents work in progress. It is a beginning not an end and is the base from which the further development of corporate governance will be chronicled.

Adrian Cadbury
June 2011

Introduction: Corporate Governance – An Emerging Discipline?

Thomas Clarke and Douglas Branson

THE EMERGENCE OF CORPORATE GOVERNANCE AS A DISCIPLINE

Corporate governance is emerging as a subject of profound and enduring significance. There are many dimensions to the increasing interest in corporate governance (Clarke & dela Rama, 2006, 2008). In the advance of business policy and practice, corporate governance is now widely accepted as an essential discipline which managers must understand and apply to achieve accountability and performance. In company law, issues of corporate governance are becoming increasingly prominent, as directoral duties and responsibilities are called into question. Among national governments good corporate governance now is universally recognized as vital to market integrity and efficiency, and an essential underpinning for financial stability and economic growth. Finally, leading international agencies such as the G20, OECD, IMF and World Bank have seized upon higher standards of corporate governance not only as the means of managing the risk of corporate failure but also as the route to improving economic performance, facilitating access to capital, decreasing market volatility, and enhancing the investment climate (OECD, 2004). Recurrent waves of corporate failure, climaxing in the systemic 2007/2008 global financial crisis, has focused attention keenly on the apparent defects in regulatory institutions and corporate governance.

All of this has made corporate governance a subject of some fascination to academics and other commentators. Since the moral economy of Adam Smith (1776), the dilemmas involved in business formation and operation have been highlighted by historians and economists (Frentrop, 2003). The monumental work of Berle and Means (1937) brought the thinking about corporations into the 20th century. Later a group of economists left an indelible intellectual impression of the agency problems of corporate governance (Coase, 1937; Jensen & Meckling, 1976;

Fama, 1980; Fama & Jensen, 1983; Williamson, 1988). Academic and policy inquiry broadened to the emergence of a new legal discipline of corporate governance in the USA, with the Corporate Governance project commenced in the 1980s of the American Law Institute (ALI, 1994; Branson, 1993). Meanwhile, Bob Tricker published the first work on corporate governance from a management perspective (1984).

Over the last two decades the research and writing on corporate governance has grown phenomenally. A sequence of serious corporate failures in the UK led to the London Stock Exchange commissioning a report on *The Financial Aspects of Corporate Governance* (Cadbury, 1992). This statement of the principles of openness, integrity and accountability as the essence of corporate governance proved inspirational in guiding many other countries towards these ideals (1992: 16). Since most countries have by now developed their codes of corporate governance through several iterations, the European Corporate Governance Institute Index of Codes (ECGI, 2011) lists over 200 codes across 85 countries (European Commission, 2002; Aguilera & Cuervo-Cazurra, 2004). Simultaneously, academic research and scholarship in corporate governance increased exponentially. In 1992 there were few publications focused upon corporate governance; by 2011 Google recorded 18.5 million hits on *corporate governance*. Academic work stretches across the academic social science disciplines, including economics, law, management, accounting, finance, psychology, organization studies and politics.

Different understandings and practices of corporate governance begin with different interpretations of what corporate governance is: competing definitions range from the very narrow, concerned simply with the relationship of shareholders with managers as in agency theory, to very expansive definitions involving all of the relationships enterprises are engaged in (Clarke 2004, 2005). European interpretations of corporate governance tend towards more substantive definitions that recognize the wider implications of governance: 'how corporations are *governed* – their ownership and control, the objectives they pursue, the rights they respect, the responsibilities they recognize, and how they distribute the value they create.' (Clarke & dela Rama, 2006: xix; Clarke & Chanlat, 2009). From this wider perspective, governance implies a large and more complex conception of how order, efficiency and equity are maintained:

> While classical economics assumed markets to be spontaneous social orders that flourish best in the absence of any intervention, many political theorists and lawyers start from the opposite assumption. Following Hobbes, they assume that the natural societal condition is one of chaos, uncertainty and conflict. New institutional economics, economic sociology and comparative political economy brought these approaches together by emphasizing that markets are not spontaneous social orders, but have to be created and maintained by institutions. These provide, monitor and enforce rules of the game, which among other things fix property rights, back up contracts, protect competition, and reduce information asymmetries, risk and uncertainties. Societies have produced a variety of institutions to govern economic transactions, help reduce their costs and hence increase the likelihood of their occurrence (Van Kersbergen & Van Waarden, 2004: 143).

Competing definitions of corporate governance

Corporate governance has competing definitions, but in Margaret Blair's estimation encompasses the 'the whole set of legal, cultural, and institutional arrangements that determine what publicly traded corporations can do, who controls them, how that control is exercised, and how the risks and returns from the activities they undertake are allocated' (1995: 3). These expansive dimensions of corporate governance were narrowly translated in the Anglo-American world in recent decades with the increasing ascendancy of financial markets and intellectual domination of agency theory into an almost obsessive concern for the problems of accountability and control involved in the dispersal of ownership of large listed corporations, and a rigid focus on the mechanisms that orientate managers towards delivering shareholder value (Dore, 2000; Davies, 2005; Froud, Johal, Leaver & Williams, 2006). European perceptions of the role and significance of governance have changed in recent years towards the Anglo-American view, but often the change has proved partial with political leaders, regulators and business executives advocating the salience of shareholder value, while acknowledging the continuing legitimacy of stakeholder values.

Hence the definition and meaning of corporate governance varies considerably according to the values, institutions, culture and objectives pursued: 'Corporate governance may be defined broadly as the study of power and influence over decision making within the corporation. … Existing definitions of corporate governance are closely tied to different paradigms or ways of conceptualizing the organization or firm.' (Aguilera & Jackson, 2010: 5). In a similar vein Davis (2005: 143) in *New Directions for Corporate Governance* suggests corporate governance refers to 'the structures, processes, and institutions within and around organizations that allocate power and resource control among participants.' However, Cadbury (2000) in work for the World Bank, recognized the role of corporate governance in contributing to the stability and equity of society and the economy:

> Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.

Diversity and convergence in corporate governance institutions

Different approaches to the financing and governance of corporations in different regions of the world have prevailed since the diverse origins of capitalism (Hall & Soskice, 2001; Amable, 2003; Deeg & Jackson, 2006). The evolution of the corporate form can be traced from the family and closely held capitalism of the early 19th century with the protection of ownership rights; through to the managerial capitalism of the early 20th century with further protection for listed corporations and limited liability; and finally the popular capitalism of the late 20th century with protection of minority interests and mass ownership. However, different routes were followed in this evolution and different destinations reached in corporate practice, company law and associated institutional development of Anglo-American, European and Asian forms of corporate enterprise. In the Asian system of corporate governance stronger elements of family ownership survive intact, and in the European system more managerial forms have survived.

Advocates of global convergence in corporate governance in the late 1990s and early in this century postulated the rapid ascendancy of one governance model, usually and chauvinistically the United States governance version (Branson, 2004). But such advocacy has retreated rapidly from the scene as corporate governance has continued to evolve along many different lines (family capitalism, dominant shareholder capitalism, many other forms of relationship-based governance, state-owned enterprise (SOE) capitalism, for example); and in differing ways, dependent upon the cultural settings which various nation-states and regions find themselves in. These developments have relegated any notion of global convergence among the many forces shaping governance models and governance best practices.

Yet the continuing insistent focus of corporate governance on boards, CEOs and shareholders – oriented almost obsessively towards financial markets has not served the discipline well (Jurgens, Naumann & Rupp, 2000; Aguilera & Cuervo-Cazurra, 2004; Deakin, 2005; Aguilera & Jackson, 2010).

This approach narrows the dimensions of corporate governance to a restricted set of interests and, as a result, it has a very limited view of the dilemmas involved in corporate governance: ‘Our perspective on corporate governance is a straightforward agency perspective, sometimes referred to as separation of ownership and control. We want to know how investors get the managers to give them back their money’ (Shleifer & Vishny, 1996). There are competing corporate governance systems in the market-based Anglo-American system; the European relationship-based system; and the relationship-based system of the Asia Pacific (Clarke, 2012a). The existing rich diversity of corporate governance systems is based on historical, cultural and institutional differences that involve different approaches to the values and objectives of business activity. When advising on the development of corporate governance principles, the OECD Business Advisory Group (1998) stressed the importance of strategic choice in the determination of governance systems:

> Entrepreneurs, investors and corporations need the flexibility to craft governance arrangements that are responsive to unique business contexts so that corporations can respond to incessant changes in technologies, competition, optimal firm organization and vertical networking patterns. … To obtain governance diversity, economic regulations, stock exchange rules and corporate law should support a range of ownership and governance forms.

CENTRAL THEMES OF THE HANDBOOK

The contributors to this Handbook highlight a number of central themes that offer a richer and more diverse interpretation of corporate governance than has prevailed in more orthodox academic approaches. First, there is a strong sense that multiple theoretical and methodological approaches are required to achieve an adequate understanding of the complexities of corporate governance (Heminway). The exclusive focus on agency theory in recent decades has limited the field of inquiry, and the conception of shareholder value as the single corporate objective has fatally narrowed the perception of corporate purpose and performance. The shareholder value regime is fatally flawed in terms of an understanding of directors’ duties (Blair); company law and practice (Deakin); strategic involvement of directors (Useem); accounting standards (Biondi); boardroom behaviour (Roberts); and executive incentives (Lazonick).

Boards of directors acting solely as monitors for shareholders, as envisaged by agency theory, is a one-dimensional view of the role and responsibilities of directors (Blair; Deakin; Useem). The great paradox of this exclusive focus on the monitoring of company directors to ensure they deliver shareholder value is that this excludes adequate consideration of the value-creating role of boards (Roberts). Boards of directors have a vital role to play in leadership of the company and in value creation. This role is often neglected because of the emphasis of regulation upon the control and accountability functions of the board, and because of the almost exclusive focus of agency theory on control and monitoring. When Adrian Cadbury was asked by the London Stock Exchange to report on corporate governance (in what became the first contemporary code of corporate governance that directly influenced many other codes around the world) he asked if he could examine how boards are responsible for driving the company forward. The London Stock Exchange insisted that the focus should be on financial controls due to the recent spate of corporate collapses in the UK in 1991.

As international codes developed and corporate governance was thrust into prominence, unfortunately the concept almost universally became synonymous with monitoring, compliance and regulation. Ironically this association of corporate governance with monitoring neglected the absolutely vital role boards of directors have to play in supporting strategies for value and growth. Corporate governance inherently is about accountability *and* strategic direction:

> The … economy depends on the drive and efficiency of its companies. Thus the effectiveness with which their boards discharge their responsibilities determines … competitive position. They must be free to drive their companies forward, but exercise that freedom within the framework of effective accountability. This is the essence of any system of good corporate governance. (Cadbury, 1992: 11)

Corporate governance is not just about accountability. Governance has an important role to play in value creation, innovation and strategy (Van Ees; Huse; Zattoni). Governance without strategy leads to paralysis, as strategy without governance leads to recklessness.

However, it is certainly the case that boards of directors, and governance institutions generally, have been challenged by the increasing pace of the opening up of global markets and the intensification of competition combined with increased shareholder monitoring (Useem). Engaging in continuous processes of strategic thinking and shareholder engagement has placed growing demands upon boards (Roberts; Pye et al.). Increasing demands upon boards to fulfil their duties and perform has in turn led to a call for higher standards for boards and directors, and the practice of board and director evaluation, once unheard of, has become accepted practice in leading corporations internationally (Nicholson et al.). Yet it is now widely recognized that the DNA of boards and directors lacks requisite variety to evolve dynamically in response to changing environments. Development and recruitment of directors has to be far more professional and extensive if requisite talent is to be discovered and employed at directoral level (Sealy & Vinnicombe; Nielsen). Meanwhile the unresolved issue of excessive executive reward unrelated to performance has proved a distracting and undermining element in corporate governance, which has debilitated boards from focusing on their main corporate objectives.

Another central theme of the Handbook is the degrees of freedom that exist in the development of governance practices, in a contingency approach to corporate governance (Aguilera et al.). Rather than there being simply two or three regional or national systems of governance, potentially there are multiple effective configurations of governance practices, with a need to examine the different industry and firm pressures to comply or differentiate from established practices. There are many dynamics contributing to the development of corporate governance: some firms become smaller and more simple, while others become larger and more complex, due to developments in technology, competition, finance and markets. These recent advances are rapidly changing the nature of many firms. The large, complex corporate group, particularly in banking and financial services (Farrar), becomes the norm, while less formal, more flexible arrangements (Loewenstein) proliferate in other business areas. Even the virtual firm, which represents the disaggregation of inputs and the antithesis of the firm in Ronald Coase's *Theory of the Firm*, has become not only a possibility but also a reality in modern settings.

The dark side of the increasing complexity of business structures, competitive strategies and financial instruments was demonstrated catastrophically in the global financial crisis (Lazonick; Clarke). The impact of the global financial crisis undermined confidence in the Anglo-American model of corporate governance and risk management: instead of risk being hedged, it had become interconnected, international and unknown. Massively incentivized irresponsibility became the operating compensation norm in the financial community, which drove markets to the point of self-destruction. The regulatory responses remain in the course of development and implementation, but the concern is that they may prove incomplete and insufficient. When regulatory intervention occurs, it is often accumulative over-regulation, rather than selective better regulation.

In a final theme of the Handbook, it can be argued that in the main, corporate governance scholarship relates to what is sometimes denominated *vertical* corporate governance: i.e. the focus is entirely upon certain organs of the company (board of directors, CEOs, and owners or shareholders) and how they relate to one another. But governance has a *horizontal* dimension as well: namely, how those organs cause the company to relate, or not to relate, to other constituencies both within (employees) and without the company (environments in which it operates, suppliers, consumers, citizens and residents of communities and regions in which the company has facilities). Many chapters of this book touch upon horizontal governance in relation to corporate social responsibility, stakeholder theory and team production. There is a critical concern of corporate governance for the respect and protection of international human rights by companies which increasingly operate globally, and too often are discovered to have denied these rights (Redmond). The issue of social and environmental responsibility is the final frontier for corporate governance. The integration of corporate governance and corporate responsibility will be required to deliver sustainability in a hard-pressed planet. Whether the existing institutions of corporate governance and regulation are capable of rising to this challenge remains to be demonstrated (Benn).

STRUCTURE OF THE HANDBOOK

The Handbook is structured into seven parts, each covering a major developmental theme in corporate governance. First, the origins of corporate governance are investigated in Part 1. The role of markets and regulation in structuring and disciplining corporate governance are examined in Part 2. The role of boards and directors in offering leadership and accountability for corporations is considered in Part 3. The new challenges and directions for the development of boards and directors are explored in Part 4. The different dimensions of the wider institutional framework for corporate governance are assessed in Part 5. Enduring dilemmas confronting corporate governance are analysed in Part 6. Finally, in Part 7, the critical emerging issues of governance and sustainability are addressed. The main elements of each of these parts of the Handbook and the substance of each of the chapters will now be briefly introduced.

ORIGINS AND DEVELOPMENT

Part 1 of the book examines how the genesis of modern corporate governance lay in the considerable development of business practice with the rapid growth of industrialism in Europe and North America. The purpose of the corporation and, consequently, the duties of directors are investigated in terms of the legal interpretation of the 'best interests of the corporation.' How the unique characteristics of the corporation, including limited liability, legal entity and indefinite life, offered a robustness to the corporate form that made it the dominant vehicle for business enterprise are explored. Finally, the different theoretical explanations of corporate governance are considered, with the belief that a multi-disciplinary and multi-theoretical approach is necessary for a full understanding of corporate governance.

Evolution

The historical origin and evolution of corporate governance is traced by Bob Tricker's opening analysis of the development of governance ideas and practices in the early adventures of the merchant traders, through the 17th and 18th century establishment of the great trading empires of the East India Companies (Chapter 1: *The Evolution of*

Corporate Governance). The themes that presently define corporate governance were present from the start of the Dutch East India Company with investors concerned about the lack of transparency and accountability of the company, the power of directors, the 'exhibitionist self-enrichment' by senior executives, the evident lack of risk management, and the consequent insecurity of investments, with dividends denied for periods up to 10 years (Frentrop, 2003). Subsequent corporate ventures recurrently demonstrated the extreme excesses and risks associated with businesses involving 'managers of other people's money' in the resounding words of Adam Smith.

Bob Tricker recounts how the innovation of the limited liability company in the 19th century provided a new platform for the growth of business enterprise. 'The key concept was the incorporation of a legal entity, separate from the owners, which nevertheless had many of the legal property rights of a real person – to contract, to sue and be sued, to own property, and to employ. The company had a life of its own, giving continuity beyond the life of its founders, who could transfer their shares in the company'. In the 20th century this original corporate concept has conceived complex corporate structures and ownership, and elaborate governance processes. Berle and Means (1932) were the first to consider the profound implications of the shift of power from diverse and remote shareholders to executive management in the developing separation of ownership and control.

As the scale and complexity of international corporations increased in the decades following the Second World War, existing company law and corporate governance were strained to their limits. A series of corporate scandals including the junk-bond merger and takeover wave in the USA in the 1980s, and the failure of the Robert Maxwell Group in the UK in 1991, prompted demands for higher standards of disclosure, accountability and governance. The effort to reform corporate governance gathered momentum in the later decades of the 20th century with the national and international effort to promulgate corporate governance codes of good practice. Despite this drive for higher governance standards, the long boom of the 1990s came to an end with the dramatic fall of the NASDAQ, and the consequent failure of Enron (2001), WorldCom (2002) and a series of other technology companies in the USA and other countries. Substantive intervention followed with new legislation (US Sarbanes Oxley Act 2002) and with increasingly rigorous corporate governance codes (UK Combined Code 2006).

Yet the intensity and contagion of the global financial crisis (2007–2008) highlighted profound weaknesses in regulatory systems, board effectiveness, risk management and executive incentive structures. This demonstrates the failure of regulatory and governance regimes to keep pace with the rapid and profound changes in markets, corporate structures and financial securities. As Bob Tricker concludes, this also indicates the limitations of our knowledge of corporate governance, both in theory and practice, and the many unresolved issues concerning board responsibilities, director and auditor independence, and the measures of governance and performance.

Directors duties

As Margaret Blair reveals, the global financial crisis also exposed serious flaws in the prevailing conception of directors' duties (Chapter 2*: In the Best Interest of the Corporation: Directors Duties in the Wake of the Global Financial Crisis*). The doctrine that corporations must be managed to maximize shareholder value had taken firm hold from the 1990s and helped to induce large financial firms to pursue increasingly risky investment strategies in their relentless drive to enhance share value. Yet contrary to popular myth corporate law in no jurisdiction requires corporate directors to maximize shareholder value. It is mythological that United States law incorporates the shareholder primacy norm (or the director privacy model either, for that matter). At best, the model which US corporate law encapsulates is an indeterminate one, as Margaret Blair demonstrates. Corporate law instructs directors that they must act 'in the best interests of the corporation' (Bratton & Wachter, 2010). The shareholder value doctrine claims that shareholder value maximization is the social and economic goal of corporations because it maximizes the overall wealth being created by the corporation, disciplining management to this metric. However, shareholder value can be increased not by adding to the social wealth generated by the enterprise, but by extracting value from other corporate participants: 'The idea that maximizing share value is equivalent to maximizing the total social value created by a firm seems obviously wrong to anyone who observes the various ways that corporations can (and do) externalize some of their costs onto employees, customers, or the communities where they operate.'

The doctrine of shareholder primacy not only has dominated theory and practice for over 25 years but also has demonstrated a corrupting influence in the last decade's numerous corporate governance debacles. Margaret Blair exposes several of the myths, often unspoken and otherwise taken for granted, which undergird the shareholder value proposition:

- The myth that maximization of shareholder value is the 'best proxy' for maximization of wealth and well-being overall.
- The myth that modern financial markets do a good job of assessing true values of shares and companies.
- The widely-held belief that a single metric (maximization of shareholder value) best holds corporate managers' feet to the fire (best 'disciplines managers') while more nuanced lists of metrics would simply cause confusion in managers' objectives.
- 'High powered incentives in the form of compensation packages tied to stock price performance' serve well the penultimate goal of shareholder value maximization as well as the ultimate goal of societal benefit (such incentives do not, serving rather to exacerbate the moral hazard modern managers face by shifting risks of loss to creditors and employees and abrogating the prospect of gain to the managers and shareholders, who thus are tempted to and have engaged in overly risky behaviours and strategies. The extreme amount of financial leverage we have just witnessed is an example).

When the pursuit of shareholder value actually contributes to undermining the capacity of the corporation to generate further value in the longer term, or persuades the directors of corporations to sanction high-risk strategies that can lead to corporate collapse, it becomes apparent that the naked pursuit of this doctrine can be both irresponsible and dangerous (Aglietta & Reberioux, 2004; Gelter, 2009). Bratton and Wachter (2010) argue that the firms that were most responsive to market pressure to increase their share price in the years leading up to the financial crisis were the firms that took on excessive leverage and fell furthest in the crisis.

Margaret Blair contends that directors have the authority and responsibility in law to consider the interests of all participants in the corporate enterprise, and to find outcomes of value to all parties. Blair and Stout (1999) have outlined an alternative *team production* approach to corporate governance and directors duties which recognizes that productive activity requires multiple parties to contribute to the enterprise in complex and integrated ways. This perspective allows directors to recognize and value the contributions of all who engage in pursuing the success of the business enterprise.

Limited liability

The conception of the corporation was the inspiration for the modern business enterprise: the specific legal form of people and resources, originally chartered by the state for the purpose of engaging in business activity. Unique characteristics distinguish the corporation from the other main legal forms – the sole proprietorship and the partnership. As earlier noted, the essential characteristics of the corporation are:

- Limited liability – the losses an investor may bear are limited to the capital invested in the enterprise and do not extend to personal assets.
- Transferability of shares – shareholder rights may be transferred without constituting legal reorganization of the enterprise.
- Juridical personality – the corporation itself becomes a fictive person, a legal entity which may sue or be sued, make contracts and hold property.
- Indefinite duration – the life of the corporation may extend beyond the participation of its original founders.

The earliest corporations were founded by religious and educational organizations, traders and merchant venturers in different countries of the world, and licenced by the state. Centuries ago it was unimaginable that these bodies might become the vast multinational corporations of the present era, dominating the world's resources, and often dwarfing the powers of the nation-state. The 1844 Joint-Stock Companies Act in England facilitated the process of incorporation and joint-stock companies quickly proliferated. Beginning in Europe and North America, but eventually in almost all jurisdictions, some legal version of the corporation was developed. The process of incorporation in which relevant documents are filed with state authorities, involves the abstract concept of clothing the entity with the 'veil' of juridical personality (*corpus* being the Latin word for 'body').

Mark J. Loewenstein (Chapter 3: *Limited Liability Companies*) investigates the particular reasons why in the United States the traditional legal form of the corporation is being superseded by the relatively recent formation of the limited liability company (LLC). The limited liability company in the USA offers the benefits of the partnership for income tax purposes with the benefits of the corporation in terms of not being liable for the debts and obligations of the entity. Prior to the creation of the LLC, investors in enterprises who wanted the tax treatment of a partnership only had the choice of a general partnership in which each partner would have unlimited liability for the firm's obligations, or a limited partnership, where the general partner would have this liability. However, though the LLC does bestow significant benefits, as with the corporation, there is a limit to which these benefits may be exploited. The Delaware LLC act does not permit the parties to waive the contractual covenant of good faith and fair dealing: hence, Wormser's (1927) insistence on the 'piercing of the corporate veil' in certain circumstances, arguing that the issuance of a corporate charter is a privilege, granted by the state, and if abused, that privilege (the granting of limited liability for the shareholders) can be revoked.

Theoretical and methodological perspectives

A discipline of corporate governance requires theoretical frameworks to facilitate understanding and methodological approaches to enable study of corporate governance in practice. Joan Heminway identifies key theories of corporate governance, and isolates a variety of methodological approaches (Chapter 4: *Theoretical and Methodological Perspectives*). Her contention is that a multidisciplinary approach is necessary for a full understanding of corporate governance phenomena. In examining theoretical perspectives, commencing with agency theory, the strengths and limitations of different theories are outlined. Agency theory does reflect some basic attributes of the corporation and explains some aspects of the behaviour of corporate executives and directors, but agency theory does not adequately explain governance in owner-managed corporations or in majority shareholder contexts, where principal/principal relations are more significant than principal/agent relationships. In general, agency theory rests upon a limited view of directors as self-interested, and focuses on the shareholder–director–executive relationships, to the neglect of other stakeholders vital to the business enterprise. Similarly, the conception of the company as a nexus of contracts based on transaction cost economic theory constitutes the corporation as the coordinator of contractual relationships, and is based on the separation of ownership and control of the US public company. In contrast, team production theory conceives of the corporation as a nexus of firm-specific investments made by a range of stakeholders. There are numerous other relevant theoretical approaches that explain the governance relationships of business, such as stewardship theory, resource dependence theory and contingency theory. In addition, there are many theoretical approaches to understanding the wider relationships of the corporation to the economy and society.

As Joan Heminway explains, the corporate governance research methodologies, as with the theories they support or refute, emanate from diverse disciplines including law, economics, finance, accounting and management, and involve distinctive analytical tools and techniques. Within disciplines there also exist methodological differences: for example, traditional legal research focuses on interpreting law and regulation, whereas legal empiricists focus on narrower, testable hypotheses. Quantitative empirical research has secured a powerful place in many disciplines, including economics, finance and accounting. Quantitative methodologies are weakened by a lack of primary data, and the central issue of determining causality. Qualitative methodologies that study social processes such as decision-making through interviews and surveys may allow greater focus, but data may not be objective or comparable. Joan Heminway concludes that corporate governance theories and methodologies are multifaceted and work depending on only one tradition has limited utility in advancing understanding of corporate governance structures, processes and dynamics.

MARKETS AND REGULATION

Part 2 inquires in greater depth into corporate regulation and accountability in terms of the legal, ownership and accounting principles that guide the performance of the corporation. The balanced view of corporate purpose and accountability traditionally held by Western legal systems appears to have become unhinged in recent decades under the pressure of regulatory reform to make corporations more accountable to shareholders. If boards of directors are to become more active in pursuing accountability to shareholders, then this calls for moving beyond the monitoring function portrayed in agency theory, towards a more balanced commitment to the creation of value. Corporate governance inherently is about accountability *and* strategic direction. Similarly, with the measurement of corporate performance, a balanced approach must be adopted. In accounting, the international move towards fair value accounting and away from historic cost accounting represents a financial logic entering corporate accounting, affirming a shareholder value vision of the firm, which exerted a destabilizing impact during the global financial crisis.

The nature of the firm

The understanding of the firm as a governance structure has been dominated by economic analysis in recent decades. In contrast, Simon Deakin offers a legal understanding of the firm (Chapter 5: *The Juridical Nature of the Firm*). 'Corporate law regimes are complex, emergent phenomena, the result of a path-dependent process through which legal systems have co-evolved alongside firms and markets in industrialising economies (Aoki, 2010)'. Instead of the theory-driven approach of economic analysis, Simon Deakin adopts a data-driven approach, building a theoretical model on the basis of observed empirical phenomena. He argues it is not only unnecessary to employ the principal–agent analogy as an explanation of the legal structure of the firm, it is misleading to do so. The idea that managers should act for the shareholders as the firm's owners has a powerful resonance in the agency theory-inspired understanding of corporate governance. Yet this does not represent the view of the firm taken by any legal system, Simon Deakin contends. In civil law the interpretation of 'company interest' is clear: that the principal task of management is not to return the surplus from production to the shareholders, but to maintain the firm as a going concern, with a view to returning value to all supplying inputs to the firm. In common law systems, the idea of 'enlightened shareholder value' has long been recognized as giving management discretion on how to balance the interests of shareholders with those of employees and creditors, and to determine the timescale over which shareholders can expect a return on their investments.

There is evidence which suggests that neither company law nor corporate governance codes were able to provide an appropriate framework for board-level monitoring of management in the years leading to the global financial crisis. Corporate governance reforms aimed at enhancing managerial accountability to shareholders paradoxically helped encourage risk-taking in financial institutions. This is explained by shareholders' greater appetite for risk relative to other corporate constituencies as a consequence of the market-wide diversification of holdings of institutional investors, and the increased liquidity of British and US stock markets. Simon Deakin argues that the most important factor in recent decades favouring the development of shareholder-oriented corporate governance has been the encouragement of hostile takeover bids by regulatory changes that have often been in tension with the core principles of company law. Interestingly, the Japanese METI and Ministry of Justice offered a more balanced interpretation of the sources of corporate value in the context of takeovers occurring in recent years:

> The price of a company is its corporate value, and corporate value is based on the company's ability to generate profits. The ability to generate profits is based not only on managers' abilities, but is influenced by the quality of human resources of the employees, their commitment to the company, good relations with suppliers and creditors, trust of customers, relationships with the local community. … What is at issue in the case of a hostile takeover is which of the parties – the bidder or incumbent management – can, through relations with stakeholders, generate higher corporate value.

Simon Deakin concludes the legal model of the firm is far removed from the shareholder-value-oriented firm that corporate governance theory often favours. Yet regulatory reform encouraging accountability has increased shareholder pressure through the medium of the capital market, and directors acting as agents of shareholders have increased further the pressures on managers to increase shareholder value through takeover bids and high-return business strategies, but have proved unable to monitor or control the resulting greater risks.

Shareholder monitoring and strategic partnering

The *dual* functions of the corporate board are highlighted by Michael Useem, both monitoring management and partnering management in strategic direction (Chapter 6: *The Ascent of Shareholder Monitoring and Strategic Partnering: The Dual Functions of the Corporate Board*). This offers a more balanced approach to directors' responsibilities. If directors are expected to primarily serve as monitors of management on behalf of shareholders, they would have little direct engagement in the company's strategic practices (beyond perhaps driving the company towards releasing greater shareholder value as in Deakin's analysis). If directors engage with management in strategic decisions they may help produce better practices and strategic results: 'Rather than straying from their mandate as management monitors on behalf of shareholders, directors in this conception of the firm would also be expected to fulfill their role as strategic partners.'

According to Michael Useem, the development that has driven the intensification of shareholder monitoring is the rise of institutional investing and its dominance of equity markets. This concentration of assets among a small group of professional investors has greatly enhanced the ability of these large equity holders to exercise influence on boards, including over executive compensation, share repurchases, anti-takeover devices and board compensation. 'The thrust of the influence has been to increase the vigilance of directors in their role as monitors of management, leading to greater board discipline of management around enhancing total shareholder returns.' The developments driving the intensification of strategic partnering involve the increasing complexity and uncertainty in executive decision-making. Opening of global markets, intensification of market competition and reduction of product cycle times have added a premium to effective strategic decisions. Facing these greater strategic challenges, executives are turning to directors to offer guidance on key decisions.

Both monitoring and strategic functions of directors have become important and independent drivers of directors' actions in the boardroom, Michael Useem contends. However, the existence of two director functions does generate tensions in the boardroom. When directors become more directly engaged in the strategic decision-making of the company, their capacity for monitoring the decisions may be compromised. Simultaneously, as boards press for greater shareholder value, their role in providing strategic advice to the company may be compromised, since they may represent investors with time horizons much shorter than the strategic thinking of managers. Despite these ongoing tensions, Michael Useem concludes that the effort to strengthen the monitoring role of directors through legislative and regulatory support may have the unintended consequence of strengthening directors' strategic partnering role.

International reporting standards

Accountants and auditors have traditionally played an important role as monitors not only of corporate performance but also of the associated standards of corporate governance and accountability. The development of International Financial Reporting Standards (IFRS) promotes the replacement of accounting practices, highly fragmented on a regional and national basis, with a more coherent and consensual international approach. Vincent Bignon, Yuri Biondi and Xavier Ragot take issue with the adoption by the European Parliament of a new principle of fair value accounting which represented a move towards IFRS, and away from the logic of historic cost accounting (Chapter 7: *An Economic Analysis of Fair Value: A Critique of International Financial Reporting Standards*). Historical cost accounting has a dynamic conception of the company as a going concern: as a whole entity, whose earnings statements make it possible to assess the net revenues that are distributable and effectively created by the firm. In contrast, fair value accounting introduces a new valuation method which is essentially financial, leading to the maximal disaggregation of firms' assets in order to estimate separately the contribution of each asset to earnings. Bignon, Biondi and Ragot argue:

> The adoption of a fair value accounting model has led to a profound misunderstanding about the place and role of accounting in the firm. This misunderstanding is directly linked to the drifts of financial capitalism that nurture a misapprehension about the place and role of finance in the economy and in society. In this way, accounting has been transformed from an instrument of management and control into a tool of marked-to-market financial valuation, generating a short-termist attitude

towards the economy of the firms to be accounted for (Orlean, 1999; Aglietta & Reberioux, 2004).

The transition to fair value accounting they insist risks amplifying upward market movements in growth phases in stock prices and downward moves in contraction phases. Fair value accounting risks compounding the procyclical effects of other regulatory interventions as businesses present flattering financial statements during times of expansion; then, in severe downturns, as in the global financial crisis, spreading crisis throughout the whole financial system, as entities urgently sell assets to obtain liquidity required to respond to their accounting write-downs, creating a mechanism by which the crisis is further amplified. Bignon, Biondi and Ragot conclude fair value is an affirmation of of a shareholder value vision of the firm, in which a financial logic enters accounting with the effect of modifying the valuation of firms and impacting income statements. If the firm exists as a sustainable economic entity they argue, then accounting systems ought to be grounded in an independent logic that constitutes a source of useful and complementary information to protect all stakeholders, including shareholders.

BOARDS AND DIRECTORS: LEADERSHIP AND ACCOUNTABILITY

The dual nature of the role of boards and directors is examined further in Part 3. Boards of directors are not uniform entities and everywhere exhibit differentiation and complexity in response to different national institutions, rationalities, contingencies and strategies. The focus on compliance in governance fails to recognize the dynamic of board relationships that determine the effectiveness of boards. Paradoxically, it is boards of directors engagement in the strategic process of corporate direction that determines their capacity to accurately assess and monitor the capability and performance of the management of businesses. Boards of directors participation and contribution to strategic thinking is a vital part of the dynamics of boards and of their relationship with management. It can be argued that the ultimate objective of the board is to create long-term values and sustainability for the firm.

Board effectiveness

The importance and contribution of boards of directors to corporate governance is widely recognized, and invariably boards are established to govern not only large and complex corporations in both the private and public sector but also boards of directors are universally adopted in smaller organizations in the professional, commercial, public service and voluntary sectors. For this reason boards of directors have proved a subject of enduring fascination for corporate governance research (Chapter 8: *Boards and Board Effectiveness*). Yet as Hans van Ees and Gerwin van der Laan argue, 'Evidence concerning direct relationships between board attributes and corporate performance is scant, ambiguous and not conclusive' (Adams, Hermalin & Weisbach, 2010). The influence and interdependencies between board and firm performance are more complex than imagined, which led Daily, Dalton and Cannella (2003) to call for analysis through multiple theoretical lenses to comprehend in a more integrated way the relationships involved.

However, Hans van Ees and Gerwin van der Laan insist integrating different theoretical approaches is only possible where the underlying assumptions fit. They consider the characteristics of three major approaches to research on board effectiveness: a structural approach of mainstream finance and economics, informed by agency theory that focuses on attributes such as board size and board composition; and management and organizational research focusing either on board relationships or board behaviour informed from a sociological or social-psychological perspective. They suggest that theoretical pluralism prevails in research on boards and directors; there remain fundamental differences between the different approaches; and that considerable progress is possible in the development of corporate governance theory:

- Assumptions about rational and self-interested human beings in agency theory can be challenged, but we have yet to incorporate incomplete understanding, bounded rationality and partially self-interested behaviour into corporate governance research.
- There is a neglect of fundamental contingencies and the heterogeneity of corporations in corporate governance research, and this a characteristic not only of agency theory but also of all perspectives on boards.
- As with the fundamental interdependence between corporate governance institutions at national levels, it may be argued that board characteristics are complementary and interdependent.
- Board characteristics are endogenous and the results of strategic choice.
- Board research has generally taken boards to be monolithic entities; however, boards are composed of individual directors operating in a team with implications for the performance of individuals and boards.

Context, process and dynamics

The universal development of corporate governance codes of good practice, reinforced by a 'comply or explain' recommendation, has had the unintended consequence of focusing the assessment of boards of directors' performance almost exclusively on compliance. John Roberts offers a more nuanced understanding of board context, process and dynamics, arguing that it is the more complex, and less readily observed *manner* of compliance which determines the effectiveness of boards (Chapter 9: *Between the Letter and the Spirit: Defensive and Extensive Modes of Compliance with the UK Code of Corporate Governance*). He portrays '... how complex, diverse and contingent the character of any board is both in terms of individual behaviour, the dynamic of relationships that this sets up, and the resultant group culture. Formal compliance masks and remote research simply ignores this relational complexity and contingency, and yet it is this that is the root of the effectiveness or otherwise of a board …'

In contrast, the oversimplified binary approach to compliance/non-compliance is compounded by the emphasis of agency theory on the monitoring and control function of boards, and the mistaken belief that directors' engagement in the strategic direction of the company inevitably diminishes the capacity of boards to exercise due control. The result is a reduction of board involvement to formalities, as John Roberts argues: 'The foreclosure of effective non-executive engagement in the strategy process is arguably here the unintended consequence of a self reinforcing dynamic of non-executive control and executive resistance that makes board governance into 'a ritual dance'.' In practice, it is the wider involvement of directors in strategy that enables them to gauge more effectively the performance of executive management: 'engagement in the development and challenging of executive strategy enhanced their exercise of control by encouraging executive openness, and provided non-executives with a more nuanced and business specific set of criteria against which performance could be appraised. From this perspective the full development of a board's strategic role is the condition for effective control, rather than a threat.'

If directors do not have a good knowledge of the specific strategies of the business, derived from being closely involved in their development, it is more likely they will be conduits for the assessment by the market, however ill-informed this may be.

> In the absence of such strategic involvement then the only criteria for appraising executive performance is that offered by the market which has little understanding of the underlying drivers of value creation in a particular business, and is possibly for the most part indifferent to the potential for short term share price management to be pursued at

the expense of longer term wealth creation. The risk of an exclusive emphasis on a board's control role is that it serves merely to crudely amplify such external pressures for immediate performance rather than mediate them through effective 'strategic value accountability' (Jensen, Murphy & Wruck, 2004).

Strategy and innovation

One of the more contested areas in corporate governance concerns the role of boards of directors regarding strategy and innovation: Is the sum of their responsibility simply to monitor and control strategic direction, or are boards responsible and equipped for a more direct engagement in strategy formulation? Amedeo Pugliese and Alessandro Zattoni (Chapter 10: *Boards Contribution to Strategy and Innovation*) consider the contribution of different theoretical approaches to boards' strategic involvement and conclude: 'The debate on board' strategic contribution has been influenced by time and contextual elements, conflicting theoretical perspectives and inconclusive empirical results.' They examine the evolution of theoretical approaches and research design, and how these impacted on the empirical studies undertaken (Pugliese et al., 2009; Rindova, 2009).

The earliest research on boards from the 1970s onwards considered the passivity of boards and how they were subject to managerial hegemony. These studies lacked theoretical coherence, relied on anecdotal and other qualitative evidence, and were driven by a practical concern regarding the desirability of boards' strategic involvement (Mace, 1971). By the early 1990s, agency theory was becoming the dominant framework for the analysis of boards' contribution to strategy, employing quantitative data concerned with metrics and structures, and a focus on control, but uncertainty regarding consequences (Fama & Jensen, 1983; Sundaramerthy & Lewis, 2003). Finally, from the 2000s onwards, though agency theory remains influential, theoretical approaches with a behavioural emphasis gain significance including stakeholder, resource-based and stewardship perspectives. These focus on boards' participation and contribution to strategic decision-making and outcomes employing qualitative research to understand more about the inner dynamics of boards and their relationship with management (Huse, 2007; Hillman, Withers & Collins, 2009).

Board leadership and value creation

The essential role in leadership and value creation performed by boards is examined by Morten Huse and Jonas Gabrielsson from a team production theoretical perspective (Chapter 11: *Board Leadership and Value Creation: An Extended Team Production Approach*). This builds on the assumption that 'the firm is a separate and independent moral entity, and that the main task of a board is to create long term values and sustainable competitive advantage in the firm.' They argue that it is the development of the firm that should have the main attention of boards of directors, rather than serving the interests of any particular group of stakeholders. Indeed, creating value for the firm is the means of creating value for all stakeholders. The board's most critical role is to maintain the balance of the firm to ensure that the firm-specific investments are made by all stakeholders to build a strong resource base and to create sustained competitive advantage (Blair & Stout, 2006). From this, the board is identified as a critical coordinating body, tasked 'to represent and mediate between all stakeholders that add value, assume unique risk and possess strategic information critical for firm operations' (Kaufmann & Englander, 2005).

This extended team production approach rests upon a conception of the firm as a nexus of team-specific assets invested by stakeholders. These investments create valuable resources that are difficult for other companies to imitate and heterogeneous, enabling the firm to create competitive advantage and higher returns (Barney, 1991; Wang & Barney, 2006). The board itself contributes important capabilities and competencies to the process of value creation in the firm, including relational, firm and market, analytical and functional abilities. Capabilities are combined competencies useful for value creation, and dynamic capabilities represent the ability to integrate and reconfigure internal and external competencies to address the challenges of changing external environments (Teece & Pitelis, 2009).

From this perspective, team production may be defined as the utilization of multiple resources and competencies (for example, materials, information, talent, skills and vision) to create end products more valuable than the sum of the separable outputs of each cooperating resource (Alchian & Demsetz, 1972). Morten Huse and Jonas Gabrielsson explain that in the boardroom, crucially, this means board members and their individual competencies may complement one another, rather than serving as substitutes for each other. 'In a team production approach boards are seen as knowledgeable and cooperative teams with the purpose to lead the corporation and coordinate corporate activities. As such, the board of directors is seen as a critical coordinating body.' It is the combined competence of the board that is used to create value, and the leadership of the board is key to the value creation of the company.

BOARDS AND DIRECTORS: NEW CHALLENGES AND DIRECTIONS

Part 4 addresses the new challenges and directions facing boards and directors in the context of market, institutional and social change. In negotiating these changes it is the dense interpersonal relationships and social networks that are critical. Understanding the significance of the deeply embedded behavioural elements in the corporate ecosystem is the key to understanding governance processes. However, as the appreciation of the importance of boards at the apex of company decision-making has grown, there has been an increasing emphasis upon the importance of board evaluation. Assessing the capability of boards in the performance of their work is now widely accepted in large corporations, and is an integral part of good practice codes.

An area of corporate governance in which progress for many decades has been at best glacial is in achieving any degree of gender balance on boards of directors. A combination of mythology, vested interests and inertia has meant that representation of women on boards of directors of large corporations internationally has scarcely improved at the same time as the benefits of achieving a greater diversity of representation on boards has become widely apparent. However, the gender imbalance of boards of directors is only one element of a lack of diversity of skills, experience, ethnicity and age on one-dimensional boards. An international policy regime aimed at challenging this narrowness of boards is likely if boards prove incapable of reforming themselves.

Changing corporate governance practice

The considerable changes in the context of corporate governance and in the nature of the governing practices of boards and directors in a longitudinal study of UK companies over the last 20 years are studied by Annie Pye, Szymon Kaczmarek and Satomi Kimino (Chapter 12: *Changing Scenes in and around the Board Room: UK Corporate Governance in Practice from 1989 to 2010*) offering 'an interdisciplinary, process-oriented analysis which gives attention to the embedded nature of behaviour in this highly complex and deeply interwoven (global) corporate ecosystem.' By integrating different perspectives they endeavour to create a more process-oriented three-dimensional perspective, with this qualitative material providing insights 'on the sources of power and political texture of relationships between actors amidst this contemporary corporate governance architecture.'

Research delving this deeply into directors' behaviour in corporate governance is rare (Hambrick, Werder & Zajac, 2008; Durisin & Puzone, 2009; Huse, 2009; Pugliese et al., 2009). In addition, the research on which this chapter is based is unique in being based on three separate projects on the changing roles of boards and directors conducted in 1987–1989, 1998–2000 and 2009–2011. The scale of the corporate transformation in the UK during these decades is indicated by the fact that only a small group of the companies in the original sample survived for the third project, with the majority of the original companies being either sold or taken over. Among the governance changes that accompanied, and to a degree induced these structural transformations, the following are highlighted:

- CEO time and engagement is becoming more externally oriented in meetings with investors, advisors, suppliers, customers and government.
- With the increasing emphasis of corporate governance codes on non-executive director (NED) representations on boards, and the reduction of the executive representation on the board, this can limit the line of sight of the board into the company.
- Strategy is an area in which NEDs 'felt best able but least often enabled to contribute,' though strategy is now more of an ongoing process.
- There was a major shift in power towards major institutional investors in the 1990s, and boards increasingly have to explain their strategy to major investors, and convince them it is the right strategy.
- However, following the global financial crisis, shareholder value and corporate governance are no longer the mantra they were in the 1990s and early 2000s; and risk management and risk assessment are higher up the agenda.
- Corporate governance regulation is 'a necessary but not sufficient cause of effective board conduct as it is ultimately people who create and run organisations.'

Pye, Kaczmarek and Kimino conclude from the three surveys that 'clearly while the people and their roles have changed the importance of relationships and their interconnectedness (embeddedness) has not.' It is the density of these social networks and the circularity of the chain of accountability that is vital to an understanding of the effective working of the board of directors:

> NEDs' ability to enact their accountability in relation to investors continues to depend to a large degree on executives' enacting their accountability towards NEDs. This reflects a strong sense of embeddedness of key people in a web of accountabilities, underpinned by the relationship forged between the CE and the Chairman which lays the foundation to board culture and effectiveness. … What cannot be mistaken across any of these studies is that this is fundamentally a social system. These key directors at the helm of their organizations are deeply embedded in a chain of accountabilities which, although regulated, are not prescribed. Hence, what is considered appropriate conduct remains open to interpretation at every step along the way, and is dependent on the personalities, interpersonal relationships and networks of power forged amongst and between key people involved, in particular contexts at particular times.

Board evaluation

Previous conceptions of boards of directors as fulfilling largely nominal roles recently have given way to a growing appreciation of the importance of boards at the apex of the decision-making of the company, and the impact this may have on corporate performance. Boards of directors are under increasing pressure to fulfil their fiduciary duties, and to achieve a great deal more, including making a central contribution to strategic direction and adding value in many ways to the companies they govern (van der Walt & Ingley, 2001; Huse, 2007; Hendry, Kiel & Nicholson, 2010). Accompanying these developments has been an increasing emphasis upon board evaluation: assessing the efficiency, capability and effectiveness with which boards' accomplish their essential tasks. Board evaluation has become widespread as it has become part of the recommendations of codes of governance internationally (Klettner & Clarke, 2010), and as proficiency in the practice of board evaluation has developed (Kiel, Nicholson & Barclay, 2005; Charan, 2009; Garratt, 2010). As Gavin Nicholson, Geoffrey Kiel and Jennifer Ann Tunny (Chapter 13: *Board Evaluations: Contemporary Thinking and Practice)* state: 'While there are ongoing debates surround what the board of directors should do … there is near universal recognition that boards benefit from feedback.'

A comprehensive guide to the practical challenges of board evaluation is provided by Nicholson, Kiel and Tunny. The first difficulty is in how to define an effective board: the different contexts in which boards operate, and the different constraints they face result in value-creating boards undertaking different tasks and having different attributes. 'Board effectiveness is both contingent and equifinal – it is contingent on the broad environment in which the organisation finds itself, and there are alternative paths to effectiveness.' Moreover, boards are responding to different sets of stakeholders, who judge board and organizational performance according to different values and objectives. It is this highly contingent and complex relationship between board effectiveness and firm performance that makes analysis and evaluation of boards a demanding task.

Women on boards

In developed nations especially, the quest for increased diversity (based on gender, ethnicity, age, nationality, professional experience, etc.) has affected nearly every field and every occupation, profession and institution. This quest has been particularly poignant in the upper ranks of corporate management (the governance structure) and for the representation of women, given that women represent 50% of the middle managers but a far smaller percentage of corporate directors, and an infinitesimal percentage of CEOs and managing directors (Branson, 2008, 2009). As the recent Davies report (GEO/BIS 2011) in the UK demonstrates, though women are well represented in all of early and middle stages of management, there is rapid erosion of representation of women among the higher echelons of management. The problem is highlighted further by the numbers of women successfully graduating from MBA, law and other advanced degree programmes considered part of the essential preparation for high-achievement in business careers, which has approached, and in some instances has exceeded, parity with men for 25–30 years now.

Ruth Sealy and Susan Vinnicombe explore the much vexed problem of women on corporate boards of directors (Chapter 14: *Women and the Governance of Corporate Boards*). First they identify a number of myths which have been elaborated to offer rationales for the paucity of women in corporate governance, which they then knock down in turn:

- The human capital myth: women today have the same as or better experience, training and degrees than the men do, but some of those in power stubbornly maintain that women advance much less frequently because they are deficient in the human capital department.
- The pipeline myth: again, those in power while professing to be pro-gender maintain that the pool is small and contains no suitable candidates (not enough in the pipeline).
- The ambition myth: women lack sufficient ambition to make it to the ranks of upper management and to the boardroom.
- The time myth: 'It's just a matter of time.' The difficulty is that those in control have been saying the same thing for 30 or more years (while representation of women on boards and among senior executives has often stalled or gone backwards).

The authors proceed on to more nuanced reasons, why so few women are in the boardroom, such as the appointment process (which established male directors continue to dominate and control); the downsizing of corporate boards, which seems to be occurring almost everywhere and leads to fewer vacancies (boards of 6, 7, 8, even of 5, directors are not uncommon today); and the myopia of executive search firms (who must be specifically instructed before they look for diversity candidates or include them on their lists). As a result, progress on this issue, of a balanced representation of women on corporate boards, has been glacial, even imperceptible for 5–6 years now, both in the USA and in the UK, as well as in most other countries. The new quota laws in Norway (adopted 2003; effective 2008) and in France (adopted early 2011; fully effective 2017), which require that at least 40 per cent of publicly held corporation's directors be of the opposite sex, will, however, re-light the burner on this important issue in the years which lie immediately ahead. Faced with the prospects of government-enforced quotas, corporations are considering diversity more seriously than before as a key aspect of their commitment to effective corporate governance (Deloitte, 2011). How this translates into practice remains to be examined.

Diversity among executives and directors

As with the debate on women's representation on corporate boards, there is considerable controversy regarding the wider issue of diversity on boards. Sabina Nielsen of the Copenhagen Business School brings up to date a review of the studies and the literature on the subject of board composition (Chapter 15: *Diversity among Senior Executives and Board Directors*), delineating and discussing many differing aspects and types of diversity, some of which remain inchoate in the literature:

- Task-oriented diversity (knowledge, skills and abilities needed, such as technological or international backgrounds).
- Relations-oriented diversity (age, gender, ethnicity).
- Demographic diversity (readily detectable characteristics such as gender but also including race and nationality).
- Cognitive diversity.

Much of the literature focuses on board composition, but Sabina Nielsen reminds us the composition of the top management team (TMT) is deserving of attention as well. Historically, she points out, studies 'trying to link board diversity to firm performance have focused primarily on board gender diversity.' Nielsen directs us to more subtle ways in which gender diversity may contribute to board performance but without a demonstrable link to firm performance, such as the underlying values, personal experiences and backgrounds, and characteristics other than gender alone which females bring to the boardroom. Sabina Nielsen offers us an extensive research agenda. Overall, those who study board (and TMT) composition 'must open the 'black box' of board behavior and study directly the effect of board composition on board processes and dynamics.' They must undertake multi-variable ('multi-level') analyses because, in addition to recognizing that various types of diversity exist, we must also recognize that 'they may not be' and often are not 'independent from each other.' There is much food for thought here, as we continue to analyse and hypothesize about the relationships between diversity, in all its guises, and board behaviour, board dynamics and firm performance.

COMPETING GOVERNANCE REGIMES

The competing corporate governance regimes are explored in Part 5, investigating the sources of convergence, differentiation, contingency and complexity. Convergence towards one model of corporate governance was predicted in the 1990s; however, the apparent ascendancy of the market-based model associated with the Anglo-American regimes has diminished significantly with successive cycles of institutional and market failure, most notably the high-tech failures in 2001/2002 of Enron and WorldCom and others, and most catastrophically in the global financial crisis of 2007/2008. The movement away from single (USA) or dichotomous (USA/Europe) conceptions of corporate governance systems leads to conceiving of multiple potential configurations of viable governance practices associated with different legal systems, ownership structures and board characteristics. For example, one of the surviving traditional forms of governance which has wide influence throughout Asian economies is the business group. For a range of economic, political and cultural reasons family-owned conglomerates continue to dominate the private sector in many Asian countries. In this context of institutional variety and contingent corporate governance practices, the international effort to introduce codes of good practice in corporate governance becomes more difficult. Do international corporate governance codes represent exercises in enhancing transparency, accountability and performance or are they largely efforts at legitimating existing relationships and institutions without significant change?

Globalization of corporate governance

One of the liveliest debates in corporate governance has concerned the thesis that a global convergence towards the market-based system was not only desirable but also inevitable. This thesis developed in persuasive power with the renaissance of the high-tech, finance-based US economy in the 1990s, which restored the international ascendancy of the US economy, the fall of the centrally planned Eastern European regimes in the same period, and their eager embrace of market-based solutions to their economic restructuring (keenly encouraged by Harvard economists) and the deflating of the self-confidence of the burgeoning East Asian economies with the Asian financial crisis in 1997. The Anglo-American shareholder-value-oriented model involved increasing emphasis on boards of independent directors with CEOs powerfully motivated by equity-based incentives. This model seemed to resonate with the times: the longest continuous market boom in business history, fuelled firstly by the NASDAQ and dot-com booms and,subsequently, by the massive growth of the finance sector with many trillions of new securities. In contrast to this, the stability of the European economies, generally typified by slower growth in more traditional industries, could be readily described by convergence proponents as a less efficient system based on outmoded institutions.

As Douglas Branson argues, the force of the convergence thesis has diminished considerably in recent times (Chapter 16: *Global Convergence in Corporate Governance: What a Difference 10 Years Make*). First, at the very time when the rest of the world was being urged by the OECD and World Bank to adopt an essentially Anglo-American mode of corporate governance as the most efficient, a series of major corporate collapses occurred in the USA, commencing with Enron and WorldCom, that undermined confidence in the robustness of this system. The fact that the early recovery of equity markets following these corporate failures led to a five-year period of extreme excess in corporate finance, followed by the global financial crisis of 2008–2009, casts doubt on the capacity of the Anglo-American system of regulation corporate self-discipline. The enforced adoption by Anglo-American corporations of reinvigorated risk management, and an orientation towards more sustainable enterprise, suggests a significant move away from the market-based model, rather than towards it. ‘Indeed, in the US emphasis has shifted away from the shareholder-oriented model to a sustainability model which dwells on restoring the effectiveness of the gatekeepers such as auditors, rating agencies, attorneys, the SEC, and others in containing risk.’

Perspectives on comparative corporate governance

The universe of corporate governance is often characterized as dichotomous between an Anglo-American world of common law, outsider-oriented, market-based systems and a European world of civil law, stakeholder-oriented, relationship-based systems. Ruth Aguilera, Kurt Desender, and Luiz Ricardo Kabbach de Castro, in contrast, argue that in fact there exist multiple configurations of firm characteristics and governance practices that may deliver effective corporate governance (Chapter 17: *Perspectives on Comparative Corporate Governance*). Although national models of corporate governance may have been helpful in examining how differences in institutional structures and shareholder rights determined differences in governance systems, the impact of financialization of the global economy, international investment institutions and the integration achieved through information technology has widened the range of combinations of governance practices that firms usefully may adopt. They insist that 'three governance characteristics (legal systems, ownership and boards of directors) cannot be conceptualized independently, as each of them is contingent on the strength and prevalence of other governance practices.' They urge researchers to move beyond country-level models of corporate governance to study the degree of freedom firms possess to embrace other governance practices. They conceive of multiple effective configurations of governance practices, with a need to examine the different industry and firm pressures to comply or differentiate from established practices.

If we accept that corporate governance concerns 'the structure of rights and responsibilities among the parties with a stake in the firm' (Aoki, 2001), a configurational approach identifies distinct, internally consistent sets of firms and the relations to their environments, rather than one universal set of relationships that holds across all organizations (as agency theory assumes). How corporate governance mechanisms interact and substitute or complement each other as related bundles of practices becomes the focus, with the theory of complementarity providing a basis to understand how the various elements of strategy, accountability, structure and processes of organizations are interrelated (Milgrom & Roberts, 1995; Aoki, 2001; Cassiman & Veugelers, 2006). Examining different bundles of practices Aguilera, Desender and Kabbach de Castro demonstrate how the legal environment, ownership structure, boards and directors and systems of corporate governance define 'the myriad of varieties of capitalism, that, ultimately, characterize corporate governance systems.' They conclude that the consideration of corporate governance bundles may be more rewarding at the firm level than the country level, and that comparative corporate governance should include exploration of 'the heterogeneity of bundles within countries in addition to comparing across countries.'

Business groups in Asia

As Marie dela Rama highlights, ownership and control of both large and small Asian private sector enterprises continues to be dominated by family businesses (Chapter 18: *Family-Owned Asian Business Groups and Corporate Governance*). Family-owned conglomerates typify large-scale enterprises in many Asian economies, resembling the network form of businesses such as the Japanese *zaibatsu*, post-war *keiretsu* and Korean *chaebols*. These Asian business groups are bound together in formal and informal ways, are the result of investments by a single family, or group of families, who keep the component companies together as a coherent group, shifting people and resources between them, while allowing individual companies to keep a separate identity. Colpan and Hikino identify the essence of these entities as 'legally independent companies [that] utilise the collaborative arrangements to enhance their collective economic welfare' (2010: 17). In economies where family-owned and family-managed corporations are pervasive the principal–agent premises of agency theory disappear as 'clan control implies goal congruence between people, and therefore the reduced need to monitor behaviour or outcomes.' (Eisenhardt, 1989: 64).

Business groups internalize the functions for which no supporting institutions or external market exists (Colpan, Hikino & Lincoln, 2010: 7). The institutional perspective adopted by Marie dela Rama sees business groups as filling the voids due to inefficiencies in the national capital, labour and product markets. The relationship of business groups with the state is fundamental and in most of Asia this relationship determines the manner in which business groups may operate. Often in Asia, business groups are the beneficiaries of state-sponsored industrialization, facilitating business group formation, while sometimes frustrating wider economic growth by inhibiting the entry of new firms into the economy (Carney, 2008: 603).

Finally, concentrated ownership in business groups tends to compensate for weak legal protection in the wider economy. Marie dela Rama states: 'While business groups may be the most *efficient* form in an *inefficient* market, because of their size, domestic business groups have an almost unassailable advantage over new entrants with foreign ownership restrictions in developing economies – in most cases – unilaterally favouring domestic participants.' Family-owned business groups share many of the unique governance traits of family-owned businesses except their scale and scope are magnified: the extent of externally funded finance and professionalization in family-owned business groups are signs of their maturity, complexity and wider participation of the market.

Governance best practices

The course of corporate governance in recent decades was punctuated by the development and application of a series of corporate governance codes at both the national and international level. Codes of corporate governance represent good practice recommendations for boards of directors and corporate governance systems, which are intended as largely voluntary means to assist the improvement and reform of corporate governance (reinforced by market perceptions of the adherence of corporations to what are believed to be good governance practices). The adoption of different codes was encouraged by different institutions, including stock exchanges, government regulatory authorities, professional associations and institutional investor bodies. The intention was to address deficiencies and weaknesses in standards of corporate governance, and to promote transparency, accountability and performance. Zattoni and Cuomo (2008, 2010) identify two opposing views explaining the introduction of corporate governance codes: the first view affirms that codes of practice have been introduced to improve the corporate governance of listed companies and the efficiency of capital markets; the second view suggests that corporate governance codes have been adopted mainly for legitimizing the listed companies and the national stock exchanges (Fernandez-Rodriguez, Gomez-Anson & Cuervo-Garcia, 2004; Hermes, Zivkov & Postma, 2006). 'Early adopters are driven to change by efficiency reasons, while late adopters are driven to conform to widely accepted practices. The common law countries as early adopters of codes of good governance provided the legitimacy for innovation; civil law countries, as late adopters, were then under pressure to implement the reforms for fear of losing legitimacy' (Zattoni & Cuomo, 2008: 12).

Hence there is often debate concerning the intent of the international codes that have pursued the harmonization of corporate governance, as international financial institutions have impelled the integration of financial markets. For example, the OECD *Principles of Corporate Governance* (1998, 2004) have been criticized for offering an essentially Anglo-American market-based approach for the rest of the world to adopt, despite the continued existence of regional institutional differences (Aoki, 2001; Hall & Soskice, 2001; Aguilera & Jackson, 2003; Clarke, 2012a). In these circumstances, the adoption of corporate governance codes may often prove symbolic, intended to impress investors, and perhaps deterring more substantive reforms (Zattoni & Cuomo, 2008: 12).

A polemical critique of both the efficiency and legitimacy views of corporate governance best practices is offered by Shann Turnbull (Chapter 19: *The Limitations of Corporate Governance Best Practices*). He argues there is no agreed basis for defining what good governance is, and the financial indicators such as share price, which are often employed as a proxy for good governance, neglect the resilience and durability of companies, the effectiveness of their risk management and their accountability not only to investors but also to the wider community of stakeholders and the environment. Furthermore, he insists that the evaluations by governance ratings agencies that are based on adherence to the published codes become an exercise in self-justification. Examining how corporate governance developed historically, Shann Turnbull radically questions the efficacy and credibility of not only corporate governance codes but also other central planks of the corporate governance reform movement, including the independence of external auditors when they are hired by the management of the company they audit and the independence of directors when they become identified closely with the company and its management, rather than the shareholders and wider stakeholders. Turnbull's exacting critique is a sharp reminder of the limitations of the existing corporate governance systems, and some of their inherent weaknesses. However, the radical utopian view of an alternative economic system with smaller, time-limited corporations engaged in more open competition – that Shann Turnbull offers as an alternative – is not an immediate prospect.

DILEMMAS OF CORPORATE GOVERNANCE

The enduring dilemmas of corporate governance are considered in Part 6, including executive pay, shareholder value, and the relationship of governance to innovation and the efficacy of corporate regulation.

Executive reward has long been one of the most controversial subjects of debate in corporate governance, and in recent years this has reached a crescendo during the global financial crisis, as finance executives insisted on retaining what were publicly perceived as excessive and unmerited bonuses, at the very time in 2008 and 2009 when their institutions had failed, and they were in the course of being rescued by huge injections of taxpayers' money. In corporate governance scholarship there are contrasting views on executive pay. The *managerial power* view holds that executive pay is excessive and out of control due to poorly designed remuneration contracts (Bebchuk & Fried, 2004, 2006; Bertrand, 2009; APC, 2009; Clarke, 2012b). In contrast, the *optimal contracting* view adopts an economic approach to the executive labour market, and suggests that though executive contracts may not be perfect, they serve to minimize the contracting costs between shareholders and managers in a complex relationship with asymmetric information (Core, Guay & Thomas, 2005; Core & Guay, 2010). There are many technical and behavioural complexities to confront in the analysis of executive reward, but the greatest mystery is why there was an explosion in US executive reward that has subsequently impacted upon inflation in executive reward around the world. A group of US and European researchers, attempting a transatlantic analysis of the executive compensation controversy, reached the following considered view:

> Ultimately, we conclude that the early 1990s created a 'perfect storm' for an explosion of option grants in the USA for not only executives but also for lower-level managers and employees. First, options were considered a 'safe-harbor' from the government's just-introduced $1 million cap on deductible compensation. Second, since options were not recorded as an expense on accounting statements, they were treated as'free' or cheap to grant (when, in fact, they are especially expensive ways to convey compensation). Third, government policies and stock-exchange listing rules encouraged firms to

> grant options to all employees, which in turn increased executive grants. Ultimately, too many options were granted to too many people. The explosion in option grants continued unabated until the burst of the Internet bubble in 2000, followed by a series of accounting scandals that re-focused attention on the accounting treatment of options. Eventually, FASB mandated expensing, and companies moved away from options towards restricted stock, which largely stopped the escalation in CEO pay. But, the 'option episode' permanently shifted pay levels for USA executives, which in turn has had global repercussions (Conyon, Fernandes, Ferreira, Matos & Murphy, 2010: 118–119).

The fierce debate surrounding executive pay will no doubt continue as long as executive reward continues to have a tenuous connection with performance, and remains vastly out of alignment with the rewards of other workers in the economy and society (Thomas, 2009; Conyon et al., 2010; Jensen et al., 2011). As successive regulators have discovered, understanding the complexities of executive reward, and intervening effectively, is a highly complex task (APC, 2010); however, allowing executive reward to become a key driver of business strategies carries its own consequences (Davis & Useem, 2002; Lazonick & O'Sullivan, 2000; Lazonick, 2007). When executive incentives are aligned to the insistent demands of short-term investors, the results for corporations can be particularly destabilizing. The combination of executive options and share buybacks has drained investment resources from US companies and weakened their innovative capacity. Different governance systems sustain different forms of innovation, and discovering how different institutional configurations may accelerate processes of innovation is important. A final and growing dilemma in corporate governance is in comprehending the structures of complex entities, conglomerates and groups. Increasing complexity of the corporate form makes both governance and regulation immensely challenging, as was revealed in the fall-out from the financial crisis, when huge groups such as Lehman Brothers tightly embraced countless other companies in counterparty risk.

Executive pay

A comprehensive analysis of executive compensation in the USA is provided by Conyon and Peck (Chapter 20: *Executive Compensation, Pay for Performance and the Institutions of Pay Setting*). They examine theoretical models of executive compensation from an agency perspective investigating the objective function that is being optimized, and agent behaviour. They investigate executive compensation contracts in practice, including the cash, bonus and options components. Bonus payments are usually made on the basis of internal accounting measures such as budgeted earnings or profits; in contrast, equity-based pay, including options, are linked to share market performance in measures such as share price returns relative to the market. They focus on stock options. which from a principal–agent view, have provided highly geared incentives for CEOs to promote value creation, and the implications of this for risk-taking. 'Stock options are the right but not the obligation to purchase a share in the firm at some pre-specified date in the future.'

Conyon and Peck argue that is because in the USA:

> CEOs build up a significant portfolio of firm related equity, they have incentives that align their interests to shareholders. Differences between pay (or expected pay), while relevant for understanding what boards pay their CEOs in any given year needs augmenting with this broader appreciation of total option and stock holdings when considering the real pay for performance sensitivities. In this sense, we think that there is ample evidence to suggest that executive pay is linked to firm performance. Indeed, the available empirical evidence shows that pay-at-risk forms the majority component of a CEOs annual package.

Finally, Conyon and Peck examine the institutions of executive pay setting, looking at how boards of directors and compensation committees, with compensation consultants, set executive pay, concluding that although there may be room for improvement in response to changing conditions, the current system appears to safeguard shareholders' interests.

Impact of shareholder value

Executive compensation, especially US-style equity-based incentive compensation, has supplanted the takeover bid as a subject for corporate governance research and scholarship. In his chapter (Chapter 21: *In the Name of Shareholder Value: How Executive Pay and Stock Buybacks Are Damaging the US Economy*), Bill Lazonick of the University of Massachusetts, undertakes a deeper and more expansive consideration of the impact of executive incentives on the direction of US industry. He demonstrates how excessive grants of stock options, devoid of meaningful performance hurdles, and stock buyback programmes of never-before revealed proportions (to boost stock prices and thereby enlarge even more profits from executive options) have robbed the US economy of several essential attributes, which, historically, had been its strengths. One attribute has been the US economy's traditional unquenchable thirst for, and investment in, innovation. For example, US information technology companies, which led the world in 1990s innovation (Microsoft, IBM, Cisco, Intel, Hewlett-Packard), 'spent more (much more except Intel) on stock buybacks than they spent on R & D on 2000–2009.' Bill Lazonick has written extensively on how the ideology of shareholder value has undermined the innovative enterprise, and contributed to economic instability and social inequality and insecurity (Blair, 2009; Lazonick, 2009, 2010).

Another attribute of the US economy depleted by stock buybacks was the maintenance of financial reserves which would have enabled companies to survive the 2008 crash of the derivatives markets, and would have allowed companies to de-leverage when excessive amounts of financial leverage had become millstones around their necks. The financial firms (Citigroup, Merrill Lynch, Lehman Brothers, Wachovia, Washington Mutual, Fannie Mae, to name a few), many of whom failed, had previously used up precious reserves in order to fund stock buybacks, which in turn made already overcompensated executives even wealthier. Why did senior executives willingly diminish the financial strength and resilience of major corporations in this reckless way? Lazonick contends: 'The ideology of maximizing shareholder value is an ideology through which corporate executives have been able to enrich themselves.' The economists' and corporate executives' mantra from 1980 until the 2007–2008 meltdown of shareholder value and the need to 'disgorge … free cash flow (Jensen, 1986: 323) translated into executive option grants and stock buybacks, and resulted in increasing dramatically those executive options' value.' This chapter examines how option grants and stock buybacks work in tandem to enrich executives and weaken companies. It explicates the damaging effects the pursuit of shareholder value has upon modern firms' other (other than shareholders) 'residual claimants,' such as employees. The latter often make greater, often non-contractual and open-ended, commitments to enterprises than do shareholders today, while the true innovators and other residual claimants are bound to what too often overcompensated executives have converted into listing or even sinking corporate vessels.

Corporate governance and innovation

Examining further the relationship of governance and innovation, how different governance systems sustain different forms of innovation is explored by Ciaran Driver (Chapter 22: *Governance, Innovation and Finance*). He investigates how different theories of corporate governance help an understanding of innovation, with a fault line dividing the agency view of governance as essentially structures for resolving conflicts and reducing contract costs, and the dynamic capabilities view which sees governance as structures for enterprise and innovation (Helfat & Teece, 2010). For some theoretical approaches the emphasis is upon the coordinating role of the firm, while for the more externally focused such as the resource-based approach, 'the coordination feature of the firm is a more positive and indeed more problematic exercise involving planning in an uncertain world, shaping markets through investment and innovation' (Chandler, 1992; Foss, Lando & Thomsen, 2000).

Different systems of governance appear to be better at doing different things (Clarke, 2011a). Driver highlights the contrasting orientations of liberal market economies and coordinated market economies: stability of employment for specialist labour in coordinated market economies favours incremental innovation, while ease of redeployment of people and assets in liberal market economies favours radical innovation. Hence, shareholder-dominated governance of liberal market economies is suited to evolving new technologies and de-maturing older technologies with access to liquid capital markets and less labour bargaining power, whereas the stakeholder governance of coordinated market economies is better at incremental innovation with skilled, secure and autonomous workers.

This pattern of institutional differences survived successive waves of international industrial restructuring. However, the shift in the locus of power from executive managers to finance markets was a destructive focus on disgorging surplus through share buybacks and dividend payments (Lazonick, 2007). 'Theory has yet to come to terms with the chasm between financial markets misallocation revealed by the credit crisis and the hubris in respect of external allocation that preceded it.' The global financial crisis revealed governance and investment institutions out of alignment with any sense of balance business development. Driver concludes:

> The question of ownership form requires more debate, because the capacity to generate innovation and enterprise within firms may indeed depend on this. To be sure there are varieties of governance for different circumstances and historical settings. But it is unlikely that innovation will be served by a combination of dispersed owners with outsider boards that rely on simple metrics; institutional funds that enforce short-term pressures; or governance structures that are too unbalanced to permit an adaptation role. We need to pin down more exactly which ownership and institutional forms are friendly to organisational learning in different contexts.

Corporate governance of complex entities

One area of innovation that has proceeded at a pace, is in the innovation of corporate forms. As corporations have developed substantially in scale and activity in the last century, they have acquired additional layers of complexity, often to the point of being impenetrable to the external observer (and sometimes to the reach of the law). Ordinarily, we tend to think in terms of a single corporate entity or of a relatively simple corporate group, consisting perhaps of a parent company and several subsidiary corporations. In his chapter, John Farrar treats with a technical, complex facet of modern business life: the large and sprawling, often multi-layered, corporate group, and does so in a straightforward, understandable manner (Chapter 23: *The Governance and Regulation of Complex Conglomerates*). These far flung corporate groups have evolved quite rapidly, particularly in the financial services area, and it is with the latter that John Farrar deals. The recent near-death experience of the global financial crisis brings to the fore the subject of the insolvency which has occurred of such complex groups as Lehman Brothers, and may well occur again. United States courts deal with group insolvencies by use of substantive consolidation while Irish and New Zealand courts do much the same by means of pooling orders. By contrast, Australian and UK courts do not have at their disposal these flexible devices which can be of significant aid in dealing with a group insolvency.

Whether courts do or do not posses these tools, the insolvency of a large financial conglomerate poses systemic risks which may destabilize a national, regional or even international financial system, as we learned in 2007–2008. HIH in Australia, and AIG and Lehman Brothers in the U.S. are examples of the swift demise and far-reaching ramifications of such bankruptcies. These and other imbroglios involving large financial services firms highlight the poignancy of being able swiftly and competently to deal with these gargantuan cases. Just the contractual tentacles, numbering in the millions, created when these large financial conglomerates act as counterparties with respect to derivatives and similar complex financial arrangements boggle the mind. The European Union staff in Brussels, the Prudential Regulatory Authority in Australia, and the Federal Deposit Insurance Corporation in the United States, among others, have begun to grapple with the complexities such large, multi-faceted financial institutions' insolvency pose. John Farrar takes his readers well down the road toward understanding the scale of the complexity and the extensive ramifications in the event of corporate failure of complex entities.

EMERGING ISSUES: GOVERNANCE AND SUSTAINABILITY

The emerging issues facing corporate governance are confronted in Part 7: issues of sustainability, not simply of governance systems, but global issues of the sustainability of corporations, markets, economies and of the planet. In the history of industrialism, corporate governance has encountered many challenging problems, but the issues faced today are of a different order of magnitude in their scale, complexity and urgency. The global financial crisis of 2007/2008 revealed how international, interconnected and unknown risk has become. Regulatory responses seem to inevitably follow the business cycle, and whether present regulatory initiatives will serve to limit the next crisis remains to be seen. Meanwhile, corporations face a new set of imperatives in the demands for social and environmental responsibility. Responsibilities for human rights violations were once lost in concealed and remote value chains, which are now becoming exposed, and return to haunt corporations. The environmental impact of corporate activity is also more apparent now than ever before, and environmental responsibilities are pressing in upon corporate governance in a way never experienced before. Whether corporations are able to work effectively towards becoming environmentally sustainable in partnership with governments and communities is the greatest governance task ever encountered.

Global financial crisis

The prolonged systemic crisis in international financial markets commencing in 2007/2008 was also a crisis in corporate governance and regulation. The ascendancy of Anglo-American markets and governance institutions was based on the apparent sophistication and efficiency of this system in the management of finance and risk. Yet this complex, over-leveraged, and integrated international financial system produced the first truly global financial crisis impacting on all regions and countries; involving the collapse or near collapse of many major financial institutions in a wide number of countries; demonstrating the ineffectiveness of all forms of existing regulatory apparatus; and necessitating the intervention of internationally coordinated state action to salvage financial markets on a scale unprecedented (and unimaginable) in earlier times. Clarke analyses the central causes and consequences of the global financial crisis, and highlights the systemic governance and regulatory failures that compounded the crisis. (Chapter 24: Markets, Regulation and Governance: The Causes of the Global Financial Crisis). A direct consequence of the global financial crisis and the huge cost to western governments of rescuing the financial institutions and stimulating back to life damaged economies was the ensuing sovereign-debt crisis of 2010/2011. This long progression of financial crises around the world serves as a reminder that the international financial system is neither self-regulating, nor robust and is certainly not well governed.

Regulatory responses

How corporate governance regulation follows the business cycle is analysed by Alice Klettner (Chapter 25 *Corporate Governance and the Financial Crisis: the Regulatory Response*). The massive dislocation and costs to society caused by the global financial crisis have justified robust regulatory intervention designed to minimize the risk of any recurrence. The immediate priority of governments that joined in the efforts of the G20 was to take emergency measures to halt the spread of the crisis and rescue failing financial institutions. This was followed by huge stimulus packages to induce economic recovery. The G20 then focused on regulatory and financial market reform. This chapter details the specific reforms in the United States, Europe, the United Kingdom and Australia. Since the crisis originated in the finance sector, the reform of prudential regulation was a priority, with revision of the rules regarding capital adequacy, liquidity and leverage ratios. However, this chapter concentrates on the corporate governance reforms in the finance sector, revolving around four overlapping issues – executive compensation, board effectiveness, risk management and shareholder engagement. A picture emerges of financial institutions drifting towards the rocks with no firm hand on the tiller:

> There were significant failures of risk management systems in some major financial institutions made worse by incentive systems that encouraged and rewarded high levels of risk-taking. Since reviewing and guiding risk policy is a key function of the board, these deficiencies point to ineffective board oversight. … Risk management systems have failed in many cases due to corporate governance procedures rather than the inadequacy of computer models alone: information about exposures in a number of cases did not reach the board or even senior levels of management, while risk management was often activity rather than enterprise-based (Kirkpatrick, 2009).

A range of international and national reports on the causes of the financial crisis acknowledged that, frequently, boards of directors had not fulfilled their task, often dominated by CEOs 'who stifled critical enquiry and challenge essential for objective, independent judgement' (OECD, 2010: 17). Regulators called for more active and engaged boards 'ready able and encouraged to challenge and test proposals on strategy put forward by the executive' (Walker, 2009: 15). The Turner Review in the UK highlighted many cases where risk management in financial institutions was not effective, with boards of directors failing to identify or constrain excessive risk taking and recommended:

- a more direct relationship between senior risk management and board risk committees;
- remuneration policy to take account of risk management considerations;
- improvements in the skill level and time commitment of non-executive directors; and
- more effective communication of shareholder views to non-executives (FSA, 2009).

In the USA there was a determination to hold Wall Street accountable, protect consumers, close the gaps in the regulatory system, and encourage sustainable growth with greater transparency. The Dodd–Frank Act (2010) was a major attempt to wrestle with the problems encountered during the crisis in the finance industries. With reference to corporate governance, Dodd–Frank introduced a non-binding shareholder vote on executive pay, increased disclosure on executive pay and its relation to performance, and a requirement that banks and other financial entities establish risk committees. Across the world, legislative and regulatory initiatives continued to unfold through 2010–2012, and it will be many years before we can judge their effectiveness. Regulatory reforms have to respond to changing contexts and threats, and it remains difficult to anticipate the causes of the next major financial and corporate governance crisis. Whether regulation may be developed to prepare for the next cycle of crisis and reform, rather than simply respond to the last cycle, remains an open question.

International corporate responsibility

In a tour de force, Paul Redmond (Chapter 26: *International Corporate Responsibility*) gives us a detailed global portrait of corporate social responsibility (CRS) and its overlapping international human rights dimension, including its strengths, its weaknesses and the gaps which exist. 'Human rights treaties are agreed upon internationally but implemented nationally.' These treaties form part of the law of nations which, first and foremost, governs nations, not corporations or similar actors. By ratifying these treaties, however, individual nation-states pluck these human rights from the firmament, bringing them down to the ground, where individual corporations should observe and respect them. It has taken a long time for international corporations to acknowledge their responsibility for human rights in the activities they undertake in many countries, but they can no longer claim the ignorance of such matters that guided them in the past.

This process of acknowledging and protecting human rights, though, is subject to recurrent neglect, as rogue and near-rogue nation-states seek a comparative advantage by enforcing human rights nominally only, or not at all (whether the international corporations involved turn a blind eye to this, or in fact encouraged the official neglect in the first place). By making the competition among nation-states more visible and more intense, globalization exacerbates the situation. Prospects of inclusion into global supply chains increase the incentives for newly developing countries to be lax, permitting domestic suppliers to become willing players in what has been termed plantation production. Observance of and protection for human rights goes out the window. Capital flies to jurisdictions seen as most willing to accommodate global players with lax or non-existent human rights regimes, who often operate through distant subsidiaries or 'independent' contractors in the rogue states.

Antidotes to this race for the bottom have included individual companies' and others' codes of supplier conduct, as well as the activities of CSR non-governmental organizations (NGOs) which also draft codes of conduct and monitor, or even audit, compliance (Fair Labor Association, Fair Trade International, Marine Stewardship Council, Ethical Trading Initiative, Forest Stewardship Council, to name a few). Certain of these NGOs have promoted eco-labelling, green labelling and other certification processes. Professor Redmond's chapter contains an encyclopedic description of these active international human rights organizations. However, on the other side of the ledger, international human rights advocacy is plagued by a sometimes weak business case for increased enforcement, free rider effects, and weak monitoring and enforcement.

Professor Redmond ends his chapter with a lengthy discussion of the United Nations' extensive initiatives in the area, beginning with the draft Code of Conduct for Transnational Corporations (1975). He does see promise in the work of UN Special Representative John Ruggie and the 'Protect, Respect, and Remedy' framework, and guiding principles which illuminate it.

Governance and sustainability

The frontier of corporate governance is explored in the final chapter by Suzanne Benn (Chapter 27: *Governance for Sustainability: Challenges for Theory and Practice*). In the past, corporations committed to wealth generation largely in a narrow economic and commercial sense. The wider social and environmental impacts of corporate activity were dismissed by corporations as *externalities*. Governments, communities and people could attend to the incidental social and environmental damage caused by corporate activities was the dominant mercenary sentiment. This coarse commercial ideology, which blighted the development of industrialism, is no longer tolerable in a globalized world with an endangered and fragile ecology, universal environmental dilemmas and demographic and socio-economic challenges greater than ever before. Corporations are having to confront their social and environmental responsibilities in accountable and transparent ways, and to make their social and environmental impact as benign as possible. The *materiality* of social and environmental sustainability is becoming increasingly apparent (Benn & Dunphy, 2007; Clarke, 2012a; UNEP FI, 2010; WBCSD, 2010; WBCSD, 2011). The integration of corporate governance with the concerns of corporate sustainability is proceeding, and boards and directors of companies are becoming increasingly aware that what is at stake is their *license to operate*. If corporations do not voluntarily respond to the sustainability imperative, then ultimately regulation will ensure they do.

Though compliance-driven approaches were once typical of corporate responses to the sustainability challenge, there is now evidence of a substantial increase in the range, significance and impact of corporate social and environmental initiatives. Corporate social and environmental responsibility appears to be becoming established in many corporations as a critical element of strategic direction, and one of the main drivers of business development, as well as an essential component of risk management (KPMG, 2010; UN GC, 2010). Corporate social and environmental responsibility seems to be moving from the margins to the mainstream of corporate activity, with greater recognition of a direct and inescapable relationship between corporate governance, corporate responsibility and sustainable development.

However, unresolved issues remain: questions continue to be addressed regarding the integrity of corporate commitments to social and environmental responsibility; and the verifiability of corporate social and environmental activities and outcomes. Despite pressure from consumers, the growing interest of investors in sustainability, and the insistent calls for corporations to be accountable to a broader range of stakeholders, it is often contended there are limits to the corporate virtue:

> There is a place in a market economy for responsible firms. But there is also a large place for their less responsible competitors. … Precisely because corporate social responsibility is voluntary and market-driven, companies will engage in corporate social responsibility only to the extent that it makes business sense for them to do. Civil regulation has proven capable of forcing *some* companies to internalize *some* of their economic activities. But corporate social responsibility can reduce only some market failures (Vogel, 2005: 3–4).

Whether corporations are able to work effectively with investors, stakeholders, communities and governments to collaborate to solve complex and demanding social and environmental problems that threaten to undermine economies and societies remains to be seen. This would involve a fundamental redesign of the role of the corporation and the institutions of the market.

These are the scenarios that Suzanne Benn investigates in her examination of different potential systems of governance for sustainability. The enormity of the current challenges of social and environmental governance are so great, that traditional theories of markets and democracy are not equipped to deal with these issues, and nor is conventional management theory. ‘The leading forms of management theory have real problems in contributing to how managers can deal with the competing interests associated with societal good, environmental protection, the distribution of environmental or social risk and economic viability.’ In this context it is instructive to assess the significance of the emergence of more radical governance theories , and a range of approaches are considered including reflexive modernization, deliberative democracy, radical pluralism, new institutionalism, ecological modernization, and ecological democracy. The search is for:

> A more productive model of governance which emphasises organisational leadership geared to diversity, communication, flexibility, reflexivity and inclusion. … This model fosters the trusting relationships necessary for managing issues of environmental and social risk for the long term while taking into account real difference in the interests of stakeholders. … This more collaborative and inter-organisational perspective on governance appears more relevant to contemporary organisations, facing responsibilities such as addressing issues of intergenerational equity and globalisation (Kochan, 2003).

CONCLUSION

Corporate governance is an important emerging discipline but remains at an early stage in its evolution in terms of the advance of theory and policy. Corporate governance in practice is involved in a process of continuous evolution in response to changing business contexts, strategies and objectives of corporations and their stakeholders. The cyclical tendency of corporate governance to reflect the business cycle shows no signs of abating, and though the post-global financial crisis regulatory initiatives are aimed at applying counter-cyclical pressure, whether this will succeed in restraining the irrational exuberance of the future is an open question. There is no perfect model of corporate governance or regulation to guide us, which makes it doubly imperative that there is the freedom to develop and apply diverse approaches to governance as long as they operate within frameworks of openness and accountability.

In preparing for the economic challenges ahead the industrial world is confronting two inescapable tasks: the first is the necessity to rejuvenate mature industries and to create new, innovative industries. The second – and much greater challenge – is to achieve social and environmental sustainability in all economic activity. It is difficult to imagine how economic reforms directed simply at developing the market mechanisms and shareholder value of the Anglo-American corporate governance model could possibly contribute substantially to either of these challenges. New modes of corporate governance and regulation will be required to achieve balance and sustainability.

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PART 1

Origins and Development

The Evolution of Corporate Governance

R.I. (Bob) Tricker

Corporate governance is as old as trade. Only the phrase 'corporate governance' is relatively new. Shakespeare understood the challenges involved. Antonio, his Merchant of Venice,[1] worried as he watched his ships sail out of sight. But his friends reminded him that he had entrusted the success of the venture and his fortune to others: no wonder he was worried.

In this chapter we trace the development of corporate governance ideas and practices through the years, from the governance of merchant ventures, through companies set up by trading empires, to the brilliant invention of the limited liability company (LLC) in the19th century, which opened the door to the bludgeoning ambiguity, complexity, and rapid changes in corporate governance today.

Whenever the owners or members of an organization hand responsibility for running their enterprise to agents, corporate governance issues inevitably arise. Corporate governance is about the challenges that principals face as they try to exercise power over their agents. Corporate governance is relevant to profit-orientated companies, both public and private, not-for-profit organizations including health authorities, educational institutions, charities, and sports organizations, as well as governmental corporate entities and quangos.[2]

THE EARLY DAYS – MERCHANTS AND MONOPOLISTS

The father of modern accountancy, Luca Pacioli, born in Italy around 1446, undertook voyages for the Venetian merchant Antonio de Rompiasi. Later, he wrote a mathematical treatise, which included an explanation of double-entry book keeping. At that time, most merchants used single-entry accounts, recording each transaction as a movement of cash. Pacioli's system reflected relationships between buyer and seller, debtor and creditor, principal and agent. It was an early exercise in corporate governance. In the 1470s, Pacioli became a Franciscan monk, which is why he is sometimes called Frater (Brother) Luca de Pacioli.

Throughout the 17th and 18th centuries, Holland, Portugal and Spain competed with

England to build empires both economically and militarily. The Dutch East India Company was granted a charter by the Republic of the Netherlands in 1602 to carry out colonial activities and trade with Asia. The Dutch West India Company was chartered in 1621 to run the slave trade between Africa, the Caribbean and North America. Both companies were joint-stock companies, issuing stock to their investing stockholders.

In 1600, England's Queen Elizabeth I granted a Royal Charter to the 'Governor and Company of Merchants of London trading to the East Indies'. The charter gave the company, known as the Honourable East India Company, a monopoly over all trade between England and Asia. The East India Company was a joint-stock company, with over 1,000 stockholders at one time, who elected a governing body of 24 directors each year. The company was a powerful force for nearly three centuries, trading principally with India and China in cotton, silk, tea and opium. At one time the company administered parts of the British Indian Empire and ran a private army. The company was finally wound up in 1874.

The Hudson Bay Company was created by Royal Charter in 1670. Two Frenchmen, Radisson and des Groseilliers, had developed a profitable fur trading business in the Hudson Bay area of what is now Canada, but failed to raise capital from France or the America states to develop it further. Prince Rupert, cousin of King Charles II, saw the opportunity and persuaded the English King to grant the 'lands of the Hudson Bay watershed to the Governor and Company of Adventurers of England trading into Hudson Bay'. This company survived until the 1820s, when it merged with a rival concern.

As happened many times subsequently, as we shall see, the success of corporate ventures and the lack of sound corporate governance led to unrealistic expectations, corporate collapses and fraud.

The South Sea Company was given a monopoly in 1720 by the British House of Lords to trade with Spain's South American colonies. The company undertook to guarantee the British national debt at a guaranteed interest rate, which led to massive speculation in its stock. Then the bubble burst. Many of the British gentry, including two mistresses of King George I, lost their fortunes. The directors of the South Sea Company were arrested and their wealth confiscated.

In France in 1716, John Law set up a private company, the Banque Générale Privée, which issued paper money for the first time. In 1718, with the support of King Louis XV, this company became the Banque Royale. Then Law created the joint-stock company Compagnie d'Occident, otherwise known as the Mississippi Company, to develop the French colony in Louisiana. Law marketed the economic potential of Louisiana aggressively and the company prospered. Stockholders were paid dividends in paper money. The bank and the company merged, with Law as the Controller-General. Then in 1720, the bubble burst. Stockholders tried to redeem their paper money, which the bank could not meet. The company failed and Law fled to Belgium.

Just as today, voices were raised against such corporate excesses and risks. Adam Smith (1723–1790), a moral philosopher at the University of Glasgow and for a while at Oxford, was prominent. Many consider Adam Smith to be the father of modern economics.[3] He argued that society benefitted as individuals pursued their own self-interest, because the free market then produced the goods and services needed at low prices. But he was suspicious of businessmen, as are many academics to this day. His oft-quoted comment on their behaviour offers a classic corporate governance perspective:

> The directors of companies, being the managers of other people's money rather than their own, cannot well be expected to watch over it with the same anxious vigilance with which they watch over their own. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.

THE ADVENT OF THE JOINT-STOCK, LIMITED LIABILITY COMPANY

By the 19th century, Britain was a dominant power both economically and militarily. Her empire embraced Australia, Canada, India and much of Africa. The Industrial Revolution was at its height and businesses needed capital to expand faster than could be achieved by ploughing back profits. Moreover, an increasingly affluent British middle class had money to invest. But there was a significant dilemma: if a business became bankrupt, its creditors could sue the owners until, ultimately, they too became bankrupt. Worse, in those days not paying your debts was a crime leading to debtors' prison and the possibility of your family ending up in the parish workhouse, which was something of a disincentive to invest in businesses run by others. Non-executive investment in proprietorships, partnerships and joint-stock companies was suspect. Then all that changed: the limited liability company was invented.

In 1855, the British Parliament passed an act, extended by another in 1862, which created a form of incorporation that limited the liability of shareholders for their company's debts. A study of Hansard[4] at the time suggests that some legislators thought they were just protecting 'sleeping' partners, those not involved in management. France had had such a system – the *société en commandité par actions* – since 1807, which limited the exposure of non-executive investors, but gave executives unlimited liability. In the event, the British Parliament's form of incorporation exempted all shareholders, non-executive and executive alike, from liability for companies' debts.

Incorporation with limited liability was made available in Germany in 1884, but as in France, German company law, being based on prescriptive civil law, lacked the ability of the common law in Britain to learn from case precedents. Developments in the United States reflected the British experience, with individual states creating their own company law jurisdictions in the later years of the 19th century. Incorporation at the federal level was not, and is still not, available.

The classical concept of the limited liability company proved to be one of the finest systems man has ever designed. The key concept was the incorporation of a legal entity, separate from the owners, which nevertheless had many of the legal property rights of a real person – to contract, to sue and be sued, to own property and to employ. The company had a life of its own, giving continuity beyond the life of its founders, who could transfer their shares in the company. Crucially, the owners' liability for the company's debts was limited to their equity investment. Yet ownership remained the basis of power. Shareholders elected their directors, who reported to them. Company law was the underpinning of corporate governance.

The notion was elegantly simple and superbly successful. It has enabled untold industrial growth, the generation of massive employment and the creation of untold wealth around the world. Although the mid-19th century model now bears little relationship to the reality of modern corporate structures, complex ownership patterns and corporate governance processes, the original corporate concept remains the essential basis of contemporary company law.

EARLY 20TH-CENTURY DEVELOPMENTS – PRIVATE COMPANIES, THE SEC, AND COMPLEX CORPORATE GROUPS

For the rest of the 19th century, all companies that were incorporated in Britain were public companies formed to raise capital from outside investors. But early in the 20th century the owners of some family firms realized that, even though they were not seeking external capital, incorporating their businesses as limited liability companies would protect them from personal liability for the firm's debts. In Britain, a Private Companies Act was passed in 1907, which provided for the creation of companies that could not seek public subscription for their shares, and with restrictions on the number of shareholders, and reduced reporting requirements. Today, private companies on the state registers of companies vastly outnumber public companies.

The early years of the 20th century also saw significant developments among public companies. In the United States, the United Kingdom, and other economically advanced countries, the shareholders in many public companies had become numerous, geographically spread, with differing expectations of their investments. Many public companies were now listed on stock exchanges. For the first time institutional investors, such as pension funds and insurance companies, were investing. Owners were becoming remote from the companies they owned. Governance power had shifted towards top management.

Two American academics, Berle and Means,[5] studied major public companies in America and noted a growing shift of power to executive management from increasingly diverse and remote shareholders. They expressed concern about the growing power of large companies in society, observing that:

> The rise of the modern corporation has brought a concentration of economic power which can compete on equal terms with the modern state – economic power versus political power, each strong in its own field. The state seeks in some aspects to regulate the corporation, while the corporation, steadily becoming more powerful, makes every effort to avoid such regulation. … The future may see the economic organism, now typified by the corporation, not only on an equal plane with the state, but possibly even superseding it as the dominant form of social organisation.

Berle and Means' seminal work remains one of the most frequently cited works in corporate governance research to this day. The need to provide investors with some protection from over-powerful corporate boards was recognized at the federal level and led to the creation of the US Securities and Exchange Commission (SEC).

Berle and Means left a vital intellectual inheritance for the subject that was to become known as corporate governance: but not for another 50 years. In the meantime, the spotlight swung to management, with management teaching, management consultants and management gurus proliferating. The board of directors did not appear on the organization chart. The activities of boards and their directors remained the province of accountants and lawyers, enlivened by occasional anecdote and exhortation.

But companies proliferated, with the arrival of large, complex corporate groups, often created through merger and acquisition. There had been mergers in the late 19th century, but then a new company was formed to acquire the assets and liabilities of the merging companies, which were then wound up. In the early 20th century it was realized that companies could own other companies, and corporate complexity had arrived. Pyramids, networks of complex cross-holdings, and chains of listed companies, leveraging the lead companies, all appeared.

DEVELOPMENTS IN THE 1970s – AUDIT COMMITTEES, INDUSTRIAL DEMOCRACY AND CORPORATE ACCOUNTABILITY

In 1972, the Securities and Exchange Commission in Washington required US listed companies to create a standing audit committee of the main board, composed of independent outside directors. Independence was defined as having no relationship with the company, other than the directorship, that could affect the exercise of independent and objective judgement. This audit committee was to act as a bridge between the external auditor and the main board, ensuring that directors became aware of issues arising between the auditor and the company's finance department. This was a response to an increasingly litigious climate in the United States, in which disgruntled creditors and shareholders of failed companies sued the auditor, knowing that they were more likely to get recompense from the audit firm's 'deep pockets' of insurance cover than from the bankrupt company or its directors. This writer was commissioned in 1977 by UK audit firm Deloittes to consider whether similar audit committees would be appropriate in Britain. But it was discovered that, although many UK listed companies had a minority of non-executive directors, at that time there was no concept of director independence.[6] A private member's bill[7] calling for audit committees was tabled in the British Parliament in 1977 but failed.

During the 1970s, the European Economic Commission (EEC)[8] issued a series of draft directives on company law harmonization throughout the member states. The draft fifth directive, in 1972, proposed that the unitary board system, in which the board of directors had both executive and outside members, should be replaced by the two-tier executive board and supervisory board governance system practised in Germany and Holland. In this form of governance, the supervisory board monitors and oversees the work of the executive board, which runs the business. No overlapping membership is allowed between the boards. Moreover, the directive required the supervisory board to be made up of equal numbers of shareholder and employee representatives. This reflected Germany's co-determination thinking, in which a company is seen as an informal partnership between capital and labour. The British response was a report by a committee chaired by Lord Bullock,[9] which suggested that the unitary board should continue, but should include worker directors elected by the employees. Neither the EEC's directive nor the Bullock proposals were well received in British boardrooms, and eventually both proposals failed.

Another interesting development in the 1970s was a concern expressed about the rightful place of the corporation in society. Reappearing 30 years later as 'corporate social responsibility', the argument was made that large public-listed companies affected the interests of many stakeholders – employees, customers, suppliers and others in the added-value chain, the local community, and the state – and should account to and, some argued, be responsible to them.

In the United States, the American Bar Association called for a broadening of corporate responsibilities beyond increasing shareholder value. The Corporate Roundtable, representing directors of major companies, strongly disagreed. Jensen and Meckling,[10] whose work was subsequently to become crucial to the development of corporate governance through agency theory, questioned whether the concept of the company could even survive.

The debate was picked up in the United Kingdom. A committee of the Confederation of British Industries, chaired by Lord Watkinson,[11] reported on the wider responsibilities of the British public company. The Accounting Standards Steering Committee[12] produced a seminal paper that called for all economic entities to report publicly and accept accountability to all those whose interests were affected by the directors' decisions. The inevitable erosion of managerial power soon consigned this report to the top shelf.

During the 1970s, board-level problems featured in a number of Department of Trade inspectors' reports of British company failures. In Pergamon Press (1971), the inspectors concluded that Robert Maxwell should not again be allowed to run a public company; that advice was ignored, enabling him to build a media empire which collapsed dramatically many years later. Rolls Royce (1973), London and County Securities (1976) and Lohnro Ltd (1976) all set the scene for subsequent concerns about the governance of companies.

DEVELOPMENTS IN THE 1980s – ABUSES LEAD TO THE RECOGNITION OF 'CORPORATE GOVERNANCE'

Unlike the 1970s, which had seen some trying economic struggles around the world, the 1980s heralded a period of significant economic growth in many parts of the world. Multi-national companies expanded dramatically, institutional investors became significant and in some countries state enterprises were privatized. Concerns about the way companies were controlled and held accountable were overshadowed by their commercial success. But corporate abuses continued.

In the United States, the investment house Drexal Burnham Lambert, together with Michael Milken, head of its junk-bond department, were investigated by the SEC in 1986 and two years later were accused of insider trading, stock manipulation and failure to disclose ownership. According to the court papers, Milken had a secret agreement with Ivan Boesky, another name to go down in corporate governance history, to exchange insider information and hold stock for each other in violation of securities law. After plea bargaining, Drexel paid a fine of US$650 million in 1988 and Milken was sentenced to 10 years in prison and permanently barred from the securities industry, although he was released after less than two years for cooperating with testimony against his former colleagues.

In Australia, a 1989 report from the National Companies and Securities Commission[13] on the collapse of Rothwells Ltd, a listed financial institution, commented that 'at no time did the board of Rothwells perform its duties satisfactorily.' The company was dominated by an entrepreneurial figure, Laurie Connell, based in Perth, Western Australia. Connell expanded the company with acquisitions providing loans to many companies on the second board of the Western Australia Stock Exchange that were newer, smaller and more entrepreneurial than those on the main board. Many were also riskier, but Connell financed them, acquiring the title 'Last Chance Laurie' in the process. The stock market collapse in late 1987 provided the catalyst that finally brought the company down, though earlier the auditors had refused to sign the 1988 accounts, and the official report disclosed 'massive private drawings by Connell and the rearrangement of affairs so that no disclosure of loans to directors had to be made.'

In Japan in the late 1980s, Nomura Securities, a large *keiretsu* organization was accused of having too close links with their regulator, having offered well-paid sinecures to senior bureaucrats on retirement (called *amakudari* – literally descent from heaven). Lavish payouts to major institutional clients to cover losses and links with a *yakuza* underworld syndicate were also alleged. The presidents of Nomura Securities and Nikko Securities resigned; so did Nomura's chairman, who also stood down from his position as vice-chairman of the *Keidanren*, the Federation of Japanese economic organizations.

Meanwhile, in the UK during the 1980s, Robert Maxwell built up a massive publishing empire, despite the admonition he had received in the 1970s from government inspectors, as I mentioned earlier. The Robert Maxwell Group plc owned nearly half of two other listed companies – the Maxwell Communication Corporation plc and the Mirror Group Newspaper plc. A self-made man, he dominated both his companies and his directors, resenting any form of criticism. In November 1991, he drowned, lost overboard from his luxury yacht. Conspiracy theories abounded – he was a British spy, he had been killed, or he had committed suicide. But his death led to the banks demanding repayment of massive loans, which the company could not meet. An inquiry subsequently discovered that Maxwell had secretly withdrawn hundreds of millions of pounds from his companies' pension funds to save his companies from bankruptcy.

Such scandals and the abuse of board-level power around the world led to calls for a rethink of the way companies were directed and held accountable at the top: the phrase 'corporate governance' appeared.

'Governance' was a word used by Chaucer in the 14th century to describe the process of governing a state, even though he could not decide on the spelling.[14] But 'corporate governance', referring to the process of exercising power over a company, did not appear until the 1980s. The phrase had been used occasionally by financial economists referring to agency problems that shareholders might have because directors knew more about the business than they did. In 1983, it was used in the title of a paper[15] in a collection of essays about management. In 1984, it appeared as the title of a report by the American Law Institute[16] and also as the title of a book.[17] By 1985, Baysinger and Butler were using the phrase 'corporate governance', when describing the effects of changes in board composition on corporate performance.[18]

Michael Gladwell, in his book *The Tipping Point*,[19] suggests that ideas can lie dormant for years before suddenly appearing like an epidemic. Corporate governance seems to be like that: for 50 years, following the original Berle and Means study, no significant interest was shown in the way corporations were governed. Then, within a few years of the introduction of the phrase 'corporate governance', the subject came to centre stage.

Professors Philip Cochran and Steven Wartick published an annotated bibliography[20] of corporate governance publications in 1988. It had 74 pages. Today Google accesses over 20 million references to corporate governance and Bing 23 million. Research into corporate governance also began to develop in the late 1980s.

But it has to be admitted that developments in corporate governance thinking and practice to date have been more regulatory responses to corporate collapses, board level excesses and dominant chief executives and chairmen than as a result of academic, research-based deliberations.[21]

DEVELOPMENTS IN THE 1990s – THE CORPORATE GOVERNANCE CODES ARRIVE

Prior to the corporate collapses of the 1980s, company regulation around the world was based on a mixture of companies' law, corporate regulations (mainly filing and disclosure requirements) and accounting standards, plus stock exchanges' rules for public listed companies.

UK codes

The first corporate governance report was the UK Cadbury Report, produced by a committee chaired by Sir Adrian Cadbury in response to company collapses, particularly the domination of boards by powerful individuals such as Robert Maxwell. Titled '*The financial aspects of corporate governance*', the Cadbury Report was not intended to be a comprehensive review of the subject, as Sir Adrian has subsequently emphasized. However, the report did call for:

- The wider use of independent non-executive directors (INEDs).
- The introduction of an audit committee of the board with a minimum of three non-executive directors, with a majority of them independent.
- The division of responsibilities between the chairman of the board and the chief executive. But, if the roles were combined in a single person, the board should have a strong independent element.
- The use of a remuneration committee of the board to oversee executive rewards.
- The introduction of a nomination committee with independent directors to propose new board members.
- Adherence to a detailed code of best practice
- Reporting that the code had been followed, or if not explaining why.

It is interesting to note, that despite being written nearly 20 years ago, this report contained many proposals that remain at the heart of today's corporate governance thinking. Britain produced the first corporate governance report and subsequently has produced more than any other country:

Cadbury Report (December 1992)
Greenbury Report (July 1995)
Hampel Report (January 1998)

UK Combined Code (1998)
Turnbull Report (1999, revised October 2005)
Higgs Report (January 2003)
Smith Report (July 2003)
Tyson Report (June 2003)
Revised UK Combined Code (July 2003)
Myners Report (December 2004)
Revised UK Combined Code (June 2006)
The UK Corporate Governance Code (June 2010)

The evolution of corporate governance thinking and practice is reflected in the development of these codes, and they have also been influential in the development of codes around the world. So it will be worthwhile briefly reviewing the proposals in each report.

The UK Greenbury Report (1995) addressed issues of directors' remuneration, and called for:

- Remuneration committees consisting consist solely of INEDs;
- The chairman of the remuneration committee to respond to shareholders' questions at the annual general meeting (AGM);
- Annual reports to include details of all director rewards – naming each director;
- Directors' contracts to run for no more than a year to avoid excessive golden handshakes;
- Share option schemes for directors to be linked to long-term corporate performance.

The UK Hampel Report (1998) was a response to a suggestion in the Cadbury Report that a review should be undertaken after a few years experience. The Hampel Report proposed that:

- Good corporate governance needs broad principles not prescriptive rules.
- Compliance with sound governance practices, such as the separation of board chairmanship from chief executive, should be flexible and relevant to each company's individual circumstances.
- Governance should not be reduced to what the report called a 'box-ticking' exercise.
- The unitary board is totally accepted in the UK. There is no interest in alternative governance structures or processes such as two-tier boards.
- The board is accountable to the company's shareholders. There is no case for redefining directors' responsibilities to other stakeholder groups.

The Hampel Committee consisted mainly of directors of major public companies and their professional advisers. Predictably, therefore, it did not criticize contemporary corporate governance practices, nor did it advocate any measures which would further limit directors' power to make unfettered decisions, nor widen the scope of their accountability. The report concluded that self-regulation is the preferred approach to corporate governance in Britain. 'There is no need for more company legislation'. Shortly after the report was published, the British Government announced a fundamental review of UK company law.

The Cadbury, Greenbury and Hampel committees were set up by City of London institutions: i.e. by the UK's financial sector. The codes were essentially voluntary and applied principally to listed companies, although it was suggested that many of the recommendations could be applied to private companies.

In 1998, the Cadbury, Greenbury and Hampel proposals were consolidated into the UK Combined Code, which was incorporated into the London Stock Exchange's listing rules. All companies incorporated in the UK listed on the main market of the London Stock Exchange were now required to report on how they had applied the principles in the Combined Code in their annual report to shareholders. In this report, companies had to confirm that they had complied with the Code's provisions or, if they had not, to provide explanations.

The UK Turnbull Report (1999) elaborated a call in the Hampel Report for companies to have appropriate internal controls. It set out how directors of UK listed companies should comply with the Combined Code requirements about internal controls, including financial, operational, compliance and risk management. The report recognized for the first time that risk assessment was a vital board responsibility and recommended that reporting on internal controls should become an integral part of the corporate governance process.

Corporate regulation in the USA

In the United States, companies must follow the company law of the state in which they are incorporated, and comply with US generally accepted accounting principles (GAAP). In addition, companies must meet the demands of the Securities and Exchange Commission (SEC), and the rules of any stock exchange on which their shares are listed. In 1997, the US Business Roundtable, which takes a pro-business perspective, produced a Statement on Corporate Governance, which was updated in 2002, listing the following guiding principles of sound corporate governance:

- The paramount duty of the board of directors of a public corporation is to select a chief executive officer and to oversee the CEO and other senior management in the competent and ethical operation of the corporation on a day-to-day basis.
- It is the responsibility of management to operate the corporation in an effective and ethical manner in order to produce value for stockholders.
- It is the responsibility of management, under the oversight of the board and its audit committee, to produce financial statements that fairly present the financial condition and results of operations of the corporation.
- It is the responsibility of the board and its audit committee to engage an independent accounting firm to audit the financial statements prepared by management and to issue an opinion on those statements based on generally accepted accounting principles.
- It is the responsibility of the independent accounting firm to ensure that it is in fact independent, is without conflicts of interest, employs highly competent staff and carries out its work in accordance with generally accepted auditing standards.
- The corporation has a responsibility to deal with its employees in a fair and equitable manner.

Codes around the world

The Cadbury Report influenced thinking around the world. Other countries, many of which had also been experiencing problems of company collapses due to inadequate corporate governance, followed with their own reports on corporate governance. These included the Viénot Report (France, 1995), the King Report (South Africa, 1995), Toronto Stock Exchange (Canada, 1995), the Netherlands Report (1997) and Hong Kong (1996). Some reports were produced by an official commission set up by the government, others by the securities regulating authority, the stock exchange, or by an independent organization such as an institute of directors.

Australia has been a pioneer in corporate governance developments. In 1993, a committee on corporate governance, chaired by Professor Fred Hilmer of the Australian Graduate School of Management, added a new dimension to the conformance and compliance emphasis of the Cadbury and the other reports. Governance is about performance, as well as conformance, Hilmer argued:

> *the board's key role is to ensure that corporate management is continuously and effectively striving for above-average performance, taking account of risk. [Adding, almost as an afterthought] this is not to deny the board's additional role with respect to shareholder protection.*

The report had the splendid title *Strictly Boardroom* – after the film 'Strictly Ballroom', which portrays the world of competitive ballroom dancing, in which originality, creativity and innovation had been sacrificed to inflexible and inhibiting rules and regulations. This is the danger facing current governance practices, argued Hilmer, if conformance and compliance overshadowed improved corporate performance. Following the Hilmer work, Henry Bosch wrote a study in 1995 and a corporate governance report for the public sector was produced in 1997.

South Africa has also been in the forefront of corporate governance thinking. There have been three reports produced by the King Committee, named after the chairman Mervyn King: King I (1994), King II (2002) and King III (2009).

In 1998, the OECD (Organization for Economic Co-operation and Development) developed guidelines on corporate governance to help countries create their own codes. The report, usefully, contrasted the strong external investment and firm corporate governance practices in America and Britain with those in Japan, France and Germany, which had less demanding governance requirements. In these countries other constituencies, such as employees, receive more deference, the regulatory structures are less obtrusive, directors are seldom truly independent and investors seem prepared to take a longer-term view, the report noted.

The Commonwealth countries also produced a code of principles of good corporate governance, which made recommendations on good corporate governance practice at the level of the company.

The impact of institutional investors

Another development in the 1990s was the growing influence of institutional investors on corporate governance issues. Some major institutional investors rediscovered investor power and became proactive in corporate governance. Peter Drucker[22] in 1991 was one of the first to draw attention to the potential governance power that lay in shareholders' proxy votes. Institutional investors called for better performance and pressed to end corporate governance practices that benefited incumbent boards and reduced the probability of the company being subjected to a hostile bid.

In the United States, organizations, including the Institutional Shareholder Services and the Investor Responsibility Research Center, emerged to inform institutional fund managers on governance issues. In the United Kingdom, the Association of British Insurers and the National Association of Pension Funds actively advised their members on proxy voting issues. In Australia, it was the Australian Investment Managers' Association.

The Californian Public Employees' Retirement System (CalPERS) was particularly active, producing Global Principles for Corporate Governance, intended to benchmark corporate governance practices in companies in their portfolio around the world. CalPERS published reports on corporate governance in Germany and Japan, specifically indicating the changes to corporate governance practices they would expect if they were to invest in companies in those countries. In the UK, the Hermes Fund also adopted a proactive stance during the 1990s.

Meanwhile, some companies, such as General Motors (1996), published their own board policies or guidelines on significant corporate governance issues.

DEVELOPMENTS AT THE START OF THE 21ST CENTURY – ENRON, SARBANES-OXLEY AND CODE DEVELOPMENTS AROUND THE WORLD

As the 21st century dawned, corporate governance seemed to be developing well around the world. Interest in corporate governance research had been growing.

The importance of good corporate governance was well recognized. Codes of corporate governance principles or best practice were in place for listed companies in most countries with stock markets. Many experts now felt that markets were offering a premium for shares in well-governed companies, not least because the apparent risk for investors had been reduced.

In the United States and elsewhere there was a widespread expectation that the rest of the world would gradually converge with the American approach to corporate governance, as well as adopting US generally accepted accounting principles (GAAP), not least because companies throughout the world, it was felt, needed access to American funds.

Enron's collapse

But the new century had scarcely begun when disaster struck. Enron, one of the largest companies in America, collapsed and in the process became a lasting symbol of corporate governance failure.

The merger of Houston Natural Gas and InterNorth in 1985 created a new Texas energy company called Enron. In 1989, Enron began trading in commodities – buying and selling wholesale contracts in energy. By 2000 turnover was growing at a fantastic rate, from US$40 billion in 1999 to US$101 billion in 2000, with the increased revenues coming from the broking of energy commodities. Enron was credited with 'aggressive earnings management'. To support its growth, hundreds of Special Purpose Entities (SPEs) were created. These were separate partnerships, often based in tax havens, that traded with Enron. Enron marked long-term energy supply contracts with these SPEs at market prices, taking the profit in its own accounts immediately. The SPEs also provided lucrative fees for Enron top executives. Furthermore, they gave the appearance that Enron had hedged its financial exposures with third parties, whereas the third parties were, in fact, contingent liabilities on Enron. The contemporary American accounting standards (GAAP) did not require consolidation with group accounts, so billions of dollars were kept off Enron's balance sheet. In 2000, Enron was ranked seventh in Fortune's list of the largest US firms and was the largest trader in the energy market created by the deregulation of energy in the United States.

In August 2001, Joseph Skilling, chief executive of Enron, resigned 'for personal reasons'. Kenneth Lay, the chairman, took over executive control. Lay was a close friend of the US President George W. Bush and was his adviser on energy matters. Enron's Chief Finance Officer was Andrew Fastow. In October 2001, a crisis developed when the company revised its earlier financial statements and revealed massive losses due to hedging risks taken as energy prices fell, which had wiped out US$600 million of profits. An SEC investigation into this restatement of profits for the past five years revealed the massive, complex derivative positions and the transactions between Enron and the SPEs. Debts were understated by US$2.6 billion. Fastow was alleged to have received more than US$30 million for his management of the partnerships. Eventually, he was indicted with 78 counts involving the complex financial schemes that produced phantom profits, enriched him and doomed the company. He claimed that he did not believe he had committed any crimes.

Enron's auditor was Arthur Andersen, whose consultancy fees from Enron were greater than their audit fees. Enron also employed several former Andersen partners as senior financial executives. In February 2001, partners of Andersen had discussed dropping their client because of Enron's accounting policies. Andersen subsequently collapsed, with clients and partners around the world joining the other 'Big Four' firms.

The FBI began an investigation into possible fraud at Enron three months later, by which time audit files had been shredded. Many Enron employees held their retirement plans in Enron stock: some had lost their entire retirement savings. In November 2001 Fastow was fired. Standard and Poor's, the credit rating agency, downgraded Enron stock to junk-bond status, triggering interest rate penalties and other clauses. Enron filed for chapter 11 bankruptcy in December 2001. The New York Stock Exchange (NYSE) suspended Enron shares. Two outside directors, Herbert Weinokur and Robert Jaedicke, members of the Enron audit committee, claimed that the board was either not informed or was deceived about deals involving the SPEs.

Jeffrey Skilling, the former CEO, was sentenced to 24 years in prison and ordered to pay $45million in restitution in October 2006. Claiming innocence, he appealed. Kenneth Lay was also found guilty, but died of a heart attack in July 2006, protesting his innocence and believing he would be exonerated.

Interestingly, although Enron collapsed with such dramatic results, most international corporate governance guidelines had in fact been followed, with a separate chairman and CEO, an audit committee chaired by a leading independent accounting academic and a raft of eminent INEDs. However, the subsequent collapse owed more to abuse by top management of their power and their ambivalent attitudes towards honest and balanced corporate governance.

The US Sarbanes–Oxley Act

But governance problems appeared in other companies in the United States: Waste Management, WorldCom and Tyco collapsed in addition to Enron. Arthur Andersen had been the auditors of Enron, WorldCom and Waste Management. American accounting standards (GAAP) were now pilloried as being based on rules that could be manipulated, rather than on the principles of overall fairness required in international accounting standards. The financial transparency, the governance processes and, most significantly, the corporate governance attitudes in other companies, were questioned. Confidence in the financial markets was shaken. Suddenly, from being the leaders of economic success, entrepreneurial risk-taking and sound corporate governance, directors were depicted as greedy, short-sighted and more interested in their personal share options than creating sustainable wealth for the benefit of the shareholders.

The response in the United States was more legislation. The Sarbanes–Oxley Act, which was rushed through in 2002, placed new stringent demands for the governance of all companies listed in the United States. This act, now nicknamed ‘Sox’ or ‘Sarbox’, significantly raised the requirements and the costs of corporate governance. Only independent directors could now serve on audit committees (at least one of whom must be a finance expert), shareholders must approve plans for directors’ stock options and subsidized loans to directors were forbidden. A new institution was created to oversee audit firms, which must rotate their audit partners, to prevent an overfamiliarity between auditor and the client’s finance staff. Auditors were also forbidden to sell some non-audit services to audit clients, and audit staff must serve a cooling-off period before joining the staff of an audit client – all of which had happened in Enron.

In 2001 in the United States, a Blue Ribbon Commission that had been set up by the National Association of Corporate Directors published the report *Director Professionalism.* A year later, the American Law Institute published a set of General Principles on corporate governance, which generated a debate on the regulation of boards and directors, with the Business Roundtable contributing their views in a further report the same year, as did the Council of Institutional Investors, which published proposals *Core Policies and Principles of Corporate Governance,* also in 2002.

However, following corporate governance scandals, companies were collapsing in other parts of the world: in the UK, Marconi, British Rail, Independent Insurance and Tomkins; in Australia, HIH Insurance; in Italy, Parmalat; and in Germany, Vodafone Mannesmann.

More UK corporate governance codes

In 2003 in the UK, the Higgs Report re-examined corporate governance in British companies, a decade after the Cadbury Report.

The proposals sharpened the requirements in the previous codes, in particular recommending that in listed companies:

- at least half the board should comprise INEDs;
- all members of the audit and remuneration committees and a majority of the members of the nomination committee should be INEDs;
- the role of chief executive should always be completely separate from that of chairman;
- director recruitment should be rigorous, formal and transparent;
- executive directors should not hold more than one non-executive directorship of a FTSE 100 (Financial Times Stock Exchange 100) company;
- boards should evaluate the performance of directors and board committees annually, and have a comprehensive induction programme;
- boards should have a senior independent director to liaise with shareholders.

The Higgs Report had been commissioned by the Labour Government, rather than the financial institutions, with the remit to see how 'more independent and more active non-executives, drawn from a wider pool of talent, could play their part in raising productivity'. Some of Derek Higgs' initial proposals were contentious. Among the proposals that were *not* accepted were:

- a ban on chief executives moving into the chair of their own company;
- a ban on chairmen heading the nomination committee of their own board;
- a ban on anyone being chairman of more than one FTSE 100 company;
- a call for regular meetings between the senior independent director and shareholders.

Also in 2003, the UK Smith Report looked at the work of the audit committees and called for:

- a strengthening of the role of the audit committee;
- all members of the audit committee to be independent;
- at least one member of the committee to have significant, recent and relevant financial experience;
- the audit committee to recommend the selection of the external auditor;
- an audit committee report to be included in the annual report to shareholders;
- the chairman of the audit committee to attend the AGM to answer shareholders' questions.

A further report in 2003, the UK Tyson Report focused on the recruitment and development of non-executive directors. It called for:

- more professionalism and transparency in the recruitment of directors;
- the introduction of director induction and training;
- use of a wider catchment area for outside directors, who could be recruited from, what the report called, the 'marzipan layer' of senior executives: that is, those just below board level, in unlisted companies, as well as consultancies and organizations in the non-commercial sector.

A revised version of the UK Combined Code was then published by the Financial Reporting Council, which by this time had taken over regulatory responsibility from the London Stock Exchange.

In 2004, the UK Myners Report addressed the responsibilities of institutional investors and defined these more clearly. Among the recommendations of Myners were:

- trustees should set clear objectives for funds, and should choose appropriate performance, risk and time benchmarks for fund managers;
- trustees should be encouraged to spend more money on advice and delegate more to paid advisors or professional trustees;
- investment advisors appointed by trustees should be different from their actuarial advisers;
- rules should be cut to make it easier for pension funds to invest in private equity partnerships and high-risk ventures.

In 2006, the Financial Services Authority (FSA) made some minor revisions to the UK Combined Code, including allowing chairmen to sit on remuneration committees if they were judged to be independent when they were appointed to the board; requiring the publication of proxies at AGMs when votes are taken by a show of hands; and where there are provisions in the Code requesting the company to make information available, to allow this to occur through placing the information on the company website.

Corporate governance principles in Australia and South Africa

In March 2003, the Australian Stock Exchange (ASX) Corporate Governance Council produced '*Principles of good corporate governance and best practice recommendations*', which added some new dimensions to the concept of corporate governance. This work offered the following essential corporate governance principles, suggesting that a company should:

- Lay solid foundations for management and oversight
  Recognize and publish the respective roles and responsibilities of board and management.
- Structure the board to add value
  Have a board of an effective composition, size and commitment to adequately discharge its responsibilities and duties.
- Promote ethical and responsible decision making
  Actively promote ethical and responsible decision making.
- Safeguard integrity in financial reporting
  Have a structure to independently verify and safeguard the integrity of the company's financial reporting.
- Make timely and balanced disclosure
  Promote timely and balanced disclosure of all material matters concerning the company.
- Respect the rights of shareholders
  Respect the rights of shareholders and facilitate the effective exercise of those rights.
- Recognize and manage risk
  Establish a sound system of risk oversight and management and internal control.
- Encourage enhanced performance
  Fairly review and actively encourage enhanced board and management effectiveness.
- Remunerate fairly and responsibly
  Ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to corporate and individual performance is defined.
- Recognize the legitimate interests of stakeholders
  Recognize the legal and other obligations to all legitimate stakeholders.

In South Africa, King II (2002) took a progressive view on the need for companies to take an inclusive view of their relationships, not only with shareholders but also with other groups in society affected by their activities:

> Emerging economies have been driven by entrepreneurs, who take business risks and initiatives. With successful companies come successful economies. Without satisfactory levels of profitability in a company, not only will investors who cannot earn an acceptable return on their investment look to alternative opportunities, but it is unlikely that the other stakeholders will have an enduring interest in the company.
>
> The key challenge for good corporate citizenship is to seek an appropriate balance between enterprise (performance) and constraints (conformance), so taking into account the expectations of shareowners for reasonable capital growth and the responsibility concerning the interests of other stakeholders in the company.

THE CORPORATE GOVERNANCE EFFECTS OF THE GLOBAL FINANCIAL AND ECONOMIC CRISIS – DEVELOPMENTS IN THE OECD, THE USA, THE UK AND SOUTH AFRICA

With the collapse of financial institutions around the world, following overexposure to risk in sub-prime market derivatives, further corporate governance regulatory or code responses can be anticipated.

The corporate governance principles published by the OECD, as we have already seen, are designed to assist countries in developing their own corporate governance codes.[23] The OECD's Steering Group on Corporate Governance re-examined the adequacy of these principles in light of the global economic problems. The real need, it felt, was to improve the practice of the existing principles, although further guidance and principles will be published in due course. In two seminal papers,[24] four broad areas were identified as needing attention: board practices; risk management; top-level remuneration; and shareholder rights.

In the United States, changes to regulatory procedures for listed companies considered: obligatory (though non-binding) shareholder votes on top executive pay and payments on appointment and retirement; annual elections for directors; the creation of board-level committees to focus on enterprise risk exposure; and the separation of the CEO role from that of the board chairman, as called for in most corporate governance codes.

In the United Kingdom, the Financial Review Council did not find evidence of serious failings in the governance of British businesses outside the banking sector. But it did propose changes to the UK Corporate Governance Code to improve governance in major businesses. The proposed changes were intended to: enhance accountability to shareholders; ensure that boards are well-balanced and challenging; improve a board's performance and deepen awareness of its strengths and weaknesses; strengthen risk management; and, emphasize that performance-related pay should be aligned with the company's long-term interests and risk policy.

In 2010, the existing UK Combined Code was re-named the UK Corporate Governance Code,[25] a name some thought might have been more appropriate all along. The main proposals for change were:

- Annual re-election of chairman or the whole board.
- New principles on the leadership of the chairman, and the roles, skills and independence of non-executive directors and their level of time commitment.
- Board evaluation reviews to be externally facilitated at least every three years.
- Regular personal performance and development reviews by the chairman with each director.
- New principles on the board's responsibility for risk management.
- Performance-related pay should be aligned to the company's long-term interests and its risk policy.
- Companies to report on their business model and overall financial strategy.

In South Africa, King III (2009) again took a progressive approach, focusing on a number of frontier topics, including ethical leadership and corporate citizenship, the governance of risk, the governance of information technology and governing stakeholder relationships.

THE EVOLUTION OF CORPORATE GOVERNANCE THEORIES

Research and writing on corporate governance has grown dramatically since the early 1980s when the term was first used. *Corporate Governance – an international review*, which publishes peer-reviewed research papers, *was* founded in 1992, with the first issue being published on 1 January 1993. The scale and scope of published papers has grown year by year with the three editors to date being based at the University of Hong Kong, the University of Birmingham (UK) and, currently, at Old Dominion University (USA). Other leading academic journals in the fields of economics, law and management have also significantly increased their publication of papers related to corporate governance. But scholarship in corporate governance still adopts competing theoretical viewpoints and lacks a coherent theoretical perspective, although there are a number of influential contenders.

Stewardship theory

As we saw earlier, the original conception of the joint-stock company, with limited liability for its investors, was elegantly simple and eminently successful. Ownership was the basis of power over the corporation, directors having a fiduciary duty to act as stewards of the shareholders' interests. Inherent in the concept of the company is the belief that directors can be trusted. This concept of stewardship provided the underpinning of the original, and indeed the present, company law. The model proved robust and adaptable. Indeed, its great flexibility has led to the huge proliferation, diversity and complexity of corporate types and structures today.

Stewardship theory reflects the classical ideas of corporate governance, believing that directors can and do act responsibly with independence and integrity. They do not inevitably act in a way that maximizes their own personal interests, as some alternative theories argue. As Lord Cairns said in the London High Court in 1874, 'No man, acting as agent, can be allowed to put himself into a position in which his interest and his duty will be in conflict'. Stewardship theorists argue that, clearly, this is what most directors actually do. Of course, some fail, but this does not invalidate the basic concept. Directors' legal duty is to their shareholders not to themselves, nor to other interest groups.

Of course, stewardship exponents recognize that directors need to recognize the interests of customers, employees, suppliers and other legitimate stakeholders in governing their organizations, but under the law their first responsibility is to the shareholders. Conflicts of interest between stakeholder groups and the company, they believe, should be met by competitive pressures in free markets, backed by legislation and legal controls to protect customers (such as monopoly and competition law), employees (employment law, health and safety law), consumers (product safety law, consumer protection law), suppliers (contract law, credit payment law) and society (environmental law, health and safety law, taxation law).

Criticisms of stewardship theory

Critics of stewardship theory point out that the de facto situation in modern corporations is very different from the 19th-century model. They argue that the concept of a set of shareholders owning a single company and appointing its directors is naïve in modern circumstances. In listed companies shareholders have become remote from the company and do not, in fact, nominate the directors. Financial reports, they suggest, have become intelligible only to experts. Complex corporations lack transparency and their directors are not really accountable to shareholders. Other critics of stewardship theory point out that, because the theory is rooted in law, it is normative, emphasizing what should be done. It is not, they argue, predictive, and is thus unable to show causal relationships between board behaviour and corporate performance.

Recognizing the apparent naivety of the 19th-century model of shareholder capitalism in the modern world, a recent theory of universal ownership recognizes that modern listed companies, particularly in liquid markets, such as the USA and the UK, are typically held by a highly diversified set of equity holders, including holdings concentrated in the hands of a few large institutional investors. Consequently, the theory argues, institutional investors should play an essential role in corporate governance, including collective action if necessary. Critics of this approach point out that institutional investors such as pension funds are run by trustees whose accountability is not always apparent and seldom challenged, whose interests do not align with those of fund beneficiaries and who may use investment funds to protect themselves from claims for negligence.

Furthermore, we need to recognize that the conceptual underpinning of company law in the USA, the UK and in many other jurisdictions around the world influenced by their early days in the British Empire, are rooted in common law principles, enhanced by the precedents of case law and relying on independent judges and juries. As a result, the rights of shareholders, particularly minorities, have been protected and in these countries the shareholder base in many public companies tends to be diversified. By contrast, in other countries, in continental Europe and Latin America, for example, civil law prevails, which has less flexibility, does not learn from precedent and is often administered by judges who are civil servants. Consequently, laws are more codified, there is less protection for minorities and share ownership is less widespread, with many companies dominated by family or other dominant shareholder interests.

Nevertheless, despite the corporate collapses in the late 20th and early 21st centuries undermining trust in directors, and adversely affecting the interests of investors, employees and communities, stewardship theory remains the legal foundation for company legislation all round the world.

The agency dilemma

We began this chapter quoting William Shakespeare and Adam Smith on the agency problem. In its simplest form, whenever the owner of wealth (principal) contracts with someone else (agent) to manage his affairs the agency dilemma arises. How to ensure that the agent acts solely in the interest of the principal is the challenge. Indeed, as we saw, in the 18th and 19th centuries many contracts were, indeed, between a single principal and a single agent – trading ventures, construction projects, running a factory. The arrival of the joint-stock, limited liability company, in the mid-19th century, increased the number of principals (shareholders) and their agents (directors). The number and increasing diversity of the shareholders in public companies meant, moreover, that the interests of shareholders were no longer homogeneous. Again, as we saw, Berle and Means showed in 1932 that as companies grew and their shareholders became more diverse, the separation between owners and directors magnified and power shifted towards the directors, which some of them abused.

Today, agency relationships in public companies can be very complex. For example, an individual owner might invest his funds through a financial adviser, who invests the funds in a mutual fund or investment trust, which in turn seeks to gear its portfolio by investing in a hedge fund, which invests its resources in a range of equities, property, commodities and other hedge funds. However, the agency dilemma potential exists throughout the chain. The demands for reporting, transparency, accountability, audit, independent directors and the other requirements of company law and securities legislation, plus requirements of regulators and stock exchange rules, and the calls of the corporate governance codes are all responses to the agency dilemma.

The agency problem is not limited to relations between investors in listed companies and their agents. The agency dilemma can occur in private companies, joint ventures, not-for-profit organizations, professional institutions and governmental bodies. Wherever there is a separation between the members and the governing body put in place to protect their interests and deliver the required outcomes the agency dilemma will arise and corporate governance issues exist. The members could be the shareholders in a company, the members of a professional institution or a trade union, a group of owners in a cooperative, or the holding company in a corporate group: the governing body might be called the board of directors, the council, the committee, the governing body, or the holding company. But whatever names are used, whenever responsibility for activities and assets are delegated by those in the principal position to those in the agent situation, the agency dilemma will arise.

Essentially, an agreement between parties with asymmetrical access to information calls for trust. In companies, of course, the directors know far more about the enterprise than the shareholders, who must trust them. This is the underpinning concept of the joint-stock limited liability company, as we have seen: the shareholders trust the directors to be stewards of their funds. The agency theory of corporate governance takes a less sanguine view of directors' behaviour.

Agency theory

Agency theory looks at corporate governance practices and behaviour through the lens of the agency dilemma. In essence, the theory perceives the governance relationship as a contract between shareholder (the principal) and director (the agent). Directors, it is argued, seeking to maximize their own personal benefit, take actions that are advantageous to themselves but detrimental to the shareholders.

As the early proponents of agency theory, Jensen and Meckling[26] in 1976 explained:

> Agency theory involves a contract under which one or more persons (the shareholders) engage another person (the directors) to perform some service on their behalf which includes delegating some decision-making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe the agent will not always act in the best interests of the principal.

Anecdotal evidence of such behaviour is not hard to find. There are myriad cases in which directors treat a listed public company as though it was their own property, exploiting their position, receiving unsanctioned benefits and taking remuneration unrelated to their performance to the shareholders' detriment. Bob Monks,[27] a shareholder activist, reckons that trillions of dollars of shareholders' wealth have been wrongly extracted from US corporations over the years by directors abusing their power.

Directors may also take a different view to that of their shareholders on corporate risk. After all, it is seldom their money they are risking. Of course, successful management involves taking controlled risks. But directors might hazard corporate funds on riskier ventures – a hostile take-over bid, for example – than many of their shareholders would expect or want.

Agency theory has been developed within the discipline of financial economics, and most scholarly research in corporate governance has used this theoretical approach. Jensen elaborated his original work in Fama and Jensen[28] in 1983. Looking at corporate governance through the agency lens enables researchers to explore relationships between governance processes and corporate performance. In other words, they test the hypothesis that there is a causal link between governance systems, put in place to control the agent, and the effect on the interests of the principal. Agency theory offers a statistically rigorous insight into corporate governance processes. Because of its simplicity and the availability of both reliable data and statistical tests, agency theory has provided a powerful approach to corporate governance theory building.

Agency theory focuses at the level of shareholders and boards as entities. Board-level activities and inter-personal relations between directors are treated as a black box. Consequently, researchers do not need access to the board room or to individual directors and use data in the public domain.

Criticisms of agency theory

Some critics of agency theory question its relatively narrow theoretical scope. To study the intricacies of corporate governance in terms of contracts between principals and agents, they argue, is naive. They express concern at a focus on purely quantitative metrics, such as board structure or corporate compensation packages, which are then compared with measures of corporate performance.

Such critics believe that board behaviour is not well represented by contractual relationships, but is influenced by inter-personal behaviour, group dynamics and political intrigue. They question whether the subtle and complex dynamics of board behaviour lend themselves to measurement and numerical analysis. Other critics have challenged the shareholder/director agency model in practice as simplistic. Where, for example, the ultimate beneficial owner has invested through a pension fund, which invests in a hedge fund, which invests in a private equity company, which places funds in the hands of a financial institution, which invests in the shares of a listed company but lends them as collateral for another transaction, who is agent for whom they ask? These days, they say, pension funds, hedge funds and other institutional investors can behave like imperial traders, even corporate raiders, rather than the long-term investors perceived by the agency paradigm.

But there is a deeper issue. Inherent in agency theory is a philosophical, moral assumption about the nature of man. The theory assumes that people are self-interested not altruistic. They cannot be expected to look after the interests of others. In other words, directors cannot be trusted. Critics of agency theory argue that it has been erected on a single, questionable abstraction that governance involves a contract between two parties, and is based on a dubious conjectural morality that people maximize their personal utility. Nevertheless, agency theoretical research remains the mainstay of corporate governance research published in the past two decades. A research frontier bridges the disciplines of economics and law, applying the agency theoretical insights of economics to the legal context of the corporation.

Transaction cost economics

Closely related to agency theory, transaction cost economics focuses on the cost of enforcement or check and balance mechanisms, such as internal and external audit controls, information disclosure, independent outside directors, the separation of board chairmanship from CEO, risk analysis, and audit, nomination and remuneration committees. The argument is advanced that such enforcement costs should be incurred to the point at which the increase in costs equals the reduction of the potential loss from non-compliance. Like agency theory, transaction cost economics assumes that directors act in their own best interests, not primarily in those of the shareholders. But transaction cost analysis focuses on governance structures and mechanisms, whereas agency theory sees the firm as a set of contracts.

Other corporate governance theoretical insights

A number of other theoretical perspectives have been applied to corporate governance research. *Resource dependency theory* takes a strategic view, seeing the governing body of a corporate entity as the linchpin between company and the resources it needs to achieve its objectives, with directors seen as boundary-spanning nodes of networks able to connect the business to its strategic environment. *Social network theory* recognizes that those involved in corporate governance processes are often linked through networks. Individuals at the nodes may have things in common, including social standing, class, income, education, institutional or corporate links, and may be pivotal nodes in a number of networks, increasing communication leverage. *Managerial and class hegemony* focuses on the view that directors have of themselves. Directors in some companies see themselves as an elite group. This self-perception encourages them to behave in an elite way, dominating both the company organization and its external linkages. *Psychological and organizational perspectives* focus on individual players in the corporate governance scene, recognizing their different mindsets, personalities and foibles. A few researchers, not prepared to treat the board as a black box, have attempted to study board-level behaviour as an inter-personal process.

A societal perspective – stakeholder ideas

Stewardship and agency theories, the two dominant perspectives in the evolution of corporate governance theory, focus on relationships between shareholders and their boards of directors. But an increasing significance perspective on corporate governance is at the societal level. Called by some stakeholder theory, it involves the balance of corporate responsibility, accountability and power throughout society, effectively being concerned with beliefs about relationships between the individual, the enterprise and the state. It is not a predictive theory that can be easily researched. Consequently, this societal view of corporate governance is considered by some scholars as rightly treated as a philosophy rather than a theory.

Companies, stakeholder advocates argue, should recognize a responsibility to *all* those affected by companies' decisions, including employees, customers, partners in the supply chain, bankers, shareholders, the local community, broader societal interests including the environment and the state. Companies owe a duty to all those affected by their behaviour, they argue. Some advocates go further and call for directors to be accountable and responsible to a wide range of stakeholders far beyond companies' current company law responsibility to shareholders. Such responsible behaviour, the stakeholder advocates argue, should be the price society demands from companies for the privilege of incorporation, granting shareholders limited liability for the company's debts.

As we saw earlier, in the 1970s there were various attempts to challenge the notions that the board's prime responsibility was to increase shareholder value. In 1975, in the UK, the Accounting Standards Steering Committee discussion paper, the *Corporate Report*, recommended that all large economic entities should produce regular accountability reports to all stakeholder groups whose interests might be affected by the decisions of that entity. In the United States, proposals for new company ordinances, including stakeholder accountability, came from Ralph Nader, who tussled with the boardroom-orientated Business Roundtable in 1970.

Stakeholder thinking faded with the free market, 'growth and greed' attitudes of the 1980s. But in the more environmentally and socially concerned world of the 1990s and early 21st century, the ideas appeared again, particularly in calls for corporate social responsibility and sustainability reporting. In 1999, the Royal Society of Arts in England published a report titled *Tomorrow's Company*, which advocated wider recognition of corporate responsibility to stakeholders such as suppliers, customers and employees.

Some scholars have argued that stakeholder ideas are fundamentally flawed, with expectations of different stakeholders being irreconcilable. Such ownership rights advocates call for boards with a single-minded responsibility to the shareholders. The 1998 UK Hampel Committee dismissed stakeholder notions, saying, 'Directors are responsible for relations with stakeholders, but are accountable to the shareholders', a view reflecting the conventional wisdom in many boardrooms around the world.

But overshadowing agency, stewardship, stakeholder and the other theoretical perspectives are some unresolved issues at a meta-philosophical level. Every theory of corporate governance needs to be founded on a view on the legitimate relationship between the individual and society. Where does the desirable balance lie between the rights, powers and duties of the individual, the enterprise and the state? Opinions vary significantly by culture, political context and social system. Moreover, they have been evolving throughout history. All systems of governance must seek an appropriate balance between the interests of self and society. That applies to corporate governance just as it does to governance in other areas of society.

A subject in search of its paradigm

Corporate governance, as yet, does not have a single widely accepted theoretical base or a commonly accepted paradigm. In the words of Pettigrew:[29]

> Corporate governance lacks any form of coherence, either empirically, methodologically or theoretically with only piecemeal attempts to try and understand and explain how the modern corporation is run.

Despite the dramatic surge in academic interest in corporate governance since the 1990s, research has so far failed to offer a convincing explanation of how corporate governance really works, and has contributed little to the development of the subject. All significant regulatory and professional developments have been responses, not to research findings or theory building, but to corporate collapses, domination by powerful individuals, or corruption. The Sarbanes–Oxley Act in the United States, and the corporate governance codes in all economically developed nations, have been based on the experience and conventional wisdom of company directors, not on conclusions from rigorous research.

Today, the subject lacks a conceptual framework that adequately reflects the reality of corporate governance. The theoretical perspectives focus on different levels of abstraction: for some the relevant system covers the financial markets, for others it is the governing body, and yet for others individual chairman, CEOs and directors are in the frame.

THE FRONTIERS OF CORPORATE GOVERNANCE

The frontiers of corporate governance are being pushed out rapidly. The importance of good governance is increasingly recognized by investors and regulators. The significance of governance for the long-term success of enterprise, in addition to sound management, is understood by most business leaders. Corporate governance reports are required by statute or regulation around the world and companies compete for awards for the best.

The scope, boundaries and frontiers of the subject are changing. The past decade has seen new emphasis on corporate social responsibility and sustainability. Corporate citizenship and business ethics have entered the lexicon of corporate governance. Following the global financial crisis, the boards' responsibility for enterprise risk management, particularly the governance of strategic risk, has grown.

The context of corporate governance is shifting. Governance in mainland China, India and Russia is no longer of incidental interest. Cultural beliefs and practices are now recognized as vital to understanding comparative corporate governance. The balance of financial power is shifting. The scale of sovereign wealth funds, the potential of private equity and the significance of hedge funds are changing. But governance power reflects ownership structures, and in many parts of the world these are still dominated by families, holding companies, or governments.

As we have seen, the assumption held by many at the end of the 20th century that corporate governance around the world would converge with what was often called the Anglo-American approach has been shattered by a growing schism between the mandatory American emphasis on corporate governance by the rule of law (obey the law or risk the consequences, including jail) and the discretionary principles approach adopted in the UK and many other jurisdictions (follow the code or explain why not).

Other unresolved frontier topics include:

- Agreeing the real role of the board, balancing conformance responsibilities with performance opportunities. What is the unitary board's real responsibility for formulating strategy? The two-tier supervisory board system splits the two roles.
- Resolving the paradox of independent non-executive (outside) directors. Can an independent director really know enough about the company and its business to contribute? Does independence really mean ignorance?
- Should the chairman of the board ever also be the chief executive? Most codes say no.

But many US companies combine the roles, although there is now some interest in separation.

- Performance assessment of directors and boards, though required by some codes, is still embryonic. Who should undertake such assessments, using what criteria, and reporting to whom?
- The rating of corporate governance performance of companies and, in some cases countries, is also embryonic. Agreed methodologies and measurement standards do not exist.
- The independence of external auditors, despite the requirements of the US SOX Act and the regulatory demands in other jurisdictions, is suspect when auditors are actually appointed by, paid by and report to the directors. To ensure that society is protected and companies respect the licence they have been given to operate in society with limited liability, should the auditors report to the company regulators?
- The governance of non-listed entities has tended to be dwarfed by the attention given to the governance of listed companies. Yet, subsidiary companies, family firms, joint ventures, private equity, investment trusts, non-governmental organizations (NGOs), charities and other not-for profit entities contribute more to employment and economic well-being.

WHAT NEXT?

In this chapter we have reviewed the way corporate entities have been governed over the centuries. As the foundations of corporate governance were laid, we have seen the evolution from medieval traders, through corporations created by Royal or State warrant, to the invention of the joint-stock limited liability company. We have noted the emergence of private companies, complex groups held together in pyramids, nets, chains and joint ventures. We have observed the arrival of complex ownership patterns with new types of investor, including institutional investors, sovereign funds, private equity and hedge funds. We have recognized the effect on shareholder power in listed companies of strings of agents between company and shareholder.

And yet, the underpinning model of the company remains as it did in the mid-19th century. The joint-stock limited liability company has been adapted. It needs to be reinvented.

Corporate governance has been evolving continuously and continues to evolve. In the following chapters of this book, scholars from around the world will explore the implications.

NOTES

1 William Shakespeare: *The Merchant of Venice*, Act 1 Scene 1, first folio 1596/8.

2 Quango – quasi-autonomous non-governmental organization.

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In the Best Interest of the Corporation: Directors' Duties in the Wake of the Global Financial Crisis

Margaret M. Blair

What are we to think about the duties of corporate directors after a decade that began with the bursting of the dot.com bubble, the collapse of Enron, the fraud at WorldCom, and the passage of Sarbanes–Oxley, and ended with the collapse of Bear Stearns and Lehman Brothers, the bailouts of AIG, GM, Chrysler, and numerous banks, the fraud of Bernard Madoff, and a full-scale financial market crisis that precipitated the deepest worldwide recession since the Great Depression? With one event after another casting substantial doubt on the argument that financial markets do a good job of efficiently allocating resources to their highest-value use, are we still to believe that corporate directors should look to the market price of their company's stock to learn about the value being created by the corporations they oversee? Are we still supposed to believe that maximizing share value provides the greatest contribution to the total social wealth?

In the last few years, even some of the staunchest defenders of the idea that corporations should be managed to maximize share value have begun backing away from that position and some strong shareholder value advocates have shifted their recommendations. Michael Jensen, for example, was one of the leading advocates of share-value maximization in the 1980s and 1990s on the grounds that, because shareholders are 'residual claimants,' maximizing value for them would maximize total social value of the corporation (Jensen & Meckling, 1976; Jensen, 1986, 1989). More recently, Jensen has recognized that shareholder value can be increased without adding to social wealth by extracting value from other corporate participants, such as creditors. He now argues, instead, that corporate managers should maximize 'not just the value of the equity but the sum of the values of all financial claims on the firm – debt, warrants and preferred stock, as well as equity' (Jensen, 2002: 66). Likewise, former GE CEO Jack Welch, considered by some to be the 'father of the 'shareholder value' movement' among corporate boards and managers, now says that 'shareholder value is a result, not a strategy ... your main constituencies are your employees, your customers, and your products' (Guerrera, 2009).

Among academics, Lucian Bebchuk, one of the most outspoken and prolific advocates of enhanced shareholder rights, now concedes that 'the common shareholders in financial firms do not have an incentive to take into account the losses that risks can impose on preferred shareholders, bondholders, depositors, taxpayers underwriting governmental guarantees of deposits, and the economy' (Bebchuk & Spamann, 2010: 2–3).

For the last three decades, during which the belief in the wisdom of share-value maximization came to dominate law and finance scholarship as well as most policy discussions about corporate governance, many reasons have been given for this approach. In addition to the argument that maximizing the 'residual' has the effect of maximizing the whole pie, another frequently heard argument for focusing on share value was that 'it is logically impossible to maximize in more than one dimension at a time' (Jensen, 2002: 68). The belief was that if directors and managers are not held to a single metric, it will be difficult to gauge their performance, and agency costs will go up as they extract more in the way of personal benefits at the expense of the corporation (Blair, 1995: 226–227; Blair, 2003a: 56; Stout, 2002).

As to the first argument, few thoughtful people still believe that maximizing share value always has the effect of maximizing total social value (Talley, 2002; Elhauge, 2005). Once that is conceded, there is no principled basis on which to argue that shareholder interests should be privileged over all others. And as to the second argument, while it may be more difficult to measure and judge the performance of directors and managers if they are charged with a broader and more diffuse responsibility, such as to act in the 'best interest of the corporation,' to require them to do something else because it is easier to measure would be like judging the quality of academic articles by how long they are or how many footnotes they have. That metric might be correlated with what journal editors are looking for, but the correlation is likely to be weak, and it would clearly create very inappropriate incentives for scholars if they know that all that matters is the length and number of footnotes.

More troublingly, the dangers of a single-minded focus on share value have become more salient in the wake of the financial crisis of 2007–2009, in which dozens of large financial firms worldwide pursued increasingly risky investment strategies in their relentless focus on driving up share value (Bratton & Wachter, 2010), and then either collapsed altogether or had to be propped up with substantial injections of cash at taxpayer expense.

In this chapter, I critique several of the assumptions, implications, and claims associated with the prescription to maximize share value, and then offer an alternative approach to understanding what it is that corporate directors should do.

THE SHAREHOLDER VALUE MAXIMIZATION DOCTRINE[1]

The shareholder value principle of corporate governance incorporates or implies several fundamental beliefs:

- Maximizing value for shareholders is the right social goal for corporations because it is equivalent to maximizing the overall wealth being created by the corporation.
- Financial markets do a good job of assessing the true value of financial securities such as common stock. Hence, stock price performance is the best measure of value being created for shareholders.

- Maximizing share value also helps to discipline managers because it involves holding them accountable for a single metric that, in theory, is forward looking. Introducing other metrics would confuse things and make it easier for managers to use their positions to advance their own interests rather than the interests of shareholders, thereby increasing agency costs.
- Managers and directors will do a better job of maximizing share value if they are given high-powered incentives in the form of compensation packages tied to stock price performance, such as stock options.
- In any case, US corporate law generally requires shareholder primacy.

I consider each of these beliefs in turn:

Everyone is better off if share value is maximized

The belief that maximizing share value serves the broader social good because it is equivalent to maximizing the total value created by a corporation derives from a theory of the firm adopted by finance theorists and legal scholars in the 1980s, in which a firm is understood to be a 'nexus of contracts' (Jensen & Meckling, 1976; Easterbrook & Fischel 1991). The theory highlights the nature of the relationships underlying a firm – that is, among managers, employees, suppliers, customers, creditors, and shareholders. But proponents of the theory argue that the relationships between the firm's participants and the firm, except for those between shareholders and the firm, are governed by contracts that specify what each party is to do, and what each party should get in return. The shareholders' role is to be the 'residual claimant': they are not entitled to a fixed amount, but are to get what is left over after all other participants have received what they are contractually entitled to receive (Easterbrook & Fischel, 1991). If the claims of all other participants are fully protected by contract, according to the logic of this theory, then maximizing what is left over for shareholders is equivalent to maximizing the size of the whole pie.[2]

The idea that maximizing share value is equivalent to maximizing the total social value created by a firm seems obviously wrong to anyone who observes the various ways that corporations can (and do) externalize some of their costs onto employees, customers, or the communities where they operate. But even from the point of view of finance theory, the idea is wrong. Finance theory teaches us that the value of any claim on a firm is a function of the expected flow of payments to the holder of that claim and the risk associated with that claim. Thus if holders of one type of claim can shift risk onto holders of other types of claims, the value of the first type can be increased at the expense of the value of the other claims.

Under corporate law, shareholders have what is called 'limited liability.' This is a legal doctrine that means that the shareholders will not be held personally liable for debts of (or tort claims against) the corporation. Thus, shareholders always gain if the price of the stock goes up, but their potential losses are limited on the downside. In effect, creditors and other claimants are bearing some of the downside risk – they may be the ones who lose if the firm loses the gamble.

The argument extends to providers of nonfinancial inputs as well. Corporate employees, for example, make investments in specialized knowledge and networks of relationships needed in their jobs as well as in developing a reputation within the firm. Such investments are specific to the enterprise, and may be worthless to other employers. If the firm does well, the employee hopes to benefit from these specialized investments over the long term as the employee earns promotions and the firm continues to pay salaries, bonuses, and retirement benefits (Blair, 1995).

Hence, all investors in corporations share to some degree in the risk of the enterprise, and it is often possible to make the holders of one kind of claim (such as stock) better off at the expense of holders of other claims on the firm (such as debt claims), simply by shifting risk. The ability to make corporate shares more valuable by taking on higher risk goes to the heart of the skewed incentives that led to the financial crisis. Klein and Zur (2011), for example, find that when hedge funds acquire a significant stake in a target corporation, the stock price of the target firm's shares increases, but the firm's bonds lose almost as much value as the shareholders gain.

Bratton and Wachter (2010: 717–718) argue that an analysis of the tendency of shareholders to encourage managers to take excessive risks (thereby imposing costs on other corporate stakeholders as well as on the society at large) would likely show that the firms that were most responsive to pressures from the market for increases in share prices in the years leading up to the financial crisis were the firms that took on excessive leverage and consequently fell the furthest during the crisis (Gelter, 2009; Bratton & Wachter, 2010). Countrywide Financial Corp., they note 'was [a] clear market favorite [among banks] at least until mid-2007,' but quickly turned into 'one of the clear villains in the story' (Bratton & Wachter, 2010: 718). Similarly, the *New York Times* has documented the way that Washington Mutual Inc. ('WaMu') internally tracked and documented the extraordinary amount of risk it was undertaking as it continued to purchase mortgages that had little or no documentation behind them well into 2008. But while it apparently understood the risk, it did not abjure this business because to do so 'would have devastated profits' in the short run (Norris, 2011). WaMu was another poster child of the failures in the financial markets. Both Countrywide and WaMu collapsed in 2008 and had to be taken over by other banks, at considerable cost to taxpayers (Blair, 2011).

This risk-shifting approach to value creation should not have been surprising, since it is precisely what took place at Enron just a few short years earlier (Blair, 2003b). The fact that shareholders can often be made better off at the expense of creditors and employees and others with firm-specific investments at risk in the corporation means that it is not true, either in theory or in practice, that maximizing the value of equity shares is the equivalent of maximizing the overall value created by the firm.[3]

Shareholder primacy advocates often argue, nonetheless, that, in the long run, corporations will have to be fair with their creditors, suppliers, employees, and other 'stakeholders' in order to ensure that they will continue to participate in the enterprise (Jensen, 2002). In this way, maximizing the 'long-run' value of the equity shares will necessarily require that the other stakeholders be compensated according to their expectations, so that in the long run, it can still be true that maximizing share value is equivalent to maximizing total social value. To whatever extent this argument is correct, it can be reversed: in the long run, regardless of whose interests are considered primary, a corporation will have to provide an adequate return to shareholders and other financial investors or investors will not continue to supply capital to the firm. In theory, then, a corporate goal of maximizing long-run value for, say, employees, would also produce the maximum social value since all other stakeholders will have to be protected to ensure their long-run participation.[4] So this 'in the long run' argument fails to make a case that shareholders' interest should be given precedence over other legitimate interests and goals of the corporation.

Stock prices reflect the true underlying value of the stock

The belief that share prices are a good measure of the actual value of a corporation to its shareholders is based on a financial theory known as the 'efficient capital markets hypothesis.' This theory says that at any point in time, if financial markets are deep and liquid enough, the price for which a share of stock trades is the best available estimate of the true underlying value of the security.

Although finance theorists understand that this theory can never be proven, they nonetheless continue to debate the question of how efficient capital markets are.[5]

On the one hand, there is evidence that market prices in US stock markets respond very quickly to good news or bad news (Fama, 1970). On the other hand, the recent worldwide financial crisis has added substantially to the evidence that financial markets as a whole go through periods of boom and bust in which, in retrospect, it becomes clear that stock prices must have deviated significantly from their underlying fundamental value (Stout, 1990; Shiller, 2000; Nocera, 2009). Some scholars have argued that, in fact, financial markets respond very quickly to information that is easy to interpret, but they respond to complex information only very slowly and imperfectly (Stout, 2005). And a growing body of empirical work in 'behavioral finance' suggests that financial markets overreact, and that they are susceptible to fads and bandwagon thinking that may allow stock prices to get badly out of line with reality before enough investors will act to sell an overpriced stock, or buy an underpriced one, to cause the stock price to move back into line. Even Judge Richard Posner, a University of Chicago professor and leading scholar in the field of Law and Economics, has backed away from belief in the efficient capital markets hypothesis (Posner, 2009).

The fact that financial markets overreact and do not absorb complex information quickly and correctly means that there is room for corporate insiders to manipulate stock prices by releasing misleading information into the markets. The experience of the last decade certainly suggests that insiders can sometimes cause stock prices to deviate widely from the true underlying value. But even when insiders are not intentionally misleading the market, they will probably have knowledge that other market investors do not have, and therefore have reason to know when a stock's market price is out of line with the underlying reality. It also means that board members and other insiders may, indeed, know more than the market knows about what a corporation is doing to create value, and that directors should not be required to choose actions to maximize the stock price even when, in their own business judgment, the markets are mispricing the stock.

Managers must have a single metric against which to measure their performance.

The argument is commonly advanced that directors and managers must be held accountable for a single metric such as share value, because otherwise they cannot be held accountable at all. In its own way, this argument is an admission that the other rationales for shareholder primacy are bankrupt, but that we should nonetheless use share value to measure the performance of corporate officers and directors because it is simple and easy to apply, while other metrics are complex, subject to manipulation by managers, and inevitably involve tradeoffs that require subjective rather than objective judgment. Here again, the events of the last decade should disabuse all of us of any notion that share price is not a manipulable metric. While it is true that share prices respond to new information, and perhaps even true that over an extended period of time, like several years, share prices on deep and liquid markets will tend, on average, to reflect the true underlying value of a corporation (whatever that means), the long run can be quite long relative to the financial health of a given corporation, which can change dramatically even in a few months. Meanwhile, the damage done in the short run, while the market is being fooled, can be substantial. The point is not that share price is irrelevant, but that it is overly simplistic – in fact, dangerously so, as I will argue below – to focus too much attention on share price to the exclusion of other measures of corporate and managerial performance.

The importance of high-powered incentives

The belief that managers and directors should be compensated in stock and stock options in order to create high-powered incentives for them to maximize share value follows naturally from the approach of using the economists' model of human behavior to analyze corporate governance questions. Economic analysis is based on a set of assumptions about the way people work in groups. In particular, part of the conventional wisdom has been that directors and managers of companies will always make decisions in ways that serve their own personal interests unless they are either tightly monitored and constrained (which is costly, and raises the question of who will monitor the monitors), or given very strong incentives to manage in the interests of shareholders (e.g., Shleifer & Vishny, 1997). This premise about the way the world works has led to a small industry of compensation consultants who have advised firms to pay corporate executives and directors in stock options, so that they would be highly motivated to get the company's stock price to go up. The problem has been that stock options, as discussed above, create skewed incentives for executives – option holders win big if the stock goes up, but they are not penalized if the stock price goes down. Furthermore, the models used by compensation consultants often provide that if the stock price goes down, then options should be re-priced, or executives should be awarded a large number of additional options (with a lower strike price) so that they will again be well-motivated to get the stock price to go up from wherever it is at the time (Gillan, 2001). The result has been a continuing orgy of stock option awards to CEOs and other senior managers of US companies (see Lazonic, chapter 21 of this handbook), and compensation that still sometimes seems disconnected to corporate performance.

Meanwhile, stock options create incentives that can be quite perverse. Stock options are actually more valuable the more risky the underlying security, so that stock option compensation can encourage CEOs to pursue very risky strategies. This is especially true if the options are 'out of the money' (meaning that the current stock price is at or below the strike price of the options). In such situations, the option holder stands to win big if a corporate gamble pays off, but can lose little or nothing if the gamble fails. Another result of stock option-based compensation has been the widespread practice of 'earnings management.' At its most benign level, earnings management is simply using the flexibility available in the accounting rules to smooth earnings or cash flow numbers. But once the practice is sanctioned, it can lead to egregious abuses and excessive pressure on managers to close deals by the end of a reporting period, even if that means taking short cuts in 'due diligence' and record-keeping, as we have seen in the 'robo-signing' scandal during the mortgage foreclosure crisis (Gopal, 2010).

US law requires shareholder primacy

Advocates of shareholder primacy often casually assert that corporate law in the USA requires shareholder primacy. This is simply a false claim (Blair & Stout, 1999; Elhauge, 2005). US corporate law comes closer to requiring 'director primacy' (Blair & Stout, 1999; Bainbridge, 2002). State laws governing the incorporation of firms typically provide that 'all corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of its board of directors' (Model Business Corporation Act §8.01(b)). Shareholders are allowed to vote each year on a slate of directors nominated, generally, by the existing directors, and they are allowed to vote on certain major transactions (such as the sale of the business or a liquidation). But other than that, shareholders in large, publicly traded corporations have few formal powers.

Meanwhile, the law regards directors as fiduciaries for the corporation, not agents of shareholders (Clark, 1986). For this reason, courts give directors very wide discretion in the choices they make about a firm's strategy or transactions. As stated by a member of the Delaware Chancery Court, 'During the board's term, the board has the power, subject to fiduciary duties, to pursue its vision of what is best for the corporation and its stockholders' (Strine, 2010).

In recent years, however, there have been some modest changes in US corporate law in the direction of giving shareholders more influence in corporations. In the early 1990s, the Securities and Exchange Commission (SEC) relaxed rules that restricted institutional shareholders from exchanging information with each other about corporate governance matters in portfolio companies. This made it easier for institutional shareholders to freely communicate with each other and with other shareholders without triggering filing requirements with the SEC (Blair, 1995; Monks & Minow, 1995).

Similarly, the emergence of proxy advisory services has offered a market solution to the collective action problem that inhibited shareholder action in the past (US GAO, 2007). Rose (2010) has developed evidence that institutional shareholders now have some significant influence on corporate policies (Rose, 2010). In particular, institutional investors have become increasingly active in pressuring portfolio companies to eliminate poison pills and staggered boards, to disclose executive compensation arrangements and to give shareholders a chance to approve or disapprove of them, and to change voting rules so that directors can only be elected by the affirmative vote of a majority of outstanding shares. In the wake of the corporate scandals of 2001–2002, Congress passed the Sarbanes–Oxley Act that imposed new requirements for director independence at publicly traded corporations. And in the wake of the recent financial crisis, the US Congress was apparently also persuaded that shareholders should be given more clout in corporate governance arrangements, rather than less, and enshrined in the Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173) that the SEC should rewrite its rules to assure that corporations must give shareholders the right to approve compensation packages for executives, and to give shareholders easier access to proxies for nominating directors. The SEC acted on this in September, 2010, but the Business Roundtable and the US Chamber of Commerce challenged these rule changes, and in the summer of 2011, the U.S. Court of Appeals for the District of Columbia struck down the new proxy access rule on the grounds that the SEC had not adequately considered the rule's effect on companies. In September, 2011, the SEC announced it would not repeal this decision (Statement by SEC Chairman Mary L. Shapiro on Proxy Access Litigation, available at http://www.sec.gov/news/press/2011/2011-179.htm, last accessed Nov. 16, 2011). Nonetheless, the reforms so far do not fundamentally undo the long-standing legal rule that requires courts to give deference to the business judgment of directors unless the action being challenged involves 'fraud, illegality, or conflict of interest' (*Shlensky v. Wrigley*, 237 N.E.2d 776, 1968). In short, directors can only be held liable for breach of their fiduciary duties if they engage in transactions that benefit themselves at the expense of the corporation or fail to act for the corporation in good faith (Fairfax, 2005: 410; ABA, 2009: 10).

THE DUTIES OF DIRECTORS

So, if directors are not required to maximize shareholder value, what are they supposed to do? Shareholder primacy advocates across the board are now retreating to the view that directors should maximize the long-run performance of the stock, or, in some cases, the long-run aggregate value of all financial securities issued by the firm (Jensen, 2002; Bebchuk & Spamann, 2010; Bratton & Wachter, 2010). 'Excessive reliance on market pricing poses problems for corporate governance,' according to Bratton and Wachter (2010: 726). 'Price signals need to be interpreted by an agent exercising sound business judgment, with the independent board of directors bearing that burden' (Bratton & Wachter, 2010: 727).

Once it is conceded that directors are not required to maximize the value of the corporation's shares, however, and that, instead, they should pursue some sort of long-run or aggregate goal, implementing this prescription becomes complicated in practice. Jensen, for example, says that

> In order to maximize value, corporate managers must not only satisfy, but enlist the support of, all corporate stakeholders – customers, employees, managers, suppliers, and local communities. Top management plays a critical role in this function through its leadership and effectiveness in creating, projecting, and sustaining the company's strategic vision. … Enlightened value maximization uses much of the structure of stakeholder theory but accepts maximization of the long-run value of the firm as the criterion for making the requisite trade-offs among its stakeholders (2002: 67).

In other words, directors have both the authority and the responsibility, without any change in corporate law, to consider the interests of all of the participants in the corporate enterprise in order to try to find the outcome that creates value for all parties. In earlier work I have done with Professor Lynn Stout, we have argued that corporate law, in fact, facilitates exactly this approach to corporate management by offering a solution to what we call a 'team production' problem.[6] We use the phrase 'team production' to refer to productive activity that requires multiple parties to make contributions that are complex, at least somewhat specific to the enterprise the team is undertaking, difficult to verify, and non-separable, meaning that it is impossible to determine ex post which team member is responsible for what part of the output (Blair & Stout, 1999: 249–250). Economists who have studied the problem of team production have observed that it is extremely difficult, if not impossible, to write complete contracts that would govern the relationships among team members (Alchian & Demsetz, 1972; Holmstrom, 1982; Hart, 1988; Rajan & Zingales, 1998; Blair & Stout, 1999: 265–271).

Building on that prior body of work, Professor Stout and I constructed a theoretical solution to the team production problem which works by allocating control rights to certain parties who are not members of the team. In particular, we suggest that corporate law provides one possible solution by offering a legal structure in which all of the assets used in production by the team, as well as the output from the efforts of the team, are the property of a separate legal entity, the corporation, and decision rights over these assets are relegated to a board of directors that is independent of the team (Blair & Stout, 1999: 271–279). Directors, then, have fiduciary duties that run to the corporation – the legal entity that represents the aggregate interests of all of the 'team members' – and only through the corporation to the shareholders.[7]

Many features of corporate law in the USA are more consistent with our team production model than they are with shareholder primacy (Blair & Stout, 1999). For example, although it has become common in legal scholarship in the last two decades to refer to corporate directors and managers as 'agents' of shareholders (Bebchuk, 1982), corporate law in fact makes a sharp distinction between the role of managers and the role of directors. Robert Clark makes this point succinctly:

> 1) corporate officers like the president and treasurer are agents of the corporation itself; 2) the board of directors is the ultimate decision-making body of the corporation (and in a sense is the group most appropriately identified with 'the corporation'); 3) directors are not agents of the corporation but are *sui generis*; 4) neither officers nor directors are agents of the stockholders; but 5) both officers and directors are 'fiduciaries' with respect to the corporation and its stockholders (Clark, 1985: 56).

As noted above, corporate law also provides enormous discretion to directors who make decisions in good faith about the allocation of corporate resources, even in cases where it is hard to show how such allocations benefit shareholders. Courts have also explicitly recognized that in situations in which share value is not a good proxy for the overall wealth-creating capacity of the corporation, such as when a firm is insolvent, directors' duties may run to other stakeholders, especially creditors.[8]

Furthermore, the rules of derivative actions are much more consistent with a team production interpretation of corporate law than with a shareholder primacy interpretation. Although ordinarily only common shareholders have standing to file a derivative action (Federal Rules of Civil Procedure 23.1; Del. Code Ann. tit, 8 § 327 (2002)), several procedural hurdles make it difficult for shareholders to take such action.[9] Moreover, if, despite the obstacles, the derivative action is successful, any damages recovered must be paid not to the shareholders who pursued the action, but to the corporation. Finally, shareholders can only win a derivative action if directors are found to have blatantly violated their duty of loyalty by appropriating to themselves resources that belong to the corporation, or have breached their duty of good faith, or wasted corporate assets. In these situations, the harm done is to the interests of the corporation as a whole, rather than directly to the suing shareholders, or even to shareholders as a group. Meanwhile, shareholder actions have not been successful where they allege that directors have made decisions or allocated resources in ways that may benefit other corporate stakeholders, even at the expense of profits (Blair & Stout, 1999).

The team production model helps explain the broad discretion granted directors under corporate law, as well as the limits placed on shareholders' ability to intervene in the decision-making process.[10] The team production model could also guide judges and lawmakers in thinking about positive duties that directors should have. I have argued in earlier work that the job of boards of directors should be to maximize 'the total wealth-creating potential of the enterprises they direct' (Blair, 1995: 239). To do this, directors should pay heed to the three ways that new wealth is created: by providing products and services that are worth more to the customer than the customer pays for them (this yields 'consumer surplus'); by providing opportunities for workers to be more productive at their jobs than they could be in other employment (yielding 'labor surplus'); and by providing a flow of profits to investors that is greater than those investors could get by investing in alternative projects or ventures (yielding 'capital surplus'). By contrast, firms could attempt to capture value for shareholders by pursuing risky financial strategies in which the firm wins if the strategy succeeds, but pushes risk onto creditors or others if the strategy fails. This approach to 'wealth-creation,' however, does not add to social wealth, and is probably not a sustainable basis for creating value even for shareholders in the long run. If a director cannot identify how her corporation creates consumer surplus, labor surplus, or capital surplus, then this may be a sign that what the firm is doing is not a sustainable basis for long-term wealth creation.[11]

On the other hand, if a corporation is going to create consumer surplus, labor surplus, or capital surplus, it seems clear that management and directors must take into account not only the investment interest of shareholders but also the interests of all of the stakeholders who have made specific investments that are at risk in the enterprise. Beyond that, however, the prescriptions that come out of a team production approach to corporate law are not very specific, and may not, in practice, be clearly distinguishable from the prescriptions that advocates of long-term share-value maximization would make. The difference is primarily in the language used to describe the duties.

WHY THE CHOICE OF LANGUAGE MATTERS

The team production model of corporate law suggests that the role of corporate directors is to mediate among members of the corporate team, making decisions in the interest of the corporate entity, which serves as a proxy for the combined interest of all the team members. And, as we have seen, leading business people, economists, and some prominent shareholder primacy advocates have claimed that the 'long-run' version of the shareholder primacy model also implies that corporate directors should make decisions that accommodate the interests of important stakeholders in an effort to maximize the long-run wealth creation of the corporation. Investment banker Peter G. Peterson, who co-chaired the Conference Board Commission on Public Trust and Private Enterprise (Conference Board, 2003), established after the Enron/Worldcom scandals of 2001 and 2002 to address the duties of directors and the role of corporate governance in preventing further corporate misbehavior, put it this way:

> Whereas managing for stock price gains too often means managing for the short term, managing with an eye towards long-term operating performance is in the best long-term interests of the corporation and its shareholders, as well as its other constituencies, such as employees, communities and customers – all of whom have a decided interest in the long-term success of the corporation. (Conference Board, 2003).

Thus, in practice, it seems clear that it will be difficult, if not impossible, to distinguish between the goal of overall wealth maximization, and the goal of long-term share-value maximization: Is a decision to award stock options to all employees made because it is good for shareholders in the long run? Or is it made to share the benefits of wealth creation with employees, and thereby encourage them to stay motivated and productive? Is a decision to aggressively reduce carbon emission from a company's plants made because it is the socially responsible thing to do, or is it made because, in the long run, it will be good for shareholders if the company plays a leadership role in developing environmentally sustainable ways to operate?

Neither a mandate to engage in long-run share-value maximization, nor a mandate to enhance the performance of the corporation as a whole by carefully balancing competing interests so that the team stays productive, provides courts with a way to tell whether directors are doing their job in an optimal way. Because of this indeterminacy, courts have, wisely, avoided trying to second-guess the decisions of directors when faced with a challenge from shareholders (or occasionally from other constituents such as creditors).[12] Instead, unless the directors are so badly tainted by self-interest that they could not be expected to be able to make a decision that fulfilled either mandate, courts have relied on the 'business judgment rule', which is 'a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company' (*Aronson v. Lewis*, 473 A.2d 805, Del., 1984). The business judgment rule protects directors from liability for honest errors and mistakes of judgment by declaring that '[t]he law will not interfere with the internal affairs of a corporation so long as it is managed by its directors pursuant to a free, honest exercise of judgment uninfluenced by personal, or by any considerations other than welfare of the corporation' (*Bayer v. Beran*, 49 N.Y.S.2d 2, 5, N.Y. App. Div. 1944).

If judges cannot constrain director behavior to conform to either mandate, why should it matter what metaphor or what language we use to describe the duties of directors? The reason is that language itself influences behavior because it is an extremely important part of the social signals that people send each other to help establish the norms and expectations that people have for each other (Rock, 1997). Although scholars steeped in the jurisprudence of law and economics tend to consider only the ways that economic incentives and legal constraints influence behavior, there is strong evidence from other social sciences that a variety of social signals also influence behavior (Blair & Stout, 2001a; Stout, 2011).

Language and cooperation

Empirical studies of the factors that cause people to cooperate in social dilemma games (Sally, 1995; Blair & Stout, 2001a), rather than to 'defect,' for example, suggest that cooperation rates in social dilemma games can be induced with considerable predictability to be as low as 5%, or as high as 95%, depending on the social context in which the game is played (Blair & Stout, 2001a: 1768; Stout, 2011). (Social dilemma games are games structured by social psychologists, sociologists, and economists in which the payoff structures are such that individual players are rewarded if they 'defect' by choosing strategies that help themselves but harm the other players. But if all players defect, they are all worse off, while if all choose not to defect, they are all better off.) The social signals that seem to matter most include instructions from authority figures, perceptions about whether the other players in the game are members of one's own group, however such groupings might be defined, and the expectations that players have about how likely their fellow players are to cooperate (Blair & Stout, 2001a: 1768–1772).

A consistent finding in social dilemma games is that cooperation rates can be dramatically increased (by as much as 40 percentage points) if the experimenter simply tells the players they are supposed to cooperate (Blair & Stout, 2001a: 1769–1770). Likewise, cooperation rates fall by as much as 33 percentage points if players are instructed to compete (Blair & Stout, 2001a: 1770). By analogy, if corporate executives and directors announce to corporate participants that the venture they are participating in is a competitive enterprise in which employees must get what they can for themselves because officers and directors are working for the sole benefit of shareholders, it seems unlikely that they will elicit as much eager cooperation and self-sacrifice for the good of the enterprise than if they announce that all of the participants, regardless of what kind of contribution they bring to the enterprise, are part of the same team, and all will share in the success of the enterprise.

The language of team production is also a language that suggests to corporate participants that they are all part of the same in-group. In contrast, the language of shareholder primacy suggests that shareholders are a privileged in-group, while all others are outsiders, and not part of the in-group. Social scientists have shown, however, that when group identity is brought into play as a factor in social dilemmas, individuals who perceive themselves to be a part of the same in-group with their fellow players are far more likely to cooperate than individuals who perceive themselves to be playing against another group (Sally, 1995; Blair & Stout, 2001a).

Social scientists have also found that individuals are much more likely to cooperate if they expect their fellow players to cooperate (Blair & Stout, 2001a). It seems unlikely, at face value, that employees, suppliers, creditors, customers, and communities will be eager to cooperate to produce a successful outcome in an enterprise if directors and managers repeatedly assert that the enterprise is all about profits for shareholders, period. Admittedly, there may be circumstances in which old implicit and explicit understandings about how economic gains from an enterprise must be broken, and new contracts (explicit and implicit) must be written. When automobile sales plummeted in the wake of the financial crisis in 2008–2009, General Motors and Chrysler simply could not pay their debts and stay in business. Both were compelled to restructure in bankruptcy proceedings where they got out from under prior commitments to creditors, suppliers, employees, and retirees that they could no longer sustain. Shareholders also lost most of what they had invested in these companies. But it seems self-evident that the auto companies would not be able to restructure those relationships if profits were still strong, and if the stated purpose of the sacrifices was to make shareholders even better off. The language of shareholder primacy is a language that draws attention to conflicting interests and announces that, when faced with conflicts, directors will choose to benefit shareholders over all others. By contrast, the language of team production is a language of shared sacrifices and shared benefits.

Language and incentive systems

As if the language of shareholder primacy were not divisive enough by itself, shareholder primacy advocates also have frequently advocated that executives and directors should be compensated in ways that are tied to share price performance. Behind this desire to link executive pay to share price is a firmly held belief by individuals trained in the logic of law and economics that corporate executives are fundamentally untrustworthy, and will abuse their positions of power and authority by redirecting corporate assets to their own benefit at the expense of the corporation unless they are given powerful economic incentives to focus solely on those activities that enhance share price. The whole idea of incentive compensation, then, became part of a set of social signals sent by investors, academics, consultants, and the media since the 1980s that corporate managers are expected to play a competitive game, not a cooperative one. Corporate managers are being told repeatedly that they, in effect, should be in the game for themselves, rather than for some larger vision, so that directors must make it attractive for the executive to work for higher share value rather than cheat the company (Osterloh & Frey, 2004).[13]

The result has been an orgy of stock option grants and other incentive compensation over the last several decades, as well as compensation levels that have risen by orders of magnitudes to heights (relative to the wages of average workers) not seen since the robber baron days (Piketty & Saez, 2003). These compensation packages have often provided huge incentives to manipulate stock prices with misleading information, or to take on enormous risks which would benefit shareholders (as well as the corporate executives who authorize them) if the bets win, while pushing large parts of the downside costs (if the bets lose) onto creditors, other stakeholders, and even taxpayer-subsidized bailouts by the federal government.

All of this was well understood in the wake of the corporate scandals of 2001–2002. 'Unfortunately, institutional investors, corporate governance activists, and even SEC regulations have led many corporations to define performance simply as stock performance – to disregard a corporation's vision and ... its value system,' observed compensation consultant Pearl Meyer in a 2003 Harvard Business School roundtable (Elson, 2003: 72). Yet stock options and stock-based incentive compensation has continued to dominate compensation packages, and boards have continued to reward risk-taking well into the financial market crisis (Thomas, 2009). 'Weren't we saying in the 1980s that we should tie CEOs to the market in order to identify them with shareholder value?' asked Joe Bachelder, a leading compensation lawyer and consultant participating in the same 2003 roundtable. 'We got what we asked for,' he added in response to his own rhetorical query (Elson, 2003: 71).

Language and ethical behavior

The language we use to describe the job of corporate officers and directors also helps to create the climate within which ethical decisions are made, which goes to the essence of one of the most important duties of directors. As Professor Lynne Dallas has observed (Dallas, 2003), the United States Sentencing Commission's Organizational Sentencing Guidelines, supported by case law (In *re Caremark Int'l Inc. Derivative Litigation*, 698 A.2d 959,968-70 (Del. Ch. 1996)), suggest that directors and officers of corporations must put in place information and control systems that will help to prevent unethical or illegal behavior by employees. The Sarbanes–Oxley Act of 2002 further directs the Sentencing Commission to re-evaluate its sentencing guidelines to be sure that they are ‘sufficient to deter and punish organizational criminal activity’ (Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, §805(a)(5), 116 Stat. 745 (2002)). The Act also directs the SEC to require public corporations to disclose whether or not they have adequate internal controls (Sarbanes–Oxley Act §404), and whether or not they have a code of ethics for senior officials and, if not, to disclose the reasons why not (Sarbanes–Oxley Act §406(a)). And it directs the SEC to require companies to disclose situations in which directors waive an ethics requirement for some employee, or for some transaction, and explain why (Sarbanes–Oxley Act §406(b)). The New York Stock Exchange’s corporate governance rules require that listed corporations adopt a code of business conduct and ethics and ‘proactively promote ethical behavior’ (NYSE Listed Company Manual, 303A.10). Similarly, the Conference Board Commission on Public Trust and Private Enterprise further espouses the principle that ‘ethical standards and the skills required to foster ethical practice throughout the organization should be among the core qualifications for the CEO and other senior management positions,’ that a board committee should be designated to oversee ethics issues, and that ‘ethics-related criteria’ should be included in employees’ annual performance reviews and in the evaluation and compensation of management (Conference Board, 2003).

In the wake of the financial crisis, the Dodd–Frank Act §922 attempted (somewhat controversially) to build on the whistleblower provisions of the Sarbanes–Oxley Act by offering reward incentives for employees to report corporate governance concerns directly to the SEC.[14]

How does a corporation ‘proactively promote ethical behavior’ and how do directors evaluate management on the basis of ‘ethics-related criteria’? Related questions have been studied in some detail by business ethicists and social scientists who have inquired into the problem of creating an ethical corporate climate (Dallas, 2003; Woodstock Theological Center Seminar on Business Ethics, 2003). Dallas (2003) summarizes literature on the subject, which, consistent with the findings on trust and trustworthy behavior in the previous section, finds that ethical behavior is more strongly influenced by situational factors than by the personal belief systems of individuals (Ferrell & Gresham, 1985; Dallas, 2003).

Dallas’s summary suggests a number of ways that shareholder primacy language, as well as incentive compensation systems tied to stock price performance, might undermine any attempt to create or maintain an ethical climate within an organization. For example, she finds several different contextual factors that encourage or discourage employees from giving priority to moral decision-making and actions (Dallas, 2003). One of these is the ‘role of expectations’ within the business environment. Because most employees segregate the values that influence their choices at home from values that influence their choices at work, ‘managerial decisions will correspond more closely to the humanistic, religious, cultural and societal values of society-at-large only when these values are made part of the job environment’ (Dallas, 2003: 26, quoting Bommer, et al., 1987: 268). The rhetoric of shareholder primacy, however, serves to suppress values of empathy toward others, and to focus attention solely on the bottom-line financial impact of corporate decisions.

Dallas further argues that the ‘ethical climate of a corporation consists of the ethical meaning attached by employees to organizational standards, practices and procedures, including managerial behavior and reward systems, that reflect the corporate norms and values’ (Dallas, 2003: 26). While it seems likely that most shareholder primacy advocates believe themselves to be highly ethical people, with a low tolerance for unethical behavior,[15] the language of shareholder primacy states outright that the norms and values of corporations should be about enhancing shareholder value, and any consideration of the impact of corporate actions on other stakeholders is only instrumental. Moreover, the incentive systems promoted by shareholder primacy advocates reinforce the message by emphasizing self-interest as a motivation, and rewarding choices that emphasize the financial bottom line over other goals. Such practices and procedures can easily undermine verbal messages that seem to place a value on ethics.[16] Dallas concludes that performance evaluations that increase the competitiveness of the work environment, and 'unduly focus on the bottom line can lead to pressures to engage in unethical conduct' (Dallas, 2003: 48).

Other scholars and commentators have made similar points. 'It was the laser focus on stock price gain that encouraged executives to drive their beasts so hard they collapsed. CEOs were the visible villains, but there were whips wielded to keep them driving toward maximum share price: whips of firing, stock options, and hostile takeovers,' observed Marjorie Kelly, editor of *Business Ethics* magazine about the corporate financial scandals of 2001–2002 (Kelly, 2002: 11). William Bratton and Michael Wachter make a strikingly similar observation about the activities of financial sector firms in the years and months leading to the financial crisis of 2007–2008:

> For a management dedicated to maximizing shareholder value, the instruction manual was clear: get with the program by generating more risky loans and doing so with more leverage. Any bank whose managers failed to implement the [high risk strategy] got stuck with a low stock price. … Unsurprisingly, its managers labored under considerable pressure to follow the strategies of competing banks (Bratton & Wachter, 2010: 720–721).

As Clarke and Klettner's chapters discuss, this behavior has been widely recognized in post-crisis inquiry reports, and regulatory reforms across most jurisdictions now recommend that executive remuneration systems should be redesigned to take into account risk strategy and promote long-term performance. To promote ethical behavior (or at least discourage unethical behavior) the Dodd–Frank Act requires much more disclosure on remuneration policy (including procedures for 'clawback' of executive remuneration) and requires that remuneration reports are subject to a non-binding shareholder vote (so-called say-on-pay).

It is true that the rhetoric of team production can also be used to promote unethical practices by supporting a 'win at any cost' mentality among corporate 'team members,' or by being used as a shield to try to protect corporate managers and directors who are merely building empires and collecting perks. But it seems inherently less likely to promote cut-throat competition among team members, and also more conducive to assessing corporate actions and choices in terms of their impact on all of the corporation's stakeholders, and not just the impact on one subset of stakeholders.

Directors who start from the premise that their job is to oversee the work of a team and to mediate among team members to encourage them to work together to achieve value-creating corporate goals are more likely to consider each decision in terms of its impact on each of the relevant and important stakeholders, as well as on the overall goals of the corporation. In the long run, making decisions in this way seems more likely to produce sustainable, long-run value creation than allowing decision-making to be driven by when management's stock options expire, or by what management thinks market analysts want to hear at the next analysts' meeting to justify their 'buy' recommendation.

CONCLUSION

Like most goal-oriented organizations, business organizations frequently rely on shorthand language or 'code' to share relevant information among the participants in the organization, to convey to all team members what the collective goals are, and to measure progress against those goals

(Wernerfelt, 2003). Any such shorthand phrase that is used to define corporate goals can be manipulated and corrupted, or interpreted in ways that produce unfortunate results. When it first came into use, it may well be, as Enriques et al. (2009), argue that the notion that corporate directors have a duty to maximize share value was 'most naturally understood as a command to maximize the net aggregate returns (pecuniary and non-pecuniary) of *all* corporate constituencies ...' (Enriques et al., 2009: 103).

But the corrupting effect of an extreme pursuit of shareholder value should now be abundantly clear. Fortunately (and contrary to much popular myth), corporate law does not require that directors must maximize share value.[17] Instead, corporate law instructs corporate directors that they must act 'in the best interests of the corporation.' (Blair & Stout, 1999; Bratton & Wachter, 2010: 712–713; Model Business Corporation Act §8.30(a)(2)). The legal model thus 'opens up a zone of discretion,' observe Bratton and Wachter (2010). Once it is conceded, however, that corporate law does not require share-value maximization, and that it may not be in society's interests for corporate managers and directors to focus exclusively on maximizing share value, or, indeed, that a mandate to maximize share value even has the same meaning for all shareholders, then theories about the role of corporate directors in the face of competing interests among shareholders and other stakeholders take on most of the important features of the team production model as laid out by Blair and Stout (1999). For corporate leaders who want to build a climate that supports trust, cooperation, and ethical behavior, the language of team production surely provides a better starting place.

NOTES

1 This section is based heavily on Blair (2003a).

2 The assertion that shareholders get what is left over is true in an accounting sense, in that assets on the balance sheet are allocated first toward all contractual claims, and whatever is left over is assigned to the 'shareholders' equity' account. But no corporate rule requires that, on an ongoing basis, profits should be paid out to shareholders, and often profits stay in the firm where they may be spent in other ways. In theory, shareholders are also residual claimants when a firm is reorganized in a bankruptcy proceeding. But in the latter case, shareholders often receive something from the bankrupt estate even when creditors have not been paid in full (Longhofer & Carlstrom, 1995).

3 See Blair and Stout (2001b) for an expanded discussion, based on options theory, of why maximizing value for shareholders is not equivalent to maximizing the total value created by the corporation.

4 Sunder (2001) notes that, since markets for financial capital are among the most liquid and efficient in the world, shareholder returns should, on average at least, always equal to the opportunity cost of capital, and there should be no excess returns. By contrast, suppliers of other resources used in the corporation often provide specialized or unique inputs that might be able to demand a premium. From this point of view, one would expect that the only wealth being created by the firm would generally be captured by other participants, and not by the providers of financial capital. Sunder makes this point to call attention to the arbitrariness of measuring the value of a firm by looking only at its value to shareholders.

5 To prove that a market-determined price accurately reflects the true value of the security would require some independent way to measure the 'true value.' Hence, any test of how close stock prices are to the stock's true value is simultaneously and unavoidably a test of whether the model being used to measure the 'true value' is a good model. If the market price varies from the price predicted by the model, we can never tell whether the problem is that the model is wrong, or that the market is not efficient in determining the prices.

6 This section is based heavily on Blair (2003b). See also Blair and Stout (1999).

7 See Restatement (Third) of Agency §1.01 (2006) 5 which states that directors are not agents of shareholders, and ABA Report 2009 : 5, which states that 'directors are obligated to make their own judgments based on the best interests of the corporation and bear the full liability for those judgments'.

8 See, for example, *Credit Lyonnais Bank Nederland NV. V. Pathe Commc'ns Corp*, Civ. A. No. 12150 1991 WL 277613 (Del. Ch. 1991) holding that directors have duties to creditors when a corporation is in the 'vicinity of insolvency.' This has since been overruled, by *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, No. 521, 2006, 2007 WL 1453705 (Del. May 18, 2007) – see

Coelho 2007; Official Comm. of Unsec. Creditors v. R.F. Lafferty, 267 F.3d 340 (3rd Cir. 2001); OHC Liquidation Trust v. Credit Suisse First Boston, 340 B.R. 510 (Bankr. D. Del. 2006). See also Shu-Acquaye, 2010. But courts still regard directors as having duties to creditors when a corporation is actually insolvent, and in such circumstances, creditors would have standing to sue derivatively to enforce those duties. See *Geyer v. Ingersoll Publication Co*, 621 A.2d 784 (Del. Ch. 1992), holding that a board of directors owes fiduciary duties to creditors no later than when the corporation becomes insolvent.

9 Shareholders must first make a 'demand' on the board of directors that it take the desired action on behalf of the firm against managers or directors who are alleged to have violated their fiduciary duties, or they must demonstrate that the board is so tainted by conflict of interest that demand should be excused. *Aronson v. Lewis*, 473 A.2d 805, 810–15 (Del. 1984). Even if demand is excused, directors may form an investigative committee of independent directors who may take control of the lawsuit and have it dismissed (Clark, 1986).

10 Bebchuk and Ferrell (2001) consider at some length the constraints on shareholders' initiatives, and propose a set of 'reforms' that would grant shareholders much more power relative to managers and directors in publicly traded corporations.

11 *Fortune* reporter Bethany McLean (2001) famously asked, 'How exactly does Enron make its money?' in one of the first direct challenges to its business model by the financial press a few months before it collapsed. Similarly, *New York Times* columnist Joe Nocera (2009) observed the following about AIG Corp. after the US government began shoveling money into the company to keep it from failing, 'When you start asking around about how AIG made money during the housing bubble, you hear the same two phrases again and again: 'regulatory arbitrage' and 'ratings arbitrage.'

12 The rules of derivative suits normally permit only shareholders to act for the corporation in bringing a derivative action against directors for breach of their fiduciary duties, but corporate law occasionally allows bondholders and other creditors to bring claims of breach of fiduciary duty against the board once a corporation becomes insolvent. Geyer v. Ingersoll Publication Co, (1992).

13 Osterloh and Frey (2004) review empirical evidence that incentive contracts 'crowd out' intrinsic motivation, and report new experimental evidence that the crowding out effect is strong enough that incentive contracts 'are on average less efficient and elicit less effort from agents, than contracts that do not provide any incentives at all.'

14 Although the intention of the whistle-blowing provision in Dodd–Frank was to promote ethical behavior, there were concerns that these provisions would weaken the internal whistleblower procedures set up by many companies following Sarbanes–Oxley.

15 Jensen and Fuller (2003).

16 'Enron rang all the bells of CSR [Corporate Social Responsibility],' observes Marjorie Kelly, editor at the time of *Business Ethics*, in the magazine's first editorial after Enron collapsed.

> It won a spot for three years on the list of the 100 Best Companies to Work For in America. In 2000, it received six environmental awards. It issued a triple bottom line report. It had great policies on climate change, human rights, and (yes indeed) anti-corruption. Its CEO gave speeches at ethics conferences and put together a statement of values emphasizing 'communication, respect, and integrity.' The company's stock was in many social investing mutual funds when it went down (Kelly, 2002).

But at the same time that it was giving lip service to the importance of ethics, Enron was providing outsized financial rewards to employees who met or exceeded aggressive financial targets, and conducting annual performance reviews of employees based solely on how they did relative to financial targets, laying off those employees in the lower tail of the distribution (Zellner, 2001).

17 Except in the limited circumstances known as 'Revlon mode' when a corporation is going to be sold: *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). Once it has become inevitable that there will be a change of control of the corporation through a merger or takeover or other transaction, then courts have said that the duties of directors is to get the best price they can for shareholders. But as if to underscore the point that this is not ordinarily what directors must do, the Revlon case clearly says that, in these special circumstances, the duties of directors 'change.'

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Limited Liability Companies

Mark J. Loewenstein

INTRODUCTION

The limited liability company (LLC) is a relatively new form of business entity, first appearing in 1977. It is best understood as a melding of a partnership and a corporation, the former because it is treated as a partnership for federal income tax purposes and the latter because the investors are not liable for the debts and obligations of the entity. This latter characteristic is referred to as 'limited liability' and is essential for promoters seeking to sell equity interests to passive investors.

Prior to the invention of an LLC, promoters who desired the tax treatment of a partnership had only the choices of a general partnership, in which each partner would have unlimited liability for the firm's obligations, or a limited partnership, where the general partner(s) would have such liability. Partnership taxation – meaning that the entity itself is not a taxpayer and any tax profits or losses 'flow through' to the partners – is especially attractive if the corporate tax rate is relatively high or the venture generates tax losses.

While many ventures seeking partnership tax status have been formed as limited partnerships, this has proved less than ideal, for several reasons. First, limited partnership statutes place limitations on the ability of limited partners to participate in the business, and exceeding these limitations may result in imposing on the limited partner the liability of a general partner. Second, the general partner was exposed to potentially unlimited liability. While this risk could be reduced by using a minimally capitalized corporate general partner, not all jurisdictions allowed this. Some courts held that a limited partnership with a minimally capitalized general partner was a sham and the individuals controlling the corporate general partner would be liable for the partnership's obligations.[1] Moreover, this structure required the promoter to maintain two organizations. Finally, the Internal Revenue Service (IRS) treated some partnerships as corporations for federal income tax purposes, taking the position that such partnerships had more of the characteristics of a corporation than of a partnership.

This set of circumstances formed the background to the creation of the LLC and is an example of the old aphorism that necessity is the mother of invention. Lawyers in Wyoming representing an independent producer of oil and gas needed an entity that would be treated as partnership, because oil exploration – which was booming in the 1970s – generated losses in the early years of its business. Needless to say, the investors had to be offered limited liability. Armed with these requirements, the lawyers drafted legislation creating the LLC and, in 1977, persuaded the Wyoming legislature to enact it.[2] In 1988, the IRS issued a revenue ruling[3] stating that a Wyoming LLC would be treated as a partnership for tax purposes. Within a few years thereafter, all states adopted LLC statutes patterned after the Wyoming law.

Despite the widespread adoption of LLC statutes, however, LLCs were not immediately the entity of choice for most legal practitioners advising new businesses. This is because the Wyoming statute, to assure partnership tax treatment, provided that the entity would not have perpetual existence and interests in the entity could not be freely transferable.[4] While this might work for some deals, in many instances promoters resisted these limitations. As a result, the IRS was lobbied to liberalize its rules and treat all LLCs as partnerships, even if the entity had these 'corporate' characteristics. Finally, in 1997 the IRS relented, issuing new regulations providing that all unincorporated entities, unless they chose otherwise, would be treated as a partnership for federal income tax purposes. These regulations quickly became known as the 'check-the-box' regulations and spurred changes to LLC acts across the country.

With more flexible statutes, the use of LLCs took off and it is now the clear choice for new businesses in the United States.[5] In 2009, for instance, 70,274 new LLCs were formed in Delaware, compared with only 24,955 new corporations. This is particularly remarkable, inasmuch as Delaware is a state that has depended on new incorporations as an important source of revenue for the state, and lawyers from across the country routinely advise their clients to form their corporations under Delaware law. With just a few exceptions, more LLCs are formed in each state than are corporations. In the state with largest number of new business entities, Florida, 123,453 LLCs were formed in 2009, compared to 103,112 corporations. Moreover, the trend is strongly in favor of LLCs. In 2004, for instance, a total of 1,041,811 new LLCs were formed in the United States, compared to 899,238 corporations. By 2007, 1,375,148 new LLCs were formed, compared to 747,533 new corporations. LLCs now likely account for roughly 70% of new business entity formations.[6]

As in the corporate world, most LLCs are formed in the state where their principal business will be located. A recent academic study noted, however, that for LLCs with 1,000 or more employees, about 50% choose to form under the law of a state other than where their principal business will be.[7] Interestingly, as in the corporate world, the jurisdiction most often chosen is Delaware, which attracts more than 80% of these out-of-state formations. The reasons for this choice likely parallel the reasons that Delaware is often the choice for new corporations: a favorable statute and a competent judiciary.

THE NATURE OF THE LLC

LLC acts

As noted above, LLCs are authorized by special statutes. Drafters of these acts have relied heavily on the Revised Uniform Partnership Act (RUPA), promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1994, with revisions in 1997. Like the LLC acts, RUPA is conceived of as a series of default rules to govern the relationship of the parties if their agreement (which may be oral) does not address a particular question. Thus, the typical LLC act, like the RUPA, deals with how profits and losses are to be shared, right to withdraw or dissolve the entity, who has agency authority to bind the entity, etc., all subject to contrary agreement of the parties.

NCCUSL has attempted, with limited success, to draft a uniform LLC act. Its first attempt, the Uniform Limited Liability Company Act (ULLCA), was promulgated in 1996, but has been adopted in only eight states. Ten years later, NCCUSL adopted a revised version (RULLCA), but to date only four states have adopted it. Thus, uniformity appears unlikely. This may reflect the intense interest that business lawyers have in the content of LLC acts, motivating them, as members of state bar association committees, to draft and propose for adoption statutes that they believe are optimal. The stakes, it seems, are too high to leave the content of the act solely to the Commissioners and the benefits to uniformity are likely to be perceived as minimal.[8]

The literature regarding LLCs is replete with the idea that LLCs are contractual in nature. This is especially so since the IRS issued its 'check-the-box' regulations in 1997, thereby freeing the organizers of LLCs to shape the entity as they desired. This freedom is reflected in many LLC acts which direct courts to honor the principle of freedom of contract. The Delaware Act, for instance, provides: 'It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.'[9] To this end, Delaware and many other states allow the parties to an LLC operating agreement to disclaim all duties, including fiduciary duties, that might otherwise be owed by those managing the entity to the owners (members), the entity itself and their co-managers. One exception to this contractual freedom is that the parties may not disclaim the contractual obligation of good faith and fair dealing. Delaware states this exception in a rather prolix fashion: 'A limited liability company agreement may not limit or eliminate liability for any act of omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.'[10]

The recent Delaware case of *R & R Capital v. Buck & Doe Run Valley Farms, LLC*[11] neatly melds these two concepts of contractual freedom and a nonwaivable covenant of good faith and fair dealing. In the relevant operating agreement in this case, the parties expressly waived their right to seek dissolution of the LLC, an important protection for passive members who are dissatisfied with the actions of the managers. The members petitioned to void this contractual provision arguing, among other things, that the provision violated public policy. The court rejected these arguments, relying in part on the notion of contractual freedom. The court also rejected the petitioners' equity argument, noting that the LLC act preserves the implied covenant of good faith and fair dealing. The court went on to observe: 'It is the unwaivable protection of the implied covenant [of good faith and fair dealing] that allows the vast majority of the remainder of the LLC Act to be so flexible.'[12]

The trend of the law relating to unincorporated business entities, including LLCs, appears to be in the direction of greater contractual freedom.[13] RULLCA, to a certain extent, represents a counter-trend, or at least an attempt to reverse the movement to displace statutory mandates. Section 110 of RULLCA lists the sections of the Act that are mandatory and this list is more extensive than under the earlier uniform act. Section 409 also provides more extensive fiduciary duties than under ULLCA, and the ability to modify these duties is somewhat narrower. This retrenchment will likely inhibit adoption of RULLCA or result in modifications in states that do adopt it.

Limited liability

Direct liability

As noted above, a key characteristic of the LLC is limited liability for the owners of the entity, who are called its 'members,' a protection typically set forth in the LLC act.[14] This protection, however, is subject to two important qualifications. First, members or managers acting on behalf of the LLC are liable for their own wrongdoing, such as tortious conduct or professional malpractice. Second, some acts expressly authorize courts to 'pierce the veil' of the LLC and hold its members liable for the debts or obligations of the LLC under certain circumstances. Even in states lacking such express authorization, courts have readily pierced through the LLC when equity so requires. Each of these exceptions to limited liability is complex and deserving of at least a brief explanation.

As to a member's liability for his or her wrongdoing, the principle is easier stated than applied. For instance, in *Weber v. U.S. Sterling Securities, Inc.*[15] a Delaware LLC sent a fax business solicitation to the plaintiff in violation of a federal statute that prohibited such solicitations. Two individuals who owned and operated the LLC were named as defendants and prevailed on summary judgment, with the trial court concluding that they could not be personally liable. The Connecticut Supreme Court reversed, holding that claims under the federal statute 'generally are viewed as sounding in tort'[16] and that the individual defendants, although they purported to act on behalf of the limited liability company, may themselves have violated the statute. What is instructive about *Weber* is what led to a disagreement between the Connecticut courts – the trial court was evidently influenced by the fact that the individual defendants were acting for the LLC, while the Supreme Court, correctly, held that fact was not dispositive.

In some ways, *Weber* is an easy case – the individual defendants were alleged to have actually committed the wrongful act. A bit more attenuated than *Weber* is *Estate of Countryman*,[17] where the defendant's wrongful act was more in the nature of nonfeasance than misfeasance. The case arose out of a residential natural gas explosion resulting in death. One of the defendants, the manager of the LLC that supplied the propane, allegedly was at least partially at fault for failing to properly warn the propane users. This negligence was enough, in the court's view, to hold the manager directly liable to the injured parties.

The *Estate of Countryman* decision pushes the boundaries of direct liability for managers of a limited liability entity because the individual defendant, at least arguably, did not have a direct duty to the plaintiffs or their decedents. The manager owed a duty to the limited liability company that employed it and many courts have ruled that an agent is not liable for damages to a third party for a breach of the duty that the agent owes to the principal. These courts have drawn a distinction between misfeasance and nonfeasance, with the former a basis for liability, but not the latter.[18] The principal in the *Estate of Countryman* – the supplier of the propane – presumably owed a duty to warn and would, of course, be liable if it failed to discharge that duty, but arguably its agents did not. By contrast, if the agent had negligently damaged the plaintiff's premises while installing a heater, the agent's liability is clearer; the agent owed a duty to both its principal and to the customer to exercise due care while on the customer's premises. Nevertheless, the trend of the law seems to be in the direction of eliminating the distinction between misfeasance and nonfeasance[19] in determining the liability of an agent and the court in *Estate of Countryman* did not even discuss the issue.

Veil piercing

Judicial decisions to pierce the corporate veil and hold individual shareholders liable for corporate obligations have their origin in the 19th century and have always generated controversy.[20] Controversy has arisen because the decisions are hard to reconcile and demonstrate an almost random quality. Although there is some variation from state to state and from opinion to opinion, typically the veil piercing doctrine is characterized as an equitable doctrine depending on a two-factor analysis:

1 Are the controlling shareholder(s) and the corporation alter egos of one another, or, in what

amounts to the same thing, did the controlling shareholder(s) dominate the corporation so that it had no separate existence of its own?

2 Does justice require ignoring the corporate fiction because it is utilized to perpetrate a fraud or injustice?

Relevant evidence for the first factor often includes an examination of whether those controlling the corporation observed 'corporate formalities': holding regular director and shareholder meetings, electing officers, keeping corporate records, etc. Some courts add a third test: Will an equitable result be achieved by disregarding the corporate form? It would be an odd case, however, where the first two tests are satisfied but the third is not.

The corporate veil-piercing doctrine has made the transition to LLCs with little resistance and with basically one modification: courts have noted that LLCs can operate informally and, therefore, ignoring 'corporate formalities' is irrelevant when considering whether to pierce the veil of an LLC. One recent development in LLC veil piercing is the application of the doctrine to *managers* of the LLC who are not also members, exemplified in *Sheffield Services Co. v. Trowbridge,*[21] a 2009 decision of the Colorado Court of Appeals. The Colorado Court of Appeals reversed a lower court decision in favor of the manager in an unusual opinion.[22] Colorado, like many other jurisdictions, has a provision in its limited liability company statute that permits veil-piercing claims against *members*.[23] The Colorado court ruled, however, that this statutory claim did not preclude a common law claim for veil piercing and, under the common law of Colorado (citing only a single corporate case), a manager of a limited liability company may be held liable for the obligations of the company if the criteria of veil piercing are present. As the lower court dismissed the veil-piercing claim, the case was remanded for a determination of whether these criteria were in fact present. The appellate court, however, clearly suggested that veil piercing was appropriate, noting how the defendant acted to 'frustrate the … creditors' and enrich himself.

Securities law issues

LLC membership interests as securities

As with any investment, there is a question as to whether the investment in an LLC is a security and, therefore, subject to the registration and anti-fraud rules of federal and state law. As more businesses are organized as LLCs, this question has arisen frequently. The short answer to this question is that the securities laws are concerned with passive investments; if the investors are engaged in the management of the business, their investment is not likely not to be identified as a security. On the other hand, if management is lodged in professional managers or fewer than all of the investors, then LLC will be viewed as issuing securities. A longer answer is needed for the gray area between these two scenarios, where the investors have the legal right (by agreement and statute) to participate in management but, as a practical matter, cannot exercise that right. This gray area is subject to some difference of opinion, but the trend of the law is that the practical realities are of predominant importance. If, therefore, the investors lack the capacity to participate in management (because of mental or physical infirmities) or the expertise (if the business is one requiring certain expertise), the courts will characterize their investment as securities.

LLC membership interests and the Uniform Commercial Code

Irrespective of whether an LLC membership interest is a security for registration and anti-fraud provisions, there is a separate question of how to perfect a security interest in an LLC interest. Article 8 of the UCC (Uniform Commercial Code) provides that an interest in a limited liability company is not a security unless it is publicly traded or 'its terms expressly provide that it is a security governed by this Article.'[24] This can be a trap for the unwary if the LLC issues to its investor/members a formal certificate representing their investment. A secured party may believe that possession of this certificate will perfect its security interest, but this is true only if the LLC opted into Article 8. In effect, a lender who holds an LLC membership certificate for an LLC that has not opted into Article 8 is unsecured unless the lender filed a financing statement. By comparison, a security interest in a certificated LLC interest where the LLC expressly opted into Article 8 may be perfected either by possession of the certificate or by filing a financing statement.

STRUCTURE OF THE LLC

Formation

An LLC is formed by filing a document with the Secretary of State, or equivalent state office. The document, typically called Articles of Organization, discloses the name of the entity, the address of its principal office, the name and address of its registered agent, and other similar information. In addition, most LLC acts require the articles to disclose whether the LLC will be manager managed or member managed. If the former, members who are not appointed as managers will likely be passive in the business and, as noted above, have the protections of the securities laws for passive investors. If the entity is member managed, each member will have the authority, like partners in a partnership, to manage the business and bind the entity in contract to third parties.

Operating Agreement

Relation to LLC act

The Articles of Organization are typically bare boned and, although the organizers can place governance provisions in the Articles, that rarely occurs. Instead, the key governance document is the operating agreement, which may contain any provisions relating to the affairs of the LLC and the conduct of its business and may be entered into before, after or at the time that the Articles are filed. This is an agreement of the members and while generally in writing, the statutes typically do not require that it be so. To the extent that the operating agreement fails to resolve a particular issue, if the statute has a relevant provision, it will apply. Thus, as noted above, the statute provides a number of 'default rules' that the parties are free to contract around.

Every statute, however, includes a few provisions that cannot be displaced by agreement and a few that may be modified only within certain limitations. An example of the former is a provision that relates to the power of the courts to order a person to sign or file a document with the Secretary of State.[25] As an example of the latter, many LLC acts permit the operating agreement to vary the fiduciary duties of those managing the entity, so long as the modification is not 'manifestly unreasonable.'[26] As noted above, the Delaware LLC Act only prohibits limiting or eliminating liability for violation of the implied contractual covenant of good faith and fair dealing.[27]

One question that arises from time to time is whether the doctrine of 'independent legal significance' applies to LLC acts. This doctrine is implicated when an action taken under one section of the law, say the statutory provisions relating to merger, has the same result as an action taken under a different section, but only the former is satisfied. For example, suppose the operating agreement requires the consent of a third party before certain of its provisions may be amended. Lenders typically insist on such a provision to protect their financing of an LLC. The lender's veto may be avoided if the LLC is merged into another entity and the resulting governing document does not contain a similar protection for the lender. In other words, for the lender in this example to protect itself, it must include a provision in the operating agreement that prohibits a merger without its consent. Delaware recently codified the doctrine of independent legal significance in its statute: 'Action validly taken pursuant to 1 provision of this chapter shall not be deemed invalid solely because it is identical or similar in substance to an action that could have been taken pursuant to some other provision of this chapter but fails to satisfy 1 or more requirements prescribed by such other provision.'[28]

Typical provisions

Parties are free, of course, to include as much or as little in their operating agreement as they wish, relying on the statute to fill the gaps in their agreement and, when both the operating agreement and statute are silent, on the courts. An operating agreement for a manager-managed LLC may cover, among other topics, some or all of the following:[29]

- Financial statements;
- Capital contributions;
- Member guarantees of LLC obligations;
- Distributions;
- Allocations of profits and losses;
- Tax provisions;
- Loans from members;
- Transfers of membership interests;
- Dissociation from the LLC;
- Consent for approval of amendments to operating agreement;
- Dissenter rights in the event of a merger;
- Derivative actions;
- Initial managers;
- Qualification of managers;
- Selection of managers;
- Election or appointment of managers;
- Removal of managers;
- Manner of consenting;
- Methods of measuring level of consent;
- Items requiring different levels of consent;
- Duties of managers;
- Good faith/fair dealing;
- Member approval of conflict of interest transaction;
- Standard for judicial approval of conflict of interest transactions between LLC and managers;
- Management fee;
- Compensation of managers.

VARIATIONS ON A THEME

The flexibility of the LLC is manifest in the many ways it has been utilized. This section covers three recent variations of the standard, for-profit business entity that accounts for the vast majority of LLCs.

Low-profit limited liability companies

The flexibility of the LLC, combined with a phenomenon known as program-related investments (PRIs) under the Internal Revenue Code, has motivated a few states to amend their LLC acts to allow for the creation of a low-profit limited liability company, commonly known as an L3C. A PRI is an investment that a private charitable foundation is eligible to make to further its charitable purposes. Private charitable foundations are limited in their grant-making authority and, among other restrictions, cannot grant or invest money in for-profit enterprises. Recognizing that some flexibility on this investment restriction may help a charitable foundation realize its mission, the IRS adopted regulations permitting some investments, provided that the investment meets these criteria:

- The primary purpose of the investment must be to accomplish a charitable purpose, as recognized in the Internal Revenue Code, and, more specifically, to significantly further the accomplishment of the foundation's mission.
- The investment would not have been made but for the relationship between the investment and the accomplishment of the foundation's mission.
- No significant purpose of the investment is to realize the production of income or the appreciation of property.
- The purpose of the investment cannot be to influence the passage of legislation or the outcome of elections.

If an investment meets these criteria, it may fit with the definition of a PRI. The underlying concept, or hope, is that the private foundation will ‘invest’ in highly risky, but socially valuable, projects, such as museums, symphonies, public recreational facilities, low-cost public housing, etc., and that private investors will then be encouraged to invest as well. The foundation will take the greatest risk and contract for a low return, while a cadre of socially conscious investors will invest with the next highest risk at a below-market rate of return and more conventional private investors will provide significant funding at market rates to help the venture succeed. Presumably, the last tranche of investment would not be made but for the investments of the foundation and the socially conscious investors, which then might be conceived as ‘social’ venture capital.

The L3C is, then, specially designed to accept these investments, presumably assuring the private foundation that its investment will qualify as a PRI under the applicable IRS regulations. Many critics have pointed out, however, that special legislation to permit the creation of L3Cs is unnecessary, as current LLC acts permit the LLC to be created for a non-profit purpose and, therefore, certainly permit the creation of an LLC for a low-profit purpose. Moreover, merely making an investment in an L3C hardly assures the foundation that the investment will qualify as a PRI; the investment must be carefully constructed to assure compliance with the relevant regulations. Some have, therefore, called the L3C a trap for the unwary.

Series LLCs

In 1996, Delaware amended the Delaware Limited Liability Company Act to allow the formation of a Series LLC.[30] A Series LLC is an LLC partitioned into distinct series with each having its own assets, debts, obligations, liabilities, and rights separate from the other series. For example, a real estate investor could form a Series LLC to own and manage various properties, with each property being a distinct series, and any loss or liability would only be enforceable against that particular series. Prior to Series LLCs, the investor would have needed to form separate business entities for each property to accomplish the same result regarding potential losses and liabilities. The investor’s use of a Series LLC could lower costs because it would require only one filing fee and tax return.

To form and maintain a Series LLC in Delaware, notice must be given in the certificate of formation and separate and distinct records must be maintained for each series and its assets. Failure to properly manage the distinct series as separate entities may subject a series to the liabilities of another series. For example, joint ownership of assets or cross-collateralization between series may deter a court from enforcing the liability limitation in the statute.

Series LLCs offer much of the same flexibility in management as a traditional LLC. Members and managers have the rights, powers, and duties that they contracted for in the LLC operating agreement. Absent an agreement, management is vested in the members based on a member’s interest in the profits resulting from the particular series. In Delaware, fiduciary duties may also be eliminated between members of a Series LLC to the same extent as a traditional LLC, which only prohibits eliminating the implied duty of good faith and fair dealing. This could be particularly important for a member who is a manager of more than one series. The rules regarding dissolution and termination of Series LLCs and traditional LLCs are also very similar. It should be noted, however, that a series may be terminated without resulting in the dissolution of the LLC, but the termination of the LLC results in the dissolution of each series.

While Series LLCs are over a decade old, they are still relatively rare. This is because both attorneys and sophisticated clients seem to be more comfortable with traditional LLCs and other entity options. There is very little case law guiding attorneys on how courts are likely to hold on various liability issues between series, and it is also unclear how both tax and bankruptcy law will be applied to Series LLCs. As these issues become clearer, both attorneys and investors may be more willing to take advantage of the Series LLC form.[31]

Special purpose entities

LLCs have also been used as special purpose entities (SPEs), especially in structured finance and securitization transactions. As with Series LLCs, the organizers of an SPE pay special attention to bankruptcy issues, so as not to saddle other entities affiliated with the SPE with the liabilities of the SPE. Thus, a typical SPE used in a structured finance and securitization transaction will have:

- A narrowly defined purpose and limitations on the ability of the SPE to engage in activities outside of this purpose.
- 'Separateness covenants' in the operating agreement, with the expectation that this will avoid consolidation with an affiliated entity that may file for bankruptcy.
- An independent director who must consent to any filing by the SPE for voluntary bankruptcy.
- Special provisions regarding the fiduciary duties of the independent director that make it clear that the independent director can act in the interests of one or more designated parties. Typically, the designated parties are lenders to the SPE.

As these provisions suggest, the lenders in a structured financing are protected by the independent director, and the flexibility of the LLC acts permit this sort of arrangement. In the absence of this contractual freedom, the independent director would owe fiduciary duties to the entity and could not act in the interests of an outsider or even a member. Fiduciary duties are described more fully in the next section.

FIDUCIARY DUTIES

Statutory provisions

LLC acts vary on the extent to which they specify the fiduciary duties that are owed by those who manage the LLC and whether those fiduciary duties may be waived in the operating agreement. As Professor Elizabeth Miller has observed:

> In very general terms, the various statutory approaches to fiduciary duties may be categorized as follows: (1) statutes that specify duties or standards and authorize contractual modification of duties and liabilities; (2) statutes that specify duties or standards but are silent regarding contractual modification of duties and liabilities; (3) statutes that do not specify duties or standards but authorize contractual modification of duties and liabilities; and (4) statutes that are silent as to both duties or standards and contractual modification of duties and liabilities.[32]

As many LLC acts draw on the Revised Uniform Partnership Act, it is noteworthy that it provides that 'the only fiduciary duties that a partner owes to the partnership and the other partners are the duty of loyalty and care,' which are then described in the statute.[33] These statutory duties are somewhat narrower than the common law duties that a partner would owe. For instance, RUPA provides that a partner does not violate the specified duties 'merely because the partner's conduct furthers the partner's own interests.'[34] At common law, a fiduciary acting to further his own interests may well be held to have violated the duty of loyalty.

A separate section then provides that these described fiduciary duties may be modified, to a certain extent. For instance, § 103(b)(3) provides that the partnership agreement may not 'eliminate' the duty of loyalty, but 'may indentify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable.' Similarly, the agreement may not 'unreasonably reduce the duty of care.'[35] Finally, the statute provides that the agreement may not eliminate 'the obligation of good faith and fair dealing…but may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.'[36]

While these partnership concepts have found their way into many LLC acts and are largely reflected in the Uniform Limited

Liability Company Act (1996), there are significant variations. As noted above, Delaware, a key state in LLC law, has statutorily permitted the elimination of all duties, save the duty of good faith and fair dealing. On the other hand, some states have deleted the modifier 'only' in describing the duties that are owed, thus suggesting that there may be other, judicially recognized, duties that are owed by those managing the LLC.

Fiduciary duties in the courts

Unsurprisingly, fiduciary duties are among the most litigated issues in LLC disputes and, increasingly, the litigation involves conduct of managers tested against a waiver in the operating agreement. The case of *McConnell v. Hunt Sports Enterprises*[37] is a good example of a court's willingness to enforce a waiver of fiduciary duties in an LLC operating agreement. *McConnell* involved an LLC that was formed to obtain a National Hockey League franchise for Columbus, Ohio. The operating agreement contained this waiver of the noncompete aspect of the duty of loyalty:

> Members shall not in any way be prohibited from or restricted in engaging or owning an interest in any other business venture of any nature, including any venture which might be competitive with the business of the Company.[38]

When the voters of Columbus failed to approve a special tax to fund the construction of a new arena, those controlling the LLC indicated that they would not pursue the franchise, whereupon some members of the LLC formed a new entity to do just that. In subsequent litigation, the LLC claimed that the members of the new entity, who were also members of the original LLC, breached their fiduciary duties to the original LLC by competing with it. Citing the above provision, and relying on the concept of contractual freedom, the Ohio court ruled in favor of the members of the new entity.

The nonwaivable duty of good faith and fair dealing

Despite the strong rhetoric in *McConnell*, one should bear in mind that this was an easy case. The original LLC, for all practical purposes, had abandoned pursuing the franchise when the new entity was formed. Thus, the members from the original LLC who were involved in the new entity were not in actual competition with the original LLC. If the original LLC was actively pursuing a franchise, it is questionable whether the outcome of the case would have been the same. Courts are reluctant to abandon all notions of equity, as a Delaware LLC case of *VGS, Inc. v. Castiel*,[39] demonstrates.

VGS involved a freeze-out merger engineered by two of the three managers of Virtual Geosatellite LLC. Geosatellite had, essentially, two investors: one, Castiel, owned 75% of the equity; the other, Sahagen, owned 25%. Each of the investors held their membership interests in Geosatellite indirectly, through limited liability companies that they owned and controlled. Under the operating agreement, Castiel was entitled to appoint two managers and Sahagan one. Each of the investors named themselves as managers and Castiel also named Quinn. Less than two years after the venture came together, Sahagan convinced Quinn to join forces with him. The two agreed to merge Geosatellite into VGS, Inc., reducing Castiel's equity from 75% to 37.5%. They achieved this by executing a written consent, as permitted by Delaware law, without notice to Castiel.

While the procedures followed by Sahagan and Quinn were perfectly consistent with the letter of Delaware law, the court would not permit the action to stand. Expressly relying on equitable maxims, the court found a fiduciary duty between managers of a limited liability company. The court wrote:

> The General Assembly never intended, I am quite confident, to enable two managers to deprive, clandestinely and surreptitiously, a third manager representing the majority interest in the LLC of an

> opportunity to protect that interest by taking an action that the third manager's member would surely have opposed if he had knowledge of it. My reading of Section 18-404(d) [which permits action by managers without prior notice] is grounded in a classic maxim of equity – 'Equity looks to the intent rather than to the form.'[40]

The equities in the case do favor setting aside the action, but the legal basis for the decision is not strong. It may be that Quinn was an agent of Castiel and acted disloyally, but that might simply give rise to a claim by Castiel against Quinn, leaving the merger intact. Moreover, it is unclear that a manager of an LLC is an agent of the person responsible for his or her appointment. It may be that managers, like corporate directors, have a fiduciary duty to act in the best interests of the entity, and it might have been in the best interests of the entity to approve this transaction.[41] That inquiry did not arise in the opinion.

Alternatively, it may be that Sahagen and Quinn breached fiduciary duties to their co-manager, Castiel. Indeed, the court so found, holding that Sahagen and Quinn 'owed a duty of loyalty to the LLC, its investors and Castiel, their fellow manager.'[42] However, that a manager owes duties to a co-manager is not immediately self-evident. A manager's duty is to act in the best interests of the entity, not the interests of a co-manager. Similarly, even if Sahagen and Quinn owed fiduciary duties to 'investors,' they may have discharged that duty. Interestingly, the court declined to explore whether their action was or was not in the best interests of the entity and, derivatively, in the best interest of the investors.

Another way to think about this case is in terms of good faith, which was not expressed in the opinion. Could Quinn and Sahagen have been acting in good faith, given their contractual understandings with Castiel, if they so conspired? To ask the question is, of course, to answer it. Castiel's reasonable expectations were that he would participate in managerial decisions, notwithstanding the statutory provision that allowed his co-managers to act without him. So, it was not a gloss on the statute that protects Castiel, nor a creative application of fiduciary duties, but an application of the good faith standard – in this case, that branch of good faith that protects a contracting party from the opportunistic behavior of the other party to the contract.[43]

The relevant contract in this case was the Delaware statute. As noted above, the Delaware Limited Liability Company Act consists, essentially, of default provisions. Section 18-404(d), under which Sahagen and Quinn achieved their nefarious plot, permitted them to consent to a merger without notifying Castiel. Under the circumstances of this case, however, good faith required them to notify Castiel, and the decision could easily have rested on that ground.

While other Delaware cases demonstrate a willingness to employ equitable principles to protect a party's reasonable expectations,[44] recent Delaware cases have resisted the temptation to use the duty of good faith as a license to set aside inequitable conduct.[45] When faced with compelling fact situations, courts are likely to employ a variety of doctrines to achieve an equitable result, including contract interpretation and the duty of good faith.

THE FUTURE OF THE LLC

In thinking about the future of the LLC, two important issues loom. First, will a unique theory of LLCs be developed in the courts? Because LLCs are a relatively new form of business entity, the answer to this question is elusive. Clearly, the courts have drawn on corporate law principles and, at other times, on partnership law principles, as might be expected. But the critical question is, of course, whether the uniqueness of the LLC as an entity is adequately understood by the courts. Judicial reliance on corporate law principles suggests that the uniqueness of the LLC may not be recognized.

The second issue, also discussed below, is whether a fundamental aspect of LLCs – that is, that they are contractual entities – will be honored by the courts. The corporate doctrine of 'oppression,' which may make inroads into LLC law, presents a major challenge. The two issues are closely related: if corporate law principles are applied to LLCs, the contractual nature of LLCs is in jeopardy.

The encroachment of corporate law

Even though LLC statutory law is based largely on partnership law, courts have frequently turned to corporate law to resolve particular issues, especially if the LLC is widely held. For instance, in *Wood v. Baum*,[46] the Delaware Supreme Court, relying on principles of corporate law, reviewed the dismissal, by the Court of Chancery, of a derivative action brought by a member of an LLC against the directors of the LLC. In general, a corporate shareholder cannot bring a derivative action on behalf of the corporation unless the shareholder first makes a demand on the board to bring the action and the demand has been refused, or the shareholder can demonstrate that making such a demand would be futile. Plaintiffs typically allege demand futility because if they make a demand and the corporation takes up the action, the plaintiff loses control of the claim, and if the demand is refused, the plaintiff bears a heavy burden to demonstrate that the refusal was wrongful.[47] The *Wood* Court considered whether the plaintiffs adequately pled that demand on the directors of the LLC was excused because it would be futile. The plaintiff alleged that demand on the board would be futile because the board faced a substantial risk of personal liability if the suit was successful. Faced with that risk, the plaintiff alleged, the board could not fairly consider a demand to bring the action.

The Court affirmed the dismissal, noting that the operating agreement exempted the directors of the LLC from all liability except in case of fraudulent or illegal conduct. It is worth noting that a similar provision in a governing corporate document would likely be unenforceable because corporate directors are subject to a duty of loyalty that cannot be waived. The Court looked at the conduct alleged by the plaintiff and concluded that the plaintiff failed to adequately allege that the conduct was fraudulent or illegal. Thus, on the basis of the complaint, the Court concluded that the directors did not face a substantial risk of personal liability and could consider the demand under their normal business judgment.

The Court also considered whether the facts as alleged demonstrated that the board's conduct amounted to a 'bad faith violation of the implied contractual covenant of good faith and fair dealing.' As noted above, the Delaware LLC Act does not permit the parties to waive the contractual covenant of good faith and fair dealing, so a bad faith violation of the covenant would be actionable irrespective of what the operating agreement provided. Here too, however, the plaintiff's complaint was deficient.

The case demonstrates well the intersection of corporate law and LLC law. Many other cases have drawn on corporate law principles, including, for instance, the standard for review of a freeze-out merger (entire fairness),[48] the business judgment rule,[49] the duty of candor,[50] veil piercing (where the LLC act did not expressly authorize veil piercing),[51] to name a few.

The contract principle in jeopardy

Since at least the mid-1970s, courts have sought to protect minority shareholders in closely held corporations from 'oppression.' If the majority shareholders have managed the corporation in a way that disappoints the reasonable expectations of the minority shareholders, the court may provide some relief to those shareholders. The classic case is *Wilkes v. Springside Nursing Home, Inc.*,[52] where the Massachusetts Supreme Judicial

Court held that a minority shareholder could not be frozen out from participating (as an officer, director, and employee) in the corporation unless there was a legitimate business reason for his exclusion and this business purpose 'could not been achieved through an alternative course less harmful to the minority's interest.'[53] Although many states have included in their corporate codes provisions authorizing a court to dissolve the corporation if those in control of the corporation have acted in a manner that is 'illegal, oppressive, or fraudulent,'[54] Massachusetts did not. Even where such statutes exist, the courts have often ignored the statutory remedy of dissolution and ordered other remedies.

The threat to LLC law is obvious: Should the courts afford similar protection to the minority member(s) of an LLC? Arguably, the answer should be 'no,' unless the applicable LLC statute so provides, because such protection, in effect, adds a term to the operating agreement of the parties. Minority members of an LLC can bargain to protect themselves and, if they fail to, the courts should leave them with the bargain that they struck. The Massachusetts courts, however, which were so influential in developing this doctrine in the corporate context, have carried it over to LLCs. In *Pointer v. Castellani*,[55] the court, citing *Wilkes* and other Massachusetts precedent, held that the president of an LLC, who was also owned a 43% interest in the LLC, was wrongfully frozen-out when the other members removed him from his position. The court upheld the lower court's findings that the reasons for his dismissal were pretextual and, to the extent that the plaintiff did act inappropriately, there were measures short of dismissal (i.e., 'communication' with the plaintiff[56]) that should have been employed by the defendants. Other Massachusetts cases echo this concept, as does a case from Tennessee. In addition, academic literature, which strongly supported the protection of minority shareholders before and after the *Wilkes* decision, is starting to argue in favor of similar protection for minority LLC members.[57]

One additional example of judicial resistance to a purely contractual approach to LLCs is worth noting. The Ohio Supreme Court was recently faced with an LLC operating agreement that provided that the successor-in-interest to a deceased member of the LLC would not become a member unless the LLC consented, which it refused to do in this instance.[58] The Ohio LLC Act provided that the successor-in-interest to a deceased member 'may exercise all of his rights as a member for the purpose of settling his estate or administering his property, including any authority that he had to give an assignee the right to become a member.'[59] The issue was, simply, which prevailed: the operating agreement or the statute? Despite the fact that the quoted statutory provision was not among the enumerated 'nonwaivable provisions,' the court held, on public policy grounds, that the statute prevailed. There was a strong dissent in the case that argued for freedom of contract.

CONCLUSION

LLCs offer promoters a flexible form of business entity and it has become the entity of choice for newly formed businesses. One of the main attractions of the LLC is that there are few statutory restrictions; the parties are free to shape their relationship in any way that they choose. There is a question, though, whether the courts will respect this contractual freedom. Corporate law has provided many precedents that the courts can draw upon to protect members of an LLC who appear to have been treated inequitably. While judicial intervention may be warranted in a particular case, it comes with the cost of jeopardizing contractual freedom.

NOTES

1 For example, Gonzales v. Chalpin, 77 N.E.2d 1253 (1990); Delaney v. Fidelity Lease Ltd., 526 S.W. 2d 543 (Tex. 1975).

2 For an excellent history of the LLC, see Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 Ohio St. L. J. 1459 (1998).

3 Revenue Ruling 88–76.

4 The Internal Revenue Service took the view that a corporation was characterized by four factors: perpetual existence, centralized management, freely transferable interests and limited liability for investors. If an entity had more than two of these characteristics, the IRS would treat it as a corporation for income tax purposes, regardless of whether it was formed under a state law partnership statute. To assure partnership taxation, the original Wyoming statute provided that an LLC formed under its provisions would lack two of these four characteristics, assuring its tax treatment as a partnership. This was referred to as a 'bullet proof' statute – meaning that if a promoter (or his lawyer) followed the statute, the tax treatment as a partnership could withstand a challenge.

5 Statistics are from the website of the International Association of Commercial Administrators (http://www.iaca.org/node/80). For a recent statistical analysis, see Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs formed in the United States between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006,* 15 Fordham J. Corp. & Fin. L. 459 (2010).

6 The dominance of LLCs over partnerships is even more pronounced. In Delaware, less than 6,000 limited partnerships were formed in 2009. Nationwide, partnerships that register with the state, including limited liability partnerships, limited liability limited partnerships, and limited partnerships account for just a small fraction of newly formed business entities.

7 Jens Dammann and Matthias Schündeln, *Where Are Limited Liability Companies Formed? An Empirical Analysis* available at http://www.utexas.edu/law/academics/centers/clbe/papers.html

8 While more states have adopted the ABA's Model Business Corporation Act, few have adopted without significant modifications, again because of the intense interest that business lawyers have in the content of the law.

9 Del. LLC Act, § 18-1101(b).

10 Id. at § 18-1101(e).

11 2008 Del. Ch. LEXIS 115 (Aug. 19., 2008).

12 Elizabeth S. Miller, *Are the Courts Developing a Unique Theory of Limited Liability Companies or Simply Borrowing from Other Forms*?, 42 Suffolk U. L. Rev. 617 (2009) (footnotes omitted).

13 In contrast, corporate law is characterized by statutory mandates that include, for instance, the requirement that the corporation have a board of directors, annual shareholder meetings, required minimum votes to amend the articles of incorporation, the right of shareholders to dissent from certain fundamental transactions and obtain a buyout of their stock, etc.

14 For example, Colorado Revised Statutes, § 7-80-705: 'Members and managers of limited liability companies are not liable under a judgment, decree, or order of a court, or in any other manner, for a debt, obligation, or liability of the limited liability company.'

15 924 A.2d 816 (Conn. 2007).

16 Id. at 825.

17 679 N.W.2d 598 (Iowa 2004).

18 Compare *Peguero v. 601 Realty Corp*., 58 A.D.3d 556, 559, 873 N.Y.S.2d 17, 21 (N.Y.A.D. 2009) ('[t]he 'commission of a tort' doctrine permits personal liability to be imposed on a corporate officer for misfeasance or malfeasance, i.e., an affirmative tortious act; personal liability cannot be imposed on a corporate officer for nonfeasance, i.e., a failure to act …') with *Gray ex rel. Rudd v. Beverly Enterprises-Mississippi, Inc.*, 390 F.3d 400 (5th Cir. 2004) ('Plaintiffs cannot demonstrate hands-on contact by the defendants, but such activity does not seem required to impose personal liability under Mississippi law. One may easily be a direct participant in tortious conduct by merely authorizing or negligently failing to remedy misconduct by one's subordinates.').

19 Restatement (Third) of Agency § 7.01, comment a (an 'agent's tort liability extends to negligent acts and omissions as well as intentional conduct').

20 Courts have considered whether a shareholder may be held liable for a corporation's debts since at least the 1800s, e.g., *Booth v. Bunce*, 6 Tiffany 139 (N.Y. 1865) Professor Maurice Wormser first popularized the phrase 'piercing the corporate veil' in the early 1900s and developed a rationale that has become well accepted. Professor Wormser argued that the issuance of a corporate charter is a 'privilege' granted by the state and, if abused, that privilege (or at least its grant of limited liability for the shareholders) can be revoked: Maurice Wormser, *Disregard of the Corporate Fiction and Allied Corporation Problems*, 8–9 (1927).

21 211 P.3d 714 (Colo.App. 2009).

22 Id.

23 C.R.S. § 7-80-107(1) provides: 'In any case in which a party seeks to hold the members of a limited liability company personally responsible for the alleged improper actions of the limited liability company, the court shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a corporation may be pierced under Colorado law.'

24 U.C.C. § 8-103(c).

25 For example, RULLCA § 204.

26 For example, Colorado Revised Statutes § 7-80-108 (1.5).

27 Delaware LLC Act, § 18-1101(e).

28 Id. § 18-1101(h).

29 This list is drawn, in part, from a draft checklist prepared by the Limited Liability Company Subcommittee of the LLCs, Partnerships and Unincorporated Entities Committee, Section of Business Law, American Bar Association.

30 In addition to Delaware, the following explicitly authorize the formation of Series LLCs: Illinois, Iowa, Nevada, Oklahoma, Tennessee, Utah, Wisconsin, and Puerto Rico.

31 For further discussion, see Ann E. Conaway, *Colorado v. Delaware Entities*, 8th Annual Business Law Institute (2007); Dominick T. Gattuso, *Series LLCs*, Bus. L. Today, July–Aug. 2008, at 33; Norman M. Powell, *Delaware Alternative Entities*, Prob. & Prop., Jan.–Feb. 2009, at 11.

32 Elizabeth S. Miller, *Are the Courts Developing a Unique Theory of Limited Liability Companies or Simply Borrowing from Other Forms*?, 42 Suffolk U. L. Rev. 617 (2009) (footnotes omitted).

33 RUPA § 404(a) (emphasis added).

34 RUPA § 404(e).

35 Id. at § 103(b)(4).

36 Id. § 103(b)(5).

37 725 N.E.2d 1193 (1999).

38 Id. at 1206.

39 2000 WL 1277372 (Del.Ch.), aff'd, 781 A.2d 696 (Del. 2001). The following discussion is drawn from Mark J. Loewenstein, *The Diverging Meaning of Good Faith*, 34 Del. J. Corp. L. 433 (2009), which includes an extensive discussion of good faith in the context of unincorporated entities.

40 Id. at *4 [citation omitted].

41 The current version of the Delaware Limited Liability Company Act does not set forth any fiduciary duties for members or managers and expressly provides that such duties as may exist 'at law or in equity' may be 'expanded or restricted or eliminated.' Del. Code § 18-1101. The Restatement (Third) of Agency § 1.01, comment (f)(2) explains that corporate directors are 'neither the shareholders' nor the corporation's agents.'

42 Id. at *4.

43 See Schafer v. RMS Realty, 741 N.E.2d 155, 179 (Ct. App. Oh. 2000) (partner's capital call to 'squeeze out' co-partner breached fiduciary duty, even if allowed under agreement); Fortune v. National Cash Register Co., 364 N.E.2d 1251, 1256 (Mass. 1977) (employer could not terminate employee at will for the purpose of avoiding commissions that would otherwise have been employee). See, generally, John D. Calamari and Joseph M. Perillo, *The Law of Contracts* 460 (4th edn, 1998); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 Duke L.J. 879, 899-901 (1988) (good faith looks to how parties perform their agreement).

44 For example, *Gelfman v. Weeden Investors, L.P.,* 859 A.2d 89 (Del.Ch. 2004); *Blackmore Partners, L.P. v. Link Energy LLC*, 864 A.2d 80 (Del.Ch. 2004).

45 *Kelly v. Blum,* 2010 WL 629850 (DelCh); *Kuroda v. SPJS Holdings,* 971 A.2d 872 (Del.Ch. 2009).

46 953 A.2d 136 (2008).

47 Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

48 Solar Cells, Inc. v. True North Partners, LLC, 2002 WL 749163 (Del.Ch. 2002) (the merger was not a classic freeze-out, as the plaintiff's equity interest was reduced from 50% to 5%); Gottsacker v. Monnier, 697 N.W.2d 436 (Wis. 2005).

49 Minnesota Invco of RSA #7, Inc. v. Midwest Wireless Holdings, L.L.C., 903 A.2d 786 (Del. Ch. 2006) (citing and applying corporate business judgment rule in analyzing claims against board members of LLC); Blackmore Partners, L.P. v. Link Energy L.L.C., 2005 WL 2709639 (Del.Ch.) (applying corporate duty of care and business judgment rule to LLC directors).

50 In re Bigmar, Inc., 2002 WL 550469 (Del.Ch.)

51 D.R. Horton Inc.-N.J. v. Dynastar Dev., L.L.C., 2005 WL 1939778 (N.J. Super. Law Div. Aug. 10, 2005).

52 353 N.E.2d 657 (Mass. 1976).

53 Id. at 663–64.

54 E.g., Colo.Rev.Stat. § 7-114-301(2)(b).

55 455 Mass. 537. 918 N.E.2d 805 (Mass. 2009).

56 Id., at 818.

57 See, Douglas K. Moll, *Minority Oppression & the Limited Liability Company: Learning (or not) from Close Corporation History*, 40 Wake Forest L. Rev. 883, 976 (2005) ('Just as courts developed the oppression doctrine to protect minority shareholders in close corporations, so too should courts extend the oppression doctrine to safeguard minority members in LLCs. Learning from close corporation history, in other words, is important to the LLC's future.').

58 Holdeman v. Epperson, 857 N.E.2d 583 (Ohio 2006).

59 R.C. 1705.21(A).

Theoretical and Methodological Perspectives

Joan MacLeod Heminway

INTRODUCTION

As this book illustrates, corporate governance may be defined in many ways in different contexts. Some define the concept more broadly than others.[1] For example, one group of management scholars defined corporate governance in their work together 'as the determination of the broad uses to which organizational resources will be deployed and the resolution of conflicts among the myriad participants in organizations.'[2] Approaching things from a slightly different perspective, a pair of finance scholars offer that '[c]orporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.'[3]

Writ broadly, when we talk about corporate governance in this chapter, we are talking about the nature and effects of the relationships between and among corporate stakeholders (constituents), including principally the three internal constituents of the corporation: directors, officers, and shareholders – also known as stockholders (although come corporate governance scholars treat shareholders, especially non-controlling shareholders, as external stakeholders). Many theorists describe an inherent tension in corporate governance between the directors or officers, as managers of the corporation, and the shareholders, as owners of the corporation. Corporate governance also often includes the interaction of directors, officers, or shareholders with external stakeholders – creditors, employees/labor (although by some measures they are internal to the firm, they are not a formal part of the corporation's legal structure), advisors (e.g., lawyers, investment bankers, and accountants), suppliers, service providers, distributors, customers, clients, members of the community, and even government and other regulatory officials.

Scholars have advanced a number of theories to explain and predict the behavior of corporate stakeholders overall and in specific circumstances. These theories emanate from and are tested through the use of analytical methods; corporate governance theories foster new research methodologies, and research methodologies help identify the need for (and paths to) new theories. Analyses in the area of corporate governance take many forms and result in many different contributions to the literature. Variations occur across different states of incorporation and different fields of inquiry (e.g., law, economics, finance, management, accounting, psychology, sociology, and other academic, professional, and practical disciplines). For example, empirical research on corporate governance – research that tests hypotheses or answers questions and formulates, supports, or refutes theory through data analysis and testing (calculation, observation, experimentation) – is comparatively new in legal scholarship.

With all that in mind, this chapter sets out to do two relatively simple, yet important, things. First, it identifies and explains key theories of corporate governance. Next, it isolates and describes a variety of approaches taken by scholars in examining the interrelationships comprising and implicating corporate governance. In each case, the theories and methodologies are labeled, elucidated, and, as relevant, appraised. Relevant terms are noted and defined in context when possible.

My approach in the chapter is multidisciplinary, but I admit to bias that necessarily affects my choice of content and terminology. I am, by educational training and professional experience, a lawyer, and I therefore necessarily view the world primarily through the lens of US corporate and securities law – the principal US laws containing rules of corporate governance. However, I have incorporated the work of non-lawyers throughout the chapter.[4] In particular, the dominant theories come from economists. My objective is to cover theoretical and methodological perspectives on corporate governance from a variety of different perspectives, because I believe a multidisciplinary approach is necessary to a full understanding. Accordingly, as a whole, the material covered in this chapter is designed both to serve as a broad foundation for the matters addressed in subsequent chapters of this *Handbook* and to enable a more critical reading of the concepts addressed in those chapters.

THEORETICAL PERSPECTIVES

> A multitheoretic approach to corporate governance is essential for recognizing the many mechanisms and structures that might reasonably enhance organizational functioning.[5]

Corporate governance theories describe, explain, predict, interpret, and model the relationships between and among the three internal constituents of the corporation and, in some cases, other corporate stakeholders. They have evolved over time in response to and as drivers of, legal and societal changes.[6] Scholars find theories of the corporate firm challenging to construct and prove out in every case. This challenge also creates opportunity, however. The fact that multiple theories describe, explain, predict, interpret, and model the complex interrelationships that exist in the corporation make the corporation an intriguing puzzle.

Although a number of corporate governance theories exist, only a few are dominant in the literature. This portion of the chapter will describe in some detail a few key theories that do an effective job of describing, explaining, predicting, interpreting, or modeling the associations between and among corporate stakeholders. Then, several other theories will be mentioned briefly and related to their dominant context.

Separation of ownership and control

One often hears and sees references to the ‘Berle & Means corporation,’[7] named for the theoretical work of Adolf A. Berle and Gardner C. Means published in 1932. These references are intended to convey a simple observation about the corporate form of business association: that it represents a structural (even if not always actual) separation of the ownership and control of a business association. Said another way, the corporate financial risk-taking generally is separated from corporate decision control and management.[8] Shareholders are the residual owners of the firm, and their welfare is considered to be the corporation's primary concern (which is referred to as shareholder primacy).[9] But, in actuality, shareholders have minimal management rights in the corporate structure. Under default corporate law rules, shareholders elect directors, are permitted to amend the corporation's bylaws, and have secondary approval rights (after action is taken by the board of directors) over fundamental – or basic – corporate changes (i.e., charter amendments, mergers, sales of all or substantially all of the corporation's assets, and the dissolution of the firm). The corporation is managed by or under the direction of its board of directors. Day-to-day management control of the corporation is vested in the corporate officers by the corporation's charter and bylaws and board resolutions. This structure allows and sometimes requires shareholders to be passive owners of the firm and can lead to manager–shareholder conflict (in particular if the directors or officers use their control to benefit themselves at the expense of the corporation's shareholder-owners).

The separation of ownership and control observed by Berle and Means describes well the overall structure of the corporation as a matter of statutory law – three distinct internal constituents with individualized roles, duties, and obligations. The typical US public corporation, which has widely dispersed individual and institutional ownership, is often touted as the best example of a Berle & Means corporation. Shareholders acquire and dispose of shares in faceless transactions in public securities markets. The shareholders do not nominate the directors they elect; in most cases, a committee of the corporation's board of directors selects the nominees. Most often, directors are elected by a mere plurality vote once a quorum of shareholders – typically those owning a majority of the outstanding common shares – is present at a meeting, in person or by proxy. And shareholders rarely use their statutory power to remove directors.[10] Although some officers may be (and often are) directors, since the adoption of the Sarbanes–Oxley Act in 2002 in the United States, most directors are 'independent,' in the sense that they are not officers of the corporation. State corporate law generally does not require that directors and officers own shares in the corporation they serve, and while some corporations do set requirements of that kind, the number of shares owned by US public company directors and officers typically does not constitute effective or actual control.

In this prototypical corporation with dispersed shareholdings, it is rational for shareholders to *not* monitor managers (i.e., to free-ride on others). However, the same is not true for corporations with concentrated share ownership. In these latter corporations, it is rational for shareholders to monitor managers. The Berle & Means model does not effectively describe these corporations because there is an integration of ownership and control. One example is the archetypal close corporation in the United States – which typically comprises, in addition to the founder, an overlapping group of the founder's family, friends, and other close associates as shareholders, directors, and officers. Here, the shareholder is an owner-operator. Substantially the same group of people both own and control the corporation, even though all three internal constituents of the corporation continue to exist as a matter of corporate law and structure.

The Berle & Means depiction of the corporation also does not always well describe corporate structures and ownership patterns in other parts of the world.[11] In fact, the dispersed passive ownership model prevalent in the United States only exists as a dominant structure in the United States and the United Kingdom. This model is sometimes referred to as an outsider system of corporate governance. In countries like Brazil and Germany, for example, insiders and families have historically owned and controlled most corporations. These types of models are sometimes called insider systems of corporate governance. In Germany, this evolved into banks and other corporations becoming the principal corporate shareholders. In each case, these dominant shareholders owned controlling positions in the corporation, resulting in no actual separation of ownership and control. Similarly, in Japan, corporations historically were owned and controlled by family groups known as *zaibatsu* and now by cross-ownership groups (including as shareholders, for example, firms from the same industry or from the corporation's supply and distribution chain) called *keiretsu*. Bank lenders in Japan also often are owners of the corporations to which they lend. In these ownership structures, public investors are relegated to a minority position. More detail is provided on these and other alternative ownership structures later in this book. In discussing the theoretical observations of Berle & Means, however, it is important to note that the potential for corporate governance conflict in controlling shareholder (insider) corporate governance models like these is *not* typically between managers and shareholders but, instead, between majority shareholders and minority shareholders. Controlling shareholders may, for example, appropriate assets from the corporation for their own benefit, either to an affiliated firm (e.g., through tunneling) or to themselves.

Agency

Observations about the nature of conflict created by corporate structures motivated theorists to pursue additional work on the relationships that exist in the corporate form of business organization. Economists led the charge, focusing on the agency and agency-like relationships represented by stakeholders in the corporate structure. Michael C. Jensen and William H. Meckling generally are the earliest scholars credited with propounding the agency theory of the corporation, but work in this area has been ongoing since the publication of their seminal paper, *The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*[12] in 1976. In their paper, 'Jensen and Meckling … proposed agency theory as an explanation of how the public corporation could exist, given the assumption that managers are self-interested, and a context in which those managers do not bear the full wealth effects of their decisions.'[13]

At its core, agency theory assumes that all individuals act in their own interests with the objective of maximizing their personal welfare. As a result, there are inherent costs associated with a structure in which one individual (the principal) delegates or entrusts the management and control of his assets or affairs to another (the agent), especially where the agent is armed with more information than the principal (known as information asymmetry). These costs are labeled 'agency costs' and comprise all negative effects of the delegation of management and control, including those associated with 'shirking' by the agent, i.e., costs resulting from the agent acting in a manner that is inconsistent with the interests of the principal (moral hazard often referred to as residual loss), and those incurred by the principal in overseeing the agent's activities to prevent shirking (often referred to as monitoring costs), as well as those incurred by the agent to reduce the potential for shirking (often referred to as bonding costs). Jensen and Meckling modeled these agency costs and showed, for example, that principals will not bear an unlimited amount of monitoring costs (ceasing to bear those costs when the marginal return on the last dollar spent equals the marginal cost).

Although the directors and officers of a corporation are not agents of the corporation's shareholders as a matter of law (since an agency relationship arises from an association of mutual consent in which one person consents that another act in his stead and on his behalf, and the other consents to act in the stead and on behalf of the one), agency theory, as applied to the corporate form, treats directors and officers as agents to whom the assets of shareholders have been entrusted. Structures and attributes of corporate governance (including decision-making by independent directors, legal and contractual incentives to align director and officer financial interest in the corporation with those of shareholders, fiduciary duties of care and loyalty, and derivative litigation) are designed to address the key possible manifestations of shirking, which include self-interested and disloyal decision-making, as well as negligent, reckless, or intentional mismanagement. The market for corporate control (i.e., the threat of a change in control of the corporation through a proxy contest or tender offer, neither of which involve action by corporation's directors or officers), if unimpeded, also allows shareholders and investors in the market to constrain opportunistic director and officer actions.

Agency theory reflects some basic attributes of the corporation and accurately explains and predicts certain observed behaviors of corporate officers and directors. Indeed, corporate directors and officers have been found liable for insider trading, for making corporate decisions for their own profit rather than for the benefit of the corporation and its shareholders, and for exercising inadequate care in managing the corporation. Each of these transgressions represents a type of shirking that corporate law recognizes as involving actual or possible breaches of fiduciary duty.

But agency theory is not a full and accurate descriptor of the corporate form in either the owner-operator context – e.g., for close corporations (where there are few, if any, standardized agency relationships among the internal corporate constituents, since they occupy roles as both investors and managers) – or in a controlling shareholder context (where the main threat is the controlling shareholder's opportunism, not that of directors or officers).[14] Moreover, agency theory sometimes inaccurately describes and predicts actual behavior, since not all directors and officers are self-interested welfare maximizers. And finally, agency theory focuses on only a few (the internal three) of the many stakeholders in the corporate firm, treating shareholders as the center of attention. This model of corporate governance exhibits, reflects and supports shareholder primacy. However, the legal rules of corporate governance rarely afford shareholders control over corporate policies and affairs, manifesting instead a system of director primacy or managerialism, in which directors or officers control the corporation's decision-making and destiny, with little opportunity for shareholder monitoring. In any event, agency theory concentrates on the investor–manager dichotomy, leaving relationships between and among the broader set of corporate stakeholders (e.g., creditors, employees/labor, and others) to supplemental and competing theories of corporate governance.

Nexus of contracts

An important alternative theory of the firm is contractarian theory. As this branch of theory observes, the corporate firm can be conceptualized as a nexus of contracts – an interconnected network of explicit and implicit agreements (not necessarily legally binding contracts) among those who constitute and interact with the corporation (i.e., internal and external corporate stakeholders).[15] The contractarian view of the firm is rooted in the work of economist Ronald Coase on transaction cost theory.[16] The firm exists because the coordination of explicit and implicit contracts that it provides is more efficient than producing the same goods or providing the same services by contracting for each of the needed components of the business in the market.[17]

Yet, the basic contractarian theory does not explain *how* the corporation coordinates the many arrangements that make up the corporation. The work of Stephen Bainbridge completes this picture by linking Coasian observations back to the control structure evidenced in agency theory. He posits that the board of directors of the corporation, as the constituent group of the corporation charged with managing or controlling management of the corporation, *is* the nexus of the contracts that constitute the corporation – the core of a web of interconnected arrangements – holding the web together, filling gaps in the contractual framework, and coordinating the use of the component contractual relationships in the operation of the corporation's business.[18] This idea evidences director primacy and is consistent with the separation of ownership and control. Accordingly, while it may describe the prototypical US public company well, it is not an accurate conception of many close corporations and majority-shareholder-controlled entities.

Team production

Corporate governance also may be described as a problem of team 'production.'[19] The team production theory, like the nexus of contracts theory, views the corporation as a cohesive group consisting of the internal and external stakeholders of the corporation. All of these constituents supply resources to the firm that are subject to opportunistic appropriation.

> The mediating hierarchy model consequently suggests that the public corporation can be viewed most usefully not as a nexus of implicit and explicit contracts, but as a nexus of firm-specific investments made by many and varied individuals who give up control over those resources to a decision-making process in hopes of sharing in the benefits that can flow from team production.[20]

The team production model reflects elements of shareholder primacy, managerialism, and director primacy. Although directors, as managers of the corporation, coordinate and reconcile the activities and relationships of team members, group members typically work out their own arrangements. Margaret Blair and Lynn Stout popularized this theory of corporate governance with their 1999 article, *A Team Production Theory of Corporate Law*, in which they classified the directors' role as that of mediating hierarchs rather than agents.[21]

Blair and Stout themselves note one weakness of their theory – that their model primarily describes US public companies. But another criticism of the team production model is that it does not fully account for corporate governance rules that place shareholder interests ahead of those of other corporate stakeholders and directors in the role of agents.[22] These criticisms essentially attack the fact that team production theory (like contractarian notions of the corporation) is principally a theory of the aggregate group, whereas agency cost theory, together with the predicate separation of ownership from control, explains the dominance of certain players in key relationships within the group.

Other corporate governance theories

The dominant theories of corporate governance described above represent only an important sampling. There are, of course multiple additional theories, general and specific. For example, stewardship theory, like agency theory, examines the investor–manager dichotomy that results from the separation of ownership and control. Stewardship theory, however, characterizes management less as opportunists and more as compliant, cooperative trustees of the shareholder's assets and affairs.

> Whereas agency theorists view executives and directors as self-serving and opportunistic, stewardship theorists describe them as frequently having interests that are isomorphic with those of shareholders. This is not to say that stewardship theorists adopt a view of executives and directors as altruistic; rather, they recognize that there are many situations in which executives conclude that serving shareholders' interests also serves their own interests.[23]

Specific conceptions of the corporation also give rise to or employ other theories of corporate governance. Corporate social responsibility (CSR) provides a good example. Like the nexus of contracts and team production theories, CSR recognizes the important role of other stakeholders in the corporation. CSR incorporates and extends a broad field of study exploring the relationship of the corporation to society. In particular, its proponents defend and promote the operation of the corporation for public benefit. CSR is not a theory: rather, a large number of theories (instrumental economic, political, social integrative, and ethical) describe and explain the various interactions of the corporation and society that are elements of CSR.[24] These theories, most of which would be described by scholars as communitarian, rather than contractarian, corporate governance theories,[25] describe the role of the corporation in society in numerous ways: as a source of wealth, a source of power, a citizen, a dependent or servant, a moral being, etc. In general, instrumental economic theory supports CSR to the extent that CSR leads to wealth maximization for shareholders or the firm; i.e., CSR is a means to an economic end. Political theory encompassing CSR explains how socially responsible behavior derives from and reifies the corporation's societal power and position. In the main, as it relates to CSR, social integrative theory argues that the corporation's reliance on society requires that it behave in a socially responsible manner, while ethical theory emphasizing CSR focuses on the corporation as a normative member of society (having roots in cooperative stakeholder management and philosophy). Subsequent chapters in this book focus on or reference some of these theories.

The list of theories applicable to corporate governance issues could consume numerous additional pages. But this brief description conveys enough information to enable an evaluation of a broad range of contentions about corporate governance in varying contexts. In addition, the theoretical perspectives described here allow us to identify, categorize, characterize, and critique various research methodologies applicable in corporate governance research. These research methodologies both reflect and assess corporate governance theories.

METHODOLOGICAL PERSPECTIVES

> To advance the study of corporate governance, researchers will need to advance beyond establishing and protecting our own fortresses of research. ... [I]ndividual research efforts that do not genuinely embrace the full scope of tools available to us as researchers will result in continued won battles, with little progress toward ending the war.[26]

Research is the way we test and expand knowledge. It is a process of inquiry, investigation, and assessment.[27] Researchers gather, process, examine, and analyze facts, data, and other information. In academic work, the manifest product of research is scholarship (or, in some cases, creative activity). Scholarship uses different research methods (techniques, processes) that are founded on different methodologies (principles, rationales).

Corporate governance research methods and methodologies, like the theories they foster and support (or refute), emanate from diverse fields of study (including – individually and in combination – law, economics, finance, accounting, management, psychology, sociology, anthropology, political science, and philosophy) and involve the use of distinctive analytical techniques and tools.[28] Researchers in different fields may describe the different types of methods and methodologies they use in different ways. These various taxonomies make it difficult for newcomers to understand the corporate governance research landscape and for scholars to communicate about research design and efficacy. To help disentangle this labeling mess, the discussion of corporate governance methods and methodologies in this chapter is divided into those used in legal corporate governance scholarship (which is somewhat *sui generis*) and those used in the corporate governance scholarship produced in other disciplines. In writing about lawyers who teach and perform research in business school programs, one commentator notes that:

> A fundamental dichotomy exists between the methodologies used for legal research and publishing by faculty holding Juris Doctor (J.D.) degrees as compared with that which is customary for faculty typically holding the degree of research doctorate (Ph.D.). For example, non-law faculty, chairs, or deans may not always differentiate between the normative legal research conducted by law faculty and the quantitative research typically conducted by faculty from social science disciplines. This difference, which is not always settled or discussed in business schools, 'makes legal scholars different in the eyes of other business school disciplines, and difference in this regard proves no advantage.'[29]

These divergent corporate governance methods and methodologies reflect historical differences in the purpose of legal scholarship (i.e., to describe, interpret, and prescribe law and legal rules) and the people for whom it was written (e.g., other law academics, lawyers, and judges). Yet legal scholarship is becoming more quantitative and multidisciplinary in response to calls for practical research output that informs both lawyers and those in other disciplines.

Research methods and methodologies in legal scholarship

Defining the unique methods and methodologies of legal corporate governance scholarship is no simple affair given the various ways in which legal scholarship is categorized. Some legal scholars separate their overall scholarship into functional classifications related to law, without reference to research methodologies. They may describe legal scholarship as theoretical (assessing or positing theoretical principles), policy-oriented (evaluating or suggesting the guiding principles underlying law and legal rules), and doctrinal (examining or recommending specific laws or legal rules). These categories may overlap in individual scholarly works. The research methods employed to create this scholarship have traditionally been non-empirical, but in recent years, some corporate law scholars have begun to use empirical methods.

As a result, many legal scholars divide the corporate governance research world into two camps, based on these two research methods. For them, the world is separated into conventional (or what some call theoretical or traditional) and empirical legal scholarship.

> Scholars employing a wide range of theoretical approaches ... have employed different perspectives to try to generalize about the origins, current state, and future of corporate law. These pieces are provocative and illuminating, but they rarely seek to test the theories developed against empirical evidence. Legal empiricists, on the other hand, have generally eschewed 'big theory' and focused their efforts on narrower, testable hypotheses. Their articles look more like those published in economics and finance journals, and that is often where they are found.[30]

Conventional non-empirical corporate governance legal research identifies and examines law (statutory and decisional), other legally relevant rules (derived from governmental and non-governmental regulatory bodies, corporate charters, bylaws, and contractual covenants between or among corporate constituents), and extant legal (and sometimes other) treatises and scholarship. (In this work, the law and rules serve as primary information sources, and treatises and scholarship are classified as secondary sources.) The examination is typically *not* quantitative (i.e., it does not use mathematical or statistical analysis). It does not consist of testing, relying instead on textual analysis and theory-based, policy-oriented, or experiential reasoning. Its objective may be descriptive (positive), interpretive, or normative. The power and value of this kind of scholarship derives from both (a) the precise selection of relevant information from law, rules, and scholarship for examination and (b) the quality (logical, rhetorical, etc.) of the arguments made by the author on the basis of that information. The approach embodied in legal scholarship is founded in traditional legal education and consistent with *stare decisis*, a common law principle holding that judges must respect legal precedent – prior binding judicial opinions – in making their decisions (i.e., law created by judges is consistent with and builds on past law). Conventional legal scholarship typically is published in law reviews and journals affiliated with law schools, which are not peer-reviewed publications.

As a general matter, legal scholarship is published in student-edited law reviews and journals, rather than peer-reviewed journals. There are benefits (e.g., extension of the educational mission, potentially faster publication cycles) and detriments (e.g., uneven selection criteria and editing) associated with this publication process. Moreover, because of its reliance on and integration with prior work, legal scholarship tends to be heavily footnoted. Footnotes may include citation to relevant sources of law, analysis, and reasoning, but also may include additional textual exposition and information. Source citations are formatted in one of several specialized legal citation styles, the most common of which is Bluebook format.[31]

Traditional legal corporate governance research has been subject to criticism on various grounds. Corporate governance scholars from other fields, many of whom do not understand the legal and scholarly tradition represented in conventional legal research, may view it legal scholarship as having limited utility in resolving corporate governance (and other legal) questions.[32] Certainly, legal and non-legal scholars alike find traditional legal research difficult to evaluate.[33] Moreover, conventional legal scholarship is not always a reliable means of identifying and evaluating the practical consequences of law and legal rules.[34] In fact, conventional legal scholarship has been criticized for being too abstract and disconnected from the practice of law.[35]

Empirical legal research resolves some of these concerns in that it enables a more comprehensive (and potentially more trustworthy) assessment of the effects of law on society through quantitative measurement and qualitative tools that allow for richer positive observations. Empirical legal corporate governance scholarship uses a variety of the empirical research methods evidenced in non-law scholarship (described below), including especially event studies. Although legal empiricists often use quantitative methods, they may also include qualitative or behavioral elements in their work. Largely because legal scholars typically have little academic or experiential training in econometrics or other empirical analytical methods, the quality of the chosen empirical methods or the resulting analyses can be uneven.[36] To address this criticism, many legal empiricists work with economics, finance, and other scholars as co-authors to provide the requisite training and experience for a particular project. Some of this work are published in law reviews, and some are published in peer-reviewed journals.

Research methods and methodologies in other scholarship

Non-law corporate governance scholarship (including principally work in finance, economics, management, and accounting) comprises predominantly empirical research.[37] This empirical corporate governance research typically is published in peer-reviewed journals and may be quantitative, qualitative, or behavioral. Quantitative corporate governance research tends to be best at showing what is happening in a particular research area, while qualitative and behavioral research often can help offer important details on why. Behavioral research in corporate governance is distinguishable from quantitative and qualitative research less by its method than by the assumptions that underlie the research. For our purposes here, the following distinction is applicable: quantitative and qualitative corporate governance literature assumes that principles and agents are rational economic actors, while behavioral literature relaxes that assumption.

These and other differences make the world of corporate governance scholarship rich and varied. Different methods and methodologies represent more than a difference in approach; they represent distinct, valid, and valuable ways to get information and solve the puzzles that corporate governance presents. As a result, an individual researcher may use more than one method to test a hypothesis or answer a research question. Alternatively, a researcher may engage in a formal or informal collaborative narrative process with other researchers. By sequencing or combining their efforts, researchers may help develop an enhanced, rich knowledge of a particular area.[38]

Corporate governance scholarship other than legal scholarship typically is published in peer-reviewed field-specific journals. Although there is some variation in the format of these published works, many follow certain standard formatting norms. Journals may require different citation formats, but many use the Chicago, American Psychological Association, or American Language Association styles.

Quantitative empirical research

Most of the empirical work on corporate governance issues is quantitative and features econometric (mathematical or statistical) analysis of data sets consisting of pre-existing (archival) and hand-collected information.[39] (Research using archival data sets often is referred to as an archival study.) Quantitative corporate governance research focuses on the outcomes of stakeholder action. Typically, researchers are looking for a relationship between corporate director or officer conduct and firm performance. There are also numerous studies that look at the relationship between individual corporate governance characteristics (e.g., board composition or institutional ownership) and either firm value or firm choices. These studies identify the correlation between and among the relevant independent and dependent variables and assess causal relationships.

Event studies, in which researchers look for market price reactions to specific corporate events involving public companies, have become particularly popular.[40] The components of an event study illustrate both its conceptual simplicity and its operational complexity.

> In order to conduct an event study, the researcher first defines the event under investigation. Events are usually announcements of various corporate, legal, or regulatory action or proposed action. Examples of events that have been studied are takeovers, equity offerings, change in state of incorporation, adoption of antitakeover provisions, filing of lawsuits against corporations, deaths of corporate executives, and product recalls. After defining the event the researcher searches for the first public announcement of the event. Identification of the first public announcement of the event is critical since, under the semi-strong form of the efficient-market hypothesis, the impact of the event on the value of the firm would occur on the announcement date. …
>
> After defining the event and announcement period, stock returns are measured for this period. …
>
> Calculation of the third component is more complicated. Although it is straightforward to measure the actual return for the announcement period, determination of the impact of the event itself on the share price is less so. To measure this impact, the *expected return* must be subtracted from the actual announcement-period return. …
>
> … The unexpected announcement period return, also known as the *abnormal return*, is computed as the actual return minus the estimated expected return. This abnormal return is the estimated impact of the event on the share value.
>
> The fourth and final step is to compute the statistical significance of this abnormal return.[41]

The popularity of event studies is understandable. Public filings and press announcements (as well as public company stock prices) are freely available, stock price changes are ill-understood, and the practical knowledge gained from stock price movements can be very useful to a wide variety of corporate governance decision-makers, including lawmakers, regulators, judges, lawyers, investment bankers, and (of course) corporate managers.[42]

Critiques of the different types of quantitative corporate governance research are many and varied. In a 2003 article introducing a special topic forum for the *Academy of Management Review*, three corporate governance scholars articulated ‘a number of potential barriers to moving corporate governance research forward.’[43] These barriers exist largely in quantitative corporate governance research and include: a dearth of primary, process-oriented data; an over-reliance on agency theory; and a single-minded approach, with a narrowly defined theoretical and disciplinary focus.[44]

In addition, quantitative empirical research in corporate governance scholarship tends to suffer from endogeneity problems (where one variable is caused by another within the research model) and omitted-variable biases (caused by the lack of an independent variable that should have been included in the model).[45] For example, if a researcher finds a correlation between board independence and operating performance, it may be difficult to determine whether firms with more independent boards perform better or whether better-performing firms seek independent boards. This is a classic endogeneity problem. The central issue is the difficulty in determining causality. Similarly, where an independent variable (known information at the outset of the analysis) is correlated with another independent variable that is not included in the model (either by design or because the data is unavailable), it may be difficult to ascertain whether the included or the omitted variable is responsible for influencing the dependent variable (the data that is generated in the study). So, a study may show that certain corporate governance provisions or structures are correlated with firm performance. But those provisions or structures may, themselves, be correlated with data not in the model, e.g., the industries in which the firms operate, board or ownership composition, or other firm attributes. It then could be these firm attributes, not the provisions or structures included in the model, that are influencing firm performance.

Event studies have been singled out for critical treatment in a number of ways. For one thing, it can be difficult to identify the date of the relevant ‘event’ being studied. In general, researchers desire to find the earliest date on which information is released to the public. That may be done through a public filing (e.g., a proxy statement) or a news release, or both. Finding the actual date on which the public knew the material information at issue may be more challenging than it appears.

Also, the value of event studies depends on market efficiency – more specifically, the semi-strong version of the efficient capital market hypothesis. If stock prices are not efficiently responsive to the dissemination of information, then event studies do not have much informative value. Stock price movements may not give us high-quality information for this and other reasons; market price changes may not be accurate indicators of future firm performance, shareholder value, or other measurements of wealth.

In addition, an event study may be conducted using various parameters, some of which may negatively impact the explanatory power of the study. For example, long-window event studies require the researcher to identify and filter out possible effects of other intervening events that may impact stock prices. The use of shorter announcement periods may not cure this problem. For example, when two different events are announced in the same press release, it may be difficult to determine which is the influencing event. In general, however, small samples and long announcement periods may weaken the explanatory power of event studies. ‘A researcher can increase the power of an event study by increasing the sample size, narrowing the public announcement to as short a time-frame as possible, or both.’[46] On the other hand, short announcement periods may result in exaggerated, incomplete, or otherwise inefficient market effects (e.g., shareholder over-reactions to news), especially where the events being studied are complex or infrequent.[47] As a result, some studies measure and report both short-term and long-term effects. In these cases, the researchers measure the short-term effects as an implication of value and the long-term effects as a measure of actual value.

Qualitative empirical research

Qualitative empirical research involves the use of reasoning and judgment in the analysis of non-quantifiable information. Qualitative corporate governance researchers study human interactions and social processes (e.g., decision-making, elements of organizational or group culture) in specific contexts, including the corporate boardroom and executive suite. Their research may involve the analysis of information obtained through interviews, questionnaires or surveys, focus groups, reviews of historical documents (including correspondence and other communications), and direct participant observation captured in journal entries (or diaries). Study designs in qualitative corporate governance research range from ethnographies (cultural examinations), to phenomenological research (experiential assessments), to approaches rooted in grounded theory (methods centered on theory formation and confirmation).[48] Qualitative research can be a flexible tool in answering corporate governance questions because it allows the researcher to focus specific questions on targeted populations from which relevant archival or documentary data may not be available.

Qualitative corporate governance research is subject to various criticisms akin to those leveled against traditional legal research on corporate governance issues.[49] Qualitative research is difficult to evaluate because of its individualized nature. The data or information on which the analysis is based may not be objective, precise, or directly comparable or may otherwise be flawed. Survey data, for example, may exhibit a self-reporting bias that makes the results less valuable than third-party observations of actual conduct. In addition, the findings of qualitative corporate governance research run the risk of being anecdotal; they may not be representative or generalizable, especially when sample sizes are small or sample cases are subjectively selected (or otherwise potentially biased). Also, qualitative corporate governance research may assume or rely on an underlying common and static corporate governance environment that does not, in reality, exist. The subjects of interviews, questionnaires, focus groups, and observational studies may have been involved in and engaged with very different corporate governance environments over a period of time. This may be difficult to tease out in the data gathering. Of course, a researcher may ameliorate some of these drawbacks by designing his or her study to avoid various pitfalls or by limiting the claims he or she makes to those that do not implicate the related weaknesses.

Behavioral empirical research

Behavioral corporate governance research is often characterized as a form of quantitative or qualitative empirical research rather than its own type of corporate governance research. It has distinctive characteristics, however, and its use supports a significant and growing interest in behavioral and behavior-related theories of corporate governance.[50]

> Behavioral analysis of the law is increasingly standing on its own as a field of inquiry outside law and economics scholarship. Legal scholars now feel comfortable enough to apply findings on human and social cognitive and emotional biases, which are central to behavioral analysis, without framing the analysis in economic terms. Corporate law scholars have applied understandings about real, personal human traits such as trust and sensitivity to dismantle the self-interested actor model of the individual.[51]

Behavioral corporate governance research distinctively features documentation of real-time observations of, or laboratory experiments involving, the dynamics of corporate governance (e.g., stakeholder interactions and processes, rather than measures of performance or outcomes), as well as other quantitative (statistical or mathematical analysis) and qualitative (data gathering through interviews, questionnaires, etc.) methods. Behavioral studies of corporate governance may identify and report the operation of various factors (e.g., cognitive biases, heuristics, social pressures, bounded rationality, satisficing, routinized decision-making, politicized negotiations, decision-making under uncertainty, risk assessment, pressures toward group conformity, emotion, and affect) that explain deviations from the wealth maximization norm that underlies the dominant economic theories of corporate governance described earlier in this chapter.[52] Behavioral corporate governance research ranges across many disciplines, and the type of method and study design may vary based on the researcher or the subject.[53] For example, one pair of accounting scholars note that

> Experimental research on earnings management and accounting choice includes two types of studies: (1) individual judgment and decision making studies, or *behavioral research*, where the primary focus is on manipulation of the environment and observation of behavior of experienced participants who have learned about their incentives in the field and (2) multiperson studies, or *experimental economics research*, where participants are given incentives and allowed to interact.[54]

Dissatisfaction with the explanatory and predictive power of other forms of quantitative and qualitative empirical research over the past 10 years has led corporate governance scholars to call for more behavioral corporate governance research.[55] Of especial interest is research on corporate board processes. This work is understandably handicapped by a lack of researcher access to the boardroom.

A shortage of opportunities for access to relevant environments and information and the time-intensive and labor-intensive nature of behavioral research may limit not only the number but also the quality of behavioral studies that are conducted. Even apart from these barriers, behavioral corporate governance research has been criticized in many of the same ways that other empirical research has been criticized. For example, the results of behavioral studies may not be generalizable; behavioral research may be conducted in a single firm, limiting the explanatory and predictive power of the findings. And, like conventional legal research and qualitative empirical research, behavioral research is not yet well understood or used by some corporate governance scholars, making it hard to evaluate. However, many of these perceived and actual criticisms of behavioral research can be overcome by collaboration with researchers from other fields and backgrounds.[56]

CONCLUSION

Corporate governance theories, methods, and methodologies are multidisciplinary, multifaceted, and interrelated. Economic theory, especially agency theory, has held a dominant position in recent years. Similarly, empirical research methods – especially quantitative methods (and in particular event studies) – have predominated in all corporate governance research other than legal research. Yet, each theory and method has both strengths and weaknesses. Accordingly, an increasing number of scholars believe that theoretical and methodological work drawing from only one discipline or tradition has limited power and influence in advancing our understanding of corporate governance structures, attributes, processes, and dynamics.[57] These scholars read and use corporate governance literature that comes from various fields and from different theoretical and methodological perspectives. Their work also may be done collaboratively with scholars from other disciplines. This *Handbook*, itself, is an example. Consider these observations and look for examples as you read and reflect on the remaining chapters.

NOTES

1 *See*, *generally*, Stuart L. Gillan, *Recent Developments in Corporate Governance: An Overview*, 12 J. Corp. Fin. 381, 382–385 (2006) (noting different definitions of 'corporate governance' and offering his own framework).

2 Catherine M. Daily et al., *Corporate Governance: Decades of Dialogue and Data*, 28 ACAD. MGT. REV. 371 (2003).

3 Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997).

4 I must thank Rudy Santore, Josh White, Tracie Woidtke, and other colleagues in the College of Business Administration and from the Corporate Governance Center at The University of Tennessee, Knoxville, who helped ensure that I reflected in this chapter the insights and work of scholars in other disciplines. I also am grateful for the research assistance of Jonathan Thomaston (J.D., 2011, The University of Tennessee College of Law). All errors and omissions are, of course, my own.

5 Daily et al., *supra* note 2 at 372.

6 *See* David Millon, *Theories of the Corporation*, 1990 DUKE. L.J. 201 (including a brief history of the theories of the corporation in the United States from the early years of the 19th century to the time of the article's publication).

7 Adolf A. Berle & Gardner C. Means, THE MODERN CORPORATION & PRIVATE PROPERTY (1932).

8 *See*, *generally*, Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. LAW & ECON. 301 (1983) (noting this dichotomy).

9 For a theoretical paper that supports an enhanced version of shareholder primacy, *see* Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

10 *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007).

11 *See* Stijn Claessens et al., *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741 (2002); Rafael La Porta et al., *Corporate Ownership around the World*, 54 J. FIN. 471 (1999).

12 Michael C. Jensen & William H. Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

13 Daily et al., *supra* note 2, at 372.

14 *See* Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POLIT. ECON. 461 (1986).

15 *See*, *generally*, Jensen & Meckling, *supra* note 12 (originating this term); *see also* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POLIT. ECON. 288 (1980) (examining the separation of ownership and control in the context of the nexus of contracts theory of the firm); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. LAW & ECON. 301 (1983) (same).

16 R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA (n.s.) 386 (1937). For more on transaction cost theory and the organization of firms, see Oliver E. Williamson, *The Economics of Organization: The Transaction Cost Approach*, 87 AM. J. SOCIOLOGY 548 (1981). Williamson articulates three levels of analysis in applying transaction cost theory to the theory of organizations: structural analysis, a role-based analysis, and an asset organization/allocation analysis. *Id.* at 549.

17 *See* Oliver E. Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LITERATURE 1537 (1981).

18 Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002).

19 *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

20 Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 285 (1999).

21 *Id.* at 280–281.

22 *See*, *e.g.*, Alan J. Meese, *The Team Production Theory of Corporate Law: A Critical Assessment*, 43 WM. & MARY L. REV. 1629, 1635–1637 (2002).

23 Daily et al., *supra* note 2, at 372 (citations omitted).

24 *See* Elisabet Garriga & Domènec Melé, *Corporate Social Responsibility Theories: Mapping the Territory*, 53 J. BUS. ETHICS 51 (2004). The summary in this paragraph relies largely on the categorizations developed in this article.

25 *See* Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856 (1997).

26 Daily et al., *supra* note 2, at 379–380.

27 For a good general book providing guidance on research, see Wayne Booth et al., THE CRAFT OF RESEARCH, 2nd edn (2003).

28 Hans van Ees et al., *Toward a Behavioral Theory of Boards and Corporate Governance*, 17 CORP. GOV.: INT'L REV. 307, 308–310 (2009) (identifying and describing six separate 'research streams' in corporate governance).

29 David Monsma, *The Academic Equivalence of Science and Law: Normative Legal Scholarship in the Quantitative Domain of Social Science*, 23 T.M. COOLEY L. REV. 157, 159 (2006).

30 Randall S. Thomas, *The Increasing Role of Empirical Research in Corporate Law Scholarship*, 92 GEO. L.J. 981, 981–982 (2004) (book review).

31 *See* The Bluebook: *A Uniform System of Citation* (19th Ed. 2010).

32 *See* Michael McConville & Wing Hong Chui, *Research Methods for Law*,18 (2007) ('[L]egal research, as taught in many law schools, is far too narrow in its outlook').

33 *See* Philip C. Kissam, *The Evaluation of Legal Scholarship*, 63 WASH. L. REV. 221 (1988); Edward L. Rubin, *On Beyond Truth: A Theory for Evaluating Legal Scholarship*, 80 CALIF. L. REV. 889 (1992).

34 Marin Roger Scordato, *Reflections on the Nature of Legal Scholarship in the Post-Realist Era*, 48 SANTA CLARA L. REV. 353, 410 (2008).

35 *See*, *e.g.*, Harry T. Edwards, *The Growing Disjunction between Legal Education and the Legal Profession*, 91 MICH. L. REV. 34 (1992).

36 Scordato, *supra* note 33, at 420–422.

37 *See*, *generally*, Sanjai Bhagat & Roberta Romano, *Empirical Studies of Corporate Law*, *in* HANDBOOK OF LAW AND ECONOMICS, Vol. 2 (A. Mitchell Polinsky & Steven Shavell eds, 2007).

38 Henry L. Tosi, *Quo Vadis: Suggestions for Future Corporate Governance Research*, 12 J. MANAGE. GOV. 153, 163–164 (2008) (suggesting the use of laboratory and survey research methods as a complement to quantitative corporate governance research based on archival state sets).

39 *See* Oliver Marnet, *Behavior and Rationality in Corporate Governance*, 39 J. ECON. ISSUES 613, 613 (2005) ('Empirical research on corporate governance typically investigates quantifiable relationships between measures of corporate performance and specific remedies to agency problems, including the number and independence of directors on a company board or board committees and the independence of external auditors.' (citations omitted)).

40 For an excellent pair of articles on corporate law event studies, see Sanjai Bhagat & Roberta Romano, *Event Studies and the Law – Part I: Technique and Corporate Litigation*, 4 AMER. L. & ECON. REV. 141 (2002) (earlier draft available at http://ssrn.com/abstract=268283) [hereinafter *Part I*] and Sanjai Bhagat & Roberta Romano Event Studies and the Law: *Part II – Empirical Studies of Corporate Law*, 4 AMER. L. & ECON. REV. 380 (2002) (earlier draft available at http://ssrn.com/abstract=268285) [hereinafter *Part II*].

> Event studies have had a major impact on corporate law. The explanation for this influence is straightforward. The objective of U.S. corporate law is furthering the interest of the owners of the firm, and the event study methodology, measuring the unexpected change in stock price due to new information about firm value, such as adoption of a new corporate law or a firm decision, provides a metric for identifying whether a specific corporate policy or action has the legal regime's desired beneficial impact on firm owners. Moreover, the event study literature serves as a helpful arbiter of corporate law debates because all sides hold the same normative conception of corporate law, shareholder wealth maximization. Bhagat & Romano, *Part II*, *supra*, at 381–382.

41 Bhagat & Romano, *Part I*, *supra* note 39, at 144–146.

42 Jonah B. Gelbach et al., Valid Inference in Single-Firm, Single-Event Studies, at 3, July 2009, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1442222 ('The popularity of event studies derives from their simple and elegant method of controlling for general market effects and other relevant covariates, thereby isolating causal effects of events like a law's passage, corporate governance adoption, and so on.').

43 Daily et al., *supra* note 2, at 378.

44 *Id.* at 378–380.

45 *See* Gillan, *supra* note 1, at 396.

46 Bhagat & Romano, *Part I*, *supra* note 39, at 164.

47 *See*, *e.g.*, Derek K. Oler et al., *The Danger of Misinterpreting Short-Window Event Study Findings in Strategic Management Research: An Empirical Illustration Using Horizontal Acquisitions*, 6 STRATEGIC ORG. 151 (2008).

48 *See* Lori J. Letts et al., *Guidelines for Critical Review Form: Qualitative Studies* (Version 2.0), 2007, pp. 2–3, *available at* http://www.srs-mcmaster.ca/Portals/20/pdf/ebp/qualguidelines_version2.0.pdf (describing these among other types of qualitative empirical research).

49 *See*, *e.g.*, David Silverman, QUALITATIVE RESEARCH: THEORY, METHOD AND PRACTICE 360–362 (2004).

50 *See* Marnet, *supra* note 38, at 613–614.

51 PRINCIPLES OF CONTEMPORARY CORPORATE GOVERNANCE 375 (J.J. Du Plessis et al., eds, 2005).

52 *See* Marnet, *supra* note 38, at 613–614; van Ees et al., *supra* note 28, at 311–313.

53 *See* van Ees et al., *supra* note 28, at 307 (''[B]ehavioral' studies of boards and corporate governance are scattered across disciplines and research traditions, and they apply different methodologies and assumptions'); *id.* at 311 (same).

54 Robert Libby & Nicholas Seybert, *Behavioral Studies of the Effects of Regulation on Earnings Management and Accounting Choice*, in ACCOUNTING, ORGANIZATIONS, AND INSTITUTIONS: ESSAYS IN HONOR OF ANTHONY HOPWOOD 290, 292 (Anthony G. Hopwood et al., eds., 2009).

55 *See* van Ees et al., *supra* note 28, at 307 ('[A] growing number of studies have emphasized the need to more closely study behavioral processes and dynamics in and around the boardroom to better understand conditions for effective corporate governance').

56 *See id.* at 315.

57 *See id.* at 311 ('[T]he idea that the different theories provide complementary perspectives, and that none of them can independently provide a full explanation, seems to have gained some ground in the field.').

PART 2

Markets and Regulation

The Juridical Nature of the Firm

Simon Deakin

INTRODUCTION

Economics provides a wealth of models and concepts through which the structure of the business enterprise can be understood. The theory of the firm as a governance structure which mitigates the effect of contractual incompleteness and other sources of transaction costs (Coase, 1937; Williamson, 1975, 1986, 1996; Zingales, 1998) has supplied the basis for the economic analysis of corporate law (Easterbrook & Fischel, 1991). This 'functional' approach has proved enormously fruitful in uncovering the deep economic structure of corporate law (Armour, Hansmann & Kraakman, 2009). By integrating legal analysis into the wider stream of thought in new institutional economics, it has provided researchers with a set of concepts which make possible to operationalise the study of corporate law rules 'in action'. It has also supplied a normative benchmark for the evaluation of legal rules by reference to concepts of efficiency drawn from welfare economics.

The economic analysis of law, or 'law and economics', seeks to describe legal phenomena (concepts, rules, procedures, etc.) using theoretical terms which have wider use within economics (transaction costs, externalities, welfare, efficiency, etc.). What is more rarely done it to invert the focus of analysis, and ask: How does the legal system view economic phenomena such as the business firm? It is important to do this, because the legal form of the enterprise matters. Business firms operate in market economies through the medium of the 'corporation', a legal institution which significantly shapes the way in which enterprises function (Robé, 2011). The corporation, and corporate law more generally, are not 'trivial' in the sense of simply providing a set of default rules which corporate actors are free to modify. While corporate law does do this, it does much more besides (Deakin & Carvalho, 2011). Corporate law regimes are complex, emergent phenomena, the result of a path-dependent process through which legal systems have co-evolved alongside firms and markets in industrialising economies (Aoki, 2010). Corporate law has both shaped and been shaped by the historical process of industrialisation and economic development (Ahlering & Deakin, 2007).

Legal concepts and rules in the area of corporate law can be thought of 'summary representations' of practices which have proved more or less successful in addressing coordination problems at the level of the firm and which have been integrated into the legal system (Aoki, 2010; Deakin & Carvalho, 2011). To study corporate law, in a historical context and across different national jurisdictions, is to get a sense of the variety of available solutions. This approach need not involve the abandonment of model building. It can be thought of as a data-driven approach to modelling, in contrast to the theory-driven approach of the predominant economic models of the firm, agency theory (Jensen & Meckling, 1976) and property rights theory (Hart, 1995).

A theory-driven approach is one which builds an economic model from a set of general axioms and undertakes empirical research with a view to determining how far that model can be validated. If the model is undermined by empirical findings, it will not be discarded until there is a better alternative. As is the case elsewhere in contemporary economics and econometrics, such an approach 'will, almost by construction, be less open to signals in the data suggesting the theory is incorrect or in need of modification and will, therefore, run the risk of producing empirically irrelevant and misleading results' (Juselius, 2011: 425). A data-driven approach does not disregard the need for theory, but it seeks to build a theoretical model on the basis of widely observed empirical phenomena, which are then embedded in it. The resulting model is continuously tested against what can be determined, empirically, of the world, and modified accordingly.

A more realistic model of the way corporate law works in the economy would be an important achievement for empirical legal studies, but it would also assist the debate over corporate governance policy. This is because, as we shall see, the legal model of the firm that can be derived from a study of the workings of corporate law (and of closely aligned areas of law such as insolvency and employment law) is at odds with the shareholder-dominated view of the firm which currently holds sway in economic theory and in corporate governance theory and practice. Study of the juridical nature of the firm reveals the numerous functions which corporate law performs beyond the maximisation of shareholder value. Because theories of the firm, in addition to shaping empirical research, also influence policy, an empirically grounded model of the corporation has the potential to avert policy mistakes of the kind to which a theory-driven account of corporate governance is prone. The recent experience of the global financial crisis and the reaction to it suggests that developing an empirically informed, data-driven model of the firm should be a priority for corporate governance researchers.

Section 2 (Economics and law) below is a step in the direction of developing a more empirically grounded model of corporate law. It discusses differences between basic legal and economic concepts, drawing a distinction between the legal notion of the 'corporation' and the economic notion of the firm or enterprise. It then seeks to develop a model which uses economic concepts drawn from new institutional economics to explain the extant legal features of the firm. In this data-driven approach, theory is used to explain the empirical (here, legal) phenomena, rather than the empirical phenomena being used to justify particular elements of the theory. In Section 3 (Law and governance), the focus turns to a number of issues arising at the interface between the legal system and contemporary corporate governance practice in three illustrative contexts: board structure and performance, hostile takeover bids and regulatory competition. Section 4 (Conclusion) provides an assessment and conclusion.

ECONOMICS AND LAW: THE FIRM AND THE CORPORATION

The first step in the analysis is to draw a clear distinction between the economic concept of the 'firm' or 'enterprise', on the one hand, and the legal concept of the 'corporation', on the other. The 'firm' is an organisation engaged in the production of goods and/or services. To do this it combines physical, human and virtual assets, with a view to realising a surplus. The task of combining these assets rests with a specialised function within the firm, its management. If management is successful in its core tasks, the firm can meet its commitments to the original owners of the assets it users (investors, creditors, workers) and reinvest what remains for its own future development. The organisational reach of the firm means that its activities are felt, both positively and negatively, by third parties. At the same time, the firm's resources and its organisational capacities endow it with the means to absorb, control and diversify the risks of harm to third parties.

The 'corporation' is the principal legal mechanism by which firms, so defined, operate in contemporary market economies. The corporation is a device through which the legal system assigns legal personality, and hence the capacity to function as an economic actor able to hold property, make contracts and more generally assert its own legal interests, to the organisational structure of the firm. Through this step, the legal system facilitates the continuity (or 'permanence') of the firm (Robé, 2011). The firm acquires a legal form which separates it from its founders, and from its managers, investors or workers at any given point. In addition, the legal system creates a degree of autonomy for the firm's asset pool. Through the device of separate personality, the firm's assets are protected against legal claims made by third parties against the assets of those who supply inputs to it (again, whether they be founders, managers, investors or workers) (Hansmann & Kraakman, 2000; Hansmann, Kraakman & Squire, 2006).

It is on the basis of these two steps – permanence and asset partitioning – that the law underpins the organisational capacity of the firm. Without confidence in its continuing identity, banks and suppliers would be less willing to extend credit, and employees less prepared to invest in firm-specific skills. Similar bonding effects arise from the identification of the firm's asset pool.

So far, the legal structure being described could apply to any of the numerous types of corporation which the legal system recognises, ranging from joint-stock companies or companies limited by share capital, to partnerships (which increasingly operate on the basis of separate personality), worker cooperatives, mutuals (in which the members are customers), public interest corporations such as companies limited by guarantee, and charities. The legal features of the company limited by share capital – delegated management under the supervision of the board, limited liability for the shareholders and transferable shares – most closely correspond to the functional needs of the private-sector business enterprise. Limited liability confers on the shareholders (if their shares are fully paid up) protection from third party claims against the company's assets, a form of reverse asset-partitioning. This has a number of effects. In organisational terms, in shielding shareholders from personal liability, it enables them to step back from day-to-day management concerns and so complements the process of delegation of operational matters to the company's officers and employees via the board (Robé, 2011). It also allows investors to diversify their holdings, thereby supporting the principle of the transferability of shares (Armour et al., 2009). In the context of a publicly listed company, these linked legal devices underpin the institution of a stock market based on anonymised exchange (Easterbrook & Fischel, 1991).

In doing all this, the corporation is acting as more than just a legal 'fiction'. The corporation is a legal mechanism, but it is no more a 'fiction' to assign legal personality to organisational structures than it is to grant it to natural persons. The capacity to hold property and enter into contracts is not something which the legal system inevitably ascribes to all 'natural' persons. Until comparatively recently, some categories of natural persons lacked full capacity to contract (as was the case with married women in even some Western European countries up to the middle of the 19th century), and some still do (the young, the very ill and those deemed incapable of acting in their own best interests) (Deakin & Supiot, 2009). In the wake of the 18th century Enlightenment, European legal systems adjusted to the idea of universal citizenship by following the principle that, as Savigny put it, 'every single human being – and only the single human being – enjoys capacity' (quoted in Wijffels, 2009: 60). The extension of capacity to privately formed business and other associations (it had already been accorded to states and to their own economic ventures, churches and universities) was an additional and controversial step. Without it, it is doubtful that the industrial economies of Western Europe and North America would have taken the form that they did. Although manufacturing firms in the early industrialising nations, in particular England, had in some cases emerged through a mixture of contracts and property rights, without the need for incorporation, the legal innovation of separate personality coupled with limited liability considerably increased the organisational scope and reach of business enterprises (Harris, 2000). By the end of the 19th century the use of the corporate form was more or less universal for industrial firms in England and the United States, while in the countries of mainland Europe, which were later to industrialise, it was present, and widely used from the outset of industrialisation (Ahlering & Deakin, 2007).

Nor is the corporation a legal fiction in the sense that the legal incidences associated with it have no consequences for the structure and operation of the firm. It matters that shareholders are not 'owners' of the firm or corporation, or of its assets. Strictly speaking, it makes no sense to talk of ownership of the firm (which is not a legal entity as such, but an organisational structure) or of the legal person which is the corporation (the corporation can own things but is not a 'thing' in itself that can be owned, any more than a natural person is). It is important, for the purposes of bonding and the credibility of the corporation's commitments to third parties, that the shareholders should not be in a position, as 'owners', to remove the capital which they have invested (Blair, 2003). Unless they clearly contract otherwise, the shareholders are locked into an indeterminate relationship with the firm, and their investments become the working capital and assets of the corporation once they have been made.

The predominant economic theory of the firm, agency theory, recognises some elements of the basic legal form of the corporation. Fama and Jensen (1982) are very clear that shareholders own neither the firm nor its assets. Easterbrook and Fischel (1991) see limited liability for shareholders as the logical consequence of their status as just one set of suppliers of inputs to the firm: they should be no more exposed to the firm's debts than banks or employees are. Nevertheless, agency theory speaks of shareholders as 'principals' and managers as their 'agents'. *This really is a fiction.* In legal terms (and these are the terms which matter when we talk about firms with investors called 'shareholders', firms which must therefore be constituted legally as corporations), the directors (not necessarily the same thing as the managers) are the agents of the company, not of the shareholders.

The economic theory of the firm maintains the fiction that the shareholders are the managers' principals because it observes (correctly) that shareholders in a company limited by share capital are the corporation's residual claimants: they stand last in line to be paid, after creditors and employees, and the income they generate from their investment is therefore proportional to the surplus that the firm generates. Shareholders' residual claimant status explains why – in the company limited by share capital – they alone are entitled to appoint and remove directors and thereby to hold the board, and through the board the officers and employees of the company, to account. But it does not follow that shareholders can accurately be called 'principals'. They can remove the board, but they have no power to intervene directly in management. They may, by contract or by law in some systems, be consulted over certain corporate transactions, but their veto right is not equivalent to a right to co-manage the firm's assets. All rights, aside from those specifically contracted for, which shareholders have – voice rights, voting rights, rights to share in the residual from production – stem from their ownership of their *shares*. And a share, while a significant form of property in its own right, is not a pro rata claim on the company's underlying assets, which remain shielded from direct shareholder influence just as they are from direct control by other groups with an interest in the firm.

In so far as the 'functional' account of corporate law speaks of 'investor ownership' (Armour et al., 2009) in the context of the company limited by share capital, which can be thought of as a kind of 'capital cooperative' in contrast to structures in which workers, producers or customers are the residual claimants (Hansmann, 1996), it is the ownership of shares not of the firm's assets that is being referred to. Similarly, the property rights theory of the firm (Hart, 1995), which claims that ownership of the residual assets of the firm gives shareholders the right to adjust contracts ex post in such as a way as to overcome the problems of ex ante incompleteness, is only a valid description of the corporate form if it is accepted that the property rights vested in shareholders through ownership of their shares are at best indirect. In certain exceptional circumstances, such as takeover bids or voluntary windings up, shareholders can, in effect, remove capital from the firm. This right can indeed confer upon the shareholder body a power to adjust the terms of the firm's relationships with other constituencies to reflect the ex post environment. This is, however, a power that can only be exercised in particular contexts, and under conditions which recognise the implicit or explicit contractual claims of employees and creditors, among others. We will return to this point in the context of the discussion of takeover bids in Section 3 (Law and governance) below.

If it is unnecessary to invoke the principal–agent analogy as an explanation for the legal structure of the firm, it is also misleading to do. The idea that managers *should* act for the shareholders as in some sense the firm's 'true' owners or, in a less extreme but still inaccurate form, the managers' 'principals', is an idea with a powerful resonance within corporate governance theory. The idea of shareholder primacy is expressed, in one form or another, in most corporate governance codes and similar non-legal guidance on governance practice (Hansmann & Kraakman, 2000), and its influence on the practice of management in large firms is increasingly clear at an empirical level (Kennedy, 2000). It is said that to give managers any other instruction would confuse the aims of the corporation and induce managerial slack (Jensen, 2005). Yet this does not represent the view of the firm taken by any legal system. In civil law jurisdictions, the much debated notion of the 'company interest', controversial as it is, is nevertheless very clear in its implication that the principal task of management is not to return the surplus from production, in whole or in part, to the shareholders, but to maintain the firm as a going concern with a view to returning value to all those supplying inputs to it (Viénot, 1995). In the common law systems, variants of the idea referred to in English law as 'enlightened shareholder value' have long been recognised, giving management discretion not just over how to balance the interests of shareholders with those of employees and creditors, but to determine the timescale over which the shareholders can expect to receive a return on their investments (Company Law Review Steering Group, 1999, 2000). On this core issue, the civil law and common law systems, despite the different language used, are not very far apart (Siems, 2008).

Why does the law take a view of the shareholder–manager relationship which is apparently at odds with the needs of the modern business firm for a clear line of accountability in the way the firm's assets are managed? Rather than trying to fit empirical data to the model at this point, it would be more helpful perhaps to see if economic theory can come up with a good, alternative explanation for what can be empirically observed. A data-driven model of the firm should reflect the economic advantages of managerial autonomy. These include the benefits in terms of bonding and credibility of commitment in the firm's dealings with third parties that have already been referred to; the avoidance of succession problems which arise in the rare but revealing situations where business firm are run as the personal property of a founder-manager or single investor (Robé, 2011); the advantages in terms of specialisation and division of labour within the firm which come from legal recognition of a separate management function (Easterbrook & Fischel, 1991); and the benefits, in terms of the reduction of enforcement costs, of a regime of legal 'forbearance' (Williamson, 1996) which implies that, as long as the firm is a going concern, the courts play a minimal role in supervising the managerial process.

It is instructive, conversely, to consider what view the law takes of situations in which the firm can no longer be operated as a going concern. Here, the law intervenes, but rarely if ever to the benefit of shareholders. Legal systems recognise that other constituencies – creditors, the government (as regulator or tax authority), or employees – become the residual claimants, with voice, voting and income rights, in situations where their own firm-specific interests are directly threatened. Insolvency (or corporate bankruptcy) law grants secured creditors rights to have the firm wound up and all or part of its remaining assets transferred to them to meet outstanding debts. These claims may be defeated by debtor-in-possession or corporate-rescue laws which allow incumbent managers to stay in place, not for the shareholders' benefit as such, but to ensure that the firm's constituencies in general, including employees and major customers, benefit from its continuation as a productive concern where that is possible (Armour & Deakin, 2001). Employment laws, by no means universally but in a significant number of countries (including all EU member states and Japan), grant employee representatives voice rights at the point where the firm is contemplating large-scale job losses or a change of ownership in the context of insolvency or near-insolvency (Armour & Deakin, 2003). Insolvency law, in addition to protecting unsecured creditors against the negative consequences of a 'race to collect', confers priority claims on tax authorities and employees. Government agencies in regulated industries such as utilities and banking have powers to intervene in management and ownership decisions if there is a possibility of the failure of the firm and/or of a change of control.

Corporate law recognises the need for managerial autonomy largely by putting in place limits on shareholder control. Aside from this, management, as a function, is rarely directly visible within company law. Some corporate law regimes, such as Delaware's, explicitly state that management is the responsibility of the board except in so far as it chooses to delegate this task to officers and employees. The model articles of association set out in the UK Companies Act 2006 take the same approach. This too is a point of departure from the emphasis within corporate governance codes, and the practice of corporate governance, on directors as monitors of management. In the legal model, boards can take on a management role directly; until recently the boards of large listed companies in the USA and UK would have contained several executive directors in addition to the CEO. However, the practice has increasingly been for boards of listed companies in common law jurisdictions to consist of at least a majority of outside or independent directors (Gordon, 2007). There is nothing in the largely permissive structure of the British and American corporate law systems to prevent individual directors playing a purely monitoring role, but it would be going too far to say that this is the role that company law in these jurisdictions intends for the board. It would be more accurate to say, simply, that corporate law in these countries has never required directors to engage in management directly, a position that is still maintained today, and so has adjusted without undue difficulty to the recent practice of regarding outsider directors as monitors. In German-influenced systems with two-tier boards, there is a clearer demarcation of execution and monitoring between the different tiers, but even here it is not the case that members of the supervisory board are agents of the constituencies (shareholders, employees or others) who elect them.

If corporate law recognises that management is either in whole or in part a function which the board delegates to the company's officers and employees, it is nevertheless almost completely silent on how the managerial function is actually performed. For a more detailed account of how management works, we have to look to other areas of law, in particular employment law and enterprise liability law (tort law, health and safety law and environmental law). The authority management needs to coordinate the production of goods and services is principally to be found within employment law. Employment law systems recognise the inherent authority of management to direct production in the form of the open-ended duty of obedience which is implied in the contract of employment. The implied term of obedience is not, as is sometimes suggested (Alchian & Demsetz, 1972), equivalent to the continuous renegotiation of the contract of employment. The whole point of the open-ended duty of obedience is to obviate the need for continuous renegotiation, as some economic accounts recognise (beginning with Coase, 1937).

As a legal concept, the contract of employment gives juridical form to the practice of employer power. But employment law goes further, in inserting into the employment relationship reciprocal duties of trust, cooperation and care. The trade-off of 'subordination' for 'security' is inherent in the structure of the indeterminate-duration contract of employment. The managerial power of coordination is qualified by the legal imposition of responsibility upon the firm for the physical, economic and psychological well-being of its employees (Davidov, 2002). While the extent of this responsibility is contingent and contested, it is unusual to see it entirely absent from any work relationship that can be justifiably be characterised as one of direct or dependent employment. Even the US model of 'employment at will' acknowledges a residual role for good faith and respect for fundamental constitutional rights, such as freedom of speech, in the context of the work relationship (Stone, 2007).

Enterprise liability law also casts light on the juridical dimension of the managerial function. Health and safety laws and environmental laws specify in some detail the level of management within the firm which is responsible for the delivery of these legal duties. Thus, it is normal for laws of this kind to identify managers with particular executive roles as having certain responsibilities. These areas of law also identify circumstances under which board-level directors can be found personally liable for breaches of regulatory statutes. Certain types of firms which, while constituted as listed companies, perform what are often regarded as public interest functions, such as utilities and banks, are subject to similar legal regimes.

The appearance of the managerial function of the firm within enterprise liability law is a signal that the legal system recognises the possibility of the firm's responsibility for the risks which its activities create both for its employees and for third parties. The firm's organisational capacity, which is in part a function of the legal form it takes as a corporation, endows it with the resources to control and diversify these risks. The firm can control risks in two ways: by using its managerial power to reduce, subject to certain limits, the possibility of negative externalities affecting third parties; and by using the financial and other resources at its disposal to diversify the risks of social harms through insurance (employers' liability insurance, insurance for environmental liabilities, and so on). The firm serves as conduit for the pricing of risks in insurance and other markets, its role in this regard serving again to minimise transaction costs. Theories of enterprise liability are one expression of the law's view of the boundaries of the firm. The outer limits of the firm's organisational structures are identifiable in concepts of vicarious liability, for example, which hold the employer liable for risks inherent to its core activities (the 'enterprise-risk' test: Deakin, 2003).

The legal model of the firm, although broad in scope and certainly wider than the shareholder-focused corporation or 'capital cooperative', is radically incomplete in one essential respect: the existence of the corporate form notwithstanding, the firm or enterprise *as such* is not a legal actor (Robé, 2011). The corporation, and corporate law more generally, only account for a fraction of the economic functions of the firm. As we have seen, it is important to bring insolvency law, employment law and enterprise liability law (as well as, arguably, tax law and competition law) in order to see the full picture. And, in fact, the full picture cannot be viewed from any one of these legal perspectives, because each of these different areas of law only describes part of the complex reality of the firm (Deakin, 2003). There is no single, all-encompassing, legal view of the firm. This matters because it makes the task of fitting the legal system to the reality of corporate practice problematic on some critical points.

The firm's controllers – its managers and/or dominant shareholders – can use the corporate form to enhance the firm's organisational capacity, in the process granting it the legal powers of natural persons. But they can also use the corporate form to avoid liabilities which natural persons cannot avoid (or at least not in the same way or to the same extent). In practice, the modern business firm is a multi-corporate enterprise (Guevara-Bernal, 2002). Within the structure of the firm, there are many reasons for the use of subsidiary company forms, special purpose vehicles, and so forth, some of which involve legitimate uses of entity shielding. At the same time, it is clear that corporate group structures can be used for welfare-reducing purposes: these include 'creative avoidance' (minimisation of tax and other liabilities) and regulatory arbitrage (using corporations domiciled or resident in low-regulation jurisdictions to avoid legal obligations). The law of corporate groups has not reached the stage of being able to deal effectively with all these abuses (Strasser & Blumberg, 2010). The consolidation of company accounts for tax and accounting purposes can address problems such as tunnelling (the extraction of shareholder value through the use of sham company forms), and the taxation of corporate profits can take account of transfer pricing issues in the relationships between parent and subsidiary companies. There, are however, many areas in which avoidance and arbitrage are not being effectively addressed, because the techniques being applied are too crude ('lifting the corporate veil'), or in which they are tacitly or even explicitly condoned by regulatory guidance or judicial indifference. We return to this issue below in our discussion of regulatory competition.

LAW AND GOVERNANCE: TENSIONS AND CONTRADICTIONS IN CORPORATE GOVERNANCE REGULATION AND PRACTICE

Board structure and performance[1]

The legal model of directors' duties which has informed the development of company (or corporate) law in Britain and America is essentially facilitative, rather than prescriptive. The concept of fiduciary duty originates in the legal institution of the trust, as adapted over time to the particular features of the company limited by share capital. The core of agency theory is observable here: the corporate form is a structure based on the delegation of use or control rights over property from the shareholders to the board, with accountability running back in the other direction. Beyond this basic idea, however, the law does not clearly define the role or function of company directors, and it is more agnostic on this point than agency theory is, with its emphasis on non-executive directors as monitors of management.

In the legal model directors must, in a manner analogous to trustees, avoid (or at least disclose) conflicts of interest, and exercise care in the way they handle the company's property (Davies, 2008: Ch. 16). They may be, but need not be, involved in the management of the enterprise. If they are not so involved, their responsibilities are hard to pin down. For most of the history of corporate law, there has been no legal principle requiring directors, whether executive or non-executive, to act as 'monitors' of management, or specifying an objective standard to which they had to adhere when doing so. In so far as there is now such a duty in the common law systems, for example, it is largely the consequence of recent changes to the law (both case law and legislation) which have been influenced by the adoption of corporate governance codes by stock exchange and listing authorities, and by changes in practice affecting listed companies. The legal model has to some extent been adjusted to the corporate governance practice of treating independent directors as monitors, but tensions remain.

These tensions are visible, for example, in the evolution of the law relating to the director's duty of care. In English law, until as recently as the 1980s, this duty was originally expressed in entirely subjective terms. In other words, a director could only be held liable for breach of the duty of care by reference to his or her failure to come up to a subjective standard based on their individual capabilities. The law also reflected the different functions, executive and non-executive, which directors could in principle be expected to perform. The effect was to make it virtually impossible for a non-executive director to be held liable for ineffective oversight of the company's management. Indeed, the less such a director professed to do, the less likely it was that they could be held personally liable for the consequences of the company's failure or otherwise for losses stemming from mismanagement. Periodic financial crises led to attempts to move the law on by litigation, but until very recently the law 'was decided with non-executive rather than executive directors in mind and, moreover, on the basis of a view that the non-executive director had no serious role to play in the company but was simply a piece of window-dressing' (Davies, 2009: 489).

The immediate aim and effect of this approach was to protect non-executives from what were seen as excessive risks of personal liability. However, the idea that the non-executive director had no real part to play in internal corporate affairs undoubtedly chimed with the managerialist ethos of the mid-20th century. It was managerialism, too, which provided the context for the next stage in the development of the law. This involved raising the standard for the duty of care, which was principally designed to ensure that executive directors came up to an objective level of managerial competence, as well as being held to a higher, subjective standard in areas where they held themselves out as having a particular type of expertise. Although in principle also applicable to non-executives, this test first emerged in the late 1980s and early 1990s in the context of litigation involving executive directors who had been involved in the day-to-day management of insolvent firms. There was now a greater likelihood that they could be held personally liable under the breach of the duty of care. Around the same time, legislation (the Company Directors Disqualification Act 1986) was passed to introduce a procedure for the disqualification of directors found to be 'unfit' to manage the affairs of a company following insolvency.

The government-sponsored review of UK company law that was initiated in the late 1990s (see Company Law Review Steering Group, 1999, 2000), and resulted in the passage of the Companies Act 2006, looked in detail at the issue of director's duties and liabilities. Section 174 of the 2006 Act has restated the common law test of the duty of care. Section 174 requires a company director to exercise

> … the skill, care and diligence that would be exercised by a reasonably diligent person with (a) the general skill, knowledge and experience that may be reasonably be expected of a person carrying out the same functions carried out by the director in relation to the company, and (b) the general knowledge, skills and experience that the director has.

This test formally extends the mixed objective/subjective test, which originated in insolvency law, to cases of breach of the duty of care in general. In principle, it applies to executive and non-executive directors alike. In practice, the content of the duty will differ from one case to another. The objective test, set out in paragraph (a), implies a higher standard of care in the case of executive directors, who are immediately involved in the running of the business, than in that of non-executives. However, this line of reasoning by no means absolves non-executive directors from responsibility. If their task is seen as monitoring, as distinct from managing, they will now be held liable by reference to a general standard of care based on expectations of the type of oversight they are capable of exercising. This standard is likely to be higher in the case of publicly listed companies, in part because of corporate governance standards and listing rules specific to companies of this type. More generally, there is now a clear expectation that one of the main functions of non-executives, in the context of this type of company, is to ensure managerial accountability. The subjective test embodied in paragraph (b) means that non-executives with particular knowledge and expertise will, as before, be held to the higher standards which their individual position entails. Non-executive directors of listed companies increasingly receive training as part of induction courses put on by their companies. In these circumstances, a defence of lack of knowledge of the way the company operates in general will rarely be available, although this is not the same thing as requiring a non-executive director to have the same degree of knowledge as an executive director.

The most difficult issue in ascertaining the limits of directors' liability for breach of the duty of care concerns the question of delegation. Delegation from the board to management is inevitable if a majority or more of the members of the board are outsiders, and the courts recognise this reality. The legal duty of the board is not to be informed on every single aspect of the company's operations, but to put in place an effective system of internal control and audit. In the UK, the Turnbull Report (1999), which came out of the standard-setting process which began with the Cadbury Report (1992), clarified this obligation. The Turnbull recommendations set out guidance for listed companies rather than a strictly binding legal provision in the manner of its nearest US equivalent, Section 404 of the Sarbanes–Oxley Act 2002. In common with other recommendations of the UK Corporate Governance Code, listed companies, subject to the principles initially set out by Turnbull, have a choice of complying with its recommendations or explaining why they do not. In practice, most UK listed companies are compliant with this aspect of the Combined Code. Turnbull reinforced a move to more systematic internal audit and reporting systems that had already begun in the 1990s.

Turnbull (1999) maintained that 'a company's system of internal control has a key role in the management of risks that are significant to the fulfilment of its business objectives'. The Report required boards to issue regular reports on the effectiveness of the system of internal control in managing key risks, and to undertake an annual assessment for the purpose of making their statements on internal control in the annual report. It also recommended that internal controls 'should be embedded in [a company's] operations and not treated as a separate exercise', should 'respond to changing risks inside and outside the company' and should be capable of being applied by the company in a manner which was 'appropriate to its key risks'. Thus, the emphasis was on internal control systems which were flexibly designed and sensitive to the particular cultures of different companies.

Thus in part through the alignment of company law with corporate governance standards, the role of the board in matters of delegation and monitoring has been clarified. The vast majority of boards of UK listed companies do not engage in management. They delegate the managerial function to specialist officers and employees. Through internal reporting systems, they aim to be in a position to monitor managerial performance. But when this system was put to the test in the context of the financial crisis of 2007–08, its shortcomings were apparent. The credit crunch, which began in 2007, and the freezing up of the inter-bank lending market, which occurred in the autumn of 2008, seem to have come as just as much of a shock to the boards of the banks and financial institutions most affected by it as to more general observers of these events. Over-reliance on mathematical models of risk (value at risk models), which created an assumption that the chances of a catastrophic failure were extremely remote, seem to have been part of the problem (Ladipo & Nestor, 2009). Director expertise, or the lack of it, was also an issue. The banks most exposed during the crisis were those with fewer directors, whether independent or executive, with expertise of banking and the financial sector more generally. It would seem that independent directors, appointed for their separation from the day-to-day running of the firm, lacked the knowledge and expertise to monitor the CEO and the wider management team, and to make an effective assessment of risk.

If the corporate governance framework was put to the test by the financial crisis, so was the framework of company law. In the British case, virtually no legal sanctions have been brought to bear on the directors of the firms which failed or nearly failed in the crisis, largely because the Company Directors Disqualification Act 1986 can only be invoked in a situation where the company becomes insolvent. As the banks exposed to the effects of the crisis were saved by government intervention, and so avoided insolvency, the procedures for director disqualification under the Act of 1986 could not be invoked. Only a handful of senior officers and executive directors have faced disqualification, under separate legal powers granted to the financial sector regulator.

Evidence emerging from the global financial crisis suggests that neither company law nor corporate governance codes were able to provide an appropriate framework for board-level monitoring of management in the years immediately prior to the global financial crisis. There is also evidence that corporate governance reforms aimed at enhancing managerial accountability to shareholders helped to encourage risk-taking in financial sector firms. Several empirical studies have identified correlations between the number of independent directors on boards and other indicators of shareholder influence over strategy, on the one hand, and the failure or near-failure of banking and other financial sector firms during the crisis of 2007–08, on the other (Erkins, Hung & Matos, 2009; Mülbert, 2009; Beltratti & Stulz, 2010; Fahlenbrach & Stulz, 2010; Ferreira, Kirchmaier & Metzger, 2010). This result can be explained in part by shareholders' greater appetite for risk, relative to the position of other corporate constituencies (Strine, 2008), a consequence of the market-wide diversification of the holdings of institutional investors and of increased liquidity in British and US stock markets. It is also seems to be linked to the growing willingness of independent directors in British and American financial sector firms to 'hold managers to account' if they failed to meet shareholders' expectations of high returns.

Hostile takeover bids[2]

The most important factor favouring the development of shareholder-orientated corporate governance since the middle decades of the 20th century has been the encouragement given to the hostile takeover bid by regulatory changes which have often been in tension with the core principles of company law. The rise of the hostile takeover can be traced back to the late 1950s and early 1960s in the UK and USA. There had always been mergers and acquisitions of firms; what was relatively new was the idea of a bid for control directed to the shareholders, over the heads of the target board. In the 1920s and 1930s, incumbent boards often 'just said no' to unwelcome approaches from outsiders, often without even informing shareholders that a bid was on the table (Hannah, 1974; Njoya, 2007). At this stage, accounting rules had not evolved to the point where companies were under a clearly enforceable obligation to publish objectively verifiable financial information. This changed in the post-1945 period as a consequence of the legal and accounting changes that were put into place in both Britain and America by way of response to the financial crises of the 1930s. Greater transparency made it easier for unsolicited bids to be mounted and more difficult for incumbent boards to resist them. Institutional protection for minority shareholders followed, with the adoption in Britain in 1959 of the Bank of England's Notes on Reconstructions and Amalgamations and, in 1968, the City Code on Takeovers and Mergers. The year 1968 was also the year in which the US Congress adopted the Williams Act, instituting a system of regulation for hostile tender offers for US listed companies.

The Williams Act sets time limits on tender offers and requires bidders with 5% of a company's stock to disclose their holdings and to give an indication of their business plan for the company, but it does not explicitly rule out two-tier or partial bids as it does not contain a mandatory bid rule along the lines of the UK's City Code. It regulates fraudulent activity, broadly defined, but does not place target directors under a clear-cut duty of care to provide independent financial information to shareholders in the way that the Code does. At state level, US courts have accepted that, under the 'business judgment' rule, target directors can take steps to resist a hostile takeover where they act in good faith and in the belief that a bid poses a threat to corporate policy and effectiveness. They are also permitted to taken into account the impact of proposed takeovers on non-shareholder constituencies. Delaware law allows target boards to trigger poison pills to defeat a bid or at least to make it more expensive for the bidder (thereby serving as a possible deterrent), unless more than one bidder enters the fray and an auction for the company begins. Under Delaware law, a board of directors is under no duty to maximise shareholder value per se, even in the context of a takeover bid (Roe, 1993; Blair, 1995).

State-level 'stakeholder statutes' were passed in the USA during the1980s and 1990s in response to the takeover waves of that time. These statutes, together with the adoption of poison pills by a majority of large public corporations, are credited with having helped to restrict the number and volume of takeovers at the end of the 1980s: by the mid-1990s, over two-thirds of large US public corporations had adopted poison pills, and acquisitions of public corporations, which had been running at over 400 per annum in the late 1980s, had fallen to half that figure (Useem, 1996: 27–28). However, the stakeholder statutes did little to deflect the wider impact of shareholder pressure on corporate management, which today increasingly takes the form of pressure from activist hedge funds and private-equity led restructurings, and which has been reflected in continuing high levels of lay-offs and restructurings during the 2000s (Uchitelle, 2006).

The City Code, like the Williams Act, dates from the late 1960s, but unlike the US measure, it did not (until recently) have statutory backing. The Takeover Panel (originally the Panel on Mergers and Takeovers), a self-regulatory body set up by the financial and legal professions and financial sector trade associations based in the City of London, initially had no direct legal powers of enforcement. Its provisions were strictly observed, however, since UK-based financial and legal professionals who were found to have breached the Panel's rulings could be barred from practising. As a result of the adoption by the European Union of the Thirteenth Company Law Directive (2003), the Panel has recently acquired a statutory underpinning, but the substance of the Code remains essentially the same as it was previously, and it continues to be based on the Panel's deliberations and rulings.

The City Code reflects the strong influence of institutional shareholder interests within the UK financial sector, and their capacity for lobbying to maintain a regulatory regime, which operates in their favour (Deakin & Slinger, 1997; Deakin, Hobbs, Nash & Slinger, 2003). Its fundamental principle is the rule of equal treatment for shareholders. This is most clearly manifested in the Code's 'mandatory bid' rule, which requires the bidder, once it has acquired 30% or more of the voting rights of the company, to make a 'mandatory offer' granting all shareholders the chance to sell for the highest price it has paid for shares of the relevant kind within the offer period and the preceding 12-month period. Partial bids, involving an offer aimed at achieving control through purchasing less than the total share capital of the company, require the Panel's consent, which is only given in exceptional circumstances. During the bid, information given out by either the bidder or target directors must be made 'equally available to all offeree company shareholders as nearly as possible at the same time and in the same manner'.

The Code also imposes on target directors a series of specific obligations that go beyond their normal company law duty to promote the interests of the company, to encompass specific obligations to shareholders. The target directors must obtain competent, independent financial advice on the merits of the offer, which they must then circulate to the shareholders with their own recommendation. Any document issued by the board of either the bidder or the target must be accompanied by a statement that the directors accept responsibility for the information contained in it. While the point is not completely clear, the likely effect of this is to create a legal duty of care, owed by the directors to the individual *shareholders* to whom the information is issued (and not to the *company* as is the case with their general fiduciary duties).

All this places the directors of the target in the position of being required to give disinterested advice to the shareholders on the merits of the offer, and makes it more difficult for them to resist a bid simply on the grounds that it would lead to the break-up of the company. In a case where the board considers that a hostile bid would be contrary to a long-term strategy of building up the company's business in a particular way, it can express this opinion, but it must be cautious in doing so, since it still has a duty to provide an objective financial assessment of the bid to the shareholders. In the case of the takeover of Manchester United FC by the US businessman Malcolm Glazer in 2005, the board took the view that the offer, because it would impose a high debt burden on the company, was not in the company's best interests. However, the board was also aware that the offer could well be regarded as a fair one, since it was by no means clear that the shareholders would not be better off by accepting it. The board issued this statement:

> The Board believes that the nature and return requirements of [the proposed] capital structure will put pressure on the business of Manchester United. … The proposed offer is at a level which, if made, the Board is likely to regard as fair. … If

> the current proposal were to develop into an offer … the Board considers that it is unlikely to be able to recommend the offer as being in the best interests of Manchester United, notwithstanding the fairness of the price.

Following this statement, a majority of the shareholders accepted the bid.

The Takeover Code contains extensive provisions controlling the use of defences such as poison pills. Once an offer is made, or even if the target board has reason to believe that it is about to be made, the target board cannot, among other things, issue new shares; issue or grant options in respect of any unissued shares; create securities carrying rights of conversion into shares; sell, dispose or acquire assets of a material amount, or contract to do so. The 'proper purposes' doctrine of company law prevents the board issuing shares for the purpose of forestalling a hostile takeover, even well in advance of any bid being made. Other advance anti-takeover defences, such as the issue of non-voting stock or the issuing of new stock to friendly insiders, have been discouraged by a combination of listing rules and institutional shareholder pressure. Protection of pre-emption rights, or the rights of existing shareholders to be granted preference when new stock is issued, is recognised by legislation as well as by guidelines issued by stock exchange and financial industry bodies. The issue of non-voting stock is permissible under general company law, but is vigorously opposed in practice by institutional shareholders.

Overall, the Takeover Code can be seen to provide strong protection for the interests of the target shareholders (see Johnston, 1980). An important side-effect of this protection is to encourage hostile takeover bids by placing limits on the defensive options available to the target management. An incumbent management is not required to be completely passive, and is permitted to put a case in its own defence, but opportunities for defence only arise in the context of an overriding responsibility to see that the shareholders' interests are safeguarded. The effect is not far removed from that of an 'auction rule' that requires the incumbent management to extract the highest possible price for the target shareholders, if necessary by making it possible for rival offers to be made. The entry of second bidders is facilitated by the bid timetable imposed by the Code and by the effective ban on two-tier and partial bids which might otherwise be used to strong-arm the target shareholders into accepting the terms of the first bid.

The rules on bid timetables might be thought to deter bids, by increasing the risk that either the target shareholders or any second bidder will free ride on the efforts of the initial bidder. However, the possibility of free riding by the shareholders is alleviated by the right of the bidder to 'squeeze out' the last 10% of shares. Other factors which serve to reduce the risk of an initial bid failing due to free-rider effects are the concentration of voting shares in most UK publicly quoted companies in the hands of a relatively small number of institutional shareholders (so reducing the number of shareholders who need to be persuaded to sell) and the right of an initial bidder to raise its offer price during the bid period (thereby enabling it to overbid a second bidder). While there may, then, be a certain screening-out of partial bids which, given their oppressive nature, are arguably not efficiency-enhancing in any event (see Yarrow, 1985), the effect of the Code is to reduce the autonomy enjoyed by the management of the target company in relation to its shareholders and thereby to limit the defensive options it has available to it.

As a result of changes made to the Code following the implementation of the Thirteenth Directive, the bidder must provide detailed information on its strategic intentions with regard to the target, possible job losses and changes to terms and conditions of employment, and the target must give its views, in the defence document, on the implications of the bid for employment. In addition, employee representatives of the target have the right to have their views of the effects of the bid on employment included in relevant defence document issued by the target.

However, statements made by the bidder concerning its future intentions rarely if ever give rise to legally binding undertakings. During its bid for Cadbury during 2010, Kraft stated its wish to keep open one of Cadbury's British factories that had been scheduled for closure. Shortly after the bid went through, Kraft announced that the factory would close after all. The case gave rise to a series of Parliamentary inquiries and a government consultation on possible changes to the law addressing the concerns of unions and employees over the negative employment effects of takeover bids, but so far no specific legislative initiative has emerged.

The Japanese approach to takeover bids offers an instructive comparison. Most large Japanese companies stress their role as social institutions or 'community firms' which provide stable employment to a core of long-term employees, in return for a high level of commitment and identification with the goals of the firm. This tension between the legal form of the enterprise and its changing ownership structure, on the one hand, and its aspect as a social institution, on the other, has recently been thrown into sharp relief by a series of hostile takeover bids.

The most controversial of these hostile takeover bids was that involving the planned takeover of Nippon Broadcasting System (NBS) by the Internet service provider Livedoor, which was launched in February 2005 (see Whittaker & Hayakawa, 2007). NBS had a cross-shareholding agreement with Fuji Television Ltd, which in turn dominated a corporate group, the Fuji-Sankei media conglomerate. Livedoor's intentions were widely interpreted as being based on 'greenmail'. When NBS attempted to issue new stock in order to dilute Livedoor's holdings and frustrate its bid, the courts declared the move unlawful. In granting Livedoor an injunction, the Tokyo District Court ruled as follows:

> It is inappropriate for the board of directors of a publicly listed company, during a contest for control of the company, to take such measures as the issue of new shares with the primary purpose of reducing the stake held by a particular party involved in the dispute, and hence maintain their own control. In principle the board, which is merely the executive organ of the company, should not decide who controls the company, and the issuing of new shares, etc., should only be recognised in special circumstances in which they preserve the interests of the company, or the shareholders overall.

When this judgement was appealed, eventually, to the High Court, it was upheld, with the court ruling that:

> The issue of new shares, etc., by the directors – who are appointed by the shareholders – for the primary purpose of changing the composition of those who appoint them clearly contravenes the intent of the Commercial Code and in principle should not be allowed. The issue of new shares for the entrenchment of management control cannot be countenanced because the authority of the directors derives from trust placed in them by the owners of the company, the shareholders. The only circumstances in which a new rights issue aimed primarily at protecting management control would not be unfair is when, under special circumstances, it aims to protect the interests of shareholders overall.

However, the High Court also ruled that defensive measures would be potentially legitimate in four situations: greenmail, asset stripping, a leveraged buy-out and share manipulation. This was an approach based in part on the jurisprudence of the Delaware courts (Milhaupt, 2006). Unable to make a new rights issue, NBS instead lent shares, minus voting rights, to two friendly parties, and Livedoor subsequently agreed to drop its bid. It sold its shares in NBS to Fuji Television, with Fuji Television, in turn, taking around 12% of the shares in Livedoor.

Around the same time, Japan's Ministry of Economy Trade and Industry (METI) and the Ministry of Justice issued takeover guidelines that drew in part on the report of METI's Corporate Value Committee (CVC). The report of the CVC referred to the concept of 'corporate value' in the following terms:

> The price of a company is its corporate value, and corporate value is based on the company's ability

> to generate profits. The ability to generate profits is based not only on managers' abilities, but is influenced by the quality of human resources of the employees, their commitment to the company, good relations with suppliers and creditors, trust of customers, relationships with the local community, etc. Shareholders select managers for their ability to generate high corporate value, and managers respond to their expectations by raising corporate value through creating good relations with various stakeholders. What is at issue in the case of a hostile takeover is which of the parties – the bidder or the incumbent management – can, through relations with stakeholders, generate higher corporate value.

The guidelines recommended giving increased power to companies to put anti-takeover defences in place to deal with what could be regarded as opportunistic or predatory bids. In 2006, a new law, the Financial Instruments and Exchange Law, amending basic securities legislation, came into effect. This introduced a version of the UK Code's mandatory bid rule: a party purchasing 10% of a company's stock over a three-month period would be required to make a public tender offer or be limited to holding no more than one-third of the company's issued share capital. In 2006, changes to company law came into effect that formally allowed companies to put in place anti-takeover defences. These included the powers to issue special class shares with limited voting rights, or which could be compulsorily repurchased by the company (thereby depriving a potential bidder of its stake); to make rights issues which excluded a bidder; and to issue golden shares which conferred certain rights such as the power to appoint directors or restrain voting rights. Some of these defences required two-third majority support from existing shareholders (Whittaker & Hayakawa, 2007).

Further encouragement for poison pills was provided by court rulings in litigation during 2006 arising from a tender offer by the US-based hedge fund Steel Partners for control of a cash-rich, mid-sized food producer Bull-Dog Sauce. The target management defeated Steel's bid by issuing shares to friendly third parties and buying its stake out at a premium to the market. The courts ruled that the target company had been entitled to treat Steel as an 'abusive acquirer' (Buchanan & Deakin, 2009).

In response to these developments, a large number of Japanese companies moved to put poison pills in place. By February 2007, 197 listed companies had announced anti-takeover strategies of various kinds. Some large companies, such as Toyota, strengthened intra-group cross-shareholdings in an attempt to deflect Livedoor-type bids, and others, such as three main steel producers, announced anti-takeover defence pacts. Whereas US-style poison pills can be seen as an effective deterrent only to those bids which do not ensure an adequate return for shareholders, the poison pills adopted by Japanese firms can be understood as intended to defeat bids which are seen as 'opportunistic' in the sense of undermining companies' long-term growth strategies (Buchanan & Deakin, 2009).

The case of takeover regulation highlights a number of aspects of the relationship between corporate law and corporate governance regulation and practice. As we have seen, the core of company law – the definition of the duty of directors individually and the board collectively to act in such as way as to promote the success of the company (as English law puts it) – provides management with some autonomy from shareholder pressure, even in the context of a hostile bid. US law and Japanese law allow considerable leeway for the use of 'poison pills' whose functions may include the protection of shareholder value in the event of an auction for the company, but can also be used to defend long-term managerial strategy from immediate financial pressure, and to protect the interests of non-shareholder constituencies. Of the takeover regimes outlined above, the UK's comes closest to a pure expression of the shareholder primacy norm. This is the result not so much of the rules of company law, however, but of the strong emphasis on minority shareholder protection within securities law, the substance of which, in this area, derives from the Takeover Code, a direct expression of lobbying by financial interests in the City of London.

Regulatory competition

The existence of competition between company law regimes is a consequence of the separation of the economic entity of the firm from the legal concept of the corporation. Firms can use the corporate form to shift the legal base of the enterprise, separating its residence or domicile for legal purposes from its main site or sites of operations. How far this can be done nevertheless differs according to the regulatory context that is being considered. In the case of employment law, it is not generally possible to avoid the application of the law where the work is carried out, although some breaches of this principle are becoming apparent through the application of EU rules on transnational corporate mobility. Tax law regimes are also becoming increasingly permissive. In the core area of corporate law, the approach of common law systems has generally been to allow companies a free choice of jurisdiction, whereas most civil law systems have observed the 'real seat' principle according to which the applicable law of the corporation is the site of its headquarters or main operations. In the USA, which has followed an incorporation-based approach to the determination of the applicable law since the early 20th century, regulatory competition between the states has played a decisive role in shaping the content of corporate law. In the European Union, regulatory competition is a growing possibility as a result of the operation of EU-level norms aimed at instituting an internal market in goods, services and capital.

So-called 'charter competition' began in the USA in the final quarter of the 19th century when New York-based corporations began to reincorporate in New Jersey to take advantage of a looser regulatory regime, designed by members of the New York corporate bar. In the 1890s and 1900s Delaware displaced New Jersey when the latter, under the influence of the Progressive political movement, introduced a number of regulatory constraints on large corporations, including controls over the holding of shares in one company by another. The Delaware corporate regime had been initially designed to facilitate the operations of the Du Pont Corporation, which, at that stage, was the only sizeable company registered in the state. The Delaware law was drafted in the interests of the Du Pont family and suited other large, family-dominated firms at this time (Charny, 1994). Since it obtained its initial advantage, a number of factors have served to consolidate Delaware's position. Specialisation means that Delaware now enjoys an advantage over other states in terms of the large body of case law which it has built up, the expertise of its courts and the speed with which they can deal with complex corporate litigation, and a concentration of professional legal and financial expertise with links to the state (Roe, 1993, 2005).

Whether or not Delaware represents the last word in the efficiency of legal rules is another matter. There are broadly two views. Those who claim to identify a race to the bottom argue that since, under Delaware law, it is managers (not shareholders) who typically decide issues of incorporation, the legislature and courts have a tendency to decide in favour of management and to dilute norms of shareholder protection (Cary, 1974). Delaware is less shareholder-friendly than, for example, English law is, in limiting the ability of shareholders to challenge the board and in allowing director entrenchment. Delaware's courts are also generally thought to have adopted a broadly pro-management stance on issues of takeover law in the 1980s and 1990s, allowing boards, as we have seen, considerable leeway to put in place anti-takeover defences and poison pills (Bebchuk & Ferrell, 1999). At best, the courts 'zig-zagged' between management and shareholder positions, in an attempt to avoid alienating either side (Roe, 1993).

The apparent susceptibility of the courts and legislature to interest group pressure during this period suggests that a state-level governance mechanism may be no more immune in principle from deleterious public-choice effects than one based at federal level (Roe, 2005). On the other hand, other analyses claim to have identified in Delaware law a largely successful resolution of the agency-cost problem inherent in manager–shareholder relations in large, listed corporations (Winter, 1977; Romano, 1985, 1993; Easterbrook & Fischel, 1991: Ch. 10). These studies pose the question of why, if Delaware was inefficient, it has not lost legal business to rival states offering, through superior legal protections for shareholders, a lower cost of capital.

This debate looks set to continue without a clear resolution, largely because of the inherent difficulty in providing a definitive test for the rival claims concerning Delaware' inefficiency: there is no effective benchmark, Delaware having long ago seen off viable alternative models. US corporate law may be state law, but its most striking feature, when compared to that of the European Union, it its uniformity. The wide differences that can be found between EU member states, according to such fundamental matters as the nature and extent of protection granted to shareholders, the powers and duties of boards and the position of employees and creditors, have no equivalent in the USA. In US history, there are examples of state-level laws which departed from the now-dominant shareholder-value orientated system, by, for example, qualifying the limited liability of shareholders, and imposing limits on the use of corporate group structures for the concentration of capital (the issue over which first New York and then New Jersey lost their preeminence as the preferred state of incorporation for large companies). None of that diversity now exists; US company law has been characterised, for much of the last century, by a *race to converge*. Delaware's primacy is that of a monopolist, able to preserve its historical advantage by exploiting the positive network externalities of a specialist bar and judiciary and a legislature more finely attuned than any other to corporate opinion.

Within the European Union, the transnational framework of rules on the movement of goods, services and capital within the internal market form the basis for a liberal 'economic constitution', guaranteeing free movement for economic resources. In the *Centros* case in 1996, the rules on freedom of establishment were used to challenge restraints on the use of the corporate form to seek out low-cost jurisdictions within the European Union. Two Danish citizens incorporated a private company of which they were the sole shareholders, named Centros Ltd, in the UK. One of the two shareholders then applied to have a 'branch' of the company registered in Denmark for the purposes of carrying on business there. Centros Ltd had never traded in the UK. The Danish Registrar of Companies refused to register the branch, on the grounds that what the company was trying to do was not to register a branch or overseas presence, but its principal business establishment. The Registrar took the view that Centros had been incorporated in the UK in order to avoid Danish minimum capital requirements, which are designed to protect third-party creditors and minimise the risk of fraud.

The Court of Justice ruled that the refusal to accede to the registration request was contrary to the principle of freedom of establishment. It held, firstly, that there was a potential infringement of freedom of establishment in any case where 'it is the practice of a Member State, in certain circumstances, to refuse to register a branch of a company having its registered office in another Member State', because:

> The provisions of the Treaty on freedom of establishment are intended specifically to enable companies formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community to pursue activities in the Member States through an agency, branch of

> subsidiary. … That being so, the fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, by itself, constitute an abuse of the right of establishment. The right to form a company in accordance with the law of a Member State and to set up branches in other Member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty.

The Court then went on to consider whether the Danish government could show that its refusal to register Centros Ltd was justifiable in the circumstances. This involved a consideration of whether there was some countervailing policy objective behind the Danish practice and whether, in the particular circumstances of this case, the proportionality test was to be satisfied. The Danish government argued that the Registrar's action was intended to maintain Danish law's minimum capital requirement for the formation of private companies. The purpose of this law was

> first, to reinforce the financial soundness of those companies in order to protect public creditors against the risk of seeing the public debts owing to them become irrecoverable since, unlike private creditors, they cannot secure these debts by means of guarantees and, second, and more generally, to protect all creditors, public and private, by anticipating the risk of fraudulent bankruptcy due to the insolvency of companies whose initial capitalisation was inadequate.

The Court ruled that the justification offered was inadequate since 'the practice in question is not such as to attain the objective of protecting creditors which it purports to pursue since, if the company concerned had conducted business in the United Kingdom, its branch would have been registered in Denmark, even though Danish creditors might have been equally exposed to risk'. In other words, the Registrar's decision failed the proportionality test since it was inconsistent – the vital factor in his refusal was, it seems, the failure of the company to trade in the UK, but this was immaterial to the protection of creditors since they would have been no better off if the company had previously traded and, as a result, had been able to get its branch registered in Denmark.

Following *Centros* and some later decisions of the Court, there was a substantial number of incorporations of German, Dutch and Danish SMEs (small and medium enterprises) in the UK, running into tens of thousands of firms. There is some evidence that firms incorporated in the UK from other EU member states were more likely on average to breach requirements of UK law for the filing of accounts and to expose creditors to loss in the event of insolvency. A further effect of *Centros* was the watering down of creditor protection laws in several member states. The *Centros* case has not yet been successfully invoked to avoid the application of employees' co-determination rights and in later case law the Court has taken a less confrontational stance towards the real seat principle. The scope for German firms to avoid co-determination and other regulatory requirements has also increased as a result of the implementation of the adoption of the EU's European Company (Societas Europaea) Regulation and Directive (Kirshner, 2009; Njoya, 2011). While the European Union is still some way from having a system of regime competition in company law to match that of the USA, transnational legal regulation is moving closer to a system in which the governing legal regime of the enterprise is separated from its managerial and operational base (Deakin, 2001, 2008).

CONCLUSIONS

Through an analysis of the juridical nature of the firm, we have seen that the law underpins the organisational structure of the firm in a number of complementary ways. Through the device of legal personality, it confers on the organisation an identity which enables it to function, for certain purposes, as a legal actor in an economy where legal enforcement of contract and property rights underpins the process of exchange and extends the scope of the market. Asset partitioning facilitates bonding and the making of credible commitments. Company law shields the assets of the firm from depletion in the form of legal claims which third parties and its core constituents, including the shareholders, would otherwise be able to bring against it. Company law also creates the possibility of management as a specialised function within the firm by limiting the rights of shareholders to intervene directly in execution. The managerial power of coordination is supported by employment law. In return, employment law recognises certain inherent duties of the firm to its employees, and enterprise liability extends the idea of the firm's responsibilities to third parties, in recognition of the likelihood that the firm, when exercising its organisational capacity, is likely to bring about negative (as well as positive) impacts on actors external to it.

This legal model is far removed from the idea of the shareholder-value-orientated firm which corporate governance theory and practice tends to favour. The firm's overriding objective is not to return value to shareholders as such or, if it is (as in the common law notion of enlightened shareholder value), this can only be done by first taking full account of the interests of other constituencies and by ensuring the firm's viability as a going concern by reinvesting part of the surplus from production, as opposed to disbursing all of it to shareholders in the form of dividends or other payments. The idea of the firm's wider responsibilities to third parties – corporate social responsibility – is also recognised, through the law of enterprise liability.

It follows that the legal model is *in tension with* the predominant corporate governance model. That model has been superimposed on the basic legal structure of the firm as a consequence of a number of developments. Regulators and policymakers have sought to enhance shareholder control with a view to ensuring more effective and transparent governance of large corporations in a context where, through privatisation and deregulation, the state has withdrawn from direct ownership of enterprise and/or from intensive regulation of industry. Shareholders in some jurisdictions have successfully lobbied for greater influence, by engaging directly with listed companies to secure greater influence, and by pressing for regulatory measures, mostly in the form of extra-legal corporate governance codes, which favour shareholder voice. Regulatory pressures have also favoured greater accountability of listed companies to shareholder pressure through the medium of the capital market. Securities law and the terms of stock exchange listing rules, by favouring the principle of shareholder sovereignty in the context of takeover bids and more generally by enhancing disclosure requirements, have greatly increased the sensitivity of equity prices to shareholder sentiment.

The result of these several developments has been to put the business enterprise form under historically unprecedented pressure. The pressure results from the tensions between an underlying legal model, which continues to see the firm as an organisational entity, and the shareholder-orientated corporate governance model. Some of these pressures were manifest in the failures of financial sector firms during the financial crisis. In particular, independent directors, supposedly acting as agents of shareholders, increased the pressures on managers to maintain shareholder value through takeover bids and high-return trading strategies, but were unable to control or monitor the resulting risks. Whether the core of corporate law will continue to move in a more pro-shareholder direction, or move back in the direction of the managerial autonomy model of the middle decades of 20th century, remains to be seen. Either way, corporate governance research needs a more realistic and relevant model of the firm, and of the role of the law in shaping it.

NOTES

1 This part draws on Deakin (2011). I am grateful to the publishers of the New York Law School Law Review for permission to reproduce the relevant material.

2 This part draws on Deakin and Singh, 2009. I am grateful to Ajit Singh, Per-Olof Bjuggren, Dennis Mueller and Edward Elgar Publishing for permission to reproduce the relevant material.

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6

The Ascent of Shareholder Monitoring and Strategic Partnering: The Dual Functions of the Corporate Board

Michael Useem

Corporate governance makes a difference in company financial performance, as a substantial body of research has confirmed (see, for example, Claessens & Fan, 2002; Gompers, Ishi & Metrick, 2003; Kang & Zardkoohi, 2005; Brown & Caylor, 2006; Gillan, 2006; Finegold, Benson & Hecht, 2007; Cronqvist & Fahlenbrach, 2009; Bebchuk & Weisbach, 2010). But does it do so because of director monitoring of management – or because of director collaboration with management?

The anticipated answer depends on the role that corporate non-executive directors are expected to play. If directors are presumed to serve mainly as monitors of management on behalf of owners, we would expect directors to display little or no direct engagement in their company's strategic practices and to have little or no impact on them. By strategic practices we mean an array of company activities that are normally the prerogative of the top executive team, such as setting strategy, restructuring divisions, guiding research, and developing talent. In this monitoring view of the firm, directors are prescribed to oversee management execution of the firm's strategic practices but proscribed from straying into them. Directors make a difference in company performance primarily because they serve as vigilant monitors of the strategies on behalf of shareholders.

On the other hand, if directors also serve as strategic partners with management, an engagement of directors in strategic decisions and an impact of directors on the decisions should be anticipated. Rather than straying from their mandate as management monitors on behalf of shareholders, directors in this conception of the firm would also be expected to fulfill their role as strategic partners.

Directors would thus also make a difference in company performance because they serve as strategic collaborators with managers – and thus help produce better company practices than would otherwise be the case.

Evidence from studies of governance of US companies in recent years points to the more active expression of both functions in the boardroom. Directors are more engaged as both shareholder monitors of management and strategic partners with management. Evidence also suggests that the strengthening of these two board function derives from recent developments in the ownership and market environments of large publicly-traded firms. Directors are more engaged as shareholder monitors because of the rise of institutional investing, and they are more engaged as strategic partners because of the rise of market complexity and uncertainty. These developments are the central focus of this chapter.

The development that drives the intensification of shareholder monitoring is the rise of institutional investing and its dominance of the American equity market. The concentration of assets among a relatively small number of professional investors has enhanced the ability of large equity holders to exercise influence on board practices, including executive compensation, share repurchases, anti-takeover devices, board composition, and voting rights. The thrust of the influence has been to increase the vigilance of directors in their role as monitors of management, leading to greater board discipline of management around enhancing total shareholder return.

The development that drives the intensification of strategic partnering is the increase in complexity and uncertainty in executive decision-making. The opening of global markets, amplification of competition within markets, and shrinkage of product cycle times have added to a leadership premium on effective executive decisions. When well appointed, well informed, and well organized, top executives can be expected to have greater impact on company operations than in an earlier era characterized by less complexity or uncertainty (as suggested by the research of Waldman, Ramirez, House & Puranan, 2001). As a result, directors are being called by executives to render guidance as trusted advisors on key decisions and even to become directly involved in strategic practices. When directors do, their actions point to their role as a strategic partner with management, not just a monitor of management.

With insistent demands coming down from institutional investors, on the one hand, and up from company executives, on the other hand, directors have thus come to more actively play two separate functions in the company boardroom. While features and implications of the shareholder-monitoring model have been repeatedly confirmed, and agency theory has proven a valuable framework for understanding director decisions, such as dismissing a chief executive, features and implications of the strategic-partnership model have received less conceptual attention and research confirmation. Though relatively under-studied to date, the strategic-partnership model of corporate governance, we believe, also has considerable power to explain the kinds of directors recruited to the board, their decisions on the board, and their engagement in strategic decisions. Both boardroom functions of directors have become important and independent drivers of director actions in the boardroom.

The joint presence of the two director functions, however, has generated a new source of tension in the boardroom. As directors become more directly engaged in major decisions of the company, their capacity to monitor management may be compromised since they have acquired a more direct stake in company decisions. Similarly, as boards press for greater shareholder value in their other role, the directors' capacity to provide long-term guidance for the company may be compromised since they represent investors whose time horizons may be significantly shorter than the strategic thinking by top management would otherwise dictate.

THE ASCENT OF SHAREHOLDER MONITORING

The triumph of institutional investing in the United States is well known. In 1950, a small fraction of the shares of large publicly-traded companies were in the hands of professional investors, but during the decades ahead, institutional investors gradually acquired a far greater fraction and, in doing so, also attained a substantial degree of influence on these companies. Their growing power reversed in part the discovery by Adolph Berle and Gardiner Mean (1932) that control of large publicly-traded companies had slipped during the first quarter of the 20th century from the hands of founding owners into the grip of qualified managers. The rising influence of institutional investors stemmed from a concentration of shareholdings among a relatively small number of large investors – and from their subsequent mastery of a host of methods for pressing companies to deliver what investors sought even when company executives resisted complying out of personal self-interest (Useem, 1996; Hawley & Williams, 2000; Davis & Useem, 2001; Davis, 2009).

The rise of institutional investing

The rise of institutional investing can be seen in the fraction of all US corporate equity held by institutional holders over the past half century: The percentage rose 10-fold from 6.1 percent in 1950 to 61.2 percent in 2005 (Figure 6.1). The growing concentration of shares in the hands of professional money managers is even greater among large publicly-traded firms. Drawing upon the largest 1,000 US companies by market capitalization as of May 1 each year, institutional investors held 46.6 percent of their shares in 1987 but 73.0 percent in 2009 (Figure 6.2).

Similar trends are evident in other national equity markets (Useem, 1998). The level of the institutional holdings varies considerably from country to country, and the composition of the non-individual holders also varies substantially. Retirement funds, investment companies, insurance companies, and bank trust departments dominate in the Unites States (Tonello & Rabimov, 2009), while cross-company and bank shareholdings remain important in Japan, Korea, and elsewhere. Yet whatever the national setting, individual investors – quaintly termed ‘orphans and

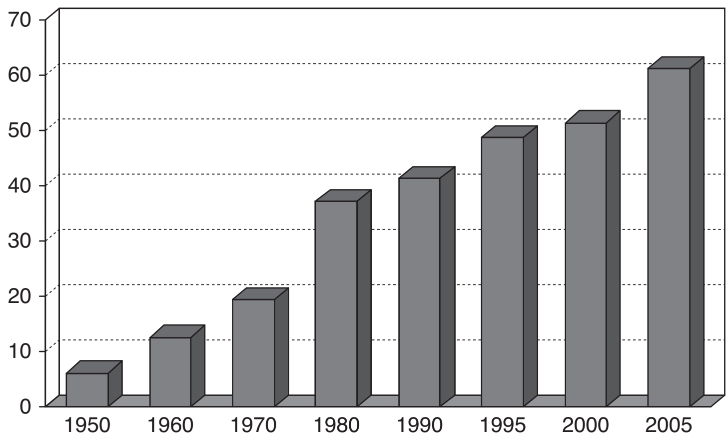

Figure 6.1 Percentage of shares of US companies held by institutional investors, 1950–2005

Source: Conference Board, 2007 Institutional Investment Report.

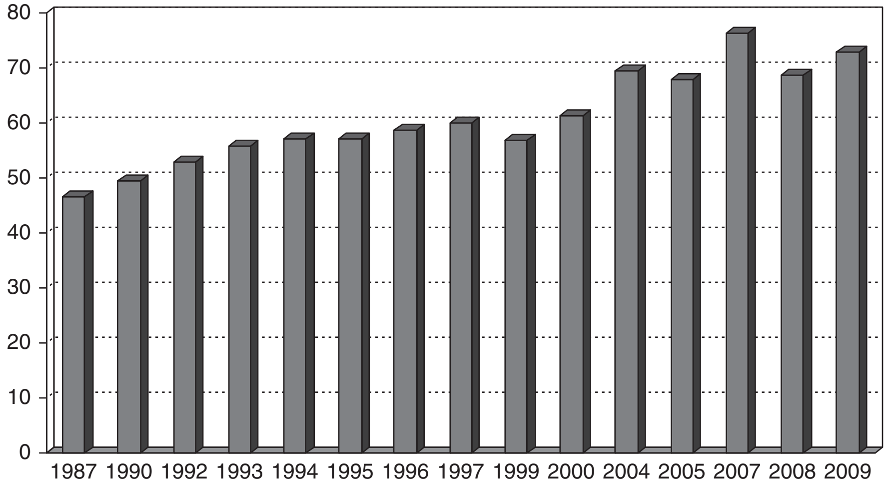

Figure 6.2 Percentage of shares of largest 1,000 US companies held by institutional investors 1987–2009

Source: Conference Board, 2010 Institutional Investment Report.

widows' on Wall Street in an earlier era – are a diminishing breed. In Japan, for instance, individual investors accounted in 1950 for 61 percent of all shares, but by 2009 just 20 percent; in the United Kingdom, the drop-off in individual holdings was even sharper, from 54 percent in 1963 to 13 percent in 2006 (Figures 6.3 and 6.4). Comparable trends are evident in most other European countries (Federation of European Securities Exchanges, 2008). Whatever the national setting, publicly-traded shares moved significantly out of the hands of individual holders over the past decade and into the clutches of professional investors.

Institutional investing also became far more cross-border during the past several decades. In 1970, foreign investors owned just 5 percent of Japanese shares, but by 2009 they held 26 percent (Figure 6.3). In the United Kingdom, foreign holdings rose from 7 percent of the share market in 1963 to 42 percent in 2008 (Figure 6.4). In Korea, foreign ownership climbed from 5 percent in 1992 to 32 percent in 2009 (Korea Financial Investment Association, 2009). Symptomatic of the product of the rising institutional and international holdings, by 2008 local institutional investor traded 24 percent of Hong Kong's exchange-listed stocks, and international investors traded another 38 percent (Hong Kong Stock Exchange, 2010).

Rising influence of institutional investors on corporate governance

Not surprisingly, the long-term growth of institutional holdings gave professional investors greater influence on companies – because of both the size of their holdings and their activism – and that generated a host of changes in company governance that has strengthened the directors' first function of shareholder monitoring. It served to reverse what Jay Lorsch had diagnosed as a dysfunctional tendency for directors to serve as 'pawns' of management rather than 'potentates' over management (Lorsch, 1989). It also served to create a new managerial mind-set of what Jerry Davis has termed 'managed by the markets' in which company directors and executives are pressed to focus on delivering steadily increasing shareholder value

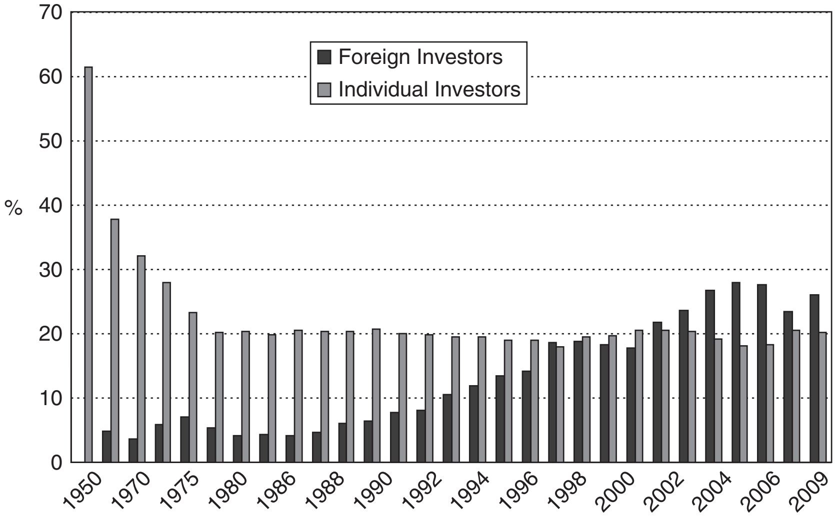

Figure 6.3 Percentage of value of Japanese shares held by individual and foreign investors, 1950–2009

Source: Tokyo Stock Exchange 2010.

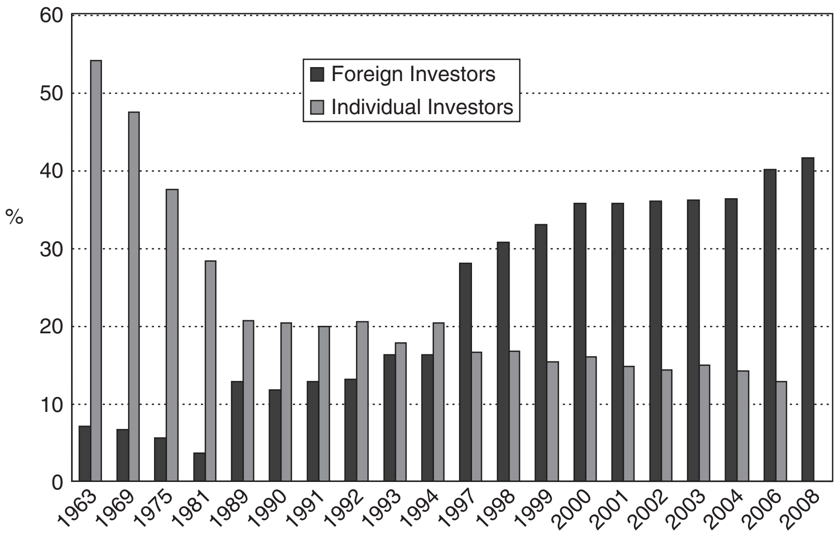

Figure 6.4 Percentage of United Kingdom shares held by individual and foreign investors, 1963–2008

Source: UK Office for National Statistics, 2010; Federation of European Securities Exchanges, 2008.

and to discipline most or all their operating decisions around that end (Davis, 2009).

We witness the consequences of this rise in monitoring of management by directors in many ways. One illustrative study of 1,914 American firms from 1992 to 1997 reported that the higher the proportion of institutional ownership of a company, the more executive compensation is tied to company performance and the lower the level of compensation, suggesting that stronger institutional pressures press directors to more effectively serve as shareholder monitors of management (Hartzell & Starks, 2003). A different but consistent illustration comes from study of the impact of institutional investors when they place their holdings in private rather than public equity, as some money managers have come to do with a portion of their assets in recent years: recipient companies tend to improve their governance practices in ways more favorable to owners in the wake of a private-equity infusion by institutional holders (Nielsen, 2008).

A third, confirming illustration can be seen in the impact of institutional investor actions against specific companies. The California Public Employees' Retirement System (CalPERS), for example, openly targets companies with especially weak governance practices. With the sting of media criticism and fears of disinvestment, targeted firms are found to diminish the number of inside, non-independent directors compared with non-targeted firms, and in the aftermath of the public shaming, they are more likely to force out their CEO in the wake of poor performance (Wu, 2004). Similarly, in a study of an association of America's largest institutional investors, the Council of Institutional Investors, which also targets poor performers, investigators found that companies it publicly criticized with more independent directors were more likely to increase the performance incentives of the CEO, indicating that their role as monitor of management was indeed strengthened in the wake of intensified pressure by institutional investor (Ward, Brown & Graffin, 2009). Research on the rise of institutional investing in OECD (Organization for Economic Co-operation and Development) countries similarly found that it led non-financial companies to place greater stress on their financial objectives (Peralta & Garcia, 2010).

Some studies of the impact of institutional investors have yielded ambiguous conclusions or pointed toward no effect (e.g., Nelson, 2006; and see Gillan & Starks, 2007; Chung & Talaulicar, 2010), suggesting that the monitoring role by directors has not been enhanced. The thrust of available research nonetheless points toward a strengthening of that role on behalf of shareholders over the past several decades.

The rise of cross-border institutional investing has brought a similar strengthening of the directors' monitoring function across national boundaries. A study of 1,108 Japanese companies from 1991 to 2000, for instance, found that firms with greater foreign holdings and weaker ties to Japanese banks and *keiretsu* were more likely to downsize and divest, the kinds of actions that international institutional investors often support to enhance shareholder value – and steps that Japanese owners had tended to eschew (Ahmadjian & Robbins, 2005; see also Ahmadijian, 2005; Seki, 2005). Similarly, an assessment of actively managed US mutual funds found that they preferred to invest in emerging markets with strong accounting standards and shareholder rights, and in companies that had adopted accounting transparency, implying that company directors in emerging markets that are seeking international equity would be more inclined to adopt such standards (Aggarwal, Klapper & Wysocki, 2005).

The regulatory vector in recent decades in the United States and elsewhere has been to strengthen the directors' monitoring role as well. The passage of the Sarbanes–Oxley Act of 2002 and the introduction of stronger listing requirements by the New York Stock Exchange (NYSE) in 2003, for instance, sought to enhance director capacity to exercise vigilance on behalf of shareholders. The Sarbanes–Oxley legislation requires that the board of publicly-traded companies constitute an audit committee of the board composed entirely of independent non-executive directors, and NYSE requires the same for the compensation and governance committee. The intention of their strengthening of the board committees in this way has been to improve their fiduciary oversight, and the behavioral results confirm the expected outcome. The revised stock-exchange listing requirements, for instance, are found to significantly reduce executive compensation of listed companies – especially at firms that had been least subject to the pressures from institutional investors – implying that the new regulations served to improve the hands of directors in monitoring management (Chhaochharia & Grinstein, 2009). The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 pointed in the same direction, giving shareholders greater say on executive compensation and requiring more independence for board compensation committees and their advisors (Weil, Gotshal & Manges, 2010).

Changed board practices create enhanced director monitoring of managers

With the strengthening of institutional investors and their ability to apply great pressure on directors to serve as their elected agents for monitoring management, we would expect a secular trend toward board practices that provide for stronger director oversight on behalf of the shareholders. And during the decade of the 2000s, directors are indeed observed to have embraced practices to significantly enhance their ability to monitor management.

Focusing on the Standard and Poor's 500 largest companies, as ranked by market value (the S&P 500), we find with annual data compiled by executive-search firm Spencer Stuart that that the fraction of company boards with only a single non-executive director, the chief executive, rose from 23 percent in 1998 to 50 percent in 2009 (Table 6.1); separation of the CEO from board chair increased from 16 to 37 percent; the proportion of boards with a 'lead' or 'presiding' director climbed from 36 percent in 2003 (data were not collected in prior years since virtually no companies had instituted such a position) to 95 percent in 2009. Similarly, 67 percent of the companies included a governance or nomination committee in 1998, but 100 percent did so by 2009; and the fraction of companies compensating directors with both retainer and equity rose from 38 to 79 percent.

Similar trend lines are reported for Europe. In tracking the 2,500 largest publicly-traded companies worldwide from 2000 to 2009,

Table 6.1 Percentage of S&P 500 companies with shareholder monitoring device, 1998–2009

Monitoring Device	*1998*	*1999*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*
CEO is the only non-executive director	23	21	27	31	35	39	30	39	43	44	50
CEO is not chair of the board	16	20	26	25	23	26	29	33	35	39	37
Boards with lead or presiding director	n/a	n/a	n/a	n/a	36	85	94	96	94	95	95
Independent governance or nominations committee	67	69	70	75	91	98	100	99	100	100	100
One-year term length for directors	39	38	41	40	40	55	50	56	62	66	68
Directors receive equity in addition to retainer	38	46	42	42	47	50	60	64	72	74	79

Source: Spencer Stuart, various years.

strategy-consulting firm Booz found that the board's combination of incoming CEO with chair had dropped among European firms from more than half in 2000 to less than one in ten by 2009 (Favaro, Karlsson & Neilson 2010).

The rise of institutional investor influence should also lead to a decline in the prevalence of anti-takeover devices such as poison pills and classified boards that are generally deemed to help shield managers from shareholder pressure when owners and executives differ on decisions seen as favorable to management and unfavorable to shareholders (Gompers et al., 2003). During the 2000s, we see a substantial retreat among large publicly-traded companies from such devices.

Focusing again on S&P 500 companies, Table 6.2a confirms that between 1998 and 2009, the proportion of firms with a poison pill declined from 59 percent to 17 percent; the fraction with classified boards (directors served multi-year elected terms, making them less subject to shareholder pressures) declined from 61 to 33 percent. Other anti-takeover devices displayed, as shown in Table 6.2b, more modest but nonetheless substantial downward trends over the decade as well.

With the greater alignment of directors with shareholders as a result of these secular changes in the board's shareholder monitoring devices and anti-takeover devices, we would also expect to observe parallel trends within the company that point toward greater alignment of executive incentives with investor interests. If directors are exercising greater vigilance in the boardroom on behalf of investors, for example, this should appear in a trend of executive pay away from fixed salary and benefits and toward contingent compensation that varies with financial results that directly benefit shareholders. Contingent pay through stock options and their variants (e.g., stock appreciation rights and premium stock options) is one way that the boards can better align investor interests with executive compensation.

As seen in Figure 6.5, total pay for the top seven executives of 45 large US manufacturing firm has indeed shifted between 1982 and 2011 from primarily fixed to predominantly variable. In 1982, a manufacturing executive arriving at work just after the New Year could expect to receive at least 63 percent of his or her pay by the end of the calendar year, regardless of company performance for shareholders; by 2011, that fixed fraction had dropped to 22 percent, and long-term incentive-based compensation, largely tied to shareholder value through stock-based pay plans, had risen from 17 to 58 percent. Since directors have a direct hand in setting executive compensation through the board's compensation committee, the trend line points to greater board monitoring of managers on behalf of shareholders.

Table 6.2a Percentage of S&P 500 companies with anti-shareholder device, 1998–2009

Anti-shareholder device	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*
Poison pill	58.8	57.2	59.8	60.2	60.0	57.0	53.2	45.4	34.2	28.8	21.4	16.8
Classified board	60.6	60.6	60.0	58.8	61.2	57.2	53.3	47.4	41.5	36.1	34.2	32.5

Table 6.2b Percentage of S&P 500 companies with anti-shareholder device, 2002–2009

Anti-shareholder device	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*
Directors removed only for cause	52.2	51.8	48.8	45.0	42.5	39.6	39.6	38.8
Shareholders cannot call special meetings	59.1	59.0	59.6	58.1	57.7	56.9	55.1	52.9
Fair price provision	32.9	32.2	31.2	30.0	26.5	24.1	23.4	22.2
Supermajority vote for mergers	31.0	29.3	29.9	29.0	28.1	26.0	24.4	24.0
Supermajority vote to remove directors	32.9	32.8	32.4	31.0	30.0	28.7	28.5	28.1

Source: FactSet Research Systems Inc., 2009 and earlier years.

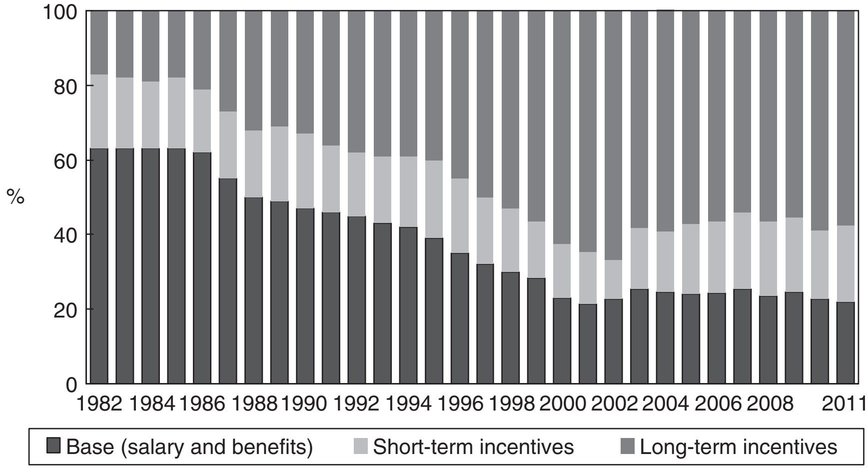

Figure 6.5 Compensation of top 7–8 managers at 45 US manufacturing firms, 1982–2011

Source: Hewitt Associates, 1982–2011.

Unintended consequences of the ascent of institutional investing

The immutable laws of unintended consequences, however, make a vivid appearance here just as everywhere else. With boards strengthened in their capacity to monitor on behalf of shareholders and executives more disciplined around producing total shareholder return, one untoward result has been for some executives to overly focus on short-term increments in their own stock-option-based compensation, to the neglect of longer-term company interests and catastrophic risks. By some accounts, this rise of ‘managed by the markets’ with its abiding focus on shareholder value contributed significantly to the financial crisis of 2008–09 (Lounsbury & Hirsch, 2010). Director vigilance on behalf of shareholders had the unintended effect of diminishing or even destroying investor assets. Companies such as AIG, Lehman Brothers, and Royal Bank of Scotland accepted excessive risk taking in the pursuit of shareholder value that regrettably resulted in the loss of much (if not all) of their shareholder value.

Regardless of the sometimes ironic outcomes of the rise of the board’s role as monitor of management on behalf of investors, the thrust and logic of the strengthening and internationalization of institutional holdings can explain important aspects of the behavior of boards and their directors. Agency theory, as originally formulated by Fama and Jensen (1983) among others, has served in director hands at the end of the 20th century as an increasingly effective antidote to the managerial revolution of the earlier part of the century, and the results are widely, consistently, and predictably evident in the strengthened directors’ role of monitoring management.

THE ASCENT OF STRATEGIC PARTNERING

At the same time and in parallel but separate development, directors have increasingly acquired a role of strategic partner with management. We believe that the underlying driver behind the ascent of strategic partnering has been the increasing complexity and uncertainty of company decisions. Annual metrics for these factors are not as readily available as for institutional holdings, and their impetus is thus more difficult to document, yet many data traces point in this direction, and informed observers posit the same (e.g., see Kleindorfer, 2008).

Consider, for instance, an interview survey conducted by IBM of 1,541 senior managers of organizations in 60 countries in late 2009 and early 2010. In prior surveys in 2004 and 2006, the top managers asserted that coping with change was their greatest challenge, but in 2009, 'complexity' emerged as the top concern, and executives attributed its emergence to the fact that their markets had become more 'volatile, uncertain and complex.' Nearly four out of five of the executives anticipated even greater complexity in the five years ahead. Yet only half asserted that they felt 'prepared for the expected complexity,' and four out of five observed that the most important quality of leadership for the next five years is executive 'creativity' for dealing with that complexity (IBM, 2010: 18–19).

One of the many drivers of heightened complexity is the proliferation of sales channels, product categories, and price points. Consider wireless carriers. Early entrants focused on just several demographically distinct markets, but later incumbent companies came to distinguish some 20 or more submarkets. The number of mobile plans rapidly expanded as well to include prepaid, postpaid, night, family, friends, data, and text plans. By the mid-2000s, wireless carriers sold through as many as a dozen separate channels, ranging from company-owned stores to affinity partners and websites, and the industry embraced as many as half-a-million distinctive price plans (Court, French & Knudsen, 2006a, 2006b).

Similar levels of complexity were reported in other sectors as well. One large consumer packaged goods company, for instance, managed some 20 million individual price points during the course of a year, and a maker of lighting equipment managed more than 450,000 stock-keeping units (Bright, Dieter & Kincheloe, 2006). In the confectionary market, the number of brands rose from 1,029 in 1999 to 1,445 just four years later (Webb, 2006: 22).

In an appraisal of five major markets – automotive, banking, telecommunications, package delivery, and pharmaceuticals – a McKinsey study found that diversity measures for the number of products, channels, segments, and prices in those markets had generally doubled between the 1990s and 2000s (Court, 2006). These changes, in turn, increased complexity in research and development, sourcing, manufacturing, distribution, marketing, and training. 'Recent advances in technology, information, communications, and distribution,' wrote the management consultants, 'have created an explosion of new customer segments, brand and service channels, media, marketing approaches, products, and brands,' and as a result, they concluded, 'marketing to consumers and businesses is becoming more complex and difficult' (Court et al., 2006a).

A related driver of complexity is information 'overload,' a condition in which the addition of still more information leads to more suboptimal company decisions rather than improving decision quality. Graphed as an inverted U-curve, as data initially become more available, decision accuracy improves, but beyond an inflection point of increasing information, still more data diminishes management capacities to process the information and thus their ability to reach optimal decisions (Edmunds & Morris, 2000; Eppler & Mengis, 2004).

A third source of complexity is the increasing movement of enterprise operations or sales across national boundaries. Company managers as a result are obliged to be more conversant in the challenges of facing markets diverse in regulatory regimes, consumer preferences, and cultural traditions. Consider the source of revenue for the 500 largest (by market capitalization) US- based companies tracked by Standard and Poor's. The fraction of the sales of the S&P 500 from sales abroad, as displayed in Table 6.3, increased from 32 percent in 2001 to 48 percent by 2008, though it declined with the

Table 6.3 Percentage of sales outside the United States by S&P 500 companies

	2001	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*
Foreign sales as % of total sales	32.3	41.8	43.8	43.3	43.6	45.8	47.9	46.6

Source: Standard and Poor's, various years.

financial crisis in 2009 to 47 percent. Or consider the flow of cross-border acquisitions into and out of major economies, such as India, as seen in Figure 6.6. Foreign direct investment coming into India in 1990 totaled $237 million but by 2008 had climbed to $41.5 billion; foreign direct investment going out of India rose over the same 18-year period from $6 million to $17.7 billion.

Though no single trend line makes the case, a host of developments taken together suggest that managers of large companies are confronting greater complexity in their markets. Though it is beyond the limits of this chapter to report trends that point toward greater uncertainty as well, we anticipate that trend data on this area will also confirm its intensification over the past several decades.

Assuming the greater complexity and uncertainty in company decisions, executives have as a countermeasure arguably sought greater guidance from directors for making company decisions. This is consistent with a study of decision-making on the introduction of new products in the computer software and hardware industries which found that firms whose executives could turn to trusted advisors inside the firm for guidance were likely to more rapidly deploy the new products than companies where executives were without inside counselors (Eisenhardt, 1990). By extension, company executives should find it more useful now than in an earlier era of lesser complexity and uncertainty to turn to a previously underused source of trusted individuals, the board of directors.

By way of example, consider a decision by the Japanese consumer products company Sony to downsize its board in 1998 from 35 directors to just nine directors. In making the announcement, Sony explained, 'we are working' to 'reorganize our group companies

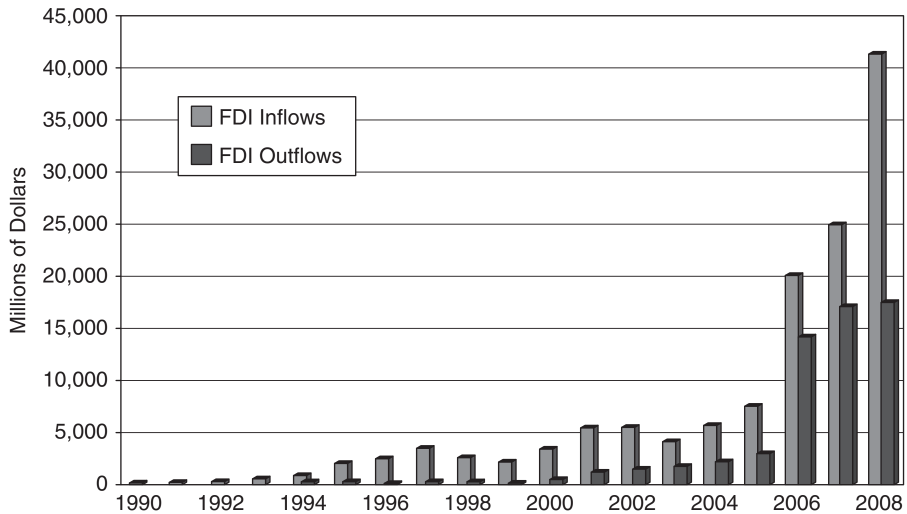

Figure 6.6 Indian foreign direct investment, 1990–2008

Source: Euromonitor, Global Market Information Database, August 2009.

and internal divisions for quicker decision-making and execution in a rapidly changing environment' (Sony Corporation, 1999). Many Japanese companies followed suit in the years that followed. By 2004, companies listed on the Tokyo Stock Exchange's 'First Section' (large companies, the bulk of the exchange) averaged just 10.5 directors on their boards (Seki, 2005).

Consistent with this framing, surveys of company executives regarding their boards point to an increasing emphasis on the role of directors as strategic partners. Executive search firm Spencer Stuart, for example, which annually surveyed corporate secretaries and general counsels of S&P 500 firms, began to report in the mid-2000s that company strategy had increasingly come to occupy boardroom concerns. From its 2006 survey, for instance, Spencer Stuart reported that company boards 'will be even more focused on regularly reviewing and tuning strategy over the long term,' and that companies are increasingly focusing on company strategy at most board meetings (Spencer Stuart, 2006: 9). Corporate secretaries and general counsels surveyed in 2008 and 2009 cited company strategy as a top concern among some two-thirds of the companies, while shareholder value was a primary focus at two-fifths, symptomatic of the separate importance of the dual roles that directors have now been pressed to play by investors and executives (Figure 6.7).

By the logic of seeing directors as strategic partners, not just shareholder monitors, several behavioral consequences are expected. First, directors and executives should view the boardroom as a place where they can mutually engage in reaching major decisions for the company. Second, when boards recruit new directors, their governance committee should place a premium on the candidates' ability to provide strategic guidance, not just investor oversight. And third, directors may become directly involved in business practices inside the firm such as leadership development or research and development.

The boardroom as a venue for strategic decisions

When directors enter the boardroom, the enhanced monitoring and partnering functions would each point to their greater engagement in company decisions, but applying distinct criteria. When directors select a new chief executive, for instance, they are likely to be mindful of both their monitoring

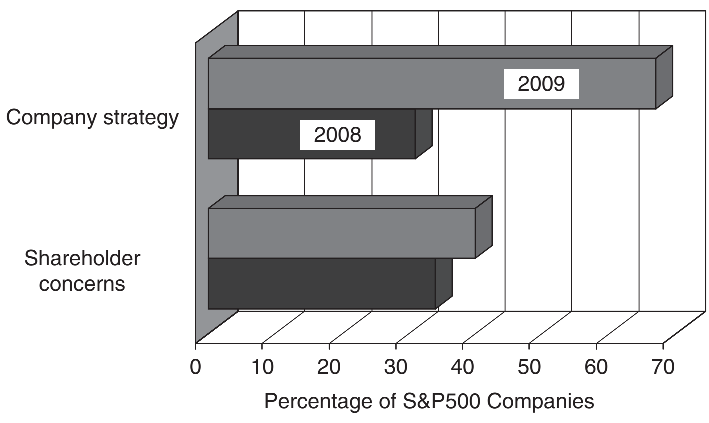

Figure 6.7 Governance topics requiring greatest attention by S&P 500 boards of directors, 2008 and 2009; N = 123 in 2009 and N = 127 in 2008

Source: Spencer Stuart, 2009; Survey of Corporate Secretaries and General Counsels of S&P 500 companies.

and partnering roles. The monitoring role would point toward selecting a new chief executive who has a proven record of creating shareholder value, either within the company or in another firm. The partnership role would point toward appointing a new CEO who has a proven record of thinking strategically and partnering with directors.

When directors are asked to characterize their boardroom decisions, we would also expect that they reference not just monitoring decisions but also strategic decisions – ranging from product launches to spin offs. In a study of the board's role in decision-making at Boeing, Tyco, and a third unidentified company, for instance, I found evidence confirming that their directors were indeed involved in the firm's strategic decisions. At Boeing, for example, directors were directly engaged in the company's design, pricing, and manufacturing of a new aircraft, the 787. At Tyco, directors were actively involved in the company's decision to dispose of a number of business lines. At the unidentified third company, a major investment management firm, directors played an active role in a decision to expand the investment field for an investment fund that was exhausting its investment opportunities (Useem, 2006a; see also, Useem & Zelleke, 2006). Other studies have similarly reported that directors bring substantial understanding of strategic issues into boardroom decisions (see, for instance, McNulty & Pettigrew, 1999; Sundaramurthy & Lewis, 2003; Carter & Lorsch, 2004; Charan, 2005; Leblanc & Gillies, 2005; Nadler, Behen & Nadler, 2006; Bezemer, Maassen, Van den Bosch & Volberda, 2007).

When companies enter into markets with greater complexity and uncertainty, we can also expect to find that their boards become more deeply engaged in strategic decisions. Evidence of this can be seen when looking closely at companies that expand internationally, entering a more complex and uncertain environment than working in a purely domestic market. Consider the changes observed in the board of directors of the largest Chinese personal computer maker, Lenovo, after it acquired the IBM personal computer line in 2005 for $1.75 billion. The acquisition came as part of a decision by the company to move outside the greater China market, where all of its sales had been concentrated until then. In the immediate aftermath of the acquisition, Lenovo radically diversified its sales among five continents (Table 6.4).

As should be anticipated by the logic of the directors' role of monitoring management, the Lenovo board took actions to improve the capacity of the board to exercise oversight on behalf of its owners, according to interviews that we conducted with Lenovo's executives and directors (Useem & Liang, 2009). Lenovo transformed the composition of its board from four non-independent and three independent directors to five non-independent directors, three private equity directors, and three independent directors, giving the board a majority of non-executive directors and thus potentially a stronger hand in monitoring management.

At the same time, as would be expected by the logic of strategic partnering, the Lenovo board took three actions to bring its directors more directly into the company's strategic decision-making. First, it changed from a board composed entirely of greater China directors to a more diverse board, including four American directors, adding members

Table 6.4 Lenovo computer sales, 2004 and 2006

Regional sales (% share)	*2004*	*2006*
Greater China	100	36
Americas	0	30
Europe, Middle East & Africa	0	21
Asia Pacific	0	13

Source: Lenovo company records.

Table 6.5 Lenovo directors, 2003 and 2007

2003			
Executive and Non-Independent Directors	*Residence*	*Position*	*Background*
Liu Chuanzhi	China	Executive chairman	Founded Legend in 1984; chairman, Legend Holdings
Yang Yuanqing	China	Chief executive officer	Joined Legend in 1989, CEO in 2001
Ma Xuezheng	China	Chief financial officer	Joined Legend in 1992; formerly Chinese Academy of Sciences (CAS)
Zeng Maochao	China	Non-executive director	Former director, Institute of Computing Technology, CAS
Independent Non-Executive Directors			
Chia-Wei Woo	Hong Kong	Non-executive director	Former president of Hong Kong University of Science & Technology
Lee Sen Ting	USA	Non-executive director	Managing Director, WR Hambrecht & Co.; formerly Hewlett-Packard
Wai Ming Wong	UK	Non-executive director	Chartered accountant; CEO of Roly International Holdings (Singapore)
2007			
Executive and Non-Independent Directors	**Residence**	**Position**	**Background**
Yang Yuanqing	China	Executive chairman	Joined Legend in 1989, CEO in 2001
William Amelio	USA	Chief executive officer	Formerly VP-Asia for Dell; NCR; Honeywell; IBM
Ma Xuezheng	China	Chief financial officer	Joined Legend in 1992; formerly Chinese Academy of Sciences (CAS)
Liu Chuanzhi	China	Non-executive director	Legend founder; chairman, Legend Holdings; formerly of CAS
Zhu Linan	China	Non-executive director	Joined Legend in 1989; managing director, Legend Capital
Private-Equity Directors			
James Coulter	USA	Non-executive director	Founding partner, Texas Pacific Group (TPG)
William Grabe	USA	Non-executive director	Managing director, private-equity investor General Atlantic (GA)
Shan Weijian	China	Non-executive director	Managing director, private-equity investor Newbridge Capital
Independent Non-Executive Directors			
John W. Barter	USA	Non-executive director	Director of BMC Software; formerly CFO, Allied Signal
Chia-Wei Woo	Hong Kong	Non-executive director	Former president of Hong Kong University of Science & Technology
Lee Sen Ting	USA	Non-executive director	Managing director, WR Hambrecht & Co.; formerly Hewlett-Packard
Wai Ming Wong	UK	Non-executive director	Chartered accountant; CEO of Roly International Holdings (Singapore)

Source: Lenovo company records.

who could provide strategic advice on the international market. Second, Lenovo explicitly recruited directors to the board who were viewed as bringing a strategic partnership to management, such as a former executive of AlliedSignal who had run its 35,000-employee automotive division and who was brought in because of his management experience with a large publicly-traded American company. Third, Lenovo formed a board strategy committee consisting of Lenovo's executive chair, its founding non-executive director, and two American private equity managers, and it charged them with regular direct engagement in the company's strategic decisions. These three changes toward a more strategically engaged board can be seen in comparison of the directors' roster before and after the company's decision to globalize through the IBM PC acquisition in 2005, as shown in Table 6.5.

As a result of these board changes, directors moved from a limited focus on company audit and executive pay, closely linked with the monitoring role, to also encompassing a partnering role, focusing on an array of strategic decisions, including whether to move into adjacent markets, resolving post-merger integration problems, repositioning its brand, revising its marketing, and globalizing its supply chain. The board's strategy committee, new to the company, now vetted all major company decisions. 'The IBM PC acquisition is a watershed,' said Lenovo founder and non-executive director Liu Chuanzhi in one of our several interviews with him. 'Before that point,' he said, 'the board of directors did not play much role at all,' he reported, but the restructured board now played a more substantial role in both partnering and monitoring. Indicative of the enhanced monitoring role, Institutional Shareholder Services, the premier governance rating agency (now renamed Risk Metrics) that evaluates company boards for their shareholder monitoring, placed Lenovo's governance practices at the 25th percentile among worldwide companies in technology hardware and equipment before the IBM PC acquisition in 2005, but at the 50th percentile after the purchase (Useem & Liang, 2009).

Partnership criteria for recruiting directors

The strategic partnership model implies that directors should bring a capacity to think strategically about the firm's competitive position, to work collaboratively with executives in reaching strategic decisions, and to engage directly in implementing those decisions. In recruiting new directors, boards can also be expected to search for candidates who are especially familiar with and experienced in the strategic issues facing the firm, and those who have a proven record of working collaboratively with executives at other companies in developing and implementing business practices stemming from those strategic issues.

Consider the challenges of post-merger integration at a firm expanding through cross-border acquisition. The board's nominations committee under the strategic-partnership model is likely to be particularly interested in director nominees who have a proven track record of working hands-on with executives on mergers across national boundaries. Such candidates would be recruited not only for their ability to monitor management decisions but also for their capacity to contribute valuable content to the strategic challenges of managing across national borders. The Lenovo board had moved in just this direction.

Even statically, we see evidence of the powerful role of strategic partnership in defining who has been recruited to a board. This is evident, for instance, at Infosys Technologies, India's premier information technology firm with more than 114,000 employees in 2010. Its directors, displayed in Table 6.6, included those defined by their prior experience in corporate strategy, consumer goods, life insurance, financial services, economics, and accounting.

Infosys board chair and former CEO Narayana Murthy reported in an interview for another study that the primary value of the firm's directors was not in shareholder monitoring but in asking questions that 'make us re-think our assumptions.' And that, he said, 'makes us look at issues we may have missed and think about alternatives.' At a recent Infosys board meeting, for instance, the executives and directors debated the synergistic merits of several acquisitions and alliances for the better part of three hours. The board deliberated the strategic issues – what were the downsides to

Table 6.6 Directors of India's Infosys Technologies, 2010

Executive and non-independent directors		
Srinath Batni	Director of Delivery Excellence	Joined Infosys in 1992
K. Dinesh	Director of Quality, Information	Co-founder
S. Gopalakrishnan	Chief Executive	Co-founder; served as chief operating officer for 5 years
N. R. Narayana Murthy	Chairman, Chief Mentor	Co-founder; served as chief executive for 21 years
T. V. Mohandas Pai	Director of Finance, HR	Joined Infosys in 1994
S. D. Shibulal	Chief Operating Officer	Co-founder; former director of worldwide sales
Independent directors		
David L. Boyles	Non-executive director	Former executive of American Express and Bank of America
Omkar Goswami	Non-executive director	Former chief economist, Confederation of Indian Industry
Sridar A. Iyengar	Non-executive director	Former partner, chairman, and chief executive of KPMG, India.
K. V. Kamath	Non-executive director	Chairman and former CEO, ICICI Bank
Jeffrey Sean Lehman	Non-executive director	Law professor and former president of Cornell University
Deepak M. Satwalekar	Lead director	Chief executive of HDFC Life Insurance Company
Claude Smadja	Non-executive director	Former director of the World Economic Forum
M. G. Subrahmanyam	Non-executive director	Finance professor at New York University

Source: Infosys Technologies company records, 2009.

combining different company cultures? Would management have the 'bandwidth' to manage a proposed acquisition? If completed, would the two firms be able to cross-sell their services to other's customers? As characterized by the board chair, a central role of the directors in that and prior board meetings had been to provide substantive guidance on the company's business strategy (Cappelli, Singh, Singh & Useem, 2010).

From the standpoint of the strategic-partnership model, a lead director, presiding director, or non-executive chair has a particularly important role to play in facilitating a substantive dialogue among directors and executives on strategic issues, reaching decisions on those issues, and implementing the practices stemming from the issues. This model would thus also anticipate that a company's lead director, presiding director, or non-executive chair would be the director most likely to embody the expertise and experience directly related to the strategic issues faced by the company.

Partnership criteria for evaluating directors

The intensification of both shareholder monitoring and strategic partnering as board functions has moved directors from beyond a relatively passive and largely symbolic role that they had played in earlier decades at many American companies. Among the consequences anticipated by the rise of both roles is a greater emphasis on evaluating the performance of the board and its members.

To examine this, we turn to the Conference Board, an independent business-sponsored research organization, for its annual profile of the boards of a large number of publicly-traded American companies. In the most recent year available, it drew upon data from the proxy statements of 2,436 companies, and also a survey of corporate secretaries of 238 companies. As expected from the strengthening of both director roles, the fraction of the boards that evaluated board performance rose from 25 percent in 2000 to 94–97 percent (depending upon the sector) in 2009. The portion that evaluated the performance of individual directors grew from 11 percent in 2000 to 28–36 percent in 2009 (Table 6.7).

It should also be expected that boards place greater emphasis on recruiting board members whose prior experience indicates that they would bring an ability to both monitor and partner with company executives. This development is likely to be reinforced by new proxy disclosure rules adopted by the Securities and Exchange Commission

Table 6.7 Percentage of large companies conducting evaluations of their board and individual directors

Performance evaluation	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2009*
Board evaluation	25	24	29	48	69	83	85	94–97
Director evaluation	11	11	13	23	28	35	41	28–36

Source: Conference Board, various years.

(SEC) in 2009: Given a company's lines of business, companies must report the experience, qualifications, attributes, and skills that make directors and nominees qualified to serve on the board. Davis Polk, a major law firm with an advisory practice on governance, recommended (in light of these rules) that its clients stress the directors' and director nominees' partnering credentials, with nothing explicitly suggested about their monitoring credentials. The law firm recommended that client companies reference their directors' and nominees' 'collegial personal attributes,' experience 'in the company's industry,' and 'experience gained in situations comparable to the company (e.g., growth companies, companies that grow through acquisitions, companies that are restructuring, leadership experience, and relevant geographic experience'; Davis Polk, 2010: 27). With no comparable reference to the directors' and nominees' prior experience in creating or monitoring the creation of shareholder value, the guidance implicitly places particular stress on the directors' function of strategic partnering.

Director engagement in company practices

As would also be expected by the rise of the strategic-partnering role, though not of the shareholder-monitoring role, company directors are likely to take a direct part in business practices. By business practices, we mean an array of company activities that have traditionally been the prerogative of the chief executive and his or her team, such as restructuring divisions, guiding research, and developing talent. Examples abound. Private-equity investors from firms such as TPG and Benchmark Capital often serve as directors of companies in which their firm has taken a significant stake, and they become relatively directly engaged in the company's business practices (Stross, 2000). Similarly, the lead director at Tyco International devoted nearly half of his time in 2003–05 to working directly with company executives on restructuring the firm – spinning off divisions, replacing executives, restoring a culture of integrity – after an accounting scandal sent the company into a tailspin and the chief executive to prison (Pillmore, 2003; Useem, 2006b). While such examples confirm that directors sometimes become directly engaged in company practices, whether they predictably and in a consequential way engage in business practices remains a research question.

Research that has touched on the question of director engagement in business practices had often reported behavioral patterns that are consistent with the logic of strategic partnership (Pugliese, Bezemer, Zattoni et al., 2009). Companies whose boards have more executive directors and fewer financial experts on the audit committee, for instance, are observed to more often commit fraud (Farber, 2005). When directors of pharmaceutical companies are moderately involved – rather than uninvolved or highly involved – in the firm's research and development, their companies are more successful in taking innovations to market (Powell, Koput & Smith-Doerr, 1996). Pharmaceutical companies whose non-executive directors have a substantial equity stake in the enterprise are more prone to favor innovating through the acquisition of other companies (Hoskisson, Hitt, Johnson

& Grossman, 2002). When companies deem leadership development more strategic, their directors are observed to become directly involved in teaching and mentoring company managers (Useem & Gandossy, 2011). When boards select new CEOs, they tend to pick executives who have experience with strategies similar to those used by the non-executive directors at the companies where they serve as executives (Westphal & Fredrickson, 2001).

Shareholder monitoring and strategic partnering

Agency theory and its corollary of director monitoring of management have long dominated both academic research and public policy on the governing board of large publicly-traded companies (Bebchuk & Weisbach, 2010). Legislative reforms and policy guidelines from public and private groups generally focus on improving the monitoring function, concerning themselves in recent years with measures such as strengthening director oversight and protecting minority shareholders that are deemed to strengthen director monitoring. Strengthening director partnering has rarely been at the forefront of regulatory policies or good-governance pronouncements.

In some instances, strategic partnering has even been proscribed: deemed a board function that should not be performed. 'The board of directors has the important role of overseeing management performance on behalf of shareholders,' declared the Business Roundtable, a large-company association in the United States, and 'Directors are diligent monitors, but not managers, of business operations' (Business Roundtable, 2005: 5). Symptomatic of the rising importance of strategic partnering, however, is the contrary advice from a leading attorney specializing in corporate governance who advocated in 2010 that we should 'expect boards' to not only 'monitor' the performance of the company CEO but also to 'provide business and strategic advice to management and approve the company's long-term strategy,' and parallel advice from an investment advisor and company director who advocated 'an active, working partnership between the board and CEO' (Lipton, 2010: 1; Nevels, 2010).

We believe, however, that both the shareholder-monitoring and strategic-partnership models characterize aspects of director behavior usefully and accurately. Each has been found to forecast director actions in ways that the other does not. Thus, it is best to view the boardroom as a nexus for the dual expression of both functions, rather than one or the other (a view long shared by some analysts; see, for instance, Hilmer & Tricker, 1994; Tricker, 2009).

To more fully appreciate those functions, it will be important to peer more directly into the boardroom than investigators have in the past. A number of researchers have urged greater attention to the behavior of directors behind the closed doors of their boardroom (e.g., Haft, 1981; Ingley & van der Walt, 2005; Perry & Shivdasani, 2005; Roberts, McNulty & Stiles, 2005; Yawson, 2006). Though this will require non-public information about directors, we believe that valuable information can be acquired by surveying executives or interviewing directors about their behavior in the boardroom.

To this end, it would be useful to develop a scheme for classifying director deliberations and decisions as primarily focused on shareholder monitoring or strategic partnering. This would allow for identifying and then explaining the relative importance of the shareholder-monitoring and strategic-partnering models in shaping director behavior in a given company in a given circumstance.

It could be anticipated, for instance, that directors of companies in a strong growth phase would be likely to devote more time to a strategic partnering with management than to monitoring of management, while directors of firms in a period of decline would give more time to shareholder monitoring than to strategic partnering. Similarly, since the strategic-partnership model is designed around the goal of improving strategic decisions and their implementation, and, by implication, long- rather than short-term company performance, companies with strong strategic partnerships should thus generally outperform other firms over long periods of time though not necessarily short durations. Firms with strong shareholder monitoring should outperform other firms in the relatively near term, though less so in the longer run.

With the monitoring and partnership functions both in place at many companies, strengthened by the rise of institutional investing and complexity and uncertainty in decision-making, company underperformance under certain conditions can also be anticipated to be greater now than in the past because of the dual functions. Each role could work to undermine the director's performance of the other.

The strategic-partnership model, for instance, could lead directors to become over-committed to strategies that later prove to be unproductive or even counterproductive when a firm's market changes, thereby diminishing total shareholder return. Though directors' collaboration with executives may bring initial performance advantages, their collaboration with executives could also constitute a source of boardroom resistance to change at a later time when company strategies should be changing. Companies with directors who have adopted a strategic-partnership model may thus be expected to perform well so long as the market suggests company strategies similar to those for which they had brought expertise and experience to the governing board, but less so when company redirection or restructuring is warranted.

While the two director roles may work against each other in certain circumstances, they may also both be essential under other conditions. Consider the financial crisis of 2008 that morphed into an economic recession in 2009: though certainly not a cause of the crisis, insufficient engagement of directors in company strategies may have been a contributing factor. When executives at financial service companies such as AIG, Lehman Brothers, and Royal Bank of Scotland sought to pursue risky strategies of acquiring sub-prime mortgages, arguably of value for ramping up short-term investor returns, if company directors had been more engaged as strategic partners, they may have more actively questioned and challenged such risks.

In seeking ways not only for overcoming the 2008–09 financial crisis but also for preventing similar crises in the future, company directors and public regulators may want to consider ways of pressing for directors to be even more effective in both monitoring and partnering. The latter, for instance, in the case of financial institutions, could take the form of greater director involvement in enterprise risk management, and in the case of manufacturing firms, greater director engagement in pre-emptive restructurings. Strengthening of the two roles is not a sure solution, but the strengthening of both could be an important step toward improving near-term performance and averting fatal risk taking.

And we can expect that the two director roles will continue to strengthen in the boardroom among large publicly-traded companies in the United States, and in other economies as well. The Dodd–Franks Act of 2010 is intended to improve the monitoring function, and similar initiatives have been taken in other countries in recent years. The China Securities Regulatory Commission and Chinese regulations have been moving in the same direction since the Company Law of 1994 and Securities Law of 1998, as has the Securities and Exchange Board of India with its Clause 49 of 2004 (Liang & Useem, 2009; Cappelli et al., 2010). Their thrust has been to strengthen the monitoring role of directors, though some legislative and regulatory provisions are found to have little of the intended impact (Brown & Caylor, 2006, 2009). Yet the effort to strengthen the directors' monitoring role could also have the unintended consequence of strengthening the directors' partnering role. By pressing directors to be stronger and more independent of management for the purpose of monitoring, government legislation and state regulations could at the same time also be creating a platform for directors to a seek a more active partnership with executives.

Moreover, the underlying sources of the enhanced monitoring and partnership by directors – the rise of institutional investors for monitoring and the increased complexity and uncertainty in company decisions for partnering – are likely to remain relatively undiminished in the immediate years ahead. If anything, available trend lines point to their further intensification. The dual functions of the corporate board are thus here to stay, at least in the near term, and they are likely to become stronger in the near-term future.

If so, understanding, explaining, and prescribing director behavior will require a healthy dose of scholarly eclecticism. The fields of financial economics and accounting will continue to play a vital role in framing how we think about the governing board as shareholder monitor. Hillman et al. (2008), for instance, argue that directors' identification with the company's CEO will weaken their role as monitors. At the same time, the fields of strategic management and leadership will continue to be important for framing how we conceive of the governing board as strategic partner. Payne et al. (2009), for instance, report evidence that boards that work as more effective teams are associated with companies that display stronger financial performance.

It is for that reason that educational programs for company directors are likely to stress both their shareholder-monitoring and strategic-partnering roles in the boardroom. This would entail, for instance, providing guidance on how directors can make a hard-headed appraisal of the impact of a CEO's proposed acquisition on a company's shareholder value, and also how directors can advise the CEO on a strategic redirection of the firm when the market calls for a new approach. In designing learning programs for directors in the United States, China, and India for the past five years, we have concluded that both subjects are essential for such programs because they constitute the two essential roles that company directors are now expected to play.

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An Economic Analysis of Fair Value: A Critique of International Financial Reporting Standards[1]

Vincent Bignon, Yuri Biondi and Xavier Ragot

PREAMBLE

The current world crisis – triggered by the breakdown of the interbank market in the summer of 2007 – has resulted in the partial and temporary suspension of fair-value accounting and given impetus for its reassessment. Hearings held before committees of the US House of Representatives in October 2007[2] led to the drafting of a report by the 'Financial Stability Forum' at the G7 meeting of April 2008. This report recommended strengthening the prudential supervision of capital, liquidity and risk, clarifying and limiting the use of fair-value accounting, improving off-balance-sheet accounting and increasing the resilience of financial and banking systems to tensions and crises.[3] On 2 October 2008, the US Parliament adopted the Paulson plan, which, in sections 132 and 133, gave the Securities and Exchange Commission (SEC) the power to suspend the application of fair value for reasons of 'public interest' and consistent with the 'protection of investors'.[4] The Paulson plan called for a study of the economic consequences of this mode of accounting for companies, their balance sheets and the overall economic system. Shortly afterwards, the European Commission obliged the International Accounting Standards Board (IASB) to review the fair-value accounting of financial instruments, allowing them to be reclassified using historical cost accounting. On 2 April 2009, in response to criticisms blaming accounting standards for the deepening of the crisis,[5] the regulatory board for accouting in the United States – the Financial Accounting Standards Board (FASB) – authorized financial intermediaries to post certain financial assets not at their market value but at a value estimated through financial evaluation models.

It is too early to conclude that fair-value accounting has come to an inglorious end.

The legal imposition of this accounting revolution on both the financial markets and the accounting profession further consolidates the alliance between the international (and European) regulator (IASB) and the US regulator (FASB), sealed in 1998. Their respective chairmen continue to call not only for the balance-sheet valuation of all risky assets and liabilities based on their fair value, but also for the convergence of all accounting regulations towards one unique set of standards starting in 2011.

The calling into question of the concept of 'high quality' demanded by these regulators (AAA FASC, 2009) also concerns their independence from the public authorities. In the world of finance and accounting, some have vested interests in establishing an universal accounting system as a matter of urgency.[6] As recent bankruptcies have shown, the fair-value accounting model has proved to be conducive to the appropriation of potential profits and the concealment of losses by clever insiders and executives to the detriment of other stakeholders (including most of the investors) and the long-term viability of the productive entity (Ijiri, 2005; Richard, 2005; Kothari, Ramanna & Skinner, 2009). This disproves the key argument in favour of fair-value accounting: that it is objective and makes accounting manipulation impossible. On the other hand, the imposition of this new worldwide accounting system, based on the expert interpretation of a voluminous and complex set of norms, has given some big accounting firms a powerful tool for creating and dominating the market of accounting services and financial and fiscal expertise that is closely tied to these services.

The crisis has revealed the short-sightedness of those financiers and accountants. First, it has shown the limitations of the correspondence between market signals and accounting information; the system of controls, of which the keeping of accounts is an integral part, failed to detect the first signs of the crisis and accelerated the way it spreads to all financial institutions. Second, it has exposed the accounting profession to the criticism and rancour aroused by the disaster, as was already largely heralded by the collapse of the accounting firm responsible for auditing Enron. The succession of financial crises calls for a rethinking of the foundations that were intended to 'modernize' the functioning of the financial system since the 1970s (Boyer, 2007, 2008; Stout, 2009).

In January 2009, a report by the 'Group of Thirty' (G30) condemned fair value for its role in creating systemic risk, low resilience and financial instability. The accounting question was raised once again in terms of the regulation and coordination of the economic and financial system as a whole. The advocates of fair value are thus faced with the shortcomings of the market as the solitary mechanism that is supposed to ensure the efficiency of this regulation and coordination. Accounting has lost its place and role as an instrument of control, contributing to public confidence and necessary for the functioning of the financial markets themselves. Although the criticisms have been severe and without appeal, both accounting regulators (IASB and FASB) have declined the idea of any fundamental change of direction. The accounting model has not been revised; it has merely been subject to a few marginal adjustments, in keeping with the initial approach. The abdication of Europe in favour of the International Financial Reporting Standards (IFRS) issued by the IASB has then placed it in a difficult position vis-à-vis China, India, Japan, South Korea, Taiwan, Brazil, Russia and Saudi Arabia, which have refused to apply these standards to their listed companies, preferring to maintain their accounting independence through independent, coexisting standards.[7]

The fair-value accounting model failed to prevent the crisis. Worse still, it accelerated the collapse. The questions that have been raised over several years have become more pressing. They concern the accounting principles framing the conception of the corresponding standards (Colasse, 2007), the spirit of the accounting laws driving these standards and their application. How was it possible to write up huge debt liabilities without the accounting system reporting it? How was it possible to report unrealized capital gains as current profits, when they subsequently turned out to be incurred losses? These shortcomings of the fair-value accounting system are linked, first, to the failure to take into account the multiple entities that constitute each corporate group and the multiple assets and liabilities that constitute their balance sheets (the problem of off-balance-sheet transactions, which had formerly been a key marketing argument for certain financial products); and second, to the criteria of fair-value measurements, particularly for financial instruments (instantaneous market-value reporting). A consensus exists on the role of fair-value measurements in spreading the crisis throughout the whole of the financial system: some entities urgently sold their assets to obtain the liquidities required to respond to their accounting write-downs, creating the mechanism by which the crisis was amplified. The method of market-price measurement therefore proved to be both useless, because it gave no new information to the stakeholders (who already knew that prices were falling), and harmful, because it can only amplify the rises and falls in financial asset prices and thus intensify the depressions and euphorias of financial markets.

Accounting systems that follow the economic and financial frontiers of business firms and determines their performance and financial position over time go back to the historical cost model of accounting. That is the model upheld in the following text, published in March 2004, well before the onset of the crisis that has now lasted two years. This approach consists in basing accounting measurements on the financial and economic flows of the business activity and adopting a representation of the firm as an economic and financial entity, of which the accounting system determines the overall performance and financial position over time.

- Whereas the fair-value approach concentrates on the valuation of each class of asset and liability, separately from the other classes, the historical-cost approach identifies the place and the role played by each class in the economy of the firm.
- Whereas the fair-value approach seeks to estimate the instantaneous value of each class, by reference to its market price or a modelling of that price, the historical-cost approach avoids such imprudent references, instead linking the balance sheet representation to the operations and transactions that the firm carries out and accomplishes over time.
- Whereas the fair-value approach imitates the investors in their assessment of the instantaneous value of the firm, the historical-cost approach recognizes the importance of an independent source of accounting information and regulation, both for the investors and for the other stakeholders interested in the overall performance and financial position of the firm over time.

As Paul Krugman (2009) has shown, the case of financial liabilities is one of the most striking examples of the difference between the two accounting approaches. The fair-value approach considers a liability (a debt that the firm owes to a third party) as if it was owned by the firm and could be sold at any time. As a result, this approach involves a market capital loss (an accounting capital gain) when the firm's credit risk increases. When it encounters financial difficulties, the market value of its debts falls. On this basis, fair-value accounting makes it possible to improve the financial position of a firm when it finds itself in difficulty, and results in a worsening of its position when its credit risk improves. Likewise, the recording of the fair value of a debt in the profit-and-loss statement leads to the recognition of a profit when the credit risk worsens and a loss when it improves. Finally, as far as its liabilities are concerned, a firm on the verge of bankruptcy presents rosier acounts than a firm in good financial health: this was the case for Citigroup and Morgan Stanley in the United States in 2009.

The same is true for the valuation of provisions for future risks and charges, as the Cour de Comptes has pointed out, taking EDF as an example (Table 7.1).

Table 7.1 Provision for future nuclear expenses (millions of euros) 31 December 2003

In millions of euros	*Gross value (estimated cost)*	*Discounted value (according to principles of fair-value evaluation)*
EDF	48,006	24,787

Source: Rapport de la Cour des Comptes, January 2005, p. 168.

In a way, this discounting of the values of liabilities amounts to carrying forward to future years a large part of their impact on the current account, and therefore of the provisions for the corresponding debts. The fact that only the discounted value weighs on the current account does not guarantee the firm's capacity to pay its debts (Biondi, Chambost & Lee, 2008, p. 215). This criticism is also valid for the application of fair value to assets, because it leads to investments being valued based on the discounting of future net flows, not on the costs invested. Because of this, the fair-value accounting of assets incorporates profits that are only virtual, latent or simply future, and can become a means to accelerate the recognition of revenues, at the risk of normalizing the distribution of fictitious dividends and instituting Ponzi-style accounting schemes. Conversely, in situations of financial crisis, valuation at the market prices has the effect of artificially passing through falls in prices to the accounting value of durable assets and liabilities that the firm still needs for its operations.

The adoption of a fair-value accounting model has led to a profoud misunderstanding about the place and role of accounting in the firm. This misunderstanding is directly linked to the drifts of financial capitalism that nurture a misapprehension about the place and role of finance in the economy and in society. In this way, accounting has been transformed from an instrument of management and control into a tool of marked-to-market financial valuation, generating a short-termist attitude towards the economy of the firms to be accounted for (Orléan, 1999; Aglietta & Rebérioux, 2004).

The questions the crisis has raised for this financialized accounting model are clear. The answer is linked to a clear return to accounting principles that favour the needs of management and control of the economy of the firm as a whole, over time. That is why the accounting system is not and cannot be solely a source of information about the firm, but one of the institutions giving structure to the firm's activity in the economy and in society. It is not so much a financial technique of measurement and valuation as an instrument of quantification and a socially constructed representation (Desrosières, 2006). As it does not consider the firm as an aggregate of assets and liabilities that can be separated, the historical-cost accounting model is the most suitable for protecting the diversity of stakeholders, mediating imminent conflicts arising from that diversity, and ensuring the long-term viability of the firm in the face of predatory and opportunistic behaviours. In this accounting model, the firm is treated as an entity, with the accounting system following the operations and transactions carried out, and the balance sheet and profit-and-loss statement determining the performance and financial position achieved over time. The different aspects of this economy can be taken into account from this perspective, including the risks that certain financial instruments and other events may constitute for long-term viability, without resorting to market values that may prove to be absent, unreliable or erratic. Additional statements and notes could thus be prepared and disclosed concerning nominal future obligations and the planned provisions made by the firm over time.

To conclude this preamble, we can only repeat the last words of the first edition of this paper, published in March 2004 (Bignon, Biondi & Ragot, 2004): to the question: 'Does there exist an information source more reliable and relevant than the spot market prices?': we would like to reply that accounting may provide this source of distinct and complementary information, if it keeps its autonomous logic in order to help the formation of prices on financial markets and to enable the verification of market valuations.

INTRODUCTION

When in July, 2002, the European Commission submitted to the European Parliament legislation anticipating the adoption of new accounting standards, it marked a stage in the history of accounting in Europe.[8] These standards, conceived and promoted by an independent private organization, the International Accounting Standards Board (IASB), took effect on 1 January 2005, for all firms quoted on stock exchanges. Their novelty resided in the introduction of a different principle of accounting valuation. Prior to the adoption of the new standards, the traditional method of valuing assets on the balance sheet was historical cost (i.e. historical cost with depreciation). The cost of an asset at the moment of purchase is recorded on the asset side of the balance sheet, net of depreciation, representing wear and tear and obsolescence in production.

Advocates of fair value criticize the central principle of historical cost: Why should past prices be thought to indicate asset values accurately? Economic or financial changes, or the circumstances of an asset's acquisition, can cause these two quantities to diverge widely. If one intends to record on the balance sheet the real wealth of a firm – i.e. the value of what it mobilizes in production – then the value of each component of an asset should be measured, not on the basis of past prices adjusted for depreciation, but directly, on the basis of the (present value of) future cash flows that each asset specifically creates. The aim of fair value is precisely to measure this quantity.

The application of the principle of fair value rests on the synthesis of two kinds of valuation: market value (or net selling price) and use value (or value in use). In the first case, assets are recorded on the balance sheet at their resale market price on the date of reporting; in the second case, the value recorded corresponds to the discounted expected cash flows generated by the asset. This discounted cash flow approach implies the construction of a valuation model.

It would be false to present fair value as the core of all the standards proposed by the IASB. Only some refer to fair value: for example, IAS 16, 36 and 39. Furthermore, the method of fair value is presented as secondary, while the method of historical cost remains the benchmark. Nevertheless, the introduction of the principle of fair value is not a minor modification of accounting principles. We think that 'from a conceptual viewpoint, fair value is without any doubt the cornerstone of the project sponsored by the IASB', and that the reference to fair value introduces a new logic into accounting records, the scope of which should be appreciated.

The goal of this text is to present the economic rationales that underpin these two approaches to accounting – historical cost and fair value – in order to shed light on their respective domains of application and the possibility of combining them.

Taking account of the principle of fair value provokes two opposing reactions: either the number, however limited, of references to the measure is too high, or the generalized application of these principles is necessary to all kinds of items, to assets as well as to liabilities. This project of systematic asset valuation, in particular financial asset valuation, is called full fair value. The present text will show that behind these choices lie two profoundly different understandings of the firm and of the meaning of accounting information.

The authors' judgement is presented in the Conclusion of the chapter, to which the reader in a hurry may refer in order to draw lessons from the recent evolution of accounting principles. The argument is presented in four sections: (Section 1) the principles of historical cost and fair value; (Section 2) asset specificity and complementarity; (Section 3) the use of current market prices in balance sheets; and (Section 4) accounting information and its political economy. More technical points or other direct information amplifying the arguments are presented in text boxes.

THE PRINCIPLES OF HISTORICAL COST AND FAIR VALUE

Historical cost

The balance sheet of a firm displays the amount of capital that is mobilized in production. The logic of historical cost with depreciation (which we shall abbreviate to historical cost) records the costs invested in production as an asset in the accounts: i.e. the cost of investments related to factors of production as they are fixed at the time of purchase, adjusted for depreciation. Thus, it involves recording capitalized monetary outflows, i.e. the capitalization, in the accounts, of effective expenditures rather than the present value of future gains associated with holding the asset (the discounted value of future monetary inflows). Between the assets on the balance sheet and the expected gains lies the firm's production function that the method of invested cost does not evaluate, leaving the task of representing the firm's performance period by period to the income statement. The evolution of the income statement and of the balance sheet gives an annual economic evolution of the performance achieved. For this reason, Biondi (2003 and 2011), in particular, describes this accounting approach as dynamic, in opposition to the static approach of fair value. The principle of asset valuation at the date of entry into the accounting entity is transparent, and the possible, lasting depreciation of the value of assets is the object of management choice. This choice is based on the lasting usefulness of these assets for the firm and on the underlying accounting principles.

Advocates of the valuation method of fair value contest this conception. In their opinion, it contravenes to a large extent the principle that accounting should provide a true and fair view of the company's situation. The numerous criticisms of historical cost accounting can be grouped under the following two main heads:

- There is absolutely nothing systematic about the depreciation of asset values. Except for the case of wear and tear or obsolescence, it is the manager who assesses the potential loss on an asset. This loss may be the result of a change of strategic direction on the part of the firm, an external event, or, more widely, the economic environment. The events of the 1990s document abundantly the impact of firms' strategic changes on their accounts. Firms adjust the values of their assets via restructuring or depreciation provisions.
- The subjectivity of valuations enables managers to disguise accounting earnings.[9] In effect, the prevailing method leaves too wide a margin of manoeuvre for constructing these results. In order to make this mystification impossible, the defenders of fair value wish the automatic end-of-period inclusion of (capital) gains and losses on assets to be made relative to a valuation basis external to the firm (i.e. the spot valuation of each single asset by the market price or a model).

Fair value

The principle of fair value suggests that asset values be determined by discounting the flows of expected profits. According to economic theory, this value equals the market value of the assets under the ideal assumption of a perfect market.[10] In effect, if competition is pure and perfect, the value of an asset is exactly equal to what it will earn (the no arbitrage [or zero profit] hypothesis). If markets are imperfect, one should be able to construct a model of the value of the flows generated by the asset. The IASB suggests choosing the larger of the two values as a standard for impairment of the value of an asset recorded at depreciated cost (IAS 36). Advocates of a switch to fair value emphasize that modifying the valuation principle

Box 7.1 The Principles and Rules Governing the Measurement of Assets – IAS 16 and 38

In accounting theory, there are two major approaches for measuring assets:

- a (static) market valuation, essentially individualist, linked to the instantaneous or spot value of the asset in isolation, either at the current price of the asset in a benchmark market, or by discounting its future cash flows;
- a (dynamic) productive valuation of the assets employed, essentially aggregated, linked to the combination of the asset in question with other resources in sustainable economic coordination, oriented and positioned within the going concern.

Fair value is a revival of the static approach and can be viewed as a synthesis of the criticisms directed at the dynamic approach of historical cost. As regards the measurement of assets:

A. the reference should become the spot value of the asset;
B. the income statement, like depreciations, should include unrealized profits and losses.

On first glance, the IASB accepts both types of valuation, the static and the dynamic. In effect, the rules that it enacts allow either the first method, considered as secondary, or the benchmark method of historical cost, although adjusted for impairment (IAS 36). We shall study these methods in greater detail later on.

This double criterion is often presented as a degree of freedom permitted to firms, allowing them to draw up the accounts better. In fact, the optional character of this fundamental feature undermines the coherence and reliability of the enactments, in particular concerning aggregation and inter-temporal and inter-firm comparisons.

From a theoretical perspective, the methods of the IASB do not respect the two key points that we have just mentioned as consequences of fair value. In the first place, the initial recognition of the asset is always made at the effective cost, which purely by chance happens to coincide with the fair value at the time of the transaction (contrary to the implication of point A above). In the second place, it is based more on the estimates of certified experts than on the current market price when the first method is followed (contrary to the supposition of point A above). Furthermore, the possible loss made on the magnitude already recorded feeds through directly to the earnings, whereas the unrealized profit is recorded in a reserve and does not pass through into the income statement (contrary to the implication of point B). Finally, the IASs do not include this profit in the income statement even at its effective realization (contrary to the supposition of point B).

That, however, involves only a partial acceptance of the principle of historical cost. In its general conclusions about the standard IAS 36 (§B28), the IASB appears to admit that the significance of the loss for depreciation should remain limited to the case where the firm wishes to own the assets in question, rather than the case where it seeks to dispose of them.

could improve accounting information on three counts:

- First, it would give shareholders a more faithful view of the firm, because of an improved assessment of wealth. The most evident example, which illustrates the conceptual basis of fair value, is the case of financial securities. If the value V of a financial security corresponds to the present value of the average future cash flow at the moment of purchase, and so it has the market price V, why should this security correspond to the same cash flow one year later, after the publication of new economic information? The value of the security, corresponding to its exchange price, should be reassessed continuously in order to reflect this new information. This possibility exists in French accounting, but only in the case of potential losses judged to be lasting.[11]

- Second, accounting documents would provide a more precise picture of the risks that firms are bearing: assessment at fair value would uncover the 'true' value of assets and liabilities. Assets and liabilities would be recorded at spot value on the balance sheet: i.e. at the current market price or at a model-generated estimate of that value (cf. Box 7.2). These values are held to reflect the complete information available at the time of drawing up the accounts. For new firms, this is a particularly delicate point, since their price varies greatly over time, reflecting at least partly the collective appreciation of the risks associated with the product. Furthermore, the evolution of the spot value is held to make possible a better appreciation of bankruptcy risk. Hence, investors' portfolio selection should be made easier by the more informative character of the accounts. Conversely, the periodical divulging of this information is thought to exercise greater discipline on the behaviour of firms in the presence of risks.
- Third, fair value would give a more truthful picture by reducing the margin for manoeuvre in drawing up income in financial statements. Accounting would thereby help external monitoring on the part of shareholders and financial markets, which would become the benchmark users.

If the arguments of the defenders of fair value seem self-evident, the next part of our text will show that nothing of the sort is true. On the contrary, the principle of historical cost finds solid foundation in contemporary economic theory, particularly in the theory of the specificity and complementarity of assets.[12]

The approach of this text consists in analysing the principle of fair value in the light of two pairs of concepts: specificity and information asymmetries,[13] on the one hand, and complementarity and indivisibility, on the other. We shall show that the recognition of the complementarity and specificity of assets involves a plurality of possible assessments of each asset. In following the principle of fair value, firms would still have at their disposal a margin for manoeuvre in the assessment of their assets, which is far from the objectivity sought by defenders of that principle. The existence of a margin for manoeuvre renders vain those efforts designed to make the overall accounting statements more truthful and fair.

The following section aims to show that it is unfounded, even dangerous, to rely on a direct transposition of financial principles, such as the principle of fair value, for valuing accounting assets. That is because these principles are subordinate to the conditions of

Box 7.2 Accounting Assets between Invested Cost and Present Value – IAS 36

With IAS 36, the regulator establishes a norm for verifying the depreciation of assets. Three possibilities are excluded: the sum of undiscounted cash flows; fair value; and value in use. The regulator keeps only the higher of the net selling price and the value in use (IAS 36, B21), which might be called the instantaneous value or spot value.

The essential problem here rests on the notion of value in use. According to the IASB, this is defined in terms of present value (IAS 36, §5), contradicting the dynamic tradition that conceives of value in use as based on invested cost, depreciated over the expected useful lifespan of the underlying resource (Richard, 1996). From this, all the measures proposed by the IASB regarding assets incline towards discounting (IAS 36, B22), and in perfect markets, they would be finally the same.

This point of view neglects the logical distinction between value and cost (Littleton, 1935). The principle of historical cost neither takes account of the spot value (cf. supra) nor of its greater or lesser fluctuations; it focuses on the economic process of the firm as an entity and, consequently, on the invested costs and their recovery. In this context, the notion of asset is justified by its combination with the other resources in goal-directed sustainable economic coordination, constituting the going concern, without reference to the discounting of expected cash flows. The notion of "asset" is based rather on reliable conventions of capitalization and depreciation of actual expenditures.

validity of the theory of perfect markets. In order to conceive firms in operation (as going concerns), this theory, in effect, would have to take account of the two pairs of concepts mentioned above.

The difficulty in applying the principle of fair value has not escaped the authors of the new standards, who foresee secondary dispositions for the cases in which this principle cannot be applied. Taking into account the limits of the applicability of fair value leads one to reverse the argument. Should not that valuation principle be restricted to highly specific cases: namely, those cases where the method founded on the principle of historical cost is manifestly inappropriate?

ASSET SPECIFICITY AND COMPLEMENTARITY

Specificity and asymmetry

The nature of a firm's assets, such as those relating to business combinations, usually differs from that of purely financial securities. For example, the external growth of a firm may lead it to acquire shares in companies, which may uncover complementarities or synergies with its core competencies.[14] Thus, the economic profitability of assets varies with the kind of acquirer, something that the theory of perfect markets says is impossible. An asset is deemed specific for a firm when its use by that firm generates a return greater than the return that would be generated by its use by any other entity. The market price of this asset – i.e. the collective assessment of its value by other agents – is different from its value for that firm. Because the firm possesses information about the specific value of that asset, an asymmetry of information exists between the firm and the market participants.

Let us take a simple and purely fictitious example. Imagine that a car manufacturer in the as-yet-unknown country Xayuvi owns a production technique similar to that of a Japanese car manufacturer, but with a considerable technological lag. The national reputation of this manufacturer makes it an obligatory benchmark. The value of the company in Xayuvi is greater for the Japanese car manufacturer than for its compettitors because of the greater technological synergies.[15]

Specificity as such does not pose a problem for the approach of fair value. Moreover, the authors of the IASs take account of the evolution of the value of an asset (IAS 36), since in order to calculate that value, they retain the greater of the net selling price and the value in use, this last being measured by present value (i.e., by discounting future cash flows). The reasoning outlined above can be taken to show that the difference between these two values is precisely an estimate of the specificity of an asset. A problem does arise, however, in measuring this specificity precisely.

The valuation of a specific asset requires precise knowledge of the firm in order to assess assets' synergies. From their experience, the firm's management and employees possess technical and operational knowledge, which the external observer does not. This observer is therefore in a position of informational asymmetry relative to the firm's executives who decide to bring onto the balance sheet assets that they consider specific. The precise measure of the synergy between the Japanese producer and the Xayuvian producer involves a very good knowledge of these complementarities by markets. The problem is similar to that of the valuation of firms on equity markets. In order to reduce informational asymmetries, investment companies have recourse to the services of an imposing array of analysts who follow each market and who replicate the managerial skills of insiders.

Firms also devote part of their resources to protecting this information or to acquiring information on their competitors through industrial espionage. Informational asymmetry is essential and inevitable to every business project. Specificity is the theoretical basis of excess value, which is the difference between the valuation of securities by the acquiring firm and the market value.[16] Excess value often gives rise to valuations that show themselves to be fantastical, like those resulting from transactions during the Internet bubble. Generalizing fair value would render structural those problems that are visible in measuring excess value. Whereas the accounting problem of excess value surfaces only when equity in, or control of, a company is acquired, the logic of fair value extends it to the valuation of all assets at every preparation or presentation of financial statements. It can be understood as an extension of the logic of financial valuation. The latter's failures – most notably at the time of the Internet bubble, but also in the analysis of companies whose bankruptcies are current bad news – cast doubt on the interest of extending such logic to company balance sheets, at the risk of seeing stock market bubbles pass into accounting bubbles.

Like the problem of bubbles and fantastical valuations, the problem of undervaluing asset specificity appears to mark the accounting standards proposed by the IASB. In effect, the analyst in a hurry finds a simplistic first approximation in the spot values of assets (cf. Box 7.2). Whatever precautions are taken, the fair value of all the assets of an entity might often equal the realizable value of firms. Furthermore, the accounting standards relating to intangible assets (IAS 38) do not value as an asset those expenditures that increase both the specificity and economic value of companies, such as research, staff training and marketing costs. These expenditures add to the human, organizational, social and technological capital of firms. They do not appear on the asset side; they only appear as expenses in the income statement. Whereas the logic of fair value is to represent a firm's wealth as an asset, the undervaluation of specificity leads to the exclusion of an important part of the economic capital of the firm from the asset side of the balance sheet, and it reduces the value of the firm's wealth to its realizable value.

To sum up, the use of fair value introduces formidable difficulties of asset valuation into accounting because of specificity, complementarity and the systematic taking into account of even remote future events. Two opposing risks are foreseeable: the appearance of accounting bubbles, similar to stock market bubbles, and the undervaluation of asset specificity. Furthermore, other essential aspects of the economic process of the firm make the application of fair value difficult. In particular, the necessity of determining the contribution of each element to future cash flows poses the question of the decomposability of the going concern, which we shall raise in the following section.

Complementarity and indivisibility

The preceding section concentrated on the valuation of a single asset in isolation. Assessing the productive contribution of different assets, even non-specific assets, poses deeper problems. According to a purely financial logic, assets ought to be perfectly independent: if I purchase the shares of company A, it has no reason to impact the return on the shares of company B, which are among my assets. Nevertheless, the logic of share-ownership is not purely financial, except perhaps in the case of cash equivalents (liquid instruments).[17] Thus, if I own the Xayuvian car manufacturer and if the Japanese manufacturer possesses techniques that can improve its productive efficiency, then joint ownership of these two assets will allow me to increase the future cash flow relative to the separate assets.[18] The complementarity and indivisibility of the assets make the attribution of cash flows difficult, even impossible.

Imagine that the Xayuvian enterprise A and the Japanese enterprise B each produce goods worth 10 million euros. After training costs and restarting the activity, the integration by company C of these two enterprises

Box 7.3 The Productive Entity and the Legal Boundaries of the Firm – IAS 22, 27, 28 and 31

As the example of ENRON shows, accounting legislation is ineffective if the economic boundaries of firms' activities and the risks involved are not taken into account. Whether it be for the protection of shareholders or of all stakeholders, this representation is indispensable.

On this subject too, the IASs are ill-defined. A paradox exists between the general notion of the control of a company in terms of the power to govern its financial and operating policies, beyond its legal boundaries (e.g. IAS 27, §6), and the ulterior, more specific criteria, which tie it to the legally binding arrangements, such as shareholder vote majorities. The standards relating to acquisitions (IAS 22), associates (IAS 28) and joint ventures (IAS 31) define criteria of control grounded in legal bases. However, the instruments covered by these standards are often used with cunning financial engineering to dress the accounts and mask the real economic issues and financial risks of an entity. Coordination of the standard on consolidated financial statements (IAS 27) with these other standards is therefore necessary.

Finally, given the let-out rules from the principle of historical cost, greater attention concerning any goodwill is merited. Standards may allow the accounting capitalization of an expected conditional excess profit, camouflaged as a depreciable intangible asset. Cunning accounting creativity might exploit this vagueness.

yields a production of goods worth 25 million euros, because of the synergies described above. The two assets are therefore complementary, since they enable a total production greater than the sum of the parts. How should one determine the value in use of assets A and B? Is it 10 million euros and 15 million euros or 12.5 million euros? A callow application of the IAS accounting standards would imply that the valuation, according to the principle of fair value, be made following the order in which the assets were acquired. If company C acquires first B and then A, the valuations are 10 million euros and 15 million euros, respectively. If the order is inverted, then B is valued at 15 million euros and A at 10 million euros.

This trivial example shows the difficulty of understanding an enterprise as the sum of the assets held by shareholders. An interpretation of the firm's balance sheet that only takes into account the idea that liabilities 'offset' assets loses sight of the fundamental understanding of the economic activity of the firm as an entity. This understanding is predicated on the idea that a firm is a whole that is difficult to decompose because of numerous complementarities and indivisibilities.

A firm is an entity that mobilizes assets for productive ends in a complex way, and for which, as an entity, accounts can be reported. The notion of value in use as defined by the IASB, in terms of discounting, is difficult to apply to complementary assets. Moreover, economists studying business organization have often underlined the fact that firms are equipped with specific skills that differentiate them (Dosi & Marengo, 2004); however, an essential asset of firms, highly complementary to other assets, does not appear on the asset side. This asset is the organizational capital embedded in the set of routines, tacit knowledge and production techniques incorporated by firms' agents. The conjunction of this organizational capital and of other assets drives the firm's income, yet it is this very conjunction that one is trying to reduce to the assets alone. Taken to extremes, the indecomposable nature of the production process becomes a caricature, of course. The underlying economic problem, which involves the marginal productivities of complementary and indivisible assets, highlights a major logical difficulty in the application and in the foundations of fair value.

Box 7.4 Combinations of Resources and Assets – IAS 38

Accounting questions the process that goes from capital invested in business resources to value creation. This capital is represented in the form of assets (tangible and intangible). Moreover, accounting assesses and represents the firm's revenues as these are generated by the productive entity. Why should one invest without a return? Every expenditure should yield income. In order to verify whether this is the case, financial statements are drawn up periodically.

Take the example of intangible assets (treated by IAS 38). Suppose that some resources capitalized as assets could be disposed of separately (e.g. a patent). If one recognizes the economic and monetary process specific to the firm, this divestment causes the loss of the usefulness of each of the other assets related to those resources and the loss of the conditional competitive advantage, which lies generally at the source of the firm's income (of the firm's revenues). The IASB argumentation neglects completely these aspects (IAS 36, B34). It is also for this reason that the assessment of these assets does not involve the discounting of future cash flows generated from their use, but rather the capitalization and depreciation of the actual corresponding expenditures.

From this perspective, IAS 38 devoted to intangible assets can be criticized, because in the case of intangible resources created internally, it fails to recognize intangible assets, such as research, start-up costs, staff training costs and marketing costs. These items are reported only as expenses in the income statement. In effect, this standard seems to connect the reliability of the measurement to the existence of a market value, rather than to a value in productive use, contrary to the conceptual framework of the IASB, which attributes asset status to every resource whose potential is useful to the firm, whether directly or indirectly.

This difficulty is obviously raised in the presentation of these standards, particularly of IAS 36. There, the recommendation is to define profit centres whose assets are independent,[19] and then to implement a byzantine pro-quota reallocation. It is easy to imagine the underlying difficulties and endless debates involving asset regroupings. Even in the framework of conglomerates with clearly separate activities, management always emphasizes the existence of complex synergies that justify the regroupings by industrial, technical or commercial hidden logics. If the profit centres coincide with the enterprise, the asset valuation problem is analogous to the problem of the financial assessment of business combinations, referring back to the problems of specificity mentioned above.

Should accountants model?

The generality of the problems of specificity and complementarity poses other difficulties for the IASs. In many cases, reference to spot values leads accountants to develop valuation models to estimate the future cash flows generated by each asset or profit centre. According to the injunctions of the IASB, all these models should be based on reasonable hypotheses, which use the best estimates of management. In fact, every modeller knows that small shifts in the parameters can result in accounting estimates differing by several orders of magnitude. It is bizarre to base the accounting valuation of assets, on the one hand, on the ability of firms' managements to forecast the future, and, on the other hand, on their simple good faith in the use of available information.

The construction of models and cash flow forecasts are usually made by a considerable number of competing analysts. There exists a competitive market in valuations, so to speak. Because of informational asymmetries, the value of analysts becomes clear in the long term through reputation building.[20] This comparison of valuations cannot happen without the existence of an autonomous source of accounting information, independent of financial valuations.

In sum, it is difficult to base a valuation principle on a method that appears incapable of determining asset values in a univocal way. Whereas the stated goal of the principle of fair value is to make accounting information more transparent and relevant, this principle harbours at its core a potential indeterminacy that opens the door to arbitrary interpretations. As indicated above, two opposing risks are foreseeable: the emergence of accounting 'bubbles', and the undervaluation of asset specificities, which reduces fair value to the simple realizable value of firms.

Thus, the shift to fair value can reduce neither the subjectivity of valuations nor the possibility of earnings camouflage. The reform may just lead to the modification of the channels used by some firms to dress up their accounting statements. On the other hand, there is a strong likelihood that the reliability of accounts be penalized by this reform, which raises the question of whether it is worth pursuing at all. As some researches point out (Casta & Colasse, 2001; Hoarau, 2003), the appropriateness of changing accounting legislation in order to adapt it to the brand new instruments of financial management is questionable. In fact, accounting valuation and financial valuation appear as two distinct logics and two complementary sources of information. The modification of the asset valuation rule seems indeed purely seasonal.[21] Notwithstanding, the consequences of such a submission may be important in terms of the stability and coherence of the accounting model and often negative economic fall-out.

One must bear in mind that firms are complex entities, which have little, if any, analogy with the financial portfolios of intersubstitutable assets. Firms' assets are simultaneously complementary, specific and indivisible. These three properties subvert the logic of an accounting legislation founded on purely financial principles. In light of this difficulty, accounting at historical cost takes on meaning. Although it may not be a panacea, the principle of valuation at cost seems the least-worst possible solution.

USING CURRENT MARKET PRICES IN FINANCIAL STATEMENTS

Does the use of current market prices yield a better understanding of the on-balance sheet risks of firms? Empirical work on asset valuation documents recurrent financial anomalies, such as excess or persistent volatility and stock market collapses.[22] These empirical observations lead one to turn the argument around and to defend the idea that increased reference to spot market prices risks creating excessive volatility in accounting magnitudes, which might have a multiplier effect on the volatility of asset prices. Based on the whole of the transactions made by the productive entity (Ijiri, 1975; Anthony, 1983), historical cost makes possible an accounting logic that is transparent and independent of market price volatility, an apparent clear advantage.

Are market prices the right benchmark?

Economic research on financial bubbles or irrationalities in stock market quotes pushes one to question the capacity of market prices to reflect the present value of future profits, and this is independent of the problems of specificity presented above. This argument seems to affect historical cost just as much as fair value: asset price variability injects into the initial purchase price an arbitrary component that depends on the acquisition date. It is at the level of the dynamic effects of asset measurement at market price that the dangers of fair value appear.

Thus, accounting and financial history of the last decade shows that a good part of the record losses recorded by firms during the 1990s do not come from the manipulation of accounts by management, but rather from the choice to assess the value of assets held on the basis of their market value. A typical example is office furniture. Its prices saw a steep increase at the end of the 1980s and at the beginning of the 1990s, followed by a steep decrease in the middle of the 1990s. Assessment (by the managements of the firms involved) of the current value of their office inventory at market prices led, after the furniture bubble burst, to a complete cleansing of the balance sheet in the form of massive recognition of depreciation provisions. The same mechanism was at work in the case of the technology bubble at the end of the 1990s. A posteriori, some firms were seen to have paid too much for their acquisitions. Perhaps one could show that, after the bubble burst, valuations were after all fairly close to what would have been expected prior to the bubble. In the meantime, however, the bubble happened. It modified the behaviour of firms and, therefore, changed their overall accounting statements.

This example raises the question of the relevance of asset accounting at fair value rather than at historical cost. Fair value did not provide investors with better information about the risks carried by investments in the 'new economy' or office furniture. At the point when the market turned, it led accountants to recognize the depreciation of asset values in the same way: i.e. by reference to market prices after the bubble. The only difference in this matter stems from the fact that, according to the method of historical cost, the gap between accounting value and market value could at least stimulate questions and perhaps trigger alarm bells.[23] There is thus no ground for arguing that fair value would have performed better than historical cost in allowing investors to anticipate the profound revaluation that followed the crash.

Unless market bubbles are banned, one cannot expect that the incidence of record losses should be reduced by shifting to fair value. In effect, the market is just as responsible for large valuation adjustments as are buyers. Fair value would only serve to transfer the arbitrariness of management valuations over to the market.[24] In this respect, one is forced to defend the principle of reference to the totality of transactions made during a period by the productive entity as a whole, which enables one best to gauge the capacity of an asset to generate income and the associated risk.

This is all the more important when the transition to fair value risks, equally, amplifying upward market movements in growth phases in stock price quotation and downward moves in contraction phases. In effect, full valuation at market prices would force one to take into account in the income statements any potential capital gain linked to continuing rises in asset prices. Firms whose businesses are centred on activities connected to the bubble would thus recognize increases in their net worth far greater and more rapid than those of firms whose activities are unconnected with the bubble. To all the causes explaining the appearance of financial bubbles, fair value risks therefore adding a new one: the pro-cyclical effects connected to all those businesses seeking to profit from market enthusiasms in order to present flattering financial statements. In rising markets, one should keep a very cool head in order not to succumb to the sirens of ever more flattering (seductive?) balance sheets and ever better results. In these circumstances, there is great danger of witnessing an increase in the scale of financial bubbles and accounting adjustments as a result of a change in the valuation rules for accounting items.

Interpreting earnings

The negative consequences associated with altering the asset valuation rule risk being reinforced by the modification of the accounting base induced by shifting to fair value. In effect, the desire to strengthen the informational character of accounting data brings with it the recognition of 'potential' capital

Box 7.5 The Productive Entity and Its Specific Economic Process: Accounting Foundations between Static and Dynamic

The current accounting issues are not new. From the beginning of the 20th century up to the Second World War, great accounting theorists such as E. Schmalenbach (1926; in Germany), G. Zappa (1937; in Italy), A.C. Littleton (1935; in the United States), were aware of the impact of accounting information on investment choices, valuation and representation of the economic activities of the firm.

Struck by the experience of banking crises and the effects of world conflagration by German hyperinflation speculative bubbles and the economic crisis of 1929, they questioned the legalistic soundness of a "static" model resting on a spot market perspective; they developed an innovative accounting perspective, which was later called "dynamic". This dynamic approach based the accounting system on the economic and monetary process implemented in the going concern on which it reports. By its nature, this process must be sustainable, situated and oriented within an uncertain and undetermined horizon.

In this context, and until the present, the spirit of accounting standards lay in the accounting principles of the entity as going concern, matching, and valuation at historical cost. The going concern was thereby clearly distinct from the wealth of its owners and fluctuations of value in the markets, specifically in financial markets.

These ideas fell progressively into oblivion. New journals, new training programmes, new academic fashions launched at the universities of Chicago and Rochester contributed to this neglect, especially in the United States. As Y. Ijiri remarks, critiques of the traditional accounting model became so virulent that "only hardcore traditionalists seem to uphold historical cost" (1975, p. 85). In the United States, the development of accounting theory without principles[25] revived the abstract soundness of a static perspective embracing the financial logic of the "fair value revolution".

Bankruptcies and speculative bubbles remind accountants that the goal of accounting is not only to offer signals for financial decision making but also, and above all, to recognize payment flows in light of conventions, which are binding by reason of their reliability as standards possessing an autonomous logic and designed to mediate conflicts of interest amongst stakeholders.

Thus, the worries of Anthony (1987) are prophetic:[26] without principles, accounting rules resemble "cook books" whose clarity, overall coherence and effectiveness are questionable and always under the threat of heavy failure. Since that time, the efforts of the IASB to create an international accounting system based on common principles have been favourably judged. Many observers recognize the quality of technical work provided by that organization. Nevertheless, must this success imply the intellectual suicide of accountants?

gains as an element of earnings or of other equity (including shareholder equity, retained earnings and/or provisions). In the case of recognition of earnings, changing the asset valuation rule would create a new source of accounting income, not stemming from any monetary flow received by the firm. This constitutes a radical change relative to the principle of historical cost, according to which the published earnings are based above all on the recognition of actual monetary flows.[27]

The IASB appears to be partly aware of the issue, for, even in the secondary method of market value, it does not record the losses and potential profits in a symmetric way, and, in general, it avoids passing the latter through the earnings statement. The recording of as-yet unrealized profits (potential capital gains) can pose a number of problems. One of the most important is linked to the determination of distributable results. It seems difficult to envisage including potential capital appreciations in these gains without risking disadvantaging creditors and damaging the continuity of the productive entity itself.

The distribution of part of these potential capital gains as dividends can turn out to be largely fictive if the asset value, once realization occurs, is very different from that recognized in financial statements. It will modify the accounting logic, which rests in the first instance on the continuity of the business activity and the maintaining of invested capital, guaranteeing the hierarchical protection of creditors requiring debt repayment and those entitled to share residual profits. Equally, it would be more difficult to determine whether earnings were achieved by the valuation method of accounting items or by the accrued performance of the business. The change of rules for earnings determination could therefore alter seriously the capacity to assess earnings and distributable profit. It might provoke conflicts over profit sharing.

Assessing risk

Recent financial scandals are good reminders of the necessity of better information about the risks taken by firms. Asset recognition at historical cost appears incapable, in its current state, of taking into account the financial risks borne by firms, even if these risk exposures may threaten the continuity of their activities.[28] Furthermore, information about these risks is essential not only to shareholders but equally to all stakeholders.

Nevertheless, the inadequacies of historical-cost valuation in dealing with the specificity of this class of financial assets and liabilities do not necessitate the adoption of the conceptual solution proposed by the IASB to remedy the deficiencies. That solution consists in bringing into accounting those products valued using the method of full fair value. It is unsatisfactory, because there is a conceptual difference between accounting for the going concern and accounting for the risks that the going concern bears. In effect, the accounts are drawn up on a given date in order to give a picture of the 'wealth' of the business on that date, whereas the risk profile is often related to possible future variations. One can question, therefore, the relevance of proposing a single set of accounts – the balance sheet – in order to measure the wealth of the business and potential risks of variation. Whether it is inspired by historical cost or fair value, the method of asset valuation does not appear best suited to represent these risks. Other standards and other representations might complete the accounting determination of assets, liabilities and earnings involving the financial statements of firms.

In addition, the solution proposed by the IASB to correct the inadequacies of the existing model creates serious difficulties, particularly in the matter of financial assets, without resolving the problems that already exist. It relies entirely on the spot valuation of assets in isolation (very often at their market values). This solution is the opposite of actual realization of assets and of their role in the economic activity of the entity as a whole. The fall-out associated with such accounting rules is well documented, especially in terms of the volatility of accounting earnings or equity. The more dynamic and systematic aspects of accounting are thereby neglected. The representation of the dangers threatening the continuity of operations and the maintaining of invested capital must be determined at the level of the entity as a whole. Hence, it is appropriate to reflect on the creation of accounting information, supplementing financial statements, and making it possible to divulge such dangers.

ACCOUNTING INFORMATION AND ITS POLITICAL ECONOMY

Management incentives and evaluations

The revision of accounting principles and standards naturally modifies one of the valuation criteria of management teams, and thus their incentives. The behaviour and choices of managers will not perhaps be radically different, but it should be recognized that the new accounting legislation favours certain choices at the margin, the appropriateness of which merits some discussion.

To the extent that the asset side of the balance sheet is used to estimate the wealth possessed by the firm, and where the expenditures that increase this specificity are only counted as expenses, there are grounds for fearing that the long-term global effect may be a reduction of the specificity of entrepreneurial ventures. In effect, an innovative industrial project rests on the tacit complementarity of certain assets. The production function of the firm is indeed specific and its valuation by financial markets remains difficult. It seems that fair value may tend to systematic undervaluation of specificity, which is not the case with historical cost. One consequence is that innovative ventures that are remote from transient fashions risk being undervalued and therefore penalized.

Just as the income statements are modified by the revaluation of assets at fair value, so their economic significance is obscured. In accounting at historical cost, earnings relate to the income generated by the firm as a whole. It is a measure of the performance of firms as wealth creators. In accounting at fair value, this income is modified by capital gains and potential losses in virtue of the short-term evolution of the value of certain assets. Advocates of fair value see no difficulties in this fall-out: managers whose asset selection is good enjoy potential capital gains, while the others must account for their capital losses. The evaluation of a firm's management becomes that of short-term investment management. This appreciation gives too much weight to short-term market prices in the evaluation of management teams, the continuity of the activity and the development of the potential of the productive entity as a whole. The best managers may even be amongst those who did not participate in the frenzy of the new economy, amongst exactly those who, because of fair value, would have had worse accounting results during that period.

A shareholder-based representation of the firm inscribed in the accounts

The introduction of fair value as an accounting valuation method, even secondary, is without doubt part of the affirmation of a shareholder-based vision of the firm. With this valuation principle, financial logic enters accounting with the effect of modifying the valuation of firms and impacting income statements. Fair value tends thus to undervalue the entrepreneurial logic, which is at the heart of the traditional perspective. By contrast, in accounting at historical cost, financial analysis is a distinct discourse that uses accounting data.

It is not self-evident that the dynamic approach of historical cost underpins a model of the firm based on the involvement of all stakeholders and that fair value is the vector of a static model, organized solely for the interest of shareholders. There is no doubt, however, that the logic of fair value, to which the standards of the IASB open the way, would protect shareholders and financial investors, who wish to quantify the risk and return of their portfolios in the most precise manner possible. To put the matter more directly: it is hard to deny that the principle of fair value contributes to increasing the weight of the financial logic in the choices and assessments of management teams.

This text has presented some theoretical reasons that question the soundness of such a development. If the firm exists as a sustainable economic entity, the accounting system that reports on it ought to be grounded in an independent logic and constitute a source of complementary information. This logic justifies the inclusion of accounting as part of the institutional structure and regulation of production. It can thus protect all stakeholders, including shareholders, and facilitate the efficiency of financial markets.

CONCLUSION

- Historical-cost accounting elaborates an economic logic founded on a dynamic vision of the corporate entity as a going concern. This entity should be considered as a whole and the disaggregated valuation of assets should not take account of the evolution of market prices. In this framework, earnings statements make it possible to assess the net revenues that are distributable and effectively created by the firm.
- The reference to fair value introduces a new and hidden valuation method into the recognition of assets. Its logic, which is essentially financial, leads to the maximal disaggregation of firms' assets in order to estimate separately the contribution of each asset to earnings.
- The conclusion of current research does not show that the method of fair value invalidates the method of historical cost. Recent work on asymmetries of information, complementarity and specificity, argues rather for limiting the principle of fair value. In addition, this method poses important problems of valuation specific to the financial economy. The use of a valuation model for accounting purposes casts doubt on the reliability of accounts, most notably because of the variability of results in response to minor changes in the hypotheses.
- In addition to this valuation problem, applying the principle of fair value introduces the risk of incorporating financial volatility into the accounts. If excessive financial volatility exists in financial markets, a phenomenon for which theoretical and empirical evidence can be provided, this generates superfluous risk, which tends to reduce the investment capacity of firms.
- Fair value tends to increase financial criteria in the assessment of management teams by financial markets and, therefore, in their appraisals of business ventures. This increase, which is necessarily to the detriment of other criteria, may not protect the totality of stakeholders, including shareholders and institutional investors, in the best way.
- It is difficult to affirm that the net contribution of fair value to the improvement of accounting standards is positive. In the presence of asymmetries of information, complementarities and specificities, the logic of historical cost may be far from ideal, but it appears the least-worst solution.

In brief summary, our text defends the use of a single accounting principle, historical cost rather than fair value, with the possibility of using other accounting valuations in clearly defined cases and without seeking systematically to increase the use of asset valuation by current prices. To the question 'Does there exist an information source more reliable and relevant than the spot market prices?', we would like to reply that accounting might provide this source of distinct and complementary information if it keeps its autonomous logic in order to help the formation of prices on financial markets and to enable the verification of market valuations.

NOTES

1 The preamble was first published in August 2009, while the rest of the chapter in March 2004. Special thanks go to Jean-Louis Beffa, Robert Boyer, Jean-Gabriel Brin, Arnaldo Canziani, Robert Colson, Philippe Crouzet, Nicole El Karoui, Sylvie Grillet-Brossier, Christian Hoarau, Gérard Liné, Antoine Rebérioux, Shyam Sunder and Jean-Philippe Touffut for critical comments that helped to clarify our arguments. We accept sole responsibility for any possible errors contained in the text.

2 See in particular the Banking Subcommittee on Securities, Insurance, and Investments of the United States Senate, 'International Accounting Standards: Opportunities, Challenges, and Global Convergence Issues', 24 October 2007, http://banking.senate.gov/07_10hrg/102407/archive.ram; Committee on Oversight and Government Reform of the US House of Representatives, 'The Financial Crisis and the Role of Federal Regulators', 23 October 2008, http://oversight.house.gov/story.asp?ID=2256

3 See also Banque de France (2008) and Banca d'Italia (2009).

4 Emergency Economic Stabilization Act of 2008, 3 October 2008, Sec. 132. Authority to suspend mark-to-market accounting:

> (a) AUTHORITY. – The Securities and Exchange Commission shall have the authority under the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934

(15 U.S.C. 78c(a)(47)) to suspend, by rule, regulation, or order, the application of Statement Number 157 of the Financial Accounting Standards Board [concerned with fair value measurements, NdA] for any issuer (as such term is defined in section 3(a)(8) of such Act) or with respect to any class or category of transaction if the Commission determines that is necessary or appropriate in the public interest and is consistent with the protection of investors.

5 Cf. 'Banks Get Leeway in Valuing Their Assets', *The New York Times*, 3 April 2009.

6 On 17 November 2005, the IASB published a paper proposing the adoption of fair value as the primary method of measurement for accounting. During the six months that followed, it received 84 comment letters. According to the IASB report of 2006:

> The majority of respondents are not supportive of the paper's overall proposals regarding the relevance of fair value on initial recognition (63%), although some of these respondents support individual aspects of the proposals, and several respondents have mixed concerns (12%). Only a small minority support the paper's proposals overall (17%).

Among others, negative comments on the paper were received from the accounting regulators of France, Germany, Italy, Russia and Japan, as well as from the professional accounting firms Ernst &Young, Grant Thornton and Mazars.

7 From a legal standpoint, listed companies are forbidden from adopting the IFRS, and must instead adopt the national standards. Consequently, any harmonization or convergence that does take place can only result from negotiations with the respective accounting authorities, and wide divergences still exist, particularly with Chinese, Japanese and Korean standards.

8 A synthesis of the legislation is available on the website of the European Parliament: http://europa.eu.int/scadplus/leg/en/lvb/l26040.htm.

9 For example, it is possible to undervalue the holding losses or, on the contrary, to sell an asset undervalued in the accounts so as to realize an effective gain, thereby increasing earnings.

10 See Cartelier (2004) on this point.

11 In effect, the prudential or precautionary principle recommends that the difference between the acquisition cost and the current value of an asset be recorded when this makes visible a devaluation judged to be lasting. On the other hand, the same principle entails not taking into account the potential profits resulting from a current valuation superior to the purchase value.

12 This is why we have ignored questions relating to the presentation and harmonization of accounting structure and books.

13 An informational asymmetry exists when one individual possesses more information than others concerning a good, a product, a situation or, in the present case, the value of an asset.

14 An acquisition by a business group that guarantees it a significant technological complementarity is in general well received by the markets. Moreover, the waves of mergers and acquisitions can be conceived as dynamic processes aiming at optimal allocation of totalities of assets among firms.

15 The Japanese builder might, for example, acquire its homologue Xayuvi in order to accelerate its technological catch-up at a significantly faster rate than that of its competitors.

16 This specific valorization of the activity of the firm as a whole takes into account in particular a conditional expected excess profit and therefore differs from both the market value and the aggregate of accounting values.

17 Even in this case, one would have to consider the internal financial process. Its particular forms might not satisfy the assumptions of cash liquidity as 'perfect' as external financial markets.

18 Possession of assets here means mastery of their use, which allows effective technology transfer between the two units. This controlling right is by nature indivisible: one cannot buy in the market half of the technology transfer between two firms. The control of assets is exclusive.

19 That is, cash-generating units to which assets belong and which generate cash inflows that are largely independent of those of other units.

20 Orléan (1999) develops a theory according to which market financial valuation is fundamentally unstable and self-referential, because of the imitative behaviour of analysts.

21 Finally, the difficulties for small investors to understand and interpret all these changes will have the effect of either increasing indirect shareholdings (via financial intermediaries) or preventing a correct interpretation of the accounts.

22 See Schiller (1989), for example.

23 With the discretionary choice of lasting depreciation (the usual rule of *lower of cost or market value*), in the framework of the underlying accounting principles, management chooses the benchmark of reference and the moment at which the depreciations are recorded. In the method advocated by the IASB, the reference to the market is obligatory and the adjustment automatic.

24 Moreover, very often the market price of an accounting asset does not exist. Its valuation is then entrusted by the IASB to the prophetic judgement of certified experts.

25 Major accounting theorists disagree on this subject, Y. Ijiri and R.N. Anthony among others. A forceful critique is developed by Kaplan (1983), with reference to Jensen (1983).

26 In this article, as in his major work of 1983, this accounting theorist draws on his experience of several years at the FASB.

27 The income statement does not coincide nevertheless with the cash balance for the period because of depreciations, provisions and other accruals.

28 This is, for example, the case with certain derivative products that mobilize weak financial outflows at the initial commitment, although they create a far greater financial risk.

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PART 3

Boards and Directors: Leadership and Accountability

8

Boards and Board Effectiveness

Hans van Ees and Gerwin van der Laan

INTRODUCTION

Boards are all around in both profit and not-for-profit organizations. Hence, questions that pertain to how, why and to what extent boards are effective are relevant and legitimate in the corporate and public arena. But before addressing them, we may think of what the possible effects of boards may be. For instance, do boards create, distribute or destroy value or performance of corporations in terms of profits, market value or contribution to society? Do boards affect the behavior of corporate actors, e.g. top managers, and/or the objectives and strategies of organizations? Case-based evidence suggests that boards are actually more effective in destroying value rather than in creating it. To put it mildly, the history of corporate scandals such as Enron, World.com, Parmalat, Ahold, and Mannesmann illustrates that corporate boards have not always been successful in preventing scandals. In addition, the recent financial crisis illustrated that boards in the financial services sector have not been fulfilling the roles the investor community expected. Kirkpatrick states that, '[T]he financial crisis can, to an important extent, be attributed to failures and weaknesses in corporate governance arrangements. When they were put to a test, corporate governance routines did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies' (Kirkpatrick, 2009, p. 22). Obviously, case-based evidence of value destruction cannot easily be generalized to conclusions about the perverse effects of board behavior; nevertheless, it underscores the relevance of the aforementioned questions as such.

The academic literature on boards has primarily focused on identifying positive effects of boards. The theoretical prerogative is that effective boards contribute unambiguously to corporate performance and value creation, e.g. by improving the efficiency of corporate decision making or the investor appreciation of the firm in the equity market. In this chapter, we survey the literature on boards from the perspective of board effectiveness. We start from the question where to expect the possible effects of boards. Indeed, the current literature can be nicely structured along the possible lines of effect. ‘Mainstream’ research on board effectiveness in the economics and finance tradition directly relates board structural attributes, such as board size and board composition, to corporate performance. It has been emphasized that this research has produced ambiguous results (e.g. Dalton, Daily, Johnson & Ellstrand, 1998, 1999; Bhagat & Black, 1999; Daily, Dalton & Cannella, 2003; Hermalin & Weisbach, 2003) and that such studies ignore more complex relationships and processes that take place within boards, or the effects boards may have on the behavior and performance of other corporate actors. Part of the ambiguity may thus be due to the complexity of board behavior. While the mainstream perspective has almost exclusively sought to understand the virtues of the monitoring role of the board, in the organization literature it is emphasized that boards do generally fulfill other (interdependent) roles as well (Zahra & Pearce, 1989). Management research on boards has been increasingly dealing with the ambiguous relationship between board structural attributes and board – and eventually firm – performance through the analysis of actual board behavior and relationships (e.g. Pettigrew, 1992; Forbes & Milliken, 1999; Hillman & Dalziel, 2003; Huse, 2009). On the one hand, a large sociological literature has taken a more relational perspective on the study of indicators of board effectiveness (e.g. Hallock, 1997; Westphal, 1998; Westphal & Zajac, 1998; Hillman, 2005). On the other hand, the behavioral perspective on board effectiveness has been focusing on what directors do and the (cognitive) drivers behind this behavior (see, e.g., McNulty & Pettigrew, 1999; Stiles & Taylor, 2001; Finkelstein & Mooney, 2003; Huse, 2005).

Together, the three research perspectives provide a comprehensive image of the current state of research on board effectiveness. Table 8.1, inspired by Hambrick, Werder & Zajac (2008, see also Zajac & Westphal 1998), provides an overview of the three research perspectives that provide the building blocks for this survey.

In Table 8.1, column 1, ‘Structures’ refer to formal organizational characteristics. In column 2, ‘Interactions’ are the informal relationships among actors involved in influencing the direction and future of corporations. In column 3, ‘Decisions’ refer to the making and shaping of strategic (control) decisions and the processes through which these decisions evolve. In Table 8.1, the second and the third rows characterize the focus on the internal or external board relationships.

Table 8.1 The three research perspectives

	Structures	*Interactions*	*Decisions*
Internal relationships	I. ECONOMICS Optimal incentive and control – Incentive conflicts and alignment – Size, composition, diversity and competence	III. SOCIOLOGY Collaboration and conflict – Political bargain – Power and trust	V. SOCIAL PSYCHOLOGY ORGANIZATIONAL BEHAVIOUR Cognition and commitment – Decision-making biases – Cohesiveness – Conflicts and emotions – Creativity and criticality
External relationships	II. LEGAL Law, codes contracts and regulation	IV. SOCIOLOGY Coordination and cooptation – Social networks and director interlocks – Social elites and social movements	VI. Conformation and ceremony – Institutional embeddedness – Norms – Symbols, language and rhetoric

'Internal relationships' refer to relationships between the board (members) and (coalitions of) internal actors, as well as the relationships among (coalitions of) board members. 'External relationships' refer to relationships between the board (members) and the corporate and institutional environment.

STRUCTURES

Principal–agent theory developed as a response to the key problems of asymmetric information between external actors, notably shareholders , and internal actors, i.e. managers, of the public corporation. Asymmetric information creates problems of moral hazard: first, because of the separation of ownership and control (Fama & Jensen, 1983); second, the perspective that self-serving managers maximize private benefits; and third, the incentive of minority shareholders to free-ride on the monitoring activities of other shareholders (Jensen & Meckling, 1976). Internal governance and incentive mechanisms may mitigate principal–agent problems. Management compensation structures align the interests of the managers and shareholders, *ex ante*, and shareholders are better off delegating their monitoring role to an independent board of directors that ratifies management decisions and monitors implementation, *ex post*.

In the principal–agent perspective, board effectiveness is captured by the reduction in agency costs. Whereas it is difficult to find direct measurable indicators, it is assumed that the effective behavior of the board will ultimately reveal itself in superior performance of the corporation. Consequently, many studies on boards of directors directly estimate reduced-form relationships between board attributes, such as size and composition, and accounting or market-based measures of corporate performance, controlling for a number of industry- and firm-specific variables. The literature on board effectiveness is huge (e.g. Yermack, 1996; Morck, Shleifer & Vishny, 1988; Core, Holthausen & Larcker, 1999; Gompers, Ishii & Metrick, 2003; Larcker, Richardson & Tuna, 2005). For instance, Adams, Hermalin & Weisbach (2010) in their survey, estimate that more than 200 working papers on boards were written in the five years since the publication of the 2003 survey of Hermalin and Weisbach (2003). The following three structural characteristics stand out in the research on board effectiveness, board size, board composition, and chief executive officer (CEO) duality.

First, regarding the effective size of the board, a large board may have more problem-solving capabilities. However, as board size increases, coordination problems may dominate the positive effects of a larger pool of expertise. In a first example of this line of research, Yermack (1996) finds support for a negative relationship between firm performance and board size of US firms. More recently, Coles et al. (2008) provide evidence that heterogeneity moderates the size–performance relationship. Their finding is that for highly leveraged or diversified firms, corporate performance is increasing in board size. Zahra and Pearce (1989) argue for a non-linear relationship; after some threshold, board size may have a negative effect on company performance.

Second, from the perspective of solving the agency problem, appointing non-executive outsiders to the board is optimal, since the lower is the disutility of monitoring, the more effective the board will be. Independent directors are more effective in their task because they are more willing to scrutinize senior management objectively and limit managerial discretion (Fama & Jensen, 1983; Dalton, Daily, Johnson & Ellstrand, 2007; McDonald, Westphal & Graebner, 2008). Consequently, a large number of studies test the value-relevance of board independence, but, despite the popularity of the independence requirement in governance practice, the support for the positive relationship between firm performance and board independence is (again) mixed. Early evidence of a positive effect of independent directors on the board is found by, for example, Rosenstein and Wyatt (1990) and Bayesinger & Butler (1985); however, Hermalin & Weisbach (1991), Bhagat & Black (1999), and Dalton et al. (1998) do not find a robust relationship, as indicated by Hermalin and Weisbach (2003) and Adams et al. (2010) in their surveys. There are several arguments that disqualify the importance of board independence. First, Byrd and Hickman (1992) argue that powerful CEOs may favor appointing independent directors only to create the impression of vigorous monitoring. Second, the effectiveness of independent directors is limited by their lack of information compared to senior management. Due to the lack of firm-specific and/or industry-specific knowledge, independent boards will always be dependent on top management (Lorsch & MacIver, 1989; Dalton et al., 2007). Moreover, Adams and Ferreira (2007) show that a more dependent manager-friendly board can be more effective. This is because CEOs may be reluctant to share information with more hostile boards, thus diminishing board effectiveness. While recognizing the advantage of objective judgment, the literature acknowledges that distance from the organization may imply that independent directors may lack sufficient information and understanding of the organization (e.g. McNulty & Pettigrew, 1999; Stiles & Taylor, 2001; Kroll, Walters & Wright, 2008; Zattoni & Cuomo, 2010).

Third and finally, it is argued that board effectiveness is affected by CEO duality. Particularly in the USA, the CEO is also the chairperson of the board, as Adams et al. (2010) report. Elsewhere, for instance in the UK, CEO duality is not that widespread and in the two-tier systems of, for example, continental Europe, CEO duality does not exist. CEO duality increases CEO control over the board. The implications for corporate performance are nevertheless ambiguous. In addition, it is possible that excellent corporate performance increases CEO power and, hence, the likelihood of CEO duality (e.g. Brickley, Coles & Jarrell, 1997; Goyal & Park, 2002).

Related to the work on board structural attributes is research on formal board structures. For instance, in research on staggered boards a negative effect on the financial market performance is reported (e.g. Bebchuk & Cohen, 2005). Similarly, Gillette, Noe and Rebello (2008) find support for inefficient conservativeness in two-tier board structures, an argument that goes back to Sah and Stiglitz's work (1986, 1991) on the implications of hierarchical decision-making structures. Steep hierarchies are more prone to risk-averse decision making (i.e. minimize the probability of ratifying projects that should not be ratified), whereas flat hierarchies may be subject to increased risk taking (i.e. minimize the probability of incorrectly rejecting profitable projects). In this respect, steep hierarchies in a board context reflect the two-tier structure, one-tier structures represent more democratic decision making.

The second entry in Table 8.1 (II) concerns the formal relationships of the corporation vis-à-vis its external environment and stakeholders. A well-structured corporate governance system may create the conditions for good governance; it does not guarantee the first-best outcomes for investors and governance gatekeepers (Coffee, 2002). Actual board behavior may not always be in line with institutionalized ideas on 'good' corporate governance, for example, with respect to the extent of independence of board members or executive pay (e.g. Langevoort, 2001; Bebchuk & Fried, 2003; Hooghiemstra & Van Manen, 2004). Finally, conformance to external regulatory pressure can be effective in terms of value creation. Evidence suggests that the compliance to a corporate governance code is positively valued by investors (e.g. Alves & Mendes, 2004; Goncharov, Werner & Zimmermann, 2006).

INTERACTIONS

The reduced-form relationship between board attributes and corporate performance is an approximation of the reality in which board members take decisions, form expectations, interact with each other and undertake activities that may or may not have a favorable impact on corporate performance. The ambiguity in the reduced-form estimates may thus be created by the complexities of the underlying processes and behaviors. Particularly, in the management literature on corporate governance, board behavior is described in more detail in terms of generic roles; next to the monitoring or control role, there are the resource, service and strategy roles (Zahra & Pearce, 1989). In contrast to the economics and finance literature, the sociological and management literatures emphasize that boards play a role in strategy and provide critical resources and links to other organizations (see, e.g., Finkelstein et al., 2009). Board effectiveness in strategic decision making may also follow from informal interactions within the board or from interactions originating from the institutional and social environment. For instance, interlocking directorates establish strategic links to the external environment and secure critical resources, including prestige and legitimacy.

This research perspective thus focuses on the interactions between board members and actors outside the organization. Studies in the third entry (III) of Table 8.1 have been concerned with conditions for collaboration and conflict between boards and internal stakeholders, with a focus on how issues like CEO duality, CEO tenure and experience, social ties, demographic similarity and timing of directors' appointment affect power and politics in the organization (e.g. Westphal & Zajac, 1995; Zajac & Westphal, 1996). The power and trust characteristics of CEO–board relationships have, for example, been considered by stewardship theory and social exchange theory (e.g. Donaldson & Davis, 1991; Davis, Schoorman & Donaldson, 1997). Note that although these theoretical perspectives may have completely opposite behavioral assumptions when compared to agency theory, they are often considered as complementary rather than competing perspectives for understanding conditions for effective board governance (e.g. Sundaramurthy & Lewis, 2003). In addition, researchers have developed behavioral theories on, for example, executive succession, director's effectiveness in curbing the growth of executive compensation and the bargaining for different goals at the top of the firm (e.g. Westphal, 1998; Westphal & Zajac, 1998). Director relationships and interlocks can consequently, from this perspective, be expected to encourage imitation not only through conscious choice but also by triggering the adoption of taken-for-granted board behavior through less explicit socialization processes (Westphal, Schoroman & Stewart, 2001).

Studies that have addressed the interactions between board members and actors in and around the organization have contributed considerably to a wider scope of research into the characteristics and implications of board relationships. However, empirically, the fundamental change is that the 'usual suspects' (Finkelstein and Mooney, 2003), i.e. the board attributes, are assigned a new interpretation. The aforementioned studies have a more sociological flavor, although scientific boundaries are blurry, here. Organizations operate in interdependent organizational fields (Giddens, 1979), in which actors interact with other actors such as suppliers, distributors and investors. The starting point is that maintaining ongoing relationships is value-enhancing by itself. Conceptually, this is rather different from the arms-length bargain of the structural approach discussed in the previous section, where actors maximize utility independent of other actors.

Pfeffer and Salancik (1978) already suggested that boards of directors may manage the environment by appointing, on the board, representatives of organizations on which the focal firm depends. Indeed, '[t]hrough providing at least the appearance of participating in organizational decisions, cooptation tends to increase support for the organization by those coopted' (Pfeffer & Salancik, 1978, pp. 162–163). Cooptation results in linkages among organizations, which lead to various pressures inside the organizational field

(DiMaggio & Powell, 1983): linkages, first, are a means of imposing one's will on another organization through coercion. Through this perspective, entry IV in Table 8.1, board appointments and social network ties are seen as embedded in the broader institutional environment. This enables board members to increase effectiveness by learning about existing norms of appropriate beliefs and behavior (e.g. Judge & Zeithaml, 1992; Westphal et al., 2001). For example, the Dutch government appointed directors on boards of banks who received state aid during the recent financial crisis. These directors were instructed to curb executive bonuses. Also, coercion has been identified as instrumental for, e.g., the diffusion of organizational structures (Palmer, Jennings & Zhou, 1993) and shareholder value orientation (Fiss & Zajac, 2004). Second, uncertainty as to what is best practice might result in mimicry of organizations that are perceived to be successful (see also Shipilov, Greve & Rowley, 2010). For example, corporate compliance with good governance codes has been related to linkages with other compliant corporations (Van der Laan, 2009): apparently, boards look upon other corporations when determining which best practices to adopt. Finally, pressure may emanate from professional organizations, such as elite training institutions, that impose their norms on organizations through directorships.

Next to the analysis of interlocking directorates (Pennings, 1980; Hallock, 1997), the attention has also been on the representation of groups who allegedly have specific expertise. Studies have analyzed the consequences of, for example, bankers (Byrd & Mizruchi, 2005), venture capitalists (Baker & Gompers, 2003) and (former) politicians (Hillman, 2005; Lester, Hillman, Zardkoohi & Cannella, 2008) on the board. The key dependent variable in these and other papers remains corporate financial performance, however, and evidence on the extent to which linkages relate to board effectiveness – survival and support – is scarce. Even in the management literature on the involvement of boards in strategy, the use of agency theory dominates (Gabrielsson & Huse, 2004; Pugliese, Bezemer, Zattoni et al., 2009), which is problematic because of conflicting assumptions underlying the effectiveness criteria, as we have outlined above. A mismatch between the starting point of the theoretical lens these studies take and the selection of the dependent variable appears present in the literature to date.

BEHAVIOR AND PROCESS

The third stream of research, as represented by the third column in Table 8.1, and which may be called behavioral or social–psychological, focuses on boards of directors as strategic decision-making groups. While, similarly to the interactions literature, boards of directors are also viewed as groups that mediate between various actors who have a stake in the corporation, it is distinctive in that it focuses on cognitive and behavioral processes inside the decision-making group (entry V) and between this group and stakeholders (entry VI). Effectiveness, loosely speaking, then refers to the extent to which decision making is smooth. Or, more formally, 'the purpose of the board is to enable cooperation (…) by engaging in collective processes of organized information and knowledge gathering' (Van Ees, Gabrielsson & Huse, 2009, p. 308). These collective processes are, on the one hand, challenged by biases in group processes, which, on the other hand, are exacerbated by specific characteristics of boards as decision makers (Forbes & Milliken, 1999): boards meet only episodically and are composed of high-status experts.

Biases in decision making result from the incapability of individual board members to process all potentially salient information. As Finkelstein, Hambrick and Cannella (2009) indicate, board members are, first, likely to scan a limited area of the environment only, leading to a restricted field of vision. Cyert and March (1963) already indicated, for instance, that scanning is initiated only after problems are perceived, a finding which has frequently been replicated in the performance feedback literature (Greve, 2003). Also, it has been found that often board members rely on information provided by the CEO and do not seek corroborating or conflicting information themselves (Lorsch & MacIver, 1989). Second, a bias is introduced because of limited perception. Board members are not only likely to look into information on some topics, but they are likely to focus on some pieces of information more than on others. A board member with a background in finance is, for example, more likely to attend to financial risks of a strategic option than a board member with a background in engineering. Finally, board members are likely to interpret what they perceive differently, based on their respective backgrounds. This implies that each individual board member construes a reality based on selection, perception and interpretation of environmental cues.

The biases at the level of the individual director are exacerbated by board-level behavioral processes. For example, minority directors – such as women or foreign directors – have been found to have a larger influence when they have social connections with majority directors (Westphal & Milton, 2000). Apparently, by itself, the information minority directors bring to the boardroom is weighed less than the opinion of majority directors. Also, when directors feel that their opinion on a specific strategic direction will not be shared by a substantial number of fellow board members, they are not likely to bring it to the fore (Westphal & Bednar, 2005). Finally, directors who do assume positions that deviate from the social norms in the corporate elite are likely to experience social distancing, in that they will not be considered in future decision making (Westphal & Khanna, 2003).

Another relatively coherent body of research focuses on the Forbes and Milliken (1999) model and aims to empirically assert its value. The papers contained in Huse (2009), for example, test relationships among processes such as conflict, trust, effort and commitment and relate to board engagement in monitoring, strategy and advice tasks. Contrary to the studies by Westphal and colleagues, these studies focus mostly on European contexts. In addition, the ambiguity of empirical findings on board effectiveness has prompted recent research that recognizes that board task performance reflects individual-level director engagement (Hambrick, Werder & Zajac, 2008; Hillman, Nicholson & Shropshire, 2008). This recent literature starts from the notion that the perspective of the board of directors solely as a monolithic entity has to be abandoned and more attention to analysis at the individual director level is warranted. For a first empirical application, see Veltrop, Molleman and Hooghiemstra (2011).

Finally, the external perspective in entry (VI), focuses on the field of rhetoric and impression management (e.g. Westphal & Zajac, 1998; Pye, 2002). This perspective studies the use of practices of symbolic management as an instrument to connect the decisions and behavior of the organization to the expectations, rules and norms in the business environment. In that way, they take into account the special order and formal behavior demanded by custom. Boards may, in this respect, be subject to processes of social construction where the adoption of practices is effective to the extent that it fulfills symbolic rather than efficiency requirements (Westphal et al., 2001).

SOME REFLECTIONS ON BOARD EFFECTIVENESS RESEARCH

This chapter has provided a sketch of the extant literature on board effectiveness. To capture similarities and differences, the literature has been structured along three different approaches that loosely reflect the dividing lines between academic disciplines: i.e. economics and law, sociology and social psychology. Excellent reviews (e.g. Daily et al., 2003; Finkelstein et al., 2009; Adams et al., 2010) have been written and the current chapter does neither reflect the ambition nor the potential to add to those contributions in completeness and authority. In this concluding section, we would like to point towards some salient aspects of the three streams of research that may provide scope for future research.

In the *first place*, it has been concluded that the ambiguity that characterizes the structural perspective on the board demography–effectiveness nexus has given rise to a more fundamental acknowledgement of the complexity of the board–performance nexus in research on boards. With the special issue on corporate governance in the *Academy of Management Review* (Daily et al., 2003) came a call to integrate the different approaches to boards. However, rather than integrating perspectives, the notion that research provides complementary perspectives on boards and boards' effectiveness, and that neither one of them can independently provide a full explanation, seems to have gained common ground (e.g., Hung, 1998; Lynall, Golden & Hillman, 2003; Hillman & Dalziel, 2003; Huse, 2005). A growing consensus concerning theoretical pluralism has emerged, and researchers can choose from a large number of relatively accepted theories, depending on the aim and scope of their research. Where integration has been aimed for explicitly, the focus has been on combining structure and interaction theories: i.e. combining agency theory with, particularly, resource dependence theory (cf. Pugliese et al., 2009). The primary rationale for combining these theories appears to be practice- and not theory-driven: i.e. the observation that directors in practice have to cope with multiple roles and identities that focus on monitoring, strategic advice and network activities (see, e.g., Hillman & Dalziel, 2003).

When considering multidisciplinarity in corporate governance, the impression emerges that, despite a few scattered attempts, the firewalls between the different approaches are solid and firm. The field of corporate governance in general, and the field of boards and governance, in particular, is characterized by a piecemeal approach. Theoretical pluralism has offered many degrees of freedom for the development of relationships and the choice of dependent and independent variables. Depending on the type of research, effectiveness has been defined in large variety without taking into account interdependencies that may exist. As a result, behavioral theories tend to ignore the implications for corporate performance, just as structural approaches tend to ignore the relevance of processes. Independence of directors from management is considered an important condition for effective monitoring by boards, thus serving the effectiveness criterion in the structures literature. Diametrically opposed to this, however, is the notion that intimate knowledge of the business is relevant for contributing to the strategic course of the corporation, thus serving the effectiveness criterion in the interactions literature. As independence is likely to generate psychological distance between directors and managers, the question arises as to how directors can simultaneously be a stimulating advisor and a vigorous monitor of management (e.g. Van der Laan, 2009). Some studies have assessed whether specific samples of boards are either collaborative or controlling (Westphal, 1999), without indicating how the fundamental conflict in assumptions of the approaches can be reconciled. The absence of coherent theory development shows itself in an overly empirically driven research approach without fundamental consideration of underlying logic and theoretical foundation. Considerable progress is possible in the development of theory in corporate governance and board research.

In the *second place*, the assumption regarding human nature in agency theory may be at odds with real-world observations. Human beings are assumed to be fully rational and capable, self-interested agents. Both assumptions regarding full rationality and self-interest only can be challenged (Simon, 1955;

Etzioni, 1988). Consequently, the assumption that all deviations from goals are due to misappropriation requires qualification and is an interesting direction for future research (Hendry, 2005). How to incorporate incomplete understanding, bounded rationality and partially self-interested behavior into the literature of corporate governance remains a challenge.

In the *third place*, particularly in the structures approach, the heterogeneity of corporations has been emphasized. The fundamental idea that good or optimal corporate governance structures may be fundamentally dependent on alternative firm characteristics is not widespread, certainly not in the interactions and process approach. Many board 'recipes' for effectiveness, e.g. the diversity and independence characteristics of boards, are presented as if they can be applied uniformly across different types of firms. In particular, Adams et al. (2010) argue that considerable progress in board research is possible in case the fundamental heterogeneity of firms is taken into account. *Mutatis mutandis*, a similar observation, holds for the incorporation of the heterogeneity of business systems and institutional order. Principal–agent theory is developed upon the institutional characteristics of a liberal market system, characterized by dispersed ownership, common law and respect for individual achievement and autonomy. It stands to question to what extent the agency perspective continues to hold in other institutional settings and to what extent modification is required. In this respect, a minor adjustment would be the development of a contingent agency theory; a more radical approach would be the development of a fundamental institutional theory perspective. Note that agency theory in this respect is to be regarded as an example, a neglect of fundamental contingencies, and heterogeneity is characteristic for all perspectives on boards.

In the *fourth place*, Larcker et al. (2005), for example, argue that the complementarity of corporate governance characteristics has to be taken into account more fundamentally. Similar, to the fundamental interdependence between corporate governance structures at national and corporate levels, it can be argued that board characteristics are complementary and interdependent when it comes to evaluating board effectiveness.

In the *fifth place*, with respect to the empirical modeling, it can be observed that board characteristics are endogenous and the result of strategic choices (Hermalin & Weisbach, 2003; Adams et al., 2010). These choices can be motivated by corporate performance, instead of the other way around. As a result, many theoretical propositions relating the attributes to the effectiveness of the board cannot be underpinned by convincing empirical board research.

In the *sixth place*, research on boards and board effectiveness has generally taken boards as monolithic entities. Only recently, has attention been directed toward individual board members and the fact that they are individual directors operating in a team (Hambrick et al., 2008; Hillman et al., 2008). However, the fact that boards are teams implies that the variation in board member effectiveness can be related to variation between boards of different organizations as well as variation between board members. To incorporate this structure into the analysis of board (member) effectiveness requires the application of multilevel methods of data analysis in the research on boards.

To conclude, a growing consensus is emerging that the evidence concerning direct relationships between board attributes and corporate performance is scant, ambiguous and not conclusive (e.g. Dalton et al., 1998, 1999; Bhagat & Black, 1999; Hermalin & Weisbach, 2003; Adams et al., 2010). This suggests that the influence of boards on firm performance is more complex and indirect than often is presumed. Daily et al. (2003, p. 375) therefore conclude that '[t]hese results suggest that alternative theories and models are needed to effectively uncover the promise and potential of corporate governance.' However, in our view, next to improving upon each individual research stream, integrating various theoretical approaches is only possible when the assumptions underlying the theories fit.

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Between the Letter and the Spirit: Defensive and Extensive Modes of Compliance with the UK Code of Corporate Governance

John Roberts[1]

INTRODUCTION

The UK Code of Corporate Governance was first issued as a *Code of Best Practice* in 1992 following the report of the Cadbury Committee into the Financial Aspects of Corporate Governance (Cadbury, 1992). The focus of this chapter is on the nature and form of director and board compliance with the Code. The Cadbury Committee suggested that this should take the form of 'comply or explain', recommending that listed companies 'state in the report and accounts whether they comply with the Code and identify and give reasons for any areas of non-compliance' (1992: p. 17). This was subsequently given force when it was adopted as a listing requirement by the London Stock Exchange. The Cadbury Committee located responsibility for putting the Code into practice with boards of directors, and here the opportunity to explain rather than comply offered companies some flexibility. However, it then looked to institutional shareholders to use their 'influence as owners to ensure that the companies in which they have invested comply with the Code' (1992: p. 52).

If understood as 'compliance with the Code', compliance is a straightforward and binary matter. In the chapter that follows, however, I explore a more complex and less easily observed aspect of compliance – the *manner* in which the Code is taken up and enacted by directors within particular boards. The chapter explores the ways in which high levels of formal compliance with the

UK Code not only mask important and consequential differences in the actual conduct and effectiveness of different boards but also, by encouraging directors to conflate effectiveness with formal compliance, in some instances can actually undermine board effectiveness.

In the UK the potential for a gap between reassuring formal compliance with the Code and actual board effectiveness has been brought into sharp relief by the financial crisis and associated bank failures. In 2009, Sir David Walker was asked by the UK government to conduct a review of corporate governance in UK banks and other financial industry entities. In his subsequent work, Walker set out to discover 'how the boards of entities that best survived the storm were different or 'better' than the boards of entities that were effectively taken over by the state or lost their identity through forced merger' (2009: p. 24). One might have expected that differences in the actual effectiveness of different boards would be reflected in different levels of reported compliance with the UK Code. In reality, however, reported compliance was uniformly high for all institutions, and instead, in his research, Walker had to go beyond formal compliance to explore the 'behaviour and culture' that characterised less effective boards. Amongst the issues described in his subsequent report, Walker notes the short-term focus and objectives of many shareholders and boards, the dangers associated with dominant and possibly arrogant chief executives officers, as well as the failure of non-executive directors to challenge executives 'on substantive issues as distinct from a conventional box ticking focus on process' (2009: p. 50).

In previous reviews of governance failures (Higgs, 2003), the regulatory response has been to seek to strengthen the Code through more fully specifying the work of the board. What was originally a two-page document now runs to some 30 pages of 'principles' and 'provisions', with associated guidance on internal control, audit, remuneration, director's liability and disclosure. In framing his recommendations, however, Walker suggests that adding yet further detail to an already extensive Code might 'risk attracting box-ticking conformity as a distraction from, and alternative to, much more important (though often much more difficult) substantive behavioural change' (2009: p. 26). His intriguing suggestion here is that, in less effective boards, directors, concerns to be *seen* to conform may have either distracted them from, or been taken as, an alternative to a focus on effective conduct.

In parallel with the Walker Review, the Financial Reporting Council (FRC) conducted its own review of the operation of the Code and has subsequently published a revised UK Code of Corporate Governance (FRC, 2010) as this applies to all listed companies. The preface to the revised Code echoes the Walker Review in arguing that good corporate governance 'ultimately depends upon behaviour not process' and acknowledges explicitly that the Code 'cannot guarantee effective board behaviour because the range of situations in which it is applicable is much too great to attempt to mandate behaviour more specifically than it does' (FRC, 2010). Formal compliance with the Code principles and provisions related to board composition and process at best serve to condition rather than determine effective behaviour, even if investors have no alternative but to treat such reported compliance as if it were a reliable proxy for actual effectiveness (Roberts, McNulty & Stiles, 2005). Of necessity the Code has to specify what can be observed and verified from a distance as the basis of its principle of 'comply or explain' (Seidl, 2007). The implication, however, is that there will always be the potential for a disjunction between the reassurance created by a board's formal compliance with the Code and its actual effectiveness, which depends upon the behaviour of individual directors and how this shapes the culture of the board as a group.

In exploring these invisible aspects of compliance, this chapter has a number of objectives. First, it seeks to highlight the gap between 'formal compliance' and the 'behaviour and culture' upon which actual effectiveness depends, a gap that has been observed but little explored in the governance literature. Secondly, it suggests that there are some observable patterns in how this gap is mediated by a board, and develops a distinction between what are characterised as defensive and extensive modes of compliance. Here, drawing upon recent empirical interview research with UK directors, the chapter explores the very different enactments of a board's control and strategic role that arise as a consequence of the relative weight directors attach to 'external legitimacy' and internal 'efficiency'. Finally, the chapter explores some of the implications of the gap between formal compliance and board behaviour and culture both for corporate governance research and the future development of the Code.

FROM VISIBLE COMPLIANCE TO INVISIBLE BOARD BEHAVIOUR AND CULTURE

Formal compliance

The worldwide proliferation of corporate governance codes as a mode of regulation over the past 20 years has been truly remarkable. In a recent review of this phenomena, Aguilera and Cuervo-Cazurra (2009) find that, following the issuance of the first code in the United States in 1978, followed by Hong Kong in 1989, and most significantly the UK in 1992, by 2008 some 64 countries had issued corporate governance codes. They also observe a comparable proliferation of codes of governance issued by trans-national institutions such as the Organisation for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF). The most obvious and direct way in which compliance has been studied has been through a number of in-country studies looking at the nature and degree of company compliance (or explanation) with specific Code principles and provisions. Werder, Talaulicar and Kolat (2005) have explored the patterns of company compliance in response to the more recent German Cromme Code. There have also been a number of UK studies tracking Code compliance since 1992 (Conyon, 1994; Conyon and Mallin, 1997; Weir & Laing, 2000; Sanderson, Seidl, Krieger & Roberts, 2010). All find high levels of reported compliance with the Code. While such studies help us to understand levels of formal compliance, as discussed above, reported compliance (or explanation) tells us little of how the Code shapes or conditions actual board behaviour and culture.

What directors should do – normative theories of a board's role

For most corporate governance research and researchers, the solution here has been to embrace a normative view of what *should* happen in boards. In this way, the invisibility of actual board conduct and culture has given theory a peculiar power over the imagination of governance practitioners and researchers. Dominant in this respect have been the assumptions of agency theory. In line with neo-classical economics, this starts from the assumption of the self-interested and opportunistic nature of the 'individual'. When applied to corporate governance it points to the potential for executives as agents to pursue their own interests rather than those of shareholders/principals (Jensen & Meckling, 1976). A number of market remedies may serve to discipline against such opportunism: the market for corporate control and the executive labour market (Fama, 1980). But it also suggests the important role of the board, and, in particular, of 'independent' non-executive directors in monitoring executive agents, and in designing incentive pay structures to align the interests of executives with those of the shareholders (Jensen & Murphy, 1990; Walsh & Seward, 1990).

Arguably these normative views of the role of independent directors within boards were influential in shaping the original UK Code and its focus on the 'control function' of the non-executive director. Agency theory has also informed numerous academic studies of corporate governance which have sought to test the relationship between governance mechanisms and firm financial performance (for a review, see Hermalin & Weisbach, 2003). However, subsequent meta-analyses of these studies have cast doubt on the adequacy of agency theory informed prescriptions for corporate governance. In their 1998 meta-analysis of 54 studies of board composition – the presence of outside/independent directors – and 31 studies of leadership structure – CEO/Chair duality or separation – Dalton, Daily, Ellstrand & Johnson found 'no evidence of a substantial relationship' (1998: p. 282). A meta-analysis of pay studies found that firm size accounted for eight times more variance than firm performance as a determinant of CEO pay (Tosi, Werner, Katz & Gomez-Meija, 2000). A subsequent meta-analysis of studies of the relationship between equity holdings and firm performance was also argued not 'to support agency theory's proposed relationship between ownership and firm performance' (Dalton, Certo and Roengpitya, 2003: p. 20).

Daily et al. suggest two possible explanations for these results:

> First, too much emphasis may have been placed on directors' oversight role, to the exclusion of alternative roles. Second, there may be intervening processes that arise between board independence and firm financial performance (2003: p. 375).

One important alternative theorisation of the *executive* director role has been stewardship theory, which argues that agency assumptions about director motivation may not be applicable to all individuals and contexts. Instead, it points to the potential, particularly in high-trust/high-involvement cultures, for executives to be motivated by 'higher order needs' and by a close 'identification' with the success of the organisation (Davis, Schoorman & Donaldson, 1997). A prominent alternative theorisation of *non-executive* director roles has been 'resource dependence theory' (Pfeffer & Salancik, 1978). This explores the 'service' role of outside directors: externally, as sources of resources and legitimacy for a firm; internally, as a source of advice and counsel for executives in relation to strategy (Johnson, Daily & Ellstrand, 1996; Zahra & Pearce, 1989).

Whereas agency and resource dependence theories of the role of the board and outside directors are each plausible and coherent within their own terms, there are clear tensions between their respective focus on control and service. As Hillman and Dalziel put it in their own attempt to integrate the two perspectives: 'Agency scholars have opposed dependent boards because of their disincentive to monitor, but we suggest that, while potentially harmful for monitoring, board dependence may be beneficial for the provision of resources' (2003: p. 392) (see also Westphal, 1999; Andersen & Reeb, 2004). This suggests that agency and resource prescriptions for the non-executive role are potentially contradictory. As Daily et al. put it: 'The challenge for directors is to build and maintain trust in their relationships with executives, but also to maintain some distance so that effective monitoring can be achieved' (2003: p. 376).

Modelling board processes

Coming to understand quite how directors meet this challenge is as difficult for researchers as it is for investors, since, as Milstein and MacAvoy argue: 'The only certain way to know whether a board is performing is to be present in the boardroom, and we cannot be present' (1998: p. 1299). In the absence of in-board access, two different research approaches have been pursued. The first has been to seek to model board processes conceptually, building upon the key observation that boards are groups. Forbes and Milliken (1999) explore the control and service task and maintenance functions of boards through modelling the impact and interactions of effort norms, cognitive conflict, the presence and use of knowledge and skills, and the impact of these on cohesiveness. They argue that the most effective boards are characterised by high levels of interpersonal attraction (cohesiveness) and task-oriented disagreement (cognitive conflict). Finkelstein and Mooney (2003), drawing upon director interviews, identify five critical 'process goals' for boards – constructive conflict, the avoidance of destructive conflict, teamwork, appropriate level of strategic involvement and comprehensive decision making. These goals can be served, in turn, by getting the right people, and by the appropriate staging and steering of board meetings. More recently, Sundaramurthy and Lewis (2003) have modelled how a collaborative climate and past success may encourage complacency, group think and strategic persistence, while control may feed executive frustration and restrict information flows. Such self-reinforcing cycles, they suggest, require the 'simultaneous need for control and collaboration' to create self-correcting cycles.

Qualitative studies of board processes

Another stream of process research has used qualitative research methods in order to draw upon directors' experiences of board processes and functioning. There is a long history of more practitioner-oriented work mostly related to USA boards (Mace, 1971; Lorsch & MacIver, 1989; Carter & Lorsch, 2004; Charan, 2005). In the UK context, there are also a small but significant number of qualitative studies of boards (Pettigrew, 1992). Prominent here is Pettigrew and McNulty's work (1995, 1998, 1999), which points to marked differences in the level of involvement and influence of a board and, in particular, non-executive directors, on the affairs of a firm. These differences between what they term 'minimalist' and 'maximalist' boards are traced to the effects of size and composition, the attitudes of a powerful chief executive or chairman, the board process, and the 'will and skill' of individual directors (Pettigrew & McNulty, 1995). A later paper traced related differences in the levels of board involvement in strategy (McNulty & Pettigrew, 1999; see also Stiles, 2001). Other notable qualitative board research includes Pye's (2001) longitudinal study of changes in board discourse.

Of most immediate relevance to the present chapter is the interview-based research I conducted with Terry McNulty and Philip Stiles (Roberts et al., 2005) on the role and effectiveness of the non-executive director, as background research for the UK Higgs Review. Drawing upon an earlier critique of agency theory (Roberts, 2001), in this work we argued that the role of the non-executive director was to 'create accountability within the board, realised in practice through a wide range of behaviours – "challenging, questioning, probing, discussing, testing, informing, debating and exploring"'. Board effectiveness, we suggested, depended upon the strength and rigour of such accountability in relation both to a board's control and strategy roles. Drawing upon our director interviews, we argued that non-executive directors must be '*engaged but non-executive*' – suggesting the importance both of the acquisition of company-specific knowledge and clarity about the non-executive nature of the role; '*challenging but supportive*' – suggesting that executives will find value in non-executive challenge if it is supportive of their performance; and '*independent but involved*' – stressing the difference between formal independence and the willingness and ability of a non-executive to exercise 'independence of mind' within the boardroom.

Building upon this tradition of process-oriented research, the chapter presents more recent qualitative empirical research with directors to explore differences in how directors' control and service roles interact and condition each other. However, whereas many process studies have focused exclusively on *within-board* dynamics, what follows suggests that the balance and interaction of these board roles is in itself conditioned by the Code, or more precisely, by the relative weight given by a board and its constituent directors to issues of perceived 'legitimacy' and/or 'efficiency' (Huse, 2005).

External legitimacy and/or board efficiency

In studies of the construction of executive pay and the announcement of stock repurchases, Westphal and Zajac have explored agency theory, not as a truth to be tested but as a 'dominant institutional logic' that informs investor appraisals of board effectiveness and can be managed symbolically by directors (Westphal & Zajac, 1994, 1998; Zajac & Westphal, 1995, 2004). Most recently, Westphal and Graebner (2010) have extended this logic to suggest that:

> Whereas researchers and corporate stakeholders have tended to view increases in formal board independence as reforms that are intended to improve governance by increasing board control, we suggest that under certain circumstances such changes are acts of impression management intended to create the *appearance* of improved governance without actually increasing board control (Westphal & Graebner, 2010: p. 16; *their emphasis*).

Visible compliance is here its own reward, regardless of actual board conduct; investors, analysts and the company stock price all respond positively to the mere appearance of compliance, a possibility echoed in an often-cited study by McKinsey (2002).

The important conceptual move made in this work is its observation that visible compliance can be 'decoupled' from actual board efficiency (Boxenbaum & Jonsson, 2008). Logically, however, the decoupling of visible compliance and actual board effectiveness implies a wider range of empirical possibilities than dramaturgy. Equally possible is that executives and non-executives attend both to visible compliance *and* efficiency, recognising that both are consequential, albeit in different ways. Alternatively, there is the possibility that, as Power argues in relation to the use of audit, 'The imposition of audit and related measures of auditable performance leads to the opposite of what was intended, i.e. creates forms of dysfunction for the audited service itself' (1997, p. 98). In other words, concerns with external legitimacy might intrude upon the operation of a board as a group in dysfunctional ways; visible compliance might be conflated with efficiency not just by investors but also by executive and non-executive directors themselves. In this respect, Hood (2007) has observed the close association between 'blame avoidance' and transparency. Relatedly, O'Neill (2002) has argued that while the rhetoric of new forms of transparency (e.g. a Code of Best Practice) is to make professionals and institutions more accountable for good performance, this can easily lead to a 'race to improve performance indicators', which in turn feeds 'a culture of suspicion, low morale and professional cynicism' (Roberts, 2009). The remainder of the chapter explores this wider range of possibilities for the relationship between formal compliance and actual board conduct and culture, in particular for the enactment of a board's control and service roles.

RESEARCH PROJECTS AND INTERVIEWEES

The empirical descriptions that follow are drawn from some 30 interviews conducted in 2005/6 as part of three related research projects. The first project had as its focus the role of the board in creating a high-performance business.[2] This involved 30 interviews with directors. A second project, which was conducted concurrently, sought to investigate the early experience of boards with the 2003 Code requirement for an annual appraisal of a board's performance and consisted of 10 interviews with company chairmen.[3] A third project from which some early interviews are included was an ESRC-funded project investigating the impact of the Code principle of 'comply or explain'.[4]

The research interviews were in large part with FTSE 100 directors, and exclusively with directors of FTSE 250 companies. They included interviews with chief executives and chairmen, as well as executive and non-executive directors and company secretaries. With the exception of the five company secretaries, all those interviewed had experience of working in different board roles and in different companies, and a particularly fruitful way to draw upon their experiences was to explore their perceptions of key differences in the dynamics and effectiveness of different boards, and different individuals in similar roles. To maximise the potential for an open exploration of individual experiences all interviews were conducted under the guarantee of confidentiality, both individual and company. The interviews were subsequently transcribed and coded according the different roles and relationships.

The timing of these research projects was significant in so far as they followed the substantive reforms to the UK Code in 2003, following from the Higgs Review. They therefore provided an opportunity to explore with directors the subsequent impact of these Code changes on board practices. Much in the 2005/6 interviews echoed the themes of our earlier Higgs research: the importance of the relationship between chair and chief executive; the pivotal role of the chairman in creating the conditions for non-executive effectiveness; and the importance for non-executives of their knowledge and understanding of a business as the basis for their work within a board. However, in the context of this earlier work, two seemingly new and distinctive notes or themes emerged in the 2005/6 interviews. The first centred on descriptions of defensive behaviour within boards – for example, executive board rehearsals, difficulties with arrogant CEOs and reputational concerns amongst non-executives. The second 'new' theme centred on explicit efforts by chairmen in a number of disparate companies to enhance the strategic role of the board. Neither theme was common across all interviews, but both were nevertheless prevalent across a number of interviews. Cross-membership did not appear to explain these commonalities.

The two themes seemingly represent opposing tendencies within boards such that each has the potential to counter or undermine the other. In what follows, the defensive dynamic is traced to the effects of external perceptions – a concern with individual reputation in the City – and the ways in which this conditions individual conduct and board culture. Deliberate attempts by some chairmen to develop the strategic role of the board possibly reflect an intuitive grasp of the ways in which this can work to restore the substance of the unitary designation of the board, and thereby counteract such individual defensiveness (Roberts, 2001).

CONCERN FOR EXTERNAL LEGITIMACY AND ITS EFFECTS WITHIN BOARDS

In the UK, institutional ownership now accounts for 70% of UK equities (Marston, 1999), and, as described above, the UK Code requires these large institutional investors to monitor company compliance. Our own and others' research suggests, however, that it is essential to understand investor pressure on companies for corporate governance compliance in the context of what is a more pervasive and intense pressure from the same institutions for financial performance.

One measure of the growing power of investors has been the increase in the amount of time and attention that must be given to such investor relations (Rao & Sivakumar, 1999). Between 1990 and 2000, Pye (2001) found that the time devoted by the chief executive and finance director to meeting their investors had increased from 10% to

25% involving 50–60 investor meetings a year. Our own and others' research suggests that within these meetings investors focus on testing and checking their model assumptions, on probing the coherence of company strategy, and on evaluating the quality of executive capabilities and relationships (Holland, 1998; Hendry, Sanderson, Barker & Roberts, 2006; Roberts, Sanderson, Barker & Hendry, 2006). For executives, the meetings provide an opportunity to directly influence investors' understanding of a business, and to demonstrate their commitment to delivering shareholder value (Marston, 1999; Hendry et al., 2006).

Investor pressure for good corporate governance has to be understood in the context of this more pervasive and direct pressure on executives for financial performance (Useem, 1993; Lazonick & O'Sullivan, 2000). Within institutions, corporate governance is typically handled separately from funds management: with a dedicated individual or small team monitoring compliance and corporate social responsibility issues, sometimes with the help of external advisors. Where there are issues, such individuals will typically communicate through the company secretary and then the chairman. Shareholder activists such as PIRC or Hermes do much to set the agenda here by targeting particular companies on governance issues (Becht, Franks, Mayer & Rossi, 2009). Our own and others' research, however, suggests that even here governance only becomes a significant issue when financial performance is perceived as poor. As MacNeil and Li (2006) put it, in practice the Code principle of 'comply or explain' is often enacted by investors in the form of 'comply or perform'.

In what follows, I want to explore the effects of this intense investor scrutiny on director conduct within boards. What is at stake here is how 'external' pressures for performance and conformance affect, or more accurately, are allowed to affect director attitudes and conduct, the dynamic of board relationships and the focus of a board's work.

One chairman suggested this was a generic and increasingly difficult challenge for any board:

> The board's job is to make a judgement. An interesting question is to what extent is the board's judgement related to the growth and development of the business in creating long term value, and to what extent does that judgement relate to the shorter term interest of value creation in the hands of shareholders. It is becoming more difficult because I think shareholders' horizons are becoming shorter. There is demanded of them performance for their clients to analyse which is pretty much quarter by quarter. So they are very concerned about that, whereas if you look at the management team in the business, a board is probably monitoring them on a three to five year time horizon (Chairman).

Here I will explore the very variable and consequential ways in which these competing concerns are balanced within particular boards. I first explore how the weight of external scrutiny can set up a defensive board dynamic.

A DYNAMIC OF DEFENSIVENESS

The subjective effect of this intense external scrutiny is to create a concern amongst directors for their individual reputations: for how their actions might be seen by the City.

> It's a big current issue I think in business in general, at least at the top end of visible business, which is the risk averseness that people are developing – people are sufficiently concerned with the optics of situations now that this is very often a key driver.

Our research suggested that such reputation concerns play differently upon non-executive and executive directors.

For non-executives, concern for their reputation within the City, emphasised, in line with agency theory assumption, their narrow governance role:

> You get the sense that the institutions work on the basis that the board is a cabal which is designed to manage the business in their own interests.

This could then influence decisions both about the composition of the board and non-executive conduct. In terms of appointments, there was the suggestion that it encouraged too rapid turnover amongst non-executives, robbing the board of institutional knowledge. There was also the suggestion that it could encourage a nominations committee to appoint the 'great and good' rather than individuals who could contribute to the conduct of the business:

> At the end of the day if a board appoints a chairman or non-exec or chief executive then it has to meet the test of what the newspaper headline says on that particular morning when it is announced, so there is a big insidious effect. The headline will be created by what fund managers say.

But while the appointment of such individuals might possibly soothe external perceptions, there was then the potential that, within a board, such individuals would have a heightened concern for their own personal reputation:

> Reputational risk is massive – if I had had two or three company chairmen or the odd FTSE 100 CEO around the table, would they have been saying I'm not sure about this, would they have given me the freedom which people who trusted me gave me absolutely (Chief Executive).

The suggestion here is that concern for individual reputation in a non-executive can go hand in hand with a certain risk aversion.

For chief executives and executive directors, there was a somewhat different dynamic to the reputation concerns created by external investor scrutiny. Given a chief executive's direct and consequential contact with his or her major investors, their preoccupation was more with financial performance than governance. However, 'external' investor perceptions of the 'success' or 'weakness' of an individual CEO then had the potential to influence that person's conduct in relation to the board. Our research included two examples where, strictly off the record, chairmen described very difficult relationships with their 'stellar' chief executives whom they felt had become resistant to board accountability. As one of the chairmen described:

> The market creates in the person of a chief executive somebody who has got to be able to communicate with the media, communicate with the investment community, you've got to be able to be a very dominant character. He's got to be strong in the face of a lot of adversity, a lot of competition. … If you think about the kind of characteristics that that creates, it creates what I call a very two-dimensional human being. He is a person who sees black and white, and is able to exercise on a white or black blackboard beautifully but grey, why should grey be relevant?

In this instance, City perceptions of the 'success' of this CEO had apparently translated, within the board, into his refusal to countenance any challenge from the non-executives in relation to his longer-term strategy for the business. Of course, the very purpose of board governance is to provide a check to such executive narcissism (Chatterjee & Hambrick, 2007). However, in this company, given the strength of immediate financial results, the chairman and non-executives felt powerless to enforce any challenge and, instead had to work hard to keep any hint of discord from the press.

Investor perceptions of the 'weakness' of CEO performance, or where an individual had yet to establish a track record of strong financial performance, could produce similar effects within a board:

> (The chief executive's) view is that you don't take things to the board until you are lords and masters, if you are unsure of the answers. So he is a little bit more paranoid or suspicious. Now that he is more involved it has become 'This is what we are doing about the challenges, the plans we already have in place, this is what we have done since we last met, we are good people aren't we, but there are small areas where we need your views'. So he is less engaged with the board and he gives them less opportunity to engage (Executive Director).

For this new chief executive the board was seen as a potentially threatening space, and his defence was to present not problems but solutions to the board. The board was a space in which he felt he should present himself as already fully in control but, as his executive colleague observes, this also had the unintended effect of foreclosing non-executive engagement. At its most extreme, such defensiveness took the form of full-scale rehearsals for board meetings, suggesting that the encounter with the board was as anxiety-provoking for executives as their carefully scripted encounters with investors (Roberts et al., 2006).

Either in the form of arrogance or felt threat, such a defensive view of the board on the part of a chief executive was then likely to inform the attitudes and conduct of other executive directors. Legally, as directors, executives are jointly and severally responsible for the conduct of the company. In practice, however, executive director conduct at board meetings is typically conditioned by the fact that they owe their career and futures to the chief executive. As one chairman observed:

> I think there is work to be done in our board and probably in every other board in the land to make sure that the executives are able and willing to express contrary views in the board without feeling that their careers will be imperilled.

So far then, I have traced how a concern with external 'City' perceptions can play differently upon the attitudes and conduct of non-executive and executive directors within a board. I now want to explore how such concerns feed into the dynamic of relations between the executive and non-executive and influence the conduct and focus of a board's work.

> The problem is that if you don't dot the I's and cross the T's you leave yourself and the rest of the board open to criticism. If for example you had poor performance and then it was discovered that there weren't some T's crossed, you're guilty. If you had poor performance and your T's were crossed, well, that's all right. If you had great performance and there were no T's crossed at all, people don't care (Non-executive).

This accurately summarises the ways in which external visibilities are seen by directors to interact. The suggestion here is that if a board is Code compliant and there is poor performance, the board at least will escape criticism, although not perhaps the chief executive. However, a board will be criticised if performance is poor and governance has been less than exact. Finally, the perception is that, if performance is good, failures of compliance in relation to governance will not matter to the investor.

In line with this, there was a widespread sense in our interviews that corporate governance, narrowly conceived as formal compliance with the Code, was a divisive force in boards:

> I think the problem you've got now is that with all this corporate governance stuff, in lots of companies I think there are two boards. All this stuff about the British model is to have a unitary board is a load of twaddle because basically now the investors tend to look at the non-executives as being policemen (Non-executive).

On the part of non-executives, this view of the purpose of boards easily translated into a rather pedantic and, at times, intrusive interpretation of their role. As one chairman described:

> I had a go at my non-executives over dinner recently and said you are being far too involved. They said what do you mean? You feel passionately we should do this but if the chief executive doesn't want to do it, that's it. One of them said so we are not responsible for the performance of the company then? I said no you are not. If he does not get it right that's his problem. All you have got to have done is test it, ask, push and there was a sort of collective sigh of relief (Chairman).

Our research included several examples of this too literal and possibly anxiety-driven interpretation of the 'control function' of the non-executive, an interpretation whose effect was to blur the boundaries of executive responsibility and sour board relations. But even without such unskilful conduct, non-executives' preoccupation with corporate governance processes encourages the executive to view the board and non-executives primarily as a mechanism for protecting distant investor interests. As one very successful chief executive commented in relation to his chairman:

> I do not run the business with any less clarity than a former executive chairman, but I recognise that shareholders need a non-executive chairman today because it gives them assurance that I will not run amok with their business (Chief Executive).

Interestingly, this chief executive saw the board very much from an agency perspective, but the corollary of this was that he did not see the board and non-executives as a resource that might help him perform. As he put it: ‘It does not help me do my job, but I recognise that it helps shareholders’. The board is then something that has to be endured by executives and, not surprisingly, this then provides an incentive for them to minimise their own engagement in board processes:

> I think that a lot of executives find the corporate governance procedures wearisome. I think a lot of executives would not consider that they add value, and therefore I think that translates into saying that for a lot of executives the board has become less relevant than it might have been a few years ago (Executive).

In sum, then, in some boards a heightened concern for external perceptions, as these play differently upon non-executive and executive directors, has the potential to create a strong divide between executive and non-executive directors within a board:

> I would liken the board to a ritual dance, where usually you had the chief executive with an executive committee, and the executives are all lined up and counting. And woe betide anyone who steps out of line at the board and expresses a different view. The papers were very polished but also very opaque and the game was about can the chief executive keep as much distance as possible from the non-executives. The chief executive was a guru by that time, of considerable arrogance as well as experience, and he didn’t think that the non-executives had very much to contribute. The non-executives were clever and able to see through the highly polished papers and work out the key points that people had missed (Non-executive).

Now for agency theorists, such divisions within a board are precisely what is needed to avoid executive capture of a board, and for non-executives to fulfil their role as local guardians of investor interests. However, our own empirical investigations suggest that such a defensive culture within a board is likely to be detrimental to the overall effectiveness of a board as a result of its impact on non-executive involvement in strategic decision making.

The Code makes company strategy a formal board responsibility. In practice, this means that the executive team develops strategic proposals which then must be submitted to the board for scrutiny and final approval. Our interviews suggested that where there is a strong divide between executives and non-executives, characterised by reciprocal resentment and suspicion, it is easy for the usefulness of this process to be undermined:

> You get a strategy book, read it a week before, come to the board meeting, ask any questions you want, but essentially the possibility of actually impacting the developing strategy process is pretty small. Certainly in my experience, it’s a deeply unsatisfying process for a non-executive director, and actually for everybody else, but particularly for the non-executive. You weren’t really involved. If suddenly this wonderful object is on the table, and there is bugger all you can do about it (Non-executive).

Here the suggestion is that formal non-executive engagement in setting the strategy of a company easily becomes an empty ritual in which non-executives are allowed no sight of the thinking that informs executive proposals, and in which there is little opportunity for them to make any substantive contribution to such thinking. Such non-executive divorce from the substance of strategy can then become a self-fulfilling and self-reinforcing process since executives can rationalise their stage management of debate on the basis that the non-executives had nothing useful to contribute.

At stake here, however, is not just non-executive involvement in the strategy process but also the content and temporal horizon of the strategy itself. Froud, Johal, Leaver and EIllimas (2006) have recently pointed to what they term the 'financialization of strategy', that is, the ways that executive strategies are increasingly geared to mange the share price in the short term through the use of devices such as share buy-backs, dividend policy, de-mergers and downsizing. Even agency theorists, in the light of the scandals of Enron and Worldcom, have pointed to the dangers of 'overvalued equity' created in part by the use of very substantial financial incentives for executives to exceed market performance expectations in the short term (Jensen, Murphy & Wruck, 2004). As described above, investors are now able to exert intense and direct pressure on the chief executive and finance director for immediate financial performance. The absence of substantive engagement by non-executives in the executive strategy process, along with the remuneration practices they administer, then only amplifies such immediate performance pressures (Kennedy, 2000).

DEVELOPING THE STRATEGIC ROLE OF THE BOARD

Since the boards of large listed companies are all subject to intense external scrutiny the defensive dynamics sketched above are a potential in all boards. However, our research included a number of boards where deliberate attempts were being made to more fully develop the board's strategic role, and, where successful, this promoted very different behaviour and culture within the board. Here I will attempt to sketch the main contours of such attempts.

At the heart of the contrast was the conduct of the board chairmen and the degree and nature of their engagement with their role and company.

> I agree with the separation of the roles of chairman and chief executive. But that's the sort of minimum and you then have all the questions about how much commitment does the chairman give to build this board and what does that leave you with? And commitment means both time and energy and intellectual application. And the difference between a board when you have a chairman who gives the time and is really interested in having feedback in working out whether his board is effective and if it's not effective what do you need to do next, and a chairman who gives a minimum of time commitment and wishes to be figurehead is huge (Non-executive).

For this director the mere separation of roles in order to be Code compliant masked huge differences in the actual conduct of different chairmen, with a person's commitment of 'time energy and intellectual application' being the key differentiator.

My primary focus here will be on deliberate attempts to enhance the strategic role of a board, but the research suggested that the success of such attempts in turn depended on two key conditions – the nature of a chairman's relationship with the chief executive, and non-executive knowledge and understanding of a business.

It is beyond the scope of this chapter to go into any detail around the chairman and chief executive relationship. However, as in earlier research, the relationship was seen as a sort of microcosm of the wider board culture (Roberts & Stiles, 1999; Roberts, 2002). In order to avoid competition and rivalry, it is essential that there is clarity that executive responsibility lies with the chief executive. In contrast to a chairman who is located away from the business and merely comes in to chair the board meetings, an engaged but non-executive chairman can act as a key resource for the chief executive. Some used the language of a coach to describe the chairman's role, emphasising the value of different skills and experiences. Others observed the importance of reciprocal trust and respect in a relationship that they argued required effort and time to develop. At the heart of a successful relationship were regular, typically open agenda meetings where the chief executive could discuss emergent issues with the chairman. Several spoke of how this offered vital support in the otherwise 'lonely' role of chief executive:

> An experienced chairman can help the chief executive a very great deal – with the City, how to

> deal with shareholders, major investors, AGMs – all that kind of thing, which are unfamiliar to him but very familiar to me. But the essence of the job is providing a sounding board for the chief executive in which he can confidentially discuss with you what he thinks he might want to do. He's got nobody else (Chairman).

While directly supportive of chief executive performance, trust and respect also made it possible for a chairman to move freely beyond the chief executive to deepen his or her understanding of the business. As long as a chairman has a clear sense of his own non-executive role, then this engagement with executive directors and with levels of management below the executive team is perceived positively. Critically, however, this effort by a chair to build his understanding of the business is also what furnishes him with the knowledge that then allows him to lead the board, and create conditions within the board for the other non-executives to be effective (Leblanc & Gillies, 2005):

> I think it's essential that the chairman knows much more about what is going on in the business than any non-executive can be expected to know. He has to lie somewhere between the position of the non-executive and full-time executive and therefore I felt that I needed to visit every part of the business on a sort of cycle (Chairman).

A further consequence of the investment of time, energy and thought by a more engaged chairman lies in greater attention to the composition of the board:

> You look for courage and their ability to confront management if they are unhappy about anything. You look for their ability to interrogate, to probe, to challenge.
>
> The confidence of the non-executives is quite important, and the fact that when they open their mouths the executives are prepared to listen to them (Chairman).

In part, non-executive credibility is created through the recruitment of relevant skills to the board rather than the simply 'great and good'. It is then enhanced, with the support of the company secretary, through the design of the subsequent induction process for new non-executives. The contrast here is between an induction process that focuses primarily on a director's legal obligations and the current financial position of a company, and an induction process that is also designed to build rapidly non-executives' understanding of the company they have joined. As one company secretary described it:

> I think it gives a sense ownership, you know what's going on. I think what is unhelpful and unhealthy is non-execs who don't get involved at all in the day to day. I think you bring an external perspective, you don't need to understand the day to day, you are not going in to try to improve the operations. What you are making sure is that you have enough knowledge of what's happening on the ground to contribute to debate in the boardroom (Company Secretary).

An open attitude to the contribution of the chairman and board from the chief executive and executive, and the careful selection and building of non-executive understanding of a business to ensure their credibility with executives, were both essential conditions for subsequent attempts by chairmen to enable a more strategic focus to the work of the main board.

In part, such a strategic focus was achieved through fuller development of the work of the board subcommittees:

> The way that we try to do the formal compliance work is to hive it off to the board committees so the audit committee now probably meets for about the same time as the board because it is actually a very complex area. ... So what you try to do is to devolve to the appropriate level ensuring that you comply and everyone is comfortable so that you actually free up time at board meetings to focus on the key issues (Chairman).

Strategic focus in the main board was not pursued therefore at the expense of compliance. Another device for freeing up space within the main board meetings was through handling routine issues through circulation and by exception. Close attention was also given to the structuring of the agenda itself:

> You'd be surprised the number of boards that still have agendas that are absolutely packed with items. And no differentiation between what they

are doig with the items, are they there to be noted, what's for information or discussion, that don't organise the time. In most board meetings we have got time for two or maybe three serious issues which need discussion and debate and you need to construct your agenda to make it clear to people which those are, have the right papers with the information available and have time (Chairman).

A further vehicle for creating the opportunity for board discussion and debate involved attempts to make full use of informal spaces like pre-board dinners:

The thing it does is to greatly extend the time we can put into one controversial issue, so that you have debated it quite thoroughly the night before and knocked away maybe some of the misapprehensions or differences of view, based upon something that just needs to be argued out. And you've done it in an atmosphere where people can be very forthright in a way that they would hesitate to be at a formal board meeting. ... The next morning the range of difference of opinion has normally narrowed, and very often narrowed to the point of where we all quite agree about what we want to do, even if it isn't what was originally proposed (Chairman).

Creating more space for the discussion of key strategic issues, however, was only one aspect of the innovations described by some of those we interviewed. Also critical, was the way in which issues were brought to the board. A number of boards were experimenting, to seemingly good effect, with what was termed 'warm up':

We call it the 3-strike rule, we give them 3 opportunities to look conceptually at what we are proposing, so that it's obviously looking at an opportunity, and then that comes back to go through the detail with the board, answer any questions and then we come back and get the approval. You wouldn't be fulfilling that purpose if you didn't do it like that, and actually nor would you really be tapping into the skills and experience that you should have appointed to your board. They are not there just to sit on the board and have the right number. They are there to add some value to your thinking in the business. You have to have a process that gets their thinking into it (Executive Director).

An important aspect of this change of process also concerned the time frame of discussions. There was a suggestion that such strategic discussions, precisely by being focused more long term, could also guard against short termism:

In many industries you can be very successful in the short term to the detriment of the medium term and longer term. So I think the board needs to think beyond the short term, i.e. annual P&L and therefore we look at the level of the investment in xxxx, for the performance we look at non financial kpi's, so we look at the performance of new product development, we also as a board review the development of the management. Things that we take to the board are succession planning and the development plans for all senior managers (Chief Executive).

In contrast then to the culture created by a defensive dynamic where board rituals seemed 'wearisome' for executives, this more inward, business-oriented focus seemed to be welcomed by executives in a way that then encouraged them to seek to make fuller use of the skills and experience of their non-executive colleagues:

Does it add value? Yes, yes and yes is the answer. If you are talking about the strategic guidance, where we have an issue, to have people in different places who have seen similar things before, have a discussion and it actually is very, very helpful because quite often you've got an instinct or intuition that you are right but you've never taken this step before (Executive Director).

Importantly, and again in stark contrast to a defensive dynamic, a further consequence of this earlier and more substantive engagement by non-executives in strategy-focused debate was a felt sense of unity amongst the directors as a group:

I think you need to have a very strong sense of team around the board and you need to have that because first of all, boards are scarce events, the amount of preparation the executive puts in to prepare for a board is large, if a non-exec is going to make comment at a board meeting, they have got to be rated, they have got to be rated by the peer group. So that what they say is listened to and taken in and is therefore making the whole affair worthwhile (Chairman).

In sum then, the strong contrast with a board where individuals were defensively preoccupied with their reputation with the

City, was that through this development of its strategic work the board was much more cohesive and focused inwardly on the development of the businesses that it led:

> I would argue very, very strongly that unless the board focuses on the operational aspects of the business, it has no basis against which it can judge whether governance is working. The reverse does not work, so if you focus a board on governance I guarantee you will not know what's going on in the operations, because the operations is real world (Chairman).

The important suggestion here – a suggestion that usefully summarises the contrast I have sought to sketch here – is that the control work of the board should be subordinate to its strategic work. Strategy and control are not just different activities but rather, while a focus on governance can occlude attention to the development of a business as in the defensive dynamic sketched above, a strategic operational focus, far from being opposed to governance, is what furnishes a board with the knowledge and understanding against which it can appraise executive performance.

CONCLUSION

The above has followed two emergent themes from recent qualitative empirical board research to illustrate how formal compliance with the UK Code masks consequential differences in director attitudes and conduct: the dynamic of board relationships and the focus of a board's work. By way of a conclusion, I want to draw out the implications of this research for our understanding of board effectiveness, and how this might best be promoted by corporate governance Codes.

The qualitative research presented above makes it very clear how complex, diverse and contingent the character of any board is both in terms of individual behaviour, the dynamic of relationships that this sets up and the resultant group culture. Formal compliance masks and remote research simply ignores this relational complexity and contingency, and yet it is this that is the root of the effectiveness or otherwise of a board. To use Giddens' phrase, corporate governance research has arguably been all too willing 'to go behind the backs' of practitioners and thereby ignore or 'derogate' their own more or less skilled and knowledgeable agency.

This fundamentally relational view of boards then offers greater clarity to our understanding of the relationship between what has typically been explored in terms of the 'control' and 'service' aspects of the work of non-executives. As emphasised by agency theorists (Jensen & Meckling, 1976; Fama, 1980), and given prominence in the initial UK Code, non-executive monitoring of executive conduct in relation to performance and areas where there is the potential for a conflict of interest – audit, remuneration and nomination – does indeed emphasise the division between roles of executive and non-executive directors. But even here, non-executive monitoring seeks only to mitigate the *potential* for such a conflict of interest: it cannot be assumed *ex ante*. By contrast, in so far as the strategic role of the board is developed, it provides a unitary point of focus for both executive and non-executive directors – a shared task on which they can work together – in which the experience, skills and contacts of non-executives can be drawn upon by executives in support of their performance. It is in this limited sense that, as activities, 'control' involves division and 'strategy' collaboration between executive and non-executive directors within boards. However, our research suggests that, empirically, these different aspects of a board's work can be enacted in very different ways in different boards.

Superficially, our sketch of a defensive board dynamic seems only to confirm the assumed opposition between control and strategy by observing how the strategic work of the board easily falls under the shadow of its control role. However, we have explained this opposition not in terms of an essential role conflict, but rather in terms of the effects, on the one hand of a pedantic and risk averse attention to compliance on the part of non-executives, and on the other of arrogance or defensiveness on the part of executives. More by default than design, this can then lead, as Sundaramurthy and Lewis (2003) suggest, to a 'self- reinforcing cycle' where executive frustration with a process that is felt to lack relevance, or is perceived as threatening, leads to the restriction of information that in turn feeds non-executive suspicion. The foreclosure of effective non-executive engagement in the strategy process is arguably here the unintended consequence of a self-reinforcing dynamic of non-executive control and executive resistance that makes board governance into 'a ritual dance'.

The second empirical theme we explored – conscious attempts to develop the strategic work of a board – offers an entirely different image of the relationship between control and strategy, and in doing so responds to recent calls for research to explain how open discussion cultures can be fostered (Hambrick, Werder & Zajac, 2008). Our analysis is broadly consonant with Forbes and Milliken's (1999) suggestion of the importance of 'cohesiveness' – the felt sense of the board as a team – while still allowing task-oriented disagreement – non-executive challenge and testing of executive proposals. As Finkelstein and Mooney (2003) suggest, this depends upon the avoidance of destructive conflict and requires an appropriate level of strategic involvement, which in turn depends critically on both the relevant skills of the non-executive and the appropriate staging and steering of a board by the chairman.

The suggestion in the literature has been that this close involvement of non-executives in a service role creates a potential 'disincentive to monitor' executives; a potential for group think and complacency (Hillman & Dalziel, 2003). As we argued in earlier work (Roberts et al., 2005), the imagination here is that the non-executives are 'torn between two masters'. Agency theory assumptions as these inform investor beliefs clearly reinforce this rather paranoid view of the board as the scene of a struggle over the divided loyalty of the non-executives. The designation of this aspect of non-executive work as 'service' also plays to the notion that control by non-executives is *for investors* while strategy is *for executives*. Our research does not support this sense of division in a number of respects. First, while non-executives drew upon their experiences elsewhere, the exercise of their service role involved subjecting executive strategy proposals to test and challenge, that is, creating accountability in relation to executive strategy. Such accountability was a counter to the group think and complacency that Sundarmurthy and Lewis (2003) see as a danger of the service role. Secondly, making space for strategic discussion and debate within the main board was not achieved at the expense of control since this was managed through the fuller use of board subcommittees. Thirdly, interviewees suggested that their engagement in the development and challenging of executive strategy enhanced their exercise of control by encouraging executive openness, and provided non-executives with a more nuanced and business-specific set of criteria against which performance could be appraised. From this perspective, the full development of a board's strategic role is the condition for effective control, rather than a threat.

Overall, the research suggests that the established distinction between control and service, and in particular the assumed opposition between these aspects of the work of the non-executive, needs to be rethought, or at least stripped of its polarised assumptions. The distinctions between 'active' and 'passive' (Milstein & MacAvoy, 1998) or 'maximalist' and 'minimalist' (Pettigrew & McNulty, 1995), as these reflect the degree of non-executive engagement in both control *and* service, seem more pertinent to understanding the conditions for actual board effectiveness.

But perhaps the most novel aspect of the above analysis lies in the suggestion that these *within-board* dynamics are conditioned by 'external' pressures from investors for both performance and conformance. Studies of the diffusion of codes have drawn a contrast between efficiency and external legitimacy as competing motives for code adoption (Zattoni & Cuomo, 2008). At a company level, Westphal and Graebner (2010) have similarly suggested that external legitimacy with investors can be 'decoupled' from actual effectiveness through the symbolic management of appearances. Our UK research interviews also pointed to the increased attention given by directors to the management of investor relations in relation both to executive performance and governance compliance. In this respect, external legitimacy was clearly of growing importance. However, what I have explored here is how these concerns for external legitimacy intrude back upon director conduct and culture within a board.

Viewed from this institutional perspective, the contrast I have sketched can be seen as different responses to the weight of these external pressures, as very different *modes* of compliance with the Code. Within the defensive dynamic corporate governance, compliance was associated with a certain pedantic application of the rules by non-executives, an individual preoccupation, in a way that might subsequently be defensible, with fulfilling the letter of the Code. In this way, effectiveness was in effect conflated with external legitimacy. From the perspective of agency theory and investors, this defensive dynamic could be viewed positively as evidence of a strong control culture and the absence of collusion or managerial capture (Westphal, 1999). However, while compliance in this form does at least ensure oversight in relation to potential agency problems, our research suggests that, as a negative if unintended consequence, it can easily result in a minimalist engagement by the board in the executive strategy process.

By contrast, in other boards, formal compliance with the Code was treated as a *necessary but not sufficient* condition for effectiveness, and, as a result, efforts were then put into actively building the conditions for actual board effectiveness. As we have described, central here was the chairman's enactment of his role: the 'time, energy and intellectual application' put into building a complementary relationship with the chief executive and wider executive team, and then the use of the knowledge gained in this way to manage the board itself. Board composition was the starting point of such efforts but so too was the quality of induction offered to non-executives, and the management of the board agenda to maximise the space available for strategic debate and discussion. The pursuit of actual effectiveness within a board involved then *a more creative, thoughtful and reflexive mode of compliance*, an embrace not just of the letter but also the spirit of the Code.

Arguably, this more extensive form of compliance comes closest to the best practice that the Code originally sought to promote, and suggests a clear limitation to the dominance of agency conceptions of the governance problem. The risks of executive self-interest to shareholder interests, which are the focus of agency theory, are an important aspect of governance, but only one aspect (Hendry, 2005). As important are the operational and strategic risks associated with the conduct of the business. Here the opportunity for non-executives to challenge, test and help develop strategy is arguably of central importance in giving substance to the stewardship role of the board (Davis et al., 1997). It has the potential to contribute directly to the quality of decision making through allowing executives to draw upon non-executive experience and skill. It also furnishes non-executives with an understanding of longer-term business objectives against which performance can be appraised. In the absence of such strategic involvement then the only criteria for appraising executive performance is that offered by the market, which has little understanding of the underlying drivers of value creation in a particular business, and is possibly for the most part indifferent to the potential for short-term share-price management to be pursued at the expense of longer-term wealth creation. The risk of an exclusive emphasis on a board's control role is that it serves merely to crudely amplify such external pressures for immediate performance rather than mediate them through effective 'strategic value accountability' (Jensen et al., 2004).

The UK Code has possibly been ambiguous as to its intentions in respect to the contrast developed here between defensive and extensive forms of compliance. The original Cadbury Report argued that its own focus on the 'control function' of non-executives was a result of its remit and should not 'detract from the primary and positive contribution which they are expected to make, as equal board members, to the leadership of the company' (1992: p. 22). Following the Higgs Review, a new founding principle was added to the Code, emphasising the importance of board leadership in setting strategy. Nevertheless, the weight of the text of the Code has remained focused on the specification of the control function, in part because this is easier to specify and codify, and in part because the development of the Code has typically been driven by governance failures (Zattoni & Cuomo, 2010). As suggested in the introduction, until very recently the seemingly natural and logical tendency was for governance failures to be met by efforts to further elaborate and extend the provisions of the Code – to further specify structures and procedures in the light of the most recent scandal or collapse. But what the research suggests, and has been reinforced by Walker's recent analysis of failures of corporate governance in financial institutions, is that this pursuit of the ideal of an evermore complete transparency can become counter-productive (O'Neill, 2002; Power, 2007; Roberts, 2009). The more the Code invests in detailed provisions, the more not only investors but also directors themselves can come to treat it as a sort of rule book for box-ticking compliance, as opposed to a guiding set of principles for the continued development of best practice *by directors* within boards.

Significantly, the very latest iteration of the UK Code, issued in 2010, is alert to this dilemma and has sought to manage it in a novel and creative way. Rather than seek to add yet further 'provisions' to an already extensive Code – to further specify detailed rules of conduct – the most recent revisions have instead reorganised the Code in order to give emphasis to the spirit of its 'principles'. Prominent here, and congruent with the above empirical analysis, is a new section on the 'leadership' role of the board that gives centre stage to the work of the chairman, a new emphasis on the importance of non-executive 'challenge' and involvement in the 'development of strategy', and a new emphasis on the board's responsibility for the 'long term success' of the company. Those elements of the Code that dealt with the responsibilities of institutional investors have now been removed, and will be dealt with instead in a new Stewardship Code, which for the first time acknowledges the heterogeneous nature of investor interests and looks only to 'long only' investors to fulfil the role of 'responsible owners'.

These latest revisions to the Code provide a rich agenda for future governance research. In this respect, possibly the primary value of qualitative empirical board research is that it can inform theory in relation to emergent best practice rather than merely test existing academic prejudice.

NOTES

1 The research reported here was conducted while I was working at the Judge Business School, University of Cambridge.

2 The research was commissioned by two member organizations – the Corporate Research Forum (CRF) and the Performance and Reward Centre (PARC) – and the interviews were in part conducted with Don Young.

3 This research was commissioned by Saxton Bampfylde Hever, an executive search firm for whom I have produced several research reports on board-related issues.

4 This research was conducted with Paul Sanderson, University of Cambridge, and David Seidl,

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Boards' Contribution to Strategy and Innovation

Alessandro Zattoni and Amedeo Pugliese

INTRODUCTION

Among the most disputed issues within the business arena and among academic scholars are which role boards of directors are expected to fulfill, and how they contribute to a company's success and survival (Monks & Minow, 2008). Recent failures of large corporations worldwide has led corporate governance and strategic management scholars to call for increased board involvement in decision-making (Tricker, 2009) that has paralleled regulators' requests for higher monitoring and punishments in the case of frauds and misbehaviors (Coffee, 2005).

Scholars in strategy, governance and entrepreneurship fields acknowledge that one of the main tasks of the boards of directors is to guarantee appropriate levels of corporate entrepreneurship and innovation in order to satisfy shareholders' request for value creation (Shimizu & Hitt, 2004). In spite of these diffuse beliefs, a clear and definite consensus about the ways in which boards contribute to companies' success is still missing, from both a theoretical and empirical standpoint. At the moment, this is still an unsolved puzzle (Kim, Burns & Prescott, 2009): extant literature provides different angles and sometimes conflicting views in terms of what should be the contribution of board members to companies' decision-making activities (Yoshikawa & Rasheed, 2009).

Agency theory and the so-called 'input–output' models have largely affected the research in the field (Lan & Heracleous, 2010). Its main concern about board composition (input) pushed forward the idea that boards' independence is the primary driver in ensuring high-quality decision-making (output). In addition to agency theory, alternative perspectives in the field of management (i.e. resource dependency theory, stewardship theory, stakeholder theory, team production theory) suggest that boards' effectiveness in executing their strategic task cannot be ascribed only to 'structural features' issues, and devote much more attention to unveil what drives boards of directors to contribute to strategic decision-making.

In this chapter, we review extant literature on boards' contribution to strategic decision-making. We discuss both theoretical underpinnings and empirical results from previous studies, with a closer look at the boards' contribution to corporate entrepreneurship and innovation activities. The chapter shows the evolution of theoretical approaches and research designs, and underlines how these trends affect empirical studies. Finally, it also highlights how research on boards' contribution to strategy and innovation is far from being conclusive and indicates open issues representing an opportunity for further investigation.

BOARDS' CONTRIBUTION TO STRATEGY: THEORETICAL PLURALISM AND EMPIRICAL INCONCLUSIVENESS

It is widely recognized that boards of directors (should) play a key role in the decision-making process of firms. Nonetheless, what should be the most appropriate role of the board of directors in formulating and implementing strategy has been long debated (Useem, 2003). In most cases, the strategic role is interpreted as a part of the broader monitoring activity, in line with an agency-based approach (Baysinger & Hoskisson, 1990). However, board involvement and contribution to the strategy process is much more complex and subtle than that one described by agency scholars. The diffusion of several theoretical lenses and the variety of empirical findings raised by Zahra and Pearce' comment on the '*controversy over the nature of directors' strategic role*' (1989) is yet timely and still needs to be addressed after two decades of further research (Ravasi & Zattoni, 2006).

The debate on the board's strategic contribution has been influenced by time and contextual elements, conflicting theoretical perspectives and inconclusive empirical results. It has been also subject to main changes across the years according to the evolution of companies and the surrounding economic environment (Pugliese, Bezemer, Zattoni et al., 2009).

The theoretical debate on the board's strategic involvement

The debate around board strategic involvement has been influenced by two main theoretical perspectives: a '*conflict view*' and a '*consensus perspective*'.

The *'conflict view'* relies upon the idea that managers are self-interested agents that should be closely monitored by independent directors (Jensen & Meckling, 1976). Such a view is prompted by ag*ency scholars* theorizing that shareholders' value maximization is the main goal for corporations. According to agency theory, boards of directors should be good monitors of top managers; hence, guidelines of good governance practices require a number of outside directors and minorities' representatives, eliminating CEO (chief executive officer) duality, creating subcommittees with independent board members, etc. (Zattoni & Cuomo, 2008). Such a 'functionalistic' approach suggests that ensuring better governance (*ex ante*) would in turn translate into better decision-making processes, with positive effects on company performance (Davis, 2005). Based on these premises, agency theory advocates a clear separation of roles and responsibilities between boards and top management teams (TMTs). Top management teams should initiate and implement strategies, while boards should ratify and monitor strategic decisions (Fama & Jensen, 1983). Direct involvement of board members into strategy is not expected, as it would (i) impose boards of directors to be co-responsible for strategic decisions, and (ii) reduce the required distance between board members and managers (Sundaramurthy & Lewis, 2003).

A '*consensus perspective*' sees, instead, managers as motivated agents acting in the best interests of the firm (Davis, Schoorman & Donaldson, 1997). This view advances the idea that managers and directors act in the shareholders' interests, and do not put at a risk their wealth. Boards are viewed as 'bundles of resources' (Dess, Lumpkin &

Covin, 1997), whose outcome is defining a company's strategy, rather than monitoring self-serving managers. Their main aim and challenge is to ensure that executives examine and exploit all existing opportunities to make shareholders better off (Huse, 2007). The board's task is not merely a supervising function, but company directors should engage managers, becoming an active part of the strategizing process together with top managers (Blair & Stout, 1999). Drawing on these assumptions, various theories (e.g. stewardship, resource dependency, and resource-based view) foster the idea that boards are organizational bodies that may support empowered managers in strategy formulation and implementation (Bezemer, 2010).

The stewardship theory challenges underlying assumptions of agency theory by arguing that the interests of managers and board members do not necessarily collide (Muth & Donaldson, 1998). According to this perspective, the role of boards is to facilitate and empower managers; therefore, it becomes relevant to investigate how boards actively contribute to the process, through interactions with TMT, interpretations and cognitive activities (Forbes & Milliken, 1999).

A resource-based view (RBV) of the firm suggest that boards represent a potential source of competitive advantage (Barney, 1991) as they are in an excellent position to contribute to (strategic) decision-making by providing access to critical resources (Hillman & Dalziel, 2003). Companies need reducing distance with their key stakeholders (i.e. financers, regulators, customers, employees' representatives): well-connected and active boards can provide external resources and legitimation (Hillman, Withers & Collins, 2009). Following an RBV, boards can contribute both to a resource provision for strategic purposes, and to their employment for the best interests of a company (Zhang, 2010).

More recently, behavioral approaches highlight the importance of cognitive contributions of board members as well as the impact of boardroom dynamics on the decision-making process (Hendry, Kiel & Nicholson, 2010). This perspective offers a broader spectrum in analyzing boards of directors' internal dynamics and external interactions (van Ees, Gabrielsson & Huse, 2009). It challenges structural tenets related to board 'monitoring and bonding' and underlines the relevance of trust and empowerment among board members and the role of relationships in determining the outcome of strategic decision-making (Huse, 2005; Hus, Hosskison, Zattoni & Viganò, 2011).

In sum, the success of agency theory among governance scholars lies in its ability to describe the key governance issue (i.e. the tension between shareholders and managers), and to propose a simple recipe to solve it (i.e. a clear separation between TMTs and boards). The competing theories challenged agency theory's simplistic assumptions and rationale, but until now failed to propose a complete and convincing view of the key governance issues, including also the board's involvement in the strategic decision process. The debate is, however, far from being conclusive, and there is still the need for future studies. Table 10.1 provides a synthesis of the competing perspectives.

Empirical findings on board strategic involvement

In the last two decades, scholars have regularly emphasized – aside from the lack of one unifying theoretical framework – the presence of inconclusive empirical findings with regard to the board and strategy debate (Pugliese et al., 2009). On the one hand, early studies have shown that boards were rather passive and subject to CEOs and managerial dominance, thus diminishing their expected contribution (Lorsch & MacIver, 1989). In addition, anecdotal evidence questions whether boards should be effectively involved in strategy and suggests

Table 10.1 The contribution of different theoretical approaches to boards' strategic involvement

	Agency theory	*Stewardship theory*	*Resource-based views*	*Team production and process-oriented approach*	*Stakeholder theory*
The main purpose of strategic decision-making	Strategies are set according to the shareholders' value maximization principle				Boards set goals which are in the best interest of various classes of stakeholders
The board–management relationship	Conflicting: outside directors are expected to oversee self-serving managers in the best interests of shareholders	Managers and directors' interests are aligned to serve the company's best interests	Boards reduce distance to the environment by dealing with external actors	Directors and management act as a team and their effectiveness depends on group dynamics	Boards include representatives of various stakeholders advancing their proposals
Expected boards' contribution through strategic involvement	Boards contribution to strategic issues is part of the broader monitoring function		Boards as a 'bundle of resources' contributing to sustained competitive advantage		
How boards participate in strategic decision-making	Boards oversee, ratify (*ex ante*), and evaluate (*ex post*) companies' strategies	Boards serve their strategic task through empowerment and collaboration with managers	Boards act as resource providers and legitimate a company in its environment	Boards contribute to strategy through continuous interactions and participation in board discussion	
Main references	Fama and Jensen (1983); Baysinger and Hoskisson (1990)	Davis, Shoorman and Donaldson (1997); Sundaramurthy and Lewis (2003)	Barney (1991); Dess, Lumpkin and Covin (1997); Hillman, Withers and Collins (2009)	Pettigrew (1992); Blair and Stout (1999)	Freeman (1984); Huse (2007)

that boards – in some circumstances – might even destroy value when they become too much involved in strategic decision-making (Hitt, Harrison & Ireland, 2001).

On the other hand, scholars have shown that boards are becoming more actively involved in strategy (Zahra & Filatotchev, 2004). Boards have affected important elements of strategies, such as the scope of the firm (Tihanyi, Johnson, Hoskisson & Hitt, 2003), entrepreneurship and innovation (Fried, Bruton & Hisrich, 1998; Zahra, Neubaum & Huse, 2000; Hoskisson, Hitt, Johnson & Grossman, 2002), strategic change (Westphal & Fredrickson, 2001), R&D strategies, and internationalization (Sanders & Carpenter, 1998).

The lack of consensus and clarity in empirical literature affects three main issues of the ongoing debate on board strategic involvement, leaving unanswered questions. First, it is not yet acknowledged whether it is beneficial for a company to have board members involved in strategic decision-making. In the early 1970s, boards were subject to managerial dominance, and were therefore seldom in any decisions; they acted as ceremonial 'rubber stampers' (Mace, 1971). Subsequently, in the next decades, boards became more involved in the identification of setting company's strategy. Increased board strategic involvement has positively affected corporate outcomes and company welfare (Sonnenfeld, 2004), but it may also have limited the speed of decision processes, reducing the responsiveness of a firm to the changing environment (Conger, Lawler & Finegold, 2001).

A second stream of criticism arises in relation to the content of board strategic involvement. What does it mean having boards involved in strategy (i.e. Which activities should they fulfill)? This is a central issue within the debate around board strategic involvement as it defines the boundaries of the expected contribution. The concept of board strategic involvement is multi-faceted by nature and rather undefined and difficult to translate into practice (Ravasi & Zattoni, 2006). Nevertheless, extant literature provides three main tenets and ways in which it has been operationalized:

- Boards are expected to participate to general strategy and decision-making (i.e. affecting the mission or the vision of one company).
- Boards contribute to shape-specific outcomes (i.e. internationalization, corporate entrepreneurship, diversification, restructuring, etc.).
- Boards take part in various phases of the decision-making processes, whether it be identification, ratification, implementation or evaluation.

The lack of uniformity in terms of what constitutes board strategic involvement increases the variance and the degree of consistency among existing studies which are not comparable as the dependent variable might differ substantially. In fact, while it is not questionable what is the driver (board features *lato sensu*), it is hard to understand which area (outcome) boards should affect through their actions (Kim, Burns & Prescott, 2009).

A third major area of conflicting evidence relates to the determinants and effects of board strategic involvement. The question 'What enhances boards' involvement into strategy?' is still left unanswered. This is strictly related to the underlying theoretical debate. Mainstream literature used to consider board strategic involvement as a way to increase shareholders' protection and wealth creation. In light of such a view, classical governance mechanisms – both board monitoring and bonding – were seen as positive determinants of higher strategic involvement (Hoskisson, Castelton & Withers, 2009). Monitoring of managers is ensured through a higher presence of outside and independent directors, while bonding refers to the use of incentive mechanisms as stock options and stock grants which align existing interests. Hence, board size, separation between CEO and chairman, insider ownership and outsider ratio were thought to positively shape the ultimate outcome of board strategic involvement (Johnson, Daily & Ellstrand, 1996).

Increasing independence and monitoring power should ultimately be reflected in the higher ability of boards to limit managerial opportunism and include shareholders' needs in strategic planning (Wu, Lin & Chen, 2007). However, empirical evidence shows that these 'usual suspects' are not able to predict whether boards will be more or less involved in strategy, nor if board characteristics can positively affects the desired outcome (Finkelstein & Mooney, 2003).

Behavioral and cognitive perspectives explore determinants of board strategic involvement from a different point of view: scholars claim that innate determinants of boards' contribution to strategy should be observed outside the restricted circle of the 'usual suspects'. Seemingly, the level of knowledge, confidence and trust within the board and in the CEO-board relationship are likely to affect strategic outcomes (McNulty & Pettigrew, 1999). Board processes (Forbes & Milliken, 1999) and the possession of information (Zhang, 2010), together with the empowerment of key actors (Gabrielsson, 2007), are the most relevant features to guarantee higher involvement.

The 'board and strategy debate': an evolutionary perspective

The debate around the expected contribution of board members to strategy has evolved across the years. This is somewhat expected, given the changes in the contexts and the evolution of board practices due to the emergence of codes of conducts and new waves of regulation. Changes have affected both practice and scientific literature in many ways since seminal articles published in the early 1970s.

The origins of the debate can be traced back to the early 1970s. Early anecdotal evidence from a few cases in the business community witnessed that boards were rather passive, hence favoring corporate failures in the USA (Mace, 1971). At that time, the debate was mainly driven by the practical needs faced by the US business community. Failures of large established corporations and early governance scandals, together with the increasing push towards higher directors' accountability, fueled studies on boards and governance issues (Lorsch & MacIver, 1989).

Table 10.2 The evolution of studies on board strategic involvement

	Early 1970s to late 1980s	*Early 1990s to 2000*	*2000 onwards*
Main issue of debate	The desirability of boards' strategic involvement	The antecedents of boards' involvement in strategy and their effects	Boards' participation and contribution to strategic decision-making
Theoretical approach	Lack of one main theoretical lens. The debate is mostly driven by practical concerns. Agency theory begins to gain momentum	Agency theory is the most commonly used framework for exploring boards' contribution to strategy	Agency theory is still the main theoretical perspective. Cognitive and behavioral approaches, together with alternative theoretical lenses (resource-based views, stewardship, stakeholder, team production), gain importance
Empirical approach	Wide use of anecdotes and a few qualitative studies	Prevalence of quantitative methods, archival data, with an 'input–output' approach	Qualitative methods observe inner dynamics on the board contribute to the flourishing of the topic in the field of governance
Main contribution	Boards were considered to be rather passive and subject to managerial hegemony. There is a call for more involvement in strategy	Boards are recognized as the main actors in the strategic decision- making process. Still doubts around what triggers their involvement and what are the consequences	A growing stream of research relates boards to strategic decision-making, while studies referring to specific strategic outcomes remain dominant

Fostered by this early evidence, there was a great call for having boards more involved in the strategic domain. In the same period, strategic management became an established research field (Pettigrew, Thomas & Whittington, 2002). During this first period, research on boards and strategy was characterized by a debate around the desirability of more active boards, also in terms of strategic participation. In his pioneering work *Directors: Myth and Reality*, Mace (1971) prompted the debate in the USA around a perceived passivity of boards of directors at that time (Herman, 1981). Empirical and anecdotal evidence shows that boards were rather passive and subject to CEO and managerial dominance, thus reducing their expected contribution to companies' activities.

Two strands of research can be distinguished during this period. On the one hand, boards are considered the main actors in strategic decision-making processes, albeit they are not expected to formulate strategy. For instance, Andrews (1980) emphasizes that boards are in a perfect position to search for alternative corporate strategies and complement managers' choices. Furthermore, Felton (1979) argues that boards should confront management in cases where results deviate from expectations, also in the realm of strategy: this is in line with the hypothesized monitoring role on behalf of shareholders. To support adequate fulfillment of the strategy role, Wommack (1979) and Harrison (1987) suggest that boards should create an internal committee dedicated to this issue. On the other hand, another group of scholars strongly argued that boards should not be actively involved in strategy. For instance, according to Heller and Milton (1972), strategic issues are difficult subjects for directors to get into, as they are often not involved in the company on a daily basis. Moreover, Mace (1971) argues that outside directors are mostly hired through cooptation and that this practice may limit their commitment and involvement in strategic issues as they belong to the '*old boys' club*'. A few years later, in their seminal work, Fama and Jensen (1983) gave impetus to the debate and provided an analytical foundation to the clear distinction between decision management, i.e. initiating and implementing (strategic) decisions, and decision control, i.e. ratifying and monitoring (strategic) decisions. Their article proposed a clear distinction between the tasks ascribed to the TMTs and the tasks devoted to boards of directors. The debate on board strategic involvement has been influenced by their subsequent contribution. Such a separation of roles has been at the basis of the development of the field over the last 30 years.

In sum, the key characteristics of research during this period are (i) the lack of one prevailing theory, (ii) the predominance of works discussing the desirability of the board's participation in strategic decision-making, and (iii) a broadly defined concept of board strategic involvement. Therefore, it comes as no surprise that Zahra and Pearce (1989), at the end of this period, assert that '*overall, empirical research on the boards' strategic role is in its infancy stage*'.

During the first period, the interest in studies on boards and strategy seems to be rather limited, owing to the slow emergence of the topic as an issue to be debated. Two breakthrough articles influenced the emerging literature on boards of directors and strategy at the end of the 1980s and at the beginning of the 1990s. Zahra and Pearce's (1989) literature review highlighted the importance of understanding the relationship between board characteristics and structure, and strategy. Additionally, Baysinger and Hoskisson (1990) discussed the prominence of board–TMT dynamics and its implications for strategy. Furthermore, they emphasized also that evaluating the strategic implications of boards of directors requires empirical analysis.

Following these suggestions, multiple studies were published during the next decades. Generally, they relate board characteristics and structure (i.e. board size, CEO duality, board diversity, outsider ratio, tenure and directors' equity stakes) to strategic outcomes, such as acquisitions, strategic change (Goodstein & Boeker, 1992), corporate restructuring (Daily, 1995), entrepreneurship (Zahra, 1996), internationalization (Sanders & Carpenter, 1998), and R&D expenditures. Generally, these studies provide mixed evidence of the relationships between board characteristics and strategy.

The second period is characterized by a wide diffusion of 'input–output studies' relying on a highly deterministic approach. This tendency is clearly shown and the major feature of this line of inquiry is that the majority of studies refer to agency theory, use US samples through analyses of archival data and are published in top US journals such as the *Academy of Management Journal*, *Administrative Science Quarterly*, and *Strategic Management Journal*. Interestingly, two different lines of inquiry start developing in this period (Deutsch, 2005). Several scholars examined the antecedents of board strategic involvement, searching for ways to increase boards' contribution in listed companies (Judge & Zeithaml, 1992). Aside from the previous group, a second one inquired into the effects of the relationship between the board and TMTs on strategic decision-making (Judge & Dobbins, 1995; Fried & Hisrich, 1995; Westphal, 1998; Gulati & Westphal, 1999).

Towards the end of the 1990s an alternative stream of literature emerged, proposing a new perspective on boards' roles and behavior (Forbes & Milliken, 1999; McNulty & Pettigrew, 1999). These scholars had a significant impact on the field, initiated the debate around more cognitive and behavioral approaches, and opened up the debate on boards' contribution to strategy processes. The previous inconclusiveness of research on what drives board strategic involvement and the search for its consequences raised a call for a different approach to the topic: structural and deterministic 'input–output studies' are abandoned in favor of process-oriented inquiries (Stiles & Taylor, 2001).

A sharp increase in the number of articles published witnesses that research on boards and strategy gained even more momentum during the third period (Pugliese et al., 2009). These years were characterized by the coexistence of different research approaches. A number of studies still focus on the determinants and consequences of board strategic involvement, use archival data in a US setting and extensively refer to agency theory. Nevertheless, a growing body of literature present different characteristics. *First*, empirical studies drawing on non-US data become more frequent. For example, the corporate governance contexts of Australia (Bonn & Fisher, 2005), Belgium (Van den Heuvel, Van Gils & Voordeckers, 2005), Italy (Zona & Zattoni, 2007), Japan (Yoshikawa & Phan, 2005), New Zealand (Ingley & Van der Walt, 2005), Norway (Huse, Minichilli & Shoning, 2005; Zhang, 2010), and the United Kingdom (Stiles & Taylor, 2001) are examined. *Second*, new theoretical standpoints are used to interpret phenomena (Clarke, 2004; Hendry & Kiel, 2004): most of the published articles do not refer to agency theory, but use alternative theoretical lenses.

Drawing on earlier contributions by Forbes and Milliken (1999), McNulty and Pettigrew (1999) and Rindova (1999), research on boards and strategy is also characterized by the emergence of behavioral and cognitive approaches. Studies in this tradition sought to understand how boards participate in strategic decision-making as an active part of it (Boyd, 1990; Stiles & Taylor, 2001). Jensen and Zajac (2004) and Useem and Zelleke (2006) highlight that boards participate in strategic processes through continuous interactions with managers and other stakeholders. Moreover, Rindova (1999) argues that the work of the board of directors is not limited to ratification and monitoring only as Fama and Jensen (1983) suggest: boards of directors should, rather, be involved in all phases of the strategic decision-making process. Furthermore, Mueller et al. (2003) underline the conflicting requirements that boards of directors face in fulfilling the monitoring role (independence) and the strategy role (involvement). One of the most debated issues became whether boards should favor independence and distance from managers or inter-dependence should prevail in order to commit to higher involvement. Scholars have also started inquiring into the joint impact of board dynamics, working style and structure on strategic issues (Golden & Zajac, 2001), as well as how the expertise, abilities and network ties of board members affect their ability and motivation to contribute to strategy formulation (Carpenter & Westphal, 2001; Hillman, 2005) and overall capacity of the board of directors to impact on CEOs and TMTs (Arthaud-Day, Certo, Dalton & Dalton, 2006).

BOARDS' CONTRIBUTION TO COMPANY INNOVATION AND ENTREPRENEURSHIP

Innovation and corporate entrepreneurship are crucial in order to guarantee survival, growth and success of a company. For this reason, governance scholars endeavor to find the optimal structures that would increase the chance of pursuing entrepreneurial actions (Wu, Lin & Chen, 2007). These activities are ultimately related to firm performance: they generate stimulus for the general economic development as well as the economic performance of individual firms (Covin & Slevin, 1991). Theory suggests that firms may derive the greatest benefits from an entrepreneurial orientation when they concurrently exhibit a high degree of strategic reactiveness and flexibility (Green, Covin & Slevin, 2008). In this respect boards of directors and TMTs play a key role in shaping the entrepreneurial orientation of a company and are expected to pursue value-maximizing activities in order to build a basis for a durable competitive advantage (Shimizu & Hitt, 2004).

Based on these premises, research has investigated how boards contribute to corporate entrepreneurship. Nevertheless, results seem to be scattered and we cannot assess to what extent boards contribute to corporate entrepreneurship. Even though entrepreneurial activities are crucial to determine a company's success, they are highly risky in nature (Covin & Slevin, 1991): therefore, managers and (dispersed) shareholders might face different incentives in pursuing or avoiding risky investments. The dominant logic behind studies on boards and innovation is driven from an agency 'dilemma': 'how boards should contribute to [shareholders' wealth through] innovation activities?' (Wiseman & Gomez-Mejia, 1998). While it is acknowledged that boards should oversee managerial action, doubts arise in relation to what they should monitor. On the one hand, managers have incentives to limit entrepreneurial orientation due to their natural risk aversion (Wright, Ferris, Sarin & Awasthi, 1996) because they cannot diversify their investment as dispersed shareholders through portfolio optimal choices. Moreover, they have a higher stake in terms of employment and reputation: they would pay for any mistake also through a job loss. While gains would advantage shareholders in case of profitable venturesome activities, in the case of losses, a managers' job tenure would be at risk as well as their remuneration (Hoskisson, Castelton & Withers, 2009). Failures of innovation activities not only depress short-term performance of a company but also reduce a manager's reputation and increase risk of unemployment (Zahra & Covin, 1995). Hence, managers might prefer limiting expenses in risky projects, thus affecting future company profitability. Following this line of reasoning, boards of directors should challenge managers to pursue venturesome activities.

Another view claims that boards should limit managerial attitude towards innovation and corporate entrepreneurship because managers do not bear all the risks connected to investments as they are only to a limited extent residual risk bearers (Audretsch, Lehemann & Plummer, 2009). As such, managers are considered highly entrenched and might be willing to pursue risky projects because their direct risk is limited compared to those of shareholders. Therefore, boards should limit managers' willingness to undergo projects with too high risk if they perceive them as harmful for shareholders' wealth.

The above reasoning is rooted in financial economics studies and to a large extent it influenced research on the role of boards of directors in corporate entrepreneurship. Scholars in this field have sought to determine (if any) an optimal structure for boards of directors to guarantee company innovation. Empirical results seem to be conflicting and in some cases even counterintuitive. What are recognized is that board structure and composition do not affect the ultimate level of entrepreneurial activities (Audretsch, Lehemann & Plummer, 2009). Three main dimensions have been taken into account: (i) board independence (outsider ratio); (ii) board ownership (percent of shares held by board members); and (iii) large shareholdings (presence of institutional investors or venture-backed firms).

Board independence, while expected to be a crucial factor in guaranteeing adequate levels of innovation activities, has a negative effect on corporate entrepreneurship (Dess, Lumpkin & Covin, 1997). Bonding mechanisms seem to be more effective than monitoring: insider ownership (among managers and directors) is positively related to company innovation up to a certain threshold (Wright et al., 1996). Such a result, consistent across time and confirmed by several studies (Fried, Bruton & Hisrich, 1998; Zahra, Neubaum & Huse, 2000), shows that if board members have 'ownership incentives' they are more proactive in fostering innovation activities. Another driver of corporate entrepreneurship is the presence of large shareholders with long-term orientation and commitment, whereas short termism is associated with negative R&D spending (Zahra, 1996).

More recently, literature in strategic management provides a different approach to the topic and challenges the structural 'input–output' studies. Management scholars stress that corporate entrepreneurship and venturesome activities are necessary to company survival independently from managers and owners' incentives (Wu, Lin & Chen, 2007) and depend to a large extent on resource configuration and capabilities within the firm (Audretsch & Lehmann, 2006). The RBV of the firm documents that participation in strategy and contribution to innovation is determined through knowledge and resources of key subjects, regardless of their labels or ownership stakes (Barney, 1991). Corporate entrepreneurship is the result of interactions between board members and the TMT (Zahra, Filatotchev & Wright, 2009); therefore, inner dynamics need to be unveiled and discovered (Hornsby, Kuratko & Shepherd, 2009). Such a call is also in line with resource dependence theory that does not limit the boards' role to monitoring, but considers boards as 'resource providers' that reduce the distance to the external environment (Gabrielsson, 2007). Boards' contribution occurs through continuative actions and interactions with managers; henceforth, collaboration, empowerment and trust should be considered as key drivers of effective innovation activities.

Overall, while there is an agreement in terms of boards' primary function in shaping firm innovation and corporate entrepreneurship, there is a dearth of clarity with regard to the type of activities that should be pursued by board members. While the literature has been initially dominated by deterministic approaches, leading to structural responses to innovation needs, more lately research has evolved (Zahra et al., 2009) questioning whether inner dynamics, capability and absorptive capacity are the most important elements to be investigated (Audretsch et al., 2009).

CONCLUSION

The contribution of boards of directors to strategic decision-making and corporate entrepreneurship has been widely discussed among practitioners and scholars. During the last four decades the topic has been revamped on several occasions, pushed by company failures (among others, Enron, Ahold and Tyco) or from general economic concern (i.e. when the Japanese economy overtook that of the USA) (Shimizu & Hitt, 2004). One of the most debated questions is whether (and how) boards should participate in the strategic decision-making process and foster innovative actions. Boards are expected to formulate a firm's strategy both from legal and management perspectives (Blair & Stout, 1999). Recent studies confirm the idea of directors being involved into the strategic decision making. However, existing literature has not been unanimous on this matter, showing a great degree of variations in findings. As outlined in previous sections of this chapter, the field of research has evolved over time in many ways: initial works did not have a solid theoretical ground (early 1970s until late 1980s), with a preference towards anecdotal works, whereas in the subsequent period agency theory and empirical application has been prevailing. More recently the dominance of Agency Theory is not so apparent anymore as witnessed by a theoretical pluralism and variety of research methods (Hendry et al., 2010).

The board and strategy debate has evolved over time, drawing upon different theoretical perspectives and empirical approaches. Agency theory provides a fundamental contribution in claiming that boards are involved in strategy for the purpose of serving shareholders' best interests (Fama & Jensen, 1983). While providing a valid an theoretically sound rationale, agency theory does not satisfactorily specify *how* boards accomplish their strategic task. Its main focus on *structural elements* of board composition leads towards mainly deterministic 'input–output' approaches in empirical research. The dominance of agency-based studies is reflected also in the prevalence of US studies on large corporations trying to assess antecedents and effects of board strategic involvement (Pugliese et al., 2009).

The evolution in this field of research has been mainly dictated by the new and emerging trends in management studies, which have provided a complementary view to the dominant agency approach. Alternative theoretical perspectives have an impact on the ways boards are expected to contribute to strategy, and provide a broader view to the understanding of governance issues. Stewardship theory contributes by arguing that managers and shareholders do not necessarily have conflicting interests, and might cooperate in setting strategic objectives. Stakeholder theory challenges the idea that shareholders' value maximization is the main objective of the firm, while different categories of stakeholders pursue different objectives. This view has a profound impact on the 'goal identification'. Resource-based approaches view boards as a potential source of competitive advantage, whose strategic impetus serves a company's success. This perspective broadens the role of boards beyond the sole monitoring and underlines the need to create links with external actors. A behavioral perspective would indeed claim that boards deal with internal and external complexities and shape company strategy through continuous interactions and teamwork; therefore, it is of great importance unveiling the inner dynamics, processes and modes of work. The contribution of alternative perspectives to the leading agency approach expands to research methods and execution: inner dynamics as well as societal concerns (i.e. interlocking directorates, diffusion of ideas and contested beliefs) are quite often a source of explanation for how boards behave in the strategic arena.

With regard to boards' contribution to corporate entrepreneurship and innovation, we have reviewed extant literature and showed that accumulation of knowledge paralleled what happened in the boards and strategy debate. In this area of strategic management, governance and entrepreneurship have been put in relation to the specific intent to address the following question: 'What is the best composition/structure of the board that can help innovation?' (Zahra & Filatotchev, 2004). Innovation is a risky activity by nature; managers and shareholders might have different incentives to (not) pursue risky projects. In light of agency theory, boards of directors are expected to monitor managers who could be too much risk averse (in order not to lose prestige on the job market) or, rather, they could gamble with shareholders' money, since they do not bear a major part of the risk (Wiseman & Gomez-Mejia, 1998). Apparently, it is hard to find a univocal relationship between board composition and level of innovation and R&D spending of a company; rather, independence and outside directorships negatively affects a firm level of venturesome activities. Bonding mechanisms seem to be more effective given that inside equity ownership or the presence of large investors positively shapes the longer-term horizon that is required to pursue innovation activities.

Again, in the field of governance and entrepreneurship there is a strong critique to approaches reduced to metrics issues (Sonnenfeld, 2004) and there is a call for alternative theoretical lenses and techniques to properly investigate the field (Audretsch et al., 2009). Strategic decision-making and entrepreneurial actions are the result of a process that requires involvement, skills and knowledge from the participants aside from the monetary incentives. According to resource-based views of the firm, boards act as a catalyst of knowledge and resources necessary to support managers in defining the strategic posture (Zahra et al., 2009). Aside from this view, empowerment, trust and collaboration between (outside) board members and insiders is crucial to determine positive choices in terms of entrepreneurial activities (Gabrielsson, 2007). Recent works are paying far more attention to inner dynamics between board members and corporate managers. Behavioral and process-oriented studies are gaining momentum in understanding the inner dynamics of boards, and how skills are developed and employed, given the often highly specialized environment in which they operate.

Overall, beyond the impact for researchers, the evolution of the field has also implications for practice: the 'structural features of boards' have proved not to be the sole trigger for effective strategic involvement; rather, sometimes they can be even misleading. At the same time, the growing importance of processes on the board, the quest for skilled directors and positive teamwork are likely to affect the outcome of strategic processes. In turn, what seems to be of great importance for practice is the idea that boards should be framed according to the company's needs. Having boards involved in strategy requires knowledge of the business and industry and linkages to the main stakeholders, whereas independence per se does not prove to be enough.

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11

Board Leadership and Value Creation: An Extended Team Production Approach

Morten Huse and Jonas Gabrielsson

INTRODUCTION

Board leadership and the importance of the leadership role of the board chair are receiving considerable attention in the practitioner-oriented literature, but it is paradoxical that this topic has so far only received limited attention in the academic literature. We argue in this chapter that the lack of focus in research on board leadership is the strong focus in the academic corporate governance debate in recent years on agency theory and a shareholder supremacy understanding. Agency theory has during recent years dominated research and the academic-oriented literature on boards and corporate governance. The popularity of agency theory is partly related to its strength in making predictions, and partly to that it is easy to communicate. But it also contains some assumptions that may be disputed. In this chapter about board leadership we relax on two sets of assumptions in agency theory: assumptions about external principals (Blair & Stout, 1999) and some of the behavioral assumptions (van Ees, Gabrielsson & Huse, 2009). We will use a team production approach that builds on the assumption that the firm is a separate and independent moral entity, and that the main task of a board is to create long-term values and sustainable competitive advantage in the firm. However, we will use a revised version of team production theory that extends it, based on implications in relation to strategic management and organizational behavior.

Team production theory has its background in property rights theory (Alchian & Demsetz, 1972) and has been extended, developed and applied to understand corporate governance (Blair & Stout, 1999; Kaufmann & Englander, 2005). This extended version of team production theory integrates cooperative game theory (Aoki, 1984) and a behavioral theory of the firm (Cyert & March, 1963). A core tenet in the extended team production approach to corporate governance is the critical function of the board of directors. It is as an impartial mediator between a firm's value-adding stakeholders to access relevant competence and strategic knowledge. From this perspective, corporate boards of directors can be considered as value-adding teams on top of the corporate hierarchy, and whose commitment should be to create value for the firm. Creating value for the firm does not need to be in contrast to creating values for managers, shareholders or other stakeholders. In fact, all coalitions of stakeholders will be better off in the long run when team-specific investments are encouraged and realized. It is the development of the firm that should have the core attention rather than the attention of serving the interests of any particular group of stakeholders. In effect, the board of directors will function as a mediating hierarchy that balances the sometimes conflicting interests of the many stakeholders who make up the firm (Blair & Stout, 1999). However, this process also poses challenges and call for effective board leadership.

In this chapter we build on the value creation board framework presented by Huse (2005, 2007) and include various recent contributions about board leadership and team production theory (e.g., Huse, Minichilli & Schøning, 2005; Gabrielsson, Huse & Minichilli, 2007; Minichilli, Gabrielsson & Huse, 2007; Gabrielsson & Huse, 2009, 2010; Huse & Søland, 2009; Huse, Gabrielsson & Minichilli, 2009a, 2009b, 2009c; Machold, Huse, Minichilli & Nordqvist, 2011). The value-creating board framework is an elaboration upon contributions from Mace (1971), Fama and Jensen (1983), Zahra and Pearce (1989), Pettigrew (1992) and Forbes and Milliken (1999) and is supported by various qualitative and quantitative empirical studies over several years (see, e.g., Huse, 2007, 2009). In this chapter we develop the value-creating board framework by positioning it within the extended team production theory. The rest of the chapter proceeds as follows:

- Corporate governance and value creation: from agency theory to an extended team production theory.
- Board tasks: from control to value creation.
- The board members: from independence to diversity and dynamic capabilities.
- The board as a team: from decision-oriented to process-oriented boardroom dynamics.
- The board leader: from a passive chair to a motivator.
- Regulating board activities: from the closed room to inclusive openness.
- Board evaluations: from external reporting to internal development.
- Conclusion: understanding board leadership and value creation requires a new way of thinking.

CORPORATE GOVERNANCE AND VALUE CREATION

Why do we have boards in corporations, and what is their main purpose? Various perspectives need to be understood when arguing for the contributions and development of boards of directors. Main perspectives on boards and governance can be differentiated along two dimensions: whether they have a firm internal or a firm external perspective, and whether they have a unitary or balancing perspective. This is presented in Table 11.1.

Table 11.1 Perspectives on boards and value creation

	Unitary perspectives	*Balancing perspectives*
Firm external perspectives	Shareholder perspectives – Value creation for shareholders – Boards are serving shareholder interests	Stakeholder perspectives – Value creation for stakeholders – Boards are serving stakeholder interests
Firm internal perspective	Managerial perspectives – Value creation for the management – Boards are serving management interests	Firm perspectives – What is best for the firm – Value creation throughout the whole value chain

Corporate governance can be studied from various theoretical perspectives and the dominating perspectives have been changing during the past decades (Clarke, 2004). During the 1970s and early 1980s a managerial hegemony tradition dominated the debate on corporate governance (Galbraith, 1967; Mace, 1971; Herman, 1981; Vance, 1983; Wolfson, 1984; Patton & Baker, 1987). This debate took a unitary firm internal perspective and emphasized value creation for the management. Boards of directors were seen as bodies primarily serving managerial interests in their pursuit of their own welfare and/or organization-wide corporate goals and objectives. However, in practice, the board of directors had no real power and at best had the role as a counsel or cabinet for the chief executive officer (CEO).

The reaction to the perceived problems of managerial hegemony increased in the 1980s (Monks & Minow, 2004). The need for control by actors external to the firm was increasingly emphasized. The shift in focus from firm internal to firm external perspectives was followed by the development of shareholder and stakeholder approaches, and they subsequently came to dominate the corporate governance debate.

A shareholder approach takes the perspective of financial investors, and thus it remains with a unitary perspective. Supported mainly by agency theory (Jensen & Meckling, 1976; Fama & Jensen, 1983), the shareholder approach argues that the boards are elected to represent shareholders. Board members should be independent from substantial managerial influence. Corporate value creation is interpreted as maximizing shareholder returns, and boards are expected to closely monitor managerial and firm performance in order to reduce the risk of opportunism and to enable the distribution of value to these shareholders.

The attention to stakeholder approaches (e.g., Huse & Rindova, 2001; Simmons, 2004; Bonnafous-Boucher, 2005; Sacconi, 2006) can be seen as a reaction to the shareholder approach in corporate governance. In principle, it is argued in the stakeholder approach that there is no set of interests that automatically should have priority over other interests, and that the survival and success of a firm depends on the ability to create value or satisfaction for all its primary groups of stakeholders (Donaldson & Preston, 1995; Jawahar & McLaughlin, 2001). Following this balancing perspective, the board of directors is hence seen as accountable to a broad variety of stakeholders, and the board must continually assess which of these are the most important for the successful development of the enterprise.

It is emphasized in both shareholder and stakeholder approaches how the corporation is there for external actors. In contemporary debates on boards and governance the firm internal perspective has only received limited attention, but it is within this perspective we find much of the strategic management literature on boards of directors. Examples are the resource dependence theory (Pfeffer & Salancik, 1978; Hillman, Cannella & Paetzold, 2000) and the resource- or knowledge-based view of the firm (Lee & Phan, 2000; Zahra & Filatotchev, 2004). However, these theories do not explicitly discuss the role of boards in strategic decision making. Boards and board members are instead most often seen as a resource (or as a resource provider), supporting the management team in the achievement of corporate goals, much in line with managerial hegemony.

A theoretical rationale for a balancing firm internal perspective may be found in the extended team production approach to corporate governance. Property rights theory and team production theory argue that the voting rights holders and property rights holders may not be the same actors. This may, in some cases, create a misalignment that will harm a firm's ability to compete effectively (Alchian & Demsetz, 1972; Blair & Stout, 1999, 2006). Those holding voting rights in the firm should thus be those stakeholders having the most at stake, those having the most relevant competence, and those knowing the strategic direction of the firm.

A core tenet in the team production approach to corporate governance is the view of organizations as a nexus of team-specific assets. Stakeholders are seen as investing firm-specific resources with the hope to profit from team production. The firm can then build on these firm-specific investments to create a unique bundle of valuable resources that are hard to imitate, heterogeneous in nature and not perfectly mobile, and which thus will assist the firm in creating competitive advantage and above-average returns (Barney, 1991). Such specialized firm-specific investments are essential to the firm because they increase the productivity and competitiveness of the organization (Wang & Barney, 2006). The team production perspective will thus emphasize a balancing perspective on corporate governance. Team production calls for the need to ensure that continued firm-specific investments take place in order to build a strong resource base and create sustained competitive advantage (Blair & Stout, 2006).

The balancing perspective implies that the governance system must provide proper incentives for *all* value-adding stakeholders to continue with their firm-specific investments. Otherwise, for example, if some coalitions of stakeholders are consistently favored, there will be concerns among other value-adding stakeholders that the returns from their firm-specific investments will not be fairly distributed. This, in turn, will risk reducing their effort and subsequently limiting the firm's ability to compete effectively in the marketplace. To overcome this potential problem the board of directors is identified in the theory as a critical coordinating body whose main task is to represent and mediate between all stakeholders that add value, assume unique risk and possess strategic information critical for firm operations (Kaufmann & Englander, 2005). To competently fulfill this requirement the team production model of corporate governance suggests that boards should be composed of a diverse set of board members who can knowledgeably express the interests, perspectives and expertise of its value-adding stakeholders (Kaufman & Englander, 2005).

In effect, it becomes important for the board to serve as an impartial mediator between various value-adding stakeholders. Their joint input of information and knowledge in the formulation and implementation of corporate strategy is seen as critical for the firm's ability to create value (Kaufman & Englander, 2005). Board members must consequently work together and share their knowledge and skills. A productive boardroom setting is important in order to enhance the board members' collective efforts and decision-making abilities. This also means looking after the interests of all stakeholders who contribute with critical resources, assume unique risk and possess relevant strategic information relevant for firm operations.

BOARD TASKS

Board leadership calls for attention to multiple board tasks. The general implication from agency theory is that boards should be involved in various control tasks to avoid managerial opportunism, and to ensure that managerial behavior is aligned to the interest of shareholders (Jensen & Meckling, 1976; Fama & Jensen, 1983). This shareholder-oriented perspective has dominated in recent years. However, as indicated in the discussion above, the boards' contribution to value creation has a considerably longer history than agency theory and control tasks. There has also been a tradition that boards on behalf of the firm and the management have contributed to corporate value creation by providing service and knowledge to the firm. This firm internal perspective has usually been represented through resource dependence theory (Pfeffer & Salancik, 1978; Gabrielsson & Huse, 2010) and in more recent work by an extended team production approach (Blair & Stout, 1999; Kaufman & Englander, 2005; Gabrielsson, Huse &

Table 11.2 Boards tasks from different perspectives and foci

	Firm external perspectives (Control tasks)	*Firm internal perspectives (Service tasks)*
External foci	Board output control tasks	Board networking tasks
Internal foci	Board internal control tasks	Board advisory tasks
Decision/strategy foci	Board decision control tasks	Board collaboration and mentoring tasks

Minichilli, 2007). The different perspectives and sets of tasks are further elaborated in Huse (2007: 33–68) and summarized in the typology in Table 11.2.

Theory and practice show that boards may have different foci for their attention: for example, attention to the external environment; to firm internal operations and behavior; and to strategic development. The typology thus contains six main sets of board tasks: sets of tasks from 'external' perspectives are output control, internal control and decision control; sets of tasks from 'internal' perspectives are networking, advice and strategic leadership. In sum, these different sets of tasks provide an overview of the range of tasks that have been found to contribute with value in the organization.

The term 'value chain' was used by Michael Porter (1985). A value chain analysis describes activities within and around an organization, and relates them to a competitive analysis of its strengths and weaknesses. Primary activities are, according to Porter, inbound logistics, operations, outbound logistics, marketing and sales, and service. Support activities are infrastructure, human resource management, technology development and procurements. We will not here follow Porter's value chain, but use it to show that boards can contribute to value creation by involvement in the various phases of a company's value chain. Board involvement may be seen as support activities in the value chain phases, and the various sets of board tasks may relate to various phases. The various phases where boards can be involved are, for example, inbound logistics (networking, lobbying and legitimacy), innovation (strategic participation), resource allocation (decision control), operations (advice and counsel), implementation (internal control) and outbound logistics and distribution (output control). The row of order among the phases may be discussed, and it will definitely vary across firms. Table 11.3 illustrates relations between boards and various value-creating activities.

Understanding board tasks from a value chain perspective helps us understand that the board may have several tasks at the same time, and that all tasks may contribute to value creation (Huse, Gabrielsson & Minichilli, 2009b). This goes beyond the arguments that board tasks primarily depend on firm contexts such as the firm's life cycle, including experience of crisis, company size, ownership structure such as ownership type and dispersion, industry and industrial environment, national, geographical and cultural differences, and CEO tenure and characteristics. However, the context may have an impact on how the contribution in various phases should be balanced. This value chain approach is still novel. Some empirical supports are illustrated in Huse and Søland (2009) as well as in many of the studies using the value-creating board survey instruments (Huse, 2009). However, there are needs for considerable empirical investigations.

The importance of board leadership is evident when including behavioral perspectives in studies of boards and governance (van Ees et al., 2009; Huse, Hoskisson, R.E., Zattoni, A. & Vigano, 2011). Board leadership can be defined as the use of knowledge and skills of board members for value creation. It is also illustrated in Table 11.3 how various aspects of board leadership relate to the 'value chain'. Board members have different characteristics, including knowledge and skills, and certain characteristics may be more

Table 11.3 Value creation and board leadership: a "value chain" approach

Value creation	*Inbound logistics*	*Innovation*	*Resource allocation*	*Operation*	*Implementation and risk management*	*Outbound logistics*
Board tasks	Networking, lobbying and legitimacy	Strategic participation and collaboration	Decision control and monitoring	Advice, counsel and mentoring	Internal control, compensation and behavioral control	Output control
Board members	Social capital and relational competence	Firm- and market- specific competence Creativity and diversity	Analytical and decision-making competence	General managerial and function-oriented competence	Process-oriented competence and board experience	Integrity and negotiating competence
Board as a team	Creativity Openness and generosity	Cohesiveness Creativity Commitment Openness and generosity	Commitment Cohesiveness	Openness and generosity Creativity Critical attitudes	Critical attitudes Commitment Creativity Cohesiveness	Cognitive conflicts Commitment
Board chair	Figurehead for the firm	Leader and motivator for the board	Decision-maker and strategist	Supporter and mentor for the CEO	Chair of board	Moderator between various stakeholders
Board regulations	Long meetings and two days' meetings. Board development. Activities outside the boardroom. Joint board-management meetings	Introduction and education. Annual plans for board meetings. Board minutes and agendas		Introduction and education. Compensation policies	Work descriptions for management Committees and division of work Control routines Alone meetings Regular meetings	Reports Stakeholder policies Ethics document
Board evaluations	Development evaluation		Recruitment evaluation			Report evaluations

important for some tasks than for others (Zahra & Pearce, 1989; Hillman & Dalziel, 2003). However, it is not evident that the knowledge and skills of the board members are used for value creation (Forbes & Milliken, 1999). How it is used depends on the value-creating culture in the board (Huse et al., 2005), the leadership of the board chair (Gabrielsson et al., 2007), various aspects of board regulations (Gabrielsson & Winlund, 2000) and also how boards are assessed or evaluated (Minichilli et al., 2007). Illustrative relationships are indicated in Table 11.3, and they are discussed in the following sections.

THE BOARD MEMBERS

Board leadership requires an understanding of how various board members can be used to create value. A board is (in much of the corporate governance literature) only understood as a group of persons with different identities. Board members are often characterized as insiders, identifying with 'internal' actors, or as outsiders, identifying with 'external' actors. 'External' actors are usually considered to be independent of the managers (Kosnik, 1987). Recommendations are made with respect to the number of board members and to the balance in number between insiders and outsiders. Human and social capital, competence and diversity are other concepts that are used to describe boards (Forbes & Milliken, 1999; Hillman & Dalziel, 2003), but these concepts have to less degree been used in empirical studies.

Diversity relates to variations among the board members with respect to their backgrounds, competences and personalities. Gender diversity has recently received considerable attention, and women are expected to contribute with different backgrounds, competencies, values and personalities than men. To understand the contribution of board value creation it is, however, needed to go beyond surface-level diversity to deep-level diversity (Nielsen & Huse, 2010), which includes various types of competencies or capabilities.

Arguments go in different directions with respect to the impact of number of board members, the insider–outsider ratio and diversity (Johnson, Daily & Ellstrand, 1996); however, various types of board member competencies are needed as they contribute to the various aspects of value creation. These types include (Huse, 2007):

- social capital and relational competence;
- firm- and market-specific competence;
- analytic and decision-making competence;
- general and function-oriented competence;
- process-oriented competence and boardroom experience;
- integrity and negotiation competence.

Most of these competencies are dynamic and complementary in the creation of value for the firm (Zhang et al., 2009). Capabilities may be defined as how these complex bundles of competencies are accumulated and can be used for value creation. Dynamic capabilities are the abilities to integrate, build and reconfigure internal and external competencies to address rapidly changing environments (Teece, Pisano & Shuen, 1997). Social and relational competence includes the abilities the board members have to build relationships with internal and external actors (Borch & Huse, 1993; George, Wood & Khan, 2001). Firm- and market-specific competence may, for example, be the capacity the board members have to absorb knowledge about the evolving main activities of the firm, the firm's critical technology and core competence, the weak points in the firm and its products and services, the development of the firm's customers, markets, products and services, the bargaining power of suppliers and customers, and threats from new firms or new products or services in the industry (Zahra, Filatotchev & Wright, 2009). Analytic and decision-making competence may include the ability to make independent and timely decisions. General and function-oriented competence may, for example, be in finance, accounting, law, marketing, human resources, organizational behavior and design, or just having general management experience (Forbes & Milliken, 1999; Gabrielsson & Winlund, 2000). Process-oriented competence may include knowledge and skills about running the board as a team (Gabrielsson et al., 2007). Integrity and negotiation competence includes the ability to balance various perspectives and liaison among different actors (Huse & Rindova, 2001). It is the joint use of these various board member competencies that may create dynamic capabilities in a productive team setting and enable the board to create value to the firm and its various stakeholders.

Arguments can be made about how these competencies may relate to the various board tasks and the various aspects of value creation: social capital and relational competence are expected to have a particular contribution for networking and inbound logistics; firm- and market-specific knowledge and diversity in knowledge for innovation and board strategic participation; analytic and decision-making competence for decision-making and strategic control; general and function-oriented competence for operations and advisory tasks; process-oriented competence and board experience for risk management, implementation and internal control tasks; and integrity and negotiation competence for outbound logistics, output control and value distribution. Availability and ability to spend time with the actual board and the company may be more important for some tasks than for others.

THE BOARD AS A TEAM

Board leadership is about making the whole board work together as a coherent team (Gabrielsson et al., 2007). The literature on boards and corporate governance, however, mostly leans on assumptions about individual decision-makers. They do not consider processes and behavioral dynamics that may reduce the potential of the board to create value (van Ees et al., 2009). Most corporate governance literature, moreover, assumes that when knowledge and skills exist, they are used. We will here include perspectives about characteristics of the board culture that may contribute to the use of knowledge and skills to achieve the listed sets of board tasks.

A key question in discussions of board leadership is the decision-making culture in the board. Is it mostly decision-oriented or has it more the features of being process-oriented?

Other key questions are how the board is working as a team, and how the knowledge and skills of the various board members are being used: there is a difference between having knowledge and skills and using them (Forbes & Milliken, 1999).

We will show that we need to go beyond the traditional decision-oriented board culture to a process-oriented culture (Huse et al., 2005). This is at the core of boardroom dynamics, where the challenge is to balance contrasting perspectives such as distance and closeness, independence and interdependence, distrust and trust, and challenge and support (Huse, 1993, 1994; Roberts, Stiles & McNulty, 2005), and to develop a positive dynamics rather than negative reinforcing cycles (Sundaramurthy & Lewis, 2003). Positive and virtuous dynamics are created in a team production culture, whereas the negative cycles stem from an individualistic culture.

Team production can be described as when several types of resources and competencies (such as information, talents, skills and visions) are used, and where the end product is greater than the sum of the separable outputs of each cooperating resource (Alchian & Demsetz, 1972; Blair & Stout, 1999). In a boardroom setting, this means that board members and their competencies may be seen as complementing one another rather than serving as substitutes for each other. By working together as a team the board should experience greater productivity than what can be achieved by individual board member effort.

In a team production approach, boards are seen as knowledgeable and cooperative teams, with the purpose of leading the corporation and coordinating corporate activities. As such, the board of directors is seen as a critical coordinating body. Its main task is to represent and mediate between all stakeholders that add value, assume unique risk and possess strategic information relevant for firm operations, while at the same time channeling their expertise and know-how by which the firm competes into the strategic decision-making process (Kaufmann & Englander, 2005). Among other things, this calls for the inclusion of board members with alternative and complementary backgrounds. They should knowledgeably express the interests of the firm's whole range of value-adding stakeholders to enhance consistency and coherence in the decision making and control over firm resources (Huse et al., 2009c).

In our previous work we have identified six critical dimensions that can help promote a team production culture in the boardroom: these are cohesiveness; creativity; cognitive conflicts; openness and generosity; criticality; and commitment (Huse et al., 2005; Gabrielsson et al., 2007). These dimensions are described below.

- A value-creating team production culture is characterized by cohesiveness. Cohesiveness relates to if board members are attracted to each other and are motivated to stay on the board. It influences the ability of the board members to continue working together. Board members often experience a higher level of satisfaction in cohesive cultures than in situations where there is little or no cohesiveness. Board members that are attracted to each other will appreciate coming together for board meetings, and give very high priority to being a part of the board.
- A value-creating team production culture is characterized by the presence of creativity. Creativity in the boardroom means that the board as a team develops creative proposals as well as creative solutions to various issues and problems. Solutions that may not be so creative can also be an input to the understandings, reflections and imaginations of the others and thus trigger creativity. Among other things, this encourages a future-oriented agenda and helps the board explore emerging issues and problems while also helping to resolve them.
- Cognitive conflicts refer to the task-oriented differences in judgment between group members. Suggestions and solutions by one party are not directly perceived and accepted by other parties. A value-creating team culture is characterized by how such cognitive conflicts are used in argumentations in finding new and good solutions. Cognitive conflicts are appreciated, and the use of knowledge and skills are utilized.
- A value-creating team production culture requires that board members are open and generous towards each other. This may lead to greater informality, and encourage free flow of information in the boardroom. By interacting in an open and generous milieu, board members may moreover be more willing to give advice based on private knowledge, share ideas and points of view, and also accept and recognize that they may be wrong in their considerations.
- A value-creating team production culture encourages a critical and questioning attitude in the boardroom. This will result in board members being encouraged to find their own information and to carefully scrutinize the information being provided by the CEO. A key issue is that the board members in their decision-making have the integrity to be independent and are allowed to ask challenging and discerning questions.
- A value-creating team production culture has standards or norms about preparations, participation and commitment. This will encourage board members to make independent preparations and investigations prior to the meetings. Team production also requires participation in the meetings and commitment to discussions and debates. Without proactive commitment from all board members, the board will not reach its full potential.

The six dimensions of a team production culture are summarized in Table 11.4 and contrasted with an individualistic boardroom culture. The table shows the two different cultures as polar entities, but in reality boards may score higher or lower in the different dimensions. Board leadership efforts should, however, target the different dimensions and take action towards developing a team

Table 11.4 Six dimensions of a team production culture

Main dimensions	*From an individualistic culture …*	*… to a team production culture*
Cohesiveness	Board members stick to their individual strategies and goals	Board members work together to coordinate organizational activities and goals
Creativity	Board members do not engage in creative discussions or reach solutions that do not match their own pre-analysis of a situation	Board members work together to come up with creative proposals as well as creative solutions to various problems
Cognitive conflicts	Different perspectives and understandings are not confronted or accepted	Different perspectives are being confronted and used as inputs in the discussion
Openness and generosity	Board members stick to themselves or their allies and power asymmetries are kept intact	Board members are open and generous towards each other, and differences in knowledge and skills are utilized
Criticality and independence	Board members are passively following the rules of the game and do not raise any serious concerns	Board members have a critical and questioning attitude
Commitment and preparations	Board members come periodically and are not always properly prepared for meetings	Board members are present, prepared before board meetings, and involved during discussions

production culture. The overall aim should be to turn a group of independent board members into an interacting and collective decision-making team (Gabrielsson et al., 2007).

Relationships between the various team production dimensions and value creation are indicated in Table 11.3. It is indicated in the table that networking may be particularly related to creativity, strategic participation to cohesiveness, strategic control to commitment, advice to openness and creativity, internal control to critical attitudes, and output control to cognitive conflicts. These relationships are empirically explored by various contributions from the value-creating board surveys (see, e.g., Gabrielsson et al., 2007; Huse, 2007, 2009; Huse & Søland, 2009; Nielsen & Huse, 2010; Machold et al., 2011; Minichilli et al., 2011).

THE BOARD LEADER

The chair has a special responsibility for board leadership. Board chair leadership has some specific features that should be highlighted. Here we will present the leadership role of the board chair compared to the leadership role of the CEO. While the CEO leads employees in everyday company settings, the board chair is generally only leader for the board members at the board meetings. This means that the team has few face-to-face meetings. It often has severe time constrains to work on multifaceted and complex tasks. As pointed out by Forbes and Milliken (1999: 492), these specific situations make the board particularly vulnerable to interaction difficulties, and puts special demands on how the board leads the team in order to carry on its work in an efficient and effective manner. The quality of board leadership could consequently be predicted to have a major impact on the effectiveness with which board members perform their duties.

The board of directors is the highest decision-making body in the business organization, but the board chair is not at the top of any decision hierarchy as is the CEO. The CEO is mainly responsible for implementation of decisions, but also makes some decisions. The board chair is responsible for decisions and generally not involved in implementation. A board chair can, moreover, settle things with his or her double vote and can also have some additional tasks compared to the rest of the board members, but regardless of these possibilities the board chair is part of a team with equal colleagues. This means that the board chair in many ways has a greater challenge than the CEO in making things happen. The board chair has no instruction authority over the other board members – like the CEO has over his/her subordinates – and the chair must never forget that the persons on the board are peers. The board chair assumes additional responsibilities, not greater authority. The chair must motivate the other directors to work as a team and to make collective contributions. In sum, board chair leadership resembles many of the characteristics of team leadership as described by Yukl (1989). Differences between CEO and board chair leadership are summarized in Table 11.5.

Despite compelling evidence that the leadership and capabilities of the chair affect the work of the board of directors (e.g., Cadbury, 2002; Leblanc, 2005), the various roles that chairs perform are still a poorly understood phenomenon. We will here argue for various leadership roles of a board chair. A list of roles may include:

- moderator or chair roles;
- figurehead roles;
- supporter and mentor roles;
- decision maker and strategist roles; and
- coach, motivator and leader roles.

The most traditional roles are those of the moderator or chair. These roles mean that the board chair prepares the agenda before the meeting and then helps discussions stay productive and within the guidelines during the meeting. The figurehead roles refer to legitimacy and that of representing the firm in relation to external groups and actors: for example, in the contact with journalists, and by using a network of contacts in a positive and favorable manner for the firm. A third possible role for the chair is as a supporter for the CEO. In this role the chair may function as a kind of mentor, where the chair gives personal advice and contributes with knowledge and expertise. But if leadership is about creating value and results through other people, none of the above-mentioned roles require any leadership skills. They are all tasks that the chair can handle by himself.

The next set of roles, the decision maker and the strategist roles, require that the board chair interacts with the other board members. But decision making and strategies can be pursued based on personal interests and agendas, and a charismatic board chair can dominate board meetings without any attention to the will and skill of the other board members.

There is a huge untapped potential in the board chair role as a leader, motivator or coach. As a leader, the board chair will work to derive value creation through the achievement of others. The board chair supports the effectiveness of the board as a whole, and

Table 11.5 Comparison of CEO and board chair leadership

CEO	*Board chair*
The CEO is accountable to the board of directors	The chair is, together with the other board members, accountable to shareholders and a broader set of stakeholders
The CEO is responsible for implementing decisions made by the board	The chair is, together with other board members, the highest level of decision making in the firm
The CEO is a leader placed at top of a hierarchy (formally and socially)	The chair is leader of a team of equal peers (formally and socially)
CEO leads subordinates on a continuous basis – generally with frequent contact with subordinates	The chair leads board meetings that generally take place with infrequent intervals
The CEO has instruction authority over subordinates	The chair does not have instruction authority over the other board members
The CEO is generally a full-time leader	The chair is generally a part-time leader of the board

brings out the potential that is in the board as a team. As Leblanc points out, it is doubtful that a strong, engaged board will have a weak chair, or that an ineffective board will have a strong and competent leader in the board chair. Furthermore, board chairs also emphasize how selecting the chair and assessing the way they make use of the leadership is one of the biggest governance problems (Leblanc, 2005). This, in turn, contributes positively to achieving performance and transparency in the board.

REGULATING BOARD ACTIVITIES

Boards have always been considered as closed rooms or even black boxes. The rules of the game in the board are often tacit knowledge among experienced board members. We are now experiencing in the ongoing international corporate governance debate that the activities behind the closed doors are becoming regulated and even opened for accountability, insights and inclusiveness.

There exist strong links between board leader attributes, on the one hand, and board-regulating activities and structures, on the other. Both the leader and the regulating activities are there to create board effectiveness and to make sure that the knowledge and skills of the board members are used for value creation. Hard and soft laws are made for this purpose. Such regulations present the 'rules of the game' and typically contain paragraphs about:

- meeting structures (how often, how long, 'two-days meetings', 'alone meetings', etc.);
- regulations of the agenda (annual, per meeting and who makes the agenda, etc.);
- board discretion (standards for who decide);
- relational norms between the board members and between the board members and other actors;
- committee structures and committee composition (e.g., nomination committee, remuneration committee and auditing committee);
- reporting to various audiences (about various standards and practices);
- board development activities (such as CEO working descriptions, board instructions, introduction plans for new board members, training of boards and board members, and board evaluations).

The academic interests in such topics have largely been related to institutional theories and to regulatory regimes. Failures in board behaviors and corporate governance have also made stock exchanges, investors and other societal actors require openness among these rules of the games. Various standards about accountability, standard-setting, openness and reporting have thus been required.

Few attempts have been made to link these board-regulating activities to the business case relating to board leadership and value creation. One reason for this may be the lack of a coherent theoretical framework or theory where these activities and structures are included. This is where team production theory comes in. Compared to the 'decision-oriented' boardroom culture emphasized in agency theory, a team production approach would, instead, emphasize a 'process-oriented' boardroom culture where board leadership becomes important. We have in our empirical studies found how board structures and regulating activities may be related to process-oriented vs decision-oriented board cultures, and also to the various sets of board tasks and company value creation (Gabrielsson et al., 2007; Huse & Søland, 2009; Machold et al., 2011). This was illustrated in Table 11.3.

BOARD EVALUATIONS

Board leadership is about development and board evaluations are among the most recommended board development activities. In the vocabulary in the public debate about corporate governance, the content of board evaluations is not clear. A main distinction is made whether the board is the object for the evaluation or not. Within the group where the boards are the object of evaluation, three main types of board evaluations are used and recommended in most codes of best corporate governance practices:

- Report evaluations, with the purpose to embed board behavior and create accountability in relation to various stakeholder groups.
- Recruitment evaluation, to ensure that there is a match between the need for competence in the board and the nomination of new board members.
- Development evaluation, as a leadership tool in ensuring that boards and board members are improving value-creating performance.

To improve and develop corporate governance practices that contribute to value creation, there is a need for a board evaluation system that can address potential gaps in relation to the board and its activities. However, conducting board evaluations is not a simple box-ticking exercise with reference to a set of universal good corporate governance practices. The key message is instead that there is no universal or 'one best way' to evaluate the board of directors, and that board evaluations will not meet their purpose unless there are answers to the fundamental questions of 'Who is doing what for whom and how' (Huse, 2007; Minichilli et al., 2007). It is hence important that there is a fit between the *agents*, the *addressees*, the *content* and the *modalities* of the evaluation. This calls for a systematic and careful approach when designing board evaluation systems. Whereas past attention has primarily been focused on the content of board evaluations, we outline in Minichilli et al. (2007) the features of an integrated board evaluation system. In this contribution we contend that a board evaluation system would need to include the following: (a) the agent who evaluates the board; (b) the content or what the evaluation should deal with; (c) the addressee and other stakeholders for whom the board is evaluated; and (d) how the board it is evaluated. The key problems and some possible alternatives are presented in Table 11.6.

It is suggested in Table 11.6 how board evaluations refer to the 'Who' does 'What' 'To whom' and 'How' questions. The agents are those who perform the evaluation. The evaluation content refers to the 'What to evaluate' questions. The addressee questions include to whom the evaluation report will be communicated, while the modalities are about how the board activities are performed. Each of the elements are presented and discussed in Minichilli et al. (2007), where typical evaluation systems are identified and illustrated.

Before a board evaluation is started, there should be an explicit purpose that can guide the whole process. With respect to purpose, there are several reasons for why a board should be evaluated. A main reason is related to accountability and value creation. This is usually the main argument, and it is done as board evaluations may help aligning board task expectations and board task performance. Transparency is another main argument for board evaluations. Boards and corporations will often benefit from embedding their actions in relation to internal and external actors. Transparency through board evaluations may help to develop trusting relations between the board and important actors like the executives and other employees, shareholder and investor communities, present and potential creditors, suppliers and customers, and different other parts of the society. Board evaluations have also been required for listing at various stock exchanges and in some corporate governance codes. Furthermore, board evaluations will normally be crucial for the work of nomination committees and the selection of board members. Board evaluations may be an important tool for training and developing boards, and it may be important for motivating and using board members. The purpose of the evaluation should thus be the driver for 'Who does what, for whom, and how'.

For whom should a board evaluation be made? The purpose and the addressee

Table 11.6 Elements of a board evaluation system

Key problems	*Some possible alternatives*
THE AGENT OF THE EVALUATION ("Who" evaluates the board?)	• Self-evaluation (the board itself) • Board committees • Consultants • Researchers • Other external agents (authorities, rating agencies, etc.)
THE CONTENT OF THE EVALUATION ("What" should be evaluated?)	• Performance of board tasks • Board membership (e.g. directors' education and professional background, capabilities, presence and preparation, independence and nominating system) • Board culture and processes (e.g. cognitive conflicts, trust and emotions, interactions and social ties) • Board leadership and structure
THE ADDRESSEE OF THE EVALUATION ("To whom" the evaluation is targeted)	• The board itself • Internal board committees • Academics, researchers • External board committees • Owners, investors, etc. • Regulators
THE MODALITIES OF EVALUATION ("How" to evaluate the board)	• Open discussion (e.g. in board meetings, or in special meetings dedicated to board development) • Self-evaluation scheme • Standardized scheme/questionnaire • Reports to authorities, etc. (including annual reports) • Benchmarking • Interviews (e.g. with board members, the management, shareholders and other stakeholders) • Participant observation by the evaluator in board meetings • Document analysis

(for whom) of the evaluation are not necessarily the same. For example, the board itself may decide to target evaluations to various internal and external stakeholders. This can be related to reputation and stakeholder management. Shareholders and investor groups may, for example, through code compliance requirements, target board evaluations to the board itself. Various internal and external board committees may also use (or be the addressees) for board evaluations. The same is the case for other actors not being important stakeholders: for example, researchers.

What should be included in a board evaluation? Table 11.2 provides some guidance with respect to the content (What) of the evaluation. Although the content of a comprehensive evaluation should depend on the purpose (Minichilli et al., 2007), it may be a valuable starting point to make a stakeholder analysis in which the stakes and power of various actors should be analyzed. This analysis should also include an attention to the various arenas where decisions are being made or influenced. An evaluation of board tasks, accountability and value creation should then be conducted. This evaluation should include both board task expectations and actual board task performance (Huse, 2005), and a gap analysis may be performed. The next step would be to evaluate the board members and board composition. This analysis may include the identity, motivation, background, competence, personality and involvement of each of the board members and the total board. An additional topic and a next step may be the evaluation of the boardroom culture, including the various dimensions related to a team production culture, board–CEO relationships, and finally should

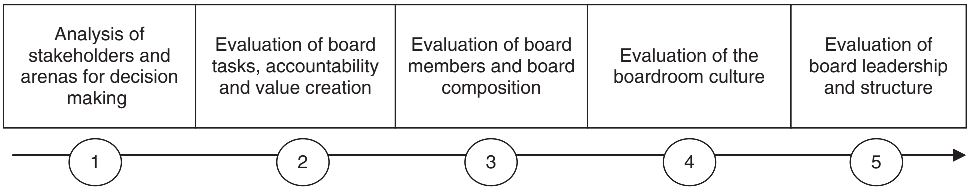

Figure 11.1 Various steps in a comprehensive board evaluation

board leadership and structures also be evaluated. Board structures include the types, length and frequency of board meetings, when and how various issues are presented on the agenda, and how the various issues are prepared and minutes are distributed and sanctioned. The existence and use of CEO work descriptions and board instructions should also be evaluated, and board development activities, including introduction programs for new members and the use and follow-up of board evaluations, should also be included in the analysis. The various steps of a comprehensive evaluation are presented in Figure 11.1.

Who should evaluate the board of directors? The questions about who should evaluate the board and how the board should be evaluated are strongly linked. The choices should follow the purpose, the addressee and the content questions. Boards may conduct self-evaluation. This is probably still the most common. Evaluations may also be conducted by board committees such as the nomination, remuneration or audit committees. These committees may also have members not being directors themselves. Various types of consultants are also used. They may have backgrounds in law, accounting, finance, management or even as boardroom specialists. The consultants may do the evaluations on behalf of the board, the committees or various external actors. There are also examples of researchers and various external agents that are conducting board evaluations.

How should board evaluations be conducted? Many different methods can be used for board evaluations and they can be both formal and informal. It is, however, recommended that the evaluations should be regular. Some evaluations may be (bi-) annual, while other evaluations may take place in relation to every meeting. Evaluations can take place in open discussions at meetings with the whole or parts of the board, and they may take place by using anonymous responses. Self-evaluation schemes and questionnaires may be used, and various computer-based systems exist. The evaluations can take place through interviews with board members, and 360-degree systems are also used. These systems use responses from various actors inside and outside the boardroom. Evaluations may take place by means of direct observations, review and follow-up of minutes and documents, and through analyzing formal reporting to authorities, etc. They can also be based on follow-up and implementation of various board decisions. Benchmarking and comparisons with boards in other firms are also used.

Board evaluations have clearly several advantages, but these advantages are far from fully exploited. Two conditions are necessary to induce the full adoption of a comprehensive board evaluation system in good corporate governance practices. The first is board-internal, and refers to a widespread acknowledgment among practicing board members of the benefits of formal board evaluations for improving corporate governance practices that support value creation and peak performance. The second is board-external, and relates to the reward markets may give to companies who conduct formal board evaluations. We anticipate that the future will be characterized by an increasing development of formalized systems for board evaluations, either for internal or external purposes. Their diffusion will open both interesting opportunities for potential evaluators, and most likely create a market of board evaluators by specialized companies that perform this service. It will also set new standards of accountability for the companies involved and their boards, with important effectiveness consequences for the whole corporate governance system. In both cases, it will pose positive challenges for board leadership practices and create evaluation systems where boards can focus their efforts and improve their contribution to long-term value creation.

CONCLUSION

We have in this chapter presented how boards and board leadership may contribute to long-term value creation in the firm. Value-creating board leadership draws on multiple perspectives, all leading to a new way of thinking in the ongoing corporate governance debate. In this chapter, we have specifically highlighted the following characteristics:

- The human side of corporate governance: one cannot discuss board leadership without understanding and emphasizing the human side of boards and corporate governance. It is not enough with normative statements or models based on some simple assumptions of human behavior. Board leadership requires insight into how decisions in organizations are actually made.
- A value chain approach: boards exist to contribute to value creation. It is a common goal for managers, the board as a whole, and individual board members to create value and long-term competitive advantages in the firm. Board leadership requires thinking through the entire value chain.
- Knowledge and skills: board leadership is there to support dynamic capabilities. It requires an understanding of what knowledge and what characteristics of the board members, individually and collectively, can contribute to value creation. In addition to relevant expertise, the board members must identify with those who have the highest stakes invested in the company and the company's overall strategies and objectives.
- Teamwork: it is emphasized that value creation takes place through teamwork and that boards must learn to work as teams. Teamwork is not just about using individual knowledge and capabilities, but includes self-correcting, value-added and dynamic processes among and between team members. Board leadership will focus on balancing different perspectives.
- The board chair as a leader: board leadership will bring in knowledge and experience from the leadership and management literature. The difficulty of leading the board as a team of equal members puts special demands on the chair. The challenge is not to retreat to a passive chair or become a supreme commander, but to step in as leader and motivator.
- Openness and transparency: board leadership is about being open and clear on the rules and structures that frame the work of the board. It is not about secrecy, but to openly and deliberately drawing attention to values and working methods so that all board members understand what is happening and are willing and able to contribute.
- Learning and development: board leadership is about continuous self-development. The board as a whole – as well as the chair and individual board members – must continually be keen to develop themselves and make things better. Those who do not see a need for learning or development may not have a place in a boardroom dominated by team production and long-term value creation.

In this chapter, we have challenged existing knowledge and practice about board leadership based on the value creation board framework. Board leadership has been understood on the basis of team production theory, and seen from a strategic and entrepreneurial management perspective where long-term value is the main goal of the firm. The main message of the chapter has been illustrated with examples and findings from the value creation board framework (Huse, 2005, 2007) and its international research program (Huse, 2009). This research program is based on both in-depth studies as well as several questionnaires from a total of about several thousand managers, chairs and other board members in eight European countries. The questionnaires have served as evaluation tools and various reports (i.e., Haalien & Huse, 2005; Lervik et al., 2005; Sellevoll, Huse & Hansen, 2007) have made it possible to make comparisons across companies.

This chapter has been written in a period of international financial crisis where various scapegoats and aids have been sought. The crisis has been questioned by the current ethics system and questions have also been raised whether we need to think about corporate governance and board leadership in new ways. We have in the chapter pointed out that a system based on agency theory easily get a bias towards control and value distribution, independence and quick decisions, as well as hierarchies and closed boardrooms – all this despite increasing requirements for external reporting. Critics argue that overemphasis on control and value distribution has prevented companies from building up resources needed to get through economic fluctuations and has contributed to active boards destroying more value than they have created. Without taking sides, at least it seems as if the system that was built up from the end of the 1980s is beginning to unravel. We have in the chapter made a contribution to this debate by describing how board leadership in a team production perspective presents a new way of thinking about how boards can work as a team to contribute to long-term value creation in the firm.

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PART 4

Boards and Directors: New Challenges and Directions

12

Changing Scenes in and around the Boardroom: UK Corporate Governance in Practice from 1989 to 2010[1]

Annie Pye, Szymon Kaczmarek and Satomi Kimino

> The Treasury Committee is in no doubt that those banks which failed were the principal authors of their own demise; bankers made an astonishing mess of the financial system. Rt Hon John McFall, MP (2009)

This statement by the Chair of the UK Government's Treasury Select Committee, provides a powerful summation of widespread concern being expressed at that time about the corporate world: it was people rather than regulations which had created a global economic crisis.

This chapter explores the people side of corporate governing by offering an analysis of how small groups of people have run large UK-listed companies across the last 20 years. We adopt a process-oriented perspective based on the premise that it is crucial to appreciate what goes on in and amongst the upper echelons of organizing in order to understand how and why things happen the way they do, and what might be learnt from this experience. While this may require us to depart from more traditional language and frameworks of corporate governance theory, this is also a necessary step in order to capture notions of embeddedness and the systemic nature of behaviour and consequences, seen by many commentators to be the cause of the recent collapse of the banking system (Tett, 2009).

We draw primarily on data gathered through a series of three, interrelated, Economic and Social Research Council (ESRC)-funded studies about how small groups of people run large companies. Serendipitously, these studies have been timed at 10-yearly intervals (1987–1989, 1998–2000 and 2009–2011) and in sequence with what has probably been the most interesting 20-year period in recent economic history. This has also been an era of extraordinary political, social and technological change, which together has had a notable impact on the conduct of those who lead large companies. Not only have these contextual dimensions changed significantly (also reflected through changing regulation and accounting standards), the 'Who', 'What', 'How' and 'Why' of upper echelons practice has also changed. We seek to illustrate the dynamic effects of such changes at this highest level of organizing in the UK and their implications for future practice, by comparing data from both in and around these board settings at three different periods across the last 20 years.

Academic theorizing on this topic has also evolved during this time, including continuing development of more conventional corporate governance literature (agency, resource dependence, institutional theories), nascent correspondence between upper echelons and corporate governance literature (Hambrick & Mason, 1984; Hambrick, 2007), and also more recent encouragement to 'dismantle the fortress' of agency theory (Daily, Dalton & Canella, 2003) and to develop more multi-theoretic approaches (Hillman & Dalziel, 2003; Hambrick, Werder & Zajac, 2008). Our chapter contributes to these developments by offering an interdisciplinary, process-oriented analysis which gives attention to the embedded nature of behaviour in this highly complex and deeply interwoven (global) corporate ecosystem.

We begin by outlining the theoretical background of our three studies, and go on to describe the contextual backdrop and changes behind each study, helping set the scene in which behaviour is understood. We then highlight key findings across each of the three studies, around three themes of people, roles and relationships; board and top team responsibilities; and board–investor relationship. This is followed by a discussion section which seeks to draw together and compare key themes of change and consistency across the three studies. Here, we identify some of the paradoxes which persist and reflect on our findings with the future in mind, both for practice and for further research and academic theorizing.

BACKGROUND AND ACADEMIC CONTEXT

This series of studies spans 20 years of asking the same research question: How does a small group of people run a large FTSE plc? We believe this is unique amongst organization studies and generates an interesting array of unusual theoretical and methodological issues (Pye, 2002), not least of which is how to account for change in theorizing and change in methods as well. For example, in 1987–1989, the (t0) project was framed by management competence and upper echelon research, such as Boyatzis (1982) and Hambrick and Mason (1984), which were considered 'break-through' studies at the time, although inevitably may now seem dated. Hambrick and Mason (1984), in particular, helped move focus away from differing views of whether or not chief executives (CEs) matter to organizational performance by considering when they matter. In so doing, they introduced analysis of executive values and attitudes and managerial discretion (Hambrick & Finkelstein, 1987), as key variables influencing corporate performance. Alongside this, Weick's (1979) *The Social Psychology of Organizing*, together with Barnard's (1938) *The Functions of the Executive*, were also important and distinctive theoretical underpinnings to this research, which sought to understand how these elite, strategic decision-making groups (Mintzberg, 1987) 'made things happen' at the helm of their organizations. Our conclusion was an analysis of their 'doing of managing' (Mangham & Pye, 1991).

The 1998–2000 (t1) study was framed by the mantra of the time, which was the ubiquitous nature of managing change: i.e. that change was the only constant in management and organizing. Theoretically, the research proposal drew on authors such as Bartlett and Ghoshal (1998) and Finkelstein and Hambrick, (1996), while continuing to be underpinned by Barnard (1938) and Weick (1995). Interestingly, once underway with fieldwork, we found quite a different response to the core research question at this time. When asked how they ran their companies, interviewees often responded by saying, ‘Oh that’s a matter of corporate governance’, or more pejoratively, ‘Oh, you’re part of the corporate governance industry’, in turn reflecting significant changes in regulatory context during course of the previous decade.

The Cadbury Committee (1992) had been followed by Greenbury (1995), Hampel (1998) and Turnbull (1999) as well as the first UK Combined Code of Corporate Governance being implemented in 1998 (see Table 12.3). This provided a very powerful reframing of their thinking and acting/doing, although clearly how they ran their companies was about much more than simply ‘corporate governance’, which tends to imply compliance. This also impacted on literatures which might inform our theorizing and also to which our findings might contribute. Hence, we developed the notion of corporate directing (Pye, 2002) as a means of retaining the process emphasis of ‘doing’ their ‘upper echelon organizing’ as well as reflecting the three key elements of the director role, which are governance (governing), strategy (strategizing) and leadership (leading). The emphasis on ‘doing’ remained important because, as before, there remains a notable difference between what people say they do via compliance with regulations or with vision statements or with annual plans, and how they actually do it. Our interest and emphasis remains on the doing/how they do it.

In preparing the ground for the 2008–2011 (t2) study, both practice and academic literature(s) now looked considerably more complex. Not only had companies grown vastly in scale/composition, turnover, market capitalization and global presence, etc., so too had the technology which underpinned them. We were to discover the real significance and deeply embedded nature of this highly complex ‘system’ when subsequently the financial world collapsed in September 2008. The media became experts in a new language of subprime markets, collateralized debt obligations and a host of other complex counter-party risks (Tett, 2009), and high-frequency trading began to flourish, in which share ownership bears more similarity to casino gambling than it does to ownership. Thus, the research proposal to ESRC in 2006 was framed in terms of the contemporary mantra of ‘value-adding behaviour’. Interestingly, this has rarely surfaced in our data collection without being prompted and is found to have implicit rather than explicit relevance for practitioners.

By 2010, academic research into upper echelons and corporate governance had grown dramatically in volume and focus. Upper echelons research has evolved into several different strands, with studies seeking to develop analysis of CEO effects on performance (Crossland & Hambrick, 2007); top management team (TMT) effects on performance (Murray, 1989; Wiersema & Bantel, 1992; Hambrick, Cho & Chen, 1996); national contexts; diversity; and a few looking at TMT–board interaction (Kor, 2006; Castro, De La Concha, & Gravel, 2009). This also clearly bridges into strategy research as well as corporate governance research, which serves to amplify the field and adds a welcome richness and complexity but, in turn, making it also more difficult to integrate. For example, strategy research has developed a strong strategy-as-practice movement (Johnson, Melin & Whittington, 2003; Jarzabkowski, 2004) which has resonance with where our research first started. However, the focus in our studies over time has been on the wide array of roles and responsibilities, practices and performance of directors – both TMT and board members – and not just their strategy practice.

It is perhaps not surprising that corporate governance did not feature in the original to research project design. Not only did this predate such things as the internet and the ISI search system, but as we found 10 years later, only 16 references to corporate governance had been published in management journals between January 1988 and December 1990 (Pye, 2000). Using the contemporary ISI Web of Science database, we find 369 references to corporate governance for the period January 1998 to December 2000, and 4,385 for the period January 2008 to September 2010, reflecting a field which is now much more fragmented and contested.

One of the most comprehensive reviews which helps summarize this burgeoning field is provided by Durisin and Puzone (2009), based on their bibliometric analysis of corporate governance research from 1993 to 2007. They found that agency theory was the dominant theoretical lens applied in corporate governance research. With its underlying assumption of human behaviour as being rational, maximization of self-interest, agency theory's focus is on the principal–agent dyad (i.e. shareholder and manager, respectively), and manager–agents not pursuing the shareholder–principals' interest in directing companies. Therefore, agency theory prescribes the separation of risk-bearing and decision functions, and asserts managers should be responsible for decision management, i.e. initiation and implementation, and the board of directors (representing shareholders' interests) for decision control, i.e. ratification and monitoring (Jensen & Meckling, 1976; Fama & Jensen, 1983a, 1983b; Eisenhardt, 1989a).

This simplification fails to reflect the complexities of corporate life where: board membership often comprises both inside (agents) and outside (principals) directors; there are now significantly increased levels of intermediation between actual shareowner and their investment with widely differing timescales of holdings; and sub-agents (i.e. employees), more commonly recognized in legal governance frameworks (Blair & Stout, 2001; Lan & Heracleous, 2010), who also play a significant part in 'doing governance'. However, the theoretical insights of agency theory have concentrated on the shareholder–manager conflict and led to classification of internal and external corporate governance mechanisms, which aim either to align managerial incentives with those of shareholders or to control managers (Harm, 2000; Ricketts, 2002).

By far the most widely researched of these corporate governance mechanisms are board structural characteristics, including issues such as board size, independence, composition, meeting frequency and board subcommittees (e.g. audit, compensation and nominating committees) as well as separation of chief executive (CE) and chairman roles. Mainly inspired by agency theory predictions, the meta-analytical empirical evidence on the impact of board independence, board leadership structure (CE/chairman role separation), equity holdings by executives and directors and board size on firm financial performance demonstrates either a very limited or non-existent relationship (Dalton, Daily, Ellstrand & Johnson, 1998; Dalton, Daily, Johnson & Ellstrand, 1999; Dalton, Daily, Certo & Roengpitya, 2003). Confronted with this evidence, scholars started invoking academics to apply multi-theoretical approaches to studying board roles and corporate governance problems in general (e.g. Pye, 2002; Daily, Dalton & Cannella, 2003; Hillman & Dalziel, 2003; Huse, 2005).

Building on Mangham and Pye's (1991) findings and Pettigrew's (1992) challenge to 'open the black box' of boardroom dynamics through process-oriented research, there have been repeated calls for greater theoretical pluralism and research to better understand and explicate the conditions for effective corporate governance (e.g. Huse, 2005; Zajac & Westphal, 1998; Forbes & Milliken, 1999; McNulty & Pettigrew, 1999; Leblanc & Schwartz, 2007). There is now also a growing body of micro-process studies, generating primary data about board directors in practice (Pettigrew & McNulty, 1995; Pye, 2000; Roberts, 2002; Samra-Fredericks, 2003; Leblanc & Gillies, 2005; McNulty, Roberts & Stiles, 2005; Huse, 2009; Machold, 2010). However as Pye and Pettigrew (2005) point out, there remains a need for developing greater analytic rigour to process theorizing.

While other schools of thought, such as institutional, resource-dependence, stakeholder, or stewardship theories, have gained prominence alongside agency theory, there are also invocations to use multi-theoretical approaches in corporate governance studies (e.g. Hillman & Dalziel, 2003; Hambrick, Werder & Zajac, 2008), which seem better suited to this highly complex world of contemporary practice. Hambrick, Werder and Zajac (2008) offer a useful map of the fields of interest in contemporary corporate governance research, which positions different disciplinary perspectives on this topic (Figure 12.1).

This depiction also helps illustrate to some extent how governance analysis remains bounded by disciplinary foundations: for example, by overlooking perspectives such as financial/accounting (e.g. Gendron & Bedard, 2006; Dey, 2008), micro-political (e.g. McNulty & Pettigrew, 1999; Pugliese, Bezemer, Zattoni, A. et al., 2009) or macro-political (e.g. Clarke, 2007; Gourevitch & Shinn, 2007). These dimensions are key to current debate about, for example, whether or not banks are too big to fail or should governments limit executive compensation agreements. Although beyond the focus of this chapter, these serve as important reminders of the complex overlapping regulatory environments and global agendas of international accounting standards, corporate responsibility and climate change, together with OECD (Organization for Economic Co-operation and Development) principles which frame the overarching, global context in which practitioners work.

In summation, academic theorizing on corporate governance has grown considerably across the last 20 years, although agency-theory-based assumptions and research still predominate. Building on what began in 1987 as an integrative analysis of 'doing', imbued with the notions of sensemaking to make sense of behaviour, the latest project continues in similar vein, studying upper echelon behaviour in FTSE 100s. In effect, we endeavour to create a more process-oriented, three-dimensional picture, drawing together and adapting insights from across the perspectives illustrated by Hambrick et al. (2008) through analysing corporate directing – the roles and responsibilities, practices and performances of directors in the upper echelons of FTSE 100 organizing, embedded in different times and in different contexts.

	Formal Structure	Behavioral Structure	Behavioural Process
Org ↓ Inward	**Economics** … designing optimal incentive and monitoring structures	**Power** … how positions affect power/politics within org	**Social Psychology** … the biases of decision making
Org ↓ Outward	**Legal** ... creating and enforcing regulations for societal benefit	**Social Networks** … power and info flows in interorgnl networks	**Symbolic Management** … understanding symbols and compliance with social norms and values

Figure 12.1 Disciplinary cross-fertilizations in corporate governance

Source: Hambrick et al., 2008.

As Dacin, Ventresca and Bell (1999: 347) put it, the benefits of such an integrative approach are:

> In studying the sources, mechanisms, and effects of embeddedness for organization forms, structures and linkages, and activity, the insights of the embeddedness literature enable us to view not only the unintended outcomes of such instrumental action, but also the collateral effects of other action motivated by other forms of rationality.

Thus, considering the outcomes of embeddedness in terms of practical action, one should also recognize that organizations can and do act strategically in satisfying normative, institutional and/or cultural demands. Drawing on this, our approach also reflects the four mechanisms through which embeddedness works (Zukin & DiMaggio, 1990): institutional/structural, cognitive, cultural and political.

We consider the institutional landscape of the UK corporate scene, including corporate governance soft law, regulators, companies, investors, auditors, etc., and their development over time as a macro-source of embeddedness. Analysing interactions, such as between the CE and chairman, non-executive directors (NEDs) and executive directors (EDs), CE and investors, etc., provides the basis for an account of their structural embeddedness. The perceptions, opinions and views of interviewees regarding their roles and those of other actors provide a reflection of their cognitive base as well as their cultural embeddedness. Finally, this qualitative material provides us with some hints on the sources of power and political texture of relationships between actors amidst this contemporary corporate governance architecture. The emerging picture of solutions and practices adopted by companies, investors and regulators can be seen as both institutional and governance outcomes of embeddedness. Through this interdisciplinary, process-oriented approach, we use these ideas to help develop a rich contextualized understanding of corporate governance practices for a sample of UK-listed companies across time. Before outlining the accompanying methodological approach, we next address what we see to have had important contextual effect on director behaviour and corporate practice more generally.

CHANGING CONTEXT: FROM THE 1980S ONWARDS

This section highlights selected key political, social and economic contextual changes which have shaped corporate conduct across the last 20 years, particularly in the UK. The election of right-wing leaders, Margaret Thatcher in the UK in 1979 and Ronald Reagan in the USA in 1981, changed the course of Western political leadership during the 1980s and had a powerful global impact as well. Global politics was largely shifting to the right and following the eras of Deng Xiaoping in China and Mikhail Gorbachev in Russia, the major communist regimes of the 1980s subsequently changed beyond recognition. Ultimately, the Berlin Wall came down in 1989, and the rest is history.

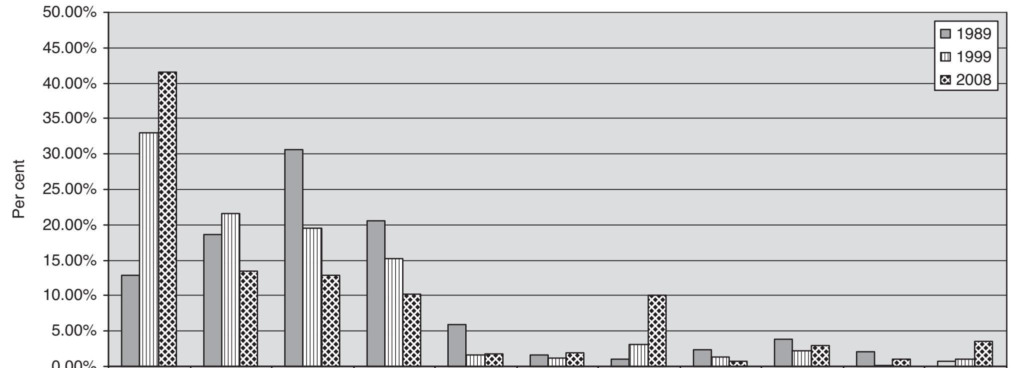
Thatcher's hallmark was a strategy of privatization of previously state-owned assets, dismantling of trade union power, and deregulation, in particular, of the financial services industry in 1986, which had a profound impact on share trading and the significance of the London Stock Exchange. She also stood firm against joining the European currency in 1989, such that the UK retained its own currency in 1995 when the rest of Europe adopted the euro. Altogether, this led to an era of unprecedented change in the political, social and economic fabric of the UK and Europe.

Along with the collapse of the housing market, the UK economy suffered an array of corporate failures, such as the Baring's Bank disaster (Brown, 2005) and the Maxwell/Mirror Group Pensions scandal, in the early 1990s. Around this time, Sir Adrian Cadbury was asked to put together a panel of experts to examine the auditing of UK companies and, in time, his brief widened to become a review of UK corporate governance practices. This marked a turning point in UK corporate regulation, followed by a series of review panels, further refining the focus and analysis of different aspects of UK corporate governance. Together with the Companies Act (2006), company directors in the UK must now adhere to seven legally prescribed 'director's duties' and a host of other 'soft law' requirements which have been developed through this evolving series of consultations, reviews and subsequent recommendations. The most recent of these has replaced the Combined Code (revised bi-annually since 1998) with the Corporate Governance Code (FRC, 2010a) (see Table 12.3).

During the subsequent period of Labour Party rule (1997–2010), dot.com stocks were found to be overvalued, leading to a major collapse in 2000 of stock exchanges around the world. More notable corporate disasters in the UK in the 2000s (Naughties) included the Long-Term Capital Management hedge fund (with implications for the Black–Scholes model of risk), Equitable Life, where unhedged liabilities were exposed, and also Marconi, where expansion by acquisition was found to be overleveraged. In the USA, the exposure and collapse of Enron and WorldCom, in particular, led to the collapse of Arthur Andersen (auditors) and the implementation of the Sarbanes–Oxley Act (SOX) by the Securities and Exchange Commission (SEC), considered by some to be a knee-jerk reaction to accounting scandals in which the costs of compliance far outweigh any benefit (Romano, 2005; Zhang, 2007). The effect was to tighten financial reporting practices of US-listed corporations significantly, and has subsequently affected reporting practices around the world.

There have been many other social changes between 1989 and 2009 which have relevance for companies in this research. Amongst these, changing demographic trends (increase in aging population alongside declining youth population) have strong implications for pension funds and insurance companies (see Figure 12.2).

Between 1989 and 2008 there were notable changes in beneficial ownership of UK shares, with the percentage of shares held by



Shareowners	Foreign investors	Insurance companies	Pension funds	Individuals	Unit trusts	Investment trusts	Other financial institutions	Charities	Private non-financial companies	Public sector	Banks
1989	12.80%	18.60%	30.60%	20.60%	5.90%	1.60%	1.10%	2.30%	3.80%	2.00%	0.70%
1999	33.00%	21.60%	19.60%	15.30%	1.60%	1.20%	3.10%	1.30%	2.20%	0.10%	1.00%
2008	41.50%	13.40%	12.80%	10.20%	1.80%	1.90%	10.00%	0.80%	3.00%	1.10%	3.50%

Figure 12.2 Beneficial ownership of UK shares

Source: Office for National Statistics, Share Ownership (2008).
Note: 'Ordinary shares' are the most common type of share in the ownership of a corporation.

individuals halving from 20.6 to 10.2 per cent. The percentage owned by institutional investors dropped considerably as well, with pension fund holdings falling from 30.6 per cent in 1989 to 12.8 per cent in 2008. Alongside this has been a sharp rise in international ownership by foreign investors (from 12.8 per cent in 1989 to 41.5 per cent in 2008: Office for National Statistics (ONS), 2010), which has important implications for corporate governance practices and especially shareholder engagement with investee companies.

As presented in Table 12.1, the performance of the FTSE 100 index for the past 20 years has been cyclical and volatile, largely depending on global and domestic economic conditions. The share index peaked at 6930 in 1999, but sharply declined to 4434 in 2008, which represented a 31 per cent decrease from the previous year due to the impact of the global economic downturn.

Table 12.1 FTSE 100 share index and percentage change between 1989 and 2009

Year	*FTSE 100 index*	
	Per cent change	*Index*
1989	35.1	2423
1990	–11.5	2144
1991	16.3	2493
1992	14.2	2847
1993	20.1	3418
1994	–10.3	3066
1995	20.3	3689
1996	11.6	4119
1997	24.7	5136
1998	14.5	5883
1999	17.8	6930
2000	–10.2	6223
2001	–16.2	5217
2002	–24.5	3940
2003	13.6	4477
2004	7.5	4814
2005	16.7	5619
2006	10.7	6221
2007	3.8	6457
2008	–31.3	4434
2009	22	5413

Source: Annual Abstract of Statistics (2010 edition); Office for National Statistics.

Note: The FTSE 100 index was launched on 3 January 1984 at a start value of 1000 and is designed to measure the performance of equity funds. It is based on the top 100 companies in terms of market capitalization. It is recalculated continuously during trading hours.

Some key financial indicators of FTSE 100 companies (based on constituents as at year end 31 December 2008) in 1989, 1999 and 2009 are also presented for comparative purposes in Table 12.2.

Unsurprisingly, FTSE companies have changed across the 20-year period, with significant implications for the jobs of those at the helm of these enterprises. On average, each has 25% more employees, a fourfold increase in sales and net income, and executive remuneration has changed hugely, both in terms of the size and composition of the package. FTSE 100 companies are also now substantially international: in both sales and assets held outside the UK, there has been a fivefold increase over the past two decades and the UK now often contributes a much smaller, if not the smallest, part of any balance sheet. This has particularly important implications for how these companies are run and, indeed, leads some to question where they may list (e.g. Wolseley recently announced they will relocate their head office and listing to Switzerland, for tax efficiency purposes).

Whereas the early 1990s recession followed the first (t0) project and the dot.com collapse followed the second (t1), the global financial crisis created a context for the current (t2) round of inquiry and can be only matched in terms of significance with the deep recession of the 1930s. To a great extent, this collapse is attributable to the unprecedented financialization of the global economy in recent years (Davis, 2009). Securitization – turning loans and other assets into tradable bonds – changed the nature of banking and finance, enabling the trade a greater number and variety of assets on markets and opening new avenues for households to participate in financial markets. There were literally myriads of new financial instruments introduced (Tett, 2009; Clarke, 2010a) and, by 2009, four of the top

Table 12.2 FTSE 100 firm performance

		1989	*1999*	*2009*
No. of employees	Mean	43,975	42,324	59,363
	Min	17	89	290
	Max	296,000	246,000	595,002
Sales	Mean	6,181	11,530	17,035
	Min	2	9	117
	Max	47,796	105,197	199,441
Gross income	Mean	1,731	2,822	3,829
	Min	1	−32	−139
	Max	14,217	21,040	25,078
Net income	Mean	373	887	812
	Min	−945	−449	−4,858
	Max	2,811	8,570	10,626
Intangibles	Mean	149	930	4,048
	Min	0	0	0
	Max	2,217	10,258	74,938
Total assets	Mean	16,924	38,662	90,709
	Min	7	64	927
	Max	205,781	567,493	1,689,447
ROA	Mean	9.26	5.76	4.34
	Min	−0.63	−55.90	−36.16
	Max	25.47	329.98	27.05
ROI	Mean	15.02	10.30	8.12
	Min	−0.63	−140.39	−39.14
	Max	39.22	148.71	54.39
EPS	Mean	0.36	0.64	0.17
	Min	−0.02	−3.50	−9.35
	Max	4.12	9.77	3.30

ROA (return on assets), ROI (return on investment), EPS (earnings per share).
Source: Thompson One Banker.
Note: Monetary values (£ million) are expressed in current values, not seasonally adjusted.

nine UK FTSE 100 banks were partly or wholly in public ownership.

Behind and underpinning, indeed perhaps even propelling, many of these changes across the last 20 years runs a period of extraordinary technological change, which has had profound implications on daily life and for what, how, where and when people do their jobs. The use of mobile phones, Blackberries and portable computers with internet access has become widespread, enhancing connectivity and speed of information flows (Figure 12.3).

With the introduction of email, internet, search engines, social networking and an apparently infinite variety of software applications, communication patterns have changed in intensity and quality. Around 65 per cent of UK households now have home access to the internet (compared with 9 per cent in 1998), illustrating how indispensable computer technology has become (ONS, 2004, 2008). Compare this with the fax machine, which was the most important form of high-speed information transfer at the end of 1980s, and it becomes crystal clear that how we live and work is very different to 20 years ago.[2]

With regards to corporate governance regulation across the two decades, shortly after the completion of the first (t0) project, the Cadbury Committee (1992) took place, which

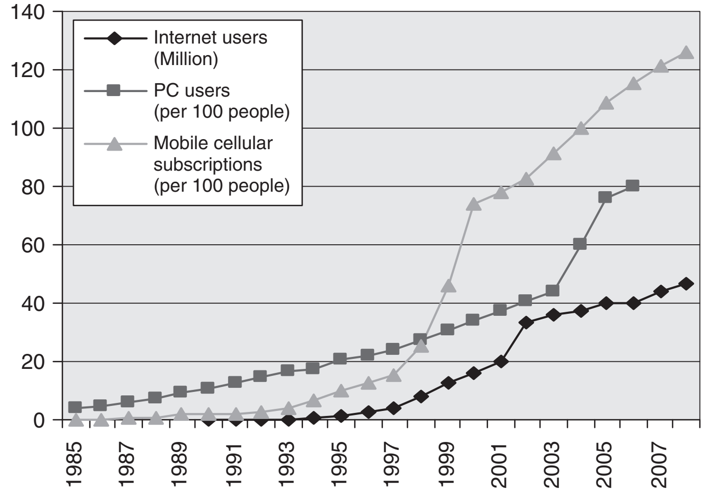


Figure 12.3 Internet and PC users and cellular subscriptions

Source: International Telecommunication Union, World Telecommunication Development Report and database.

set the scene for developing corporate governance soft law based on the 'comply or explain' principle in the UK. Since then, the UK has frequently served as a landmark for other countries in terms of their development of a corporate governance regulatory framework.

The 2010 Corporate Governance Code (FRC, 2010a) now includes: the annual election of all directors; external evaluation of the board every three years; and a call for a wider mix of backgrounds and capabilities, especially women, on boards. Simultaneously, the Institute of Chartered Secretaries and

Table 12.3 A synopsis of recent corporate governance regulation in the UK

Corporate governance soft law in the UK	*Main theme*
1. Cadbury Report (1992)	'Report of the Committee on the Financial Aspects of Corporate Governance'. A milestone marking the beginning of the development of corporate governance regulations
2. Greenbury Report (1995)	'Directors' Remuneration'. The study group on executive compensation
3. Hampel Report (1998)	'Committee on Corporate Governance: Final Report'. A review of the implementation of the findings of Cadbury and Greenbury committees
4. Combined Code (1998), with subsequent editions in 2003, 2006, and 2008	The first corporate governance code in the UK (principle-based approach), bringing together recommendations from the Cadbury Report (1992), Greenbury Report (1995) and Hampel Report (1998). Subsequent editions in 2003, 2006 and 2008 were based on further rounds of review of corporate governance practice, coordinated and published by the Financial Reporting Council (FRC). Importantly, this was established on the principle of 'comply or explain'
5. Turnbull Guidance (1999)	'Internal Control: Guidance for Directors on the Combined Code'. Best practice in terms of internal control with significant impact on internal audit
6. Myners Report (2001)	'Institutional Investment in the United Kingdom: A Review.' A review of types and process of institutional investment in the UK, e.g. pension funds, actuaries and investment consultants, pooled investment vehicles, investment decision making by trustees
8. Smith Guidance (2003)	'Audit Committees: Combined Code Guidance'. A report and proposed guidance by an FRC-appointed group providing best practice insights into the role of audit firms and audit committees

Table 12.3 A synopsis of recent corporate governance regulation in the UK

Corporate governance soft law in the UK	*Main theme*
9. Higgs Review (2003)	'A Review of the Role and Effectiveness of Non-executive Directors'. The purpose of the review was to shed some light on the role of non-executive directors in the boardroom and to make recommendations to enhance their effectiveness
10. Tyson Report (2003)	'The Tyson Report on the Recruitment and Development of Non-executive Directors'. A report commissioned by the Department of Trade & Industry following the publication of the Higgs Review of the Role and Effectiveness of Non-executive Directors in January 2003
11. Companies Act (2006)	After almost 10 years in consultation, this Act forms the primary source of UK company law. It is one of the longest acts in British Parliamentary history: 1,300 sections, covering nearly 700 pages, and containing no fewer than 15 schedules. It superseded the Companies Act 1985 and for the first time, included seven primary duties for company directors and was brought into force in stages, with the final provision being implemented on 1 October 2009
12. Walker Review (2009)	'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities'. This report was commissioned (Feb 2009) by the Prime Minister to review corporate governance in UK banks in the light of critical loss and failure throughout the banking system, following collapse of Northern Rock, Lehman Bros and other BOFIs
13. UK Corporate Governance Code (2010)	This new corporate governance code supersedes the Combined Code (2008) and maintains the UK's principles-based approach to governance through 'comply or explain'. It was informed through consultation by the FRC and the Walker Review undertaken amidst the 2008 financial crisis. Similar to its predecessors, the Code is based on the underlying principles of: accountability, transparency, probity and focus on the sustainable success of an entity over the longer time. Published by the FRC, the new Code applies to accounting periods beginning on or after 29 June 2010, and, as a result of the new Listing Regime (in April 2010), applies to all companies with a Premium Listing of equity shares regardless of whether they are incorporated in the UK or elsewhere
14. The UK Stewardship Code (2010)	The Code sets out good practice on engagement with investee companies to which the FRC believes institutional investors should aspire. It is hoped that this will create the much needed, stronger link between governance and the investment process, and lend greater substance to the concept of 'comply or explain' as applied by listed companies. The FRC therefore sees it as complementary to the UK Corporate Governance Code (2010) for listed companies
15. Guidance on Board Effectiveness (2011)	ICSA were commissioned by FRC to review the Higgs Guidance on 'Improving board effectiveness'. The new guidelines include clear guidance on particular board roles and board effectiveness, and also specify in greater detail the role of Chairman, reproduced here in Appendix 5

Administrators (ICSA) has been commissioned to work on the review of the Higgs Guidance (2003), the aim of which is to provide some insights on the role of NEDs and desired boardroom dynamics. The Walker Review (2009) of banks and other financial institutions (BOFIs) highlighted the need for effective board leadership as well as for a strong repertoire of capabilities and financial expertise, and also for sufficient time commitment by NEDs.

Finally, another innovation 'inspired' by the financial crisis has been to replace Section E of the Combined Code (FRC, 2008) with a separate Stewardship Code (FRC, 2010b) to deal with shareholder relations. The Stewardship Code (based on the Institutional Shareholders' Committee (ISC) Statement of Principles (2007) for institutional investors) aims to give best practice guidance for engagement by institutional investors in investee companies. The first of its kind in the world, it is overseen and implemented by the Financial Reporting Council (FRC), the UK's independent regulator responsible for promoting high-quality corporate governance and reporting to foster investment. As we write this chapter, there are other regulatory changes and recommendations coming forward, including EU remuneration guidelines for banker's pay, and in the UK, the Financial Services Regulation Bill, which aims to ensure that aggregate risk and imbalance in the economy will be properly monitored and managed, thereby helping maintain financial stability (Number10.gov.uk); the ICSA Review of the Higgs Guidance; and the Davies Review of Women on Boards (January 2011). In contrast to 20 years ago, it requires significant corporate resource to keep abreast of these continuous regulatory updates and changes, which encourages an attitude of compliance rather than spirited engagement.

METHODOLOGY

The research underpinning this chapter is drawn from a series of three ESRC-funded projects conducted at 10-year intervals, which explore how small groups of people run large companies: 1987–1989 (t0), 1998–2000 (t1) and 2009–2011 (t2). Primary data have been collected through semi-structured interviews with directors of a sample of FTSE companies, which has expanded with each round of the project. This has been supported by extensive secondary material, including Report & Accounts, company documentation, website and media coverage. Given the fact that the FTSE constituents change with each quarter and that corporate ownership changes across time through merger and acquisition, this creates an interesting challenge for any longitudinal sample design. Coupled with the great difficulty of gaining access to this elite cadre (Pettigrew, 1992; Maclean, Harvey & Press, 2006), it is simply not possible to design a representative sample per se. However, we approached the companies in the original t0 project because they were large FTSE companies, reputed by analysts and commentators at that time to have 'interesting managements and boards doing interesting things' (with the exception of Avon Rubber, a local firm where we pilot-tested our method). As far as possible, we also sought to have representation from different sectors across the FTSE 100.

Academic research that delves more deeply into the role of directors' behaviours in corporate governance is relatively sparse, and our inquiry over time is unique. The approach in the first two projects was qualitative and in the third, has also involved building a quantitative dataset as well. Throughout all three studies, we have also drawn on case study methods (Eisenhardt, 1989b; Yin, 2009). In the first project, we wrote to the CE (who was sometimes also the chairman) in each company, to request an interview. Following this, we then sought permission to interview others of their team or inner cabinet. This was in part, a way of gaining their confidence about who we were, our purpose, and the kinds of questions we were asking and, in part, gaining their support for this research with a snowball effect. Most were happy to introduce us to at least two others of their top team and usually also a board member such as the chairman: in one case we had seven interviews. This way, the 1987–1989 (t0) project generated 46 interviews in 12 different companies, with at least three interviews or more in each of 10 companies, and two with only one or two interviews: Avon Rubber, Beazer, BTR, Coats Viyella, Glynwed, Hanson, Lucas, Marks & Spencer, Metal Box, Prudential, Reckitt and Colman and TSB (Mangham & Pye, 1991).

In the 1998–2000 (t1) project, sample companies had changed such that three effectively dropped out of the sample: Lucas Industries and Metal Box were no longer UK-listed, and BTR was being taken over by Siebe in 1998, to become Invensys.[3] The remaining nine companies from the t0 sample were then approached at t1 and interviewed in this second round of the project, together with Scottish Power, representing the utility sector which was not FTSE- listed at t0. In recognition of the increasing role played by active investors in 1998, interviews were also carried out with five CEs from large institutional investment firms (Hermes, Gartmore, Liontrust, Merrill Lynch and Phillips and Drew). Out of 46 directors who contributed to the t0 project in 1989, by 1999 15 had fully retired from any board roles, three were deceased, two had emigrated, and 26 were still active, mainly in non-executive corporate roles. Only one of those 26 active directors declined to contribute to the second round of the project (Pye, 2001a, 2001b).

The third in this series of projects (t2) is currently ongoing (2009–2011): hence the findings reported in this chapter represent work in-progress. Due to takeovers, change of listing and organizational restructuring, only four companies from the original 1987–1989 sample remain in the current sample: Lloyds Banking Group (formerly Lloyds TSB), Marks & Spencer, Prudential and Persimmon (formerly Beazer plc). Thus, we have recruited new firms to our core sample, and have currently completed similar case studies at BAE Systems, Pearson and Rolls-Royce (see Table 12.4).

In effect, through these studies we have developed a selection of illustrative cases of how small groups of people run companies (Eisenhardt & Graebner, 2007; Siggelkow, 2007). In so doing, it is valuable to explore the notion of variance within and between cases, which, we argue, enables us to shed some insight on their practice, reflecting behaviour both representative across and distinctive from others in this sample, and from which we can draw out implications for the wider population of directors (Gerring, 2004). We compare across cases, to look for consistency and difference in what they are saying, and within each case, interrogating the data more closely to develop a deeper understanding. Across each of the studies, we have also then sought to develop a theorized storyline in writing up the analysis to make a relevant contribution to academic literature and practice of the time (Golden-Biddle & Locke, 2006). Without doubt there is a separate paper to be written about this on the methodological implications of analyzing qualitative data across time which we will develop in due course.

Similar to the t1 project, we are also interviewing a selection of senior executives and directors at institutional investors such as Governance for Owners, Hermes Equity Ownership Services, Legal & General, Railpen, Standard Life and USS. In addition, we have sought the views of people in

Table 12.4 Core sample companies in each study

1987–1989 (t0)	*1998–2000 (t1)*	*2009–2011 (t2)*
Avon Rubber plc	Avon Rubber plc	
Beazer plc	Beazer plc	Now Persimmon plc
BTR plc	*Being taken over by Siebe*	*Operating as Invensys plc*
Coats Viyella plc	Coats Viyella plc	*Sold to private ownership*
Glynwed plc	Glynwed plc	*Sold and non-UK listed*
Hanson plc	Hanson plc	*Sold and non-UK listed*
Lucas Industries plc	*Taken over by TRW Inc.*	
Marks & Spencer plc	Marks & Spencer plc	Marks & Spencer plc
Metal Box plc	*Separated and sold to Caradon and Carnaud MB*	
Prudential plc	Prudential plc	Prudential plc
Reckitt and Colman plc	Reckitt and Colman plc	Reckitt Benckiser plc – secondary data
TSB plc	Lloyds TSB plc	Lloyds Banking Group plc
	Scottish Power plc	*Sold to Iberdrola*
		BAE Systems plc
		Inmarsat plc
		National Grid plc
		Pearson plc
		Rolls Royce plc
		Severn Trent plc

influential/corporate advisory or oversight roles, including auditors, regulatory institutions, recruitment, compensation and management consultants, and a proxy voting services providers such as Ernst & Young, International Corporate Governance Network (ICGN), Institute of Chartered Secretaries and Administrators (ICSA), Financial Reporting Council (FRC), KPMG, Manifest, National Association of Pension Funds (NAPF), TowersWatson and Zygos Partnership. So far, fieldwork includes 100+ interviews.

As with all qualitative research, the data analysis process begins as soon as one starts collecting and it has proven a fascinating challenge to tackle such an array of data in a systematic method. We have used a similar process to before, writing memos and coding data, then comparing and cross-checking with each member of the three-person fieldwork team, as we cluster sense-data, sift out some codes, review and revisit the data to double-check and examine the veracity of the developing analytical framework (Miles & Huberman, 1994; Golden-Biddle & Locke, 2006). Not only does this dataset stand alone as illustrative of contemporary practice but also it can be compared with previous project datasets – hence, we have structured the next sections around three key themes that recur in each sample: the people, their roles and relationships; board and top management responsibilities (strategy, governance and remuneration); and board–TMT relationships with investors.

PEOPLE: ROLES AND RELATIONSHIPS

In each study, at least one contributor has reminded us that 'the CE runs the company and the chairman runs the board'. Technically, this is accurate but in practice, as one chairman forcefully put it, you cannot run a board without a thorough understanding of the operational issues, so they must work in sympathy with each other such that boundary lines between them remain as important as ever (Pye, 2001b). In terms of role execution, these boundary lines seem clearer than they were at t0. We suspect a combination of increasing regulation and more widespread use of the internet as a means for accounting for governance practice may affect how and why this is now more keenly felt and spelt out for all main directors.

Without doubt, the CE role is to run the company and, in each study, CEs have done this by working through an executive operations group, usually of around 8–15 people, who meet at least monthly. The classic Monday Morning Meetings, characteristic of t0 companies, are less common now, although smaller 'inner cabinet' meetings of key executives – finance director (FD) and perhaps two or three others, e.g. divisional CEs – still occur, both formally and informally. The relationship between them is no longer explicitly ascribed the *primus inter pares* quality that characterized many t0 top management teams, although these teams are key to the CE's ability to perform his/her part. Most, if not all, executive team members continue to be direct reports of the CE, so how power is felt and enacted in these relationships is crucial to their functioning as a group.

At t0, the most pivotal director relationship seemed to be between CE and FD 'to run the numbers', with the chairman as more the avuncular backstop whose primary role was to get matters approved by the board. By 1999, the balance had shifted such that chairmen then had a more important part, described as a key axis of organizing and board culture, in particular (Pye, 2001a). This remains the case at t2, although the roles and power dynamics of the who, what and how has changed considerably across time. At t1, there was more delegated authority to divisional CEs for sign off of capital expenditure than at t0 and much of the FD talk of financials was framed in terms of generating shareholder value and earnings per share, than had been the case at t0 (where cash flow and ratios were more important). Now (t2), we are finding that the FD role itself seems to have changed across the last decade and is becoming more strategic, such that in one case, the FD role is the equivalent of a chief operating officer. As a consequence, the roles of head of treasury and group finance officers have blossomed together with expanding finance departments/functions. It is undoubtedly the case that increasing external regulation, such as SOX, more complex risk (stress-testing) and compliance requirements, together with changes in global taxation and international accounting standards all impact significantly on the corporate finance function. However, with regards to grooming future CEs, at t0 FDs were generally seen to be better suited to becoming chairmen, providing essential anchorage to strategic-visionary CEs, whereas by 2010, this role is now more frequently a stepping stone to becoming a CE.

Interestingly, in each study, at least one person has said 'our people are our organization' and yet there remain very few, if any, EDs on main boards with responsibility for human resources (HR) or people issues: one exception is Pearson where they have had a director of people on the main board since 1998. Similarly, there continue to be very few, if any, strategy directors on main boards, although the number one board role throughout each iteration of the Combined Code is to 'set the strategic aims' of the company. Each company has strategy/planning departments/staff functions which support the strategy function, but this remains ultimately the responsibility of the CE, who will engage with both executives and non-executives in the process of developing strategic direction (see next section).

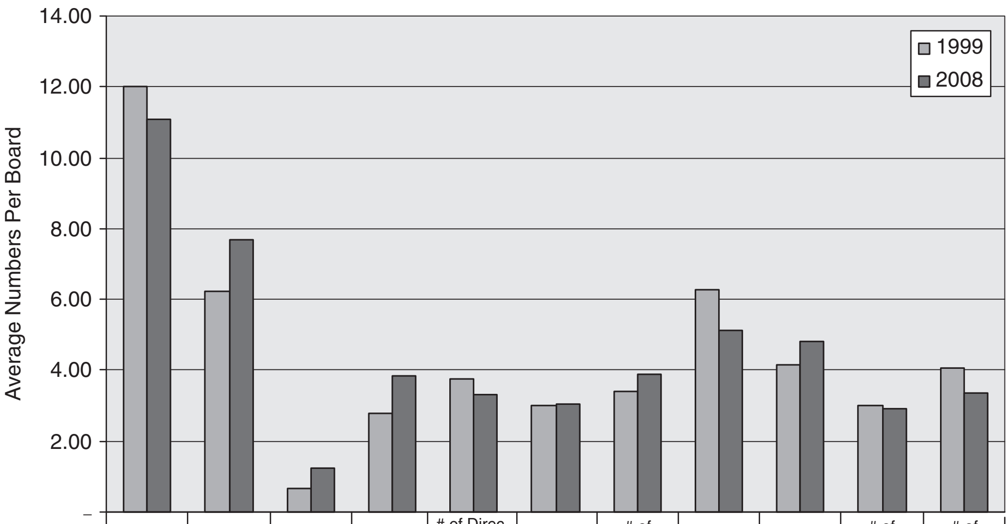
CE time and engagement is now substantially more externally oriented than in 1989, although as far as we are able to infer from our data, this is relatively little changed to 1999. This may be because they are now enabled to do their jobs more time efficiently by internet technology, with more ready access to video-conferencing and virtual team meetings. While they do still endeavour to spend time 'walking around' their local patch, reports of this have steadily declined since 1989 and, instead, more time appears to be spent in meetings and networking with people outside the firm, e.g. investors, advisors, suppliers, professional associations and government or advisory boards, as well as in NED roles. They do still travel considerably, networking globally and visiting foreign operations and business opportunities, and see the CE role to be a 24/7 job (see section below).

FTSE100 boards currently meet between 6 and 10 times per year, with usually at least one meeting held in an overseas setting. Improved technology makes a significant difference to where and how these take place, not least the Blackberry (aka crackberry), without which many say they couldn't do their jobs! During the recent financial crisis, for instance, mobile phones were essential for urgently needed, conference call board meetings. Clearly this was simply not possible in 1989, and affects how people engage with each other, understand and give attention to issues and how decisions are achieved, as non-verbal behaviour gets recast through more sensitive (or not) interpretation of intonation, inflexion, pauses and turn-taking (or not) (Pye, 2010).

Board size and composition are now notably different to their 1989 counterparts. Bank boards have always been and continue to be the largest, reducing from 31 at TSB in 1989 to now 13 on the Lloyds Banking Group board. By t2, average FTSE 100 board size is 11 (t0 ≈ 14, although the range was much wider, from 5 to 31). In 1989, relatively few FTSE 100 CEs were appointed from outside their companies in the preceding five years (2 out of 12 in our sample). By t1, in the majority of our sample, these were external appointments while at t2, the balance is currently just in favour of internal appointment. At t0, there were three out of 12 cases of CE duality in our sample, i.e. one person holding both the CE and chairman's role. Following regulation through the 1990s, this practice has become substantially reduced across the FTSE 100, although was retained in our sample at t1 by Marks & Spencer: having separated the roles in 2000, they then recombined them again in 2005, and are no longer the only case at t2 where this occurs.

Figure 12.4 depicts a variety of compositional changes based on FTSE 100 data between 1999 and 2008, indicating that: boards have become incrementally more open to women and foreign nationals, although overall the numbers still remain tiny (0.11 and 0.34, respectively); directors are now invariably better educated, with around a third holding either a degree or professional qualification in finance or a finance-related discipline; and boards now tend to have around four subcommittees (i.e. one more than the recommended nomination, remuneration and audit committees).

The balance has also changed with regards to the non-executive/executive composition of boards. At t0, there were far fewer NEDs than EDs on FTSE 100 boards; and average executive board tenure was relatively high (8 years in our sample). By 1999, this had reversed: there were more NEDs than EDs on each board in our sample and average CE tenure had dropped to around 3.5 years. By 2009, FTSE 100 CE tenure was also reported to be increasing to around 5 years (Grant Thornton, 2010), although the average number of external board appointments remains around three each. There are now consistently more NEDs than EDs on each board in our t2 sample and, indeed, in one case, the ratio is 7:2. Interestingly, some t2 interviewees feel board discussion suffers when the executive representation is reduced to CE and FD, as this potentially limits the NEDs' line of sight into the company which they direct. However, not all agree with this



	Board Size	# of NEDs	# of Female	# of Non British	# of Directors with a financial background	Education	# of Board Committee	Board Tenure	CEO Tenure	# of Interlocks by NEDs	# of Interlocks by All
1999	12.00	6.24	0.67	2.80	3.74	3.02	3.41	6.28	4.15	2.99	4.08
2008	11.10	7.67	1.24	3.83	3.32	3.03	3.88	5.10	4.83	2.91	3.34

Figure 12.4 Board structure and characteristics of FTSE 100 companies, 1999 vs 2008

Source: BoardEx.

Note: FTSE 100 companies are constituents as of 27 December 2008. Education is measured on the scale of educational achievements coded as 1-School/Vocational, 2-Bachelor, 3-Master, 4-MBA and 5-Doctor. Financial background is accounted for as possession of an educational degree in finance or a finance-related discipline and/or professional qualification in finance or a finance-related discipline.

view and one FTSE 100 CE was keen to point out that by reducing ED representation, NEDs are left in no doubt about the fact that their job is *not* to run the company.

Notwithstanding regulation across the last 20 years, this shift in the balance of board composition is worth noting because the role of the non-executive (i.e. independent, or outside) director remains relatively opaque. They are employed part time, do not have executive authority, are considered to be ‘independent’ of the company, and are usually paid on a fixed fee/attendance based basis. In the t0 study, NEDs barely featured as they had very limited part or influence in the running of the company. Indeed, one t0 NED was famously reported to open his brown envelope and remove the board papers as he entered the boardroom and at the end of the (short) meeting, stuff them back in the brown envelope and hand them to the board secretary again on his way out to lunch. By t1, the NED role was no longer seen as a sinecure, although there was still a tendency for the chair’s ‘old boys’ network’ to prevail. By t2, legislation, regulation and media attention on the role of the board (and public expectations of boards) in directing these hugely influential companies mean the NED role is more in the spotlight, although it is clearly the case that ‘one size does not fit all’ (Pye & Camm, 2003a) such that some ambiguity remains. Ironically, NEDs are increasingly hired for the particular skills and capabilities which they may contribute, yet in regulatory terms directors (and their contribution) are legally of equal merit, as board decisions represent a case of collective responsibility. So what comprises an effective NED contribution remains equivocal, as each company and board situation is as different as each director and the interpersonal dynamics between them may be (Pye & Camm, 2003b; McNulty, Roberts & Stiles, 2005), which is, of course, also time- and situation-dependent.

As required by regulation, much more time and attention is now (t2) given to board induction and director ‘education’ in organizational issues as well as more regular evaluation of board effectiveness than was previously the case. Some contributors, however, remain sceptical about the value of these effectiveness evaluations and are less inclined to see need for personal development. In 1999, only one in 10 companies in our sample had conducted a board evaluation process. By 2009, 90 companies in the FTSE 100 index reported in their (2008) Annual Reports and Accounts that they undertook an evaluation of board proceedings, with 25 using external consultants in the process (ahead of the Corporate Governance Code (2010) recommendations). As far as we are able to judge in 2010, although more is done to induct directors into their role, there is still relatively little time and money invested (particularly relative to their potential impact) in the longer-term continuous professional development of directors.

Regardless of these changes to composition and regulation, NEDs continue to remain dependent principally on the chairman and CE (as well as the company secretary) for the very lifeblood of their work – information – in terms of how board agendas are put together, meetings and issues are framed, information shared and, ultimately, decisions made. Yet information is not necessarily knowledge and ‘more’ is also not necessarily a good thing. At t1, we had varied examples of board style and engagement, including one case where the same, highly competent NED felt enabled in one board and disabled in another by two contrasting chairmen and board cultures and another case where NEDs felt distracted by the volume of paperwork which they felt had been sent to take their eye off strategic issues. In contrast, by t2, several core sample companies routinely provide minutes of the executive management group meetings to the NEDs, along with board papers. As one FTSE 100 divisional CE put it recently,

> […] actually what you want from non-executives is good, balanced, dispassionate, common sense judgement and you frequently get that by people not being too … – of course people have got to

> have enough detail – but too much information and too much 'eyes down' involvement in the day to day issues sort of impairs the ability to make that contribution.

However, adjudging the differential between quantity and quality of information is a very fine judgement call, probably only known with hindsight.

In concluding this section, NEDs' ability to enact their accountability in relation to investors continues to depend to a large degree on executives' enacting their accountability towards NEDs. This reflects a strong sense of embeddedness of key people in a web of accountabilities, underpinned by the relationship forged between the CE and the chairman, which lays the foundation to board culture and effectiveness. It also illustrates how and why there remains a tendency for these to become consensus groups, making it difficult to raise challenges at this level (Kakabadse, Kakabadse, & Barratt, 2006). What cannot be mistaken across any of these studies is that this is fundamentally a social system. These key directors at the helm of their organizations are deeply embedded in a chain of accountabilities, which, although regulated, are not prescribed. Hence, what is considered appropriate conduct remains open to interpretation at every step along the way, and is dependent on the personalities, interpersonal relationships and networks of power forged amongst and between key people involved, in particular contexts at particular times.

BOARD AND EXECUTIVE TEAM RESPONSIBILITIES: STRATEGY, GOVERNANCE AND REMUNERATION

The board role as defined by UK corporate governance regulation is to oversee strategy, governance and remuneration, so we now turn our attention more closely to these responsibilities to see what has and has not changed in directors' conduct of these roles. In 1999, contributors voiced concerns about the danger of NEDs becoming monitors, policing management and ticking corporate governance boxes rather than being effective contributors to shaping strategic direction of the company. At the time, they saw strategy as being the area to which they felt best able but least often enabled to contribute and this anxiety still remains in 2009, probably heightened by the recent financial collapse. As one FTSE 100 chairman recently put it:

> There's a disturbing tendency to regard the non-execs as watchdogs on the one hand, and quasi-executives on the other, and there's a real lack of clarity of thinking about that which has crept in, and it needs very careful thought.

There was little doubt at to that the ED team was responsible for strategy: the CE would present it to the board and by and large, the board would sign it off perhaps with minor amendments. By t1, increased NED presence on main boards, together with corporate governance regulation, led to the situation where NEDs were being expected to be more challenging of executive strategy presentations. All boards in the t1 sample had an annual two-day strategy 'awayday' type event, and NEDs were more proactively engaged in influencing and shaping the strategic direction of their company. There were a few slightly dissenting voices at that time, suggesting the value of the awayday was more in terms of socializing the board rather than creative strategic outputs, or that, ultimately, strategy is formulated with hindsight, dependent on the opportunities available to the board (Pye, 2005).

By t2, we find two particularly notable developments with regard to the strategy development process. While boards continue to hold strategy awaydays and expect strategy to come from and be led by the executive, we also hear that strategy development is now much more of an ongoing process. There is less expectation of major change in direction and, instead, boards engage in more regular review and updating against targets at each meeting with an annual or biannual 'deep dive' event to revisit, challenge and, if need be, refresh strategic thinking and direction. This perhaps makes it easier for NEDs to feel able to input regularly to strategic decision making and for EDs to feel greater benefit from the expertise amongst their NEDs. It also means that it continues to be rare for executive strategy proposals to be unpicked by NEDs.

Secondly, the internet makes a significant difference to communication, not least with regards to strategic direction and implementation. Corporate websites and Annual Report and Accounts are replete with information about strategy and corporate values, often deeply embedded in their performance management and reward systems, and still bearing resemblance to the Balanced Score Card models which were commonplace in t1. It is also easy to find videocasts and interviews with CEs online, explaining strategy and performance as well as outlining future expectations, and many use regular CE blogs, emails and instant messaging for important announcements.

From a corporate governance point of view, there is also significantly more information now available about every aspect of corporate practice, both on intranets and external-facing websites. Through the internet, inquirers can usually find the Report and Accounts, podcasts of presentations to analysts, analysts' reports, terms of reference for board committees, letters of appointment, as well as corporate social responsibility reports and many other forms of accounting for corporate governance practice in the organization. The Annual Report and Accounts are often now very lengthy (up to 504 pages, HSBC, 2009) and usually have lengthy sections on corporate governance, which regrettably, often provide boilerplate coverage of all points required to be addressed by relevant regulators, not least because of the increasing role of lawyers in any corporate (re)presentation.

Remuneration remains a highly sensitive and contested subject, not least because the average boss-to-worker pay ratio across the FTSE was reported to have grown to 88:1 in 2010 (IDS survey). Packages were much simpler in 1989, and it is relatively hard to find executive remuneration data for that time. Figures were presented in Annual Reports and Accounts in terms of a range of values, and average NED compensation was around £10,000–15,000, with up to £100,000 for a non-executive chairman (Pye, 2001a), and executive remuneration was around £150,000–200,000. Since then, executive remuneration disclosure has become more detailed across each decade, such that in their 1999–2000 Annual Report and Accounts, Marks & Spencer plc gave eight pages of information on remuneration in comparison with 15 pages in the 2009–2010 equivalent. In 1999, executive remuneration had increased such the highest-paid FTSE CE received £3.64 million, while NED pay ranged between £25,000 and £40,000 with up to £175,000 for a non-executive chairman in this sample. In 2009, these figures have now increased to: £92.60 million (nominal value) for the highes-paid FTSE CE (Executive Pay Report, 2010); approx £60,000 for average FTSE 100 NEDs and around £334,000 for a similar chairmanship, with the highest at £750,000 (O'Grady, 2010).

Increases in ED remuneration were perceived as justified in 1999 in the light of shortened executive tenure, greater public awareness and scrutiny of the person and their role, the CEs' importance in sustaining relationships with major shareholders and the overall level of responsibility. However, concerns were voiced with regard to the weak relationship between performance and reward, as well as rewards for managerial empire building (mergers and acquisitions) rather than creating sustainable future value. As for NEDs, the feeling persisted that their contribution remained undervalued, although it was also recognized that intrinsic motivation and non-pecuniary benefits, such as reputation and social capital, mattered for people taking on this kind of role.

The changes in board composition and remuneration packages at t1 reflected largely the recommendations of the Combined Code (1998). They included the governance mechanisms (aligned with agency theory assumptions) of: more substantial incentivization of managers through performance-related pay components; significant NED ratio; and separation of the CE and chairman's role (Pye, 2001a). Using share options to align executive interests with those of shareholders was beginning to happen at that time but not uniformly across the FTSE: there was presumably less exposure of management to NED questioning and internal company hierarchy mattered for career and promotion prospects, in turn reflecting on how executives perceived and enacted their role.

Figure 12.5 illustrates some changes in remuneration across the time period 1999–2008.

Clearly, share options and the long-term incentive plan (LTIP) components of executive remuneration have grown considerably since then, such that board members continue to be better paid. Boards apparently experienced institutional strengthening of the NEDs' oversight and yet, at the same time, the *quantum* of executive remuneration is perceived as an issue by many (cf. Clarke, 2010b). There continues to be concern about rewards for failure, such that more recently, companies have been urged to use 'clawback' clauses. With the recent increase in higher threshold taxation in the UK, however, human ingenuity prevails such that we are told there is now increasing use of off-shore payment taking place and pension provision as cash.

Overall, these changes have had an important impact on different aspects

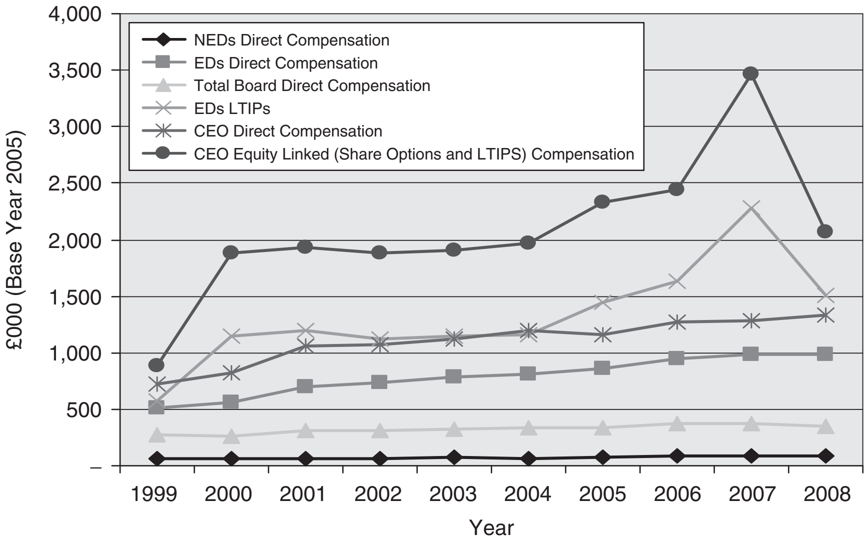


Figure 12.5 Average real remuneration of FTSE 100 companies in 1999–2008

Source: BoardEx.

Note: FTSE 100 companies are constituents as of 27 December 2008. Direct compensation refers to cash-based compensation, i.e. salary/fee, bonus, pension and other. Pension is defined as contribution pension and does not include any private pension schemes individuals hold or contribute in the given period. Other includes non-salary or bonus-related pay such as care expenses/gym membership or other cash-based expenses. Long-term incentive plans (LTIPs) are the part of equity-linked compensation displayed as the maximum value obtainable under the long-term incentive plan. The actual amounts directors receive may vary depending on the achievement of performance. The nominal values are converted to real values using output deflators (100 = 2005).

of embeddedness. Structurally, executives face greater exposure than they did at t0 to NEDs, whose role is to provide challenge and support to the executives (Forbes & Milliken, 1999; Pye, 2001b; McNulty et al., 2005). There is also increasing recognition in the literature that boards in general, and NEDs in particular, should be able to contribute to the strategy-making process (McNulty & Pettigrew, 1999; Pye, 2001a; Pugliese et al., 2009). Socially, this has implications for the relationships between them, which take place and gain meaning in context. At t1, power had shifted towards investors in terms of defining the acceptability of corporate performance. Returning to directors at t2, we find this balance has now shifted again, with increasing globalization of business and financial services in particular, with collapse of banking systems and with changing regulation in different parts of the world, notably the UK and the USA. Hence, we now turn to explore relationships between investors and investees in developing this comparative analysis.

INVESTOR–BOARD RELATIONSHIPS

Share ownership and investment practice have changed significantly across the last 20 years and form the basis of a significant body of literature in their own right. Attention to investor influence on boards only arose in the t1 study, where consistently repeated (and unprompted) reference to strategic focus, corporate governance and shareholder value, alerted us to a significant shift in terms of power towards major institutional investors to shape corporate performance which had taken place during the 1990s. One active investor in particular provided a clear statement of their 'absolute rights' to question whether the board's strategy, management, or capital structure is right and 'to change the management' if they felt they were underperforming. Thus, boards have to explain their strategy and convince investment company management that they are the right people with the right strategy as well (Pye, 2001a, 2001b).

Active investors expected that CEs and FDs would make themselves available to have meetings with investors and explain their actions as well as outline their analysis of the future. At t1, CEs estimated they devoted 20–25 per cent of their time to the developing relationships with investors, which was a considerable increase on the 10 per cent of their time spent 'talking to the City' in 1989 (which included results presentations to investors, talking to stockbrokers' analysts, seeking advice from the merchant bank, etc.).Where in 1989 there had been a sense of reluctance in having to spend time doing this, by 1999 the majority of CEs described it as a vital part their and their FDs roles. Both CEs and FDs seemed to have substantial staffs, which provided essential background work for investor meetings, indicating their growing significance in these governance process (Pye, 2001a, 2001b). Hence, in terms of political embeddedness, the design of corporate architecture and corporate practices had now tipped the balance of power away from executives toward investors.

By 2009, with the internet and widespread information availability, communication departments have also now grown and for many FTSE 100 companies, their accountability (particularly corporate social responsibility and governance) is widely recounted and available for scrutiny online. Investors, however, continue to exercise their rights in a quiet way and away from the public spotlight and, once again, the balance of power between boards and investors has shifted, now with greater overseas ownership of UK equities (see Figure 12.2) and also increasing volumes of high-frequency trading (accounting for 32% of daily trades on the London Stock Exchange at present). Technological change has played a significant part in these changes and we comment on this again later in this section.

In the latest (t2) study, active investors themselves have spoken about their relationship with companies with relative confidence.

Similar to t1, we find a preference for backstage actions, so that reputations and share price performance are not affected by discussing problematic issues in the public spotlight. The triggers for engagement were mainly code non-compliance and performance issues. Following the introduction of the Say on Pay advisory vote by shareholders in 2002, many companies tend to contact their main investors themselves to consult about planned executive compensation packages (and some would say for free advice!) before the AGM (annual general meeting) vote. Some investors also mentioned the importance of engagement on strategy and board nomination issues and greeted the principle of annual re-election of all directors (Corporate Governance Code, 2010) with satisfaction. They commonly suggested that executive remuneration probably receives too much attention relative to other areas of engagement.

By the time a key proposal or nomination reaches the shareholders' AGM, it will have been well-polished and will be acceptable to major shareholders. A recent engagement survey by the Investment Management Association (IMA, 2008) demonstrates that, on average, institutional investors voted against 3.3 per cent of resolutions voted in 2008 and 3.8 per cent in 2007, an increase on 1.8 per cent in 2005 and 2006. This suggests a higher number of controversial votes in 2007–2008 than in previous years but, overall, demonstrates that investors vote with management in the great majority of instances. Relatively few cases of changing appointments or strategic direction were given, except where investors had to exert overt pressure to achieve their goals rather than attaining them through quiet mediation. This implies that investors are performing their roles effectively to the extent that they are able to bring about change without publicly undermining executives or share price performance. However, it remains impossible to establish how much of this influencing takes place and with what effects. So, despite the aim of regulation to make corporate governance more open and transparent, typically company–investor relationships were played out backstage in 1999, and we find this essential paradox of corporate governance continues to be the case (Pye, 2001a). Investment management firms are generally accountable to investment trustees; however, the latter are frequently fragmented, diverse and do not have sufficient expertise to hold fund managers to account adequately (Pye, 2001a). The chain of intermediation between the original share buyer and fund manager also now makes this a much more fragmented line of influence.

Investors in our sample are generally in favour of the introduction of the Stewardship Code (2010), which provides main principles on institutional shareholders' engagement in investee companies. Seen by many as an important regulatory step towards strengthening the ownership relationship by encouraging shareholders' oversight of company management in the wake of the recent financial crisis, this is itself a product of regulatory and corporate governance failures (Clarke, 2010a). However, investors were generally hard-pressed to specify the benefits and costs of shareholder engagement, although for economic reasons, in the majority of instances, exit is not a real option for them. They also admitted to undertaking occasionally self-initiated, collective efforts[4] with other shareholders in engaging with investee companies, although we could find no pattern to such collective actions. Even with this increasing endeavour to develop more engaged ownership through direct dialogue with investee companies and disclosure of policies on engagement and voting, evidence suggests that more covert behaviour remains their preferred option. This is a deeply embedded social network of influence of traders not owners (Hendry, Sanderson, Barker & Roberts, 2006), in which directors and investors 'take risk' at each others' expense and seek to avoid damage to their company, board and, most importantly, their personal reputations, by avoiding the public spotlight. We conclude that this remains an inherent tension underpinning the process of corporate governing, which, our evidence suggests, has grown greater in its impact and effect on the behaviour of directors running large FTSE companies over the last 20 years.

CONCLUSION

Large multinational corporations continue to grow in size and influence in the global economy, generating market capitalization which exceeds the gross domestic product of smaller countries. For example, on this basis, Walmart is bigger than Pakistan and Peru, and Exxon is bigger than New Zealand and the Czech Republic (De Grauwe & Camerman, 2003).Yet their leaders are unelected by the general public and their decisions remain obscured from public scrutiny. As the recent financial crisis demonstrated, even corporations such as Lehman Brothers, once regarded as having excellent practices in place, can go bankrupt within a very short period of time and, as a consequence, flagship financial institutions of Anglo-American capitalism, such as Lloyds Banking Group are now partly owned by taxpayers. Like Enron and Marconi before them, Lehman Brothers had external auditors who had signed off their accounts annually, had governance practices which gave no external cause for alarm, and were still rated AAA by credit rating agencies, even minutes before their collapse. So, once again, we conclude that corporate governance regulation is a necessary but not sufficient cause of effective board conduct as it is ultimately people who create and run organizations (Pye, 2000).

Reflecting back across the three studies, clearly while the people and their roles have changed, the importance of relationships and their interconnectedness (embeddedness) has not. Strategy, governance and remuneration remain fundamental areas of board responsibility and key points of interaction between board and TMT, although how these responsibilities are carried out has changed. For example, shareholder value and corporate governance are no longer the mantras that were widely proclaimed in the t1 study, and instead, risk assessment and management is now much higher on the agenda. Board–investor relationships also remain key to practice. However, with around 80–90 per cent of publicly quoted UK shareholdings now being controlled by financial institutions rather than individual shareowners, these share traders have quite different objectives to those of ultimate shareowners. Along with high frequency trading, the nature of shareownership, and how these relationships are conducted, has changed significantly with new technologies and also with an increasing role for private equity, sovereign wealth funds and new forms of exchange trading. So what can we learn from this which may benefit future conduct?

Overall, the picture of corporate governance at the end of 1980s reflected the trends of that time in management process and practice of corporate control. Executives enjoyed relatively high degrees of freedom in terms of running corporations, pursuing diversification and restructuring strategies. Finance was relatively easily available and, in 1989, the governance mechanisms of incentivizing executives through significant levels of performance-related pay, high NED ratio, separated leadership structure and shareholder activism were not in place to the extent observed in the subsequent, post-Cadbury period.

In the 1998–2000 study, we found substantial change in corporate governance architecture in comparison with the end of 1980s. The mechanisms of governance had been strengthened through wider representation of NEDs on boards, separated roles of CE and chairman and endeavours to link pay with performance through greater use of share options and LTIPs. Company practice had tended to follow regulatory change, post-Cadbury, and the implementation of the first Combined Code of Corporate Governance Practice (1998) was beginning to have effect. However, questions were being raised, for example, about levels of executive remuneration, rising rapidly following the Greenbury Review (1995). With hindsight, we also notice several contributors at the time were saying that there was 'too much debt sloshing around in the system'. The role of a chairman and his or her leadership abilities was crucial for enabling NEDs to enact their roles effectively and institutional investors were now more powerful in their influence on board attention such that the balance of power appeared to have shifted away from executives running companies towards active investors in particular (Pye, 2001b, 2002).

In 2009–2011, the corporate landscape looks very different: companies are much bigger and more complex across a variety of different measures and use different means of communication and control, including cloud computing, mobile phones and instant messaging. Accounts of their corporate governance practice are available in great detail on their websites as well as many other places such as blogs, Facebook, Google and Wikipedia, providing almost infinite sources of information. By comparison, at t0, one chairman recounted that his CE did not have a contract because if that was something he needed, then he was clearly the wrong man for the job! At t1, all directors had contracts, although these were still considered largely to be proprietary knowledge and none was shared with us. At t2, a vast amount of information is routinely available on the corporate websites, as noted above, and contracts together with D&O insurance are essential!

Although interviewees at t2 have not consistently recited the mantras of shareholder value, strategic focus and corporate governance, this perhaps reflects the changing times in which even Jack Welch (2008) was famously quoted as saying '… shareholder value is the dumbest idea in the world' (Guerrera, 2009). Undoubtedly, shareholder value and corporate governance underpin their accounts of goals and compliance with regulatory codes as well as provide important framing for behaviour and action. Ultimately, however, as many a CE who has seen their share price go down although announcing improved corporate results will attest, interpreting corporate performance still depends on human judgement of (an)other human beings in which the way they appear to interrelate or work together can have a very strong effect (Pye, 2001b). The triad of executives, NEDs and investors lies at the heart of this judgement and therefore deeply embedded in a chain of accountabilities, in which their interactions and interpretations matter for corporate action and outcomes. So who is accountable to whom for what and how, in terms of context, content and process, is that accountability enacted? Regardless of the statutory and regulatory changes in the UK, this enduring question about accountability still lacks an unequivocal answer, not least because of the classic tension underpinning group behaviour which holds individuals responsible for individual action which is understood (gains meaning) at a particular time and in a particular context.

Something else which remains unchanged across the three studies relates to ambiguity about effective 'NEDship', where, on the one hand, they are expected to provide 'challenge' to management, but, on the other hand, must not run the company: as one NED put it, NIFO prevails – 'noses in, fingers out'. How one does this is undoubtedly a matter of judgement, both one's own and that of others in the board collective situation. NEDs also care for their own reputation in the market, so prefer not to be seen as either troublemakers or micro-managers of their company. In order to fulfil their role, they still depend primarily on executives for the supply of company relevant information and indeed, as before, if (an) executives choose(s) deliberately to misinform or mislead the NEDs, there is little which can be done to stop them. And despite recent statutory and regulatory change in the UK, this remains the case and will always be thus, unless their non-executive or independent outsider status changes.

This is perhaps one of the many reasons why, throughout all three studies, the relationship between the chairman and CE stands out as critical to effective board conduct and company leadership, although the quality of this has changed with each decade. At t0, effective chairmanship meant to be quietly influential, particularly with merchant banks and the City, and in support of CE preferences; at t1, this was now more specified through regulation, with greater attention being given to accounting for board conduct and process; at t2, once again spurred by regulation as well as economic change, this is now more clearly a leadership position, and more overtly in partnership with the CE, becoming more publicly known both inside and outside their companies.

Respect, judgement and trust remain three essential ingredients on which the success of this relationship turns and are deemed crucial for effective oversight and involvement on and by boards. Contributors readily admit, however, that this relationship ultimately depends on the styles and personalities of both parties, which, in turn, provides testimony to the embeddedness argument and its crucial role in shaping effectiveness at this apex of organizing. The same also applies to relationships between executives and NEDs: while they meet each other in the same, often collegial, unitary board setting, they have different interests and personalities, work from different agendas and are guided by their personal experience to help them judge the truthfulness, reliability and significance of statements made by the other party. As pointed out by many, over time, executives get to know whose NED contribution they can value as opposed to others, and the same is true of NEDs as each side weighs up the other to adjudge 'Do I have respect for this person and their judgement?' and 'Can I trust him/her?'. Thus, the social dynamics and quality of embeddedness play a crucial role in shaping boardroom culture, dynamics and dialogue.

The current (t2) project has been characterized by probably the most intense regulatory efforts since the Cadbury Committee (1992) in response to the 2008 financial crisis. There have been further regulatory attempts to strengthen governance mechanisms across all four dimensions of embeddeness, including: broader representation of NEDs, their capabilities and skills; separated leadership structure; as well as board evaluation; the Stewardship Code (2010); and annual re-election of directors. However, we notice a sense of regulation fatigue. Executives, non-executives and investors remain enmeshed in a situation in which regulation now gives primacy specifically to the 'long-term success' of the company, to the leadership role of the board (Corporate Governance Code, 2010) and to the active engagement of shareholders in conducting their role as owners (which, as noted above, is not the natural preference of the majority of share traders).

This latest UK Code was drafted to engender engagement with the spirit of the code rather than the letter of compliance which has characterized behaviour prior to this. However, our findings suggest it may take more than that to bring about wider, systemic change as while there are many honourable and engaged people in these responsible roles, there are few incentives for individuals in corporate roles to challenge embedded practices and/or institutions. During the recent financial crisis, some of the most powerful and critical questioning of the capitalist system came from the UK Treasury Select Committee process, chaired by John McFall, MP, in which a panel of members of parliament interrogated representatives from across the banking sector. In his conclusion, McFall noted that 'the corporate reporting model is broken' and that 'we must seize the moment (to bring about radical change) or risk sleep-walking into the next crisis' (2009). There has been little overt change since then and, as time passes, so the urgency for change seems to be diminishing, as investor bonus pools prove plentiful (£8 billion at Goldman Sachs, 2010) and executive pay continues to rocket. This leads us to conclude that until all four mechanisms of governance change together, including, for example, a wider representation of other stakeholder groups in these elite decision-making forums, it may be a case of *plus ça change*.

In conclusion, while developing multidisciplinarity in upper echelons research is essential for developing an understanding which closely reflects practice, it remains deeply challenging in terms of both epistemology and ontology, as well as crafting a theoretical niche in which to locate one's findings. The different perspectives identified by Hambrick et al. (2008) of economics, power, social psychology, law, social networks and symbolic management do not make easy bedfellows and, without accounting and finance, perhaps also lack a common language with which to make a shared sense of practice. Perhaps this is one reason why agency theory assumptions prevail and, although failing to adequately represent what happens in the relationships between corporate upper echelons and their owners, still inform the work of regulators and underpin the Corporate Governance and Stewardship Codes. Consequently, our effort in this unique long-term project remains focused on developing a process-oriented understanding of how small groups of people run companies. We look forward to returning to this sample in 10 years' time to find out what the next chapter holds.

NOTES

1 We are grateful to the ESRC for their continued funding of this work, under grant numbers WF 2925 0020 (1987–89) and R 000236868 (1998–00).

2 Concurrent with continuing technological developments has also come much greater awareness of and attention to issues of climate change and corporate social responsibility. This is a global matter with major local consequences and which impacts on business practice through a host of regulatory as well as corporate value(s) issues, and could easily be a chapter in its own right. It will not be further elaborated here, except to say that being mindful of national and international targets for tackling climate issues through responsible business practice, we remain surprised at the relatively limited attention given to this in some of our interviews with corporate leaders, even at t2.

3 Lucas Industries was taken over by Varity Inc. to become Lucas Varity in 1996, which was subsequently acquired by TRW Inc. in 1999 and was US-listed. Metal Box split into Carnaud MB and Caradon in 1992, whereby Carnaud MB (Paris-listed) was subsequently taken over by Crown, Cork and Seal Inc. in 1995 (US-listed).

4 An interesting phenomenon that is relatively and not apparent in the t0 and t1 studies is specialist engagement houses, such as Hermes Equity Ownership Services or Governance for Owners which take action on behalf of several investors. Pension funds are more likely to subscribe to such services, whereas large investment management companies generally prefer to engage on their own.

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13

Board Evaluations: Contemporary Thinking and Practice

Gavin Nicholson, Geoffrey Kiel and Jennifer Ann Tunny

INTRODUCTION

As the top tier of the corporate decision-making hierarchy, boards of directors can have a substantial impact on corporate performance (IoD, 2010). While there are ongoing debates surrounding what the board of directors should do (e.g., different perspectives on the importance of the monitoring role and independent directors), there is near universal recognition that boards benefit from feedback.

Practitioners and policymakers prescribe board evaluation as fundamental to effective corporate governance (e.g., Walker, 2009; ASX Corporate Governance Council, 2010). As summarised below, most corporate governance codes require boards to outline whether they are carrying out an evaluation on an annual basis, and regulators are taking an increasingly aggressive stance to require evaluations (e.g., APRA, 2009). Coupled with advice from practitioners (e.g., Garratt, 1996, 2010; Kiel, Nicholson & Barclay, 2005; Charan, 2009), it is clear that board evaluations are now a feature of governance practice.

Academically, there has also been a rise in interest in board evaluations. Research from the behavioural sciences, applied to boards of directors, highlights that groups need feedback to learn and develop (e.g., Sonnenfeld, 2002). There is also emerging evidence that reflective boards outperform those that do not take time to review how and why they operate in the way they do (Brown, 2007; Dulewicz & Herbert, 2008). Moreover, in the field of behavioural governance, the last decade has seen the emergence of new models that move beyond the highly simplified agency theory (e.g., Hillman & Dalziel, 2003; Nicholson & Kiel, 2004; Huse, 2007, 2009) against which boards can be compared.

In this chapter, we provide a summary of the trends, challenges and approaches taken around board evaluations. While we draw on academic insights wherever possible, we also provide commentary on contemporary normative advice and practice. First, we provide a brief overview of the major trends surrounding board evaluations. Next, we address the major challenges for the topic, focusing on how the theory and practice of board evaluations can be informed by the elements common to most models of effective corporate governance. With the background to and foundations of board evaluations covered, we spend the remainder of the chapter providing practical options for boards based on both normative advice and insights from research into boards and groups generally.

TRENDS IN BOARD EVALUATION

A major trend in corporate governance has been the shift from boards being seen as 'ornaments on the corporate Christmas tree' (Mace, 1971: 90) to boards being seen to have responsibility for strategy and adding value to the organisations they govern (Pound, 1995; Hendry & Kiel, 2004; Huse, 2007; Hendry, Kiel & Nicholson, 2010). As a result, directors and boards are under increasing pressure to do more than simply fulfil their fiduciary duties (van der Walt & Ingley, 2001). At the same time, academics have increasingly concluded that the most used or investigated potential correlates of governance effectiveness (e.g., board structure, independence of directors, use of committees) appear to have little explanatory power in predicting board effectiveness (Tricker, 2009). Thus, there are now calls to understand and manage how boards work, rather than to simply adopt preferred board structures and policies.

One outcome of this shift in thinking about boards is the increased use of board evaluations as a method of performance improvement. Previously, performance improvement took place in an informal way, but there is now pressure to make it formalised (Tricker, 2009), standardised (e.g., National Standards Authority of Ireland, 2010) and more rigorous (Clarke & Klettner, 2010). While there have been many changes over the past 10–15 years, there are at least three key themes to emerge: (1) increasing regulatory prescription and recommendation; (2) increasing use of board self-evaluations, and (3) the rise of external reviews.

Increasing regulatory prescription and recommendation

Perhaps the most significant change over the past decade is the increase in regulatory requirements and advice surrounding board evaluations. Nearly every major report and governance-related body has issued advice on conducting evaluations. We have compiled a list of many of these in Table 13.1.

Boards should note, however, that these requirements are the baseline for societal expectations. In Australia, the Corporations and Markets Advisory Committee (CAMAC) stated that it is the directors, not regulators, who carry the responsibility for ensuring boards have an appropriate evaluation process in place (CAMAC, 2010).

The prevalence of evaluations

While there have long been arguments that boards need to focus on professionalisation (and the consequent demands for evaluation of directors; e.g., Tricker, 1999), globalisation and the pressures associated with international competitiveness have driven measures such as board evaluations aimed at improving board accountability (Ingley & van der Walt, 2002). Thus, the last two decades have seen a shift in the use of board evaluations from a relatively rare event (e.g., Steinberg, 2000 reports 20% of boards undertaking a review) to a far more regular occurrence (e.g., Clarke and Klettner [2010] report 70% of boards undertake an

Table 13.1 Governance codes and board evaluations

Country	*Code/guideline*	*Date*	*Recommended / mandated*	*Frequency*
Australia	Corporate Governance Principles and Recommendations	2010	§2.5	Regularly
Belgium	The 2009 Belgian Code on Corporate Governance	2009	§4.11	Regularly (e.g. at least every 2–3 years)
Canada	Corporate Governance Guidelines	2005	§3.18	Regularly
France	Corporate Governance Code of Listed Corporations	2008	§9	Annually, with a formal evaluation at least once every 3 years
India	Corporate Governance Voluntary Guidelines 2009	2009	§II.D	Annually
Italy	Corporate Governance Code	2009	§1.C.1(g)	Annually
Netherlands	Dutch Corporate Governance Code: Principles of Good Corporate Governance and Best Practice Provisions	2009	§ III.1.7	Annually
New Zealand	Corporate Governance in New Zealand: Principles and Guidelines	2004	§2.10	Annually
Norway	The Norwegian Code of Practice for Corporate Governance	2010	§9	Annually
South Africa	King Code of Governance for South Africa (King III)	2009	§2.22	Annually
Sweden	The Swedish Corporate Governance Code	2010	§8.1	Annually
Thailand	The Principles of Good Corporate Governance for Listed Companies	2006	§5	Regularly
UK	The UK Corporate Governance Code	2010	§B.6	Annually – externally facilitated at least every 3 years
USA	NYSE Corporate Governance Standards	2009	Rule 303A.09	Annually

annual evaluation). This is particularly so in listed companies where they are often mandated or strongly encouraged through governance codes (see the preceding section).

The preceding comments and figures relate to 'board-as-a-whole' reviews, where the overall performance of the board is reviewed. A second and complementary approach to reviews is individual director evaluation. While recent attitudes to individual director evaluations have changed, and few would now argue against them (Tricker, 2009), they are clearly employed less often then whole-of-board reviews. For example, a 2004 survey by Korn/Ferry International reported that 21% of boards conducted self-evaluations (Stybel & Peabody, 2005), while Nadler (2004) reported 24% of respondents carrying out individual assessments.

External reviews – a new phenomena

In addition to a rise in internal evaluations, there has also been a rise in the number of external reviews conducted by ratings agencies, pressure groups, investors, and so on (Collier, 2004; Van den Berghe & Levrau, 2004). External evaluations are largely conducted through analysing statements by the board in external reports. These are then compared with some benchmark such as the Combined Code (now the UK Corporate Governance Code) (Collier, 2004) in the UK (Financial Reporting Council, 2010) or the ASX Principles in Australia (ASX Corporate Governance Council, 2010). There are a number of organisations producing such reviews. Standard and Poor's, the FTSE Group in collaboration with International Shareholder Services (ISS), GovernanceMetrics International (GMI), Deminor Corporate Governance Ratings, and Thai Rating and Information Services (TRIS) are examples of groups providing ratings assessments (Tricker, 2009).

A major criticism of external reviews is that they rely on the published statements of companies as to their practices. These statements may not fully reflect what the company does or does not do. In addition, these public statements are contrasted against criteria that not all directors and commentators would agree represent best practice. Finally, they are not informed by the behaviours and decision making that actually goes on in the boardroom. Nevertheless, they are an important trend.

DEFINING AND MEASURING BOARD EFFECTIVENESS

Clearly, boards are being pressured to undertake more rigorous evaluations, more often. Yet, this trend to an increasing use of board evaluations has highlighted some of the challenges facing boards. One of the greatest challenges for both academics and practitioners lies in how to define an 'effective' board. The different contexts in which different boards operate (e.g., different legal structures, for-profit vs not-for-profit, family owned vs listed, stable vs turbulent industry) and the various constraints they face (e.g., constitutionally imposed constraints, operating environment shocks, institutional forces) results in 'value creating boards' (Huse, 2007: 4) undertaking different tasks and having different attributes. In short, board effectiveness is both contingent and equifinal – it is contingent on the broad environment in which the organisation finds itself, and there are alternative paths to effectiveness. The existence of these alternative paths to board effectiveness can be seen in the differing models of how boards work (e.g., Donaldson & Davis, 1994; Hillman & Dalziel, 2003; Nicholson & Kiel, 2004, 2007; Huse, 2007).

The problematic nature of measuring board performance springs, we believe, from three major sources. First, the focus of a board evaluation is often ill-defined and mixed; in academic language, the unit of analysis is poorly defined. Second, there are few sources of data and the key sources (the board itself and key employees) are subject to bias. Third, current thinking on the relationship between boards and performance emphasises the contingent nature of the board's work, meaning there may be no singular way to measure board effectiveness. In fact, we know that different stakeholders judge board and organisational performance differently (Herman, Renz & Heimovics, 1997; Callen, Klein & Tinkelman, 2003; Balduck, Van Rossem & Buelens, 2010). And while there is some limited, coherent, case or survey-based understanding of what makes a very effective director (e.g., Tricker & Lee, 1997), there are quite disparate views on the attributes of an average or poor performer (Balduck et al., 2010).

Thus, the definition and measurement of board effectiveness is a key problem for board evaluations. To some degree, the topic is like the definition of hard-core pornography offered by Justice Potter Stewart: we cannot define it, but we 'know it when we see it' (*Jacobellis v. Ohio* 378 U.S. 184 (1964)). In the following sections, we outline these key challenges and summarise the implications for board evaluations and current thinking about how to solve these problems.

Evaluation focus – unit of analysis problems

One of the major challenges facing a board evaluation is choosing the appropriate level of analysis for the process. A key error is substituting organisational performance for board performance (Nicholson & Kiel, 2004). Quite simply, just because a company is performing well does not mean the board is effective. There may be an exceptional management team in place, the current organisational performance may reflect previous (not current) board performance, or it may be a matter of luck (e.g., Mauboussin, 2009) – a point to which we return in our discussion on contingency. Thus, the first step in defining effectiveness lies in differentiating board performance from organisational performance.

Despite these significant difficulties, we would propose that it is possible to assess board effectiveness accurately. To do so requires us to understand the complex nature of the issue. Boards, like most groups (see Hackman, 2002), require three different types of effectiveness if they are to maximise their potential. These types of effectiveness operate at three different levels – the organisational level, the group level and the individual level. The idea of different levels of performance is put in different language in the governance literature. Some authors concentrate on the work of the board. They look at board roles (Zahra & Pearce, 1989) or board tasks (Huse, 2007), and how they add value to the corporate value chain (Huse, Gabrielsson & Minichilli, 2009a, 2009b), while others concentrate on the group (Forbes & Milliken, 1999) and individual requirements (Tricker & Lee, 1997).

Instead of being the exclusive domain of one level of analysis, board effectiveness is likely to be highly complex (Ingley & van der Walt, 2002), requiring a sophisticated approach (Dilenschneider, 1996). Board evaluations should include both group and individual levels of evaluation (Epstein & Roy, 2004b), where the attributes of a director affect their ability to contribute to a board in complex ways – for example, minority directors have more influence on strategic decision making if they have experience as directors (Westphal & Milton, 2000). To understand this dynamic better, we provide current thinking on the three key levels of analysis – board purpose, group development and individual contributions.

Fit for purpose

First, a board needs to be fit for purpose or able to carry out the tasks the organisation requires of it. In the organisational psychology literature, this would be considered the team product (e.g., McGrath, 1984) and follows the major academic research traditions that focus on understanding the tasks required of the board (e.g., Johnson, Daily & Ellstrand, 1996; Hung, 1998) and normative prescriptions for the board to clarify what it sees as its role. An effective board is one that knows and can execute the tasks required of it, irrespective of how those specific tasks vary with each board. Ultimately, relevant board task execution determines whether a board adds value, not the execution of a standard role set.

Different researchers provide different terminology to the area, with the team product being called board roles (e.g., Zahra & Pearce, 1989), board tasks (e.g., Huse, 2007) and board functions (e.g., Cornforth, 2001). Similarly, there are different terms and categorisations used by different researchers. These range from Hillman and Dalziel's (2003) two role models of control and access through various three-role typologies of service (including advice giving and strategy), networking and control (Zahra & Pearce, 1989) through to six role models (e.g., Hung, 1998) and more.

Similarly, there is no agreed role set among the normative literature (e.g., Garratt, 1996; Charan, 1998; Carter & Lorsch, 2004). However, there is emerging evidence that practitioners focus more on a normative list of their tasks than on a generic set of limited roles as described in the academic literature (Nicholson & Newton, 2010). What is critical is that the board's product – its 'core responsibilities and activities' – need to be translated into expectations of the board (Conger & Lawler, 2009).

Group

In order to deliver its core responsibilities and activities, a board requires its directors to work together effectively. Recent analysis of board contributions to the global financial crisis highlight how board 'effectiveness has been undermined by a failure to observe appropriate boardroom behaviours' (ICSA, 2009: 3) such as the willingness and ability to challenge management (Walker, 2009). Furthermore, if we combine (1) the definition of a team as a group with a common goal (Hackman, 2002) and (2) the legal concept that a corporation is a separate legal entity founded for a common purpose and which is directed by the board (Micklethwait & Wooldridge, 2003), then clearly the board is an autonomous team.

Recognising an effective board as a high performing group leads to the conclusion that boards, like other work groups, would benefit from active construction (or 'board building') and management (Nadler, 2004: 104). Effective boards will share the attributes of an effective team – cohesion, cognitive conflict, shared commitment and values, and so on (Huse, 2005). These team-based attributes are no substitute for individual competence or task execution, but rather allow the board to make the most of the people that they have serving on the board to execute the required task set. Thus, in-depth interviews with 60 Belgium directors highlighted how both team attributes (e.g., board meeting quality, board composition, decision making) *and* fit-for-purpose outcomes (i.e., role of the board, management–board–shareholder relationships, etc.) are seen as elements of an effective board (Van den Berghe & Levrau, 2004). Similarly, the kinds of information that the board possesses (diversity of information) and the way board meetings take place (open discussion and active search for information) affect the CEO ratings of board strategic tasks immediately and into the future (Zhang, 2010).

There is growing evidence of the importance of group-based performance to board effectiveness. For example, a survey of 495 small Norwegian firms found that group attributes (e.g., board working style and board quality attributes such as motivation) were more predictive of the board's strategic task/role involvement than individual director attributes (such as traditional composition measures) per se (Pugliese & Wenstøp, 2007). Similarly, the individual attribute of motivation is an important factor, with clear evidence that individual motivation is related to both peer-perceived and self-rated engagement and execution of board work (Stephens, Dawley & Stephens, 2004).

Thus, the relationship between team development and task or role execution is complex, and is an important component of the current research agenda (Zona & Zattoni, 2007). Board effectiveness is intertwined with the intra-board relationships and relationships with management (Castro et al., 2009) whereby group-based issues such as inter-group dynamics are likely to affect roles like advice and service (Kor, 2006). In short, the ability of directors to work together is critical to the board's roles/tasks – and this itself relies on the competency of directors.

Individual

An effective board is also one where directors have the required competencies (Tricker & Lee, 1997), are contributing appropriately (Dulewicz & Herbert, 2008), and enjoy their work (Preston & Brown, 2004). As a starting point, a director's human capital (knowledge, skills, abilities and social networks) is thought to be important to board performance (Hillman & Dalziel, 2003). Directors need to be competent (Roberts, McNulty & Stiles, 2005) and have firm-specific knowledge and skills such as company and industry knowledge (Charan, 1998).

There is, however, no clear competency list to guide any assessment process. In regulatory frameworks there is there is little consideration given to a director's competencies beyond independence (Zattoni & Cuomo, 2010). Thus, most advice on director competence focuses on the fiduciary duties of directors, and is insufficiently tailored to the myriad of company contexts (Tricker & Lee, 1997). Instead, director competencies vary from company to company and board to board (Coulson-Thomas, 2009) with the various 'fit-for-purpose' requirements (e.g., monitoring, advising, strategy, access to resources) differing between boards. By implication, so will required competencies (Tricker & Lee, 1997) and what often results in a complex list of highly desired competencies that are almost impossible to satisfy (e.g., Balduck et al., 2010 identified some 41 different competencies in their study of volunteer board members of community sports organisations).

The focus on individual competencies needs to be broader than knowledge and cognitive competencies, however. The omission of emotional and social competencies neglects important components of an effective director's competency set (Balduck et al., 2010). Engaged individuals work harder, use their knowledge and contacts more and generally feel more satisfied with their role and contribution (Kahn, 1990; Meyer, Becker & Vandenberghe, 2004; Cropanzano & Mitchell, 2005). While it is important to consider if the individual directors are contributing effectively, this does not mean that an effective board requires the same kind and level of performance from each director, but rather that each is contributing from their capabilities appropriately and gaining sufficient satisfaction from the role. Finally, boards and those involved in evaluations need to realise that, in many contexts, director competencies may need to be built over time (van der Walt & Ingley, 2001).

In addition to this general guidance, there is emerging evidence that individual directors do make a difference. Thus, director commitment is related to self-reported and peer-perceived involvement in non-profit board work (Preston & Brown, 2004). More directly, above-average directors (measured as those hired following losing a position following a takeover) were associated with subsequent above-average firm financial performance in the firms into which they were hired (Fairchild & Li, 2005).

The interaction between individual and group-based attributes is also reflected in the growing importance placed by academics on information gathering and processes (e.g., Forbes & Miliken, 1999; Nicholson & Kiel, 2004; van Ees, Gabrielsson & Huse, 2009). Normative advice, such as requirements to have board papers prepared well in advance of meetings (Kiel & Nicholson, 2003; Epstein & Roy, 2004a), is clearly evidence of how the functioning of the group interacts with the traits of the individual to affect board performance.

Finally, on a practical level, there is a complexity in board evaluations of individuals that springs from differences in the ease with which a director's skills and experience can be assessed compared with how well she or he works with others (Clarke & Klettner, 2010). As we move from more objective assessments of experience and verifiable skills into important concepts such as trust, politics, power plays and decision flaws, objective verification and personal perceptions become more important. These issues are critical to board effectiveness, independent of the individual director's abilities (Finkelstein & Mooney, 2003; Huse, 2009b).

Evaluation of the levels – evidence from the field

Despite the strong theoretical issues surrounding selecting an appropriate level of analysis, it is generally treated tacitly or ignored in board evaluations. Spencer Stuart's (2010) 25th annual study of S&P 500 boards found that of those companies evaluating their boards, only 26% evaluate individual directors in addition to the entire board – a rise from 22% in 2009 (see Figure 13.1). Conger and Lawler (2009) report that in large US corporations, some 98% evaluate overall board performance, 97% evaluate committee performance and 84% evaluate individual director performance.

At a more subtle level, our experience of evaluating and assessing individual performance largely ignores the group nature of the board's work. Since directors share a common legal liability (e.g., Baxt, 2009), most boards assess the requirements of each individual director with the same tool and requirements.

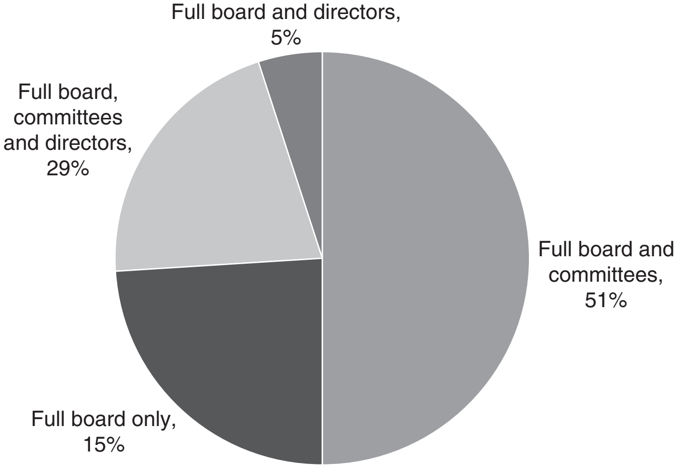

Figure 13.1 Types of board evaluations conducted

Source: Spencer Stuart. (2011). *Spencer Stuart Board Index* (26th ed.).

Questions of preparation, contribution and so on are uniform; however, each individual director may bring a different set of attributes and behaviours that are not suited to uniform assessment. For instance, consider the finding that some 28% of directors reported that they did not understand the basic insurance agreements housed in their directors' and officers' (D&O) insurance policy (PricewaterhouseCoopers, 2010). While this is an obvious concern for an individual director's personal liability, is it a concern for the board's performance? If one director does understand it, has assessed it, and concluded it is appropriate, then the impact of all other directors not knowing is nil. We believe the lack of attention provided to issues such as these is an area for future development.

In summary, to carry out an effective evaluation, boards need to consider the level of effectiveness on which they want to focus, bearing in mind deficiencies in a higher-order level of effectiveness (e.g., fit-for-purpose problems) may be caused by lower-level deficiencies (e.g., inadequate team development). For example, if a director is not sufficiently engaged or competent, he may not contribute to board discussions and decisions for fear of appearing foolish. As a result, the board can develop a climate that does not encourage robust discussion and debate, leading to ineffective performance of the board's tasks – it may not exercise decision control well over a proposed capital expenditure, because not all possible risks or flaws in the management proposal are identified. An effective board is one with a holistic understanding of the relationship between the elements of effectiveness and an approach to working and evaluating all three levels over time.

Contingent nature of board performance and resulting corporate governance models

Finally, a key issue facing boards is the highly contingent and complex relationship between board effectiveness and firm performance. The relationship between boards and firm performance is often affected by factors outside the board's control (Clarke & Klettner, 2010), particularly in the short term. Economic conditions, industry conditions, lifecycle, management development and myriad other factors (e.g., Nicholson & Kiel, 2004) all affect the relationship between board and firm performance. Importantly, the board's role is almost universally thought to be contingent on these and other important contingencies (e.g., Carter & Lorsch, 2004; Hillman & Dalziel, 2003).

MODELS OF BOARD EFFECTIVENESS – RESPONSES TO CONTINGENCY

Most often, models of how boards work assist researchers and practitioners understand this complexity. In a board evaluation context, governance models dictate the type of data collected, the analysis process employed and, from a practitioner's perspective, the action plan that is developed. They allow people to conceptualise the 'inner workings' of a board – what a board actually does as well as the way in which it accomplishes its work.

Until relatively recently, the preponderance of interest was in the way the board could be used to monitor and control management (e.g., Smith, 1776) to overcome the problems caused by the separation of ownership from control (Berle & Means, 1932). While there are clear models of this agency relationship (Jensen & Meckling, 1976), there was no real model of board effectiveness.

Thus, practitioner recommendations focused on board structure (independence from management in the form of outside directors and separating the chair/CEO role), but with divergent rationales (e.g., in a study of 60 different governance codes recommending board independence, Zattoni and Cuomo [2010] fail to identify a consistent rationale). Similarly, academic research into the monitoring role has failed to provide consistent, robust evidence that independence is how boards add value to their corporations (Daily, Dalton & Cannella, 2003; Finkelstein & Mooney, 2003).

Over the past several decades, views on effective boards have evolved, however. The following sections outline five such models, and conclude with observations on their commonalities and implications for board evaluations.

Zahra and Pearce's (1989) integrated model

The first integrated and widely cited model of board effectiveness was proposed by Zahra and Pearce (1989) (see Figure 13.2). Their review of 22 empirical articles revealed the role of the board went beyond monitoring and included what they termed the strategy and service roles. Importantly, the authors recognised that organisations face different challenges during their life cycle and so 'boards are expected to perform qualitatively different roles at various points of the cycle as exemplified by the different way a board performs its control function in an entrepreneurial firm as opposed to a well-established, mature operation' (Zahra & Pearce, 1989: 298).

Additionally, they provided a logic that linked the antecedents (composition, characteristics, structure and processes) to these role requirements, and the complex relationships that linked attributes to roles. Thus, their contribution provides a contextual contingency as well as a path from board attributes through board roles to organisational performance.

Nicholson and Kiel's (2004) intellectual capital framework

Building on Zahra and Pearce's (1989) contribution, Nicholson and Kiel (2004) provide a more detailed, group- and individual-focused framework that attempts to link boards and corporate outcomes. The three advances in their model are: (1) an explicit recognition of the group, individual and corporate levels of performance required in a

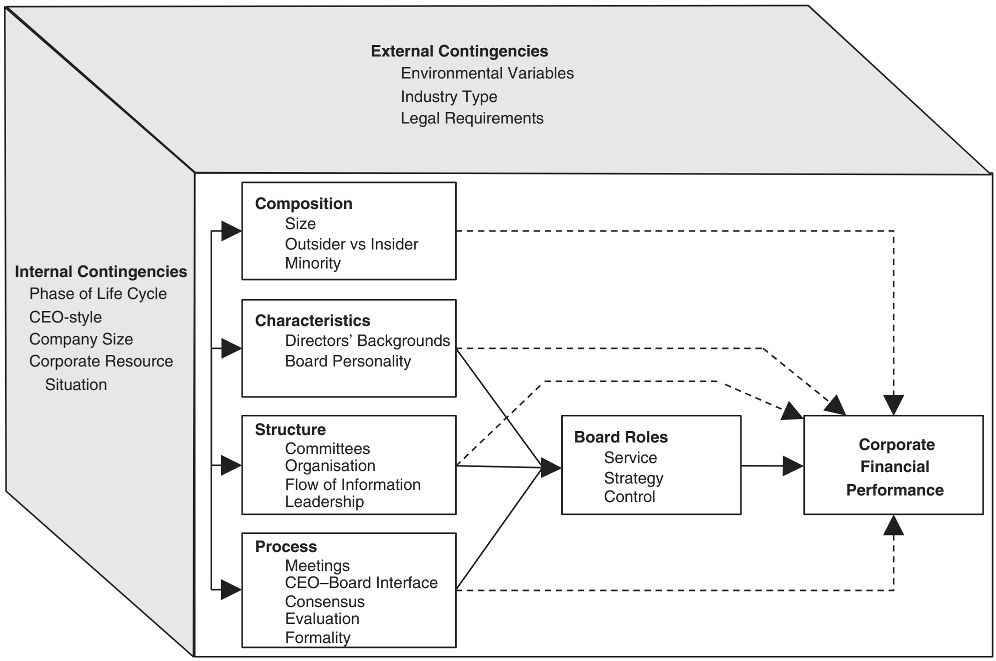

Figure 13.2 Integrated model of board attributes and roles

Adapted from Zahra & Pearce, 1989: 305.

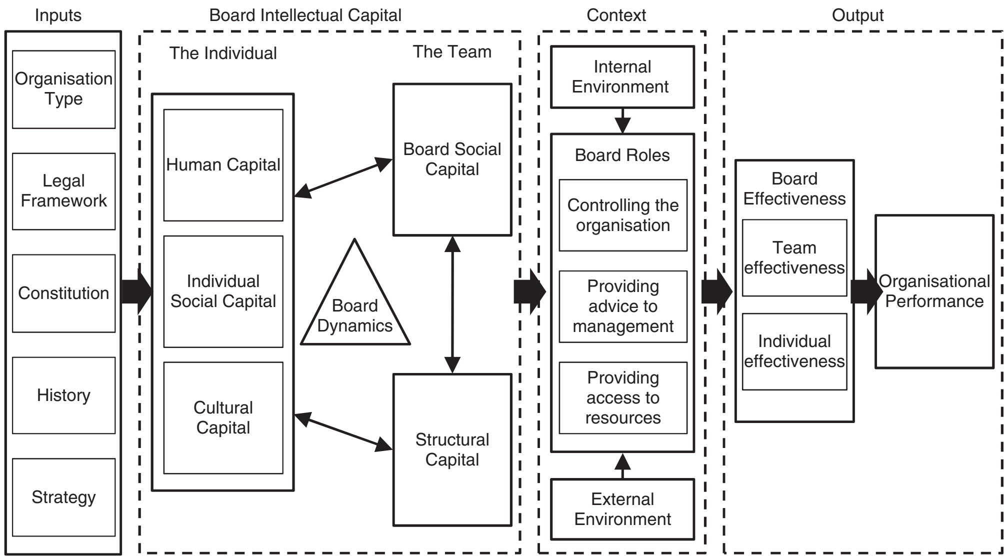

Figure 13.3 The board intellectual capital framework

Adapted from Nicholson & Kiel, 2004: 456.

board system; (2) the explicit recognition that the attributes of board (what they term the board intellectual capital) are themselves a result of the corporation's context; and (3) the emphasis that 'an effective corporate governance system requires a series of components to be in a state of congruence or alignment' (Nicholson & Kiel, 2004: 443). Their overall model explicitly recognises the notion that there is no one-size-fits-all approach to board effectiveness (see Figure 13.3).

Carter and Lorsch's (2004) board as a system

While presented differently, Carter and Lorsch's (2004) model of board effectiveness shares several attributes with that of Zahra and Pearce (1989), and Nicholson and Kiel (2004). First, they explicitly recognise the contingency of the relationship between board roles and the company situation (Figure 13.4). Second, they also propose that the group's performance is critical to board effectiveness – it is often not so much how individual directors perform, but how they function together. Finally, they see that the elements of the board need to align with the role of the board. In so doing, they explicitly call for performance reviews to assess board behaviours and to collect information from executives who 'see the board in action' (Carter & Lorsch, 2004: 178).

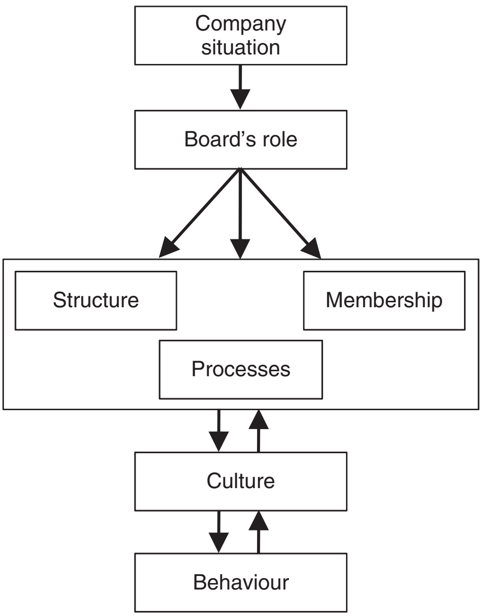

Figure 13.4 The board as a system

Excerpted from Carter, C. B., & Lorsch, J. W. Back to the drawing board: Designing corporate boards for a complex world p9. Copyright 2004 by Harvard Business Press, Watertown Mass. Reprinted with permission.

Charan's (2005) board as a source of competitive advantage

In line with all three preceding models, Charan provides a view of the board that has evolved from a compliance-focused, ceremonial body to one that is ideally active and 'liberated' (2005: 30). Based on his extensive consulting practice, he viewed an effective board as having: (1) good group dynamics; (2) an appropriate information architecture; and (3) a correct focus on the substantive issues (Figure 13.5). These three building blocks allow the board to carry out the roles (or tasks) required of it.

As with Carter and Lorsch (2004), Charan (2005) emphasises the importance of group dynamics and the advantages of peer-evaluation as part of a review process. By concentrating on continual improvement, he advocates for the board as a source of competitive advantage.

Huse's (2007) value-creating board

Huse's (2007) most recent conceptualisation of the board as a system (e.g., see Huse [2000] for earlier versions) provides a broader, societal focus for understanding how boards add value. In line with all the previous models, the value-creating board model concentrates on how the board's composition and routines, processes and policies allow it to execute the role set required by its context.

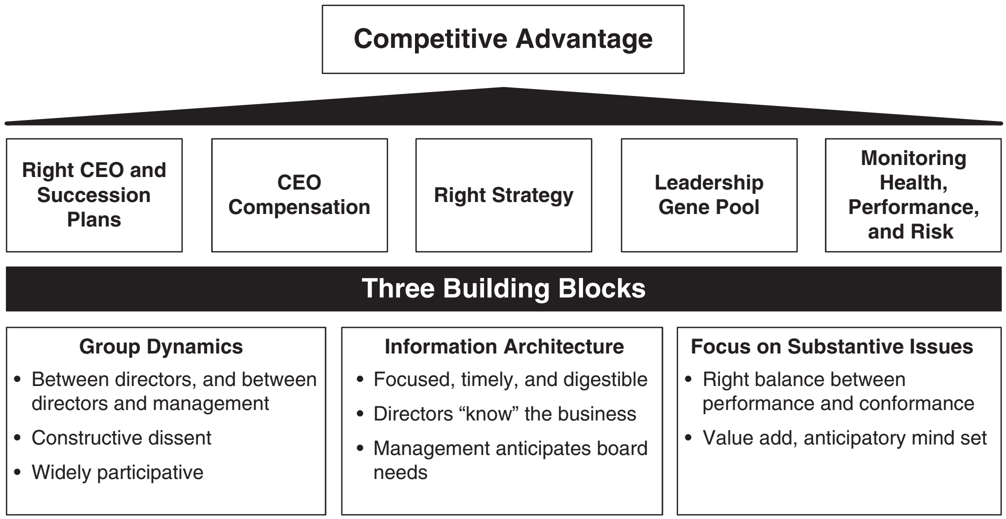

Figure 13.5 The board as a source of competitive advantage

Source: Charan, 2005.

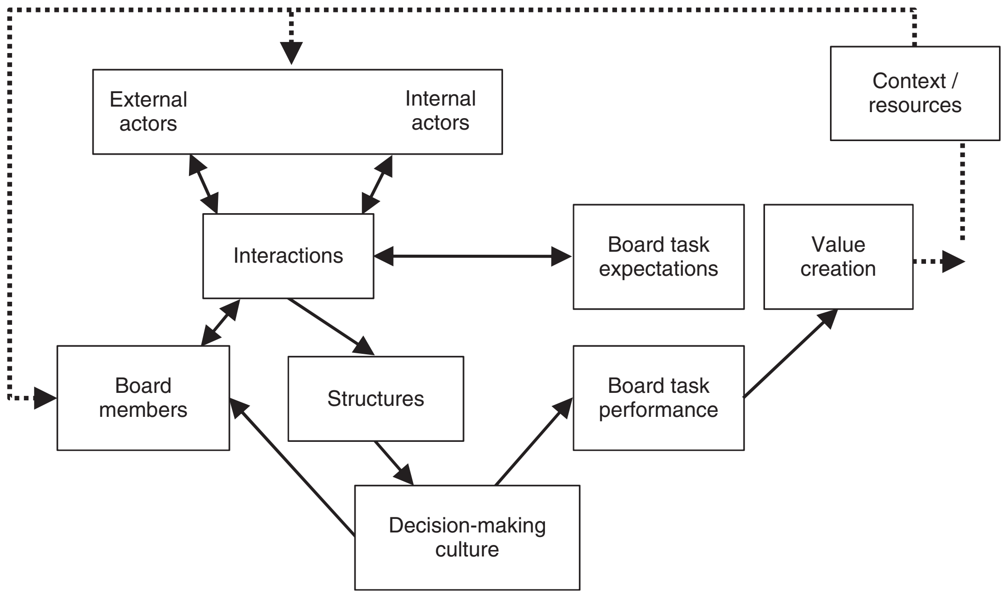

Figure 13.6 The value-creating board framework

Source: Adapted from Huse, Morton, Boards, Governance and Value Creation: The Human Side of Corporate Governance, 2007, Cambridge University Press, p4.

MODELS OF BOARD EFFECTIVENESS – SOME SHARED ATTRIBUTES

While there are clear differences between these models, there are some important similarities they share that can inform a board evaluation. First, they highlight that the relationship between organisational performance and board effectiveness is complex and not easily studied (Cadbury, 1997; Herman & Renz, 2000) and varies from company to company – there is no 'one size fits all'. Similarly, they aim to look beyond simple agency theory approaches (Daily et al., 2003) and the consequent monitoring role of the board.

Another commonality is a shared pattern of thinking of how boards add value. First, the board has a set of roles or tasks that it is required to perform. These roles/tasks vary with context and allow the board to work with, and through, management to add value to the company it governs.

Second, the board has a series of attributes that will determine how well these roles are executed. The attributes involve three broad headings: (1) the composition of the board; (2) the policies, processes and routines the board uses; and (3) the relationships between board members and the board and management. Again, the key inference is that board effectiveness involves getting the fit between these components right, rather than fulfilling any singular recommendation for every board.

We bring these common elements together in Figure 13.7, which also recognises the impact the board has on company performance directly: for example, through the decisions it makes, the resources it can bring to the organisation, and through the support the board can give to management, because of its range of skills, knowledge and experience.

Hard to measure and few metrics

An interesting feature of the board evaluation terrain is the plethora of tools available to boards – a Google search of the term 'board evaluation tools' revealed 15,400 hits, many of them to resources that boards can download for free. Despite the enormous number of tools, we are aware of only four with any kind of empirical validation process.

Gill, Flynn and Reissing's (2005) Governance Self-Assessment Checklist (GSAC)

One useful resource is the Governance Self-Assessment Checklist (GSAC) developed by Gill, Flynn and Reissing (2005). While it does exhibit sound psychometric qualities,

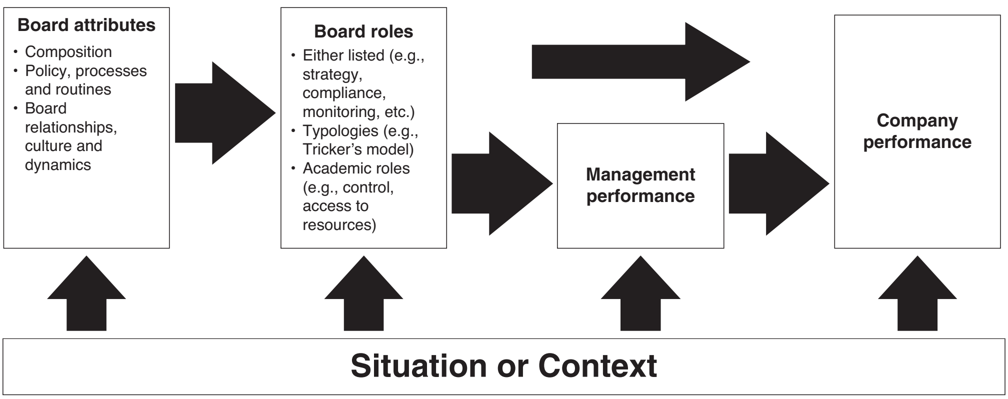

Figure 13.7 Board effectiveness: a synthesis of the models

there are a number of potential difficulties. There are two concerns with the GSAC, common to the other instruments. First, the tool centres on board effectiveness as a single construct with what appears to be a large number of redundant items in the scale. The checklist has 12 dimensions or scales, with an average 12 items per scale or 144 items. The tool may well benefit from removing items, as suggested by the very high reliability scores (Cronbach's alpha) reported. Second, while the instrument is explained as a 12-dimension, single construct (board effectiveness), the technique used to validate this structure could have been more robust.

Slesinger's (1991) Board Evaluation Tool

Herman and Renz (1997, 1998, 2004) have produced a stream of research investigating Slesinger's (1991) board evaluation tool. Like Gill et al. (2005), they have a single construct (board effectiveness) that is made up of 11 questions drawn from 11 different dimensions of effectiveness. This instrument produced wide variability in effectiveness ratings between raters. Additionally, 'both board members and chief executives apparently regard the financial condition of the organisation as the true measure of board effectiveness' (Herman & Renz, 1998: 700) – an interesting phenomenon in a sample of non-profit organisations. It appears to confirm the difficulty (particularly for respondents outside the boardroom) to differentiate between (1) organisational and board performance and (2) financial performance and other important aspects of performance.

Holland's (1991) BSAQ

The BSAQ (Holland, 1991) is perhaps the most extensively published instrument designed to measure board effectiveness. It conceptualises board effectiveness as requiring six dimensions (i.e., context, education, interpersonal, analytical, political, and strategic skills). It appears the BSAQ is evolving as the number of items reported varies across the studies: for example, 69 items in Holland (1991); 73 items in Jackson and Holland (1998); unreported in Holland and Jackson (1998); and 37 items in Brown (2005). Reliability measures in the studies have ranged from good (Brown, 2005) to marginal (Holland, 1991).

An area of potential concern involves the construct dimensions. As with Gill et al. (2005), board effectiveness is presented as multidimensional, and the papers report subdimensions load on a single factor. It is difficult to assess the attributes of the instrument as presented, because we cannot assess the cross-loadings across factors or dimensions. A more convincing case could be made through the use of multiple factor analytic techniques including confirmatory factor analysis undertaken with structural equation modelling (e.g., Anderson & Gerbing, 1988; Arbuckle, 2003). Additionally, the sample involved US seminaries or smaller liberal arts colleges/universities and so the instrument may not generalise, although, in fairness, Brown (2005) did report a more generalised sample.

Nicholson and Newton's (2010) Board Roles

The most recent validated tool to be published is Nicholson and Newton's (2010) Board Roles instrument. In what is an early stage of their research, they build on the work of Nicholson et al. (2008) to develop an instrument to measure ideal and board role performance. They report a five-dimensional model of board roles performance (strategy, oversight and mentoring of the CEO, risk and compliance, oversight of the governance system, and access to resources) with good psychometric properties. As with Holland (1991), it would benefit from replication and a greater breadth of sample.

Few metrics

Overall, these tools are definite steps forward in helping boards improve their performance. However, there are potential drawbacks when applied to governing bodies, particularly in more diverse contexts. First, all tested tools are focused on one issue – board effectiveness – and not the possible issues leading to board effectiveness. There are potential statistical problems with the dimensionality of the BSAQ and GSAC as well as unclear reliability traits. Third, there are some unique samples used in the research that would appear to differ substantially from many board contexts – several of these instruments were tested on samples drawn from small US liberal colleges, seminaries, entirely non-profit samples, and similar.

In summary, there are few hard metrics or systems to conduct board evaluations and many of the advances in measuring organisation and management performance have yet to transfer to the measurement of board performance (Epstein & Roy, 2004b). While some steps to improve measurability of board performance, including metrics, include the adaptation of the Balanced Scorecard methodology (Epstein & Roy, 2004a) and more rigorous approaches to measuring aspects of what boards do (Nicholson & Newton, 2010), these methods are either only part of the solution or based on normative views of governance effectiveness.

Overcoming individual resistance to and negative perceptions of board evaluations requires us to address the issues we have outlined. The subjective nature of inputs and the complex measurement issues involved in assessing director and board performance are important considerations to any evaluation process (Ingley & van der Walt, 2002).

Problems in self-rating

Another practical problem involves identifying appropriate data to verify effectiveness. Most boards operate in commercially sensitive environments. Consequently, few individuals outside the board (and generally only a few select individuals such as the company secretary, CEO and CFO) have any substantial exposure to the work of the board. Thus, board evaluations most often rely largely (if not solely) on self-evaluations or, at best, the feedback of individuals in a subordinate position. As a result, any conclusions need to be treated with care, as they may suffer from a number of biases.

Perhaps the key problem associated with board self-evaluations is the general tendency for people to rate themselves as superior compared to an ‘average’ or generalised other, sometimes called illusory superiority. In fact, some studies indicate that more than 90% of respondents will overrate themselves (Gramzow et al., 2003) and that it will occur across a range of different criteria (Robins & John, 1997). Importantly, this tendency to overrate is correlated with positive self-esteem (Brown, 1986), a person’s need for achievement (Gramzow et al., 2003) as well as poor prior performance (Gramzow et al., 2003). In the case of boards, it is reasonable to conclude that individuals at the apex of the organisation have both high self-esteem and a high need for achievement.

Consequently, most board members view their performance as above average. Figures 13.8 and 13.9 provide an insight into this phenomenon. Each is a histogram of the average board rating in response to the question, ‘Overall, how well is your board performing?’ Figures 13.8 and 13.9 provides the data from a board evaluation company Effective Governance and a summary from a similar question asked of non-profit boards in the Developing Your Board research program run out of the Queensland University of Technology (QUT). Out of 95 boards comprising 870 directors, not one rates itself below average (5/10). Of the directors, only 55 individuals rated their boards as less than 5/10 out of the 870 – some 6.3%.

While it is possible to compensate for this consistent bias across respondents (for example, standardising scores or simply transforming the scores downwards), more difficult issues arise when poor performance is associated with greater than normal exaggeration. In our experience, there is often an inverse relationship between a board’s rating of itself in this question and the performance of the board as observed by the team undertaking the board assessment. This point is

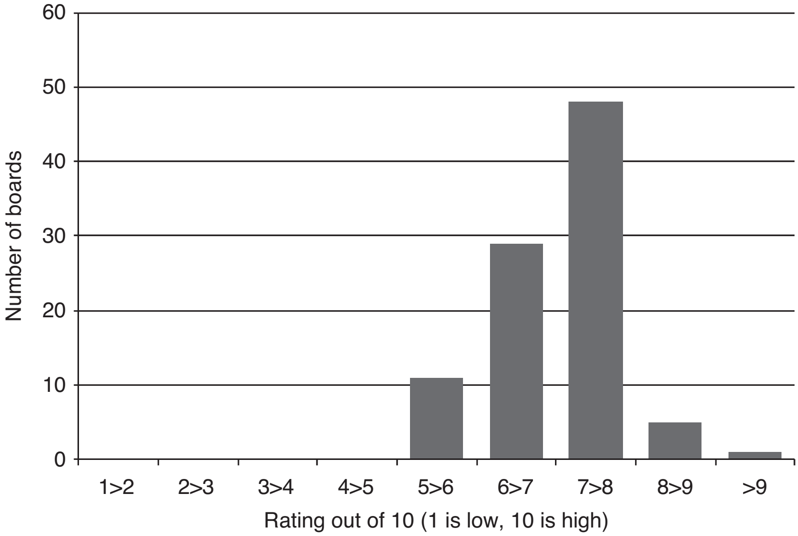

Figure 13.8 Average self-rating of board effectiveness by members of the board (n = 95)

Sources: Courtesy of the DYB Project, QUT.

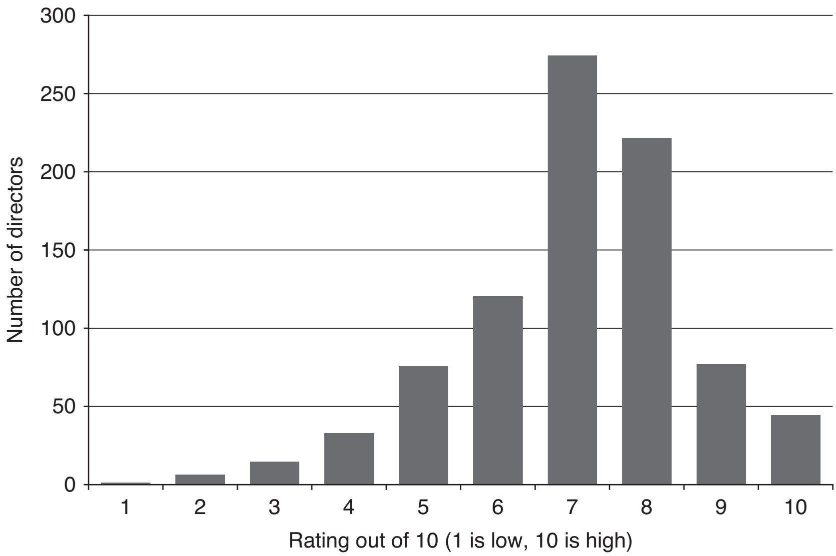

Figure 13.9 Rating of board effectiveness by each director (n = 870)

Source: Courtesy of the DYB Project, QUT.

reinforced by evidence from the field that often directors performing poorly have been known to give themselves 'outlandishly positive scores' in self-assessments (Behan, 2006: 50). While this could be a general tendency in people (Gramzow et al., 2003), we hypothesise (in line with the overconfidence bias and a lack of situational awareness) that it often occurs on boards and with individuals who have little governance experience to act as a reference point.

These observations raise another issue in board evaluations – Is it possible to benchmark boards? Some commercial organisations offer benchmarking services where, by using a common questionnaire over multiple boards, comparisons can be made as to how one board rates relative to others. Based on the discussion above, this process is quite misleading. First, as noted, the absolute rating of a board on a construct is a function of the level of insight of the directors – high scores do not necessarily represent high performance. Second, as covered in our previous theoretical discussion, board performance is both contingent and equifinal, a point that is ignored where a score is simply contrasted with a sample of other scores.

Although a concern, there are several ways to compensate for this effect. First, using a mixed method approach will likely highlight potential issues irrespective of the individual ratings of items that directors make. Similarly, involving outsiders in the review (either as the source of data or to facilitate the review) can help. Finally, work on cognitive biases indicates that simple awareness can go a long way to overcoming the negative outcomes associated with a decision-making heuristic (e.g., Bazerman, 2002). Thus, making boards aware that they are likely to overrate themselves, may go some way to ensuring they discount this possible bias in rating.

Time-based problems

Finally, there are significant problems in assessing the impact of the board due to the confounds of time: the lag between board activity and firm or management performance. While the board's decisions may result in substantial immediate performance effects (e.g., responding to a crisis), board decisions generally involve long-term time horizons. For instance, hiring a new CEO is unlikely to have any immediate effect on organisational performance (here we exclude any possible announcement effect), but rather a medium- to longer-term impact, as the new CEO gains a solid understanding of the company and begins to implement substantive change. Similarly, capital expenditure decisions and changes in strategy take significant time to implement and flow through to clear corporate performance. Thus, the ability to link board activity to overall corporate performance is problematic. Variable and long time lags, problems of reverse causality (e.g., declining CEO performance may lead to greater board involvement in their oversight of the position) all inhibit our ability to measure and demonstrate board effectiveness.

STEPS FOR AN EVALUATION

Having outlined the trends in evaluations and the major challenges facing boards and academics, we now turn to the key issues involved in developing a successful board evaluation. This section is based on Kiel and Nicholson's (2005; Kiel, Nicholson, & Barclay, 2005) model for designing an evaluation process (see Figure 13.10). It shares many attributes with other work in area – for example, Minichilli, Gabrielsson and Huse's (2007), 'Who does what, for whom, and how?'

What are your objectives – Why are you doing it?

The first (and, in our view, most important) aspect of any evaluation is establishing why you are doing it. Without a solid rationale

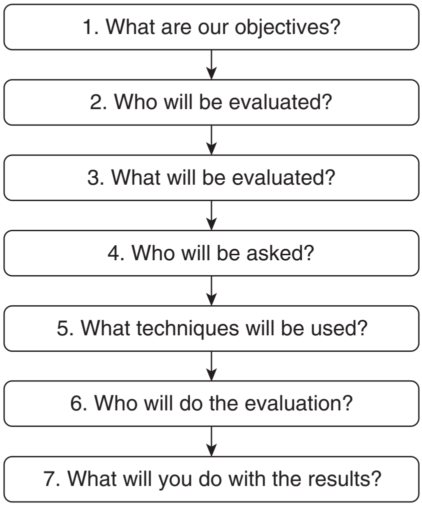

Figure 13.10 Board evaluation framework

Source: Kiel, Nicholson & Barclay, 2005.

shared by the board members, any evaluation is likely to meet resistance and/or fail. Rather than focusing on the actual areas of governance for review, the first step is to be clear on the why – What is your board's motivation in undertaking a review? The real value in a board evaluation springs not from following what others are doing, but focusing on what your board wishes to gain from the process.

Most directors report they experience positive outcomes from evaluations (Clarke & Klettner, 2010). In this section, we detail the key reasons to undertake a review. These are to: (1) highlight areas for improvement, either in a general or specific way; (2) model good performance management to the executive and organisation; (3) signal to stakeholders that you value governance; (4) comply with requirements of the regulator; and (5) act as a mechanism to protect directors.

Problem identification and resolution

The most common reason for board evaluations is improvement at the group level. As Sonnenfeld (2002: 114) highlights:

> People and organizations cannot learn without feedback. No matter how good a board is, it's bound to get better if it's reviewed intelligently ... . If a board is to truly fulfill its mission – it must become a robust team – one whose members know how to ferret out the truth, challenge one another, and even have a good fight now and then.

An effective board evaluation can improve the working conditions of the board, in particular the development of the requisite team capacity to perform the roles required of it. For example, an evaluation may clarify individual and collective responsibilities (Conger & Lawler, 2009). As a result, an effective evaluation can assist boards to attract and retain good directors (Nadler, 2004), as well as build the culture of the board (Stybel & Peabody, 2005). Unlike retirement age or term limit policies, board evaluations contribute to board renewal in a targeted way that distinguishes between high and low performance (Behan, 2006) such that evaluations can feed into the training and development approach of the board. For instance, in the UK, Hampel (1998) provides normative advice for targeted director training (recommendation 3.5) informed by a process for assessing collective and individual performance, a position carried over into the Combined Code in 2006 (Principle A.6) (Dulewicz & Herbert, 2008).

These effects are noted in the literature, particularly for decisions about board composition. Dulewicz and Herbert (2008) report that board evaluations influenced a director's decision to resign in nearly one-third of cases and the appointment of directors in over two-thirds of cases in their sample drawn from the FTSE 350. Similarly, board evaluations provide a basis for the chair (or lead director or similar) to discuss strategies for personal development with each director, often separately (Tricker, 2009).

Perhaps the most important way a board evaluation helps is by enabling the board to recognise both straightforward and complex issues and bring them to the surface for resolution (Wolf & Stein, 2010). Thus, board evaluations can address important board–management relationships, concerns surrounding individual directors and power issues in organisations (Stybel & Peabody, 2005; Conger & Lawler, 2009), especially in situations where individuals might feel reticent about raising problems without being asked directly. As part of this process, it can allow directors to ensure that what they perceive or espouse as the issue is in fact the cause of problems. For instance, Nadler (2004) reports how a board espousing problems around the CEO/president role ambiguity actually related to wanting more information about acquisitions being pursued.

This factor also transfers through to the individual level of analysis, where it provides important feedback for directors on their performance. Evaluations contribute to director satisfaction (Nadler, 2004) and provide an important basis for self-development for the individuals involved.

Performance improvement itself, however, has a number of dimensions. It can range from a review of previous evaluations or a simple check-up against a governance framework, through a process designed to address known challenges to the situation where a board knows that something is wrong, but is unsure of exactly what it is or what they can do about it. Figure 13.11 provides a conceptual framework for thinking about this important aspect of a board review.

Modelling performance management and culture building

From an organisational perspective, board evaluations can also play an important symbolic role as the board leads by example (ICSA, 2009), models performance management to the senior managers (Behan, 2006) and sets the tone for a continuous improvement approach within the organisation (Clarke & Klettner, 2010). A highly structured approach can include benchmarking the board's performance, although this will take the commitment and time required to build sufficient goodwill and trust to make it possible (Garrett, 2003).

Signalling to stakeholders

Externally, evaluations perform a number of roles. First and foremost, evaluations are often viewed as an accountability mechanism for investors (Conger & Lawler, 2009) and, therefore, are prescribed in guidance on good governance (e.g., APRA, 2009; Walker, 2009). Similarly, they can also be a key source of legitimacy and signalling, particularly to investors and stakeholders (Connelly et al., 2011). We have noticed this is particularly the case where there is a concentrated share ownership – say in the case of a government-owned corporation or company with significant institutional shareholdings.[1]

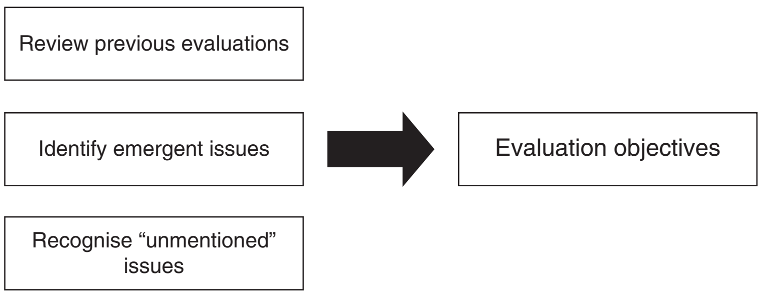

Figure 13.11 Setting your evaluation objectives

Source: Kiel, Nicholson & Barclay, 2005.

Compliance with regulatory or stakeholder requirements

Regulatory requirements for board evaluations are closely aligned to, but different from, signalling. Whereas signalling is voluntary, mandatory evaluations provide an ends in themselves with recommendations or requirements under various regulatory regimes, codes of conduct and listing rules fast becoming one of the major reasons for a board evaluation (Ingley & van der Walt, 2002). Table 13.1 highlights the widespread recommendation of board evaluations.

However, care should be taken so that compliance does not become the sole driver of the process, as it is seen as the worst motivation for an evaluation (Tricker, 2009). A compliance focus quickly turns an evaluation into a 'pesky 'checklist' item' and boards fail to spend 'the time and effort to conduct a comprehensive assessment process' (Wolf & Stein, 2010: 17). Consequently, there is little benefit as they 'skate by with paper-and-pencil surveys comprising recycled checklists cobbled together by another company's attorney' (Nadler, 2004: 104).

While boards may complain that regulation and standards encourage a tick-the-box approach, it is in fact the boards themselves that make this decision when they adopt 'a ritualistic approach to important and substantive governance processes' (Clarke & Klettner, 2010: 9) and effectively ignore the benefits that an effective evaluation can bring will range across the organisation, group and individual level.

Mechanism to protect directors

Finally, on a very practical level, evaluations can provide a modicum of protection for individual directors. When successful, evaluations improve the board's functions, demonstrate due care and diligence to the task and actually safeguard each director's assets and reputation (Garratt, 2003). As a result, there are also reports in the literature of evaluations decreasing director and officer insurance premiums (Stybel & Peabody, 2005).

Table 13.2 sets out the potential benefits of board evaluation for various aspects of governance.

DRAWBACKS OR REASONS NOT TO EVALUATE

Thus far, we have presented board evaluations as a positive step for all boards. However, there is a school of thought that sees them as adding little value (Kazanjian, 2000). While most commentators would disagree with this stance on whole-of-board evaluations (e.g., Sonnenfeld, 2002; Nadler, 2004; Huse, 2007; Charan, 2009), our observation is that criticisms are based on failed implementation rather than a general criticism of board evaluations. For instance, we have already covered off the problems with a compliance-focused evaluation process (see earlier) and we note that criticisms of low value tend to focus on process- rather than content-orientated approaches (e.g., Kazanjian, 2000).

One issue that has been raised by some boards is the legal issue of the discoverable nature of board evaluations. The argument is that to be useful, the board evaluation will need to raise some issues critical of current governance practices. In situations where a nation's legal code allows for discovery of relevant documents in civil and/or criminal court actions, the existence of a board evaluation could provide evidence for parties bringing an action against the company, board and/or individual directors. There is some merit in this argument. However, on the other hand, boards leave themselves open to criticism in such actions, if they have not undertaken a board evaluation. This can be seen as the board failing to institute a process that is widely seen as conducive to good governance. In this legal sense, a board may be

Table 13.2 Potential benefits of board evaluation

Benefits	*To organisation*	*To board*	*To individual directors*
Leadership	• Sets the performance tone and culture of the organisation • Role model for CEO and senior management team	• An effective chairperson utilising a board evaluation demonstrates leadership to the rest of the board • Demonstrates long-term focus of the board • Leadership behaviours agreed and encouraged	• Demonstrates commitment to improvement at individual level
Role clarity	• Enables clear distinction between the roles of the CEO, management and the board • Enables appropriate delegation principles	• Clarifies director and committee roles • Sets a board norm for roles	• Clarifies duties of individual directors • Clarifies protection of directors • Clarifies expectations
Teamwork	• Builds board/CEO/ management relationships	• Builds trust between board members • Encourages active participation • Develops commitment and sense of ownership	• Encourages individual director involvement • Develops commitment and sense of ownership • Clarifies expectations
Accountability	• Improved stakeholder relationships, e.g., investors, financial markets • Improved corporate governance standards • Clarifies delegations	• Focuses board attention on duties to stakeholders • Ensures board is appropriately monitoring organisation	• Ensures directors understand their legal duties and responsibilities • Sets performance expectations for individual board members
Decision making	• Clarifying strategic focus and corporate goals • Improves organisational decision making	• Clarifying strategic focus • Aids in the identification of skills gaps on the board • Improves the board's decision-making ability	• Identifies areas where director skills need development • Identifies areas where the director's skills can be better utilised
Communication	• Improves stakeholder relationships • Improves board–management relationships • Improved board–CEO relationships	• Improves board–management relationships • Builds trust between board members	• Builds personal relationships between individual directors
Board operations	• Ensures an appropriate top-level policy framework exists to guide the organisation	• More efficient meetings • Better time management	• Saves directors' time • Increases effectiveness of individual contributors

Source: Kiel, Nicholson & Barclay, 2005.

damned if it does an evaluation, which reveals governance issues, but conversely may be damned if it cannot present evidence of a rigorous review. Our view is that generally boards should not be concerned with undertaking rigorous reviews, but should ensure that they have taken action on any issues the review highlights. In this way, the board can demonstrate that it is taking its governance responsibilities seriously and is engaged in a process of continual self-improvement.

Individual director evaluations are a more controversial subject, with varying views on whether they are useful (Clarke & Klettner, 2010). Importantly, individual director evaluations often rely on the views of peers and this has the potential to undermine a director's independence (Clarke & Klettner, 2010). Similarly, poor evaluations can overemphasise the output of a homogeneous 'perfect' director at the expense of how the individual contributes to effective governance (see our earlier discussion on the individual- vs group-level of analysis).

Even when there is agreement that a board evaluation can add value, it will often meet with resistance from directors (Ingley & van der Walt, 2002). The most commonly reported source of resistance involves the evaluation undermining the working relationships of the board. Directors fear that an evaluation will open a Pandora's box of governance issues and undermine board cohesion (Ingley & van der Walt, 2002) and disrupt the boardroom dynamics (Kazanjian, 2000). Other reasons cited for resistance include a fear of alienating directors, objection to the amount of time the review will take, fear of litigation arising because of the review (e.g., Stybel & Peabody, 2005) and concerns with the 'accuracy and meaningfulness' of evaluations (Ingley & van der Walt, 2002: 173).

While some of these concerns may be justified, our experience is that they are all manageable and that the major source of resistance is that a board evaluation can be particularly daunting for the individual. Many directors may not have faced an evaluation for a long time (Steinberg, 2000) and may fear that any assessment will find them lacking (Garratt, 1996). This creates a threat to their reputation (Stybel & Peabody, 2005; Behan, 2006), particularly if they are very senior and the results will be disclosed in any way (Kazanjian, 2000), even to other directors. Thus, it is important for a review to carefully consider how the results will be used and who they will be fed back to during the process.

Setting the objectives – agreeing the why

While there are many positive reasons for undertaking a review, boards also need to understand the constraints. Key factors include the context of the organisation – the scale of the performance problem (if any), the size of the board, stage of organisational life cycle, changes in the firm's environment and so on (Kiel & Nicholson, 2005). Feasibility will also play a role, and the board will need to consider the scope of the review and resource implications. Major resources will be money, a reviewer with sufficient skills and the time availability of the reviewer and participants.

On a practical level, it is important that all board members understand this rationale. Normally, this involves the delegated individual (the chair or lead independent director) or group (the nominations or governance committee) documenting the objectives for the review and obtaining sign off from the board. With the objectives or rationale of the evaluation in place, the process is ready to move on to the 'what' of the evaluation.

What will be evaluated?

As with the other key decisions in the process, deciding what will be evaluated depends on the purpose and scope of the review. While evaluations will have a targeted objective (e.g., addressing a specific, known problem in governance), the complexity of possible sources and solutions nearly always requires a broad selection of topics on which data will be collected. Most governance issues involve complex interactions between the board's composition, relationships (e.g., between the board and management) and supporting policies, procedures and processes (Nicholson & Kiel, 2004; Huse, 2007). Consequently, most evaluations do not involve a single issue, but rather a systematic review of the likely causes and consequences. This ensures the process is broad enough to: (1) clearly articulate areas for improvement (or any problems); (2) identify the underlying mechanisms (i.e. source of the problem or how to make improvements); and (3) test potential solutions (Nicholson & Kiel, 2005). Similarly, if the review's objectives are to provide an overall check-up (or benchmark) then the review should focus on a wide range of areas. This will allow the process to collect information across the levels of analysis described earlier in the chapter and the associated wide variety of areas for improvement.

For these reasons, board evaluations generally use some form of governance 'best practice' framework (Kiel & Nicholson, 2005). There are many such frameworks available. In addition to the models detailed earlier in this chapter, frameworks include Carver's Policy Governance model (e.g., Carver & Carver, 1997), Kiel and Nicholson's (2003) Corporate Governance Charter framework, and regulatory frameworks and advice such as *The UK Corporate Governance Code* (Financial Reporting Council, 2010), the *OECD Principles of Corporate Governance* (OECD, 2004) and the Australian Securities Exchange (ASX) Corporate Governance Council's (2010) *Corporate Governance Principles and Recommendations*. While a detailed review of each is beyond the scope of this chapter, they provide a sense of topics on which boards can focus.

Selecting a framework provides a focus for the evaluation. The next stage involves translating the framework for the objectives of the review and the context of the specific board. An example might assist: say a board wants to review its composition (objective of the review) and selects Huse's (2007) value-creating board as their framework. The task then becomes developing an idea of the data the review needs to collect. This is often accomplished by developing a series of questions that we might want answered. An example is provided in Table 13.3, where an extract of the elements of the value-creating board framework are translated into questions to guide a review of composition. As this example demonstrates, the combination of a framework and clear objectives leads to a successful evaluation.

Deciding the topics on which to concentrate is a critical component of the evaluation design. Yet, the evidence from practice suggests that boards often do not agree what will be evaluated in terms of both agreed target activities and clarity of expectations around those activities. For instance, in a survey of companies from the FTSE 350, Dulewicz and Herbert (2008) report that an agreed list of performance criteria were used in only 62% of cases. To address this concern, the individual running the process treads a delicate balance between providing sufficient detail to meet the objectives of the review, while also ensuring the project is manageable with the resources available to the organisation and board.

Who will be asked?

The next step in the process involves deciding on data sources – Who will be asked to provide a view on the board's effectiveness? As indicated earlier, evidence suggests that most evaluations are self-evaluations based on director feedback (Dulewicz & Herbert, 2008; Roy, 2008), which are sometimes referred to as 180-degree processes (Blake, 1999). While a self-evaluation allows a board to ask itself how it is contributing to organisational effectiveness (Stybel & Peabody, 2005), there are major weaknesses to overcome unless there are other inputs to the process – it is almost impossible to fully evaluate performance (Epstein & Roy, 2004b) and self-evaluations are best used when the individual(s) involved have high levels of self-awareness. It is our experience that the board as a whole is often unable to assess its task performance. Quite simply, the board is doing all it can to carry out its role and believes it is executing its roles and tasks appropriately – if they thought they could do things better, they would change things.

Table 13.3 Key questions

Element of framework	*Questions*
Board members	• Who are the current board members? • What skills and attributes do they bring? • Are there any obvious gaps?
Interactions	• Do board members have appropriate relationships and interactions with each other (respect, capacity to disagree, trust, etc.)? • Does the board have appropriate relationships with management? • What are the interactions between the board and chair like? The CEO and chair? • Is information shared in an appropriate way? • Would changes in the composition improve or undermine these relationships?
Structures	• How does the board structure compare with regulatory and other practice guidelines (e.g., independence, diversity)? • Would changes in composition address any gaps here?
Decision-making culture	• Does each director contribute to decision making? • Is there a free and frank exchange of views on the board? Why or why not? • Is a change in composition necessary to improve the decision culture?
Board task expectations	• Do board members have the same expectations of their role and tasks? • Do they have the same expectations of the relationships they will have with each other and management? • Do they have the same expectations of the way board discussions and decisions should take place? • Do they have the same expectations of how information should be shared? • Would a change in composition improve these shared expectations?
Board task performance	• Is the board performing its roles and tasks appropriately? • Do individual directors contribute to task performance? • Do directors work well as a team together to execute tasks? • Could changes to composition be made to improve task performance – and what would they be?

This is where other internal and external sources of information become crucial. Often referred to as 360-degree feedback (Kiel et al., 2005), they allow the reviewer to corroborate insights and views from board members with others both within and outside the organisation. Internal participants could include senior managers (particularly the CEO and company secretary). Sometimes other management personnel and employees can contribute, if the data sought is about general governance issues (e.g., issues affecting culture), but our experience is that the lower the level of interaction between the board and the participant, the less useful it becomes. For instance, shop-floor employees often have little insight into how the board is performing, so a targeted approach is most useful.

One possible area of sensitivity with using other internal sources involves the possible dynamic it can create, if the board is not ready for full and frank feedback or there is a poor relationship between the board and management. Implemented poorly, feedback from executives can lead to an 'us versus them' dynamic; for instance, if there are significant ratings differences on director knowledge or understanding reported (Clarke & Klettner, 2010). Although a potential problem, this can be handled sensitively using alternative techniques (e.g., using interviews rather than surveys) and through ensuring an appropriate feedback loop.

State-of-the art views on board evaluations would also favour both external sources of information and participants (Kiel & Nicholson, 2005; Minichilli et al., 2007; Conger & Lawler, 2009). External sources of information include auditors, financial commentators and institutional investors

(Tricker, 2009). Depending on the company, government departments, major customers and suppliers with close links to the board may also provide insight (Kiel & Nicholson, 2005). Of course, a constraint of external sources is that they may have little exposure to the board and their responses are often more about organisational performance than board performance. As with non-board internal sources of information, the information source needs to be targeted and relevant, having some knowledge of the actual role the board is playing. Table 13.4 provides a summary of possible participants in a review, as well as the benefits and drawbacks of each particular participant.

An important and common question often arises around whether retiring or new directors should participate in board evaluations. Retiring directors are thought to be less committed and new directors may lack the necessary insight into how the board operates. Again, consensus from the field indicates that both retiring and new directors can assist, as they can provide different perspectives on the issues (Wolf & Stein, 2010).

Once the advantages and disadvantages of participation have been assessed, the decision on who should participate involves understanding:

1 Who has the knowledge required to inform the questions formulated in the previous step.
2 Whether the board is open to hearing the view of that person/group (even if anonymous).
3 What the potential impact might be for the person or group who will be asked.
4 Whether it is feasible to collect this information (resources, access and so on).

Thus, there is no standard list of participants for a review – rather, it requires a considered review of context, objectives and feasibility.

What techniques will be used?

Method selection is critical to an effective board evaluation (Behan, 2004). Since evaluations are a specific context for social science research, determining a suitable fit between research aim and research method is essential. Our observation is that this is an underestimated aspect of board evaluations, as practitioners often lack any grounding in research methodology and fail to consider the strengths and weaknesses of different techniques and approaches. Alternatively, many academics are trained in a single research tradition (or even technique) and/or have a single area of investigation that drives their method decision. In both cases, those developing the process may pay insufficient attention to the scope of the evaluation and, to some degree, come with their preprepared tools or approach. As the saying goes, if you only have a hammer, everything looks like a nail.

The most basic question in method selection involves the decision to use quantitative, qualitative or mixed (i.e. combined) methods. For most people, research is associated with experiments, statistics and careful measurement. These generally involve quantitative methods, or approaches that allow the researcher to precisely measure the topic of interest (often called a construct) and identify the strength of relationship between that construct and other constructs of interest. In contrast, qualitative methods use rich or thick data from which the researcher draws conclusions. Rather than focus on measuring quantity, qualitative methods focus on the nature or quality of the phenomena under study. For example, if we were interested in 'board contributions,' and were using a quantitative method, we could measure the number of minutes a director spent talking in a board meeting or the percentage of meetings he or she attended. A qualitative method would take a different approach and might involve watching the director in question, interviewing her or his colleagues and reviewing the minutes of previous meetings. Based on these sources, it may be possible to conclude whether the director was a good or poor contributor. The difference between the two approaches – possessing the quality of being a 'good contributor' versus the precise

Table 13.4 Who has the knowledge?

Category	*Information sources*	*Knowledge benefits*	*Potential drawbacks*
Internal sources	Board members	• Should have key knowledge on skills, processes, relationships, level of shared understanding	• Suffer from biases (such as groupthink) • Little understanding of external perceptions of the board • Do not provide a "set of fresh eyes" with which to examine governance processes
	CEO	• Should have a different perspective on all elements of board activity • Key insight into the advice role of board • Key insight into succession issues	• Potentially suffers from biases • Potentially impression manages for the board, particularly on issues of management activities • May have a limited or biased understanding of external perceptions
	Senior managers	• Generally good insights into communication between the board and management	• May not have enough exposure to the board • May be tainted by internal company politics
	Other employees	• Should have insight into the culture of the organisation. • The further removed from the board, the less likely employees can comment on actual performance	• Limited exposure to the board
External sources	Owners/members	• Understand ownership aims	• Will depend on the ownership structure (may be disparate)
	Customers	• Can have unique insights, particularly if the company has very few customers	• Most likely will have little insight into how the board operates • Potential to "game" the system
	Government	• Can have insightful views, particularly in certain areas of compliance, if these are critical	• Often limited interaction with most companies
	Suppliers	• Can have unique insights, particularly if the company has very few suppliers	• Most likely will have little insight into how the board operates
	External experts	• Useful benchmarking or best practice insights	• May not understand company's context
	Other stakeholders	• Will depend on nature of the company	• Will depend on nature of the company

Source: Kiel, Nicholson & Barclay, 2005.

measurement of an observable fact – is the key distinction, not the data type.

What makes the situation more confusing is that most board research tries to quantify what are essentially subjective assessments. Perception-based research (where we ask governance actors their perceptions of specific events or activities) are qualitative assessments of the phenomena. Whether these questions are asked as part of an interview (where we have the rich data of their open-ended response) or as part of survey (where we reduce the complexity of their response to a point on a predetermined scale), the source of the data is the same – it is a subjective assessment of the enquiry.

In general, quantitative methods are best used when the topic being assessed is well understood, the measurement tools are well used and verified and/or benchmarking or comparison is a key goal. In contrast, qualitative research relies on induction (Glaser & Strauss, 1967; Christie et al., 2000) and so is often best used when conducting exploratory research (e.g., Bowen, 2004) – where you are not sure what the issues are. In practice, most rigorous evaluations involve mixed methods (both quantitative and qualitative data) – generally, a combination of surveys, individual interviews and facilitated group sessions (Behan, 2004).

Moving to the specifics, there are many different approaches used in board evaluations, including questionnaires, interviews (van der Walt & Ingley, 2001), free-form discussions (Wolf & Stein, 2010), '180- and 360-degree' reviews (Blake, 1999), best practice benchmarking (Garratt, 1996; Hawkins, 1997; Davies, 1999; Walker, 1999) and psychometric testing and the use of assessment/development centres (Garratt, 1996; Tricker & Lee, 1997). In the following sections, we outline some of the more popular methods used in board evaluations.

Surveys

Surveys or questionnaires are reported as the most common form of evaluation (Clarke & Klettner, 2010). In addition to providing summated ratings of director perceptions, surveys can be examined to look at gaps between current and desired performance or engagement (e.g., Nadler, 2004) to provide greater focus for change. Sometimes this can involve a comparison between board and management perceptions to highlight differences (positive or negative) and/or the similarities or differences between self-perceptions and colleague perceptions (Nadler, 2004).

A key concern is that surveys by themselves may not uncover the key governance improvements required. For example, Behan (2004) reports how in a NASDAQ company experiencing high growth, a standard survey revealed board members had concerns about information flows, board leadership and corporate strategy, while the CEO reported the board took too long to make decisions. Only a subsequent group discussion (a qualitative group probing of the issue) revealed that the board lacked a sufficient understanding of the corporate strategy to make faster decisions. There are myriad technical difficulties involved in surveys that we have discussed earlier or are beyond the scope of this chapter: for example, measurement error, problems with response bias (scaling difficulties, whether to use an 'average' rating of the board and so on) that are usually not considered during the evaluation process.

Individual interviews

One of the most prevalent techniques used in board evaluations is interviews with directors. This may be a formal process, with an independent advisor conducting the interview, or it may take the form of an informal 'chat with the chairman' organised prior to a board meeting. Both share the characteristics of an individual session focused on identifying strengths and weaknesses of the governance of the company. Important aspects to the interview involve deciding (1) who will conduct the interviews, (2) the line of questioning or format of the interviews and (3) the level of confidentiality.

Deciding who will conduct the interview will likely be determined by the answer to who is conducting the review. Nevertheless, it is important to recognise that interviewing, particularly for research purposes, is a complex skill that can be underestimated (Kiel et al., 2005; King & Horrocks, 2010). Building rapport and trust with directors will go a long way to ensuring full and frank views are collected during the process. Similarly, an interviewer who is the cause of governance problems (e.g., a dominant chair) is an obvious concern.

Interviews can take many forms from structured (i.e., only asking specific, prewritten questions) to unstructured (i.e., no specific questions) (Kiel et al., 2005; King & Horrocks, 2010). The level of structure is best aligned with the aim of the evaluation: more structure is generally useful where the evaluation is focused on specific issues (e.g., a known problem), whereas less structure is generally more useful where little is known about the performance of the board.

A final factor to consider is the confidentiality of interview material. Often it is necessary to balance the feedback with the confidentiality promised as part of the process, and this is a key practical and ethical consideration for the process. While promising confidentiality can engender trust and forthright responses, it can make reporting the findings difficult. One way to balance this issue is to assure participants of non-attribution, but not confidentiality. The interviewer can also provide a space for 'off the record' comments that the reviewer can use to find other information.

Group interviews

It is also possible to collect the views of directors in a group setting. This can be done as a separate component of a board meeting or at a dedicated setting. Boards that use this method often conduct it as part of a regular annual strategy and/or reflection setting. Obviously, issues of the structure of the session (e.g., topics raised) are important, as is the session facilitator. Given that group sessions (such as focus groups) are more complex than one-on-one sessions, our suggestions regarding sufficient facilitator skills and the structure of the session are even more important. Obviously, it is nearly impossible to ensure confidentiality during these sessions, although we are aware of some reviews using networked computers to try to achieve this through directors typing in anonymous comments (which raises its own challenge).

A major advantage of the group interview approach is efficiency – the facilitator and participants dedicate time in the same session, and there is often little need for preparation by the board members (Behan, 2004). It also can provide collaboration and corroboration of insights in real time, so that the group can move quickly to an agreed position on the issues facing the governance of the organisation. It serves as a positive team-building exercise at the same time as data are collected (Behan, 2004).

As with the other techniques, there are significant downsides as well. The most crucial difference between group and individual interviews is the obvious impact of the group dynamic on feedback and insights. The group approach works best where board members share mutual respect and trust (Behan, 2004). While there might be an obvious concern with how forthright participants may be in a group setting (particularly around sensitive issues), there are other less obvious downsides. For instance, the ability of each individual to contribute is constrained, the known group effects of 'piggybacking' (i.e. the first idea mentioned tends to focus participants on that issue, rather than a range of issues) as well as the potential effects of impression management (Goffman, 1959) and power distance (Hofstede, 2001) (e.g., not wanting to appear foolish in front of colleagues) means that group interviews or focus group approaches need to be carefully considered and facilitated.

Observation methods

Researchers argue (e.g., Pettigrew, 1992; Roberts et al., 2005; Brundin & Nordqvist, 2008; Petrovic, 2008; Huse, 2009a) that the future research on boards should focus on the actual behaviours demonstrated in the boardroom and this should be explored by being there and observing. This will further help to understand what directors actually do and how decisions are made (Pettigrew, 1992). While gaining access to boardrooms is not easy, Huse (1995), Samra-Fredericks (2000), Leblanc and Schwartz (2007) and Brundin and Nordqvist (2008) show that it is possible to study boards at work.

Observation involves reviewing the board in action and is particularly useful when the board is interested in an external review of the dynamics of the board team or group. Rather than dealing with perceptions (and historical perceptions at that), the data is direct and to a large degree untainted by the views of participants. While it is possible for insiders or participants to conduct this review (e.g., we know of several boards where there is a review of the meeting efficacy at the conclusion of each meeting), perhaps the most useful approach involves using a trained observer to sit in on one or more meetings and using techniques well developed in sociology and anthropology (e.g., Douglas, 1976; DeWalt & DeWalt, 2002) to draw conclusions related to the objectives of the board review.

Observation most often occurs in one of two instances: either a participant (or insider) or an independent, trusted advisor. Again, boards often need to consider the specialist skills required to interpret group dynamics as well as the potential bias that might shape a participant–observation approach. We also note that it is possible to video and code board meetings (a current research focus of the authors), which can provide interesting quantitative data to highlight specific issues or corroborate qualitative insights. Figure 13.12 provides an example of meeting observation outcomes.

Document review or analysis

Another potentially useful technique used for evaluations is a document review. Analysis of board and committee agendas, board papers, meeting minutes, director attendance records and other documents can provide meaningful insights into the work of the board and even the contribution of individual directors (Tricker, 2009). Governance documentation highlights the areas the board emphasises. Gaps in the documentation can provide insights into the sophistication of the board and its understanding of issues such as its legal responsibilities. The flow of activities across time can also highlight if boards follow through on decisions and if matters are dealt with in a systematic way.

Board papers also provide an important comparison point for the opinions of directors that might be evident in other techniques. For instance, document reviews can be used to compare what the board says it should be doing with the record of its work (Behan, 2004). If the board believes its involvement in strategy is the most important aspect of its work, is this reflected in the minutes

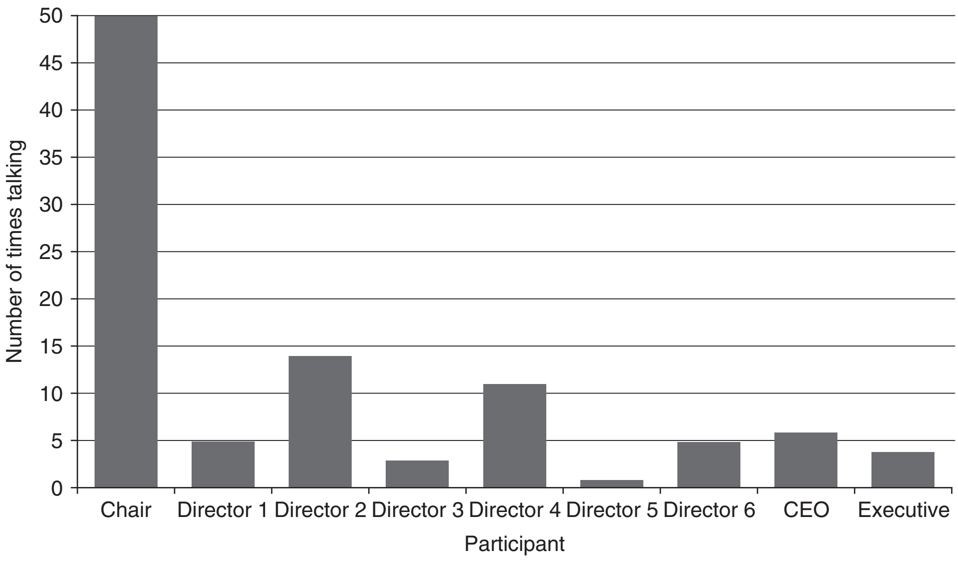

Figure 13.12 Meeting observation – Number of times participants spoke

and board papers generally? How – or if not, why not? Thus, document reviews can form an important component of a rigorous review, particularly when used to identify differences between perceptions and records.

Psychometric testing and other instruments

Given that directors' personalities are often seen as a key factor in boardroom behaviours (ICSA, 2009), it is interesting that standardised tests and instruments are not used more during board evaluations. While we have been involved in hundreds of evaluations, we can only think of a handful of occasions where they have been employed. Dulewicz and Herbert's (2008) findings corroborate this, as only one of the 29 companies they surveyed had used psychometric testing. While a definite proportion of directors do not subscribe to these tools, we conjecture that for most high-status individuals, these instruments are extremely threatening, as they fear 'not measuring up' or having their weaknesses exposed.

Analysis

In addition to the techniques, the review needs to have an appropriate analysis of the data collected. Often, understanding the results requires reviewing and coming to an initial conclusion about the pattern of responses as much as the averages themselves (Wolf & Stein, 2010). A response to a survey item that yields three 'strongly agrees' and three 'strongly disagrees' has the same average as a board that has six members rate 'neither agree nor disagree.' Clearly, these responses have different conclusions.

A more subtle analysis issue involves drawing unsupported conclusions from quantitative data – for instance, survey results or measures of contribution. Just because a director comes to every meeting, does not mean he or she contributes more than a director who has missed a meeting or two during the year. Thus, a process that involves multiple techniques reviewed by experienced individuals is more likely to yield valid and valuable conclusions.

Table 13.5 Evaluation techniques

Technique	*Source of data*	
	Internal participant*	External participant
Interviews	33%	9%
Survey	68%	0.5%
Other	4%	0.5%

* Columns may add to more than 100% because boards may use more than one technique.

Adapted from PricewaterhouseCoopers (2010: 25).

Techniques – evidence from the field

While there is a wealth of techniques available to boards seeking a robust evaluation, evidence suggests that practice is dominated by surveys administered to people within the organisation. Table 13.5 provides a summary of the current practices of more than 820 US boards that responded to the Annual Corporate Directors Survey conducted by PricewaterhouseCoopers (2010). Column one clearly highlights that more than two out of every three board evaluations used surveys and only one in three used interviews to gather data. A very small 4% used some other method and at least 90% of boards only used data from participants within the organisation. The dominance of one technique and potential bias from using internal participants is a point for reflection for the field.

Who will be evaluated?

While most board evaluations involve reviewing the board as a whole, there are several other options surrounding the selection of the individual or group that can form the basis of a review. These are summarised in Figure 13.13. Generally, boards consider the work of the group and its subgroups (committees) as well as sometimes focusing on individuals holding specific positions (such as the chair or lead independent director or company secretary) and/or individual directors.

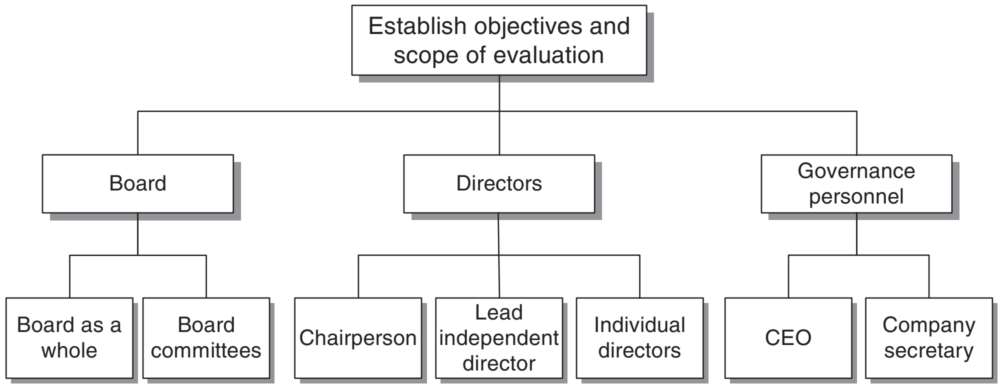

Figure 13.13 Who will be evaluated?

Source: Kiel & Nicholson, 2005: 618.

Who will undertake the review?

Another critical decision facing the board is who will conduct the review. While a review is often best performed by the board itself, it does require 'facilitation that provides expertise, challenge and objectivity' (Aronson 2003: 8).

While there are at least five key categories of facilitator, the major decision involves the choice of an internal or external facilitator. Internal reviews respect the board's authority, are more likely to provide directors confidence surrounding the confidentiality of the process (Kiel et al., 2005) and are likely to cost less. All of these are important considerations when making the decision.

There are, however, several limitations to an internally conducted review. The internal reviewer may lack the skills required (e.g., interview technique, survey design), they are likely to have a bias (often unconscious) that carries over into the assessment and it is a less transparent process where the review process is carried out by one of the board's own. Perhaps most significantly, the review is likely to achieve little if the reviewer (e.g., the chair) is the source of much of the problems or it may not be appropriate given the objectives of the review. For example, a review focused on benchmarking requires external data that an internal reviewer is unlikely to possess and/or the review may mandate or recommend an external facilitator.

An external facilitation, while more costly, can offer a number of advantages. First, a good external facilitator is more likely to have undertaken a significant number of reviews and will often provide important insights into techniques, comparison points and new ideas. Second, an external party often aids transparency and objectivity, which can be particularly important for boards with an external constituency interested in the review (for instance, if they are a government-owned corporation). Third, a good external party can play a mediating role for boards facing sensitive issues through being the messenger for difficult issues involving group dynamics and egos.

As with internal reviews, there are a number of potential downsides to an external facilitator. First, there is a great deal of variability in consultants, and the board needs to have confidence in the reviewer's ability and that they will handle the review in a supportive manner (Clarke & Klettner, 2010). Second, the reviewer needs to be able to establish the confidence of the board, so that they will be honest in their responses. Third, the use of an external party is likely to involve greater cost for the organisation than an internally conducted review. An elaboration of the benefits and downsides in the

Table 13.6 Chair, non-executive director and committee evaluations

Chair		*Non-executive director*		*Committee*	
Advantages	*Disadvantages*	*Advantages*	*Disadvantages*	*Advantages*	*Disadvantages*
• Part of leadership role – clear acceptance by board members • Clear accountability • Can align process with overall board agenda	• Possible bias • Concentration of power, particularly if the CEO is chair • Heavy workload	• Clear accountability • More independent view • More time to devote to task • Other leadership experiences/ skills	• Possible bias • Possible effect on board dynamics • Knowledge of the company will be less than that of the chair	• Relieves chair/ non-executive director of workload • Less reliant on the viewpoint of one person • Less subject to individual bias	• Longer process • Demands greater resources (time, money, etc.)

Source: Kiel, Nicholson & Barclay, 2005.

choice of who should conduct the review are provided in Table 13.6.

Interestingly, national context appears to play a role in who conducts the review. In countries with a separate CEO/chair, the chair or independent facilitator often plays a key role. For instance, Clarke and Klettner (2010) report that in Australian companies it is common for the chair to lead the process. In contrast, large US companies nearly always have the governance or nominating committee conduct the review (Clarke & Klettner, 2010; Roy, 2008).

The majority of the normative literature generally highlights that the chair will most often conduct the review (e.g., Kiel & Nicholson, 2003), an approach that has been criticised as lacking the objectivity required by a serious review (Tricker, 2009). Thus, there is a distinct trend, reinforced by regulatory and code guidance, to use external parties to conduct the process. For example, the UK Corporate Governance Code recommends that an external facilitation should occur every three years (Financial Reporting Council, 2010: B.6) and the OECD Steering Group on Corporate Governance (2010) recommends the board be supported periodically by external experts (Kirkpatrick, 2009). This matches the Australian experience that outside facilitation can be very valuable, but may not be necessary every time (Clarke & Klettner, 2010). Practically, it appears that, in Australia, around half of listed companies use an external facilitator, at least periodically (Clarke & Klettner, 2010).

What to do with the results

Collecting and analysing the results is not the end of the process; rather, it is critical that the board decides what to do with the data. A board's response should be based on how to satisfy the original objectives of the review. In most cases, the objectives involve the board reviewing the results and agreeing targeted actions for governance improvement, particularly when the focus of the review is on whole-of-board improvement.

In the case of individual director evaluations, what to do with the results should again reflect the objectives. Most individual director evaluations are formative – they concentrate on providing the individual director with feedback. In these cases, the results are likely not shared with the whole board. Instead, they are the subject of discussion between the board chair (or process faciliator) and each individual director, which '(1) significantly reduces the threat of a review to the individual and associated resistance to the process, (2) provides an appropriate venue for difficult performance discussions, if they are necessary, (3) maintains the key aspect of objectivity and accountability and (4) aligns with good performance management practice and respects each individual's integrity.

Often the board will communicate aspects of the review to different parties, particularly where the board has agreed that governance improvement requires the group. For example, if an area for improvement is the board–management relationship, the relevant results will generally be shared with management. Sometimes this may also involve a regulator or key shareholder.

Disclosing results more broadly is a topic of increasing importance. This needs to be agreed prior to commencing the review, as full and frank views are likely to vary with the confidentiality assured to participants. Often the regulatory regime of a company will specify that disclosures needs to take place (e.g., see the Walker Review, 2009). These requirements and recommendations are put in place to improve transparency and accountability; however, recent evidence indicates that these rules-based regimes encourage standardised responses, and even in principles-based regimes like the UK and Australia disclosure is often similar (Clarke & Klettner, 2010). This is because excessive disclosure is seen as problematic, since it involves personal sensitivities and can inhibit the work of the board (Clarke & Klettner, 2010).

Interestingly, there are mixed views on the disclosure of even non-sensitive aspects of board evaluation, and it is dependent on the reviews objectives and stakeholder group to whom disclosure is made. Feedback from boards indicates a reticence to communicate, because it can inhibit a rigorous review and because they see it as adding little value. Thus, a willingness to disclose information depends on who it might be disclosed to, with Dulewicz and Herbert (2008) reporting that virtually all boards think that disclosure of board evaluation results to suppliers, customers, employees, the media and banks or lenders is inappropriate. A minority believed it desirable to disclose the results to senior management (29%) or major institutional investors (34%).

Consequently, those boards that do disclose results more broadly tend to divest generic information with little insight for those interested in the board's work in this area (Roy, 2008). For example, in a detailed review of 30 large companies by Clarke and Klettner (2010) only eight (just over a quarter) reported outcomes and, of these, some three (or 1 in 10) gave examples of specific actions taken. While there is little investigation in the topic, disclosure of evaluation results does not appear to be a major concern for key stakeholders. For instance, Australian fund managers report they see little value in improving this disclosure (Clarke & Klettner, 2010).

Getting practical – implementing a review

Thus far, we have concentrated on outlining trends in board evaluations, the major challenges involved in conducting an effective evaluation and a review of the key decisions that are required. In this final section, we outline major implementation issues for boards – how to use a single evaluation as part of a system of continuous improvement.

The evaluation cycle

Board evaluations are not standalone processes, but rather form part of an integrated, evolving cycle of corporate governance accountability and improvement (Aronson, 2003). Effective evaluations require the board to set annual objectives, collect, disseminate information on progress toward the objectives, then judge performance, and make adjustments on an ongoing basis (Conger & Lawler, 2009).

Agree standards

Since the role of the board will vary, so should those performance criteria or agreed standards (Collier, 2004). For instance, different board compositions work better under different environmental conditions (Rost & Osterloh, 2010) and it has long been recognised that a company's context will affect its role set (e.g., Zahra & Pearce, 1989). Thus, the first step in an evaluation is to be clear what is expected of the director, preferably in the letter of appointment or similar (Tricker, 2009), as this can form the basis for the standards investigated in an evaluation. Similarly, it is important that the board agree the desired function of the group as the starting point for assessment (Blake, 1999).

Our experience is that this step is often not carried out – and is a key stress point in evaluations. Without agreed standards, different people have different ideas on what they and the board should be doing. As Van den Berghe and Levrau (2004: 471) report, they found it 'striking to observe the different and even contradictory responses of directors who are members of the same board' around the issues involving board evaluations.

Agree the broad cycle frequency and focus

In addition to the standards, boards need to have a sense of the frequency and pattern of their reviews – how they will cycle through the various important aspects of governance over time. Most boards undertake an annual evaluation process – for example, Clarke and Klettner (2010) report 70% of their sample undertook an annual review.

However, an annual review does not make sense for some elements of governance. For instance, if a remuneration committee meets three times a year, they could conceivably spend the first meeting discussing what they thought the process should include, the second meeting carrying out the review and the third discussing the results. Evaluation would be a constant agenda item. Instead, many organisations have a changing approach for evaluation – for example, BHP Billiton alternates whole-of-board evaluations one year with individual director evaluations the next (BHP Billiton, 2010: 136). Similarly, smaller update or check-in evaluations undertaken in-house can be alternated with a rigorous extensive review conducted by an external party every two or three years. Approaches such as these are made to balance the resource implications of conducting an evaluation with rigour.

Agree the implementation and integration process

Another key to success is the implementation of change – or turning the review into positive outcomes and improved performance (Aronson, 2003; Clarke & Klettner, 2010). Research indicates that this aspect of the review could be substantially improved: for example, Nadler (2004) reported that only a quarter of boards conducting a review reported they have a plan to address issues they identify (Nadler, 2004), while PricewaterhouseCoopers (2010) reported that some 14% of respondents made one or more major changes based on their evaluations.

Along with the implementation of any recommendations for change, the results of any board evaluation process need to be integrated with other governance process such as director selection or nomination processes, or orientation and education programmes (Roy, 2008), since an evaluation can inform these areas.

CONCLUSION

As effective corporate governance has become a major concern of governments, investors, academics and directors themselves over the past two decades, so too has interest in board and director evaluations. Board evaluations are now part of the governance landscape for a wide range of boards in many countries and are not just confined to large publicly listed corporations. They are also seen as a valuable tool for non-profit boards and boards in the government sector whose increasing importance can be seen in the significant increases in adoption of evaluations over the past few years.

Experience has shown that board evaluations require a different approach to the managerial performance assessments, which are now a routine process in many organisations. Board evaluations differ because of the unique nature of the board as a decision-making group: while the board is accountable to the organisation's members, only the board members really know what goes on inside the boardroom, leading to issues as to whose views are taken into account in the evaluation and the use of the evaluation outcomes after the process is completed.

What has become apparent over the past two decades is that there are a multitude of approaches to (and techniques of) board evaluations. These range from the chair's chat with the board to full-blown, consultant-conducted reviews that involve questionnaires, individual interviews with directors and others, who have insight into the board processes, as well as an extensive discussion of the results with the board. In this chapter, we have set out the key questions that any board needs to ask itself when setting out to undertake an effective board evaluation. We believe this to be a useful model and framework for understanding board evaluations.

This chapter has also highlighted a number of the theoretical issues related to board evaluations. These issues include: having a model of how boards work, which will inform the approach to the board evaluation; the unit of analysis; the appropriate use of scales; the difficulties stemming from the psychological construct of illusory superiority and consequent issues to do with the reporting and interpreting the results; and attempts at benchmarking board performance. A further significant problem is that the inclusion of board evaluations in various codes and other requirements by regulators for companies can lead to a 'tick the box' approach whereby boards seek to meet perceived external requirements for a board evaluation at the expense of using these tools to improve their own performance. While these are significant issues, experience from the field suggests that boards are overcoming these issues to provide real and meaningful feedback, which leads to significant improvements in board effectiveness and individual director effectiveness and, ultimately, organisational performance.

We believe that over the next two decades, the processes and application of board evaluations will continue to improve. There are interesting developments in the use of methodologies such as observation to help boards reflect on their own performance. The use of these new methodologies, as well as improvements in existing methodologies such as the use of standardised scales and more rigorous qualitative methodologies such as individual in-depth interviewing, should lead to more effective board evaluations. However, ultimately, the real success of any board evaluation must be the commitment and honesty that all members of the board bring to the process. Boards that seriously seek to improve their performance will do so – while boards which are comfortable with mediocrity will no doubt continue until external pressures bring personnel and structural changes to the board. Unfortunately, these mediocre boards may impose significant costs on their organisations until such change is forced on them.

NOTE

1 This does not mean that the results need to be disclosed, however (see discussion pp. 316) on what to do with the results.

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14

Women and the Governance of Corporate Boards

Ruth Sealy and Susan Vinnicombe

Following the corporate scandals of the late 1990s, the USA's Sarbanes–Oxley Act (2002) and the UK's Higgs Review of Corporate Governance (2003) both called for significant changes to the composition of the corporate boards (see Chapter 12). Both called for more balanced boards, addressing both the relative lack of independent advice through non-executive (NED) or outside directors, and also the homogeneity of the directors. In the UK, the Higgs Review made a clear call for more diversity among board directors, which should have led to substantial increases in the numbers of women on corporate boards. But the pace of change did not increase and, between 2003 and 2010, the percentage of women on the boards of the largest 100 Financial Times Stock Exchange (FTSE) companies in the UK rose by just four percentage points from 8.6% (101 directorships) to 12.5% (135 directorships). The UK figures for women on boards appear to have plateaued over the three years to 2010, interestingly echoing figures in the USA and Canada, two other countries which have pioneered the monitoring of women's progress into the boardroom over the past decade.

In this chapter we consider the issue of gender diversity in the boardroom. We start with a discussion around why it is important and what difference diversification might make to governance. We then reflect on some of the myths that have developed regarding the continued lack of women's representational presence in the boardroom, despite more than 30 years of equality laws in many Western economies. We then pay particular attention to the appointment process to the board, one of the least-researched areas in this field, highlighting findings from recent research with chairmen of FTSE 100 companies in the UK. Finally, we look across the world at the pace and process of change.

LINKING GENDER DIVERSITY AND GOOD GOVERNANCE

The persistently low figures of women on private corporate boards continue to exist across developed economies. But aside from issues of equality, why should we believe this to be important? A Canadian study entitled 'Not just the right thing, but the Bright thing', looking at public, not-for-profit and private boards, found that boards with three or more women on them showed very different governance behaviours than those with all-male boards (Brown, Brown & Anastasopoulos, 2002). The more gender-balanced boards were more likely to identify criteria for measuring strategy and monitoring its implementation, to monitor conflict of interest guidelines and to ensure a code of conduct. They were more likely to ensure better communication and were more likely to focus on additional non-financial performance measures, such as employee and customer satisfaction, diversity and corporate social responsibility. In addition, where there were two or more women on a board, the appointment process was more likely to involve independent search consultants. They were more likely to have new director induction programmes and closer monitoring of board accountability and authority.

In 2004, Singh and Vinnicombe found that UK FTSE companies with more women on their boards were more likely to adopt the governance recommendations from the Higgs Review earlier than those without. In particular, they focused on better succession planning and the use of external search consultants; new director induction and training; audit and balance of the whole board's skills, knowledge and experience; and regular reviews of board performance.

These findings are again confirmed in more recent research. A 2010 survey commissioned by search consultancy Heidrick & Struggles, conducted by Harvard Business School researchers (Groysberg & Bell, 2010), suggests that women appear to be more assertive on certain important governance issues such as evaluating the board's own performance and supporting more supervision on boards. The researchers suggest that this changing dynamic may bring in a new era of governance.

Performance

There is much debate concerning whether the addition of a woman to the board affects performance, and a number of research projects in the Western economies have attempted to provide evidence for or against this argument. We would strongly caution this line of enquiry as being able to provide such evidence, first questioning what aspect of performance is likely to be affected and how it is measured – e.g. board 'performance', defined as what, or some measure of corporate performance? Second, how can causality between an addition (or not) of a single individual to a board and whatever measure of performance be proven? This is especially the case when the individual takes a non-executive role – as is the case for the majority of women directors. Some studies have suggested measuring share value at the point of the director's announcement, but surely all that is then being measured is investor bias?

Some of the more commonly cited articles favouring female director appointment include Fondas and Sassalos (2000), showing that female directors enhance board independence. Better governance is assumed to occur through a more diverse range of directors' experiences and backgrounds. Izraeli (2000) and Huse and Solberg (2006) found that women take their NED roles more seriously, preparing more conscientiously for meetings. They also suggested that women more frequently ask the awkward questions, and decisions are less likely to be nodded through, suggesting better decisions are made. Women become more vocal when there are three or more of them (Konrad, Kramer & Erkut, 2008), or perhaps chief executive officers (CEOs) are just more likely to hear them. Homogeneity among directors is more likely to produce 'groupthink', which the individuals cannot recognise when they all come from same experiences (Maznevski, 1994). Women bring a difference of perspective and voice to the table, to the debate and the decisions made (Zelechowski & Bilimoria, 2004).

A more recent non-academic study conducted by an asset management firm in the UK looked at those companies with a threshold of at least 20% female representation across FTSE-listed boards. They found that operational and share price performance was significantly higher at 12-month and three-year averages for those companies with 20% women on boards than those without (Bhogaita, 2010).

In the UK since the economic crisis there has been much public debate concerning gender differences in risk preferences and behaviours. Experimental studies looking at trading and investment have shown 'excessive risk-taking' is linked to testosterone levels (Coates & Herbert, 2008). There are also gender differences in attitudes towards indebtedness and debt management. Another recent study considered the proportion of female directors in UK bankruptcies and company failures over the past decade, with a particular focus on the period of the recent economic recession 2007–2009 when there was a significant increase in insolvencies. Wilson and Altanlar (2009) find a negative association between female directors and insolvency risk – having gender balance reduces risk. The negative correlation between the ratio of female directors and insolvency appears to hold when controlling for size, sector and ownership, for established companies as well as for newly incorporated companies.

Culture

In 2008, Singh reported on a boardroom culture study of FTSE-listed companies in science, engineering and technology (SET) sectors. Her findings revealed that men demonstrate less political behaviour when women are present and that women tend to want to 'focus on the job' and not 'play games'. Her study confirmed previous findings that men change their language and behaviour, moderating their displays of masculinity and becoming more 'civilized' (Fondas & Sassalos, 2000), as well as becoming more open to other's perspectives (Bilimoria, 2000). In the opinion of the men in Singh's study, this made for more effective performance and governance. Huse and Solberg (2006) found that while women's presence 'lightens up' the atmosphere in the boardroom of Norwegian firms, there is no effect on the openness of the culture unless the women's backgrounds are different from the men's. Otherwise, boards may have female representation, but only masculine behaviours, losing any diversity benefits (Sheridan & Milgate, 2005).

The wider business case

As well as impacting the culture and governance of the boardroom, there is a broader business case for gender diversity at leadership levels (Terjesen, Sealy & Singh, 2009).

In terms of talent, women make up a significant part of the available talent pool – 47% of the workforce in the UK, over 50% in the USA. The majority of university graduates in OECD (Organisation for Economic Co-operation and Development) countries are now female and this is also the case in the developing countries (OECD, 2010). In a meta-analysis in the USA in 2002, Eagly, Johannesen-Schmidt and van Engen (2003) concluded that women have more transformational leadership styles than men and that these styles are connected with a greater effectiveness. Having good numbers of women in leadership positions contributes to an organisation in terms of mentors, role models and female retention from a better understanding of the issues women face at work. Such an organisation will benefit from gaining a reputation as an employer of choice for women.

In terms of market, it is believed that in the USA and Europe, approximately 80% of all consumer decisions are strongly influenced by women (from groceries to large ticket items such as computers, cars and houses). In the UK, women currently own 48% of Britain's personal wealth and this figure is set to rise to 60% by 2025. Gender diversity at leadership levels is increasingly scrutinised as a criterion in the procurement of projects. This is particularly the case for those commissioned by the public sector, but becoming more so in the private sector – for example, in the USA, pension funds vet companies for investment in terms of the presence of women on boards.

In terms of group processes, some research has already been referenced above regarding ‘group-think’ in homogeneous groups. Better corporate decision making (Brown et al., 2002) and greater creativity and innovation (London Business School, 2007) are also known outcomes from more gender-balanced groups.

A DECADE OF DATA

At the International Centre for Women Leaders in the UK, we have been studying the data on women’s progress to the boardroom since 1999. As well as tracking the figures, we have considered wider issues, including some of the myths concerning apparent reasons why women are not progressing faster. As previously mentioned, research has also been forthcoming from the USA and Canada during this decade and more recently across other Western world economies. Below we consider some of the more common myths prevalent in the Western economies.

The human capital myth

Human capital describes an individual’s accumulated educational qualifications and experience, which are perceived to affect cognitive ability and potential productivity. Individuals aspiring to board-level positions must acquire significant stocks of human capital over time (Kesner, 1988). In previous decades women have invested less in education and did not build up the experiences perceived to be necessary. This was reflected in their lower levels of achievement in terms of career hierarchy and lower levels of pay (Tharenou, Latimer & Conroy, 1994). However, research has shown that women were not offered the same level of training and development (Oakley, 2000), including the big ‘stretch assignments’ viewed as promotion criteria, nor the same levels of pay – often presumed to be indicative of one’s ability or potential. At the turn of this century, CEOs in US-listed companies were asked to explain the lack of women’s progress to the board and they cited the lack of human capital as the main reason. Conversely, when senior women from those organisations were asked the same question, they responded that the main barrier was CEOs’ negative stereotypes about women (Burke, 2000). Zelechowski and Bilimoria (2004), in their study looking at women who had made it to executive/insider directorships (EDs), found them to hold less powerful titles, more likely to be in support functions and to earn less than men. More recently, Singh, Terjesen and Vinnicombe (2008) dispelled the human capital myth in their study looking at new board appointments to the UK’s top FTSE 100 listed firms. They found that female appointees were more likely to have both international experience and MBA degrees than their male counterparts. Peterson and Philpot (2007) produced similar findings in the USA. Following the introduction of significant numbers of women to corporate boards in Norway, post quota legislation, studies have found that average education levels of the boards have risen substantially (Sealy et al., 2009; Teigen & Heidenreich, 2010). Singh et al. (2008) also found women were significantly more likely to have experience as directors on smaller, broader-based boards, although less often as CEOs or chief operating officers (COOs). This experience is often cited as a prerequisite to a major corporate board position, although the rationale behind this has been called into question by the continued homogeneity of failed boards in the wake of the global financial crisis. For more than a decade, research has argued that diverse perspectives facilitate better problem solving and decision making (Maznevski, 1994; Shrader, Blackburn and Iles, 1997), using resource-based theory to argue that differing human capital brings competitive advantage.

The majority of graduates in the developed world are now female and this is increasingly the case in the developing world also. Some 54% of entrants in higher education in OECD countries were female in 2008: the range was from 61% in Iceland to 44% in Turkey. And women are outperforming men in higher education, as in 2009, 46.9% of women completed their tertiary qualification, as opposed to just 30.8% of young men (OECD Education Report, 2010). Some suggest that this increase in female educational levels will inevitably lead to an increase in women on boards, given time. However, research by the consultancy firm McKinsey (2007), shows otherwise. Based on historic trends they show linear projections of women's progress to top management positions. For example, female graduation levels of 41% in France in 1975 have led to 8% of board directors being female in 2007. Extrapolating these figures from the 58% of female graduates in 2005 only leads to a prediction of 11% female board directors in the year 2035. This is the case even when taking into account the educational channels that are most likely to produce managers – i.e. graduates of engineering and MBAs from the *Grande Ecoles*.

Hillman, Cannella, and Paetzold (2000) showed that in US Fortune 500 firms, women and African-American board directors were more likely to have advanced degrees. Hillman, Cannella and Harris (2002) developed this to show that minority groups who hold postgraduate qualifications can utilise these to compensate against effects of subjective bias in the board selection procedure. Predictions of 70% (Ibarra, 2010) of OECD graduates being female by 2020 make a nonsense of any talent argument. With the majority of the baby-boomer generation retiring, if businesses want to utilise full talent capacity and take advantage of all of the human capital available, they are going to need to do a better job of retaining their women.

The human capital argument has previously been proposed as an explanation for the lack of women on boards, suggesting there are insufficient numbers of women waiting in the pipeline to those positions.

The pipeline myth

One of the common responses from CEOs or chairmen, when questioned as to why there are no (or few) women on their boards, is to say that while they are personally pro-gender-diverse boards, they could not find any suitable candidates. This is the pipeline argument of those suggesting that the lack of women on boards is a supply-led problem. In 2004, Zelechowski and Bilimoria found that while there were no sex differences in human capital or corporate tenure, the female inside/executive directors held less powerful corporate titles, were more likely to be in staff, rather than client-based functions, and earned considerably less than their male counterparts. These trends have implications for the pipeline, as it does mean that women are not so strategically well-placed to move into CEO positions as their male colleagues.

However, in the UK, the annual Female FTSE Report census has argued that, on the contrary, there is no shortage of well-qualified, highly experienced women, suitable as board candidates. Since 2007, each year the report has identified the number of women at executive committee level of the FTSE 100 largest companies, and also on the boards and executive committees of smaller FTSE-listed organizations. In 2010, the report identified an increase to 2,551 women across approximately 1,700 companies, showing a substantial and growing pipeline of women available to search firms and companies alike. These figures clearly refute the myth that there is a supply problem with talented women in the UK. In 2010, 17.2% of executive committees of the FTSE 100 companies (i.e. one level below the board) were female and 82 of the 100 companies have women in this top management layer. Women's roles on this team have also broadened. Whereas human resources and legal counsel/company secretary used to be the only roles women at this level held, the variety of other roles held by women is increasing – for example, divisional/regional CEOs, managing directors (MDs), chief financial officers (CFOs) and COOs. The 179 women identified on the FTSE 100 executive committees clearly provide future talent for the FTSE 100 board pool. However, they might also be appropriate candidates for the smaller FTSE 250 non-executive (NED)/outside directorships immediately. In addition, there are 27 female executive/inside directors of FTSE 250 companies, including 10 female CEOs and seven female CFOs, who are potential NED candidates for FTSE 100 companies immediately.

In the UK in 2010, there are just 116 women holding 135 directorships in the FTSE 100 companies, and 139 women holding 154 directorships on FTSE 250 companies. Therefore, the number needed to totally transform the landscape for women in the top 350 UK plcs is not huge: from a talent pool of 2,551, it would seem to the authors that 200 women could be found.

The ambition myth

The notion that women lack sufficient ambition to reach the top roles of the largest corporations was inflamed by an article in the *New York Times Magazine* entitled 'Q: Why don't more women make it to the top? A: They choose not to'. The article suggested that highly educated professional women would prefer to leave the workforce to become full-time parents rather than pay the work–life balance price of a high-flying career (Belkin, 2003). The notion of 'choice' and women 'opting out' of senior careers has become highly contentious in the past five years. In a major study across the USA and Europe, Hewlett and Luce show that 'off-ramping' for child-care, elder-care or any other reason is a major problem career-wise and although most of the women want to return to their career, only a small fraction manage to do so at the same level as they left. Some surveys have compared men's and women's espoused levels of ambition to reach the top corporate positions, giving men higher percentages (e.g. Hewlett, Luce, Shiller & Southwell, 2005). However, a recent survey of women at executive committee level of FTSE 350 companies found that 80% of those women aspired to have an NED role in a similar company (Sealy, Vinnicombe & Singh, 2008). But these contrasting findings have to be put into context.

Whereas opting out of a high-flying career can be a genuine choice for some women, for most the decision to leave is related (consciously or otherwise) to perceived lack of opportunities within organisations (Stroh, Brett, Baumann & Reilly, 1996). Work by Peters et al. (2010) in male-dominated work environments (medical surgery and the police force) shows how a lack of successful female role models directly affects women's levels of ambition, causing women to rethink the degree of their aspiration. They explain this as an inability to reconcile values and ways of working of those that they see above them with their own needs. Sealy (2009) had similar findings in another male-dominated work environment – that of investment banks. The women in her sample, despite having already had very successful careers, reached a point where the majority could not believe any future career progression was likely and for the most part could not identify with those above them. Ibarra and Petriglieri (2007) introduce the notion of the 'impossible self' and the negative impact for career transitions that not being able to identify with those above can have. Although both men and women face barriers to advancement, there are also gender-specific ones such as masculine work cultures, prejudice and stereotyping (Catalyst, 2004; McKinsey, 2007) and a number of studies have identified the lack of female role models as a developmental barrier (Rosin & Korabik, 1995; Catalyst & Opportunity Now, 2000; Gibson, 2004; DDI/ Leadership Forecast Survey, 2005). When women become aware of the additional obstacles that lie ahead, the paucity of role models in top leadership positions makes it difficult to identify with success (Sealy & Singh, 2010).

In the light of these findings, simply declaring that women are less ambitious than men masks a more complex reality. Women's aspirations to sit on boards of directors are naturally calibrated by the perceived chances of this occurring, and low opportunities seldom lead to great expectations. Any analysis of differences in individual ambition cannot be divorced from the social or organisational context that nurtures (or fails to nurture) that ambition. This is highlighted in a special issue edited by Lewis and Simpson (2010), where authors comment on how notions of 'choice' (Anderson Vinnicombe & Singh, 2010) and 'merit' (Sealy, 2010) are individualised. This conceals structural and organisational processes behind women's disadvantage and allows the 'blame' for women's absence to be put upon the women themselves.

The time myth

Research over the past decade in the Western economies has shown – contrary to intuitive ideas that time and market forces will sort this problem out – a progress so glacial that it has all but stalled, despite women making up approximately half the workforce (*The Economist*, 2010). In the UK, despite a decade of initiatives led by the many of the largest corporations and professional service firms, the figures for the past three years, for example, for women on boards, has stalled at around 12% (Figure 14.1).

With much publicity concerning girls' and women's 'over-achievement' in education, some are content to believe that this rebalance will trickle through, just 'given time'. However, as discussed above, research has shown that increasing proportions of female graduates in a number of countries does not give the same proportionate increase in women attaining senior career success. Countless 'diversity initiatives' at lower and mid-managerial levels across global corporations have failed to make significant inroads to the proportion of women on their boards. As also shown above, this is not just a supply-side problem. With significant

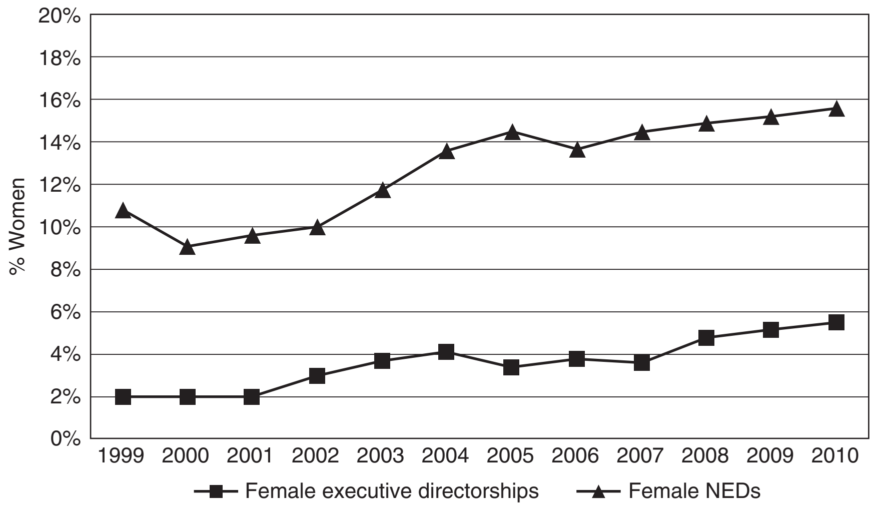

Figure 14.1 The plateau of progress – female FTSE 100 executive directorships and non-executive directors

numbers of women sitting just below the boardroom level, the one issue currently under-researched in this area is that of the appointment process.

THE APPOINTMENT PROCESS

For over a decade it has been recognised that simply interviewing for appointments or promotions is a flawed system due to inherent bias and lack of objective criteria assessment (Jelf, 1999). And so, throughout most large corporations in Western economies, more rigorous appointment processes have been put in place with what are perceived to be more objective criteria and systems – for example, using psychometrics and structured competency-based trained interviewers. However, while these methods are the accepted norm for most levels in organisations, when it comes to board positions, the process is much less clear.

The psychosocial mechanism of *homophily* (Ibarra, 1995) or *homosocial reproduction* has been recognised as both individuals and groups have a tendency to surround themselves with similar others. This can obviously negatively affect selection procedures for board members and Schulz (2003) suggested that excessive recruitment of personal contacts and a fear of diversity are the most common mistakes made by organisations in creating and using their boards. Research in US Fortune listed companies, leveraging theories of homosocial reproduction, showed that CEOs are more likely to lead boards composed of like others in terms of sex, age and experience (Daily & Dalton, 1995; Westphal & Zajac, 1995). Farrell and Hersch (2005) suggest that in Fortune 500 companies if there is already one woman on the board this negatively affects the likelihood of another being appointed. However, the figure increases if a female director is leaving – companies are likely to want to replace a female board director with another woman. Peterson and Philpot (2007) found that CEOs were concerned about appointing 'untried' women on their boards, yet they lacked this concern about 'untried' men. This reveals differing standards in the appointment of men and women, driven by unconscious bias and fear of the unknown.

In the UK, the Higgs Review of 2003 recognised the informal and opaque practices in the appointment of NED positions, noting that more than half of those he investigated had gained their position through personal contact. Higgs recommended the appointment process be led by Nominations Committees and involve external search consultants.

Given evidence of a substantial pipeline in the UK, attention of academics and practitioners has turned to the appointment process to the boardroom. In the UK's FTSE 100 companies, 83% of Nomination Committees are chaired by the chairman of the company, and in the 12 months to October 2010, just 13% of new FTSE 100 board appointments went to women. In May 2010, the UK's Corporate Governance Code introduced a new principle:

> To encourage boards to be well balanced and avoid 'group think' … the need to appoint members on merit, against objective criteria, and with due regard for the benefits of diversity, including gender diversity (Financial Reporting Council, 2010).

Therefore, in the 2010 Female FTSE Report, interviews were conducted with a number of FTSE chairmen to ascertain more detail concerning their role in the appointment process. The findings are outlined below.

Most of the chairmen acknowledged that executive committees are a major supply pool for NEDs, but also that the focus on developing internal female talent pipelines is crucial. The FTSE 250 companies (those ranked 101–350 on the stock exchange in terms of market capitalisation) have a big part to play: their female EDs are a supply of talent for FTSE 100 boards and the FTSE 250 boards should provide excellent '*development positions*' for FTSE 100 EDs to take on non-executive roles. The proportion of women directors on the FTSE 250 companies is significantly worse than their FTSE 100 counterparts (7.8% compared to 12.5%) and a number of the FTSE 100 chairmen believed they had a role to play in almost mentoring the FTSE 250 chairs to see the benefits of having a gender-balanced board.

Most of those interviewed felt that the recent gender diversity principle in the Corporate Governance Code underlines good practice but would not bring about change on a bigger scale. For chairmen who already consider diversity in the appointments process, the new clause was welcomed as being at the forefront of good governance and as a helpful reminder. [The following quotes are all from FTSE 100 chairmen, interviewed for the Female FTSE Report – July to September 2010.]

> I think that the fact that it is there as a spur to remind people is a good thing, but really it shouldn't be necessary. … I'm rather of the view, that boards who do pay consideration are happy to see it in writing.

It was also felt that, as one chairman put it:

> It will underscore it for those who are not at the forefront.

Another said

> It will make a difference in a modest way – it will guide behaviour at the margin.

However, there was also concern expressed that

> anything you put in a code ends up being box ticking.

Interestingly, there was a definite emergent sense that the appointment of women to boards was becoming a political issue that companies cannot ignore. Despite the fatigue expressed by some about corporate governance measures in general ('*After the last 24 months many chairmen feel they have to comply or they'll be beaten up!*'), there was still some doubt that this measure had not gone far enough. One chairman described the principle as '*wishy-washy*' by not being a required point of disclosure and another said:

> It's a signal that this is a good direction to go in if you want to, no more than that. The Code is still 'comply or explain'. I would say it's a weak acknowledgement of an issue. I'm sure it was right not to go the prescriptive Scandinavian route for instance with 40% requirement.

The latter viewpoint about quotas was echoed by all of the chairmen we interviewed, although several were supportive of targets to set direction for improvement.

The chairmen for the most part reported their belief of the tangible value in having women on their boards. A number also reported that robust processes had recently been put in place for identifying the skills/experience required, based on a matrix of the whole board. However, a number indicated that this was a very new procedure for their board. Most chairmen suggested that they still have to specifically and often repeatedly ask search firms to put women on long lists:

> If I am looking for a woman NED then I have to ask the search consultants – they don't automatically do this; you need to make it part of the search.

Some of the chairmen seemed prepared to take 'risks' on women, more so than the search firms suggest:

> What it means is taking women who haven't yet served as NEDs. Any chairman worth his salt should be comfortable in chairing a board of NEDs with varying degrees of NED experience.

Board size

The reduction in the number of directors on a board in recent years makes the opportunity to appoint new directors all the more challenging. As one chairman put it:

> On a FTSE 100 board, eight people is not much to play with. It's like assembling a football team – you don't want four left backs.

In our view, however, chairmen overplay how the small size of a board can constrain gender diversity. The top two companies in the 2010 Female FTSE ranking both have only eight and nine board members, respectively, yet manage to have three female directors each. Much has been made over the past few years of the link between company board size and the ability to place women on the board – the average size of FTSE 100 boards is 10.7. We compared companies who have consistently performed well in terms of gender diversity at board level and executive committee level from 2006 to 2010 (the 'heroes') and those who had no women on their boards and very few at executive committee level over the same period (the 'zeros'). There was very little difference, with companies in both groups having boards of various sizes. Having compared the extreme companies and found no link between board size and women's presence, we looked at the whole FTSE 100 group. What became apparent is the danger of just looking at averages. Board sizes range from 6 to 18 in FTSE 100 companies and at every size of board we have found those with women and those which are all male. In fact, with the exception of eight board members, at every size of board there are more boards with women on them than without. This provides more evidence that size need not constrain choice when it comes to gender diversity.

Director criteria

With a focus on both the chairmen and the search consultants in terms of bringing more women onto boards, there has been a degree of mutual blame seen during 2010. There appears to be much ambiguity around prerequisites such as former CEO experience or prior listed board experience, in order to be a credible candidate for a board. Some chairmen were more relaxed about this than others, with several emphasising the importance of drilling down on skills during the skills audit '*otherwise there is a temptation to say you need P&L experience*'. One chairman was very clear about **not** needing P&L experience in every NED prior to appointment as '*you can teach people that*'; and another said:

> I don't think that every NED has to tick every box at the basic level, as long as the board in aggregate has sufficient of those skills.

Several chairmen cited examples of women (and men) whom they had appointed to their boards without any plc experience at all. Describing one such example, a chairman said:

> She had a fantastic overview of the business scene … the international scene and was very, very sensitive to the public mood – a huge amount of emotional intelligence if I can put it that way.

Another chairman voiced the opinion that companies might think about taking a few more risks with NED appointments in this context:

> NEDs are only here for 21 days a year as opposed to 220 (for Executive Directors). It should therefore be slightly easier to take a risk.

Several of the chairmen interviewed could name individual women on their boards with whom they had taken risks; i.e. women who would not have appeared on search consultants' lists. We would support a call for both chairmen and search consultants to make the required qualifications and skills more explicit and question the normative assumptions of prerequisite experience (Burgess & Tharenou, 2002; Vinnicombe, Sealy, Graham & Doldor, 2010).

Chairmen also need to take care not to stereotype particular roles as being unsuitable paths to NEDs – human resources and law being two often quoted examples. One chairman, who fell into this category, promptly pointed out how his (male) legal director had just successfully been appointed to an NED in another company and what a good appointment it was. Chairmen, Nominations Committees and search consultants need to look beyond the role at the person.

Working with search consultants

There was a concurrence of views that the quality of search varies and chairmen felt they could only refer to experience with individual search consultants and not search houses in general. Some search consultants seem to take the search for female candidates seriously. Chairmen talked about having to be explicit with search consultants to produce a candidate list which includes women, as well as people from other underrepresented groups:

> If I am particularly looking for a woman NED then I have to make sure I ask the search consultants – they don't automatically do this; you need to make it part of the search, just as you would say 'I want someone Chinese on the board'.

There was a view that the consultants are behind the curve on this issue and have not yet grasped the importance to UK plc of identifying and supplying female talent on their long lists. Several chairmen felt that while the search consultants are excellent at carrying out objective evaluations of candidates, they could do much more to be proactive in finding them:

> I was searching for a female NED and I found that the choice and the quality of the lists that were sent to me were depressing.

> I think they could certainly up their game because when you say I would like to be in the market for a new candidate and I would be particularly interested if you could find me a suitable female candidate, invariably they are disappointing.

> Headhunters need to offer a more rigorous service. It's right for them to challenge the Nominations Committee. My advice to women who are seeking NED roles is to get plugged into the right part of the headhunters' database, e.g. if you want to be on a retail board then you have to make sure you're speaking to the headhunters who deal with retail appointments. Once you've done that, you have to go back and let them know you're still alive; don't expect them to automatically think of you.

Another chairman described the short-termism of the search consultants' approach to potential candidates:

> It is a little bit like a grocer turning over stock; if they can't turn over quickly, they are not interested.

There were some examples of search consultants exhibiting a more developmental approach and coming forward with women candidates to chairmen prior to there being a vacancy on the board. It is evident that in these circumstances the chairmen remember good women and we heard of several examples where chairmen had looked out for opportunities, even where these did not exist on their own boards. One chairman talked about '*lowering the bar*' as part of a developmental approach in bringing women onto boards, but explained that this is not about taking women who are less qualified or experienced in their functional role:

> What it means is taking women who haven't yet served as NEDs. Any chairman worth his salt should be comfortable in chairing a board of NEDs with varying degrees of NED experience.

In a number of cases, chairmen had appointed women they had met personally and had not relied on the search consultants. On the whole, however, the move towards a skills audit approach and the use of search consultants, means that it is becoming more normal for NEDs not to be known particularly well to chairmen. One chairman said that he had known only one of his NEDs previously and another said:

> Most of my non-executive appointments are perfect strangers to me.

Several chairmen expressed the view that the more objectivity there is in the process (and provided the search consultants play their part), the more likely you are to find women, whereas asking directors to use their own networks is likely to reduce diversity.

Search consultants, therefore, have an increasingly important role to play in the sourcing of good female talent and can either be extremely important champions for change in this process or they can be a block. We heard examples of consultants making judgements on 'fit' and experience of women, with which chairmen disagreed. As one chairman said:

> I have never found that people don't 'fit' at this level. I have no concern about people not fitting in. I'm more concerned about non-contribution and people who are sitting silent. You want everyone's mind – you want everyone to contribute from their perspective.

Another chairman had referred two female acquaintances to various headhunters who rejected them instantly because they did not have prior board experience. This chairman was adamant that previous board experience is not necessary:

> It's more important to understand the company's business.

Interestingly, these interviews illustrate that certain FTSE 100 chairmen are more prepared to 'take a risk' than the search consultants who take a more traditional and narrow view of 'suitable' NED candidates. However, we are cognisant that this research reported only one side of the story. Anecdotal conversations with individual headhunters often express the view that it is the chairmen themselves who are more traditional in their outlook and less likely to accept a more 'risky' candidate, such as a woman who has not previously served on a significant board.

Nominations committee

Across the FTSE 100 companies, 83 chairmen chair their Nomination Committees. In every case bar one, the chairmen we interviewed chair their board Nominations Committee and are highly engaged in the appointments process, seeing it as one of the most crucial parts of their role. As one said:

> I couldn't be more engaged with the process. I think one of the most important responsibilities of any chairman is the shaping of the board that he or she chairs and therefore the selection of the individual candidate is absolutely crucial because in the small hours of the morning, what matters, when you have got a crisis, is the culture that exists around the board table.

In terms of how a 'long list' is reduced to a 'short list', this varies. In a recent search, one company had asked the search firm to come up with names after they had done a skills audit. The search firm produced 20 names. Then, a combination of the CEO, chairman, HR director and company secretary met all 20 before this was whittled down to four and circulated to the whole board. In some companies, the chairman and one or two members of the Nominations Committee reduce the long list, but the whole Nominations Committee then meet and interview each person on the short list. Another chairman discusses the long list with the senior independent director (SID) and, out of that discussion, they reduce it to a short list which is circulated to the whole board either for additional names or to see if any of the board knows anyone on the short list. The chairman and the SID would then interview five or six people to get down to the last two, who are met by other members of the board.

From our conversations, it seems that moving from a long list to a short list is one of the most critical points of the process. This is where a large number of the candidates 'disappear'. As one chairman said,

> I would generally expect the long list to be discussed with myself and the SID but not more widely. And then I'd expect out of that to come a shorter list – five or six candidates. I would usually circulate that list to the board because it's always seemed stupid to me that there may be someone else on the board who knows someone. Why not get their feedback? And then I would expect generally myself and the SID would see probably five or six people and attempt to get it down to one or two and then widen the group to look at the one or two.

This is clearly a process which is potentially infused with unconscious bias. Personal knowledge and reputations of candidates dominate these conversations. Personal sponsorship of candidates, particularly by the chairman is crucial here, as is the position of the chairman in terms of holding to the criteria set for the appointment. It is clear from our interviews that chairmen vary: some hold rigorously to the original criteria, while others are prepared to relax them if they see other potential contributions that candidates offer.

In most cases, the Nominations Committee is made up of the most senior directors on the board (often the heads of each of the other committees) and therefore from the companies interviewed there was not always a woman on the Nominations Committee by dint of length of service and experience. There are 81 (out of 116) women on the Nomination Committees of the FTSE 100 companies. We asked chairmen whether this mattered and, although some of them did not think so, several said that women did add a particular value to the process. Amongst those where women are on the Nominations Committee, there was a view that

> Women bring a whole new dimension to the quality of the debate when you're hiring. They are not looking just at technical aspects of the role; they will look at the softer skills and so on.

Another chairman said,

> I think it just makes people stop and think and gives space to consider everybody on the candidate list.

So, gender diversity on the Nominations Committee can promote a more inclusive discussion of candidates.

A Heidrick and Struggles report (2008) found that Nominations Committees who were themselves more diverse and larger, logically, tend to consult a more diverse pool of candidates for board positions. In a more recent report of almost 400 board directors in the USA (Groysberg & Bell, 2010), 62% of women versus 43% of men support the new Securities Exchange Council (SEC) ruling (December 2009) that Nominating Committees should explain by proxies the role that diversity plays in the selection of new board members. In addition, 90% of the female directors surveyed and just over half of the males believe that women bring unique attributes to the boardroom. A substantial proportion of both the men and women surveyed felt that their boards were not highly effective either in advancing diversity or in their succession planning. Of the women and men surveyed, equal numbers spoke of having actively sought their first board position, but the women had taken significantly longer to achieve that first seat at the table – 2.4 years for women versus 1.4 years for men.

ACROSS THE WORLD

This chapter has already mentioned that progress in terms of the statistical representation of women on boards has all but stalled in the UK, the USA and Canada: But what of other countries around the world? Some countries have only very recently started formally measuring the numbers of women at the top of their listed organisations. For example, Mahtani Vernon & Sealy, (2009) found that 8.9% of the board directors of the top 42 companies listed on the Hang Seng Index are women and Banerji Mahtani, Sealy and Vinnicombe, (2010) found the same headline figure on the Bombay Stock Exchange 100 to be 5.3%. In Pakistan, a study into corporate governance of the top 100 listed companies of the Karachi Stock Exchange found only 22% of them had any women on their boards (ACCA, 2010).

International comparisons

In Australia, New Zealand and much of Europe similar studies have been charting these figures for a few years, but until very recently any increase in numbers has been slow and most countries have a long way to go before anything approaching parity can be anticipated. A few studies have also started to look at between-country differences in the figures (for example, see European Professional Women's Network, 2008; McKinsey, 2008; Terjesen & Singh, 2008). Whereas initial conversations with academic colleagues across the world suggest that there are many similar issues around increasing women's representation on corporate boards facing both individual women and organisations in various countries, there are also some clearly significant contextual differences which make international comparisons difficult, if not inappropriate. These include issues around board structure, employee and shareholder representation, social policy, the role of government, state ownership, etc. Recently, in the literature, there have been calls for work that goes beyond purely looking at the demography (Huse, Nielsen & Hagen, 2009) to actually explain the impacts of the composition, particularly on governance issues and boardroom practices.

An obvious example of a context that has received much coverage in the financial and business press over the past two years has been that of the Norwegian government's quota of 40% female representation on all publically listed companies, which came into force in January 2008. The interest stems predominantly from a desire to know what the impact of the enforcement has been. According to the *Financial Times*:

> As a corporate and public policy experiment it is being watched by businesses and governments around the world, in the wake of a global financial crisis that many argue might have been averted if bank boards in particular had less of a testosterone-fuelled culture (Milne, 2009).

The challenge is that governance and governmental differences between countries can detract from the real meaningfulness of comparisons. This was highlighted in a recent book edited by Vinnicombe Singh, Burke, Bilimoria and Huse (2008), which contained chapters looking at the state of women on boards in 12 different countries. The differences were stark. For example, in terms of government policy, at one 'extreme' end of the spectrum was Norway, with mandated quotas legislated on all listed companies, mid-spectrum was Spain, where the government has made recommendations, but stopped short of a law, and at the time most other countries had no government interventions in terms of quotas or recommendations (see below for more updates). Changes in many European women's working lives are predominantly driven by public policy and it will be interesting to see if corporate initiatives are able to benefit from this additional talent pool. In stark contrast to Europe, the other 'extreme' of the spectrum would appear to be the USA, where the principles of liberal freedom and free markets would prohibit any government intervention and any impetus for demographic would change come almost entirely from private initiatives.

Another area of difference is the structure of corporate boards: for example, in Norway and many European countries there is a two-tier board structure, meaning that there are no executive positions on the corporate board. In addition, in Norway the government owns 30% of several large organisations, and has a stake in board appointments. Making comparisons with, say, one-tier UK boards, is obviously not comparing like with like. In addition, in the UK since 2003 after the Higgs Report, the balance of executive and non-executive positions on corporate boards of FTSE organizations has shifted substantially. For example, with an average board size of just under 11 people, 62% of FTSE 100 companies now have only one, two or three executives on the corporate board (Vinnicombe, Sealy, Graham & Doldor, 2010).

In addition, in the few women on boards studies where international comparisons are made, it is not always clear that the figures being compared are like for like. For example, when comparing percentages of female executive directors on corporate boards, the

USA is usually heralded as having better figures than the UK (currently at around 5.5%). However, on closer inspection, it would appear that the figures are not compiled in the same way. In the US studies (Catalyst, 2010), the number of female executive directors is given as a percentage of the total number of female directors (i.e. what percentage of female directors are executive). In the UK, the figure calculated is the number of female executive directors as a proportion of the total number of executive directors. If the comparable figure to the US calculations was quoted for the UK, it would be 13.3%, higher than the American figure.

Measuring headline figures of the numbers of women on boards gives us a snapshot of where each country is: But what about the pace of change?

The pace of change across the world

> As Chairmen, we have an obligation to speed up the pace of change and influence the board selection process to widen the female talent pool for consideration. To do this, we need to champion gender diversity within our own organisations, develop our female talent and be prescriptive with search agencies to work towards an aspirational target for better female representation on boards (Sir Win Bischoff, Chairman, Lloyds Banking Group, UK).

Every year in the UK, approximately 12–15% of the total number of FTSE 100 directors is replaced. This is obviously the mechanism through which any change in demographic composition will normally occur and therefore, in addition to measuring the total number or status quo of female directors, we also separately monitor the numbers of new female appointees. Of the 137 new appointees to FTSE 100 boards in 2010 (12.5% turnover), only 18, just 13.3%, were women. Therefore, the pace of change is very slow (1.6%) and it will clearly take decades to substantially alter the percentages of women on boards.

However, in other countries there have been substantial increases in the pace of change in 2010 (Figure 14.2). Across the world, a number of countries are in the process of introducing, or have already introduced, either regulation (or even legislation) designed to radically increase access to the female talent pool at board level. Some countries are surging forward and others look to be left behind.

In Australia, the Stock Exchange Securities Council has introduced gender metric reporting as part of its governance code on an '*if not why not*' basis. The aim is to implement a substantial increase in the proportion of female directors, and thereby avoid any requirement for government intervention in the form of legislation. The Council's figure of 27% of new appointments going to women in the first half of 2010, compared to 5% in 2009, with 46 new women in the first six months (compared to 10 in the whole of 2009) shows the dramatic changes that can occur when there is real motivation.

As in the late 1990s and early 2000s, once more we find ourselves in the wake of global

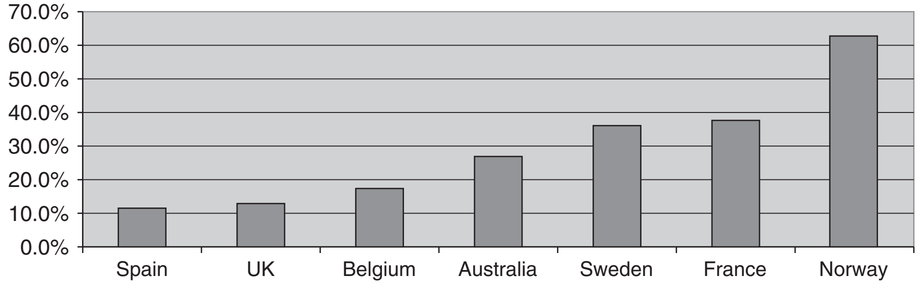

Figure 14.2 The pace of change – percentage of female new appointees 2010

corporate governance scandals, but this time on a scale so massive they caused a global meltdown hitherto unfathomable. This may have led to an openness to change and the possibility of ideas previously unthinkable. For example, in France, a quota law has just passed through the 'second house', having faced little resistance because it signifies a radical change and a very different way of business conducting itself (Anne Bouverot – personal communication, 2010). The law will mandate 20% of board directors to be female by 2012 and the target is to reach 40% by 2016. The latest figures available for August 2011 show an increase in female board directors to 18%.

What initially appeared to many Anglo-American businesses and governments as a uniquely Scandinavian approach to addressing the lack of women on boards – the imposition of a quota – is fast spreading to other countries. As this chapter is written, the landscape is changing. Following Norway, other countries that have announced quota laws, many in the first few months of 2011, include Finland, Iceland, Spain, France, the Netherlands, Malaysia, Italy and Belgium. European Commissioner Vivian Reding is pressing the whole European Union with the threat of a quota for women on boards if individual countries do not redress the problem themselves. On the 100th anniversary of International Women's Day (8 March 2011), the Indian Minister for Corporate Affairs publicly announced that going forward in India, any company with five or more independent directors will need to have at least one female director. Citing the study by Banerji et al. (2010), he said: 'The proposed provision in the Companies Bill will give rightful due to our women in the corporate world'. The proposed quota will be made mandatory through the inclusion of a new provision in the Companies Bill.

The Groysberg survey of female directors mentioned above revealed that 'The women directors surveyed seem to express a feeling that the status quo has not worked and that they are open to more aggressive changes to rebuild stakeholder trust in boards' (2010, p. 4). Our work within the UK would concur with this sentiment expressed by increasing numbers of senior women in major global corporations. In 2010–2011 in the UK, there is a sense of a changing mindset with regards to gender diversity on corporate boards. It is not the ethical or moral stance that is gaining traction, but a greater understanding of and frustration about the waste of female talent that is occurring, and an increasing sense of a need to change. Quotas are at least in the discussion. Some in the UK are taking heed of the apparent impact of the Australian change to the Code of Governance and British business organisations are calling for similar reporting measured to be introduced (CBI, 2010). From the interviews with FTSE 100 chairmen, there was a general feeling amongst the chairmen that the political pressure is on (especially from the European Union) for UK plc to 'get its house in order' over the appointment of female directors, or legislation could be forced upon them.

As this book was going to press a substantial government review in the UK, led by Lord Davies (former Chairman of Standard Chartered Bank and a former UK Trade Minister), reported its recommendations following evidence gathered from search consultants, senior business women and men, investors and chairmen of major corporations. The review stops short of advising quotas but focuses on 'soft targets' set by the businesses themselves. Lord Davies also highlights the role of other stakeholders in the appointment of women to board positions: CEOs, chairmen, search consultants and investors. In his introduction, Lord Davies states:

> The boardroom is where strategic decisions are made, governance applied and risk overseen. It is therefore imperative that boards are made up of competent high calibre individuals who together offer a mix of skills, experiences and backgrounds. Board appointments must always be made on merit, with the best qualified person getting the job. But, given the long record of women achieving the highest qualifications and leadership positions in many walks of life, the poor representation of women on boards, relative to their male counterparts, has raised questions about whether board recruitment is in practice based

on skills, experience and performance. This report presents practical recommendations to address this imbalance.

The report made 10 recommendations, which the UK government has welcomed and which Lord Davies has stated he intends to pursue vigorously. In summary, the recommendations are:

1 By September 2011, all chairmen of FTSE 350 companies should set out the percentage of women they aim to have on their boards in 2013 and 2015. FTSE 100 companies should aim for a minimum of 25% and we expect that many will achieve a higher figure. Also, we expect All Chief Executives should review the percentage of women they aim to have on their Executive Committees in 2013 and 2015.
2 Quoted companies should be required to disclose each year the proportion of women on the board, women in Senior Executive positions and female employees in the whole organisation.
3 The Financial Reporting Council should amend the UK Corporate Governance Code to require listed companies to establish a policy concerning boardroom diversity, including measurable objectives and disclosure of progress in the annual report.
4 Companies should report on these issues in their Corporate Governance Statement whether or not regulatory changes are in place. Chairmen will be encouraged to sign a charter supporting the recommendations.
5 Chairmen should disclose meaningful information about the company's appointment process and how it addresses diversity in the company's annual report.
6 Investors play a critical role in engaging with company boards. Therefore investors should pay close attention to recommendations 1–5 when considering company reporting and appointments to the board.
7 We encourage companies periodically to advertise non-executive board positions to encourage greater diversity in applications.
8 Executive search firms should draw up a Voluntary Code of Conduct addressing gender diversity and best practice, which covers the relevant search criteria and processes relating to FTSE 350 board level appointments.
9 In order to achieve these recommendations, recognition and development of two different populations of women who are well-qualified to be appointed to UK boards needs to be considered: Executives from within the corporate sectors; and women from outside the corporate mainstream – e.g. entrepreneurs, academics, civil servants and senior women from professional service firms.
10 The steering board will meet every six months to consider progress against these measures and will report annually with an assessment of whether sufficient progress is being made.

Lord Davies concludes that 'government must reserve the right to introduce more prescriptive alternatives if the recommended business-led approach does not achieve significant change' (Women on Boards, 2011).

In the first three months of 2011, already 12 of 35 (i.e. 34%) new board appointments on FTSE 100 boards have gone to women. Compared to the more normal percentage of 12–15% female appointments, this larger figure is what is required to make the substantial changes to the landscape of women on corporate boards in the UK.

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15

Diversity among Senior Executives and Board Directors

Sabina Nielsen

INTRODUCTION

While research on diversity in top management has accumulated a large number of empirical studies (for reviews see Carpenter, Geletkanycz & Sanders, 2004; Finkelstein, Hambrick & Cannella, 2009; Joshi & Roh, 2009; Nielsen, 2010), empirical works on board diversity are still limited. In the governance literature, attention has mostly been devoted to board gender diversity, while only few studies focus on board task-oriented diversity. The predominance of gender studies has led many to associate the term 'board diversity' with gender diversity or women directors. Yet, this review seeks to look beyond narrow conceptualizations of diversity and focuses on the consequences of different types of diversity in the context of boards.

Early works on board diversity focused on traditional, task-oriented directors' attributes such as educational and functional background, organizational and board tenure (Golden & Zajac, 2001; Goodstein, Gautam & Boeker, 1994; Westphal & Zajac, 1995). With the increased pressures to increase minority representation on corporate boards (Daily & Dalton, 2003), the focus has shifted towards more relations-oriented diversity dimensions. In North America, attention is increasingly paid to ethnicity and gender of corporate directors (Hillman, Shropshire & Cannella, 2007; Miller & Triana, 2010; Westphal & Milton, 2000). In Europe, nationality appears to become an important dimension of board diversity (Oxelheim & Randoy, 2003; Ruigrok, Peck & Tacheva, 2007; van Veen & Elbertsen, 2008) alongside gender (Nielsen & Huse, 2010a, b; Singh & Vinnicombe, 2004). Hence, board diversity may have different meanings in different contexts, and in order to understand the role of diversity for the effectiveness of corporate boards, and ultimately for firm performance, it is important to understand the different types of diversity and the mechanisms through which they operate in the context of boards and corporate governance.

This review focuses on board diversity, yet it also includes some relevant and interesting studies from the top management team (TMT) literature. As conceptualized by

Finkelstein et al. (2009), strategic leadership encompasses both the TMT and the board of firms; while the two governance bodies play different roles for firm strategy, organization and performance, theoretically the effects of their team composition on firm-level outcomes can be quite similar. As the TMT diversity literature is in certain ways more advanced than board diversity research, insights from this field can be used to provide inspiration for future research on board diversity.

This chapter proceeds with a discussion of different definitions of diversity and their meaning in the context of boards and governance research. Next, theories from different disciplines that help explain the consequences of diversity in corporate boards are introduced and the findings of prior empirical research reviewed. Based on the review of theories and empirical findings, a conceptual framework of the effects of board diversity is developed. Specifically, the chapter progresses to discuss different mediators and moderators of the board diversity–firm performance relationship and concludes with outlining directions for future research focusing on the multilevel nature of board diversity phenomena.

CONCEPTUALIZING BOARD DIVERSITY

Diversity as a team-level construct

Diversity is most commonly defined as *'the distribution of personal attributes among interdependent members of a work unit'* (Jackson , Joshi & Erhardt 2003). The emphasis in this definition is on interdependence in that diversity is most important when performance is a team-level outcome and depends on the joint actions of team members. The mere presence of individual differences is not sufficient to influence team and organizational outcomes; it is the interaction among team members that allows them to utilize their differences in decision making and problem solving. Furthermore, diversity research recognizes that the nature of the task performed is an important factor determining the outcomes of diversity.

Boards, as teams, have specific features that distinguish them from lower work groups or other governance bodies such as TMTs. Forbes and Milliken (1999) identified some distinctive features of boards of directors: i.e. they (1) include many outside members, who serve on a part-time basis; (2) have a size considerably greater than that of other organizational groups; and (3) function only episodically. As such, boards of directors may be considered as 'large, elite, and episodic decision-making groups that face complex tasks pertaining to strategic-issue processing' (Forbes & Milliken, 1999: 492). Owing to their intrinsic characteristics and the nature of their tasks, boards can potentially greatly benefit from the diversity in board members' attributes. At the same time, because of these characteristics, boards are also particularly vulnerable to process losses typically attributed to team diversity, and their effectiveness depends heavily on social-psychological processes, specifically those pertaining to team dynamics and interaction in decision making.

Diversity as a multi-dimensional construct

Jackson, May and Whitney (1995) developed a widely used taxonomy, which distinguishes between task-oriented and relations-oriented diversity as well as demographic (observable) and cognitive (underlying) diversity. Demographic attributes such as age, gender, nationality, race and ethnicity are often considered representations of underlying (deep-level) individual values, beliefs and attitudes. Relations-oriented diversity refers to demographics such as age, gender and ethnicity, which may shape interpersonal relationships but typically do not have direct impact on performance. Task-oriented diversity reflects attributes which are likely to be related to knowledge, skills and abilities needed in the workplace (i.e. function, tenure, education). Researchers often apply a two-by-two matrix to classify diversity attributes according to these two categorizations (Pelled, 1996). For example, sex, age and nationality diversity falls into observable relations-oriented attributes, whereas educational and functional background and tenure are observable task-related attributes. Knowledge, skills and previous experience are task-related underlying attributes; personality, attitudes and values are underlying relations-oriented diversity dimensions.

An extensive discussion exists in both group diversity and upper echelons literature as to the extent to which observable (demographic) diversity dimensions can serve as proxies for underlying attributes or these two diversity categories should be studied as separate dimensions. The organizational demography approach criticizes the use of constructs such as attitudes, needs, values, preferences and cognitions, as such constructs are 'difficult to reliably measure and conceptually validate [and] are neither concrete nor unambiguous in their meanings and interpretations' (Pfeffer, 1983: 302). Based on this argumentation, upper echelons theory (Hambrick & Mason, 1984) suggests that demographic characteristics can be used as proxies of top managers' and corporate directors' underlying attributes. As a result, a large empirical literature based on upper echelons theory and the organizational demography approach has emerged over the last decades. These studies attempt to link TMT and board demographic attributes to organizational outcomes and provide largely inconsistent findings regarding the effects of demographic diversity (Finkelstein et al., 2009; Nielsen, 2010).

The mixed results regarding diversity effects lead to open criticism of the use of demographic characteristics, and scholars suggest that underlying (cognitive) attributes need to be studied simultaneously with demographic characteristics (Lawrence, 1997). The common practice of using demographic variables as proxies for psychological dimensions of upper echelons diversity leads to sacrificing construct validity for higher measurement reliability (Priem, Lyon & Dess, 1999). Looking back to the classical Hambrick and Mason's article, it is evident that the authors were already aware of this issue as they acknowledged that 'observable demographic factors simply do not provide a reliable portrayal of a person's makeup' (1984: 204). Accordingly, a number of studies have attempted to measure both demographic and cognitive diversity among firm upper echelons and assess the extent to which they can be used to predict firm-level outcomes. For instance, Glick, Miller and Huber (1993) measured cognitive diversity directly and found no evidence for a link between demographic and cognitive diversity. At the same time, Kilduff, Angelmar and Mehra (2000) report that cognitive diversity had a strong impact on team processes and performance. Demographic diversity, however, had no effects on either firm performance or cognitive diversity. Miller, Burke and Glick (1998) found strong support for a negative impact of TMT cognitive diversity on the comprehensiveness of decision making and the extensiveness of strategic planning. A study by Barsade et al. (2000) similarly confirmed that, when measured directly, affective cognitive diversity in TMTs exhibits a negative impact on team processes and performance. In the same vein, group diversity research has increasingly focused on studying cognitive (underlying or deep-level) diversity directly (Harrison, Price & Bell, 1998; Harrison, Price, Gavin & Florey, 2002; Jehn, Northcraft & Neale, 1999) and demonstrated that demographic and cognitive diversity effects can be either independent from each other or have interaction effects on team processes. The consistency of empirical results is a clear indication of the importance of focusing on cognitive diversity of top managers and corporate directors instead of relying on diversity in demographic characteristics. Jackson and Joshi (2001) noted that the main question is not whether demographic diversity can be used as an indicator of cognitive diversity; in order to fully understand diversity and its consequences, it may be necessary to assess and study all categories of attributes. This conclusion has important implications for future board diversity research, which has traditionally been dominated by demographic studies and has so far overlooked board cognitive (underlying or deep-level) diversity.

A closer look at TMT and board diversity studies further reveals that diversity is defined as a general construct. Typically, an assumption is made that all diversity aspects will have similar influences on TMT and board choices and behavior. Yet, diversity theories differentiate between the effects of different types of diversity, and reviews of group diversity research conclude that the effects of individual diversity dimensions should be studied separately as the different diversity dimensions have differing effects on team and organizational outcomes (Joshi & Roh, 2009; Milliken & Martins, 1996; Williams & O'Reilly, 1998).

Recently, however, researchers are calling for even more advanced conceptualizations of diversity: namely, to consider all relevant diversity dimensions simultaneously (Ashkanasy, Haertel & Daus, 2002; Jackson & Joshi, 2001). Jackson et al. (2003) criticize the existing practice to empirically test and discuss findings about different diversity dimensions included in a single study separately. Such an approach is based on an assumption that the effects of each type of diversity are independent of the presence of other types of diversity (Jackson & Joshi, 2004). Previous empirical research, in particular on TMTs, shows that this is not the case. Pelled, Eisenhardt and Xin (1999) found that a combination of multiple diversity attributes has effects on the strength of relationship between diversity and different types of group conflict. The combinations of gender and age diversity as well as gender and functional background diversity were found to have positive interaction effects, whereas age and tenure diversity had negative interaction effects on emotional conflict. At the same time, race and functional background diversity had a negative interaction effect on task conflict. These first attempts to consider multiple dimensions simultaneously and to measure interactions among them are encouraging evidence for future diversity research. In their review, Carpenter et al. (2004) point at the need to regard directors as a 'bundle' of attributes and study the interactions between the various dimensions of their personalities and demographics in order to understand their combined and cumulative effects on organizational outcomes. The possible interactions among different diversity dimensions has important implications for future research on board diversity, as ignoring such interactions provides incomplete and often misleading explanations for the organizational implications of upper echelons diversity.

Recent advances in group diversity research further suggest the demographic faultlines approach (Lau & Murninghan, 1998), which considers simultaneously multiple aspects of individual members' characteristics and estimates the probability of forming subgroups based on similarity in more than one attribute. Empirical studies confirm that group faultlines are a powerful predictor of team dynamics and performance (Lau & Murninghan, 2005), which holds great promise for uncovering the simultaneous effects of multiple group composition aspects. For instance, a study by Li and Hambrick (2005) demonstrated that factional groups in joint-venture teams (resulting from group faultlines) experience greater levels of conflict and behavioral disintegration, which in turn lead to poor performance. In a study of Dutch TMTs, Barkema and Shvyrkov (2007) found that demographic faultlines had a negative effect on foreign expansion moves, whereas diversity had positive effects on the same outcome.

Diversity as variety, separation and disparity

A recent conceptualization by Harrison and Klein (2007) suggests that diversity can be defined in three different ways: as separation, variety and disparity. Diversity as variety represents differences in kind or category, primarily on information, knowledge, or experience among unit members. Diversity as separation refers to differences in position or opinion among unit members and reflects horizontal distance along a single continuum in a particular attitude, or value. Finally, diversity as disparity indicates differences in concentration of valued social assets or resources such as pay and status among group members. Most board diversity studies use a definition of diversity as variety and investigate team-level diversity across different demographic characteristics. While some TMT studies on pay disparity and power differentials exist in the literature (e.g. Siegel & Hambrick, 2005), diversity as disparity has rarely been investigated in board research. Theoretically, it can be expected that whereas board diversity as variety may lead to divergent thinking and generation of a large number of strategic alternatives, diversity as disparity and diversity as separation may constrain the board's ability to act as a team and make decisions. As a result, the different types of diversity might have opposing effects on board effectiveness, firm strategic behavior and performance. Hence, future research may greatly benefit from studying the simultaneous effects of board diversity as separation, variety and disparity as well as their possible interactions on firm-level outcomes and performance.

THEORIES AND EVIDENCE OF BOARD DIVERSITY

Upper echelons theory: board diversity and firm-level outcomes

The upper echelons perspective (Hambrick & Mason, 1984) can help explain the influence of board diversity on firm-level outcomes. Based on the behavioral view of the firm (Cyert & March, 1963), the main underlying assumption of upper echelons theory is that human limitations influence the perception, evaluation and decision about organizational problems and hence influence firm choices and behavior. In a perceptual model of strategic choice under conditions of bounded rationality, Hambrick and Mason (1984) visualize how individual characteristics affect strategic choice in a three-stage process. As humans have only limited field of vision, when scanning the environment, managers cannot depict the whole complexity of a situation. In addition, due to selective perceptions of all information available to them, individuals only notice and register a certain part. Finally, the noticed stimuli are interpreted based on an individual's 'givens': i.e. their background characteristics and experiences. As a result, strategic choices are made not on the basis of objective information but on individuals' interpretation of this information. Through these processes, diversity in team members' attributes is conceptualized as an important predictor of firm-level outcomes (Hambrick & Mason, 1984).

Yet, empirical research on TMT and board diversity on firm behavior and performance has been largely inconclusive (Carpenter et al., 2004; Finkelstein et al., 2009; Nielsen, 2010). Studies trying to link board diversity to firm financial performance have focused primarily on board gender diversity. As a notable exception, Filatotchev and Bishop (2002) found that board task-related diversity is negatively associated with underpricing of initial public offerings (IPOs). Some gender diversity studies find a positive relationship between women directors and firm performance (Carter, Simkins & Simpson, 2003; Erhardt, Werbel & Shrader, 2003), while others find no significant relationships (Rose, 2007; Shrader, Blackburn & Iles, 1997) or even a negative relationship. This is consistent with the conclusions drawn from a meta-analysis of board research which demonstrated that there is little evidence of a systematic relationship between board composition and financial performance (Dalton et al., 1998). Consequently, board researchers have lately emphasized the importance of studying intervening mechanisms (mediators) in the relationship between board demography and firm performance. While Hambrick and Mason (1984) initially suggested firm strategic choices as mediators, others propose to explore boards as a decision-making group (Forbes & Milliken, 1999; Rindova, 1999), focus on team processes and dynamics (Finkelstein & Mooney, 2003; Huse, 2005; Letendre, 2004; Pettigrew, 1992), and evaluate board effectiveness in relation to various aspects of board task performance (Forbes & Milliken, 1999; Minichilli et al., 2011; Zahra & Pearce, 1989).

In terms of firm-level outcomes, early research has explored the effects of board task-oriented diversity on strategic and governance choices. Kosnik (1990) found that the more similar the board members occupational backgrounds, the higher corporate resistance to greenmail transactions. At the same time, Siciliano (1996) found board occupational diversity to be positively associated with social performance and fundraising. In a study of hospitals, Goodstein et al. (1994) found that boards with high diversity in occupational or professional backgrounds of their board members were less likely to initiate strategic changes in times of environmental turbulence. Subsequently, Golden and Zajac (2001) advanced the notion that the relationship between board occupational diversity and strategic change may be curvilinear, as beyond a certain point the benefits associated with varied board members' experiences and expertise may be outweighed by greater conflict and disagreement. More recently, Nielsen and Nielsen (2008) found that both level of – and growth in – TMT and board nationality diversity are positively associated with subsequent firm internationalization.

Board relations-oriented diversity has been linked to a number of firm-level outcomes. For instance, Siciliano's (1996) study showed that board gender diversity is positively related to social performance, while board age diversity was linked to higher levels of donations. Coffey and Wang (1998) found that the percentage of women on boards is positively associated with corporate philanthropy (charitable giving). By the same token, Williams (2003) found that female directors are more likely to engage in philanthropic giving. More recently, Miller and Triana (2010) found board gender diversity to be positively related to firm-level innovation. The same study also explored the effects of board racial diversity and found that it is positively related to both firm reputation and innovation. Moreover, this study provides support for the upper echelons notion that firm-level outcomes (i.e. innovation and reputation) partially mediate the relationship between board demographics (i.e. racial diversity) and firm performance (Figure 15.1).

Governance theories: board diversity and board effectiveness

Accounting for the complexity of board work and the multifaceted nature of board roles, scholars advocate board effectiveness in terms of performance of multiple tasks as an intermediate step of the relationship between board demography and firm-level outcomes (Forbes & Milliken, 1999; Zahra & Pearce, 1989). Two organizational-level (governance) theories – agency theory and resource dependence theory – provide the broad theoretical underpinnings for how board diversity influences board effectiveness.

Agency theory (Fama, 1980; Fama & Jensen, 1983; Jensen & Meckling, 1976) is primarily concerned with the separation of ownership and control in modern corporations and the board control/monitoring tasks. Boards are considered a crucial governance mechanism to align the interests of management and shareholders and reduce managerial opportunism. Early research on corporate boards focused on the board control tasks and suggested that boards of directors are ineffective in monitoring firm management (Mace, 1971). As a result, directors' independence and the separation of the chairperson

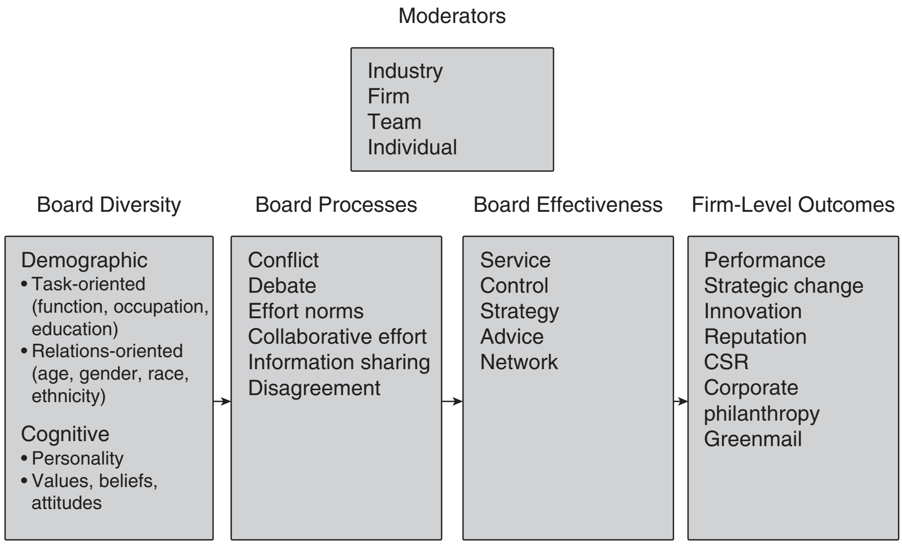

Figure 15.1 Theoretical framework of the consequences of board diversity

and chief executive officer (CEO) positions were proposed as important board structural features to increase the board control effectiveness. Yet, research failed to establish clear-cut findings as to the effect of such measures on firm performance (Dalton et al., 1998) and the emphasis has shifted from board independence to the competences and qualifications of corporate directors (e.g. Hillman & Dalziel, 2003; Hillman, Cannella & Paetzold, 2000) and to the knowledge and skills they bring to the boardroom (Forbes & Milliken, 1999).

Besides the presence of relevant knowledge and expertise, some authors argue that diversity in directors' background can contribute to board effectiveness in performing the multiple board tasks. Diversity in corporate directors' backgrounds is a construct distinct from the presence of knowledge and skills in the board (Forbes & Milliken, 1999). The underlying logic is that if all directors have similar knowledge, skills and competencies, the performance of multiple board tasks will suffer from 'group think' (Janis, 1982). Diversity in backgrounds, however, is believed to bring different knowledge, skills and competences to the boardroom, which will lead to differences in directors' perspectives. Such differences are believed to stimulate discussions, help generate more numerous and creative alternative options and find better problem solutions (Williams & O'Reilly, 1998).

From an agency theory perspective, board diversity may enhance board effectiveness in performing board monitoring and control tasks. First, in order to exercise its control function, the board needs the appropriate mix of experience and backgrounds to evaluate management and assess business strategies (Hillman & Dalziel, 2003). Hence, board diversity may provide the necessary knowledge, skills and competences for the board to effectively monitor firm management. Second, board diversity can decrease the power of the 'old boy's network' and lead to deviations from the inner circle (Westphal & Milton, 2000). Previous research suggests that social cohesion in the inner circle can be attributed to board homogeneity (Useem, 1984) and that demographically diverse directors are less likely to be compliant directors (Westphal & Stern, 2006). An explanation for such dynamics can be found in the similarity–attraction paradigm (Byrne, 1971), suggesting that demographic similarity increases inter-personal attraction. Third, board diversity can influence CEO–board dynamics, as CEOs are less likely to dominate a heterogeneous board. In support of the agency logic, Westphal and Zajac (1995) found that the power of the CEO over the board is positively associated with demographic similarity between the CEO and corporate directors. Moreover, the study's findings suggest that greater demographic similarity between the CEO and the board results in more generous CEO compensation.

The resource-dependence perspective (Pfeffer, 1972; Pfeffer & Salancik, 1978) emphasizes the institutional role of boards in linking firms to their environments and thus securing crucial resources, such as legitimacy, advice and counsel (Hillman & Dalziel, 2003). Furthermore, from a resource-dependence perspective, corporate directors are boundary spanners and have important network roles. As such, corporate directors are regarded as a valuable source of knowledge and expertise and have certain roles related to providing advice to firm management, particularly in relation to firm strategic vision and development (Judge & Zeithaml, 1992; McNulty & Pettigrew, 1999). Corporate directors with different occupational and professional backgrounds facilitate links to banks, policymakers and industry experts (Hillman et al., 2000). Furthermore, board diversity has an important signaling function, as diversity is well received by external constituents such as customers and investors (Daily & Dalton, 2003). Board resource diversity may also enhance network ties that foster collaboration and cooperation with key stakeholders (Beckman & Haunschild, 2002). Diversity in directors' backgrounds and experiences also contributes to the understanding of customers and increased marketplace knowledge (Robinson & Dechant, 1997). Hence, such diversity may help enhance the board network and advise task performance.

Very few studies have explored the effects of board diversity on multiple board tasks. Empirical research on the relationship between board gender diversity and effectiveness in performing board tasks suggests that the effects of diversity are not uniform in that board gender diversity has varying effects on different board tasks. In a study of the qualifications of the women and men inside directors of the Fortune 1000 companies, Helfat, Harris and Wolfson (2006) reveal a large disparity in terms of functional areas served by women, in that women are underrepresented in operations, accounting, secretary and legal functions and over-represented in public relations and human relations. Given existing evidence that women directors have non-traditional backgrounds and experiences (Hillman, Cannella & Harris, 2002), fewer directorships of other corporations (Ruigrok et al., 2007; Zelechowski & Bilimoria, 2004), are less likely to hold CEO and chief operating officer (COO) positions (Singh, Terjesen & Vinnicombe, 2008) and business occupations (Kesner, 1988; Ruigrok et al., 2007), it can be expected that they may be better able to contribute to certain board tasks rather than others. Supporting this line of logic, previous research on the role of women on board committees shows that this disparity translates directly into women responsibilities in the boardroom. Bilimoria and Piderit (1994) found that while men are preferred for membership in compensation, executive and finance committees, women directors are preferred for membership in public affairs committees. As a result, women are more often assigned and expected to effectively perform tasks of a qualitative nature.

Empirical evidence from several surveys conducted in Norwegian companies confirms that the representation of women directors on boards has a positive impact on the performance of qualitative board tasks, such as corporate social responsibility (CSR) and strategic types of control, but has no significant effect on the operational, budget and behavioral control tasks (Huse, Nielsen & Haagen, 2009; Nielsen & Huse, 2010a). At the same time, Nielsen & Huse (2010b) demonstrate that certain women directors' characteristics can help enhance board strategic involvement. These fine-grained insights about the differential impact of women directors on the performance of multiple board tasks can help explain the lack of robust prior empirical results as to the effect of women directors on firm financial performance. If women directors make a visible contribution only to some aspects of board work, it is difficult to discern these effects in overall firm financial performance. Thus, future research might benefit from investigating the effects of different types of board task-related diversity on different board tasks in order to provide a more complete understanding of how board diversity influences performance.

Diversity theories: board diversity and board processes and dynamics

Diversity is often characterized as a 'double-edged sword' or a 'mixed blessing' (Milliken & Martins, 1996; Williams and O'Reilly, 1998) as it has both positive and negative effects on team functioning and performance. These countervailing influences can be explained with two main theories: social categorization theory and information-processing theories (Williams & O'Reilly, 1998). The information/decision-making perspective suggests that variation in group composition leads to an increase in the skills, abilities, knowledge and information of the team as a whole. Such an increase significantly enhances decision making, as the different views and perspectives of diverse team members lead to in-depth discussion and consideration of different alternatives (Watson, Kumar & Michaelsen, 1993). Hence, diversity leads to generation of more alternative solutions to a problem, more thorough evaluation of different options and results in superior decision making (Williams & O'Reilly, 1998). By the same token, Nemeth (1986) argues that the quality of reasoning in majority opinions is enhanced by the consistent counterarguments presented by minority team members. Consequently, diversity increases the group's ability to process information, perceive and interpret stimuli and, ultimately, to make decisions. In general, information/decision-making theories put forward that team diversity increases group creativity and problem-solving ability (Hoffman & Maier, 1961).

At the same time, social identification (Turner, 1982) and social categorization theories (Tajfel, 1981; Turner, 1987) suggest that diversity may have a negative influence on team dynamics and performance. According to these theories, individuals define their own identities through social comparison with others. In the process of social categorization, individuals divide group members into in-groups and out-groups based on perceived similarity/dissimilarity of others. In order to maintain high levels of self-esteem, people have the tendency to positively perceive and favor in-group members (those similar to themselves) and dislike and judge out-group members (those who are dissimilar). As a consequence, team diversity results in negative affective consequences such as decreased identification with the group, lower satisfaction, etc. (Milliken & Martins, 1996). Such negative effects are typically more pronounced for gender and race diversity, on which social categorization usually occurs, than, for instance, functional and educational background diversity, indicating that they might be a result of deep-seated prejudices and stereotypes.

Several scholars have argued that the conflicting results of prior upper echelons diversity research are due to inherent limitations of organizational demography related to not accounting for the intermediate role of team processes and dynamics (Lawrence, 1997; Priem et al., 1999). By critically assessing its logical and methodological foundations, Lawrence concludes that organizational demography creates a 'black box', which '*moves researchers further and further away, both empirically and theoretically, from the actual mechanism underlying observed relationships*' (1997: 19). A main point of criticism is the so-called 'congruence assumption'; research models based on demography include processes as concepts, which are expected to explain the relationships between demographic characteristics and organizational outcomes; however, these process constructs are not being investigated and directly measured. Thus, Lawrence (1997) argues that through the organizational demography approach the actual underlying phenomenon and the theoretical mechanisms remain unexplored. Similar to this line of argument, a number of board and governance researchers suggest to open the 'black box' of board behavior and to study directly the effects of board composition on board processes and dynamics (Forbes & Milliken, 1999; Huse, 2005; Pettigrew, 1992).

Following this line of inquiry and the predictions of social categorization theory and information-processing perspective, a number of process studies have attempted to advance TMT and board research. Different models relating team demography, processes and performance have been theoretically developed and empirically tested. Empirical findings show that demography and team processes have direct effects on group and organizational performance. In addition, processes act as important mediators of the relationship between team diversity and performance. For instance, debate was discovered to mediate the interactive effects of diversity and decision comprehensiveness (Simons, Pelled & Smith, 1999). Similarly, collaborative effort mediated the link between TMT diversity and decision quality (Michie, Dooley & Fryxell, 2002). Knight et al. (1999), furthermore, found that demographic diversity affects consensus through two intervening processes: interpersonal conflict and agreement seeking. Information sharing is another important mediator variable (Bunderson & Sutcliffe, 2002). By blending qualitative and quantitative methods in a case study design, O'Reilly, Snyder and Boothe (1993) found that team homogeneity is associated with better team dynamics and related to more efficient firm adaptation to change.

In the context of corporate boards, Westphal and Bednar (2005) found that board diversity (with respect to gender, functional background, education and industry of employment) significantly moderates the occurrence of pluralistic ignorance on boards. The authors argue that heterogeneity in board members' backgrounds reduces the propensity for individual directors to express their concerns about the current corporate strategy in board meetings, thus decreasing the likelihood that boards will initiate strategic change in response to low firm performance. Nielsen et al. (2008) found that the level of board debate mediates the relationship between board task-oriented diversity and service and control tasks as well as firm performance. Pearce and Zahra (1991) reported that boards with a higher representation of women (characterized as participative boards) had higher degrees of debate and disagreement and were associated with higher perceived and objective corporate performance. Similarly, Nielsen and Huse (2010a) demonstrated that board gender diversity enhances board effectiveness through the mediating effects of increased board development activities and decreased levels of conflict. Furthermore, Nielsen and Huse (2010b) revealed that women directors' contribution to decision making mediates the relationship between diversity in women directors' backgrounds and values and board's involvement in strategy. In general, empirical studies attempting to open the 'black box' of TMT and board behavior confirm that team processes add significant explanatory power and help shed light on the relationship between diversity and performance.

Yet, theory and research further suggest that the impact of diversity on board dynamics may be even more complex. For instance, Westphal and Milton (2000) showed that the influence of directors who are demographic minorities on corporate boards is contingent on the prior experience of board members and the larger social structural context in which demographic differences are embedded. By assessing the impact of minority status of directors in large US corporations according to functional background, industry background, education, race and gender, they made three main conclusions: First, Prior experience of minority directors in a minority role on other boards can enhance their ability to exert influence on the focal board, while the prior experience of minority directors in a majority role can reduce their influence. Second Prior experience of majority directors in a minority role on other boards can enhance the influence of minority directors on the focal board. Third Minority directors are more influential if they have direct or indirect social network ties to majority directors through common memberships on other boards.

In a study of Norwegian corporate boards, Nielsen and Huse (2010b) found that it is not the mere presence of women on corporate boards (the number or ratio of women directors) but the directors' characteristics (e.g. diverse professional experiences and values) that women bring to the boardroom that influence board decision making. Hence, it is not the gender per se but rather the unique resources individual women directors bring along which help them exercise their influence on the work of corporate boards. Taken together, these results suggest that future research needs to consider corporate directors as 'bundles of attributes' (Carpenter et al., 2004) and explore the effects of multiple diversity dimensions simultaneously or else the results of board diversity studies may be incomplete or misleading. To improve our understanding of the complex ways in which board diversity influences it is not sufficient to assess board members' gender, occupation, etc.; rather, it is necessary to also consider the influence of their underlying values as well as their prior experiences.

The role of context as a moderator of board diversity effects

Joshi and Roh (2009) note that current theoretical perspectives framing diversity appear to be insufficient for resolving the inconsistent results regarding the consequences of diversity. They suggest that contextual considerations are pertinent for reconciling the mixed findings from past research and can contribute to the theoretical and empirical developments in the diversity field. For instance, diversity research often relies on an assumption that all diversity aspects are considered equally important; however, certain characteristics can be more or less salient, depending on the context (Krammer, 1991). Furthermore, the consequences of diversity are shaped not only by the individuals involved but also by the broader social context such as organizational and national context (Nkomo & Cox, 1999). Organizations can create a climate that accepts and fosters diversity. Similarly, decision makers at the national level can implement policies and practices that reduce the negative attitudes towards diversity. Based on this criticism of the individual approach to understanding diversity, attention is increasingly being paid to the different layers of context in which diversity is embedded, and the influence that factors at individual, group, organizational and societal levels may exert on the consequences of diversity (Jackson et al., 2003).

Board research is inherently multilevel in nature as it involves individuals, teams, organizations and their environments. Individuals interact and exchange inputs to contribute to decision making at the team level, which influences both board- and firm-level performance. However, prior TMT and board research has largely ignored the role of different levels of context and has been criticized for its de-contextualization (Carpenter, 2002; Keck, 1997). Context can set specific constraints and opportunities that either enhance or minimize the effects of team diversity on performance and, as a consequence, different-level contextual factors may influence the effects of upper echelons diversity on team and organizational outcomes (Joshi & Roh, 2009). According to this view, a number of TMT studies have started to explore moderators of the diversity–performance relationship at different levels of analysis.

The most often studied level of analysis is the environmental context, which has been shown to play an important role in shaping the effects of TMT and board diversity. Managerial and firm actions are constrained by the environments in which firms operate, such as industry settings and institutional context. Nielsen (2010) reports that increasing numbers of studies model interaction effects between TMT diversity and environmental and organizational context, showing a rising awareness of contextual influences on the consequences of diversity. Carpenter et al. (2004) noted that results of empirical studies are typically consistent as to the moderating effects of environmental characteristics defined at industry level. Keck (1997) found evidence that short-tenured diverse TMTs are better performing in unstable (uncertain) environments, whereas long-tenured homogeneous TMTs are likely to be more successful in stable environments with low uncertainty. Finkelstein et al. (2009) similarly note that in high-turbulence environments, diversity in top managers' backgrounds is more important compared to stable environments as it promotes rigorous strategy formulation and evaluation of all viable alternatives. This reasoning was supported in a number of empirical studies (Eisenhardt & Schoonhoven, 1990; Hambrick, Cho & Chen, 1996; Lant, Milliken & Barta, 1992; Pegels, Song & Yang, 2000). Hence, the link between TMT diversity and firm performance is believed to be stronger in unstable industry environments characterized with high uncertainty compared to stable industry contexts. By the same token, a recent study of corporate boards showed firms operating in complex environments do generate positive and significant abnormal returns when they have high gender diversity (Francouer, Labelle & Sinclair-Dessagne, 2008).

Several studies investigate the simultaneous moderating effects of multiple levels of analysis. For instance, Carpenter (2002) found that the effects of TMT task-oriented diversity on performance are moderated by both internal (team) and external (environmental) context. Cannella, Park and Lee (2008) provided evidence that TMT task-related (functional) diversity has stronger positive effects on firm performance when TMT members work at the same physical location and in highly uncertain industries.

Board studies have typically focused on moderators at the team or individual level. Building on stereotype threat theory (Steele, 1997; Steele & Aronson, 1995), Nielsen & Huse (2010b) found the perception of women directors as non-equal board members to be an important moderator. Their results show that inequality perception can significantly reduce the potential for women to contribute to board decision making, regardless of the diversity in values women may bring to the boardroom. The fear that one's behavior will confirm an existing gender stereotype can adversely affect performance and this study provided evidence that when made salient in the context of corporate boards, gender stereotypes may limit the potential for women to exert influence and make a contribution to the work of boards.

Another potential moderator of the board diversity–performance relationship is the CEO power over the board. Prior research fails to recognize the special role of the CEO as a leader for the consequences of diversity. Jackson (1992) points at the paradox that upper echelons theory, which argues the strong impact of leaders on their organizations, ignores the role of the CEO as the leader of the TMT. The degree to which the board is able to influence firm-level outcomes is largely dependent on the power of the CEO (McNulty & Pettigrew, 1999), who as a group leader has the 'potential to neutralize both beneficial and debilitating composition effects' (Jackson, 1992: 371).

Furthermore, Peterson et al. (2003) found that CEO personality has important effects on TMT dynamics and organizational performance.

CONCLUSION

This review identified three important directions for future research that can help advance our understanding of the consequences of diversity in corporate boards. The first important issue that deserves further attention in future research is the conceptualization of the diversity construct. As noted above, future studies need to distinguish between different types of diversity, as not all diversity aspects have the same consequences for team decision making and corporate performance. At the same time, researchers need to consider that the effects of the various diversity dimensions may not be independent from each other. While a large number of diversity attributes have been explored in the literature, their effects have been scrutinized in an isolated manner. Recent advances in group diversity research (Jackson & Joshi, 2004), considering interaction effects among diversity dimensions, can help shed some new light on the relationship between board diversity and team and organizational performance. The fact that important interactions between different diversity dimensions have been omitted in prior research may help explain the inconclusive findings of prior board diversity research. If the effect of a certain type of diversity (e.g. gender) is highly dependent on the degree of other types of diversity (e.g. cognitive diversity or occupational diversity), studies of single board diversity attributes will not provide adequate results. Recent advances in the literature suggest for instance that it is not the gender of women directors per se, but the diversity in their values, that has a positive impact on board decision making and strategic involvement (Nielsen & Huse, 2010b). At the same time, the study findings suggested that diversity in women directors' prior professional experiences has a negative effect on the same board outcomes. Hence, it is important not only to appoint women but also to understand how their profiles of personal and professional characteristics interact with other aspects of board composition. Furthermore, diversity may interact with other aspects of board composition that have important implications for board effectiveness, such as board independence. Future research may explore the cumulative effects of diversity and independence in determining the optimal design for board decision making and effectiveness.

Moreover, the distinction between diversity as variety, separation and disparity (Harrison & Klein, 2007) can advance our theoretical and empirical understanding of the consequences of board diversity. For instance, an exploration of how faultlines emerge in boards and influence team dynamics and decision making may help to better explain the effects of board task- and relations-oriented diversity. At the same time, pay disparity and power differentials (diversity as disparity), and their independent and interactive effects with diversity as variety, can help explain contradictory findings of previous studies on board diversity. Whereas the effects of diversity as variety on firm strategy and performance may be positive when disparity in boards is low, high disparity may cause some of the anticipated negative consequences of diversity, thereby leading to difficulties in making strategic decisions and exercising control over management, resulting in lower firm performance. Thus, future research needs to not only consider the differential effects of the three types of diversity but also their possible interaction effects.

Second, future research needs to further explore intervening variables that mediate the relationship between board diversity and firm performance. As evidenced by recent studies that measure directly team processes and effectiveness, understanding about the way boards work and perform their vital tasks can help explain how board composition relates to firm performance. Several studies have provided evidence that board processes can help explain why certain boards perform their tasks better than others (Ingley & van der Walt, 2005; van Ees, van der Laan & Postma, 2008; Wan & Ong, 2005; Zona & Zattoni, 2007). In addition, some recent works have linked board process not only to board effectiveness but also to firm financial performance (Minichilli et al., 2011; Nielsen et al., 2008). This line of work indicates that a combination of primary survey data with secondary financial data may help us better investigate the mechanisms through which board composition affects firm performance.

Finally, multilevel issues are pertinent to address in future board diversity studies. One of the most critical questions is the individual vs team level of analysis, or how individuals come together to make team-level decisions (Cannella & Holcomb, 2005). This question raises the need for further investigation of board processes as well as of the role of the CEO as an important actor in the TMT–board relationship dynamics. Besides team, organizational and industry contexts, the country level of analysis needs to be more clearly integrated in board diversity research. Novel work by Crossland and Hambrick (2007) proposed that national systems may influence the extent to which CEOs affect firm-level outcomes. A recent study by Minichilli et al. (2011) further demonstrated that the impact of board processes on board effectiveness differs within different country settings. This line of work can be extended to research on board composition in order to explore the extent to which the consequences of diversity on board processes, effectiveness and firm performance may differ with different national settings. Institutional theory (North, 1990) can help inform future inquires about the source of differences in the effects of board composition across national contexts. In addition, multilevel design and methodologies can be utilized to understand the relative importance and influence of factors at different levels of analysis and analyze data with a complex nested structure.

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PART 5

Competing Governance Regimes

16

Global Convergence in Corporate Governance? What a Difference 10 Years Make

Douglas M. Branson

INTRODUCTION

In the waning days of the previous century, the elites in corporate governance scholarship, at least the American ones, began to posit a worldwide movement toward a single governance model. Moreover, those elites concluded that the point of convergence would be the United States model. One noteworthy exposition was a 1999 article by a professor at Harvard University School of Law and a professor at Yale University School of Law entitled *The End of History for Corporate Law*,[1] which another elite (from Columbia University) termed 'boldly argued,' 'stating a strong convergence position.'[2] No need any longer existed for law reform, research, or factual inquiry: the US shareholder centric model with shareholder value as its predominant goal had not only vanquished its competitors but also had achieved near perfection. In only a very few years, this US model would dominate around the world.

Arguing from other ivory towers, scholars accepted the convergence thesis but quibbled. Some thought convergence would be near complete (form as well as function) while others solemnly agreed that convergence would occur but more along the lines of function (for example, a broad field of play for takeover defenses) rather than similarity of discrete legal rules.[3]

These convergence advocates ignored naysayers. Those scholars who questioned whether convergence would be as complete or as universal as advocates predicted, or who questioned whether certain impediments might stand in the path of convergence, were ignored, not cited in the convergence scholars' works. The neglect of all contrary writing and reasoning took place, despite the existence of a considerable number of opposing views, opining that complete convergence was unlikely and, to the extent convergence did occur, the focal point might very well not be the US model and its variants but along various lines.[4]

In this chapter, I wish to make establish several points:

- Convergence or the possibility thereof exists, as the Internet, email, jet travel, and global attitudes shrink the corporate governance world.
- The US model, however, with shareholder wealth maximization as its goal, has gone by the wayside. Enron, WorldCom, Adelphia, Tyco, Parmalat and similar cases which became household names first called the model into question. The worldwide 2008–2009 financial meltdown demonstrated further that a shareholder wealth maximization mantra leads to moral hazard and greed, resulting in nearly unlimited systemic risk for which all of us bear the burdens but only the few benefit.[5]
- Risk management, limitation of risk, and sustainability are the new watchwords (goals), which supplant the shareholder wealth maximization that the convergence advocates once framed as eternal.
- Max Weber in his *The Protestant Ethic and the Spirit of Capitalism* made the error of projecting his findings from Germany and the United Kingdom onto the entire world.[6] One hundred years later the convergence elites persist in the same error, projecting onto all peoples and all economies lessons the convergence advocates recognize as universal truths, based upon observations of a small and unrepresentative sample of nations (Germany, Great Britain, the United States and, perhaps, Japan).[7]
- Economic efficiency is not the only talisman, as convergence advocates assert ('The fundamental force is efficiency. If there is one efficient corporate governance mechanism, competitive pressures push firms around the world toward that structure').[8] Cultural and political differences will always act as culverts which shoot various countries and their economies off in different directions. Corporate governance in the Muslim world will not always succumb to efficiency. The same may be said of Pacific Rim countries in which the overseas Chinese and familial and extended familial considerations dominate economic sectors, as well as in civil as opposed to common law countries.

Seismic economic shifts have taken place over the last 10 years. More than any other development, those shifts put paid to the convergence advocates and their strong form analyses, if they ever did contain a kernel of truth.

Moderate convergence views do find support in reality but in a patchwork rather than the uniform pattern the elites predicted. Certain nation-states' efforts at reform and modernization of governance, though, result in faux rather than real change, moderate or otherwise, further confusing the picture and making what convergence appears to exist less extensive than it really is. Last of all, cultural and similar obstacles always will block any path toward universal convergence, strong or moderate, in entire sectors of the world.

WHAT IS GLOBAL CONVERGENCE?

Simply put, convergence is what results when the world goes through a phase of dramatic shrinkage. In the course of history, true convergence occurs infrequently. For example, for 2,000 years, a traveler from point A to point B was limited in the speed of her travel by the speed of a horse. A carriage may have been faster than a wagon, and a rider on horseback the fastest of all, but, overall, the limiting factor was the capability of a fast horse. Then, in the late 18th century, the Scot James Watt invented the steam engine, in the 1830s, railroads proliferated, and in 1844 the American Samuel Morse invented the telegraph. Very quickly the world became 10 times smaller than it had been. A traveler could get to point B 10 times faster. News and other information could reach its destination almost instantaneously.

In our times, mostly due to the information revolution, the world has again become much smaller, and on an international basis as well. I can email colleagues in Germany, Italy or France, or Australia or Hong Kong in the other direction, receiving a reply in a few hours rather than 10 days. I can refresh my memory on the OECD (Organization for Economic Co-operation and Development) Corporate Governance Code simply by using my web browser and the Internet. If a conference in the Netherlands, or Poland, or New Zealand appeals to me, I can register for it, traveling there far more readily than 20 years ago and more cheaply as well.

Global convergence has had its undoubted effects upon corporate governance. Scholars in Singapore or Kuala Lumpur know about the Cadbury Codes in the UK[9] as well as the America Law Institute's *Principles of Corporate Governance and Structure* in the USA.[10] Governance experts in Scandinavia know about the Australian Institute of Company Directors Corporate Governance Code as well as about the *Vienot Report* in France.[11] Or those scholars know who they might ask or where they might go (the Internet) to access the desired information. At the company level, boards of directors, or at least those directors on the governance committee, feel pressure to explore and perhaps adopt devices, structures, and practices from a global array of what might be best practices. Alternatively, the experts who advise those boards or board committees are 'plugged in' globally, having a sense of where to go to 'get up to speed.'

TAKING CONVERGENCE TO LOGICAL BUT NONSENSICAL EXTREMES

The Americanocentric convergence thesis contends that the tendency or trend toward some sorts of convergence just outlined has resulted in the supreme, and platonic, form of corporate governance. Logic and competitive pressures have combined, or will combine, to dictate that corporations adopt the shareholder-oriented model, which will come to dominate around the globe. The model includes, among its ingredients, boards composed of independent directors, board committees such as audit and governance committees, shareholders derivative actions, and a robust market for corporate control with a relatively large field of play for takeover bids.

The evidence for such convergence was always scanty, based largely upon its suitability for Germany, or the UK, or the USA. Thus,

> [r]ecent years … have bought strong evidence of a growing consensus on [convergence] issues among academic, business and governmental elites in leading jurisdictions.[12]

Continuing,

> [a]t the beginning of the twenty-first century we are witnessing rapid convergence on the standard shareholder-oriented model as a normative view of corporate structure and governance. [W]e should also expect this normative convergence to produce substantial convergence in the practices of corporate governance ….[13]

In the international products and financial markets, according to the authors,

> [i]t is now widely thought that firms organized and operated according to the shareholder-oriented model have had the upper hand.[14]
>
> [N]o important competitors [for example, labor-oriented, stakeholder, communitarian, team production, family capitalism models] to the standard model of corporate governance remains persuasive today.[15]

Globally then, according to the strong form thesis, in the 21st century we will witness the American model's dominance, with the

> appointment of larger numbers of independent directors, reduction in board size, development of powerful committees dominated by outsiders (such as audit committees, compensation committees, and nominating committees), closer links between management compensation and the value of the firm's securities, and strong communication between board members and institutional investors.[16]

Thus, we are told, in Asia or South America, or the former Russian republics, as well as in the European Union (EU), only one way – the American way – will emerge:

> [T]he triumph of the shareholder-oriented model of the corporation is now assured …. [T]he standard model earned its position as the dominant model of the large corporation … by out-competing during the post World-War II period all alternative models of corporate governance …[17]

RESERVATIONS AND DOUBTS ABOUT THE STRONG FORM CONVERGENCE THESIS

Hansmann, Kraakman, and their imitators predicted universal and lasting US governance supremacy on the eve of Enron, WorldCom, Tyco, Adelphia, and others, spectacular demises all. Those abject failures of the shareholder-oriented governance model demonstrated that the model composed of boards of independent directors and powerful board committees was an ineffectual if not a bankrupt one. The strong form convergence model's license for pursuit of self-interest led to greed and inordinate risk-taking. Corporate managers were entitled to much of the upside potential but shareholders, employees and the society at large bore the risk of any downside, resulting in a classic moral hazard for corporate managers.

Indeed, in the USA, emphasis has shifted away from the shareholder-oriented model to a sustainability model which dwells on restoring the effectiveness of the gatekeepers such as auditors, rating agencies, attorneys, the Securities and Exchange Commission (SEC), and others in containing risk.[18] Inordinate reliance, or, much reliance at all, on independent directors and board committees (the shareholder-oriented model) has been thought by some to have been a principal cause of the moral hazards, which, again, consisted of the excessive risk-taking, and outlandish greed (US executive remuneration, for instance) that led to the economic catastrophe of 2008–2009.

Not only is it outmoded, culturally, the shareholder model, which relies on rugged individualism among directors, who will not blink in removing an ineffectual chief executive officer (CEO), and among activist shareholders, who will file derivative actions or commence hostile takeover bids, would not fit at all in many societies, either in the past or today. For example, in the Asian economic crisis of 1998–99, 38 banks failed in Indonesia, the world's fourth most populous nation, resulting in losses of over US$90 billion. Existent Indonesian corporate law provided for shareholder derivative actions. Yet not a single suit was filed, in a set of circumstance that would have produced score after score of lawsuits in the United States.[19]

In Indonesia, and around the Pacific Rim, the social order takes precedence over the economic one if, indeed, a separate economic order can be deemed to exist, as will be seen more fully.[20] Matters economic are subsumed in and subservient to the social order. So-called post-Confucian values dominate, at least among the overseas Chinese, who have inordinate power and control over economic matters in many countries.

Strong form convergence ideas by and large have little practical application today.

RESERVATIONS ABOUT GLOBALIZATION GENERALLY

The so-called G-7 (now G-8) and World Trade Organization (WTO) held a joint annual meeting in Seattle, Washington, USA, in 1999. Seattle, a placid city on the Puget Sound, close to the Pacific Ocean and surrounded by snow-capped mountains, seemed an ideal showcase for the United Sates to host leading nations' heads of government and the finance ministers. The city and its port were focal points for Pacific Rim trade.

Instead of an orderly, restrained episode, however, the meeting became a lightning rod for long dormant forms of opposition to globalization. Labor union members demonstrated, clamoring for increased emphasis on safety and fundamental worker protection in trade treaties and with the World Trade Organization. Environmental activists were also present in great numbers, urging the insertion of green provisions in trade treaties, evincing concerns for clean air and water. Most visible of all were the anarchists. Groups such as the Black Clad Messengers broke windows and defaced buildings, causing millions of dollars in damages. Curiously, they wreaked havoc on the properties of multinational corporations such as McDonald's and Starbucks. They left local businesses untouched.[21] Seattle city officials had to call in thousands of armed troops and police officers from other jurisdictions in order to quell the demonstrations.

Further protests against globalization greeted foreign ministers and representatives attending the 2000 annual meetings of the World Bank and the International Monetary Fund (IMF).[22] Since that time, the time of the Battle in Seattle, as it is called, virtually every meeting of the G-8, the G-20, the World Bank, the IMF, or the WTO has faced the prospects of protests against globalization. Particular concerns of trade unionists and workers aside, and the concerns of environmental activists aside as well, what motivates these protests and forms the underlay beneath the not-inconsiderable obstacles to global convergence in governance?

EMBEDDED CAPITALISM

Globalization advocates hold as a universal a view of economies as freestanding mechanisms, with profit maximization as each firm's primary and one of the nation-state's principal goals, with the society apart from and perhaps subservient to the economy. That mindset, heavily imbued with laissez faire, traces its roots to the writings of John Stuart Mill, Adam Smith, Karl Marx, and Max Weber, who, as had been seen, mistook the tendencies of 19th-century English and a few other markets to be universal.[23]

Yet, outside the former British Empire, and to an extent within in, the world's economies are perceived as serving the society as a whole. Citizens and leaders perceive the economy as but an element of the larger society. The view is that for most capitalistic countries the proper form of capitalism is 'embedded capitalism.'[24] Anti-convergence protesters and other opponents see the overtures toward globalization as an attempt to reverse this. The WTO and the organizations seek unilaterally to impose (cram down) the Anglo-American view of the proper social order, or hierarchy.

Welfare economists believe that the natural state of things consists of a constrained, regulated capitalism rather than unfettered market capitalism. Such a constrained economy is the inevitable result of the interplay of capitalism with democracy. Through politics, the majority ('the have nots') will elect representatives who promise to brake or temper the Darwinian 'survival of the fittest' emerging from any unfettered market system and limit at least runaway economic success by the most fortunate ('the haves').[25] In fact, relatively unfettered markets have existed in only two eras: Victorian times and the Thatcher–Reagan years in the UK and the USA.[26]

THE INDIVIDUAL VERSUS THE SOCIETY

Stronger still, protesters and other of globalization's opponents simply regard the unbridled individualism of market-leaning economies to be intolerable. The economy is embedded in the social order; social cohesion, not rugged individualism, should be in the ascendancy.[27] For example, '[l]ife in a collectivist and group-dominated society means that the Chinese self is not isolated in the same sense as the Western one.'[28]

In certain cultures, firms are 'independent legal entities which are well-bounded and distinct from their environments.' By contrast, Asian business firms' 'form and operation are contingent, socially contextual phenomenon varying across cultures and historical periods.'[29]

Convergence advocates might, as Professors Kraakman and Hansmann do, point to the unparalleled economic success the United States enjoyed in the 1980s as a predictor that the US model of capitalism and governance will vanquish any rivals. But the world views US economic success, with its concomitant supremacy of the individual, as destructive of social cohesion and to be avoided rather than emulated.[30] To opinion makers in many countries, the United States' high divorce, murder and incarceration rates, categories in which the United States leads the world, [31] together with the obscene rates of executive remuneration in the United States, symbolize the abandonment of social cohesion. For much of the world, modernization and Westernization have become diverging trends or, indeed, anathema to one another.[32] Globalization efforts seem to ignore this divergence. Under the guise of progress, globalization advocates ignore the reality that many less affluent nation-states regard themselves ahead of, not behind, the United or the United Kingdom, in the march of progress.

In fact, in much of the world the belief is that by blindly emulating the United States and copying its economic theories and institutions, a sort of Gresham's Law will prevail:[33] bad capitalism (United States style) will drive out good capitalism (family capitalism, bamboo capitalism, guided capitalism).[34]

THE DETRITUS OF GLOBALIZATION SO FAR

Yet another group of critics examines what so far globalization has wrought. In theory, the expansion of trade and commerce, which globalization portends should make everyone better off. In 1777, Adam Smith coined the phrase 'division of labor.'[35] The division of labor raises productivity. Instead of raising chickens, tending vegetable and crafting wagon wheels, the wheelwright can concentrate on wagon parts, producing a great many more. In turn, the farmer can raise animals and crops, leaving wagon parts' manufacture and repair to the wheelwright.

In turn, increased productivity results in more income to spend on food, health, education, and consumer goods. Although certain persons lose their jobs as the trade patterns change, the winners gain enough to compensate the losers and still have some left over for themselves. There is a trickle down as well: unemployed find new occupations, producing the new goods and services others consume as a result of the overall increase in affluence.

The division of labor and benefits of trade supposedly are produced on a macroeconomic and, indeed, international as well as a local scale. The WTO and its predecessor, the General Agreement on Tariffs and Trade (GATT), base themselves on this principle. Break down barriers, increase trade, foster an increasingly international division of labor, and make rise dramatically the ensuing tide.

The World Bank, the IMF and the Asian Development Bank, among others, have pledged themselves to this globalization gospel. In return for the grant or loans of funds to newly emerging or industrializing nations, these powerful organizations demand letters of commitment. They insist upon wholesale privatization, financial austerity, and modernization of economic laws so as to increase direct foreign investment (DFI), domestic investment, and trade volumes. In promoting private enterprise in these ways, the IMF and others are following the so-called Washington Consensus, which sees the expansion of free-market capitalism as the route to economic development and to prosperity. In the words of *New York Times* columnist Thomas Friedman, authoritative international organizations have for last 25 years been fitting the less endowed nations with the 'golden strait jacket,'[36] strong medicine, which in the end will bring many good things.

Globalization has not worked out that way. There is little trickle down. Instead, the rich get richer and the powerful get, well, more powerful. Since 1990, the number of people living on less than US$2 per day, generally accepted as the poverty line, has increased by several hundred thousand, to three billion, one-half of the world's approximate six billion persons.[37] The gaps between rich and poor persons and between rich and poor countries have turned into chasms. Globalization has not worked for most of the world's poor and has not worked for, if not detracted from, the stability of the global economy.

WHY GLOBALIZATION HAS NOT FULFILLED ITS PROMISE

According to Noble Prize winning economist Joseph Stiglitz, the rich countries on earth have hijacked globalization. They have done so to serve their own and their wealthier citizens' selfish interests.[38] The fears of the newly industrializing and less developed nations were that by insisting upon worker protection measures and green provisions in treaties the more affluent nations, or some of them, were pursuing a globalization agenda that had, as its (not so secret) objective, keeping poorer nations and peoples 'in their place.'

The net effect of IMF, OECD, World Bank and WTO policies has been to 'benefit the few at the expense of the many, the well-off at the expense of the poor.' By Stiglitz's lights, the governments of the rich countries have pushed the less affluent nations to open their borders to computer hardware and banking services but continued to protect their own farmers and textile workers from the inexpensive food and clothing which poorer countries are capable of producing.[39] G-20 powers, consisting of the rich nations, have supported the extension of patent protection to guarantee continued high profits for Pfizer, Merck and GlaxoSmithKline, while aiding the continued deprivation of the affordable drugs which poorer governments need to fight HIV and AIDS epidemics.

International organizations aid and abet the hijack of globalization. The IMF, for example, seems to revel in its role as an enforcer of the Washington Consensus. Because countries approach the IMF principally when they are desperate for money, the IMF has extreme leverage over the poorer nations. As has been seen, the IMF uses this leverage, which is directed exclusively at the poorer nations, to force governments to corporatize and privatize agencies and ministries, reduce or eliminate budget deficits, and raise taxes. IMF representatives seem

> oblivious of the human suffering they cause.[40]
>
> Modern high-tech warfare is designed to remove physical contact: dropping bombs from 50,000 feet ensures that one does not 'feel' what one does. … Modern economic management [such as that by the IMF or the WTO] is similar: from one's luxury hotel, one can callously impose policies about which one would think twice if one knew the people whose lives one was destroying.[41]

The misgivings about globalization generally play a principal role in creation of the many doubts and reservations and, indeed, complete disagreement with many of the theses advanced about widespread or complete convergence in corporate governance.

MORE MODERATE, NUANCED CONVERGENCE THESES

Backdoor convergence

The thesis is that as foreign firms seek stock exchange listings in the United States, they will sign listing agreements with the exchanges (the New York Stock Exchange, or NYSE, for example). Those listing agreements will obligate foreign corporations to implement a high form of US-style corporate governance. The improved share price performance of those firms, which will eventuate as a result of their gold standard governance norms, will cause certain other foreign firms to follow their lead to US shores, or to adopt US norms back home, even if strictly speaking the firms do not have to do so.

Occasionally, similar arguments are made for other fora. For instance, at least once upon a time, say, 2003–2007, firms from the People's Republic of China (PRC) floated shares over the Hong Kong rather than the Shanghai stock exchange for the signaling effect. By subjecting themselves to the British era rules, and the Hong Kong court system, Hong Kong-listed PRC firms sent a message to other regions of the world that their governance standards were high, if not state of the art.

US scholars have constructed elaborate empirical models to test the thesis that foreign firms cross-list and thereby garner reputational gains, governance improvements, and share price increases.[42]

Such research is backward looking, for several reasons. One is that foreign firms no longer seek to cross-list in the United States, because of the hassle and the cost of compliance with the 2002 Sarbanes–Oxley Act (SOX), estimated to cost an average of over US$7 million per year for a public corporation.[43] From a robust flow (70–80 firms per year in the mid 1990s on the NYSE alone) to a trickle post SOX (3–4 listings per annum).

The latter figure represents a few outliers. Infosys, the Indian information technology company, listed on the NYSE because the firm wanted to be known as ready, willing and able to subject itself to the highest of governance standards. But such an example has become an aberration.

More importantly, most firms today do not list for bonding and signaling benefits. Firms cross-list because they believe, or wish to determine if, the new host country or exchange is a place where the money might be. Historically, foreign issuers came to the US shores because that is where the money was, not because of any increased protection US law gives to minority investors, or governance regimes the stock exchanges require.[44]

Today, however, there is money in many places other than the United States – plenty of it in fact, in Dubai, Riyadh, Sydney, Singapore, Hong Kong, Frankfurt, London, and a host of other financial centers. In fact, aware of the sums available in East Asia, seven US technology firms listed shares on the Hong Kong Stock Exchange as long ago as 2000.[45]

Second, cross-listing is no longer needed to reach distant investors. With computers, the Internet, and an ever-increasing array of financial products, investors can seek out the companies rather than the other way around (companies seeking out foreign investors). An investor can purchase investment company shares, exchange traded fund (ETF) shares, or with a few telephone calls, make direct investments in distant regions or particular corporations.

Third, companies make strategic use of cross-listing, without any deep thinking about reputational gains or governance standards. An Australian firm may counterprogram, cross-listing its shares in Kuala Lumpur, where the shares might be regarded as novelties. Finding Malaysia not as hospitable as it predicted (hypothetically), the Australian firm might delist there and seek a listing in Singapore, or in Hong Kong, or in both places. Cross-listing is neither as expensive nor nearly as difficult as it was even 12–15 years ago.

Fourth, more and more we can expect stock exchanges to get out of the corporate governance business as much as they can. The reason is the demutualization taking place as major stock exchanges convert from a member-owned mutual benefit form of entity to publicly held for-profit shareholder-owned corporations.[46] In the United States, both the NYSE and NASDAQ are publicly held corporations with a profit maximization motive, as is also true of the ASX in Australia, the London Stock Exchange in the United Kingdom, Euronext exchanges in Paris, Brussels and Amsterdam, and so, all around the world.[47] Profession to strong public interest motives, and the high governance standards accompanying those motives, are rapidly disappearing from exchanges and markets.

The more muted, subtle thesis of convergence indirectly, as a byproduct of quests for investment capital, has been passed by, rendered obsolete by other developments.

Convergence but muted and blocked by 'path dependency' and rent-seeking

With 240 million inhabitants, Indonesia is the fourth largest nation on earth. Sprawling from Northern Sumatra to West Timor, the nation consists of 17,000 islands. Yet if a foreign investor wishes structure a transaction of any complexity (construct a large hotel, open an assembly plant, form and equip a subsidiary), she must go to Jakarta, the capital, located on the island of Java. In the highly centralized milieu, she must seek out one of only 12–15 attorneys who know how to structure such a complex transaction, which buttons to push, and to whom facilitating payments (grease payments, not bribes) must be paid.

These few attorneys are what economists term rent-seekers – those whose income exceeds (greatly exceeds) the income they would earn in their next highest and best use. These exclusive few may not know the term, but they do know that they are highly elite gatekeepers, constituting the eye of the needle through which all substantial investments and investors must pass. Because of the stranglehold they have, and the outsized power and income it gives them, these rent-seekers have little desire to see the system (corporate law, corporate governance, capital markets) change, or modernize in any way. The rent-seekers do not wish to see a system evolve that might be less centralized, with many more professionals able to push the right buttons and to do complex deals. In part to preserve their franchise, and in part because the government has no others knowledgeable enough to whom it can turn, the rent-seekers also have a significant control over, or in many cases, a stranglehold on legislative and regulatory reform. The rent-seekers are the movers and shakers, a group of which will populate every reform committee, spinning any outcome their way if not dominating it.

In less commercial nations especially, large (India, the People's Republic of China, Brazil) or small (Slovakia, Serbia, Nepal, or Bhutan), a similar capture of the potential for reform takes place. Convergence scholars, or a group of them, give this scenario, and other phenomena similar to it, the name of 'path dependency':

> [T]he corporate structures that an economy has at any point in time are likely to depend on those it had at earlier times.[48]

Rent-seeking and path dependency stand as roadblocks astride any path or route toward global convergence in corporate law or in corporate governance.

What might cause or would enable an observer to predict a higher degree of path dependency? Professors Lucian Bebchuk and Mark Roe attribute path dependency to patterns of ownership that tend also to replicate themselves:

> [A] country's pattern of ownership structures [family ownership exclusively, ostensibly public but with controlling shareholders or families, state owned or partly owned enterprises (SOEs)] at any point in time depends partly on the patterns it had earlier.[49]

The effect of a particular ownership pattern also will extent to the legal regime in a particular country:

> *rule-driven path dependence* arises from the effect that initial ownership structures have … on the legal rules governing corporations. …. Corporate rules themselves, we show, are path dependent.[50]

Path dependency, and the rent-seeking branch of it, have explanatory power. The legislative and regulatory reform processes in most countries do not resemble the paradigmatic processes existent in the United Kingdom, the United States, New Zealand, Australia, and larger European nation-states. Indeed, the actual processes in the latter states do not always match up well with the paradigm, often being subject to secret deals, hidden agenda, and rent-seeking. So, path dependency, including rent seeking, joins the growing objection to globalization generally, articulated by authors such as Sir John Gray and Professor Joseph Stiglitz, explaining why very little of the global convergence once predicted has come about in corporate governance.

Varying patterns of and protection for property rights as an impediment to convergence

The scope given private property rights and *ex post* the protection given those rights by courts and government agencies varies much from country to country. For example, formerly socialist states which now have adopted mixed economic systems still may not recognize private ownership of real property. In certain other formerly pure socialist states, even the concept of private personal property many have only limited recognition or protection. In still other states, property owners may be wise more to rely on bureaucratic or political rather than legal rights as the primary bulwark against arbitrarinees or expropriation.

Along these lines,

> [g]overnance diversity among [a limited sample of] the United States, Japan, and South Korea can be explained as the result of rational adaptations to the different property rights environments … seen in the three countries.[51]

Property rights, broadly defined, consist of the rules (legal, political or social) by which control over assets is allocated and enforced.

The publicly held corporation – characterized by a separation of ownership from control, widely dispersed share ownership, and a free standing board of directors – predominates among larger companies in the United States. By contrast, larger companies in Japan will be lodged in a constellation of companies, large and small, know as a *keiretsu*. Cross-ownership of significant but perhaps not majority blocks of shares greatly impedes hostile takeovers, real control resides in a council of presidents rather than a board, and lifetime employment (the iron rice bowl) is the norm. Korean corporations group themselves in a constellation known as a *chaebol*, controlled by a founding family rather than a board or council of presidents and, through its control of the banks, also controlled by the government. Differing property rights environments explain these and corporate governance differences among countless other states as well.

Property rights environments are by no means uniform. Nor are they converging. As a result, at best, based as they are on property rights milieus, 'convergence of national corporate governance systems will be slow, sporadic, and uncertain.'[52] Convergence in certain areas of governance may not occur at all. The determinants of property rights environments, ownership patterns and corporate governance structures and guiding principles will be determined by

> (1) the extent to which control rights over assets are allocated to politicians and bureaucrats rather than private economic agents; and (2) the degree to which control rights over assets are legally as opposed to politically or socially enforced.[53]

Property rights shape corporate governance. They determine what types of firms will emerge or predominate in a particular nation.

> For example, large publicly held firms with dispersed shareholders are not prevalent in insecure property rights environments. Instead, smaller firm and family corporations, some of which may be very large, control most segments of the economy.[54]

There exist still other explanations of why convergence, if it occurs, will be far less than complete and sporadic. A political–institutional thesis holds that in the United States strong corporations and relatively weak banking institutions exist. By contrast, many European nations are characterized by weak corporations and strong intermediaries, especially banks. These conditions are unlikely to change dramatically. As a result, divergence rather than convergence of corporate governance conditions has been the order of the day.[55]

A PARTIAL TAXONOMY OF CONVERGENCE OR DIVERGENCE

Off the cuff one can name several alternatives to the convergence-from-competition hypothesis so dear to the US elites in the 1990s, which posited the coming dominance of a shareholder-centric governance system and which placed shareholder wealth maximization above all else. Alternatives would include:

- A shareholders-centric governance model but with sustainability and limited, informed risk-taking rather than wealth maximization (and the unlimited outlet for greed it represented).
- A stakeholder model with various responsibilities to various corporate constituencies (employees, consumers, suppliers, local and regional economies and the environment, as well as to shareholders).[56]
- A communitarian model which emphasizes labor as the principal stakeholder occupying a hierarchal position equivalent to that of shareholders.[57]
- A 'Third Way' model, emerging most particularly in the United Kingdom:

> [Britain's] 'third way' explicitly advocates a shift in focus to the long-term,'enlightened shareholder value' and requires that companies recognize and report on their effects on extended stakeholder constituencies such as employees, suppliers, communities, and the environment.[58]

- Two-tiered governance structures, such as those required in Germany, the People's Republic of China, the Republic of Indonesia, and other countries. American elites, of course, appearing very ill-informed, evince a belief that the two-tiered board structure lives only in Germany, where, since the days of the Weimer Republic, the supervisory board of large corporations must consist of equal proportions of owner and labor representatives.[59] In turn, the supervisory board appoints a managing board, which both oversees and conducts the corporation's business on a week-to-week and month-to-month basis. Truth be told, as many as a third of developed nations' citizens inhabit countries whose statutes mandate two-tiered governance structures. While the structures may be very similar, the objectives are not. Chinese law seems to require a second tier as an additional anti-corruption device. By contrast, Indonesian corporate law seems to envision the second tier as providing for management succession as well as reduction of corrupt practices. The point may well be that just that choice, between a unitary or a two-tiered board structure, introduces a number of new focal points for partial, yet differing, types of convergence. On that score alone, the choice is not binary but hydra-headed , the key variable being not merely co-determination (labor representation), as many US academics have posited as the sole or principal objective of two-tiered board systems.

CONCLUSION

More so perhaps than any other chapter of this book, this chapter is as much backward- as forward-looking. The drumbeat for convergence in corporate governance achieved its peak volume 10 or more years ago and did so most strongly among the elites in the US corporate law academy. Even at that time, the chorus for convergence was far from universal. Since that time, the late 1990s and first few years of the new century, the assessment of prospects for convergence have been heard less and less. Some convergence will appear but it will be in fits and starts and around various focal points rather than around one particular structure or the US way of doing things. Part of the reason, of course, has been the complete meltdown of the US brand of governance in the Enron era of 2001–2002 and again in the financial crisis of 2008–2009. Strong-form 'global' convergence in corporate governance is now a historical relic, but perhaps one worth remembering.

NOTES

1 Henry Hansmann & Rainier Kraakman, The End of History for Corporate Law, 89 Geo. L. J. 489 (1999).

2 CONVERGENCE AND PERSISTENCE IN CORPORATE LAW at 6–7 (Jeffrey N. Gordon and Mark J. Roe, eds, 2004) (hereinafter cited as GORODN & ROE).

3 *See, e.g.,* Ronald Gilson, *Globalizing Corporate Governance: Convergence of Form and Function*, 49 Am. J. Comp. L. 329 (2001).

4 Douglas M. Branson, *The Very Uncertain Prospect of 'Global' Convergence in Corporate Governance*, 34 Cornell Int'l L.J. 321 (2001); Cally Jordan, *The Conundrum of Corporate Governance*, 30 Brooklyn J. Int'l L. 983 (2005).

5 William Bratton, *Enron and the Dark Side of Shareholder Value*, 75 Tulane L. Rev. 1275 (2002), first made several of these points.

6 MAX WEBER, THE PROTESTANT ETHIC AND THE SPIRIT OF CAPITALISM (1905).

7 *See, e.g., Mark J. Roe, Some Differences in Corporate Structure in Germany, Japan, and the United* States, 102 Yale L. J. 1927 (1993). *Cf.* Curtis Milhaupt, *Property Rights in Firms*, 84 Virginia L. Rev. 1145 (1998) (Korea, Japan and the United States).

8 GORDON & ROE at 27.

9 The Cadbury Code is actually an amalgam of several codes and reports, the first of which was produced under Sir Adrian Cadbury, dealing with auditor independence and the supervisory role of non-executive directors. Its latest iteration is Company Law Steering Group, Department of Trade and Industry, Modern Company Law for a Competitive Economy (1999), although the committee was convened in 1991. The Confederation of British Industry convened the Greenbury Committee to deal with executive pay. The Hampel Committee reported in 1998, recommending corporate governance structures for listed companies. The first three reports were integrated into the Combined Code in 2003. The London Stock Exchange has a 'comply or explain non-compliance' in its listing requirements. The corporate governance requirements are contained in what is known as the little yellow book. *See* Brian Cheffins, *Current Trends in Corporate Governance: Going From London to Milan to Toronto*, 10 Duke J. Comp. & Int'l L. 5, 16–18 (1999). The Turnbull Committee deals with the installation and review of internal control devices in publicly held corporations.

10 AMERICAN LAW INSITUTE, PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE (1994) (2 volumes).

11 Reviewed in James Fanto, *The Role of Corporate Law in French Corporate Governance*, 33 Cornell Int'l L. J. 31, 87 (1998).

12 Hansmann & Kraakman, *supra*, at 440.

13 *Id.* at 443.

14 *Id.* at 450.

15 *Id.* at 451.

16 *Id.* at 455.

17 *Id.* at 468.

18 *See e.g.*, JOHN C. COFFEE, JR, GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006); Douglas Branson, *Enron –When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?, 48 Villanova L. Rev. 989. 991–992 (2003);* Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 Boston U. L. Rev. 301 (2004).

19 Branson, *Uncertain Prospects, supra*, at 345–346 ('The absence of suit may in part be explained by the weakness of the Indonesian legal system but cultural factors are also at work …').

20 In 2000–2002, the author was a consultant to the Indonesian Ministry of Justice on corporate law and corporate governance reform, sponsored by the US Department of State and making four trips to Indonesia. In 2006, he was a consultant to the Asian Development Bank in Manila, the Philippines, on corporate governance.

21 For description of the G-7 and WTO meeting in Seattle, *see* Sam Verhovek & Steven Greenhouse, *National Guard Is Called to Quell Trade-Talk Protests*, NY Times, Dec. 1, 1999, at A1; Timothy Egan, *Black Masks Lead to Pointed Fingers in Seattle, id.,* Dec. 2, 1999, at A1; Sam Verhovek, *Seattle Is Stung, Angry and Chagrined As Opportunity Turns to Chaos, id.*, Dec. 2, 1999, at A16; Tom Hayden et al., *The Battle in Seattle: What Was That All About?, id.* Dec. 5, 1999, at B1.

22 *See, e.g.*, John Burgess, *Activists Aim to Halt Meeting of the World Bank and the IMF*, Int'l Herald Tribune, Jan. 27, 2000, at 17; David Sanger, *Global Storm: Loan Agencies under Siege*, NY Times, April 16, 2000, at 1; Burgess, *Globalization and Its Discontents*, Wash. Post, April 13, 2000, at A!; Helene Cooper & Michael Phillips, *Protests Hit World Bank/IMF Sessions*, Wall St. J., April 17, 2000, at A2.

23 JOHN GRAY, FALSE DAWN: THE DELUSIONS OF GLOBAL CAPITALISM 169–170 (1998).

24 *See, e.g.*, Mark Granovetter, *Economic Action and Social Structure: the Problem of Embeddedness*, 91 Am. J. Soc. 481, 481–482 (1985).

25 *See* KARL POLANYI, THE GREAT TRANSFORMATION 119 (1944) (noting that Edmund Burke and Jeremy Bentham, among others, 'refused to defer to zoological determinism … reject[ing] the ascendency of economics over politics proper').

26 Gray, *supra*, at 14–16.

27 *Id.* at 26 ('In the normal course of things markets come embedded in social life, They are circumscribed in their working by intermediary institutions [such as trade unions and professional associations] and encumbered by social conventions and tacit understandings.' & at 182 (for example, 'Chinese capitalism comes embedded in the networks and values of the larger society').

28 S. GORDON REDDING, THE SPIRIT OF CHINESE CAPITALISM at 95 (1990).

29 S. Gordon Redding & Richard D. Whitley, *Beyond Bureaucracy: Towards a Comparative Analysis of Forms of Economic Resource Co-ordination and Control* in CAPITALISM IN CONTRASTING CULTURES at 80 (S. Gordon Redding & Stewart Clegg, eds, 1990). *See also id.* at 79 ('Anglo-Saxon conceptions of the legally bounded form as the basic unit of economic action are inadequate to explain the economic actions and structures of Korean *Chaebol* and Chinese family businesses').

30 *See, e.g.*, GRAY, *supra*, at 101 & 115–116.

31 *Id. See also* Graham Searjeant, *Jails Cost More Than Corner Shops*, The Times (London), Dec. 11, 1995, at 38 ('Why do we look to America for economic and social models, from deregulation and institutional investor power to workfare schemes, if they produce this kind of society?').

32 *See* GRAY, *supra*, at 78–79.

33 Sir Thomas Gresham explained that 'bad money drives out good.' RICHARD G. LIPSEY & PETER O. STEINER, ECONOMICS at 592 (3rd edn, 1972).

34 GRAY, *supra*, at 78–79.

35 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1777).

36 THOMAS FRIEDMAN, THE LEXUS AND THE OLIVE TREE: UNDERSTANDING GLOBALIZATION (2000). *See also* FRIEDMAN, THE WORLD IS HOT, FLAT AND CROWDED (2007).

37 *See* John Cassidy, *Master of Disaster*, The New Yorker, July 15, 2002, 82, at 84.

38 In his book, GLOBALIZATION AND ITS DISCONTENTS (2002), Professor Stiglitz sets out and offers proofs of his hypothesis,

39 *See, e.g.*, Cassidy, *supra*, at 84.

40 Cassidy, *supra*, at 85.

41 STIGLITZ, *supra*.

42 A leading academic exposition is Kate Litvak, *Sarbanes-Oxley and the Cross-Listing Premium*, 105 Mich. L. Rev. 1857 (2007). *See also* John C. Coffee, Jr, *Racing Toward the Top: The Import of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 Columb. L. Rev. 1757 (2002).

43 One set of numbers records that annual compliance with SOX § 404 attestation of internal controls alone costs on average US$4.36 million for mid cap publicly held firms (market capitalization of US$5 billion). Such firm have also seen their annual auditing costs rise from US$2.9 million to $7.4 million. Douglas M. Branson, *Too Many Bells? Too Many Whistles? Corporate Governance in the Post Enron, Post World Com Era*, 58 South Carolina L. Rev. 65, at 71 & 74 (2006).

44 Historically, the money may have been there because US and UK law did give a high, or optimal, level of protection to minority shareholders, but in recent times that has evolved merely to avoidance of those jurisdictions that have little regard for the rule of law, a corrupt or non-functioning court system, and/or a lack of regard or protection for minority shareholders.

45 International Developments, *Seven NASDAQ Stocks to be Available in Hong Kong in Pilot Program*, 31 BNA Securities Reg. & L. Rep. 1654 (Dec. 20, 1999)(Microsoft, Intel, Cisco, Dell Computer, Amgen, Applied Materials and Starbucks).

46 See Roberta Karmel, *Turning Seats into Shares: Causes and Implications of the Demutualization of Stock and Futures Exchanges*, 53 Hastings L. J. 367 (2002).

47 In fact, the New York Stock Exchange has acquired Euronext, changing its name to NYSE-Euronext (trading under the symbol NYX).

48 Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 Stanford L. Rev. 127, 169 (1999).

49 *Id.* at 127.

50 *Id.* at 131.

51 Curtis J. Milhaupt, *Property Rights in Firms*, *supra*, at 1179.

52 *Id.* at 1148. *See also id.* at 1558 ('weak, limited, and episodic') (footnote omitted).

53 *Id.* at 1146.

54 More broadly yet, persistent differences in governance structures may be seen as a function of the larger sets of rules governing economic exchange that have evolved in different communities. *See, e.g.*, Harold Demsetz, *Toward a Theory of Property Rights*, 57 Am. Econ. Rev. 347 (1967).

55 This is the central thesis of MARK ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994).

56 *See, e.g.*, KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES (2006); Greenfield, *Saving the World Through Corporate Law*, 57 Emory L. J. 948 (2008); Greenfield, *There's a Forest in Those Trees: Teaching About the Role of Corporation in Society*, 34 Georgia L. Rev. 1011 (2000);

David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 Washington & Lee L. Rev. 373 (1993); Millon, *Redefining Corporate Law*, 24 Indiana L. Rev. 223 (1991).

57 *See, e.g.*, Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure*, 22 Comparative Labor Law & Policy Journal 97 (2000); O'Connor, *Reconceptualizing Corporate Law to Facilitate Labor–Management Cooperation*, 78 Cornell L. Rev/ 899 (1993).

58 Cynthia Williams & John M. Conley, *An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct*, 38 Cornell Int'l L.J. 493, 496 (2005).

59 *See, e.g.*, Thomas Andre, *Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany*, 73 Tulane L. Rev. 69 (1998); Andre, *Reflections on German Corporate Governance: A Glimpse of German Supervisory Boards*, 70 Tulane L. Rev. 477 (1996).

17

A Bundle Perspective to Comparative Corporate Governance

Ruth V. Aguilera, Kurt A. Desender and Luiz Ricardo Kabbach de Castro

INTRODUCTION

In this chapter, we seek to bring to the core of the study of comparative corporate governance analysis the idea that within countries and industries, there exist multiple configurations of firm-level characteristics and governance practices leading to effective corporate governance. In particular, we propose that configurations composed of different bundles of corporate governance practices are a useful tool to examine corporate governance models across and within countries (as well as potentially to analyze changes over time). While comparative research, identifying stylized national models of corporate governance, has been fruitful to help us think about the key institutional and shareholder rights determining governance differences and similarities across countries, we believe that given the financialization of the corporate economy, current globalization trends of investment, and rapid information technology advances, it is important to shift our conceptualization of governance models beyond the dichotomous world of common-law/outsider/shareholder-oriented system vs civil law/insider/stakeholder-oriented system. Our claim is based on the empirical observation that there exists a wide range of firms that either (1) fall in the 'wrong' corporate governance category; (2) are a hybrid of these two categories; or (3) should be placed into an entirely new category such as firms in emerging markets or state-owned firms. For example, we have firms listed on the New York Stock Exchange (NYSE) such as Nordstrom, which has a majority owner (Nordstrom family), and firms in the traditional Continental model, such as Telefónica in Spain which has dispersed ownership. This is the opposite of what the insider/outsider models would predict. To push the example further, there are firms in Japan which are concentrated, such as NTT DoMoCo, Hitachi and Nissan, and others which are dispersed, such as Sanyo Electronics or NEC Corporation. In sum, it is difficult to continue to equate firm nationality with governance model.

In addition, as Aguilera and Jackson (2003) argue, firms, regardless of their legal family constraints, their labor and product markets, and the development of the financial markets from which they can draw, have significant degrees of freedom to chose whether to implement different levels of a given corporate governance practice: i.e. firms might chose to fully endorse a practice or simply seek to comply with the minimum requirements without truly internalizing the governance practice. An illustrative example of the different degrees of internalization of governance practices is the existing variation in firms' definition of director independence or disclosure of compensation systems.

In this chapter, we first discuss the conceptual idea of configurations or bundles of corporate governance practices underscoring the concept of equifinal paths to given firm outcomes as well as the complementarity and substitution in governance practices. We then move to the practice level of analysis to show how three governance characteristics (legal systems, ownership, and boards of directors) cannot be conceptualized independently, as each of them is contingent on the strength and prevalence of other governance practices. In the last section, we illustrate how different configurations are likely to play out across industries and countries, taking as the departing practice, corporate ownership.

BUNDLES OF CORPORATE GOVERNANCE PRACTICES

Corporate governance relates to the 'structure of rights and responsibilities among the parties with a stake in the firm' (Aoki, 2001). Effective corporate governance implies mechanisms to ensure executives respect the rights and interests of company stakeholders, as well as guarantee that stakeholders act responsibly with regard to the generation, protection, and distribution of wealth invested in the firm (Aguilera, Filatotchev, Gospel & Jackson, 2008). The empirical literature on corporate governance has been mostly rooted in agency theory, assuming that by managing the principal–agency problem between shareholders and managers, firms will operate more efficiently and perform better. This stream of research identifies situations in which shareholders' and managers' interests are likely to diverge and proposes mechanisms that can mitigate managers' self-serving behavior (Shleifer & Vishny, 1997), such as the board of directors, shareholder involvement, information disclosure, auditing, the market for corporate control, executive pay, and stakeholder involvement (Filatotchev, Toms & Wright, 2006). Despite the large body of research, the empirical findings on the link between governance practices and firm outcomes (e.g., firm performance) continues to be mixed and inconclusive (Dalton, Daily, Ellstrand & Johnson 1998; Dalton, Hitt, Certo & Dalton, 2007).

Within this stream of work, the influence of board independence on firm performance has been of great interest (Dalton et al., 2007, Finkelstein & Hambrick, 1996, Johnson, Daily & Ellstrand, 1996). However, empirical research from an agency perspective is equivocal as neither Dalton et al.'s (1998) meta-analysis nor Dalton et al.'s (2007) literature review offer support for this relationship or agency prescriptions in general. Likewise, neither the joint nor separate board leadership structures have been found to universally enhance firm financial performance (Beatty & Zajac, 1994; Dalton et al., 1998, 2007) nor has support been found for the hypothesized relationship between share ownership by large blockholders and performance measures (Dalton, Daily, Certo & Roengpitya, 2003). The ambiguity regarding empirical evidence also applies to other areas of corporate governance research (Filatotchev et al., 2006), such as executive pay (Bebchuk & Fried, 2004) or the market for corporate control (Datta, Pinches & Narayanan, 1992; King, Dalton, Daily & Covin, 2004).

The weak interrelationships between 'good' corporate governance and firm performance cast doubt on several premises of agency research and suggest a need to reorient corporate governance research frameworks. Filatotchev (2008) argues that one reason for the mixed empirical results related to the effectiveness of various governance mechanisms may be the neglect of patterned variations in corporate governance contingent to the contexts of different organizational environments. Likewise, Aguilera and Jackson (2003) posit that the 'under-contextualized' approach of agency theory remains restricted to two actors (managers and shareholders) and abstracts away from other aspects of the organizational context that impact agency problems, such as diverse task environments, the life cycle of organizations, or the institutional context of corporate governance.

A growing literature has sought to develop a configurational approach to corporate governance by identifying distinct, internally consistent sets of firms and the relations to their environments, rather than one universal set of relationships that hold across all organizations, and by exploring how corporate governance mechanisms interact and substitute or complement each other as related 'bundles' of practices. The theory of complementarity provides the basis to understand how various elements of strategy, structure, and processes of an organization are interrelated (Aoki, 2001; Milgrom & Roberts, 1990, 1995). The concept of complementarity offers a rigorous explanation to the synergistic effects among activities. Two activities are complementary when the adoption of one increases the marginal returns of the other and vice versa (Cassiman & Veugelers, 2006). This configurational logic is also fairly well-devloped within the field of Human Resource Management (HRM), and in particular in efforts to predict what combinations of HRM practices lead to high work performance systems (Delery & Doty, 1996; Huselid, 1995; Lepak, Liao, Chung & Harden, 2006; MacDuffie, 1995).

Within the context of strategic and governance research, Rediker and Seth (1995) introduced the concept of a 'bundle of governance mechanisms' under the rubric of a cost–benefit analysis. They propose that firm performance is dependent on the effectiveness of the bundle of governance mechanisms rather than the effectiveness of any one mechanism. Additionally, they argue that even though the overall bundle is effective in aligning manager–shareholder interests, the impact of any one mechanism may be insufficient to achieve such alignment. For example, the effectiveness of board independence is likely to increase in the presence of other corporate governance elements such as the existence of board committees, which structure and enhance the influence of independent directors within the board. Likewise, independent directors are argued to play an important role in setting executive pay and assuring appropriate incentive alignment between executives and shareholder interests. At a broader institutional level, the factual independence of directors is enhanced by the existence of comparatively strong legal protection of shareholder rights. In short, this approach helps explain why no one best way exists to achieve effective corporate governance. Rather, corporate governance arrangements are diverse and exhibit patterned variation across firms and their environments.

In general, when one mechanism acts as a substitute for another mechanism, this refers to the direct functional replacement of the first mechanism by the second. An increase in the second mechanism directly replaces a portion of the first mechanism, while the overall functionality of the system remains constant. Rediker and Seth (1995) empirically examine the substitution effects between board monitoring, monitoring by outside shareholders, and managerial incentive alignment. If managerial incentives are aligned with shareholder interests such that acting in the best interest of shareholders is also in the best interests of the managers, then the need for the board to monitor the actions of management on behalf of shareholders is reduced and the governance mechanisms are substitutable. Similarly, if board monitoring is comprehensive and the board actively sanctions management when management is not acting in shareholder interests, then the alignment of managerial incentives to shareholder interests may be less necessary. Indeed, Zajac and Westphal (1994) find that the use of long-term incentive plans for chief executive officers (CEOs) are negatively related to the monitoring processes in place; firms that have stronger incentive alignment tended to have weaker monitoring mechanisms and vice versa. In this way, monitoring and incentive alignment act as substitutes for one another to provide a general level of governance effectiveness in controlling for agency issues. In addition, Desender et al. (2011) demonstrate that ownership concentration and board composition become substitutes when it comes to monitoring management. They uncovered that while the board of directors complements its monitoring role through the higher use of external audit services when ownership is dispersed, this is not the case when ownership is concentrated.

However, Ward et al. (2009) propose that in some circumstances, instead of acting as substitutes, monitoring and incentive alignment may act as complements to one another, where the presence or addition of one mechanism strengthens the other and leads to more effective governance in addressing agency problems. For instance, Rutherford and Buchholtz (2007) empirically examine the complementarity of board monitoring and CEO incentive systems and find that CEO stock options complemented boards that monitor through frequent, formal meetings. Independent and active boards can also be functional in prohibiting managers from repricing stock options in the face of poor performance, or modifying performance targets or metrics that trigger incentive compensation. In this way, the addition of monitoring facilitates the improvement of incentive alignment, avoiding moral hazard issues, even when the incentive structure itself does not change.

In applying complementarities to corporate governance, various works have stressed that the simultaneous operation of several corporate governance mechanisms is important in limiting managerial opportunism (Hoskisson, Hitt, Johnson & Grossman, 2002, Rediker & Seth, 1995; Walsh & Seward, 1990). For example, Anglo-American or shareholder-oriented corporate governance systems are based on broad interdependencies between performance incentives within executive remuneration, board independence, and the market for corporate control. These corporate governance mechanisms serve to align incentives within and outside the organization, and to make corporate governance more effective in environments of dispersed ownership. Yet, even these interdependent mechanisms of corporate governance would remain quite ineffective without further complementary mechanisms, such as high information disclosure to investors, which allows the market to price shares accurately, and a rigorous system of auditing to assure the quality of information disclosed (Aguilera et al., 2008).

Elements common in Anglo-American corporate governance systems often remain absent in other countries, where other corporate governance mechanisms may effectively substitute and display different sets of complementarities. Where one specific mechanism is used less, others may be used more, resulting in equally good performance (Agrawal & Knoeber, 1996; Garcia-Castro, Aguilera & Ariño, 2011). For example, in German and Japanese corporate governance, monitoring by relationship-oriented banks may effectively substitute for an active market for corporate control (Aoki, 1994). Jensen (1986) also suggests that when the market for corporate control is less efficient, the governance effects of debt holders may play a particularly important role in restraining managerial discretion. The long-term nature of bank–firm relationships may also display critical complementarities with a more active role of stakeholders, such as employees, as employees' investments in firm-specific capital are protected from 'breaches of trust' (Aoki, 2001) and employee voice helps to make managers more accountable internally by more thoroughly justifying and negotiating key strategic decisions (Streeck, 1987).

The number of potential combinations of corporate governance practices, and hence their complementarities, is extensive. These configurations remain to be systematically theorized and investigated empirically. Moreover, a particular corporate governance mechanism, such as the market for corporate control or independent board members, may have opposite effects in different institutional contexts. Whereas the market for corporate control may help exert discipline in the context of dispersed ownership and high transparency, the same may undermine the effective participation of stakeholders. At the level of institutions, corporate governance practices embodying conflicting principles may also allow for more heterogeneous combinations of corporate governance characteristics and maintain requisite flexibility for future adaptation in a population of firms (Stark, 2001).

Building on strategic governance and institutional analysis, a number of recent studies develop a conceptual framework for better understanding the influence of organization–environment interdependencies on the effectiveness of corporate governance in terms of firms' contingencies, complementarities between governance practices, and potential costs of corporate governance (e.g., Aguilera et al., 2008; Filatotchev et al., 2006).

This research proposes that effective corporate governance depends upon the alignment of interdependent organizational and environmental characteristics and helps to explain why, despite some universal principles, no 'one best way' exists. Rather, the notion of corporate governance as a system of interrelated firm elements having strategic or institutional complementarities suggests that particular practices will be effective only in certain combinations and, furthermore, they may grant different patterns of corporate governance (Aguilera et al., 2008; Garcia-Castro et al., 2011). This research sustains that corporate governance recommendations and policymaking will be more effective if they take into account the potential diversity of governance mechanisms, which deal with important firm-level contingencies.

In the next sections, we discuss how three different governance practices – legal pressures, ownership structure and board practice – are defined in the context of other governance mechanisms.

LEGAL ENVIRONMENT

Inevitably, corporate law and regulation in every country deal with different kinds of corporate governance challenges starting from the classic potential conflict of interests between the managers and shareholders, extending to the opportunism of controlling shareholders against minority shareholders, to the tensions between shareholders and managers with other corporate constituents such as employees or debt-holders (Aguilera & Jackson, 2003; Davies, Hertig & Hopt, 2004). In this regard, rather than addressing actor–actor conflicts in isolation, different configurations of bundles of corporate governance mechanisms explore the interactions among the multiple firm actors (i.e., shareholders, managers, employees, state, suppliers, etc.), their respective interests and constraints, and the associated legal tradeoffs to become effective members of the intra-firm relationships. In this section, we first discuss how different legal jurisdictions impose a diverse sort of constraints (or enablers) to reduce (or to enhance) the opportunism among the multiple constituencies of the firm. Second, we comment on the emerging issue of new governance or the existing debate between soft law and hard law.

Legal strategies and legal families

The baseline regulatory paradigm constrains corporate actors by requiring them not to take particular actions, or engage in transactions, that could harm the interests of other stakeholders. Lawmakers can establish such constraints as *rules* (*i.e., laws), which* relates to prohibiting some kind of behavior, *ex ante,* or *standards* (*i.e., soft law*)*, which* leaves the compliance determination to the courts, *ex post (i.e., jurisprudence)* (Kraakman, Davies, Hansmann et al., 2004). In most countries, corporate governance practices fall in the domain of mandatory corporate and stock exchange law, as well as a set of self-regulation initiatives (*standards*) such as codes of corporate governance (Aguilera & Cuervo-Cazurra, 2009; Hopt, 2011).

In general, the rule strategy is more common in Continental Europe, while in the United States and the United Kingdom jurisprudence is preferred to rules. Kraakman, Armour, Davies, Henriques, Hansmann, Hertig, Hopt, Kanda and Rock (2009) propose two main hypotheses to explain this sharp division. First, they draw on the traditional legal origin dichotomy between common and civil law. In civil law countries such as France or Spain, judges follow and enforce strict and clearly defined rules. Second, the implementation of *rule* strategies in corporate governance has its roots in capital markets history.

However, when it turns to corporate governance regulation, influenced by the United Kingdom, there is a convergence towards the use of codes of corporate governance in Continental European countries (Aguilera & Cuervo-Cazurra, 2004, 2009; Kabbach-Castro & Crespí-Cladera, 2011). In fact, on February 22, 2006, the European Union (EU) Corporate Governance Forum strongly endorsed the view that national corporate governance codes should be implemented under the 'comply or explain' principle as proposed by the UK Cadbury's Report (IFC 2008).

The law and finance literature focuses on the importance of law (i.e., rules and standards) and its enforcement to protect the property rights, particularly, minority shareholder rights (La Porta et al., 1998; Shleifer & Vishny, 1997). The main argument is that the protection of investors' rights, which is granted by the origin of the legal system (civil or common law), is a central determinant of investor willingness to finance firms (La Porta et al., 1998, 1999). It follows that, in countries with strong shareholder protection, investors are more willing to take minority positions rather than controlling the firm. On the contrary, where shareholder rights are not well protected, investors will compensate for this deficiency by taking controlling positions in a firm (Shleifer & Vishny, 1997). Then, the supply of finance through minority shareholders is constrained by the extent of their protection under the law or other kind of financial regulation (Milhaupt & Pistor, 2008). And, ultimately, it is argued that the quality of property rights' protection determines economic outcomes in those countries. For example, La Porta et al. (1998) claim that a 1.6-point increase in the shareholder rights measure, roughly the distance between the American common law legal origin and French civil law averages, reduces ownership concentration by five percentage points.

La Porta et al. (1998), and subsequent work, has placed research on legal families at the core of the corporate governance discussion.[1] These studies have had a large impact on public policy and scholarship and have also triggered an extensive debate on the role of law in corporate governance (Aguilera & Jackson, 2010). However, scholars are critical of their core arguments (Aguilera & Williams, 2009), in part because their assumptions are believed to be too narrow and do not hold for recently important economic success stories such as China, whose remarkable economic growth is not tied to the common law system as an 'ideal rule-of-law' (Milhaupt & Pistor, 2008). In fact, recent studies (Gilson, 2006, 2007) have raised doubts about the overwhelming focus on controlling shareholders as value-destroying actors in concentrated ownership systems of corporate governance. The argument is that some private benefits of control are necessary for inducing the controlling shareholder to exercise a monitoring function. The need to secure activism from the controlling shareholder is made particularly crucial in countries with both ineffective corporate law and weak commercial law.

In the same logic, Roe (2002: 271) concludes, '[The] quality of a country corporate law cannot be the only explanation for why diffuse Berle and Means (1932) firms grow and dominate. Perhaps, for some countries at some times, it is not even the principal one.' He argues that corporate law protective of minority shareholders cannot cover every instance of destruction of shareholder value. Even in the best-case scenario, i.e., the United Kingdom and the United States, the system of corporate law protects minority shareholders well against breach of fiduciary duties, lying, stealing (i.e., dishonest behavior). Yet, even the Anglo-American system does not protect minority shareholder against managerial mistakes (i.e., the business judgment rule). As such, shareholder value destruction can take place not only through managerial dishonest behavior but also because of managerial errors.

The puzzle for Roe (2002) is that ownership is diffused in the United States and the United Kngdom despite the fact that the law does not cover every instance of shareholder value destruction; hence, some other mechanisms must be activated in order to account for this behavior, and Roe proposes that we need to take into account *politics*[2] (Roe, 1994, 2000). In his view, for example, European social democracies pressure corporate managers to forego opportunities for profit maximization in order to maintain high employment. Therefore, concentrated ownership is a defensive reaction to these pressures. In a different way, in the United States, legislators responded to a populist agenda in the 1930s and limited the power exercised by large financial conglomerates, reducing the ownership concentration. Franks, Mayer and Rossi (2009) offer further empirical evidence for Roe's argument as they demonstrate that dispersed ownership emerged rapidly in the first half of the 20th century in the United Kingdom, even in the absence of strong investor protection.

More recently, novel research by Deakin and others (Armour et al., 2009; Deakin, Lele & Siems 2007; Siems & Deakin, 2010) sheds light into the unexplained issues of the influence of legal families on corporate governance practices and firm behavior. Siems and Deakin's (2010: 17) main conclusion is that 'legal rules are, to a significant degree, endogenous to the political economy context of the systems in which they operate.' Hence, there exist two main theories of corporate regulation. On the one hand, the public interest theory argues that a government pursuing social efficiency (i.e., social welfare) will respond to market failures by looking after the public interest through regulation (Djankov, 2009). On the other hand, the public choice theory (Peltzman, 1976; Stigler, 1971) claims that regulation is socially and economically inefficient, favoring bureaucrats to social welfare. An illustrative example is Djankov, La Porta, Lopez-de-Silanes & Shleifer's (2002) study of entry regulation across countries. They find evidence that less democratic countries are heavily regulated, and such regulation does not yield visible social benefits, supporting the public choice theory that emphasizes rent extraction by politicians.

In sum, to understand the relationship between legal differences and the patterns of bundles of corporate governance practices, we have to consider not only the legal origin of a particular environment but also political forces shaping the corporate agenda, capital markets history, and corporate law differences as an integrated framework. In this regard, one emerging debate in the comparative law and governance literature concerns the effectiveness of soft law (i.e., *standards*) versus hard law (i.e., *rules*), which still needs to be answered.

Hard law versus soft law

Since the turn of the century, corporate governance in the form of soft law in various forms has gained ground (Aguilera & Jackson, 2010; Hopt, 2011). Aguilera and Cuervo-Cazurra (2004) argue that corporate governance codes are designed to address deficiencies in corporate governance systems by recommending comprehensive set of norms on good practice to firms in regulatory environments, which are hard to change. The content of many of these codes stipulates guiding principles on board composition, ownership structure, and executive compensation schemes (Kabbach-Castro & Crespí-Cladera, 2011). And, in fact, most advanced and emerging economies have relied on codes of good governance based on the 'comply or explain' principle as an expediting mechanism to update their corporate regulation, given their often-outdated and rigid legal system.

It is interesting to observe, for example, how the United States continues to develop hard law such as the 2002 Sarbanes–Oxley Act and the 2010 Dodd–Frank Act to improve governance accountability and transparency, whereas most of the other advanced industrialized countries continue to rely mostly on voluntary codes of good governance (Aguilera & Cuervo-Cazurra, 2009; Aguilera & Jackson, 2010). Hopt (2011) claims that this dichotomy between hard law and soft law might be explained as a positive byproduct of scandals, when policymakers can see where regulation has lacunae or is not effective. However, he continues, scandal- or crisis-driven regulation often becomes too strict. For example, in Germany, instead of giving the corporate governance code commission time to revise its recommendations on directors' remuneration, in 2009, the German Parliament reacted with a mandatory reform law on this issue (Aguilera & Jackson, 2010; Hopt, 2011).

In sum, we reach the conclusion that there is neither an optimum regulation level nor a 'one size fits all' *magical* bundle of corporate governance practices that copes with different firm's realities and their industry and countries contingencies. In addition, we suggest two policy implications. First, a balance between *rules* (i.e., hard law) and *standards* (i.e., soft law) is context-dependent, and policymakers have to behave accordingly in order to avoid the risk to overthrow well-established culture, values and governance practices to new norms that not necessarily resolve immediate crisis or corporate scandals. Second, corporate governance codes introduce flexibility to the corporate governance system, allowing firms and corporate stakeholders to adapt governance's practices to their contingencies; yet a clear enforcement mechanism should be in place to guarantee the desired outcomes. Finally, it seems inevitable that we are moving towards a new territory of global governance where regulation is implemented at the industry level and enforced at a transnational level (Aguilera, 2011).

OWNERSHIP STRUCTURE

One important component of the corporate governance bundle is the ownership structure of the firm. Differences in ownership structure have two obvious consequences for corporate governance, as surveyed in Morck, Wolfenzon and Yeung (2005). On the one hand, dominant shareholders possess both the incentive and the power to discipline management. On the other hand, concentrated ownership can create conditions for a new problem (agency type II), because the interests of controlling and minority shareholders are not aligned and the controlling shareholders could expropriate the minority shareholders. Connelly, Hoskisson, Tihanyi and Certo's (2010) review suggests that shareholders with significant ownership have both incentives to monitor executives and the influence to promote strategies they feel will be beneficial.

The ownership structure is quite diverse across countries, with dispersed ownership being much more frequent in US- and UK-listed firms, compared to Continental Europe, where concentrated ownership is prevalent (La Porta et al., 1999). Faccio and Lang (2002) report in a study of 5,232 publicly traded corporations in 13 Western European countries that only 36.93 percent could be considered firms with dispersed ownership. In many transition economies (and emerging economies), family owners and other blockholders are an important governance constituency (Douma, George & Kabir, 2006).

The nature of governance problems differs greatly between publicly traded companies with and without a controlling shareholder (Bebchuk & Hamdani, 2009, La Porta et al., 1999). With controlling shareholders, the market for corporate control that plays such an important role in the analysis of companies without a controller cannot provide a source of discipline. With a controlling shareholder, the fundamental governance problem is not opportunism by executives and directors at the expense of public shareholders at large but rather opportunism by the controlling shareholder at the expense of the minority shareholders. Shareholder control is an internal governance mechanism, which can range from a sole majority owner to numerous small shareholders, and is likely to influence other elements of the corporate governance bundle. For example, Desender, Aguilera, Crespi-Cladera and Garcia-Cestona (2011) argue that there may be substitution/complementary effects between dimensions of the ownership structure (concentration/dispersion) and the board of directors in terms of monitoring management.

Several researchers, including Aguilera and Jackson (2003) and Adams et al. (2010), call for a distinction between types of controlling shareholders when studying ownership structure because different types of owners pursue different strategic objectives, and thus can be expected to exert different demands from boards and disciplinary effects on managers. We distinguish between family ownership, institutional ownership, and bank ownership.

Family control represents a distinctive class of investors in that families hold little diversified portfolios, are long-term investors, and often hold senior management positions, which places them in a unique position to influence and monitor the firm (Shleifer & Vishny, 1997). For example, Anderson and Reeb (2003) find that families that appear in both Forbes' Wealthiest Americans Survey and the Standard & Poor's 500 Index (S&P 500) have over 69 percent of their wealth invested in their firms. The incentives to directly monitor management increase with the wealth at stake. In addition, the distance from controlling shareholders to management is likely to be minimal, as very often owners will be managers themselves. Anderson and Reeb (2003) find that family members serve as CEOs in about 43 percent of the family firms in the S&P 500. Family members have both the incentives and abilities to monitor and discipline management, because of their close interaction and their incentives to protect their investment, but also because family members have excellent information about the firm, as a result of a long-term relationship with the firm (Smith & Amoako-Adu, 1999). Since the family group has often been running the company since its founding and generally has representatives within different levels of management, they are in a unique position to effectively monitor the operations of the company (Demsetz & Lehn, 1985). In addition, they can monitor the operations of the company at a much lower cost than other monitors due to their better understanding of the firm's wealth-creation processes and their better access to internal information (Raheja, 2005). Desender et al. (2011) argue that, as a consequence of substitution effects, boards in family firms are less focused on monitoring compared to boards in firms with dispersed ownership.

Institutional investors are mutual funds, pension funds, hedge funds, insurance companies, and other non-banking organizations that invest their members' capital in shares and bonds. The main goal of institutional investors is to maximize the financial gains from a portfolio of investments, which makes them more concerned about maximizing shareholder value and liquidity (Aggarwal et al., 2010, Thomsen & Pedersen, 2000). To accomplish this goal and reduce the uncertainties of their investments, institutional investors usually have an arm's-length relation with firms, where rather than spending time and resources trying to improve the performance of a company in its portfolio, they simply sell the shares of the underperforming company and walk away (Ingley & van der Walt, 2004). The presence of institutional investors is likely to have influenced other elements of the corporate governance bundle. For example, Ahmadjian and Robbins (2005) report that Japanese firms were influenced by Anglo-American institutional investors to adopt business practices more consistent with the Anglo-American shareholder-based system.

Banks often have multiple ties with the firms in which they own shares and their equity stake primarily serves to cement an often-complex set of non-shareholder relationships with the firm (Roe, 1994). Kaplan and Minton (1994) and Kang and Shivdasani (1997) point out that banks possess private information on firms, either through the past repayment records of the bank's existing borrowers or through the banks' superior knowledge of local business conditions (Triantis & Daniels, 1995). As shareholders with superior access to information and power to discipline management, it can be argued that banks are able to reduce the monitoring efforts needed, which may have an influence on other elements of the corporate governance bundle.

BOARD OF DIRECTORS

Boards are by definition the internal governing mechanism that shapes firm governance, given their direct access to the two other axes in the corporate governance triangle: managers and shareholders. The board receives its authority from stockholders of corporations and its job is to hire, fire, compensate, and advise top management on behalf of those shareholders (Jensen, 1993) as well as monitor top management teams to assure they comply with the existing regulation. This delegation occurs because stockholders generally do not have a large enough incentive to devote resources to ensure that management is acting in the stockholders' interest. It is the duty of the board of directors to manage the company's affairs in the interests of the company and all its shareholders (fiduciary duty), within the framework of the laws, regulations, and conventions under which the company operates. Boards are therefore an alternative to direct monitoring by shareholders (Bebchuk & Weisbach, 2010). Board members depend on the CEO to provide them with relevant firm-specific information. Therefore, the better the information the CEO provides, the better is the board's advice but also the better the board can perform its monitoring role. In addition, boards typically delegate some of their duties to specific board committees such as audit, remuneration, and nomination committees as additional monitoring controls.

Fama (1980) argues that the composition of the board of directors is important, as it likely to influence the monitoring efforts of the board. Observers typically divide directors into two groups: inside directors and outside directors. Generally, a director who is a full-time employee of the firm in question is deemed to be an inside director, while a director whose primary employment is not with the firm is deemed to be an outside director. In recent years, public pressure and regulatory requirements have led firms to have majority-outsider boards and there is a lot more surveillance on what constitutes independence. The characteristics of boards of large US corporations have been described in a number of studies. For example, Fich and Shivdasani (2006) find for a sample of 508 of the largest US corporations that, on average, the board contains 12 board members, of which 55 percent are outsiders, and has 7.5 meetings a year. A number of the directors served on multiple boards (i.e., interlocking directorates); the outside directors in these firms averaged over three directorships. Linck et al. (2008) present similar findings for a larger sample of 8,000 smaller firms.

Since 2002, there have been significant changes. The Sarbanes–Oxley Act contained a number of requirements that increased the workload of and the demand for outside directors (see Linck, Netter & Yang, 2008 for a description of these requirements). In addition, the scandals at Enron and WorldCom have led to substantially increased public scrutiny of corporate governance, accountability, and disclosure. Consequently, boards have become larger, more independent, have more committees, meet more often, and generally have more responsibility and risk (Linck et al., 2008). These changes both increased the demand for directors and decreased the willingness of directors to serve. As a consequence, director pay and liability insurance premiums have increased substantially.

Zahra and Pearce (1989) argue that the two main roles of the board are monitoring and advice. The monitoring role of the board is rooted in the agency theory where the primary concern of the board is to curb the self-serving behaviors of agents (the top management team) that may work against the best interests of the owners (shareholders) (Eisenhardt, 1989; Jensen & Meckling, 1976). Agency theory strongly favors outside directors, those detached from management and daily operations, as they facilitate objectivity (Kosnik, 1987), while separate CEO and chair positions provide further checks and balances (Rechner & Dalton, 1991). Several theoretical papers in the finance literature examine why boards may not monitor too intensively. Warther (1998) shows how the management's power to eject board members may result in a passive board. Similarly, Hermalin and Weisbach (1998) use a manager's power over the board selection process to show how board composition is a function of the board's monitoring intensity. However, Almazan and Suarez (2003) argue that passive (or weak) boards may be optimal because, in their framework, severance pay and weak boards are substitutes for costly incentive compensation. Empirically, the evidence with respect to the relationship between board characteristics and firm performance has been mixed (e.g., Dalton et al., 1998, 2007).

The advisory role is rooted in the resource dependence (Boyd, 1990: Daily & Dalton, 1994; Gales & Kesner, 1994; Hillman, Cannella & Paetzold, 2000; Pfeffer, 1972; Pfeffer & Salancik, 1978) and stakeholder traditions (Hillman, Keim & Luce, 2001; Johnson & Greening, 1999; Luoma & Goodstein, 1999) and suggests that boards should take a role that centers on advising management and enhancing strategy formulation. The resource dependence theory (Pfeffer & Salancik, 1978) argues that corporate boards are a mechanism for managing external dependencies (Pfeffer & Salancik, 1978), reducing environmental uncertainty (Pfeffer, 1972) and reducing the transaction costs associated with environmental interdependency (Williamson, 1984) and ultimately aid in the survival of the firm (Singh, House & Tucker, 1986). Furthermore, insiders on the board are viewed as important contributors as they are knowledgeable about firm operations. Empirical studies in the resource dependence tradition have shown a positive relationship between board capital and board effectiveness (e.g., Boyd, 1990; Dalton et al., 1999; Pfeffer, 1972). Carpenter and Westphal (2001) found that boards consisting of directors with ties to strategically related organizations, for example, were able to provide better advice and counsel, which is positively related to firm performance (Westphal, 1999). In addition, Hillman et al. (1999) found that when directors established connections to the US government, shareholder value was positively affected. They conclude that such connections held the promise for information flow, more open communication, and/or potential influence with the government, a critical source of uncertainty for many firms.

Boards are faced with an apparent paradox in that, on the one hand, they are expected to exercise control over the top management so that interests of shareholders (and other stakeholders) are protected, whereas, and zon the other hand, they need to work closely with the top management to provide valuable support in choosing corporate strategy and make informed decisions in implementing strategy (Hillman & Dalziel, 2003; Sundaramurthy & Lewis, 2003). While there is a large literature that studies the monitoring role of boards, research on the advisory role, the interaction between the board's two roles and the interaction between board roles and other elements of the corporate governance bundle has been scarce.

Desender et al. (2011) argue that the primary role of the board of directors is not independent from the context in which the company operates. The importance of the monitoring and advisory role is expected to be influenced by other elements of the corporate governance bundle, such as the legal protection of shareholders. For example, Adams (2005) find for a sample of Fortune 500 firms that, boards devote effort primarily to monitoring, rather than dealing with strategic issues or considering the interests of stakeholders. Other elements of the corporate governance bundle, such as the ownership structure or the executive compensation, could also influence the importance of one role or the other. To illustrate, firms with controlling shareholders may benefit more from putting emphasis on the advisory role of the board compared to firms without controlling shareholders.

When ownership is diffuse, the monitoring role of the board is likely to be more important because it is difficult for the dispersed shareholders to coordinate their monitoring activities and is also not worthwhile for any individual investor to monitor the company on a continuing basis (Aguilera, 2005; Davies, 2002). To resolve the alignment problem in firms with dispersed ownership, the board may prioritize the monitoring role, as collectively all shareholders benefit from the monitoring efforts by the board of directors. Shleifer and Vishny (1986) argue that large shareholders have strong incentives to monitor managers because of their significant economic stakes. Even when they cannot control the management themselves, large shareholders can facilitate third-party takeovers by splitting the large gains on their own shares with the bidder. Large shareholders might have access to private value-relevant information (Heflin & Shaw, 2000), engage with management in setting corporate policy (Bhagat et al., 2004; Davies, 2002; Denis & McConnell, 2003), have some ability to influence proxy voting, and may also receive special attention from management (Useem, 1996). Since blockholders have both the incentives and the power to hold management accountable for actions that do not promote shareholder value (Bohinc & Bainbridge, 2001), the monitoring role of the board, in such a situation, is considered to be less important (Aguilera, 2005; Desender et al., 2011; La Porta et al., 1998).

SYSTEMS OF CORPORATE GOVERNANCE

Probably, the quintessential question in comparative corporate governance is: *What describes and explains variation in corporate governance systems across countries?* To answer this question, most comparative corporate governance researchers contrast two dichotomous models of corporate governance: Anglo-American and Continental European. At the core of this distinction are the different systems of corporate ownership (Aguilera & Jackson, 2003, 2010; Ahmadjian & Robbins, 2005; Barca & Becht, 2001; Becht & Röell, 1999; Berglöf, 1991; Gedajlovic & Shapiro, 1998; Hall & Soskice, 2001; La Porta et al., 1998; Rajan & Zingales, 1998; Shleifer & Vishny, 1997). Franks and Mayer (1990, 2001) describe two types of ownership and control systems, the so-called 'insider' and 'outsider' paradigms. The insider system corresponds to an ownership structure where few or even a single shareholder has the control of a firm, which is the case in most Continental European countries (Barca & Becht, 2001). On the other hand, the outsider system is characterized by the separation between ownership and control where ownership is dispersed amongst a large number of shareholders. Both the United States and the United Kingdom are examples of outsider systems.

Together with ownership structure, the legal systems, and its related corporate law, the development and structure of capital, product, and labor markets, and the political and economic institutions define the myriad of varieties of capitalisms that, ultimately, characterize corporate governance systems (Hall & Soskice, 2001). In this regard, although the dichotomy remains a useful framework to start with, the stylized Anglo-American and Continental models only partially account for governance realities in Japan (Aoki et al., 2007; Dore, 2000; Gerlach, 1992), East Asia (Dore, 2000; Feenstra & Hamilton, 2006; Fukao, 1995; Gerlach, 1992; Hamilton et al., 2000; Lincoln et al., 1998), a wide range of European countries (Lubatkin et al., 2005; O'Sullivan, 2000; Pedersen & Thomsen, 1997; Prowse, 1995; Rhodes & van Apeldoorn, 1998; Weimer & Pape, 1999; Whittington & Mayer, 2000), and the new emerging markets (Aguilera et al., 2011, Chung & Luo, 2008; Khanna & Palepu, 2000, Singh & Gaur, 2009).

More recently, there have been efforts to more systematically account for these cross-national differences, resulting in a wide range of categorizations of corporate governance systems. We summarize what we believe are the current main four comparative corporate governance system categorizations. In Table 17.1, we outline the core governance characteristics indentified in the different corporate governance categorizations.

First, Weimer and Pape (1999), starting from the observation that the debate on corporate governance in an international setting is restricted by the lack of a clear framework, propose a revised taxonomy of corporate governance systems. They based their analysis upon eight firm characteristics: (1) the concept of the firm, (2) the system of the board of directors, (3) the main stakeholders that exert control on managerial decisions, (4) the development of the capital market, (5) the role of the market for corporate control, (6) the corporate ownership structure, (7) the executive compensation system, and finally (8) the time perspective of economic relationships. And, to allow for an international comparison of these attributes, they divided countries into 'market-oriented' systems (the Anglo-American system) and 'network-oriented' systems. Then, the latter is composed of Germanic countries (e.g., Germany and the Netherlands), Latin countries (e.g., France and Italy), and Japan. After discussing the diverse characteristics across geographic regions, Weimer and Pape conclude that the central attribute to the market-oriented systems is the market for corporate control, which serves as an external mechanism for shareholders to influence managerial decision. In the opposite side, in the network-oriented systems, oligarchic groups with different identities substantially manipulate managerial decisions by direct modes of influence.

Second, Aguilera and Jackson (2003) draw on an 'actor-centered' institutional approach to explain firm-level corporate governance practices in terms of institutional factors that shape how actors' interests and conflicts are defined ('socially constructed') and represented. In their model, they examine how labor, capital, and management interact to explain firm's governance patterns under diverse institutional settings. First, they use 'forward-looking' propositions to analyze the isolated effects of each institutional domain on each stakeholder and illustrate this mechanism around three different conflicts: (1) class conflicts, (2) insider–outsider conflicts, and (3) accountability conflicts. And then, to explain cross-national variation on corporate governance systems, they turn to 'backward-looking' propositions that capture the cumulative and interdependent effects of different institutional domains within countries.

Third, Millar et al. (2005), taking an international business orientation, classify three different systems: (a) the Anglo-Saxon (i.e., *market-based system*), (b) the Communitarian

Table 17.1 Review of country-level systems of corporate governance

Weimer and Pape 1999

	Market-oriented		*Network-oriented*	
	Anglo-Saxon	Germanic	Latin	Japan
Countries	USA, UK, Canada, Australia	Germany, The Netherlands, Switzerland, Austria, Denmark, Norway, Finland,	France, Italy, Spain, Belgium	Japan
Concept of the firm	Instrumental, shareholder-oriented	Institutional	Institutional	Institutional
Board of directors	One-tier	Two-tier	Optional (France), general one-tier	Board of directors; office of representative directors; office of auditors; de facto one-tier
Main stakeholder	Shareholders	Industrial banks (Germany), employees, in general oligarchic group	Financial holdings, the government, families, in general oligarchic group	City banks, other financial institutions, employees, in general oligarchic group
Capital markets	High	Moderate/High	Moderate	High
Market for corporate control	Active	Inactive	Inactive	Inactive
Ownership concentration	Low	Moderate/ High	High	Low/ Moderate
Executive compensation, performance-dependent	High	Low	Moderate	Low
Time horizon	Short term	Long term	Long term	Long term

Millar et al. 2005

	Market-based system		*Relationship-based system*	
	Anglo-Saxon	Communitarian	Emerging Market	Developing Countries
Countries	USA, UK, Canada	Continental European countries	East European countries, Asian countries such as some provinces of China (e.g. Shanghai, Guangzhou, and Shenzhen); Malaysia; Thailand; Indonesia; the Philippines and some of the Latin American countries such as Mexico, Chile, and Brazil	In Asia: Burma, Laos, Cambodia, India and some provinces of China
Shareholder rights	High	High	Low/Moderate	Low
Control function	Market	Market/Governments	Governments	Governments

Main stakeholder	Shareholders	Industrial banks (Germany), industrial firms, families, in general oligarchic group	Financial holdings, the government, families, in general oligarchic group	Financial holdings, the government, families, in general oligarchic group
Capital markets	High	Moderate/High	Low/Moderate	Low
Market for corporate control	Active	Inactive	Inactive	Inactive
Ownership concentration	Low	Moderate/High	High	High
Time horizon	Short term	Long term	Long term	Long term
Institution transparency	High	High	Low/Moderate	Low

Gilson 2006

	Efficient controlling shareholder system	*Inefficient controlling shareholder system*
Countries	USA, Sweden, Canada	Italy, Mexico, South East Asian countries
Ownership concentration	Low/High	Moderate/High
Shareholder rights	High	Moderate
Quality of law	High	Low
Management monitoring	Market/Majority shareholders	Majority shareholders
Private benefits of control	Non-pecuniary	Pecuniary
Capital markets	High	Low/Moderate/High
Market for corporate control	Inactive	Inactive
Institution transparency	High	Low

system, which includes Continental European countries (i.e., *stakeholder-based system*), and (c) the Emerging Market system that comprises the East European countries, Asian countries such as China, Malaysia, Thailand, Indonesia, the Philippines, and some of the Latin American countries such as Mexico, Chile, and Brazil. Taking into account the reality of the local, non-economic forces that influence firm capabilities and behaviors, they conclude that business systems have a strong influence on corporate governance practices, particularly information disclosure and corporate transparency. They show that the institutional arrangements representative of a certain type of business system affect information disclosure, among which is the effectiveness of legal institutions that set boundaries between mandatory and voluntary information disclosure.

Finally, from the legal perspective, Gilson (2006: 1643) states that, 'the familiar dichotomy is simply coarse as to be wrong.' He proposes to respond to its deficiencies by looking more closely at two central features of a more complex taxonomy: (1) the concepts of controlling shareholders, and (2) of private benefits of control. In the first place, Gilson defines two patterns of ownership concentration, *inefficient* and *efficient* controlling shareholders. Countries where 'bad' law allows the cost of private benefit extractions to outweigh the benefits of monitoring are characterized as *inefficient* systems. By contrast, the ownership pattern may reflect a structure of *efficient* controlling shareholders, in which good law helps the benefits of more focused monitoring to be greater than the costs of private benefit extraction. Secondly, he turns to the nature of the private benefits of control to distinguish between *pecuniary* and *non-pecuniary* private benefits. The first is *pecuniary* private benefits of control: i.e. the non-proportional flows of resources from the firm to the controlling shareholder. The second is *non-pecuniary* private benefits of control: i.e. forms of emotional and other benefits that do not involve transfer of 'real' resources. After characterizing the controlling shareholder taxonomy, Gilson discusses how prior distinct countries such as the United States and Sweden can be similar in terms of 'real' outcomes in protecting the minority shareholders and, ultimately, the financial investors. And he concludes that 'to better understand the macroeconomic impact of efficient controlling shareholder systems, we need to better understand the micro-level dynamics of this ownership structure. As the focus of corporate governance scholarship shifts to controlling shareholder systems, we need to think small' (Gilson, 2006: 1678).

DISCUSSION

The growing integration of financial markets is a key factor of convergence of corporate governance systems. Investors in most countries increasingly accept the proposition that holding an international equity portfolio leads to higher returns and lower risk than a purely domestic portfolio. As a result, many pension funds now allocate a certain portion of their portfolios to international equities, while a large number of specialized mutual funds have been developed to allow individuals to participate in foreign equity investment. At the same time, non-financial companies realize that broadening the investor base will lower their cost of capital and may also lessen volatility in the price of the company's stock.

The growing wish of both investors and issuers to operate in the international capital market requires some degree of acceptance of common values and standards. Institutional shareholders have brought with them expectations about shareholder value and are increasingly requiring firms to establish profit targets and to produce competitive returns on equity. Institutional investors also insist that companies respect international norms of governance, particularly concerning the fiduciary duties of management and obligation of controlling shareholders to respect demands of minority investors concerning transparency and the procedures for exercising corporate control, especially at the shareholders' meeting. Thus, in addition to the legal and institutional changes, which are occurring in their home countries, companies are forced to adapt their behavior in order to be able to tap global capital markets.

Since the mid-1990s, there has been much talk of the convergence of corporate governance systems to Anglo-American standards, and several trends have pointed in this direction (e.g., Coffee, 1999, 2002; Denis & McConnell, 2003). However, Thomsen (2003) argues in favor of *mutual convergence*, i.e. that not only has European corporate governance converged to US standards but also US corporate governance has effectively converged to European standards through the concentration of ownership and increasing levels of insider ownership (Holderness et al., 1998; Meyer, 1998), the separation of management and control in more independent boards (Monks & Minnow, 2001), the deregulation of the banking system (Financial Services Modernization Act, 1999; *The Economist*, 1999), and the increasing importance of stakeholder concerns (Agle et al., 1999; Jawahar & McLaughlin, 2001; Jones & Wicks, 1999). These shifts indicate that it is increasingly more relevant to look at the configuration of governance practices at the firm level.

Moreover, the fact that there are firms that fit within the different corporate governance models within countries is indicative of the current hybrid trends away from stylized arrangements. An illustrative case is the rapidly changing configurations in emerging markets as they get strong influences from abroad. The case of Brazilian Stock Exchange (BSE) segmented listing is worth discussing. The Brazilian capital market faced a dramatic decrease in the number of listed firms and the trade volume during the last decade of twentieth century, going from 551 firms in 1996 to 428 firms in 2001, and from 112 billion to 65 billion dollars over the same time period (WDI, 2011). In December 2000, the Brazilian Stock Exchange – BM&FBovespa – issued new listing rules, the 'Novo Mercado.' The aim of this regulation was to increase investors' confidence in the BSE market and to raise the level of management and majority shareholders' accountability through good corporate governance practices and greater transparency, and, as a consequence, to reduce the cost of capital. The Novo Mercado listing rules establish that public share offerings have to use mechanisms to favor capital dispersion and broader retail access such as the 'one-share-one-vote' principle. Additionally, among other requirements, firms have to maintain a minimum free float, equivalent to 25 percent of the capital, to disclose financial information according to the US GAAP or IFRS accounting standards, and to have at least five members on the board of directors and 20 percent of independent directors.[3] These governance requirements are indeed very much in line with NYSE requirements.

The interesting dimension of the BSE market regulation is that recognizing that some existing listed firms would find it difficult to adopt the new rules, which were quite restrictive compared to the traditional market rules and the corporate law, the BM&FBovespa proposed two differentiated levels of corporate governance practices, level 1 and level 2 (Carvalho, 2003). Altogether, there were four listing types: (1) traditional market, (2) level 1, (3) level 2, and (4) Novo Mercado.[4] In March 2011, BM&FBovespa has 422 listed firms, of which 17 are on the level 2 trading list, 38 on the level 1 trading list, and 117 on the Novo Mercado; the remaining 250 are on the traditional market. This is very interesting because within a given stock market there are several degrees of compliance with governance rules which in a way equate to different models of corporate governance within a given country. The Brazilian example also supports the argument that firms do have choices within a given legal jurisdiction and a given country to adopt certain practices over others.

In sum, assembling corporate governance practices into bundles according to country institutional characteristics needs to be reconsidered, given the increase of the heterogeneity of corporate governance practices adopted by firms within countries as a result of internationalization and information advances. Therefore, we believe the discussion of corporate governance bundles is more fruitful at the firm level than at the country level and comparative corporate governance research may want to explore the heterogeneity of bundles within countries in addition to comparing across countries. Some scholars are currently developing empirical papers using set-theoretic methods (QCA/Fuzzy sets) to uncover different configurations of corporate governance practices across countries leading to high firm performance (García-Castro et al., 2011; Misangyi & Holehonnur, 2010) or to high IPO performance (Bell et al., 2010).

In following sections, we exemplify how different configurations of corporate governance practices could play out across countries, taking as the departing practice, corporate ownership. We distinguish between family ownership, bank ownership, institutional ownership, state ownership and firms with dispersed ownership.

Family ownership

Family control represents a distinctive class of investors in that they hold little diversified portfolios, are long-term investors, and often hold senior management positions, which places them in a unique position to influence and monitor the firm (Shleifer & Vishny, 1997). Obviously, the higher the stake in the firm, the higher the alignment between the family owners and other shareholders will be. In an extreme case scenario, where the family owners are also actively involved in management and have an ownership stake above 50 percent (examples include Oracle Corp., Reebok Int. Ltd in the US market, BMW and Inditex in Continental Europe or Samsung Group in Korea), the role of the board of directors is unlikely to strongly focus on monitoring. Second, the executive compensation package often intended to enforce alignment is of little relevance if managers hold an important stake of their wealth in the company. Third, disclosure is likely to be lower for family-controlled firms, as a consequence of their lower need for financing through the capital market. Finally, other elements of the corporate governance bundle are also likely to be influenced by the presence of family owners. While family firms are typically more associated with the insider system, for the United States, Anderson and Reeb (2003) show that one-third of S&P 500 firms can be classified as family-controlled firms. We believe that corporate governance dynamics for family-controlled firms are likely to be similar, independent of the country in which they are incorporated. Perhaps, the better protection of minority shareholders allows family firms to rely more on the capital market for financing than on bank debt in countries with strong legal shareholder protection; however, banks could perform an important monitoring role to reduce expropriation risks in countries where shareholders are less protected and firms rely for external financing on bank debt. Therefore, we argue that, on average, family firms at least across the advanced industrialized and emerging market world, are likely to rely on a similar corporate governance bundles.

Bank ownership

Studies on comparative corporate governance have associated insider systems of corporate governance with a high dependence of firms upon banks and high debt/equity ratios. Instead of arm's-length lenders, banks tend to have more complex and longer-term relationships with corporate clients. Exmples of firms controlled by banks include Compagnie des Alpes in France, Banesto in Spain, and NEC in Japan. Firms with a strong bank relationship often rely on confidentiality, as information is shared between the bank and its corporate clients. In addition to holding considerable equity portfolios themselves, banks name representatives to the company boards and are seen as exercising a leadership role in non-financial companies or among groups of companies. Banks are often seen as representing all shareholders: their power extends beyond direct share ownership, as they hold and vote shares for individual investors. As a shareholder with superior access to information and power to discipline management, banks are likely to influence the priorities of the board of directors, other monitoring mechanisms, and the design of executive incentives plans. Insider knowledge of the business allows the banks to serve a critical monitoring function, at a lower cost than what would be possible for other shareholders. In addition, as an important provider of financing to the firm, the bank is likely to offer much stronger incentives to executives in order to promote long-term profit maximization. Therefore, bank ownership affects the corporate governance bundle in a number of ways. First, we believe that the role of the board is likely to be less focused on monitoring and more focused on the provision of resources. Second, the bank's high monitoring is likely to reduce the importance of executive incentives to achieve alignment of their interests. Third, disclosure to outside investors is typically linked to the need of external financing. In this sense, firms with a strong bank relationship are more likely to depend less on financing through the stock market and have lower disclosure needs. Other elements of the corporate governance bundle, such as the reliance on the market for corporate control or importance of external auditing, are also likely to be influenced by the presence of a bank as controlling shareholder.

Institutional ownership

The main goal of institutional investors is to maximize the financial gains from a portfolio of investments, which make them more concerned about maximizing shareholder value and liquidity (Aggarwal, Isil, Miguel & Matos, 2010; Thomsen & Pedersen, 2000). Examples of firms controlled by institutional owners include Kaufman & Broad and Rexel in France and Vedanta Resources in the United Kingdom. Prior research finds that a small number of institutional investors take an active role in the governance of their portfolio firms by waging public and private campaigns, sponsoring shareholder proposals, and voting against management attempts to entrench (Gillan & Starks, 2003). For example, the mutual fund industry is generally far less committed to activism than the pension fund industry. This partly reflects the fact that the mutual funds must differentiate their products by applying their skills in assembling portfolios that are different from those of competitors and must demonstrate their portfolio management skills; thus, they do not emulate but try to beat indexes. On balance, this sector is more likely to continue to pursue 'buy and sell strategies.' To accomplish this goal and reduce the uncertainties of their investments, institutional investors usually have an arm's-length relation with firms – where rather than spending time and resources trying to improve the performance of a company in its portfolio, they sell the shares of the under-performing company and walk away (Ingley & van der Walt, 2004). Bushee et al. (2008) find that large, low-turnover institutions with preferences for growth and small-cap firms tend to prefer firms with existing preferred governance mechanisms and that these institutions are associated with future improvements in shareholder rights.

The degree of the involvement of institutional owners is likely to affect the corporate governance bundle. Improvements in disclosure, board independence, and a focus of executive compensation on long-term value creation are more likely in firms with high levels of institutional investors' involvements. Besides, institutional investors have both the incentives and ability to operate as an effective monitor and they have acquired important experience regarding the effectiveness of corporate governance by their presence in other firms. The extent to which they may pursue direct monitoring instead of monitoring by the board or alignment through incentives is likely to depend on their total investment portfolio and limitations in terms of personnel. Institutional investors following a short-term investment strategy are much less likely to operate as active monitor or to instigate significant changes in the corporate governance dynamics of the firms in which they invest.

State ownership

In several countries, state ownership is a salient feature in some industries. State companies have received less attention in the international corporate governance debate. Examples of state-owned firms include NTT in Japan, Électricité de France in France, PetroChina in China, and Lloyds Banking Group in the United Kingdom. The state is generally said to be a passive owner, with a general tendency to be an owner with a long-term perspective, emphasizing value creation over time. A common argument in favor of state ownership is that there is a need to secure social welfare and protect certain national strategic sectors, and that such welfare and strategic concerns may not be addressed by firms which are run according to the principle of profit maximization. The alleged weaknesses of state companies are explained by their deviation from the principle that the control of a company should be vested in the hands of its owners. While, in theory, the tax-paying public owns state companies, they are controlled by bureaucrats. Hence, the companies are run according to the goals of bureaucrats, which in Shleifer and Vishny's (1997) opinion are neither social welfare nor maximizing profits. Bureaucrats are first of all inclined to pursue their own political interests, such as securing votes by catering for the interests of special interest groups such as public employee trade unions. Several challenges relate to how state ownership should be organized and administered, as it needs to balance political and economic goals, on the one hand, and the state's parallel functions as owner and regulator, on the other hand.

In terms of corporate governance, state ownership is more likely to strongly focus on a stakeholder approach to corporate governance than a shareholder approach. In terms of the board composition, this means the inclusion of politicians and employee representatives. This is likely to reduce the monitoring role of the board and to enforce their advisory role. Furthermore, state-owned firms are likely to have other objectives beyond financial performance, such as long-term growth, which are likely to influence the sensitivity of the executive compensation to financial performance. In addition, disclosure is unlikely to be higher than in firms without state ownership, given their access to private information and reduced need to rely on the capital market. Finally, the risk of hostile takeovers is minimal, as it depends on the willingness of the controlling owner to sell.

Ownership dispersion

Grossman and Hart (1980) argue that the free-rider problem makes it cost-ineffective for small shareholders to act as monitors of management. Firms without controlling owners therefore are more likely to assign a strong monitoring role to the board of directors, emphasizing board independence. Examples include Japan Airways and Honda in Japan, BAE System and British American Tobacco in the United Kingdom, and Total and Air Liquide in France. In addition, executive compensation is another mechanism that could help reduce the possible divergence of interests between shareholders and managers. In terms of disclosure, one could expect firms with dispersed ownership to provide more information to their shareholders, as these firms tend to rely on the capital market for financing. Furthermore, the market for corporate control moderates the divergence of interests, because shareholders acquiring control can discipline managers who fail to create shareholder value. This discipline can take the form of a takeover, closer shareholder monitoring, or dismissing management (Jensen, 1988; Shleifer & Vishny, 1986). To the extent that shareholder monitoring is less present when ownership is dispersed, or the board is dominated by management, reliance on the market for corporate takeover is going to be more important to align management interest with those of shareholders.

The above examples demonstrate that there is a wide range of combinations of corporate governance practices that firms can adopt which might be partly limited by the environment but are also constrained or enabled by the set of governance practices available. To conclude, we urge future research in comparative corporate governance to adopt a more holistic view of the firm–environment relationship and to examine the firm interdependencies among corporate governance practices. In other words, we encourage corporate governance scholars to move beyond the country-level models of corporate governance and study the degrees of freedom that firms have to embrace governance practices. Future research should also (1) study the increasing governance shifts towards a hybrid or mutual convergence system with multiple effective configurations of corporate governance practices, (2) explore existing industry pressures to comply or deviate towards certain practices, (3) expand the configurational framework to firms in emerging markets as these firms vary tremendoustly, and (4) rely on research methods that nicely capture this configurational approach. There is much exciting work to be done ahead of us!

NOTES

1 La Porta et al. (1998) focus on four legal origin families: English common law, French civil law, German civil law and Scandinavian civil law. On the other hand, Zweigert and Kotz (1998) distinguish among five legal families: namely, Romanistic (France), Germanic (Germany and Switzerland), Anglo-American (United States and United Kingdom), Nordic, and East Asian (Japan and China).

2 We would like to thank Michael Goyer to point out this important dimension.

3 For further details, see http://www.bmfbovespa.com.br/

4 In addition to these four categories of corporate governance practices, the BM&FBovespa also includes a corporate governance differentiation for the over-the-counter market where only those publicly traded companies duly registered with CVM (Securities and Exchange Commission of Brazil) can be listed, called BovespaMais.

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18

Family-Owned Asian Business Groups and Corporate Governance

Marie dela Rama

Concentration of ownership in the Asian private sector is manifested in the corporate form known as business groups. Family-owned business groups, also known as family-owned conglomerates, dominate the private sector landscape of the region with exemplars being the Japanese pre-war *zaibatsus* (Miyajima & Kawamoto, 2010), post-war *keiretsus* (Lincoln & Shimotani, 2010) and Korean *chaebols* (Chung, 2005). Their size, scale and scope mean that, aside from government, they are the most influential and economically important institutions in these countries.

Business groups are:

> collections of firms bound together in some formal and/or informal ways, characterised by an 'intermediate' level of binding…they are the outcome of investments by a single family or small number of allied families who, once having acquired the component companies, keep them together as a coherent group among which personnel and resources may be shifted as needed. Yet the individual companies continue to keep some separate identity. (Granovetter, 2001: 69–70).

In other words, they are:

> legally independent companies [that] utilise collaborative arrangements to enhance their collective economic welfare (Colpan & Hikino, 2010: 17).

This chapter begins by explaining the challenge of applying agency theory in understanding the corporate governance of Asian business groups and puts forward other theoretical perspectives. Next, the ownership structure is looked at with a scrutiny on the central role business group-owned banks play in the group's financial arrangements as they facilitate the funding and coordination of the sets of companies. The political perspective of business groups as bulwarks against a predatory state is briefly mentioned before looking at the internal pressures faced by these business groups: namely, its family owners. The impact of family dynamics, business family and family business relationships are discussed, then the choices between internal and external financing, and managerial professionalisation. Finally, this chapter ends with the board structure and the role of independent directors within these entities.

ASIAN BUSINESS GROUPS

Theoretical perspective on Asian business groups

The use of agency theory to explain corporate governance is well-established (Berle & Means, 1933; Alchian & Demsetz, 1972; Demsetz, 1983; Fama & Jensen, 1983; Jensen & Meckling, 1976; Boyd & Hoskisson, 2010 and other chapters in this Handbook). The application of agency theory is commonly represented in studies of corporate America and Anglophone countries where research primarily looks at the relationship between principal and agent – mainly the financial principals (such as shareholders with their representatives on the board of directors), and the managerial agents (that of executives and managers) (Mace, 1971; Lorsch & MacIver, 1989; Clarke, 2004).

However, the applicability of agency theory in explaining business groups and their corporate governance is rather more problematic. In 1989, Kathleen Eisenhardt crystallised the relevance and applicability of agency theory across a spectrum of social science research disciplines in a well-cited précis of the theory: 'Agency Theory: An Assessment and Review'. According to Eisenhardt, 'Agency theory provides a unique, realistic, and empirically testable perspective on problems of cooperative effort.' (1989: 72). However, she also points out the inherent limitations of the theory:

> Agency theory presents a partial view of the world that, although it is valid, also ignores a good bit of the complexity of organisations. Additional perspectives can help to capture the greater complexity (1989: 71).

In trying to understand the 'greater complexity', the challenges in agency theory's applicability have become more obvious, with its widespread use in the last quarter of a century to explain control – or lack thereof – and costs in principal–agent relationships. Given major American listed corporations have widely dispersed ownership and generally do not have a dominant owner-manager, this ownership composition does not hold in other parts of the world, especially in Asia. In countries where family-owned and family-managed corporations dominate, the premise of agency theory disappears as there is unity in strategic decisions: 'Clan control implies goal congruence between people, and therefore the reduced need to monitor behaviour or outcomes' (Eisenhardt, 1989: 64).

Nevertheless, studies of corporate governance have expanded internationally, consequently broadening the theory's scope and audience. Despite the anomaly of agency theory's application, there is persistence in its use in studies where ownership and control is one and the same (see Schulze, Lubatkin, Dino & Buchholtz, 2001). Tsai, Hung, Kuo and Kuo (2006) applied an agency theory perspective to the chief executive officer (CEO) tenure of two different groups of Taiwanese firms: one family-owned, the other non-family-owned. They found that 'the turnover of family CEOs is about half that of non-family CEOs; poorly performing family CEOs are more likely to be dismissed than non-family CEOs; family CEOs are more likely to enhance corporate value' (2006: 23–24, 26). The last result goes against the trend of studies that stated separation of ownership and control produced better corporate performance. They find that family control serves as the crucial monitoring factor that is generally absent in widely dispersed ownership corporate forms:

> Agency theory is not applicable to family firms because self-interest and information asymmetry are not factors. Family control seems to serve as a monitoring system that substitutes for CEO bonding. We have shown that agency theory is applicable for non-family firms but unsuitable for family firms (2006: 26).

Dharwadkar, George and Brandes (2000) looked at the failure of privatisation in emerging economies from an agency theory perspective.

The weak corporate governance structures within companies and lack of recognition of property rights in the external environment of most emerging economies resulted in an agency problem unique to developing economies – that of expropriation:

> Expropriation occurs within the weak governance context when large or majority owners assume control of the firm and deprive minority owners the right to appropriate returns on their investments. Thus, traditional agency problems based upon principal–agent goal incongruence are supplanted by unique agency problems arising from principal–principal goal incongruence (2000: 660).

Young, Peng, Ahlstrom, Bruton and Yi Jiang (2008) supports the principal–principal problem of owner vs owner value expropriation to differentiate this from the traditional Western agency problem of owner vs agent. Supporting this principal–principal conflict, Villalonga and Amit have described this as Agency Problem II to describe the awkwardness in agency theory's applicability in the situations documented above. Where Agency Problem I deals with the classic principal–agent problem of the despotic manager controlling the board, uncontrollable remuneration and ineffective monitoring popular in Anglo-American countries, Agency Problem II covers the asymmetrical relationship of the controlling shareholder, close monitoring and the issue of expropriation (2006: 387).

Agency theory remains a powerful and influential theory to study corporate governance. However, it is proving to be problematic to apply this theory in countries where firms have high ownership concentration in view of how questionably it explains the phenomenon of business groups.

Having established agency theory's limitations, other theoretical perspectives provide a more compelling reason why business groups should exist, evolve and are the common form of private sector organising in the region. Explaining business group development has been a source of rigorous debate. A variety of theories proffer different perspectives to their enduring existence. Khanna and Yafeh propose a triangular perspective on business group development: the structure of the group depends on the extent of horizontal diversification, vertical integration and financial involvement; the control depends on family involvement and degree of pyramidal ownership; and the relationship of the business group with the state (2010: 578). On a more macroeconomic vein, Chung looks at six different theories (including agency) – institutional, failure, transaction cost, resource-based and social capital – to provide perspectives on business group development in developing countries. Table 18.1 summarises these theoretical perspectives.

For the most part, the theoretical perspectives on business group development show how important the external political environment is in determining business group development. Indeed, '[t]he nature of institutional country effects in which business groups are embedded…shapes the governance of business groups and their member firms.'(Boyd & Hoskisson, 2010: 691). They 'internalise functions for which no external market or supporting institution exists' (Colpan, Hikino & Lincoln, 2010: 7).

The institutional perspective sees business groups as filling in the voids due to inefficiencies in a country's capital, labour and product markets. The market failure perspective supports this notion of business groups as filling in the institutional voids. The lack of trust in the political environment means the ability to transact commercially and with confidence with well-connected and well-established (albeit complex) entities supports to overcome this impediment. As a result, the market failure theory endorses the transaction cost theory, which states business groups are more economically efficient in such a prevailing environment. In addition, the resource-based and social capital theory of business groups lends support to the efficiency and value creation argument. Finally, as reiterated earlier, the agency problems present in Anglo-American countries rarely exist in Asian companies.

Table 18.1 Theoretical perspectives on business group development

Institutional theory	Institutional theory asserts that highly diversified business groups (BGs) create value by compensating for a nation's inefficient capital, labour and product markets.
Market failure theory	Market failure theory, concurring with institutional theory, argues that external markets can fail due to inefficient market mechanisms, legal impediments and lack of trust.
Transaction cost theory	Transaction cost theory argues that internal business transactions lower transaction costs because they avoid costs associated with contracts, negotiations and contract enforcements.
Resource-based theory	Resource-based theory asserts that BG-affiliated companies have opportunities to acquire and accumulate valuable resources, such as industry entry skills, trained employees, managerial skills, export-related skills, giving them resource advantage over non-affiliated companies.
Social capital theory	Social capital theory proposes that intra-firm networks such as BG companies are social capital that can facilitate value creation.
Agency theory	Agency theory argues that because BGs are owned and managed by founder families, agency problems are minimised between professional managers and shareholders.

Source: Adapted from Chung (2005).

It is also worth noting, in studies of business groups in developing economies, their relationship with the state is fundamental. It is this relationship that determines why the other non-agency theories provide a more useful explanation of this phenomenon. In most Asian countries, the relationship business groups have with the state determines and influences the manner by which these companies operate. Carney supports this notion by proposing four hypotheses of business group development in Asian business groups: institutional voids; life cycle; state-led industrialisation; and crony capitalism (2008: 602). Of the four, two are most pertinent in a developing country situation such as in Indonesia and the Philippines: that business groups fill the institutional void (Carney, 2008: 598) with the provision of infrastructure which is normally the realm of the state, and the proliferation of crony capitalism in the post-dictatorship era, which has allowed the endurance of some business groups. The state played a dysfunctional role (Granovetter, 2001: 97) in these countries. Yet, dysfunctional business–state relationships are far from unidirectional, as business groups with enough extraterritorial might and political connections can play a pivotal role in overthrowing the elected government of the day, as in the case of Chile's Allende government (Zeitlin, Ewen & Ratcliff, 1974: 120–121) while some Philippine business groups actively supported the removal of Marcos in the dying days of his dictatorship.

Other countries in the region – namely, Taiwan, South Korea and Japan – were beneficiaries of state-led industrialisation, (Fligstein, 1996). The relationships between business groups in those countries and their governments were mutually beneficial, united by a common goal towards greater economic development and providing a distinct form of Asian capitalism (Granovetter, 2001: 71–73). Finally, Carney's hypothesis of business groups as part of the life cycle proposed that business group formation and affiliation by entrepreneurs was important in developing countries but they would also 'frustrate continued economic development by inhibiting the entry of new firms into the economy' (2008: 603).

The dominance of business groups and their structure

Ownership concentration is a manifestation of economic control (see Berle & Means, 1933; Sales, 1979 for classifications of control).

In the ground-breaking study by Claessens, Djankov and Lang (2000) of 2,980 East Asian-listed corporations, they found more than two-thirds of firms are controlled by a single shareholder. Table 18.2 shows the percentage of concentrated ownership across the region, ranging from Japan, where the top 15 families control 2.1% of that country's gross domestic product (GDP), to Hong Kong, where the top 15 families control over four-fifths of that island state's wealth.

According to the 2002 World Development Report, there is a link between high concentrated corporate ownership and the efficacy of legal protection in countries: i.e. 'concentrated ownership tends to substitute for weak legal protections' (World Bank, 2001: 58). This view complements and supports resource dependence theory and the resource-based view of the firm in developing countries: where there is an unstable political environment, the conglomerate form is the preferred method of organising. Investors in weak institutional environments also pay a premium on firms who are part of conglomerates due to the perception that 'concentrated ownership delivers great benefits when those owners in control have appropriate incentives and when owners outside the firm have more leverage' (World Bank, 2001: 58). This was supported by a McKinsey study that showed an average premium of 24% an investor would pay for a well-governed company in the Asian region (2002: Exhibit 4).

It was also notable that during the most recent global financial crisis of 2008–2009, Asian family-owned business groups ably managed to weather the storm. The 1997 East Asian Crisis heightened the awareness that poorly-run and weakly-managed business groups in the region need to institute robust controls that promote transparent and accountable decision-making. Apart from some Korean *chaebols* being broken up, the financial crises did not lead to fundamental, structural reform of the ownership of Asian business groups. Instead, these groups proved resilient in the aftermath of both crises, with some opportunistic business groups consolidating their interests in the insurance sector after the bailout of American Insurance Group (AIG) and its divestment of extensive Asian interests in 2009. The owners of these Asian business groups remain solidly family-based.

However, the dominance of family-owned business groups means their treatment of minority shareholders can be less than satisfactory and is a pressing corporate governance issue in countries with concentrated ownership. Even where the prevalence of business groups is a private response to weak government institutions, the concentration of wealth in a few people, families or groups is

Table 18.2 Concentration of family control in East Asian corporations

Country	*Average number of firms per family*	*Per cent of total value of listed corporate assets that families control (1996)*				*Per cent of GDP*
		Top 1 family	*Top 5 families*	*Top 10 families*	*Top 15 families*	*Top 15 families*
Hong Kong	2.36	6.5	26.2	32.1	34.4	84.2
Indonesia	4.09	16.6	40.7	57.7	61.7	21.5
Japan	1.04	0.5	1.8	2.4	2.8	2.1
Korea	2.07	11.4	29.7	36.8	38.4	12.9
Malaysia	1.97	7.4	17.3	24.8	28.3	76.2
Philippines	2.68	17.1	42.8	52.5	55.1	46.7
Singapore	1.26	6.4	19.5	26.6	29.9	48.3
Taiwan	1.17	4.0	14.5	18.4	20.1	17.0
Thailand	1.68	9.4	32.2	46.2	53.3	39.3

Source: Claessens, Djankov and Lang (2000: 108).

a 'formidable barrier to policy reform' and could negatively affect 'the evolution of the legal and other institutional frameworks for corporate governance and the manner in which economic activity is conducted' (Claessens et al., 2000: 110).

Business groups are a form of organising that tries to mitigate uncertainty, especially where the country has a dominant public sector and government executive. By being part of a business group, transaction costs between affiliated companies are lower and being part of a group may help overcome market failure problems, allows the transfer of managerial talent across businesses, and sharing of other resources between affiliated companies (Kim, Hoskisson, Tihanyi & Hong, 2004: 28).

The might of business groups and conglomerate power also allows competitive advantage over single firms. As business groups dominate industries, being affiliated with a business group allows a company access to the network and resources available within that group. Being part of a business group builds up and consolidates the economic, intellectual and social capital amongst members.

Business groups that are vertically integrated, reflect a great degree of control by owners (Khannah & Yafeh, 2007: 333). Leff also saw this structure as substitutes for the imperfections in the capital market (1978: 672). While business groups may be the most *efficient* form in an *inefficient* market, because of their size, domestic business groups have an almost unassailable advantage over new entrants with foreign ownership restrictions in developing economies – in most cases – unilaterally favouring domestic participants. Figure 18.1 shows the structure of two Filipino business groups with their listed and unlisted companies across different industrial sectors.

In the Philippines, listed business groups tend to be in the mature phase of their life cycle. They privately build up their businesses before utilising the capital market to unlock the market value of their assets. Business groups list one business after

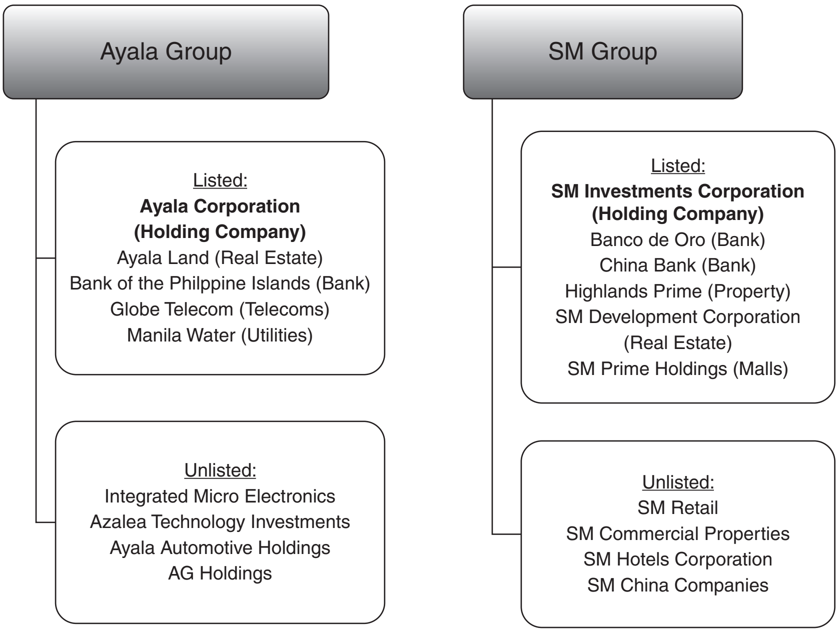

Figure 18.1 Listed and unlisted subsidiaries of two Filipino business groups in 2007

another and not at the same time. Therefore, a business group's portfolio has assets that are listed and others that remain private. In Figure 18.1, the Ayala Group has five listed and four unlisted companies, whereas the SM Group has six listed and four unlisted companies. Both the Ayala and SM groups are family-owned by the Zobel de Ayala and the Sy Families, respectively.

As Guillen points out, in sectors where foreign investment is restricted, domestic business groups that have proliferated under such protectionist policies will be reluctant to lose this 'asymmetrical' position. Foreign entrants have little choice but to collaborate with them, thus ensuring the continuation of the status quo of the dominance and entrenchment of business groups (Guillen, 2000: 376).

The ambivalence towards the domination of a few select groups was provocatively looked at by Khanna and Yafeh in their 2007 article called 'Business Groups in Emerging Markets: Paragons or Parasites?' The authors conclude that both types of business groups exist: business group paragons have a good reputation premium and practice good corporate governance (Carney, 2008: 597), while the parasitic business groups rarely practice good corporate governance and depend largely on the largesse of their political connections (see Faccio, 2006) and superior contacts to sustain the viability of their companies (Fisman & Khanna, 2004: 621). This parasitic view of business groups provides support for Carney's hypothesis that some business groups emerged due to the reciprocal nature of crony capitalism.

The principal–agent problem common in Anglo-American countries is not present in Asia, as most owners are themselves part of management. In most cases, the control of business groups has not been decoupled from the owners. Unlike their widely owned and held non-family and listed Anglo-American counterparts, out-of-control managerial remuneration is less of an issue, and a long-term outlook on the group of companies allows a lengthier strategic planning, albeit conservative, process.

The concentration of control and reasons for a complex structure

Concentration of control is manifested in the importance of the holding company in a business group structure and how the holding company effectively controls other companies. For business groups, the holding company is the most important corporate entity in its structure. This issue of cross-shareholding of related interests and the role of the holding company has had a long history. In 1932, in their study of holding companies of major utilities in the United States, Bonbright and Means pointed out the fundamental conflict of interests between the dominant shareholder, its subsidiaries and minority investors. The majority owner will normally exercise control through the holding company, which in turn executes strategy by taking into account the entire financial health of the business group:

> … one of the serious weaknesses of the holding company lies in the fact that there is so often a conflict of interests between the holding company, as the dominant stockholder, and the minority stockholders in its subsidiaries. This conflict is generally due to the fact that the holding company is willing to sacrifice the profits of any one of its subsidiaries if in so doing it can increase the profits of the entire group of properties under its control (Bonbright & Means, 1932: 343).

The strategy of the holding company behaving as the asset manager allows a highly vertical and centralised control over a diversified group of assets or companies.

A phenomenon known as cross-shareholdings allows a major shareholder to control a company or sets of companies even if the owner holds less than the majority stake[1] While not limited to business groups in emerging economies, cross-shareholdings are more common in the business group form than other corporate forms. Chung (2005) tries to make the distinction between control-based business groups to ownership-based business groups:

> A Control Based Business Group (CBBG) is a collection of legally independent companies, which were formerly business units of an Ownership Based Business Group (OBBG), bound together under the control of a founder family or managerial elite by means of interlocking ownership (cross-shareholdings) (Chang, 2003; Claessens, et al. 2000). In this structure, founder families or managerial elites hold or control relatively insignificant amounts of bona fide ownership shares of their affiliated companies. But, they can inflate their controlling shares by means of cross-shareholdings. When equal amounts of investment dollars are cross-shared between affiliated companies, there is no net increase in invested capital, and yet it gives the controlling stakeholders effective controls over their affiliated companies. Although the amount of cross-shareholdings is not necessarily equal, the purpose of interlocking ownership is to inflate the controlling shares for founder families and managerial elites (Chung, 2005: 68).

Through an intricate ownership structure, control of a company by a dominant player can be achieved even if the player does not own a majority ownership of the business (Dumlao, 2006).

The family's holding company may own a majority stake in one company; in turn, this company owns a majority stake in another company. Although the effective ownership of the family's holding company is less than the majority, and may be a minority stake, the effective control rests with the holding company.

Such a web of shareholdings was a contributing factor to the collapse of the Italian dairy company Parmalat owned by the Tanzi Family (Clarke, 2007), while in the wake of the East Asian Crisis, Korean business groups known as *chaebols* were pressured to reform for eventual dismantling of these corporate complex structures (see Chung, 2005; Li et al., 2006). The application of this intricate web with varying degrees of ownership ensures control across entities and shows the distinct form of corporate governance in family-owned businesses. According to one Filipino academic:

> Family-owned corporations (FOC) are so dominant in the country as in many countries in Europe. One thing I've observed is companies in these countries with greater concentration ownership have poorer corporate governance. There are specific corporate governance processes of protection of minority shareholders. Is management competent? There are layers and layers of ownership. The main family have minority ownership but has 100% of control. It's a problem of control to ownership ratio (in dela Rama 2010).

Does such a structure hinder the implementation of good corporate governance and effective functioning of corporations? As one local manager commented:

> The million dollar question is how do you address it? It is not as if the case in the Philippines [is unique but] other countries have [this as well]. For some reason here, there's a trend, those who are controlled by families have poorer corporate governance. This structure allows for poor corporate governance. But having this structure doesn't mean poor corporate governance but allows poor corporate governance (in dela Rama, 2010).

Intricate ownership complexity is not directly causal, but may facilitate for poor corporate governance.

THE CENTRAL ROLE OF BUSINESS GROUP-OWNED BANKS

A core aspect of a business group's structure is its bank-based model of financing. Having a bank at the centre of a business group allows a highly controlled form of financing to mitigate the effects of inefficient capital markets and high transaction costs. The bank-based model of financing is not new. Lamoreaux's study of 19th century New England documented banks of kinship groups were at the core of financing affiliated firms, as this provided stability, strength and long-term investment horizons (1986: 659, 666). Sales' study in Quebec also found that the intense concentration of banking and industrial capital allowed investment in developing large projects (1979: 296).

Once business groups discover the best form of financing for their web of businesses, where and how to invest the capital they receive is a strategic challenge. The best way to conceptualise the investment strategy of a business group is akin to an investor who has different assets in different sectors but the assets are major vertically integrated businesses or companies across a variety of industries. Depending on the level and appetite for risk – as in any investment portfolio – a wide variety of assets are present across different industries. Large business groups in Asia behave like a diversified investment portfolio, with the holding company acting like the fund manager and the bank at the core. Similarly, with a business group, several companies that it owns may be classified as the aggressive/high-growth entity, the conservative asset or the diversified business.

Figure 18.2 is the owning family/holding company perspective of the business group. The figure shows the business group as an investment portfolio, with different businesses classified according to the level of risk appetite and growth strategy.

Professional managers working in these companies must be aware of the investment strategy of the owning family/holding company, so that their sense of purpose in the business is tempered by this knowledge. A well-diversified portfolio spreads the assets and the risks. Business groups generally take such an approach with companies under their umbrella.

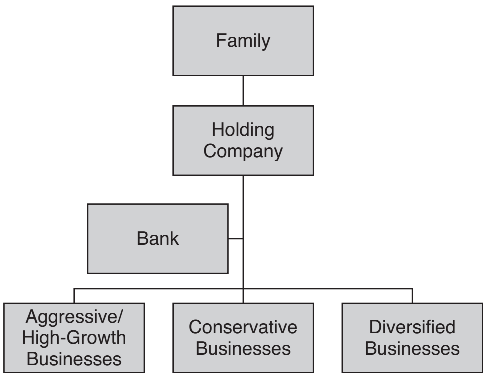

Figure 18.2 Business group as an investment portfolio

Business groups in the Philippines are normally owned by families. A strong family-orientated culture permeates both the private sector and public sector spheres of the country, with the dominance of business families paralleling the dynastic political families (Dumlao, 2006: 38–39).

A brief political economic perspective of business groups

This section briefly mentions the political economy perspective behind this ownership complexity. A volatile political environment influences business groups to organise in a form that can operate in a perceived absence of institutional order. According to Dyer and Mortensen:

> Hostile environments create a situation where individual entrepreneurs face significant moral dilemmas. They can either comply with the law, thus forfeiting the success of their businesses and their own economic well-being, or they can attempt to work within the context of a corrupt system in order to survive. Most choose survival (2005: 253)

This was the case for Philippine and Indonesian business groups under the Marcos and Soeharto dictatorships, respectively. How to manage the political risk in a predatory, crony capitalist state required major manoeuvrings that blurred the line between business and politics.

For one Filipino business group, mitigating this political risk included having a major foreign investor present in its companies, as it would be to Marcos' detriment to diplomatically offend another foreign government if he decided to expropriate the assets of a foreigner whose political masters were bigger and mightier – economically, politically and militarily – than an archipelago on the western Pacific.

Managing political risk in this way has been applied before in corporate history, with varying degrees of success. In Mitterand France, the presidential decree of nationalising strategic sectors and companies was met with fear and resentful acceptance. Making overtures to a foreign investor to mitigate government expropriation is not an uncommon business strategy. Indeed, one French bank invited the 'U.S. Treasury to threaten France with retaliation if the takeover went through. The Treasury refused' (Byron, 1981).[2] Unintended consequences arise when the lines between political and business risks intersect.

As Schneider points out, the degree of political intimacy a business group has with the government of the day can readily determine its ability to strategise and operate in the future:

> Business groups on the more intimate end of the spectrum generally have more volatile fortunes, rising quickly when they are close to political patrons and falling dramatically, Icarus-like, once the incumbents or policies change or the business groups falls out of favour. However, some adept groups use their close connections, like a gravitational slingshot, to launch them into longer-term expansion even after their government patrons have decamped. However, on the other end of greater political intimacy, Icarus groups seem to outnumber slingshot groups (2010: 662).

Indeed, the complexity of family business group ownership complements the opacity of political strategies to rein in the financial strength of the former, or to bring the oligarchic private sector under the rule of the state. However, the strength of business-affiliated business group transactions can also be the source of its weakness. In an era that emphasises transparency, related party transactions of business groups must ensure they can withstand such scrutiny. Financial markets readily punish business groups which have less than transparent business arrangements, as owners of India's Satyam Group (Leahy, 2009) and the aforementioned Parmalat Group discovered.

Finally, in a regional context with the economic dominance of China and her state-owned enterprises in the region, family-owned Asian business groups provide an alternative way of facilitating investment, economic growth and development.

The next part of this chapter looks at the literature of the specific issues facing family businesses and business families. The first half looks at internal family-related issues, while the second half deals with the external relationship a family has with the business.

THE BUSINESS FAMILIES OR FAMILY OWNERS

The family owners of business groups

The family owners of business groups play a pivotal role in determining the strategic future of their conglomerate. It is worthwhile to note that family-owned business groups share traits with other family businesses, except their scale and scope are magnified. For family-owned business groups, the extent of externally funded financing and professionalisation in their companies are signs of maturity, recognition of greater complexity of the business and wider participation in the broader market. This section discusses the characteristics of family owners.

There are seven stakeholders in a family business (Sharma & Nordqvist, 2008). They are:

1. Passive family members and non-owners not involved in the business.
2. Non-family employees.
3. Non-family owners not involved in the operations of the business.
4. Active family members, owners and employees.
5. Passive family member-owners not involved in the operations of the business.
6. Employee-owners and not members of the family.
7. Active family member employees but not owners (Sharma & Nordqvist, 2008: 78–80).

Sharma and Nordqvist's three-circle Venn diagram contains the three dimensions of family business ownership – family members, employees and owners – and the areas and interests where they intersect.

Sharma and Nordqvist's model is a useful way to understand the different categories and interactions of family and non-family members in the family business. For a family member who is both an employee and owner, his/her role in the business family is pivotal as s/he represents both management and ownership interests. Family member-owners involved in the business also display the continued operational interests of owners, as control is not decoupled from management control (Davis, 2008: 141).

The importance of family values

Behind each family-owned business group is a business family. Behind each business family is a set of family values. Each family has its own distinct set of values that permeates through the ownership philosophy of the company and is inadvertently reflected in the culture of the organisation.

The family business literature is replete with management challenges facing a business family. The journal *Family Business Review*[3] provides a comprehensive account of such challenges. However, at the core of what makes a family business different from a non-family business is the notion of values. Family values are fundamental to the family business. Cultural and core values distinguish a family-owned business group from its non-family counterparts. As argued by Ward:

> family businesses are value driven … [pervading] every aspect of a family business. … The family's values are the company's culture (2008a: 2–4).

The endurance of family values in a business is also a reflection of the family as society's most fundamental unit and reliable form of 'security' blanket in an insecure, unstable environment:

> … the family is perhaps the most reliable of all social structures for transmitting cultural values and practices across generations (Gersick et al. 1997: 149).

Non-family firms tend to focus on short-term, transactional, financially driven goals, while family-owned firms tend to emphasise the long-term, intangible and collective goals (Ward, 2008a: 5). A strong family culture also 'affects the relationship between family power and the agency/control of the board role in family firms' (Corbetta & Salvato, 2004: 129). Family-owned business groups firms have a natural fit in the collectivist culture of Asia. Asia's strong familial culture is reflected in the dominance of family-owned business groups in the region. The family's influence is embedded in the regional fabric and cannot be underemphasised in trying to understand the context of a business group. Family values are the foundations of the Asian corporate culture and they strongly influence attitudes towards corporate governance in a business group.

The sentimental value of ownership

A sentimental relationship is fostered in the family ownership of a business. The sentimental value in owning a business founded by a parent or ancestor may define the relationship a business family member has with the business, especially if the member takes an active rather than a passive role. Heroic stories of the founder/entrepreneur generation and the survival of the business provide a basis upon which business family members across several generations can unite around and have a profound sense of belonging. For one Asian business group matriarch, taking 'care' of the family business was a way of remembering and taking 'care' of her now deceased parents, as the companies were their legacy to her.

Behind each company name is a family – the listed company is the public face of the family. The performance of the company is personal – the reflection of its performance on the stock exchange in some way is a reflection of the family's. This personalisation of the company embodies the relationship-based culture of Asia. During periods of crisis in a professionally run but family-owned company, a family owner-member may come to the 'rescue' not only of the company but also of the family 'name'.[4]

For business families, their members have some form of sentimental or emotional value attached to the business (Zellwegger & Astrachan, 2008). This value can be shaped by their upbringing or their experience firsthand of what it means to be a business family member. Table 18.3, from Birley (1986), displays the four manifestations of emotional ownership of a family business: from weak detachment to strong attachment and belonging; and from positive affiliation to negative resentment.

Emotional ownership also manifests itself when it comes to succession, when sentimental attachment may hinder an objective attitude towards successful succession (Davis, 2008: 142).

Succession

Arguably the most difficult internal business family issue is that of succession or handing over the business from one generation to another (Ward, 2008a: 3). Andrea Santiago's (2000) study of the 'Succession Experiences in Philippine Family Businesses' provides an excellent insight into how Philippine business families deal with this issue. Santiago's study points to the importance of family values in determining successful succession:

> When the family adopts a succession process that is consistent with the values by which they live, the chances that the succession will be smooth increase, regardless of whether there was formal planning (2000: 15).

Santiago's research also found Filipino-Chinese business families were more likely to be guided by the Confucian values of seniority and harmony (2000: 16). Her research supports Chau's investigation with the succession approaches between coparcenary traditions, which are identifiable with Chinese business families, and observed primogeniture traditions, which she identifies with Japanese business families. According to Chau (1991), Chinese families tend 'to share ownership among siblings when starting a family company … [and] practice a *coparcenary* (joint heirship) approach to ownership succession which divides ownership among each generation relatively equally' (cited by Gersick, Davis, McCollom Hampton & Lansberg, 1997: footnote 8 in 56). Chau's insight provides a perspective on how ethnic

Table 18.3 Four manifestations of emotional ownership in family firms

		Emotional ownership	
		Strong	*Weak*
Direction of emotion	Positive	**Deep sense of belonging and shared fates** 'I feel strongly about the family business: it makes me proud. The success of the business is my success.'	**Superficial, happy go-lucky** 'I'm happy it's there but I don't care that much. It does not define who I am.'
	Negative	**Disillusioned and rigid fusion** 'The family business gives me pain, but I can't free myself from it. It is part of who I am.'	**Superficial rejection** 'I'm not bothered with the family business, and I don't feel like part of it.'

Source: Birley (1986: 36).

Chinese businesses view succession and the issues that go along with it.

The succession process can be an emotionally difficult issue for business families, as a person's mortality is recognised and this is rarely a pleasant topic. Succession is a volatile subject that can easily divide family members. During my fieldwork in the Philippines, several business families were in conflict, principally due to succession, and some of their struggles were played out in public (Calderon, 2007; Salverria, 2007). Succession in the family business brings to a head simmering non-related business issues and is a test of the functionality (or dysfunctionality) of a business family. As pointed out by Ward, succession also brings to the fore family values that will be transmitted to the next generation, which will be 'the core of long-term ownership unity' (2008a: 3).

For outside board directors on a family-owned firm, 'it is of utmost importance that [they] are aware of potential conflict of interest issues [on succession]' (OECD 2006: 12), but the long-term future of a family business largely depends on how succession is managed by family members.

The family council

The existence of a family council becomes pivotal when dealing with contentious issues such as succession, as it is a mechanism that mitigates 'internal strife and disruption' that may affect the company (OECD, 2006: 12). The following definition of a family council is provided by Gersick et al.:

> A family council is a group who periodically come together to discuss issues arising from their family's involvement with a business. The fundamental purpose of a family council is to provide a forum in which family members can articulate their values, needs and expectations vis-à-vis the company and develop policies that safeguard the long-term interests of the family (1997: 237–238).

Aside from succession, family councils are an important body for business issues and family-related discussions. Family councils can be formal mechanisms where issues, concerns and/or grievances can be aired amongst the working members, non-working members, owning-members and/or extended members of the business family. Having a family council and family constitution becomes of great import when there are succession issues that need to be discussed and resolved. While these formal mechanisms may not mitigate all sorts of conflict, they are useful aids for business families and prevent family conflicts spilling over into the business and the public sphere.

Family councils are normally present in business families that are large, extended and multi-generational. Where the company is largely family-owned, the family council exerts its influence on the business with representation normally through the positions of chair, CEO and/or executive directors. Figure 18.3 shows the context of the family council as it relates in a company board. Figure 18.4 shows the board of directors of the Ayala Group and its family council.

Family councils are a pivotal governance mechanism and their existence and role must be appreciated to understand the corporate governance of family-owned business groups.

One of the biggest challenges for family councils is when formal mechanisms, such as the constitution, do not reflect the situation of the family and the business. As advised by Ward, agreements should respond and be altered according to the changing circumstances of the family – and the business (Ward, 2008b: 114–116).

In Ward's chapter (2008b: 104), he sets out a complex structure composed of different bodies available to large, complex family-owned businesses. This perspective places into context that the company board is but one of many operating branches in a business family, with their control manifested under the holding company. Future research could explore the influences and relationships of these various bodies, how they impact the

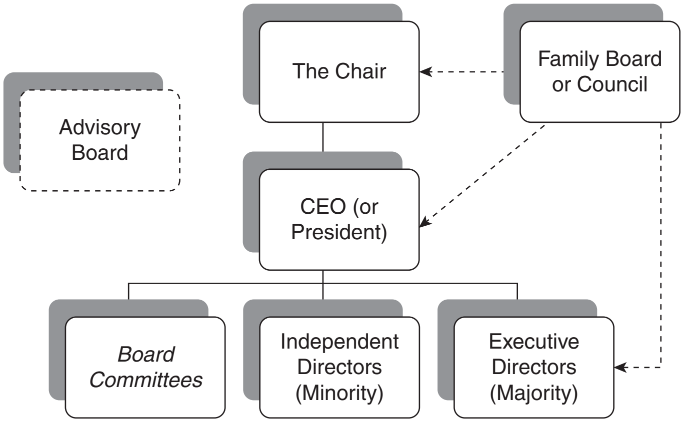

Figure 18.3 The family council as it relates to the company board

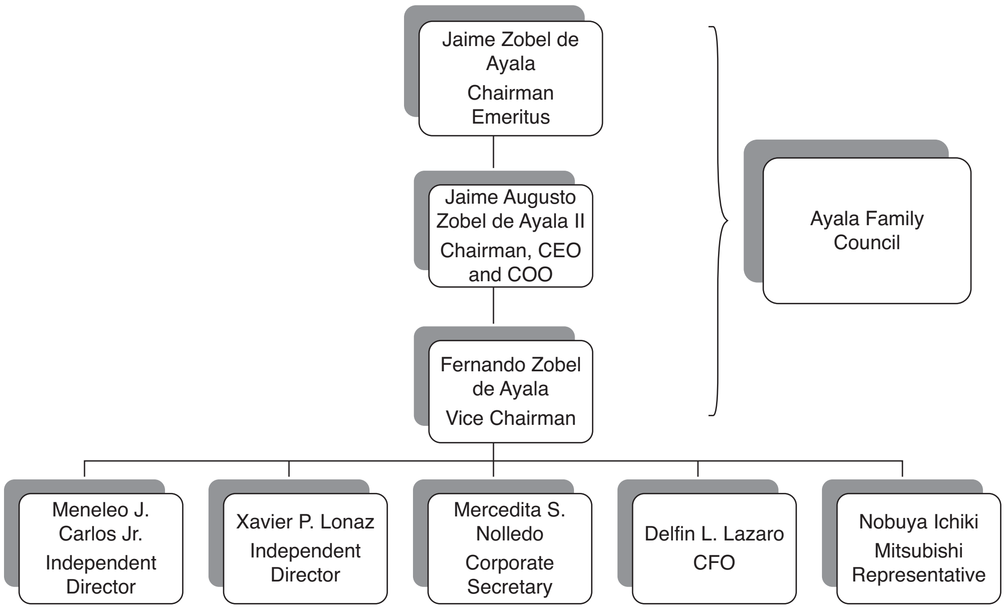

Figure 18.4 Ayala Corporation – board of directors (2009) and the family council

company board, and where they fit in the study of corporate governance of family-owned businesses.

The next two parts of this section look at the two other main challenges that business families face: financing and the professionalisation of management.

Financing

Most business families pride themselves in having grown the business by financing internally. However, when business groups become large and more complex, seeking external sources of finance to fund future investments become a pertinent issue. Going to market or listing on the capital market for family-owned business groups can be an emotionally charged decision. The step of listing is a paradigm shift, as the family business is taken to another level: opening up to outsiders and placing the family and the business to scrutiny.

When family businesses list, aside from the financial motivation, ownership and emotional considerations are normally taken into account. Listing may also not receive the unanimous support of all family members and the costs of intra-family conflict may outweigh the benefits of listing (Gersick et al., 1997: 54). For families that have managed to continue the business for several generations, the main ownership issue of multiple shareholders may be the catalyst for going public as some family members may wish to cash in their ownership stake (Gersick et al., 1997: 54–55) Being removed from the founder-entrepreneur generation, remote attachment to the business is a compelling argument for going public. For families that are in the founder-entrepreneur and first-generation stage, unlocking the value of the family business is a strong financial motivation that will allow the company to expand and to attract outside investors.

From a business portfolio point of view, listing provides a more objective, discerning capital market assessment of the value of a group's companies. Having a controlling owner behind a business group means there is an ultimate oversight of a diverse portfolio of assets. For the ultimate owner/s (and in some cases, managers) of a business group, they can assess which listed assets are performing; which company has the highest market value; the best projections for future opportunities; and which companies have the best, competent managers running the company (McVey, 1992: 14).

Nevertheless, for those business groups who are brave enough to jump through the hoops, listing on the stock exchange has a profound effect on the company, with the financial rewards outweighing the administrative obstacles. For families, listing can profoundly alter their relationship or attitude towards the business. Listing is a double-edged sword: on the one hand, listing can be the catalyst for renewing interests amongst owners while providing a good injection of liquidity for the business; on the other hand, the emotional issues may include the bittersweetness of selling and losing a certain amount of control and privacy as the family interests in the business are scrutinised by outsiders (Davis, 2008: 140).

Professionalisation and professional management

Another sign of maturity and development in a family business is the introduction of professional managers. Professional family business management is defined as having the

> means [of] an in-depth enough understanding of the owner family's dominant goals and meanings of being in business (i.e., cultural competence) to be able to make effective use of relevant education and experience (i.e., formal competence) in a particular family business (Hall & Nordqvist, 2008: 63).

Dyer posits three ways in which professional management skills can be introduced into the company:

1. Professionalise members of the owning family, so they have the expertise to take over the business.
2. Professionalise non-family employees currently working in the business and up-skill these internal candidates.
3. Bring in outside professional management talent (1989: 227–228).

The first two options are evolutionary and incremental, while the third option is revolutionary and signals a significant change. The family business literature is replete with accounts and challenges of professionalisation as business families realise the natural limitations for internally grown management talent (see Hall & Nordqvist, 2008; Dyer, 1989 and various articles on professionalisation from *Family Business Review*).

Professional managers in a business may also improve professional conduct practices and counterbalance the 'familiarity' and 'familiness' of family businesses, as excessive informality in the family business may 'lead to unprofessional practices in order to avoid family conflicts' (Ward, 2008a: 5).

Professionalisation has a lot to do with whether different family businesses grew and expanded successfully or unsuccessfully. Therefore, a distinction must be made for those family-owned business groups that are professionally run and are still run by the family. This difference is crucial in the competent running of a company.

On the board appointment level, it has been argued that, for non-listed firms, competent professional outside directors (who may have pre-existing links with the company) are preferable over wholly independent outsiders who have no connection to the owner-controlled firm (OECD, 2006: 10).

The career development path of professional managers in family businesses must also be considered, as generally family owners try and ensure the senior executive roles are filled by family members or owners' representatives. The issue of nepotism is central in family-owned businesses, and resentment may be fuelled amongst outside professional managers who see the careers of family member employees, who have not the same qualifications and competence, progress due to their connections rather than talent (Donnelley 1988). Where there is excessive nepotism in place, this will put the family business under pressure (Gersick et al., 1997: 4–5). Policies regarding mentoring, grooming and/supporting of family employee members by professional managers may help clarify the latters' roles and career opportunities in a family business (Gersick et al., 1997: 128). Professionalisation represents maturity in a family-owned business, and professional managers bring an economic and reputational value to the company that is appreciated by outsiders.

However, issues arise when professional managers and family owners work with each other. For family members who intend to work in the business, grooming them for the responsibilities of the family-owned business and navigating them through their working relationship with non-family professional managers are crucial. Where there are professional managers in place, and an Asian society that values seniority, the working relationship between family members who are younger than the non-family professional managers challenges this cultural norm. The power dynamic is biased in favour of ownership, as strategic decisions are still the domain of the owner while the strategic execution is the province of the professional manager.

The optimal interaction between family members and non-family professional managers must be based on mutual respect for one another. In attracting professional managers to join a family-owned business, the rewards must be commensurate with the work performance. Connected to the principles of meritocracy, where there is excessive nepotism within the business, the level of professional managerial competence suffers.

In a family-owned business group it is generally accepted that there will be family members who will work in the company to look after the owners' interests. To the extent that a family business has professionalised and has professional non-family managers on board, the dynamics becomes that of balancing the needs of professional managers in being rewarded and continue to be attracted to work for the business, with the ambitions of the family to have continued involvement of its members in the business.

THE BOARD OF FAMILY-OWNED BUSINESS GROUPS

Company boards of business groups

Theoretical literature on company boards distinguishes between exogenous issues (in the domain of agency, resource dependence and stakeholder theories) that look at how the board relates to its external shareholders, and endogenous issues which look at insider relationships within the board (Corbetta & Salvato, 2004). Boards are 'at the apex of the internal governance system, [are] responsible for corporate leadership and strategy, recruiting top management and monitoring managerial performance' (Song & Windram, 2004: 198).

The role and nature of the relationship between the CEO and chairman is pivotal in the board. If the CEO and chair roles are unified, this is commonly referred to as CEO duality, and power is heavily concentrated:

> The power of the chairman added to the power of the chief executive presents a formidable combination (Cadbury, 2002: 110).

CEO duality may lead to what Finkelstein and D'Aveni point to as its double-edged sword: 'forcing boards to choose between the contradictory objectives of unity of command and [CEO] entrenchment avoidance' (1994: 1080).

Where the roles are separated, chairmen must decide whether they are an executive or non-executive chair. For UK and Australian corporations, there is a requirement to explain why or why not the roles of chair and CEO are united. The premise behind this is that concentration of power with a CEO that has both roles may prevent objective decision-making to the detriment of the company and may overburden the person with responsibility. As Cadbury points out:

> The separation of the two roles builds in a check and a balance. Chairmen are responsible for ensuring that their boards take account of the interests of the shareholders and that they carry out their supervisory functions conscientiously. Chairmen, who are also chief executives, have to be scrupulously clear in their own minds when they are acting as the one and when as the other, as they move between the two roles. It can be done and it is done, but it is less demanding on all concerned to divide the roles rather than the individual. When someone who holds both positions is determined on a course of action, which perhaps entails high risks for the company, who is to challenge their judgement? (2002: 110).

Boards of family-owned business groups have close relationships with their owners. Asian corporations normally have their CEO and chair roles combined or represent the controlling family's interests. This is a reflection of the business being an extension of the family, with the family's 'identity or reputation' intricately linked to the business (Gersick et al., 1997: 37).

Figure 18.5 shows the company board of the Sy Family's business group and the presence of its family members in key director positions on the company board.

Quo vadis? The role and presence of independent directors on Asian boards

For family-owned Asian business groups, the main challenge and adjustment for this generally insider culture is the introduction of outside, independent directors. The phenomenon of independent directors on company boards is a distinctive feature of the Anglo-American form of corporate governance that has now been transmitted to Asian corporate governance practices, though adapted to suit the prevailing conditions.

For Asian business groups, the external imposition of this Western standard has proven to be challenging, not only for the board and its owners but also for the independent directors themselves. This form of coercive and normative isomorphism (see DiMaggio & Powell, 1983; Boyd & Hoskisson, 2010) has meant independent directors have come about as an external imposition on these insider boards. Independent directors were largely formulated as a control and verification mechanism by Anglo-American institutional investors on Anglo-American listed companies. Hence, their presence on Asian company boards was not born of the prevailing environment but rather a response to the pressure from Anglo-American institutional investors to improve and professionalise the standards of board behaviour.

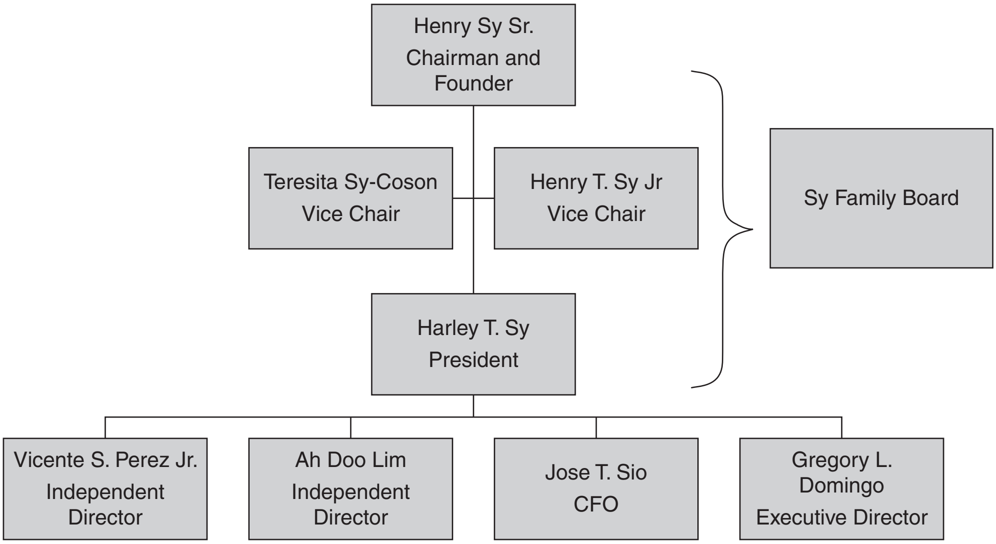

Figure 18.5 SM Investment Corporation – board of directors (2009) and family board

The belief is that the presence of outside directors on a board gives non-controlling shareholders a voice, in that they provide the monitoring mechanism inside the board, and that they will make boards 'more active' by their incorporation (Üsdiken 2010: 703). In Anglo-American corporations, outside directors have been found to be

> more vigilant than directors with other firm affiliations because:
>
> 1 They focus on financial performance which is a central component of monitoring.
> 2 They are more likely than insiders to dismiss CEOs following poor performance.
> 3 Protecting their personal reputations as directors gives them an incentive to monitor (Finkelstein & D'Aveni, 1994: 1081–1082).

In these corporations, independent directors play pivotal roles on boards and it is common to have independent directors wholly comprising and chairing the all-important board audit committee (ASX, 2007: 11, UK FRC 2008: 17). Empirical research has also found that financially literate (Al-Mudhaki & Joshi, 2004: 33) independent directors are seen as best improving the effectiveness of this committee (Beasley, 1996: 458, 463; Song & Windram, 2004: 203).

However, for non-Anglo-American corporations, outside directors on family-owned businesses are not as welcomed. Lansberg and Perrow's study of Latin American companies showed that the personalistic and insider business culture made business families paranoid about the presence of outsiders on their board, raising issues of 'confidentiality and security' (1991: 143).

As most Asian conglomerates have a major block ownership of 50% or more – compared to the widely dispersed ownership of Anglo-American companies – the independent director theoretically represents the minority, non-controlling shareholders. In some Asian countries, the pool of professionally trained directors still has a way to go before it can reach critical mass.

One independent director felt that the only way he could try to exercise his duty – independence of mind and action – in a family-owned and controlled board was to form a close relationship with the other independent director (for they are not in the majority) so that their views could be heard by the board. However, their introduction has also meant their resignation from company boards are a strong signal to the external market that something is amiss in the board and, generally, the company's strategic direction. Hence, their presence – though neither loved nor despised – is an important insight into the sometime murky politically and emotionally baggage-filled family-owned and controlled boards.

In Asian corporate governance, the role of independent directors will continue to be a source of adjustment.

CONCLUSION

Corporate governance of family-owned Asian business groups has characteristics that make them distinct from their private sector counterparts in the Anglo-American business world. Understanding the context of their structure, ownership, control and external environment allows us to appreciate their form, variety and survivability despite (or in spite of) political upheavals. Business groups are social institutions in their countries and their family owners have a wider societal obligation, and a more personal affiliation to their control. Family-owned business groups are, by extension, the public face of these families. Understanding the relationships and attitudes family owners have towards the business is key to understanding the strategic choices these groups make and the structures they have created to ensure they retain control.

Like any other institution, Asian business groups are undergoing a state of change brought about by internal factors (such as managerial succession and professionalisation) and external factors (government, corporate governance codes and regulation). The focus on their corporate governance practices in recent years means the power and control behind business groups are more scrutinised than ever.

Business groups will remain the dominant form of organising in the region. The private sector of the region is highly concentrated in its ownership and control and is reflective of an oligarchic private sector. Nevertheless, reforms in the private sector will need to take their dominance into account as they 'will continue to be important vehicles for the sustained future growth of this region' (Chang, 2003: 414). The corporate governance approaches of Asian business groups must be understood in the context of the interests of their owners and their responses in a rapidly changing globalised world.

NOTES

1 Almeida and Wolfenzon (2006) discuss the more aggressive form of cross-shareholdings known as pyramidal ownership.

2 This 1980s strategy had ramifications for another business 20 years on. For the French cosmetics company L'Oréal – in anticipation of the Mitterrand regime – invited the Swiss multinational Nestlé to take an ownership stake in the company in 1974. This fear proved to be unfounded, as Mitterrand did not seize the company as he did not see the company or the fashion sector as strategic enough. Nevertheless, Nestlé's ongoing ownership stake in the company through the decades means that,– in light of the global financial crisis and family disputes of the L'Oréal owners, the Swiss conglomerate is being touted as a potential buyer of the French company (*The Economist* 2009).

3 *Family Business Review*: http://fbr.sagepub.com/ (accessed 6 July 2010).

4 In 2010, a family-owner member of the car maker Toyota, Akio Toyoda, wrenched control back from the company's professional managers after a prolonged period of credibility crisis (see Shirouzu 2010).

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19

The Limitations of Corporate Governance Best Practices

Shann Turnbull

INTRODUCTION

To understand the limitations in corporate governance practices and codes, the inherent conflicts and inconsistencies in the corporate concept need to be reviewed as presented in the next section. To explain how the inherent conflicts and inconsistencies in the corporate concept arose, the origins and purposes of progenitor corporate concepts need to be considered, as outlined later sections.

A review of the objectives of the many corporate governance codes reveals that their aims can vary but with a general focus on the economic performance of corporations, their accountability, access to capital, and operations of their board (Gregory & Simmelkjaer, 2002: 1–20). However, none of the codes advocating best practices appear to offer a test for defining when good governance is achieved. Empirical evidence is accumulating that corporate failures can still occur unexpectedly, even when firms are considered to have fully complied with governance codes (Turnbull, 2008a). Enron is a notable example, with other examples arising from the global financial crisis (GFC) that suggests that there is a systemic problem in the current dominant Anglo system of corporate governance as identified by Pirson and Turnbull (2011) and Turnbull (2004).

There is no agreed basis for defining what is good governance and thus no empirical test for identifying the existence of good governance. The share price of listed corporations is commonly used as a proxy for good governance. However, this proxy neglects other economic concerns, like the ability of firms to be resilient and the ability to manage known risks and identify and manage unknown risks. The proxy also neglects the non-economic aspects of governance such as accountability to investors, stakeholders, and the broader community; or concerns about ethics, harms to stakeholders and/or the environment.

The evaluation of corporations by governance rating agencies is generally[1] based on how well corporations meet the processes and practices of one or more codes. Because the codes are widely believed to improve economic performance, market expectations are generated to believe that superior performance is achieved with superior governance to produce a circular self-reinforcing justification for the codes. This phenomenon is illustrated in a report by McKinsey (2002) that found 'An overwhelming majority of investors are prepared to pay a premium for companies exhibiting high governance standards.'

The European Corporate Governance Institute (ECGI 2011) lists over 80 countries that have published corporate governance codes, with some additional codes being issued by groups of countries like the Organization for Economic Co-operation and Development (OECD) and Pan Europe. The United Kingdom leads the way, with 31 different codes published over the 18 years from 1992 to 2010. This is over twice as many codes as the next most prolific code-producing countries of the United States and Germany, who each have published 14 codes since 1997. Each of these three leading countries is on average producing one new code each year. This indicates that codes represent a Band-Aid for a systemically flawed governance system that is neither found in nature nor makes common sense, as discussed in this chapter.

Many of the UK codes, investment guidelines and financial practices were established by committees chaired by prestigious practicing company directors such as Cadbury (1992), Greenbury (1995), Hampel (1998), Turnbull (1999), Myners (2001), Higgs (2003) (revised 2006), Smith (2003), and Walker (2009). As these chairman included Lords and Knights of the Realm, the result was the establishment of a gentlemanly culture that expected directors to do the right thing. This also resulted in rejecting or neglecting any proposals or practices that could seriously challenge, or make life difficult, for their company director cohorts or colleagues in the audit profession. In the United Kingdom, codes were established on a voluntary 'comply or explain basis'. In this way the risk of corporations migrating away from the United Kingdom to more business-friendly jurisdictions could also be avoided.

The comply or explain approach also suited governments who did not want to alienate their business constituencies but still wanted the general public to be aware that steps were being taken to correct corporate excesses and failure. Credibility and gravitas was given to the codes by them being promoted by prestigious multinational agencies like the World Bank and the OECD. This created a worldwide herd instinct for governments and/or their regulators to accept, promote and even require the adoption of codes by regulation and/or by legislation. The adoption of codes by regulators and lawmakers reinforced and perpetuated the credibility of the practices and processes developed by business practitioners designed not to undermine their power status and influence as business leaders.

There is now a highly influential corporate governance industry based on providing education services[2] in corporate governance codes and best practices. Professional services providers heavily support the industry like the leading audit firms, governance-rating agencies, professional institutes and their members offering consulting services to advise on how to establish various board practices, set up various subcommittees and undertake risk management, director evaluation and board evaluation services.

As a result, the intellectual and reputational investment in various codes and practices is considerable, not unlike the commitment of many financial regulators to a belief in traditional economic orthodoxy before the GFC. The GFC has allowed many professionals and the general public to question the relevancy and efficacy of economic orthodoxy. The GFC, likewise, provides a basis to question the corporate governance orthodoxy as undertaken in this chapter.

Many codes promote the idea of director and board evaluation. While just this idea has made some directors uncomfortable (Anderson, 2007: 18), the process has developed in a way that does not challenge the blind spots and inconsistencies in corporate governance codes (Turnbull, 2008b).

For example, research commissioned by the Australian Council of Superannuation Investors (ACSI, 2010) into how corporations undertook evaluating board effectiveness and director performance revealed that the most fundamental questions were avoided. An example is how can boards carry out their most basic role to monitor, evaluate, remunerate and replace management with 'due care and vigilance' as required by the law when directors mostly rely on information provided by the management they are monitoring? No court of law, prudent newspaper editor or commonsense person would accept the credibility, without question, of information provided by individuals such as corporate executives on their own performance.

It could be expected that managers would not have an interest in suggesting to researchers that directors should obtain information about themselves from any independent third party, except perhaps a director who was so independent that she or he had little knowledge or authority to provide a credible opinion. This could explain why the 'fetishization' (Rodrigues, 2007) of director independence is so widely supported. The ACSI research revealed a number of other 'blind spots' (Turnbull, 2008a) in the criteria used by corporations to evaluate boards in regards to the other intrinsic conflicts of interests, inconsistencies, and information gaps as identified in this chapter.

Corporate governance codes are continually being updated and expanded as they prove to be ineffectual in avoiding problems, unexpected corporate failures and, as demonstrated by the GFC, systemic failures.

To understand the current problems in the way publicly traded Anglo corporations are governed it is instructive to review how the concept of corporations developed in quite different political, social and economic contexts. The corporate concept was initially created and used as a formal means for sovereigns to delegate power. Corporate governance remains about how power is exercised, as is next outlined.

POLITICAL ORIGINS OF CORPORATE CONCEPTS

This section reviews the origins of the corporate concept in England, the United States and Continental Europe. It explains how earlier practices provided better governance and how these were lost, or how their use created problems as new institutional structures and relationships evolved. This review also provides a context for forming a definition for 'good corporate governance', as provided in a later section.

The English concept of a corporation evolved as means for the sovereign with absolute powers to delegate some powers of self-governance to towns, guilds, abbeys, and universities. The Continental European concept of a company developed later for commercial reasons through common law.

The Corporation of the City of London has its origins in a charter granted by King William the Conqueror in 1067 that allowed Londoners to maintain some of their existing powers of self-governance. For similar reasons, English sovereigns granted charters to monasteries, other local government bodies, and universities at a time when Parliament did not exist or did not have such discretions for governing the nation. Consistent with the political context in which the charters were issued, the rights of self-government were granted without a time limit.

The first charter granted for commercial purposes in England was in 1407 for a 'Company of Merchant Adventurers' in London to trade wool with Amsterdam. In 1494, the Pope allocated the right to trade and colonize new lands to only Portugal and Spain. This provided a contributing reason for the establishment of the Church of England in 1534. During the 16th century, English sovereigns granted seven charters for English merchants to trade and colonze foreign lands as a way to privatize empire building. Each charter provided English investors monopoly rights to a specific country, but in competition with Portuguese and Spanish interests.

The history of the East India Company (EIC) formed in 1600 illustrates how empire building could be privatized while simultaneously raising revenues for the Crown from taxes collected on imported goods. Queen Elizabeth delayed the incorporation of what was formally described as 'The Governor and Company of Merchants of London Trading into the East-Indies' so as to not offend the Spanish King (Harris, 2005: 24). The Spanish had been given exclusivity by the Pope to trade East of Spain to what later became the Western Australian border.[3] The initial EIC charter was for only 15 years. Its political nature was explicit, with it stating that it created 'one body corporate and politick' with a 'Court of Governors'. Standards of transparency, administration and auditing were detailed in its charter.

Consistent with its role of empire building and governing foreign colonies, the rights of perpetual existence were granted by King James in 1609. However, initially investors only obtained limited life investments committing their funds to finance a specific voyage or after 1613 for fixed three-year terms. It was the Dutch East India Company, formed in 1602 with an initial charter for 21 years, that invented the idea in 1606 of investing in the company rather than in a specific venture governed by the company (Frentrop, 2002).

The EIC first issued permanent shares in 1657 (Harris, 2005: 45). But unlike the initial shares issued by the Dutch, the English shares obtained unlimited life to allow investors to receive profits for a longer period than the investors required for obtaining the incentive to invest. Profits in excess of the incentive to invest are defined as 'surplus profits' (Turnbull, 1997: 142).[4] Accountants do not identify surplus profits and so they are not reported and noticed by economists. It is for this reason that they require a different nomenclature from 'economic rent' or 'excessive profits' that are identified and reported by accountants. While surplus profits can arise from long life assets, most real assets except land and collectibles depreciate. The only other type of publicly negotiable unlimited property right is to land invented in South Australia in 1858. It has become adopted widely around the world to exacerbate the inequity and inefficiency of capitalism by allowing corporations to capture both windfall gains in land values as well as surplus profits as described in Turnbull (1973). Unlimited property rights allow corporations to grow too big to be allowed to fail. It also means that corporations can grow too complex to be reliably managed, governed or regulated (Pirson & Turnbull, 2011).

During the 17th and 18th centuries, English sovereigns granted a number of corporate charters that furthered the colonization of different regions of America. As noted by a 20th century economist, such corporations introduced 'unlimited, unknown and uncontrollable foreign liabilities' (Penrose, 1956). The exploitation introduced by English corporations became a contributing cause for the American War of Independence. To negate the political power of English corporations with the declaration of independence in 1776, state governments in the United States initially placed limits on the life of corporate charters and the nature of their ownership. 'Having thrown off English rule, the revolutionaries did not give governors, judges or generals the authority to charter companies. Citizens made certain that legislators issued charters, one at a time and for a limited number of years' (Grossman & Adams, 1993: 6). However, the ability of corporations to again colonize the United States and other economies in perpetuity was reinstated by the Supreme Court in 1819 (Grossman & Adams, 1993: 11).

LIABILITY LIMITED FOR WHOM, FROM WHOM, AND FOR HOW LONG?

Enterprises with their life limited to the life of one or more owners had been universal until creation of English and Dutch companies in the 17th century. Limited life corporations were the rule in England and elsewhere when established without a civil law charter. Instead, an unincorporated company would be created through a common law deed of association between individuals. To attract passive investors, a time limit would be established for the company to allow passive investors an exit with a return *of* their investment while obtaining a return *on* their investment from the distribution of dividends during the operating life of the firm. The deed of association creating the company would typically limit the life of the enterprise to around 20–30 years (Turnbull, 1998) or such an earlier time if the equity invested was impaired by a set about amount, typically 50 per cent.

Some US states in the 18th and 19th centuries limited the life of charters to 20 years, with the right to cancel a charter earlier if the firm broke the law with some banks limited to 3–10 years (Grossman & Adams, 1993: 9, 12). Continuity of business operations became dependent upon shareholder reinvestment in a successor entity, as was the initial practice with the EIC. Cyclic recapitalization of enterprises was a common feature, as it created a compelling incentive for managers to promote the interests of their investors so that they would be rehired in a successor enterprise.

Making executives accountable is a corporate governance benefit of reintroducing 'Time Limited Corporations' (Turnbull, 1973). Establishing the processes found in nature to govern corporations with cycles of termination and rebirthing introduces a number of other profound benefits such as:

1 Allowing market forces to allocate corporate resources through cyclic recapitalizations instead of relying on a very imperfect market for corporate control through takeovers.
2 Avoiding corporations becoming too big to fail.
3 Establishing many more smaller firms with less market power to improve competition in providing goods and services.
4 Reducing the economic and political power of corporations that can undermine democracy.
5 Distributing locally surplus profits to increase the efficiency and equity of corporate capitalism.
6 Allowing enterprises to become locally owned and governed to protect their host environment. And so …
7 Furthering the financial independence of local communities to provide prosperity even without growth (Turnbull, 2011a).

These objectives can be voluntarily introduced by a relatively modest tax incentive, as shown in Turnbull (2000c).

A common law deed of association of unincorporated companies created limited liability for managers, by requiring that the company be liquidated if it did not maintain adequate capital to cover the debts for which managers were responsible under common law. This also provided an incentive for managers to avoid the risk of losses. Lead investors formed what is now described as a supervisory board to appoint managers. In this way, directors, like silent partners in limited liability partnerships, avoided personal liability by not personally incurring debts. The liability of shareholders was further protected by them being issued bearer shares that could be transferred from hand to hand like currency notes to avoid the need for establishing a share registry. Unincorporated companies became a society of anonymous investors and hence the term *Société Anonyme* and the letters *S.A.* located after the names of some European corporations. On the other hand, in the 19th century some US states made each shareholder individually liable for the debts of the company (Grossman & Adams, 1993: 10).

As a reaction to the failure of the South Sea Company, English law made it illegal from 1721 to 1825 for 20 or more individuals to form an unincorporated enterprise without a government charter. No limited liability was needed or given for directors or investors in the EIC. It was inconsistent with the colonizing objective of a company established for the purpose of acquiring foreign lands for the corporate charter to provide the directors with the power to borrow money. Without this power, the need to provide limited liability was not required and, most importantly, it prevented a newly colonized territory being lost to a foreign moneylender[5] if the terms of the debt were not met.

The invention of a no liability (NL) form of company in Australia in 1871 provided another way of attracting funds from shareholders with a small investment without them obtaining a liability to contribute additional funds if they were needed (Lipton, 2007: 820). This situation commonly occurs when a successful prospecting company needs to raise additional funds to begin mining. It highlights the point that limited liability was required more to protect shareholders from calls made upon them by their directors rather than protecting shareholders from the liabilities incurred by their directors on behalf of the company.

The need to protect as well as to further the interest of shareholders provides one objective in designing the governance architecture of firms. However, as reviewed above, corporations evolved in the context of complementing the political objectives of the state. But having obtained unlimited life like a state, some corporations have grown in size to command more resources than some nations. The collective power of corporations considered too big fail is able to influence decision making in some of the most power democratic economies (Monks, 2008). Any definition of good governance needs to recognize their political role, as is next considered.

IDENTIFYING GOOD GOVERNANCE

In this section, good governance and the problems in achieving it will be considered. The idea of government of the people by the people for the people is used to describe democracy. To avoid corporations undermining democracy, they need to be organized in a consistent manner.

As outlined above, corporations were nurtured and used by sovereigns to delegate some of their absolute powers to facilitate elements of self-governance to social institutions like churches, guilds, towns, universities and business undertakings. Initially, the business undertakings expanded the empire, and then they were use to provided public services like water and sewage, and later to facilitate private enterprise. The need for corporations to become self-governing provides a basic criterion for furthering the interest of business undertakings in a manner that is consistent with supporting democracies.

As noted earlier, good governance is typically defined in terms of practices, processes, or economic performance. In this chapter, good governance is defined as the ability of corporations to efficaciously achieve their purpose while minimizing the involvement of the law or regulators in protecting and furthering the interests of corporate stakeholders and society in general. Implicit in this definition is the need to recognize companies' multiple concerns and objectives, as is mostly recognized by law. This definition also offers a criterion by which good governance is judged. In other words, good governance becomes dependent upon firms furthering their self-governance. In this way, social and environmental concerns become included.

Good corporate governance becomes a way to enrich the governance of society by allowing firm stakeholders to obtain the information, will, and power to protect and further their interests while minimizing reliance on the law and regulators. This definition recognizes that firms are part of the political system of how power is distributed and exercised in society.

The above definition is also consistent with the control and communication systems of living things. The natural science of control and communication was identified only in the previous century when Wiener (1948: 11) named it *cybernetics*. He defined cybernetics as 'the science of control and communication in the animal and the machine.'

Stafford Beer pioneered the application of cybernetic insights into the design and management of social organizations in the 1960s and 1970s. His prolific publications were variously described as 'management cybernetics', 'operations research', 'management science', or 'system science'. At that time, most management systems were organized as command and control hierarchies. Later, Tricker (1984) promoted the phrase 'corporate governance' to describe the governance of firms that were organized as management hierarchies. The word 'governance' had been used by economists in relation to describing transactions, with the index of Williamson (1985: 445) listing 147 entries for the word 'governance', with only eight referring to 'corporate governance'.

Technology now allows grounding organization design in the natural sciences to permit cybernetics to be described as the science of governance (Turnbull, 2002b, 2003, 2008b). This allows physical laws to provide the criteria for determining how corporations can become self-governing on the most reliable basis. It also means that the self-regulating strategies found in biota can provide a model for designing the control and communication architecture of corporations to further their self-governance.

The three most relevant natural laws of the science of governance are those that specify how to improve the reliability of (1) communications (Shannon & Weaver, 1949), (2) control (Ashby, 1957) and (3) decision making (Neumann, 1947). The gist of these laws is that communications, control and decision making can be made as reliable as desired by increasing, respectively, the number of communication channels, control agents and decision-making centers.

Of particular importance is a corollary of Ashby's (1957: 206) law of requisite variety. It means that it is impossible to directly amplify control in the same way it is impossible to amplify energy. However, in a like manner to amplifying the energy of a TV signal indirectly by supplementing it with the energy from a power point, so is it possible to amplify control of many variables indirectly through the supplementation introduced by a requisite variety of co-regulators. This has profound implications for corporate governance. It means that it impossible for a chief executive officer (CEO), board or regulator to reliably control complex business operations directly without establishing a requisite variety of supplementary co-regulators (Turnbull, 2001b).

NO SUPPORTING THEORY FOR GOVERNANCE CODES

There is little evidence that management and regulatory theorists or practitioners have recognized the need to establish co-regulators to control complexity. Auditors and credit rating agents could act as co-regulators if they became subject to the power of the investors seeking protection rather than the firms being regulated.

In the 1990s, scholars began describing, identifying and developing theories of nonhierarchical organizations (Nohira & Eccles, 1992; Mathews, 1996; Craven, Piercy & Shipp, 1996; Jones, Hesterly & Borgatti, 1997; Podolny & Page, 1998; Zingales, 2000). Radner (1992: 1384) stated, 'I know no theoretical research to date that compares the relative efficiency of hierarchical and nonhierarchical organizations within a common model.' In the following year, Jensen (1993: 873), an author of agency theory mostly used for providing a theory of corporate governance, observed that: 'We're facing the problem of developing a viable theory of organizations.' Other leading workers in the field have also identified this problem. Zingales (2000: 4) states that '[existing theories] seem to be quite ineffective in helping us cope with the new type of firms that are emerging.' The new types of nonhierarchical firms include those with *network governance* that diminish the relevancy of agency theory (Jensen & Meckling, 1976) and stewardship theory (Davis, Schoorman & Donaldson, 1997) commonly used by governance scholars.

Jones, Hesterly and Borgatti (1997) report that network governance organizations emerged by competitive necessity in the more dynamic and complex industries such as electronics and biotechnology. The laws of requisite variety can explain this phenomenon, as network governance introduces a variety of communication channels, control centers and controllers. However, Jones et al. defined network governance as arising *between* firms to exclude networks also being established *within* firms. To allow the term 'network governance' to apply to the 'architecture of life' (Ingber, 1989), I use the term to describe both inter- and intra-firm networks (Turnbull, 2002a, 2010a, 2011b). In this way, phenomena can be included as reported by Baldwin and Clark (2006); Craven et al. (1996); Podolny and Page (1998) and Zingales (2000).

A framework for analyzing and comparing non-hierarchical organizations with network-governed firms became possible from technological advances in the 1990s. Cochrane (1997, 2000), the head scientist at the British Telecom Research Laboratories, measured the maximum rate at which humans can receive and transmit data in terms of bits and bytes used to describe the capabilities of electronic networks. Likewise, Kurzweil (1999), an MIT voice recognition scientist, reported the limited ability of humans to process and store data measured in the bytes used to define the operating capabilities of computers.

Cochrane and Kurzweil identified the physiological and neurological limits of humans to receive, store, retrieve, manipulate and use or transmit data on a reliable basis. These human limitations restrict the ability of more complex organizations to operate efficiently, effectively, or on a sustainable self-governing basis. The limited ability of humans to transact bytes is independent of the technology that they may employ to receive or transmit data and its higher-order derivatives of information, knowledge and wisdom. While measuring the number of bytes associated with these higher-order social constructs is impossible, their transmission is dependent upon bytes being transacted. Transaction Byte Analysis (TBA) provides a way to explain 'bounded rationality' (Williamson, 1975: 4) and the need for multidivisional ('M-Form') corporations (Williamson, 1975: 136) to minimize information overload (Turnbull, 2000d: 106). M-Form corporations reduce information overload of senior managers by decomposing decision-making labor into various specialized divisions such as production, marketing, finance and human resources.

TBA provides a basis for explaining why firms exist and how to create the most effective and sustainable structure (Turnbull, 2001a, 2010a, 2011b). The Williamson framework, described as transaction cost economics (TCE), is based on socially constructed transaction costs that are difficult to identify and impossible to measure without making assumptions about relative contributions of fixed and variable costs. Williamson (1979: 233) recognized that 'Transaction costs have a well-deserved bad name as a theoretical device' and presciently supported the development of TBA in note 4 by stating: 'But for the limited ability of human agents to receive, store, retrieve, and process data, interesting economic problems vanish'.

TBA provides the framework sought by Radner (1992: 1384) to compare 'the relative efficiency of hierarchical and non-hierarchical organizations.' It provides a basis for the efficacy of the communication and control architecture between humans to be evaluated by its ability to economize the transaction of bytes while achieving the desired integrity of communications, control and decision making. Economizing the transaction of bytes is necessary to keep communication, control and decision making in social organizations within 'human constraints in transacting bytes' as set out in Turnbull (2000d: 111)'. As the transaction of bytes involves perturbations in energy or matter, economizing bytes also economizes the social construct of cost. Indeed, in knowledge-intensive organizations, transaction costs can represent a proxy for bytes. In this way TBA can subsume TCE.

TBA has been used to demonstrate the competitive advantages of network governance as found in the stakeholder-controlled cooperatives with multiple boards (Turnbull, 2000d: 243–247, 2011b). With an appropriate communication and control architecture, multiple boards can introduce distributed intelligence, control and communications. They also introduce the decomposition of decision-making labor to minimize information overload by CEOs and directors of firms governed by a unitary board. In this way, internal network governance can introduce a requisite variety of communication, control and decision making to meet the natural science criteria for furthering reliable or ‘best practices’. A condition precedent for enhancing self-governance and good governance, as defined in this chapter, is the division of power and the checks and balances that network governance can introduce and so *A New Way to Govern* (Turnbull, 2002a). A corollary is that complex corporations without appropriately designed multiple boards are less able to be self-governing and thus less able to represent best practice.

A related problem of firms governed by a single board is the manifold conflicts of interest for the directors (Turnbull, 2000d: 115). As Monks and Sykes (2002: 9) note, directors obtain ‘major inappropriate powers of corporate management.’ In particular, directors obtain absolute power to identify and manage their own conflicts of interest. This provides a basis for directors to corrupt themselves and/or their company.

SUPERIOR AUDIT PRACTICES

The Joint Stock Companies Act of 1844 was the first law to allow a group of investors to form a corporation without a special act of the English Parliament. Consistent with the precedents established by the EIC, the Act made provisions for one or more shareholders (not necessarily an accountant) to carry out an annual statutory audit. The auditors were appointed by and reported to shareholders but were paid by the government through the Commissioners of the Treasury (O’Connor, 2004). The company was required to reimburse the government for the cost of the audit.

This arrangement avoids the untenable conflicts of interest for both directors and auditors imposed by the so-called best practice of the UK Corporate Governance Codes and the Sarbanes–Oxley Act (SOX) in the United States (Romano, 2004). The nature of these conflicts is best explained through comparing the ethical standards of a modern court of law. For example, allowing those being judged to select and pay a judge would be unacceptable. This is only common sense. But the Combined Code and SOX prescribe just this relationship, with directors selecting and paying those judging their financial statements. It also creates a conflict for the auditors who are being selected and paid by the directors whose statements they are judging.

The 1845 UK Companies Clauses Act authorized elected shareholder auditors to hire accountants (O’Connor, 2004). The Act also introduced the concept of limiting the liabilities of company members to the nominal value of the shares acquired. The exposure of shareholders to liability arose from the practice of directors demanding shareholders contribute additional funds than the moneys initially subscribed to form the company. By establishing a nominal or ‘par’ value for the initial issue of shares, directors could still issue shares below their par value but shareholders would know that their total liabilities would be limited to the nominal value of each share. The doctrine of the maintenance of capital established with unincorporated companies to avoid managers and directors incurring debts for the company becoming personally liable was continued with directors remaining liable if they continued trading while not being able to pay debts as and when they fell due. Limited liability companies protected shareholders from their directors, while only protecting directors from liabilities if the company remained solvent.

The 1845 act required the audited accounts and balance sheet to be filed for public inspection at a government registrar. A model constitution was attached to the UK 1862 Companies Act. This provided for the formation of a shareholder audit committee (discussed later in this chapter). However, because the law did not make the model constitution a requirement, it was not widely implemented: one reason being that most publicly traded companies had a family as a dominant shareholder, who, in any event, could control the auditor through their board representatives.

Even with the conflicts identified thus far, regulators around the world allow auditors to attest that they are independent. The use of the word 'independent' in this context is misleading to the general investing public, who are unfamiliar with the ability of lawyers to prostitute the accepted understanding of words. The fact that auditors can attest to their independence reveals the extent to which their profession has captured lawmakers and regulators. Some Continental European jurisdictions avoid the conflict by allowing shareholders to elect a second board that is constituted independently from the directors being held to account (Analytica, 1992): the second board became a shareholders' audit committee to avoid conflicts between directors and auditors.

However, the Italian statutory shareholder audit committee for Parmalat was elected on the same plutocratic basis as for directors with one vote per share (Melis, 2004, 2005). As the CEO was also the major shareholder, he could control both the board and the independently elected audit committee in a way similar to many Anglo corporations with only a single board. Parmalat failed in 2003. This situation could not have occurred if the shareholder committee had been elected on a democratic basis of one vote per investor.

It was to protect minority investors from oppression and exploitation from large investors that I introduced a democratically elected shareholders committee described as a corporate senate in an Australian start-up company in 1988 (Turnbull, 2000a). The incentive for shareholders to approve such a change in their corporate constitution was to attract funds from overseas investors on a basis that they obtained superior protection. The senate appointed and controlled the auditor and any other advisors, chaired shareholder meetings and could veto any board decision in which a director had a conflict of interest such as determining his or her own remuneration, nomination or any related party transaction.

BEST PRACTICE WOULD AVOID DICTATORSHIPS OF MAJORITIES

As an additional safeguard to protect shareholders, I arranged for directors to be elected by a type of preferential voting described as 'cumulative voting' (Bhagat & Brickley, 1984). Each share still had one vote, but each shareholder obtained as many votes as there were vacancies on the board, with the option of cumulating all their votes for one or more nominees. In this way, minority interests can appoint directors to avoid a dictatorship of the majority. In addition, to avoid a minority director being considered a 'whistle blower', I introduced an amendment in the constitution to make it a duty of any director to privately inform the senate of any matter in which any director had a conflict of interest. The failure of a director to disclose a personal beneficial interest can in some jurisdictions automatically disqualify the director remaining a director. If this condition applied to reporting any conflict of interest, directors representing a dominant shareholder would also obtain a compelling incentive to report conflicts to a watchdog board (Turnbull, 2002c).

The idea of an investor audit committee was established by the EIC and set out in the

1962 UK Companies Act. The idea was also raised in the UK by Hatherly (1995), who was once the director of accounting and auditing research at the Institute of Chartered Accountants of Scotland and Wales, a member of the UK Auditing Practices Board, and chairman of the Audit Practice Board's Auditing Research Group. As reported by *Accountancy Age* (2004), the National Association of Pension Funds recommended a shareholder audit committee to the UK government in 2004 but the government ignored this recommendation. Earlier in Australia, Senator Murray (1998) recommended in his minority report to the Australian Parliament the adoption of a more robust version of the corporate senate. Murray more aptly described it as a 'Corporate Governance Board' (CGB). Unlike a corporate senate, which only had veto powers over director conflicts, the CGB obtained the additional power to make decisions on audits, director remuneration and nomination.

The only proactive powers of a corporate senate were to provide the chairman for shareholder meetings and manage the voting process for directors. The purpose of holding an annual general meeting of shareholders in the United Kingdom and many of its former colonies is to hold the directors accountable, vote for their election and determine their pay. An untenable conflict of interest is created if any director controls these processes and chairs the meeting. However, these unethical conflicts are so ubiquitously accepted that they are commonly ignored in considering best corporate governance practices. Likewise, the belief that share markets are transparent and informed is inconsistent with the practice of stock exchanges concealing from investors the identity of those buying or selling their shares. This practice developed to allow stockbrokers to exploit their clients by secretly trading ahead of them or with them. This problem is avoided by unlisted public companies that determine and directly control the basis for their shares to be traded. Electronic share trading offers a way for network-governed corporations to manage their own share transfers, as is commonly undertaken by thousands of private firms with employee ownership in the United States and around the world. Empirical evidence and the science of governance indicate that network governance is a condition for wholly owned stakeholder firms to become sustainable (Turnbull, 2000d: 81, 284).

Covert share trading practice exposes another best practice myth that: Directors should only trade shares after a meeting of shareholders when the public is supposed to be equally informed. Best practice would be for directors and any other insiders to inform the market and their counterparties before trading rather than after the event. A prior-warning approach described as 'sunlight trading' would allow insiders to trade at any time during the year to create a more informed and liquid market.

HOW AUDIT PRACTICES DEGRADED

Until the mid-19th century, US corporations were, in effect, audited directly by citizens and regulated by state legislatures. Even the constitutions of states limited the powers they could delegate to corporations (Grossman & Adams, 1993: 8). This was at a time when shareholders elected directors on a democratic one-vote-per-investor basis rather than by a plutocratic one vote per share. The New Jersey Supreme Court ruled in 1834 that corporate constitutions with one vote per share were illegal (Dunlavy, 1998). However, wealthy and influential interests later persuaded judges to reverse this decision. Today, giant corporations such as News Corporation and Google can issue common shares without any voting rights.

The initial intense local democratic supervision and regulation of US corporations was cast aside by the growth and influence of giant enterprises that emerged at the end of the 19th century. Friedman (1973: 456) reported that powerful shareholders 'bought and sold governments' as well as judges.

States competed with each other to introduce more liberal conditions for corporations to obtain charters and to operate. As O'Connor (2004: 30) notes, this created a 'race to the bottom' in corporate deregulation. As a result, by the beginning of the 20th century few states required corporations to present accounts or to appoint auditors. Consequently, more than 30 per cent of companies quoted on the New York Stock Exchange during the 1925–1929 economic boom did not provide accounts.

Even when corporations did not publish accounts, some non-executive directors (NEDs) would still establish what today would be described as a board audit committee (Guthrie & Turnbull, 1995). Their motivation thus had nothing to do with the presentation of accounts or accountability to investors. Instead, NEDs were entirely motivated by self-interest to avoid becoming personally liable for loans obtained by the firm that were supported by negative pledges given by the directors.

To ensure that management complied with the loan covenants, NEDs would meet separately from the executives and hire a public accountant to follow the money trail. There was no need for the accountant to make judgments on the timing of recognizing income or expenses, or on the value of liabilities and assets or which accounting policies to adopt. In this way, external auditing was established in the United States to carry out an internal audit function for the directors. This played a role in adoption in the United States of confused and conflicting audit practices (O' Connor, 2004; Turnbull, 2005).

In 1933, the US Congress established the Securities and Exchange Commission (SEC) with an Act that also required corporations to audit accounts when issuing shares interstate. The US audit requirements were modeled on the prospectus provisions of the 1929 UK Companies Act. The UK Act did not require a balance sheet, only a 'certified profit and loss statement' for the previous three years (O'Connor, 2004). UK prospectus information is concerned with the economic performance of the company to protect investors. This is different from the legal role for UK statutory audits. The House of Lords determined in the Caparo case of 1990 that the purpose of a statutory audit was to carry out a governance role. This purpose is consistent with the requirement that audits are also required for non-profit corporations that do not issue shares, such as professional associations and charities.

In the United Kingdom, directors appoint the auditor for a prospectus and the audit report is addressed to the directors. However, statutory auditors in the United Kingdom are appointed by shareholders/members and the audit report is addressed to them, not the directors. Under some circumstances, members may not be shareholders, such as when a corporation has it liabilities limited by a guarantee and not by shares, as for professional associations and charities. The statutory need for an audit of a company without shares explains why the House of Lords in the UK ruled that audits have a governance role rather than an economic one.

The requirements in the US 1933 Act for audited accounts regarding newly issued shares were carried over into the US 1934 Act for the interstate sale of existing shares. O'Connor (2004: 61) reports that as the US 1933 Act 'left it open as to who would hire and set compensation for the auditors, this responsibility fell to management and/or the board of directors – the very parties whom the auditors were supposed to be checking up on!'. O'Connor (2004: 59) points out that:

> The SEC then had to find a way to make sure the accountant-as-auditor was independent of the client, so as to be able to render an objective and accurate opinion. The result was a labyrinth compendium of principles, rules, interpretations, and no-action letters whose sole constant feature seemed to be change. The most recent revision to this bramble bush is the auditor independence provisions of the Sarbanes–Oxley Act of 2002.

O'Connor (2004: 60) states that 'the problem of auditor independence was created by the federal securities laws: initially, through the statutory audit provision for prospectuses in the 1933 Act, and then exacerbated by the de facto extension of this audit to an annual requirement under the 1934 Act.' O'Connor (2004: 62) observes:

> Thus, the American accountant/auditor is placed in the untenable position of the agent serving many masters with conflicting interests. In such an imbroglio, is it any wonder that the group who hires, fires, and sets compensation for the auditor becomes the *de facto* client? Over time, laudable efforts to establish protections such as audit committees of company boards that would insulate auditors from the direct influence of management have been instituted. But these still fail to take the simple step of pushing control of the audit relationship back to shareholders where it belongs.

SPREAD OF UNETHICAL COUNTERPRODUCTIVE AUDIT PRACTICES

Rather than remove the conflicts of interest for auditors and directors created by the SEC-mandated rules, SOX has exacerbated the problem by enshrining them in statute. As Romano (2004: 16) notes: 'The learning of the literature, which was available when Congress was legislating, is that SOX's corporate governance provisions were ill conceived. The political environment explains why Congress would enact legislation with such mismatched means and ends.' Companies registered in other countries that are seeking to have their securities traded in the United States are adopting the intrinsically flawed US auditing architecture.

There are many reasons other countries are encouraged to enshrine the conflicted US audit practices in their own economies. First, other countries see the United States as the prime role model for a market-based economy. Second, the OECD Corporate Governance Principles follow US practice. Third, corporate governance rating agencies typically base their metrics on OECD-like principles, creating market forces for corporations outside the United States to adopt US practices. Fourth, the size and influence of US markets provide practical incentives. Fifth, the World Bank, International Monetary Fund, and other international and bilateral finance and aid agencies, proselytize and encourage so-called good governance using the US and/or OECD principles.

The sixth and most insidious influence on other countries is the presence and actions of the big international accounting firms. The United States remains their most important client base. The fact that some other countries assume the US approach represents the most credible, relevant and advanced example of audit practices is understandable. Indeed, as Hatherly (1995: 504) notes, the belief that existing practices 'represent the natural order of things' provides a basis for insinuating US practices around the globe.

Many governance commentators are surprised that US laws, regulations and stock exchange listing rules provide less protection for minority shareholders and investors than in other much less influential countries. The management-friendly US jurisdictions provide an incentive for foreign multinational corporations to move their domicile to the United States in the same way US companies raced to the bottom to change their domicile to Delaware. According to Bush (2004: 5), 'the State of Delaware 'has no framework for public financial reporting.'' The ability of corporations registered in Delaware to facilitate continued family control and/or allow a family control block to be disposed of, without providing adequate protection for minority shareholders, provides one explanation of why the formerly Australian-registered News Corporation Limited moved its registered domicile to Delaware in 2004.

Delaware's system of plurality voting allows any director who obtains one vote to be elected, regardless of how many negative votes are cast against him/her. This self-perpetuating practice is unacceptable in many non-US jurisdictions. Also unacceptable elsewhere is the US practice of allowing brokers and advisers to vote shares when shareholders themselves fail to vote. This practice provides another way for directors to obtain support for their tenure, pay and other actions that may be in conflict with the beneficial shareholders.

Shareholders of corporations incorporated in the United Kingdom and its other former colonies have more powers than those incorporated in the United States. However, notwithstanding the suggestion by O'Connor (2004) that the UK system has advantages over the US audit regime, governance practices in the United Kingdom also create conflicts of interest for auditors and directors.

The US. audit conflict created by directors appointing the auditor is prima facie avoided in the United Kingdom, where the law requires members/shareholders to approve their appointment. In practice this means that the directors nominate and remunerate the auditor, so identical conflicts arise. However, the audit report is prepared for members, not for directors as in the United States. Another difference is that in the United Kingdom the accounts are audited, not just the financial statements, as in the United States. This allows the US audit to be more superficial in its scope, especially when materiality becomes a criterion.

In his House of Lords judgment, Lord Justice Oliver (Caparo, 1990: 16) posed the following rhetorical questions: What is the purpose of holding an annual meeting and what is the purpose of the directors presenting accounts to be audited? He answered these questions by pointing out the following:

> This is the only occasion in each year upon which the general body of shareholders is given the opportunity to consider, to criticize and to comment upon the conduct by the board of the company's affairs, to vote upon the directors' recommendation as to dividends, to approve or disapprove the directors' remuneration and, if thought desirable, to remove and replace all or any of the directors. It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinize the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided.

To counter the argument that the purpose of the audit was to inform investors of the economic value of the company, Lord Oliver (Caparo, 1990: 17) went on to express his disbelief that: 'the legislature, in enacting provisions clearly aimed primarily at the protection of the company and its informed control by the body of its proprietors, can have been inspired also by consideration for the public at large and investors in the market in particular.'

Lord Bridge supported the view of Lord Oliver (Caparo, 1990: 11) of the need for audits to provide shareholders with 'reliable intelligence for the purpose of enabling them to scrutinize the conduct of the company's affairs.' Bridge quoted a 1896 judgment in affirming that there is 'No doubt [the auditor] is acting antagonistically to the directors in the sense that he is appointed by the shareholders to be a check upon them.' Because Anglophone corporations do not establish a shareholder audit committee, auditors now treat the directors and the company as their client, rather than the shareholders. Lord Bridge noted this and stated: 'In carrying out his investigation and in forming his opinion the auditor necessarily works very closely with the directors and officers of the company. He receives his remuneration from the company. He naturally, and rightly, regards the company as his client' (Caparo, 1990: 12).

This explains how UK audit practices became muddled. For the existing flawed system of so-called best audit practice to have any creditability, it becomes crucial to support the myth that auditors can be independent. As considered next, empirical evidence shows this independence to be impossible.

IMPOSSIBILITY OF AUDIT AND DIRECTOR INDEPENDENCE

As Shapiro (2005) notes, auditors cannot be independent of the directors they judge because the legal architecture of Anglophone corporations makes this impossible. Describing some directors as independent and using them to control the auditor cannot remove the conflict. This is because all directors, including the NEDs, are accountable for the financial statements. The very process of establishing a director audit committee in either the United States or the United Kingdom exacerbates the conflicts. Audit committees provide a more intimate and frequent basis for bonding the external auditor to the directors rather than to the shareholders who use the information.

The Cadbury (1992: 27) guidelines recommend greater interaction between the auditor and the directors by stating, 'the external auditor should normally attend audit committee meetings, as should the finance director.' However, this exacerbates the unconscious bias noted by Lord Bridge and scholars discussed below. Nevertheless, the UK Combined Code (2003) perpetuates these practices that should create ethical dilemmas for both directors and auditors. However, both directors and auditors typically vigorously deny dilemmas as they see themselves as professionals beyond such venal subconscious influences.

Bazerman, Morgan and Loewenstein (1997) identify five reasons for why externalaudits fail that are relevant to either the United States or the United Kingdom. Experiments reported by Bazerman, Loewenstein and Moore (2002) validate their analysis. The results are consistent with earlier experiments by Milgram (2004) that explain how good people can do bad things, as occurred in Nazi Germany and with the My Lai massacre.

In the context of corporations governed by a single or unitary board with dispersed shareholders, as found in the United Kingdom and the United States, having shareholders manage and pay the auditor is impractical. Therefore, directors in the United Kingdom are forced to act as the agent for shareholders in this regard. As the role of the auditor is to act 'antagonistically', this creates a fundamental conflict of interest for the auditor. Even the most ethical and conscientious director is placed in the position of exerting power over the auditor and so perceived to be in a conflict of interest situation that corporate constitutions and the law generally require directors to avoid.

Whereas many people, including some scholars, view directors as acting as agents for the shareholders, this is not their normal legal relationship. Directors are principals of the company, not its agents. The confusion arises because directors are elected by (and are accountable to) shareholders. Yet, the fiduciary duty of directors is to the company as a whole. The company is a different legal entity from any one shareholder or even all shareholders as a whole.

Technically, managers become the agents of the company and, thus, agents of the directors. When corporations have widely dispersed shareholders, managers form 'power coalitions', as described by Dallas (1988: 28), to co-opt directors and make them their agents.

Bazerman et al. (1997, 2002) point out that auditors unconsciously become agents of the directors as the directors employ them. Directors, in turn, become a tool of an internal coalition in which management is the 'dominant coalition member' (Dallas, 1988: 29). Auditors then become agents of management to subrogate the very purpose of appointing auditors.

In an effort to deny the conflicts of interest that current arrangements create, the big audit firms and directors have developed a self-serving myth that the role of the external auditor is not to check the company and directors, but rather to check management. This has led to what Rodrigues (2007) describes as the 'fetishization' of appointing so-called independent directors.

As Rodrigues (2007: 1) states, 'According to conventional wisdom, a supermajority independent board of directors is the ideal corporate governance structure. Debate nevertheless continues: empirical evidence suggests that independent boards do not improve firm performance.' Baghat and Black (2002) provide one such source of empirical evidence. Rodrigues (2007: 1) points out that the SOX concept of director independence represents 'fundamentally different conceptions of independence' than that set out by Delaware Law. Clarke (2007: 73) identifies three types of independence and states, 'the whole purpose of having independent directors is surprisingly under theorized, leading to inconsistent rules.' Page (2009) identifies the 'unconscious bias' of 'independent' NEDs. Monks and Sykes (2002: 16) ask why 'refine definitions of 'independence' which everyone knows to be untrue?' Hayward (2003: 3) was a former audit partner of one of the big four audit firms in the United Kingdom and confirms this view by stating:

> There are two fundamental problems with independent audit. The first is that it isn't independent at all. It is in reality – and, as things stand, inevitably – closely aligned with the company management. The second problem is that it is an uncompetitive market, dominated by four large firms.

CONCLUSION

Monks and Sykes (2002: 37) state 'Corporations are ultimately a system of power.' In spite of continuous inquiries, reviews and law reforms, the power of corporations continues to increase. An important source of increased power is changes in the nature of corporate shareholders. Instead of shareholders being individuals representing their own interests and that of society, shareholders are increasingly becoming faceless investment institutions that can have interests that conflict with and/or are irresponsible with the interests of personal investors and society.

The conflicts can arise from many sources. A common situation is when a bank or insurance company or other financial institution holds shares in a company that has a significant shareholding in the financial institution. No employee of the financial institution is then likely to hold to account the directors of their investee company who could be their own directors or their associates. In this way a self-reinforcing circle of no one making directors accountable arises. This situation is most prevalent in the largest and most influential institutions. Other networks of directors and their associates extend the impotence of institutional investors to hold directors accountable. The inhibitions of financial institutions to hold directors to account is reinforced, extended and compounded when the institution wants to gain the favors of the directors of the companies they invest in so as to sell insurance, banking or other services to them. The impotence of the institutions of capitalism to be self-regulating arises from the increasing trend of capitalism to be managed by faceless and conflicted fiduciary agents. 'Fiduciary capitalism' (Hawley & Williams, 1997) inhibits good corporate governance and debases democracy.

A cure for the problems of fiduciary capitalism would be for the ownership of corporations to become vested in voting citizens after the time horizon of fiduciary equity investors, which is around 10 years. This outcome could be achieved on a voluntary basis from a tax incentive referred to earlier. The incentive would transfer the corporate tax base to investors so more revenue could be raised than lost (Turnbull, 2000c).

Governments typically commission powerful and influential business people to lead inquiries into how to reduce abuses. Using such individuals for this purpose has allowed the powerful and commercial vested interests to perpetuate the current system and only make token changes. Definitions of best practices become self-serving rhetoric to preserve the status of the powerful. Monks (2008) describes how CEOs used their power through the US Business Roundtable to persuade the leading accounting firms to accept the big business self-serving agenda of not expensing options. The professional integrity of other service providers to CEOs like auditors, consultants and rating agencies are likewise compromised. As a result of this and the muddled thinking explained in this chapter, regulators and lawmakers have been captured by existing accepted so-called best practices and politically cannot consider fundamental changes. In some cases, good people have promoted counterproductive practices, as when the United States adopted the UK prospectus arrangements for annual audits and the United Kingdom adopted the US practice of audit committees made up of directors instead of shareholders.

Widely accepted best practices involve such matters as having so-called independent directors as a board majority to monitor and direct executives. Best practice is then to form board committees with a majority of directors classified as independent to manage the conflicts that arise from determining the accountability of directors through their audited accountants. Best practice also requires transparency in publishing information on the terms of reference of these committees with their composition and operating procedures. The separation of the role of CEO and board chair is also seen as a best practice.

However, the classification of a director as independent may not be relevant to the decisions being made. Board conflicts of interest cannot be avoided by delegation to subcommittees. Unitary boards are inherently conflicted no matter how a director may be classified. The more independent a director is of colleagues, the business and its industry, the less information and authority a director possesses to carry out his core fiduciary duty to monitor and direct management without relying on management reports with their inbuilt incentive to be self-serving. The fetishization of independence just does not make common sense. It also means that current so-called best practices are uncompetitive as well as unethical (Turnbull, 2004, 2010b).

Corporate power as exercised by Anglophone countries has been a highly influential model for the rest of the world. Prestigious and influential institutions such as the World Bank and many other well-meaning agencies promote it globally. Financial aid has been tied to the fundamentally flawed governance system and practices of Anglophone countries. As Monks and Sykes (2002, 19) note, ‘When the overall system is flawed, ‘best practice’ comparisons have no place.’ Convincing the existing keepers of the currently accepted best practices – especially government regulators, professional advisers and those with corporate power – to change their minds is difficult.

Reversing current views may require a new generation of influential leaders educated in governance science. At present the relevancy of the natural governance laws to social organizations has not gained traction in scholarly discourse, let alone among regulators and lawmakers. One exception was former US Vice President Al Gore, who saw the need for changing the role of government for it to become consistent with the science of governance. Specifically, recognizing that regulating the complexities of society required an indirect approach (Ashby, 1957), Gore (1996) believed that the role of government should be ‘more on imprinting the DNA’ of social institutions to make them self-regulating like biota.

The DNA of social institutions is represented by their constitutions. The role of government is therefore to license organizations to operate provided that they adopt constitutions to protect and further the interests of their stakeholders. This would require corporations to establish their own firm-specific system of co-regulators to provide the requisite variety of control to match the variety of interests and concerns of their stakeholders. The role, cost and intrusion of government into corporate activities would be displaced by corporations acting as co-regulators to further and protect the interests of citizens. Corporations, in turn, would need to distribute and share powers with their stakeholders and other citizens so these constituents could obtain the power to protect themselves directly and/or through others to safeguard their interests (Turnbull, 2008c).

The objective of reducing the role of government while increasing the public good in protecting and furthering the interests of citizens necessitates corporations adopting network governance (Turnbull, 2002a). Network governance by nature distributes power and so is not likely to be voluntarily introduced by command and control hierarchies in the government or private sector. The introduction of network governance is thus likely to evolve from the bottom up, with the development of ever-more complex and dynamic industries, as described by Jones et al. (1997).

Another possible way in which current flawed corporate governance systems could be replaced is that they will become sufficiently discredited and/or broken. A breakdown of an existing system facilitates a breakthrough to a new one. The global financial crisis of 2008 has instigated some minor changes that were not possible to consider or implement previously. Proposals put forward in 1977 to give US shareholders more power to nominate directors and make them accountable were reintroduced in May 2009 (Shapiro, 2009). Yet correcting the current flawed practices apparently requires a much more serious breakdown and/or a much longer time period to allow the insights of governance science to be applied.

The most promising way to reform the inefficiencies, inequities and unsustainable practices of contemporary capitalism is to introduce the tax incentive required for shareholders to vote to change corporate constitutions to limit their ownership to 20 or less years. This would introduce a more level playing field between patents and all other intellectual property that has limited life. As institutional investors commonly hold the largest proportion of shares of the largest corporations, they would have a fiduciary duty to vote for a proposal that provided less risky short-term higher profits in return for giving up long-term ownership providing smaller profits that are more speculative. A present value analysis of the trade-off from obtaining lower taxes in return for diminishing ownership is presented in Turnbull (2000c: 409).

As noted earlier, terminating property rights offers a number of profound benefits. These include avoiding firms growing too big to manage, govern or regulate. It would keep firms to a more human scale. It would also facilitate nurturing the environment with more competition, efficiency, equity and local self-reliance. Network governance would arise as a natural outcome from the recapitalization process and this would provide a way for corporate governance to supplement and support democracy at the local and higher levels instead of undermining it and perverting it with lobbying powers.

The imperative to redistribute income and power by democratizing the ownership and control of corporations with local citizens provides the most efficient and politically attractive way to widely distribute prosperity as populations of the world decline (Turnbull, 2011a). De-population is already occurring in 20 advanced countries and the United Nations (2003) expects the global population will decline in 2075. The tax incentives required to introduce prosperity without growth would become part of the process of reducing the cost, role and size of government to enrich democracy from the bottom up as well as from the top down.

NOTES

1 An exception was the governance ratings undertaken of the largest 100 public, government or non-profit corporations by turnover in Australia. This was undertaken by the author from 2001 to 2003 using the ratings methodology based on the natural science of governance, as explicated in Turnbull (2000b).

2 Turnbull (1971) suggested an educational qualification for company directors that became the first in the world when established in 1975. The Australian Institute of Company Directors presents it

nationally and internationally. However, the course content that identified flaws in the Anglo system of governance and ways for overcoming them were removed when codes emerged in the 1990s.

3 Eastern Australia had been discovered by the Portuguese in the 16th century, but this was not publicized as the region had been reserved for the Spanish by the Pope.

4 An analysis of surplus profits in refereed publications is presented in Turnbull (2000c: 403, 2006).

5 An example of a charter that did not provide directors with the power to borrow money is provided by the one granted in 1825 to the Van Dieman's Land Company that obtained a grant of land in Northern Tasmania. The company was still operating in 2011.

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PART 6

Dilemmas of Corporate Governance

20

Executive Compensation, Pay-for-Performance and the Institutions of Executive Pay Setting

Martin J. Conyon and Simon I. Peck

INTRODUCTION

Executive compensation is a highly controversial subject that has attracted the attention of policymakers, the media and academics for many years now. There are essentially two competing theoretical perspectives about executive compensation determination. One asserts that executive pay is too high and contracts are poorly designed; this is the 'Managerial Power' view of executive compensation (see Bebchuk & Fried, 2004, 2006; Bertrand, 2009). Chief executive officers (CEOs) and executives exercise undue influence over the pay-setting processes that lead to contracts that are not in the best interests of shareholders or society. The other approach to CEO pay is the 'Optimal Contracting' model (Core & Guay, 2010); this is essentially an economic or market-based view of the executive labor market. The optimal contracting model stresses that contracts may not be perfect, but they do minimize the myriad contracting costs that shareholders and managers face in the real world of imperfect and asymmetric information. This chapter outlines this economic approach to executive compensation, illustrating the importance of the level of executive pay, the pay-for-performance link, and the institutions of pay setting.

Controversy surrounds CEO pay; several factors currently drive this. First, the 2008 recession has led to stagnant or declining real incomes for many Americans. However, there is a strong perception that CEOs are insulated from this and that their pay has been increasing despite the recession. The outrage over pay is made worse by the fact that many of those CEOs receiving high pay are running firms that had to be bailed out by the taxpayer. This is especially true of some American banks: Merrill Lynch and American International Group (AIG) stand out. Merrill Lynch is reported to have paid around \$3.6 billion in bonuses to its employees in 2009. AIG paid about \$218 million in bonuses to employees. Many Americans were outraged, as these same institutions demanded taxpayer dollars for their very survival.

Second, American CEOs earn millions of dollars a year. Many people think that the level of pay for all CEOs is simply too high, not just bankers. The typical CEO in the S&P 500 earned about \$8 million dollars in 2008. In addition, annual growth rates in CEO pay can often exceed 10%. Third, critics of CEO packages assert that CEO compensation is insufficiently tied to the performance of their firms. Perhaps high pay could be justified for stellar returns, but question marks remain as to whether performance does drive pay. Worse still, CEOs often receive high pay when company returns have collapsed – creating the impression that CEOs are 'rewarded for failure'.

Finally, it is inevitable that people will compare the paychecks of CEOs to the compensation received by the typical American household. Kaplan (2008) showed that US CEOs earn about 100 times more than median household income in 1993. By 2006, it was more than 200 times higher. Growing income equality has sparked considerable interest in executive compensation, even though the causes of income inequality are complex and hotly debated themselves.

The rest of this chapter is organized as follows. Section 2 gives a theoretical context. It outlines the standard principal–agent model, which forms the basis of much executive compensation research. Section 3 discusses executive compensation contracts in practice. It discusses salaries, bonuses and, most importantly, equity compensation. The importance of stock options is discussed. Section 4 delves inside the black box and discusses the institutions of executive pay setting. Specifically, it evaluates the role of independent directors, compensation committees, and executive compensation consultants. Overall, the chapter suggests the evidence is broadly consistent with the optimal contract model of executive pay. Contracts contain significant incentives to motivate CEOs and to align investor and manager interests. In addition, the institutions of pay setting are found to be reasonably effective in making sure that shareholder interests are safeguarded; at the very least, the case against many of these institutions has not been proven by the vocal critics.

2. THEORETICAL CONTEXT[1]

Principal–agent theory is at the cornerstone of executive compensation and corporate governance issues. It helps understand how to motivate managers in the presence of asymmetric information. Importantly, it gives important predictions on the optimal design of executive compensation contracts. It contrasts to descriptive pay models that assert that CEO behavior stems from the inappropriate use of power, and CEOs extract greater than necessary pay because shareholders are weak and powerless. This section describes the basic agency model, highlighting the central prediction of the incentive–risk tradeoff (Laffont & Martimort, 2002; Bolton & Dewatripont, 2005).

The basic principal–agent model has the following features (Jensen & Meckling, 1976). There are two parties. The 'principal' delegates decision-making authority to an 'agent', who takes actions that materially affect the welfare of the principal. The classic example is the relationship between a shareholder and the CEO–manager. The shareholder wants the CEO to maximize the value of the firm, but is not involved in the strategic decisions of the firm directly (Mirrlees, 1976). Usually, the principal cannot monitor or observe at zero cost the actions that the agent takes. This asymmetric information is termed a moral hazard. In addition, the agent's actions are hidden from the principal. This gives rise to a complex set of problems. How does the principal guarantee that the agent takes the right action to optimize the principal's welfare? The principal's objective is to find an optimal contract that induces the agent to take the 'right' action of his own free will. The solution to this problem depends critically on the structure of the model. These include, the payoff functions for each party, the information each party knows, and the number of times the parties interact.

It can be shown that the optimal degree of incentives for the CEO is given as:

$$\beta = \frac{a}{(1 + c''(e) \times r \times \sigma^2)}$$

where β is the proportion of firm value, V, paid to the CEO (sometimes called a 'sharing-rate'). The term a is the marginal product of CEO effort, the term r is the CEO's coefficient of absolute risk aversion. The term σ^2 is the variance (or riskiness) in firm output V.[2] The term $c''(e)$ is the change in the marginal cost of CEO effort. This well-known result identifies incentives in the agency model.

This model yields a number of predictions and insights. First, the optimal incentives are almost always less than 100%. The CEO is risk averse and the shareholder is risk neutral. The optimal incentives would be equal to 100% if the CEO's is risk neutral ($r = 0$). One way to think about this is that the moral hazard externality could be completely internalized. The shareholders could sell the firm to the CEO, who then has 100% incentives to maximize its value. Any moral hazard now is fully reflected in a decline in the market value of the firm, of which the CEO bears the full financial cost. Second, there is an inverse relation between incentives and risk aversion. This is particularly important to economists. As risk and/or uncertainty in the operating environment increases, this model predicts fewer incentives for the CEO. Why? It is because it is not optimal to impose incentives on the CEO for actions that are beyond his control. Third, incentives are proportional to the marginal product of CEO effort, which in this model is set equal to a – the term in the numerator. This means that the greater effect the CEO can have on the incremental value of the firm (higher a), then the higher are optimal incentives (higher β), other things equal. This is intuitive. The more the CEO can influence outcomes, the more it makes sense to incentivize his marginal productivity.

The model described here and some extensions[3] provide important insights into the optimal design of CEO contracts. It is possible to relax some of the model assumptions and build in other features. For example, in more complex models Holmstrom (1979) describes a situation where any performance metric that provides a signal of the CEOs effort may be (optimally) contracted on. This is the 'informativeness' principle in contract theory. Second, other models allow for the agent to engage in multiple tasks. Holmstrom and Milgrom (1991) provide such a model, and it shows that the optimal incentives for the CEO will depend, among other things, on the weight assigned to each of the tasks. Yet other models deal with the complexities of modeling performance. As is well-known, perfectly measuring the performance of an employee is extremely difficult; doing so at low or zero cost is nearly impossible. The performance measures that we use are frequently impact measures of what we are really interested in. For example, shareholders might want the CEO to focus on the long-term success of the firm. It is hoped that maximizing stock market value does this, but it may not. The CEO might focus excessively on short-term earnings, or strategically manage earnings, all of which muddy the waters of optimal incentive compensation design. How to deal with imperfect performance measures is an important issue for firms to address.

EXECUTIVE COMPENSATION CONTRACTS: FROM THEORY TO PRACTICE

Agency theory, then, is at the cornerstone of executive compensation studies. In practice, executive compensation is made up of a number of components. These may be usefully divided into cash compensation and 'pay at risk'. CEOs typically receive a fraction of their annual pay in the form of a cash salary. The cash component does not vary with firm performance. It is only at risk in the sense that the CEO may be terminated, and that tenure is short. Usually, the cash element is benchmarked against the market. The board of directors and the compensation committee carries out such a benchmarking exercise. The compensation committee is a subcommittee of the main board that is charged with the responsibility of setting pay. In doing so, they frequently hire professional advisors (consultants). We evaluate the institutions of pay setting later.

In the United States, cash pay as a fraction of total pay has been falling over time. Conyon, Fernandes, Ferreira, Matos and Murphy (2011) showed that in 1992 salaries made up about 41% of total CEO pay. By 2009, cash compensation made up about 19% of CEO pay. There has been a decided move towards more 'pay at risk' over time (either in the form of annual bonus plans, or equity pay). CEOs also receives annual incentives in the form of a cash bonus. In the United States, Conyon et al. (2011) showed that non-equity incentives (including bonuses) accounted for about 25% of pay in 1992 and about 25% of CEO pay in 2009. In Europe, their study showed that cash compensation was a significantly higher fraction of CEO pay, approximately 40% in 2008. The annual incentive is normally triggered by an accounting-based measure of firm performance such as earnings per share or budgeted earnings. It is rarely tied to stock market performance measures such as total shareholder returns (Murphy, 1999). The payout schedule is also non-linear. What this means is that a minimum performance threshold needs to be met before any payments are made. This then triggers the bonus. However, bonuses are usually capped at some multiple of targeted performance. These features of the contract can give rise to gaming and perverse incentives in some situations. For example, CEOs who have maximized their potential bonus have few incentives to increase performance further, and worse, may engage in strategic behavior to, for example, influence the following year's performance target (Murphy, 1999).

Stock options

Stock options form a significant part an executive's compensation package. Their use is predicted by principal–agent theory as a way of reducing the latent moral hazard problem described above. Unlike bonuses, equity pay (such as options, but also including grants of restricted or common stock) are automatically linked to the firm's share price. Stock options were especially important in the United States up to the early 2000s. Conyon, Fernandes, Ferreira, Matos and Murphy (2011) showed that in 1992 stock option pay accounted for about 23% of CEO pay. By 2001 stock option pay accounted for approximately 43% of CEO pay. However, by 2009 stock options made up about 22% of pay. This was not because equity pay as such became more unpopular, but because other types of equity pay, such as restricted stock, were increasingly used instead. Stock options became increasingly common in the UK too during the 1990s, though here too their use has waned in favor of other types of equity pay plans. For example, the Greenbury Committee (1995) explicitly encouraged firms to explore alternatives to stock options. Compared to Anglo-Saxon economies, stock options have been far less common in continental Europe (Conyon & Murphy, 2000; Conyon et al., 2011).

Stock options are the right but not the obligation to purchase a share in the firm at some prespecified price (the exercise price) at some date in the future. The period of time that the executive has to exercise the option is the maturity term, about 7–10 years. The options vest at about 3 years, and at this time they may be exercised. Options awarded to UK executives often have additional performance criteria attached too. The UK CEO has to attain a performance level (usually an earnings per share or total shareholder returns target) in addition to the time vesting constraint, though these targets have not traditionally been particularly demanding (see Conyon, Peck, Sadler & Read, 2000).

A fundamental question is how to assign value to the stock option, whose end-of-contract value is not known with certainty at the time the option is granted. It is customary to value stock options as the economic cost to the firm of granting an option to the executive. This is the opportunity cost to the firm that is forgone by not selling the call option in the open market. The basic question is what value the firm could have got for issuing options in the market rather than allocating them to the executive. Most firms and academics use the Black and Scholes (1973) and Merton (1973) option pricing formula to value options. The Black–Scholes equation for a European call option on a share that pays dividends is:

$$\text{Option value} = c = Se^{-qt}N(d_1) - Xe^{-rt}N(d_2)$$

where

$$d_1 = (\ln(S/X) + (r - q + \sigma^2/2)t)/\sigma\sqrt{t} \quad \text{and}$$

$$d_2 = d_1 - \sigma\sqrt{t}$$

The variable c is the call value of the option. With information on six basic input variables it is possible to assign a present value estimate to the call option. The input variables are: S, the stock price;, X, the exercise price; t, the maturity term; r, the risk-free interest rate; q, the dividend yield; and σ, the volatility of returns. N(.) is the cumulative probability distribution function for a standardized normal variable. Using this formula, the excepted value of the option can be calculated. For example purposes, if we define a standard option where the stock price S is \$100 and that the option is granted *at the money* so the exercise price is also \$100 (i.e. X = \$100). The stock volatility is set at 30%, the annual risk-free interest rate is 2.0%, the option maturity term is set at 7 years, and the stock's dividend yield is 2.0%. In this case, the Black–Scholes value of the option, given by the formula above, is calculated as \$26.82. The option has economic value, even though in this case the so-called intrinsic value of the option is zero. The *intrinsic value* of the option is the stock price minus the exercise price (S – X), and when an option is granted at-the-money this value is zero. This does not mean that the option has zero value. Positive economic value comes from the so-called *time value* of the option. This reflects the fact that the option has time before it needs to be exercised (in this example 7 years) and the value reflects that there is a probability that the options will end up in the money. As the contract nears maturity, the time value of the option diminishes and most of the value of that time is given by the (hopefully) positive intrinsic value.

How is option pay linked to firm performance? For a common share (as opposed to a stock option) the pay-for-performance link is simple. A dollar increase in the stock price increases the value of the share by one dollar. Unlike ordinary shares, the value-to-asset price relation is non-linear for a stock option. The Black–Scholes model shows that, holding all other variables constant, the value of the option displays a convex relation to the share price. A simple example illustrates the point. Suppose the stock price increases by 10% (\$10) in the previously defined standard option, and the values assigned to the other variables are held constant. The value of the stock option increases from \$26.82 to \$32.70. However, the percentage increase in the expected value of the option is 21.92%. The key point is that the percentage increase in the share price has resulted in a *more than proportionate* increase in the value of the stock option.[4] If we were describing a common stock, and not a stock option, the $10 increase in the share price would have increased the value of share by exactly $10 too. However, the convexity of the stock option payoff schedule leads to a greater than proportionate effect on the value of the option for a given increase in the share price, other things equal. In this sense, share options, rather than ordinary shares, provide greater incentives for executives to raise share prices, for the same shareholder dollar outlay.[5]

We should stress some of the implicit assumptions underlying the Black–Scholes model (e.g. Murphy, 20019; Hull, 2009). First, in the context of the executive labor market, many assumptions underlying the Black–Scholes model are unlikely to hold in practice. In particular, the assumption of risk neutrality of the option recipient is likely to be violated: or hold only by luck. The violation of the assumption means that the CEO will place a different value on the option compared to the excepted value assumed by the firm. A standard way to think about this is that executives are typically risk (and effort) averse, undiversified, and prevented from trading the options or hedging their risk by selling short the company stock. Since these are binding constraints, executives will (in general) place a lower value on the stock option compared to the Black–Scholes cost to the company. By how much it is difficult to assess, and, in the absence of experimental evidence, will depend on assumptions about the functional form of the utility function of the CEO, the degree of risk averseness and the CEO's wealth. Unfortunately, there is little hard empirical evidence on exactly how executives value options and how far their value differs from option values given by the Black–Scholes formula.

Second, the differences in the option valuations between the firm and the option recipient have important implications for the use of options as a compensation instrument (see Murphy, 2002). For the CEO to accept the contract in an open market, the firm must pay a premium to motivate the CEO to accept the risky option versus risk-free cash compensation. In consequence, firms will want to make sure that the resulting increase in executive and firm performance from using options covers this risk premium. In this sense, stock options are an expensive way to reward executives compared to simply providing risk-free cash to the executive. However, the use of options is beneficial if they induce sufficient extra effort or performance by the executive to cover the incremental costs.

There is evidence that difference in risk can account for differences in compensation practices across countries. Conyon, Core and Guay (2011) study US CEOs and compare these to CEOs in Europe. They find that median US CEO pay in 2003 – defined as the sum of salary, bonus, grant date value of restricted stock and options, and benefits and other compensation – is about 40% greater than for UK CEOs. They show that US CEOs hold more risky pay in the form of equity, and are therefore likely to demand a risk premium. In addition, the authors make risk adjustments to observed total pay, based on assumptions about CEO risk aversion and outside wealth owned. They show that there is little evidence that US CEOs' risk-adjusted pay is significantly greater than that of UK CEOs. In a related study, Fernandes et al. (2010) also find that the US CEO pay premium falls significantly if one controls for relative risk aversion. Their analysis is based on compensation practices in 14 countries where there is sufficient mandated pay disclosure. Overall, they concluded that a large part of the observed US pay premium reflects compensating differentials for the higher risk of US pay packages.

Stock options and asset price volatilities

This subsection briefly considers the relation between options and asset price volatilities.

The 2008 recession caused considerable volatility in the markets, so understanding how this affects option values is important. Options certainly link pay to performance, and the convexity of the payoff schedule might encourage executives to increase underlying asset prices more than if they simply held ordinary shares. In showing this result, we held other factors, such as the interest rate, stock volatility, and dividend payments, constant. In reality they vary, and might well be endogenous. One factor that seems especially important is asset price volatility, which can be approximated as the standard deviation in the firm's stock price. It is one measure of firm risk. The standard deviation of the stock price (i.e. volatility) is a key determinant of the price of the option. Specifically, it can be shown that *increases* in stock option volatility are associated with *increases* in the value of the option.[6]

This has potential implications for managerial behavior. First, the positive correlation between option value and price volatility means that the manager has an incentive to increase this volatility (i.e. he may engage in risky behavior). This creates a tension between investors and managers, if investors prefer less variance in asset prices. Second, the effect of a change in price volatility on the option value is less than the effect of a change in the level of the stock price on option value. Although, managerial behavior is tilted towards increasing the volatility of the option, the incentive is less than the motivation effect arising from a change in the stock price alone. Third, it is reasonable to suppose that underlying asset prices, and therefore the volatility of the firm's stock price, is endogenous from the perspective of the CEO. His actions affect both the level and distribution of asset prices. In consequence, there are regions of the stock price and risk mapping that the CEO might exploit that might not be in the interests of the investor. For example, the CEO may try and increase the level of the stock price only modestly (perhaps to thwart potential hostile takeover attempts) but enhance the value of the option by taking actions that increase the volatility of the firm's stock prices.

US CEO pay and the pay-for-performance link[7]

A central question in empirical studies of executive compensation is whether CEO pay is connected to performance. There are at least two reasons for this. First, agency models that we considered earlier implied that to solve the moral hazard problems firms should tie CEO pay to measures of firm performance. That is, to stop CEOs taking the wrong kind of actions, and align the interests of the CEO with investors, the firm should pick the king of performance measures that signals the quality of CEO effort that the investor is interested in. Typically, this will mean equity pay such as stock options, and restricted stock. But other forms of payments might also work, such as cash bonus systems triggered by stock price targets. The second reason is more of a moral one. It is generally thought that CEOs receive high sums of money. Often these sums are significantly greater than those earned by the typical employee. One justification of these high pay levels is that executives might 'deserve' them because the performances of their companies were excellent. The alterative perspective is that sometimes a firm's performance is lamentably poor. If CEOs get high pay when performance is low, then what is the justification? For many people there is none. Low performance and high pay simply translates to 'rewards for failure'.

How high is CEO pay in the United States and how has it evolved over time? Is CEO pay effectively linked to firm performance? Or are CEOs rewarded for failure, as some critics assert? There are many studies that have empirically looked at the level and structure of CEO pay, and determined whether CEO pay is aligned with shareholder interests (Murphy, 1999). Each study, of course, has its own nuances and qualifications. However, from our reading of this large literature, we think that there is a robust positive association between CEO pay and measures of firm performance. These studies also show that CEO pay in the United States is generally high, especially when compared with European CEOs. However, recent studies have shown that when studies control for CEO risk and incentives, then CEO pay in the United States may not be as high as originally thought compared to countries such as the United Kingdom (e.g. Conyon, Core & Guay, 2011).

Many empirical studies have shown that US CEO pay increased considerably during the 1990s. A full account of this evolution is given in Core and Guay (1999, 2010), Kaplan, (2008), Murphy, (1999) and Hall and Liebman (1998). The first issue is to ask how CEO pay is measured. CEO pay is generally defined as the sum of salary, bonus, long-term incentive payouts, the value of stock options granted during the year (valued on the date of the grant using the Black–Scholes method), and other cash payments (including signing bonuses, benefits, tax reimbursements, and above-market earnings on restricted stocks). The issue for measuring the flow of compensation during any given period is that one only values the equity and option pay during that time period. For example, this mean only the options granted in that period and not the whole stock of stock options that the CEO may have accumulated during his time at the firm. This would be a larger figure, and really is a measure of the CEOs *wealth* held in the firm rather than a per-period measure of CEO *pay* for services rendered during that period.

Table 20.1 provides some estimates of CEO pay in the United States over various years from various studies. The precise figures are perhaps slightly less interesting than the general patterns that can be deduced. First, CEO pay is high in the sense that the figures are higher than the compensation relative to typical employees. In recent history, median and average pay has been greater than US$1 million per annum. Second, the data show that larger companies receive higher compensation than smaller companies. There are various ways to see this. Our estimates in Table 20.1 show that median CEO pay in large S&P 500 companies is about $7 million dollars in 2009 compared to about $2.2 million in the smaller S&P Mid Cap and Small Cap companies. This finding is reinforced in the Larcker and Tayan (2011a) data, which covers a very large set of US firms – up to 4,000 firms in fact. They find that the top 100 firms in the sample have median CEO pay of about $11.3 million dollars. The median pay for the whole set of about 4,000 firms is about $1.6 million. The precise figures are not as important as the fact that there is a strong positive correlation between CEO pay and firm size. Why might this be? The most obvious reason is that these are larger and more complex firms to run. Indeed, the largest firms have market capitalization values of $36,577 million, whereas the smallest have values of about $35 million. These are, indeed, large firms and CEOs are rewarded for running them.

Third, CEO pay levels increased considerably during the 1990s. The Conyon, Core and Guay study shows that the average changed by about 32% between 1997 and 2003 and the median by about 15%. The 1990s was a period of rapid CEO pay growth, as shown in a number of studies (Core & Guay, 2010). The recession and collapse in equity prices in the early 2000s was associated with a slowdown in CEO pay. The Kaplan (2008) data show little change in median CEO pay between 2000 and 2006, for example. It is also noteworthy, that in this quite narrow sense, pay is also linked to performance. Why? As US equity markets declined, and assets prices fell, so too did CEO pay – or at least it seemed to stagnate relative to the growth rates of the 1990s.

Fourth, median CEO pay is empirically always less than the average. The reason for this is clear. CEO pay is bounded below at zero. However, when there are some companies that pay their CEOs very high amounts, then this forces the average level upwards but has little effect on the median. And this is

Table 20.1 US CEO pay estimates

Study	*Year*	*Average Pay ($000s)*	*Median Pay ($000s)*	*Comments*
Conyon, Core and Guay (2011)[1]	1997	$3,522	$975	1,327 firms
	2003	$4,651	$1,121	1,511 firms
Core and Guay (2010)[2]	1997	–	$3,800	S&P 500 firms
	2008	–	$7,600	S&P 500 firms
Kaplan (2008)[3]	2000	$16,000	$7,000	S&P 500 firms
	2006	$8,000	$8,000	S&P 500 firms
Larcker and Tayan (2011)[4]	2008/09	–	$11,357	Top 100 US firms
		–	$1,588	Largest 4000 US firms
Conyon and Peck (own estimates)[5]	2009	$8,481	$7,037	S&P 500 firms
	2009	$3,102	$2,243	S&P Mid-Cap & S&P Small-Cap

Notes:

[1] Table 1 of the study.

[2] Table 1 of the study.

[3] Based on Figure 1 of the study; these figures are approximate.

[4] Derived from Larcker and Tayan (2011a) "Seven Myths of Corporate Governance". Exhibit 2. Total annual CEO pay is the sum of salary, bonuses, options and other flow period pay.

[5] CEO pay is the sum of salary, bonus, other annual compensation, the total value of restricted stock granted, the total value of stock options granted (based on the Black–Scholes method), and long-term incentive payouts, and all other pay. It is variable TDC1 in the Execucomp database. Non-S&P 500 firms are selected.

one of the reasons CEO pay is often thought to be high. Outliers (which may not be representative of the population as a whole) drag up the average, especially in times of high CEO pay. Figure 20.1 illustrates the point more vividly. It shows the kernel density estimates of about 1,700 CEOs (both S&P 500 and non-S&P 500 firms together) in the Execucomp database for the year 2009. The mean of the variable is about $4.6 million and the median about $3.1 million. However, as one can see the fewer high-paying CEOs significantly alter the central moments of the distribution.

Fifth, is the 1990s CEO pay hike just an anomaly? Conyon et al. (2011) report on the evolution of CEO pay, using data from Professor Kevin Murphy's various studies (see Murphy, 1999). They showed that CEO pay increased steadily during the 1970s, but the large increases in CEO happened from the mid 1980s. Similarly, Frydman and Saks (2010) study long-run trends in US executive compensation going back to the 1940s. They showed too that CEO pay increased from the 1980s onwards. Prior to this, modest growth of about 1% per annum was the norm. Conyon et al. (2011) have provided a political economy explanation of these changes in CEO pay, focusing on taxes, accounting rule changes, and political pressures. The current global economic downturn has dampened the growth in CEO pay and led to increased demands for more regulation.

Pay-for-performance

The level of pay is only part of the story. Pay-for-performance shows the degree of alignment between managers and shareholders. In their now classic study, Jensen and Murphy (1990) demonstrated that CEO wealth varied only lightly with firm performance. A $1,000 increase in shareholder wealth was associated with a $3.25 increase for the CEO. It turns out that it was the lack of firm equity ownership (equity and options) in the CEOs contracts that explained this weak association. Hall and Liebman (1998) showed that since about the mid 1980s stock options became a critical feature of CEO pay.

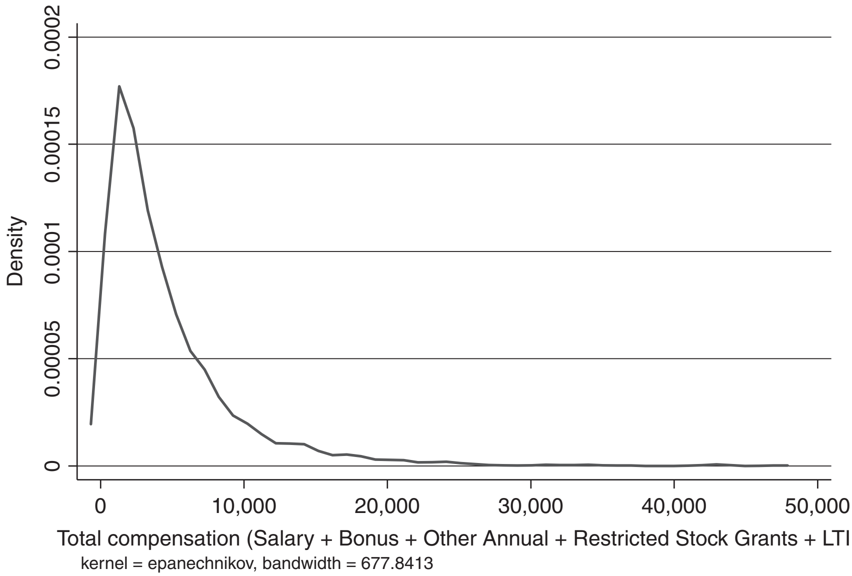

Figure 20.1 The distribution of US CEO pay in US S&P ExecuComp firms in 2009

Note: Total executive compensation is defined the sum of salary, bonus, other annual compensation, the total value of restricted stock granted, the total value of stock options granted (based on the Black–Scholes method), and long-term incentive (LTI) payouts, and all other pay. It is variable TDC1 in the Execucomp database. CEOs are defined by selecting on the variable ceoann = CEO in the Execucomp database. Nominal value reported. Epanechikov kernel; bandwidth = 677.8413.

The notion that CEO pay and performance were unconnected was upended. They showed a strong positive correlation between CEO compensation and firm performance, arising almost entirely by changes in the value of CEO holdings of stock and stock options. In addition, they demonstrated that both the level of CEO compensation and the sensitivity of compensation to firm performance increased dramatically since 1980, largely because of increases in stock option grants. The big question then is whether CEO pay is linked to performance. The answer to this question is generally ‘Yes’.

There are several ways to show that CEO pay is linked to firm performance. The first method, advocated in Murphy (1999), and pioneered in Murphy (1985) and Coughlan and Schmidt (1985), is to perform a simple linear regression of the change in CEO cash compensation on the change in stock market value. This is the elasticities approach to estimating the link between CEO pay and firm performance. Since it focuses on cash (rather than equity pay), the method is picking up the correlation between bonuses and value creation. Conyon, Fernandes, Ferreira, Matos and Murphy (2011) in their study of US and European CEO executive pay find that CEO cash pay is positively correlated to firm performance. However, they also find that the link between CEO pay and firm performance appears to be stronger for US firms compared to European firms.

Another way to look at the link between CEO pay and firm performance is simply to investigate the different levels of pay associated with different levels of firm performance. Again, the question is, of course, how do we measure pay and how do we measure performance. To illustrate, we investigated a generally accepted measure of (current) total CEO pay. We calculate CEO compensation as the sum of salary, bonus, other annual compensation, the total value of restricted stock granted, the total value of stock options granted (based on the Black–Scholes method), and long-term incentive payouts, and all other pay.[8] The measure of firm performance that we used was the 3-year returns to stockholders with dividends continuously reinvested.

We then ranked this level of performance into deciles, from low (1st) to high (10th). The mean stockholder return in the 1st decile was −47.1%; the mean in the top decile was 29%. In Figure 20.2 we plot the correlation between CEO pay and firm performance. What one sees is that at low levels of firm performance (bin 1) CEO pay is lower than for higher levels of firm performance (say bin 9 or 10). This shows that CEO pay and firm performance are positively correlated: firms with better performance reward their CEOs with high levels of pay. The evidence is suggestive that owner and managerial interests are aligned through compensation contracts. Of course, the descriptive data should, at some future stage, be probed further and fully tested using econometric methods controlling for endogeneity and (company and manager) fixed-effects. However, the raw data do seem to show an interesting picture.

Another way to look at the link between firm performance and CEO pay is to focus on the *wealth* that the CEO has accumulated in the firm, rather than just the level of *current pay*. For example, a CEO might receive 1,000 units of restricted stock this year, but this might add to 9,000 that he received in previous years, making a total of 10,000. From an incentive and alignment perspective, what is more important is the CEOs willingness to increase firm value. And this will be related to the total of 10,000 units of

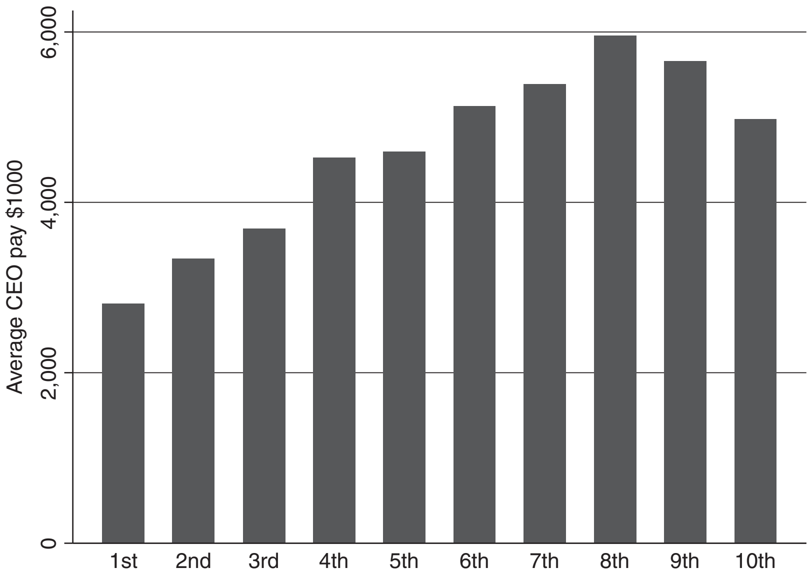

Figure 20.2 The relationship between CEO pay and stock market performance in US firms

Note: Total executive compensation is defined as the sum of salary, bonus, other annual compensation, the total value of restricted stock granted, the total value of stock options granted (based on the Black–Scholes method), and long-term incentive payouts, and all other pay. It is variable TDC1 in the Execucomp database. CEOs are defined by selecting on the variable ceoann = CEO in the Execucomp database. Nominal value reported. Deciles are defined on the 3-year returns to stock holders and ranked from low (1st) to high (10th).

stock and not simply the 1,000 granted this year. Focusing only on current grants (or pay) can miss the bigger picture.

The available evidence shows that CEO wealth (and pay) is linked to firm performance. David Larcker and Brian Tayan (2011a) explode the myth that there is no pay-for-performance in CEO compensation contracts (see their Myth #3). They assert that 'While there are examples of unreasonable compensation, it is not true that the typical CEO is not paid to perform'. They show that the typical CEO in their large sample of firms receives about $4.6 million in stock and options. They calculate that a 1% change in the firm's stock price leads to about a $54,000 change in the underlying value of shares and stock held. If the CEO doubles the stock price, then CEO wealth increases by about $5.2 million. As these authors note, this provides the CEO with powerful incentives to create not destroy firm value.

Core and Guay (2010), too, calculated CEO incentives from 1993 to 2008. They find strong evidence that CEO pay is correlated to performance. They sort their sample of S&P 500 firms into performance deciles (the lowest decile is –44.7% and the highest is 68.8%). They consider both annual pay and overall CEO wealth effects. They find that CEO annual pay falls by about 13.7% in the lowest decile and increases by about 19.7% in the highest decile. This shows that pay is related to performance. They find more dramatic effects for CEO wealth. In the lowest decile (stock returns = –47%) of performance, CEOs loose $32 million in wealth. In the top decile (stock returns = +68.8%), CEOs gain $31.4 million in wealth. In addition, Kaplan and Rauh (2010) also find that pay in the top quintile is correlated to superior relative performance. Firms in the bottom quintile of pay were the worst performance firms relative to the market. Overall, there appears to be ample evidence that boards set compensation incentives to motivate CEOs. However, there is always room for improvement. CEOs might take the 'wrong' actions to improve performance, or they might conceal bad news for fear that it might have on their asset values. Hence, the institutions and mechanisms of pay governance are important, which we consider next.

THE INSTITUTIONS OF EXECUTIVE PAY SETTING[9]

Shareholder power and 'Say on Pay'

The analysis in Sections 2 and 3 suggests that shareholders set pay and incentives in order to minimize agency costs. It is as if shareholders meet, figure out the contract, and then offer it to the CEO, who in turn accepts or rejects it. Clearly, shareholders do *not* set pay: they are too numerous and too diverse. In reality the board of directors sets pay. Indeed, in the United States the boards have a fiduciary duty of care and loyalty to shareholders and to act on their behalf.

Although investors are not directly setting pay, it is not to say that they have no say over pay-setting arrangements. Hartzell and Starks (2003) show that where institutional investors have significant concentrated ownership stakes in companies, managerial compensation was lower than might be expected using economic variables and the link to performance higher than firms with more diffuse ownership. Recent policy in this area has also centered on giving shareholders themselves more say over the pay process. In the United Kingdom, under the recommendations of the 'Combined Code', companies were encouraged to voluntarily submit a remuneration report to scrutiny and approval from shareholders, but few in reality did. In the face of mounting concern, the Directors Remuneration Report Regulations 2002 (SI 2002/1986) came into force in August 2002. This piece of legislation departs from the notion of voluntary best practice that has traditionally formed the cornerstone of corporate governance reform in the United Kingdom, by introducing a legislative requirement for the approval of the remuneration report by shareholders.

The newer UK regulations require that companies must publish a remuneration report on directors' pay packages that must be approved and signed by the board of directors. In addition, this report will itself need to be sent out to shareholders with the annual report and accounts, and also presented to them for approval as the annual shareholders meeting (or AGM in the United Kingdom). In the first empirical tests of the legislation, Conyon and Sadler (2010) find relatively little material effect of the legislation on pay arrangements, not least as the percentage of shareholder voting against pay arrangements is actually falling since the introduction of the legislation. This resonates with the findings in Conyon et al. (2000), who in interviews with compensation committee members of large UK companies, find that seeking approval from large shareholders in advance of major issues relating to executive compensation helps 'avoid surprises'. This suggests that to large shareholders ex-post evaluation of executive compensation is considered less effective than having a say in any proposal ex-ante.

In the United States, 'Say on Pay' is now guaranteed by the Dodd–Frank Act (2010), which requires that companies grant shareholders a non-binding, advisory vote on executive compensation plans. This legislation followed considerable outrage about executive pay levels, especially since the financial crisis of 2008. Shareholder votes must be carried out every 1, 2 or 3 years. The practice follows what has been happening in other countries. The overwhelming majority of companies receive approval for their executive compensation plans. Congress gave shareholders the right to vote on pay: and shareholders said 'Yes'. Semler Brossy (2011), a consulting company specializing in executive compensation matters, surveyed 2,293 of the Russell 3000 companies. According to their report, 71% of firms received over 90% approval for their compensation plan, 21% received 70–90% approval, 6% received 50 to 50% approval. A tiny fraction, 2%, received less than 2% approval. These 37 Russell 3000 companies failed to receive at least 50% of the 'Say on Pay' vote. Eight of these companies were members of the S&P 500. It would appear, then, that shareholders (the owners of the firm) overwhelmingly endorse the pay practices of the companies that they own.

Board power and independent directors

Such recent Say on Pay legislation notwithstanding, the primary institution of pay setting is still the main board of directors. In the United States there is a single board, consisting typically of about 10–15 members. Other countries, such as Germany, operate two-tier boards – one is a management board and the other a supervisory or oversight board. The size of the main board is positively correlated to firm size: bigger more complex firms have larger boards. Each board has various specialized committees. Almost all boards in the United States now have an audit committee, a compensation committee, and a governance or nomination committee. Some have other specialized committees, such as an executive committee, strategy committee, or environment committee. For the purposes of executive pay, the compensation committee is central. It deliberates matters of executive pay, taking professional advice from consultants as appropriate, and makes recommendations to the main board for ultimate approval. When considering CEO pay-setting institutions, then, one must evaluate the role of the independent director, the compensation committee, and compensation consultants. Each has an important role to play. Failures in these institutions can lead to non-optimal executive pay contracts.

Critics of executive compensation claim that CEO pay is too high, and that the design of the contract is not sufficiently demanding. Managerial power models of executive pay generally claim that compensation arrangements are too generous (Bebchuk & Fried, 2004). CEO power leads to levels of pay above the arms-length negotiated optimal contracting level. Corporate boards are relatively weak compared to the CEO, though the presence of 'outrage' costs acts as a binding constraint to stop pay rising indefinitely. However, CEO power and influence is sufficiently widespread that deviation from market forces and optimal contracting are common. There are many potential tests of the managerial power hypothesis, and a challenge for research is to design tests that rule out the competing efficiency (optimal contracting) explanation. Specifically, much of the literature that seeks to test the effects of board power can rely on indicators that at best provide part of the picture. Thus, the inability of studies to isolate significant relationships around exploration of issues such as CEO tenure (Wade et al., 1990) or CEO shareholdings (Finkelstein & Hambrick, 1989) are examples of just such issues. Moreover, Westphal and Zajac (1995) show that the picture may be nuanced; CEO 'power' was associated with the adoption of plans that appeared to put a lot of CEO compensation at risk through long-term incentive plans; shareholders would vote to approve such schemes, as they approved of such measures to link pay and performance. The authors suggested that there was a significant symbolic element to such behavior by boards, however, as the actual level of implementation of such plans after formal adoption was low.

One test of the managerial power hypothesis is that weak boards lead to high CEO pay (Bebchuck & Weisbach, 2010). Thus, what constitutes a weak board? The literature typically designates a board as poorly constituted if it is too large, and therefore it is difficult for directors to oppose the CEO, or if the CEO has appointed the outside directors, who are beholden to the CEO for their jobs. In addition, boards may be termed as weak when directors serve on too many other boards, making them too busy to be effective monitors; or if the CEO is also chair of the board, since conflicts of interest arise. Alternatively, the board may be too friendly with the CEO, coming from the same social or friendship groups, and therefore pay insufficient attention to their fiduciary duties to shareholders (Westphal, 1998). When boardroom governance is poor, excess pay as an agency cost is expected. Empirical evidence using cross-sectional data often support the claim that agency costs are greater when boards are poorly constituted. The evidence shows that, in a cross section, poorly designed board structures are associated with greater excess pay (Core et al., 1999). Studies have also sought to add more nuance to the notion of the power of the CEO versus the board. Using measures such as CEO duality (where the CEO also holds the position of board chair) and the number of directors appointed to the board after the CEO's appointment as determinants of this power dynamic, the empirical evidence is somewhat mixed. Westphal and Zajac (1994) suggest this latter measure is positively related to CEO pay, a result consistent with Lambert et al. (1993). Duality appeared to be an important predictor in some studies (Main et al., 1993), though other studies found no such effects (Boyd, 1994). Deutsch (2005) provides a meta-analysis of some 38 studies related to the issue of outsider (rather than strictly independent) status and finds no robust relationship.

An important challenge to the managerial power view is the time-series behavior of executive pay and independent directors. Boards of directors have become more independent over time, at the same time as executive pay has increased. Another way of stating this is that executive pay has increased as boards of directors have become stronger and more independent. The time-series data, at first glance, is at odds with the managerial power view of CEO pay. It predicts that as governance quality goes up, CEO pay should go down. However, the converse is true in the United States, and other countries too (such as the United Kingdom).

Compensation committees

Baker et al. (1988) identified the compensation committee as the key board institution that sets CEO pay. A compensation committee that contains a CEO raises a potential conflict of interest, and this is a concern for investors. Independent committees (with no insiders) make pay setting much more transparent and hopefully better by removing the CEO from deliberations about compensation. Ineffective pay committees give the CEO an opportunity to promote his interests at the expense of shareholder welfare.

Previous studies have found little evidence that compensation committees are ineffective. Conyon and Peck (1998) investigated the relation between board control, the compensation committee, and executive pay, using panel data on the 100 largest UK firms between 1991 and 1994. They found that the quality of governance increased over time and their study showed that CEO pay is greater in firms with compensation committees or those with a greater fraction of outsiders on the committee. However, they found the link between pay and performance was greater in firms with a greater proportion of outside directors on the compensation committee. Thus, there was little evidence that compensation committees were failing investors.

In another study, Daily et al. (1998) investigated 200 Fortune 500 companies in 1992. They found no relationship between CEO pay and the proportion of affiliated directors on the compensation committee. Other studies from the United States and the United Kingdo have also failed to find that compensation committees result in excess CEO pay or poorly designed compensation contracts (Anderson & Bizjak, 2003; Bender, 2003; Conyon & He, 2004; Gregory-Smith, 2009). However, other studies, drawing on more behavioral theories of how boards operate, have isolated some interesting results; O'Reilly et al. (1988) showed that CEO pay was positively associated with the pay levels of both compensation committee members and other outside directors. They suggest that social comparisons become an important mechanism in the pay-setting behavior; a theme that may become particularly important is that social comparisons are based on friendship ties (Westphal, 1998). Overall, there is little compelling evidence that the design of compensation committees is failing investors.

Compensation consultants

Compensation consultants are firms who advise the board of directors about executive pay practices. Critics argue that pay consultants lead to excessive CEO pay and poorly designed contracts (Bebchuk & Fried, 2004; Waxman, 2007). While boards are not mandated to use any external advisors when considering pay in their organization, in the United Kingdom, the key public policy review of CEO compensation, the 1995 Greenbury Committee recommended, 'the [compensation] committee's should … have access to professional advice inside and outside the company' (Greenbury Committee 1995, Recommendation A7). It is argued here that the primary function of the consultant is to provide expert advice on the design and structure of CEO pay. The process of consultant advice may have implications for the design of CEO pay, in particular when the consultants make extensive use of surveys and social comparisons. Bebchuk and Fried (2004) argue that consultants are not sufficiently independent and suffer from conflicts of interest because they sell other services to their clients and are thus wary of provoking the CEO for fear of jeopardizing this other business. If true, the CEO pay contract is not best from the shareholder's perspective. On the other hand, the optimal contracting view argues that compensation consultants are experts who provide valuable information and data to busy boards of directors. Their presence ameliorates opportunistic behavior by CEOs and leads to well-structured optimal compensation contracts.

Do pay consultants promote the best interests of the firm's owners or do they simply enrich entrenched CEOs?

The available empirical evidence shows that consultants have a relatively limited effect on CEO pay and incentives. It was perhaps thought that consultants would explain a large amount of the variation in CEO pay, but this does not seem to be the case. Consultants do not appear to be the primary driver of the recent growth in executive pay. Nor does the available evidence suggest that contracts are especially badly designed by consultants. Murphy and Sandino (2010) find evidence in both the United States and Canada that CEO pay is greater in companies where the consultant provides other services. In addition, they find that pay is higher in Canadian firms when the fees paid to consultants for other services are large relative to the fees for executive-compensation services. This evidence suggests that greater agency costs lead to higher compensation. However, they unexpectedly find that CEO pay is higher in US firms where the consultant works for the independent board rather than for management. In another study, Cadman, Carter and Hillegeist (2010) investigated compensation consultants' potential cross-selling incentives in 2006. The authors are 'unable to find widespread evidence of higher levels of pay or lower pay-performance sensitivities for clients of consultants with potentially greater conflicts of interest.' Cadman et al., 2010: 263). They conclude that there is little evidence that potential conflicts of interest between the firm and its consultant are a primary driver of excessive CEO pay. Conyon, Peck and Sadler (2009) also performed a comparative study of the relation between CEO pay and consultants using British and American data for 2006. They found that CEO pay is generally greater in firms that use compensation consultants, which is consistent with the managerial power theory of executive pay. They also showed that the amount of equity used in the CEO compensation package, such as stock options, is greater in firms that use consultants. This is consistent with alignment of manager and shareholder interests, and the optimal contracting theory of pay. Finally, there is little evidence that using consultants with potential conflicts of interest, such as supplying other business to client firms, leads to greater CEO pay or the adverse design of pay contracts. The evidence is consistent with Cadman, Carter and Hillegeist (2010). In a related study Conyon, Peck and Sadler (2011) suggest that some significant behavioral process may work in the operation of consultants; the market for such consultants is quite concentrated and often boards can be interlocked both through the use of consultants and board members. Such high-contact interlocks can provide a significant basis for recommending pay arrangements based on social comparisons, and they find that CEO pay is indeed related to such shared director–consultant use.

Proxy voting agencies

Proxy voting agencies are specialist institutions that advise investors on how to vote their shares. They carry out their own research and, on the basis of this research, make available recommendations on CEO pay and other matters of corporate governance. In the United States a major proxy advisory company is Institutional Shareholder Services.[10] It is widely believed that these parties lead to better outcomes by helping shareholders. Many investors do indeed consult with such proxy advisor companies prior to voting their shares. There is now a nascent academic literature that is investigating whether proxy voting agencies do or do not increase shareholder value.

The existing evidence suggests that proxy voting agency recommendations are influential in the sense that their advice and recommendations can lead to reductions in shareholder votes for given issues. However, this does not necessarily mean that their recommendations are accurate. Larcker, McCall, and Ormazabal (2011) investigate shareholder voting, proxy agencies, and option exchange programs (stock option exchanges are where firms replace out of the money stock options with new awards of options). Proxy voting agencies recommend against option exchange programs. However, Larcker and colleagues find that stock markets generally respond positively to these exchange programs, so the more companies adhere to the restrictions imposed by the proxy voting agency, then the worse their performance is. The authors conclude that: 'compliance with ISS or Glass Lewis guidelines on stock option exchanges limits the recontracting benefits of these transactions and is not value increasing for shareholders.' Overall, the existing evidence suggests that proxy voting agency firms might not be the panacea institution to solve moral hazard problems within firms.

Regulation: the Dodd–Frank Act

The perceived problems with executive pay have led to many calls for legislation and regulation, in the United States and elsewhere in the world. On 21 July, 2011 President Obama signed into law The Dodd–Frank Wall Street Reform and Consumer Protection Act. This is a wide-ranging Act, and is the second major piece of securities legislation affecting the governance of firms in 10 years. In 2002 the Sarbanes–Oxley Act was passed in direct response to the accounting scandal at Enron, as well as other scandals at WorldCom, Tyco, etc. Most of the provisions of Dodd–Frank relate to banks and financial institutions – as the Act itself was a response to the 2008 recession and the desire to end the 'too big to fail' mentality on Wall Street. However, the Dodd–Frank Act has implications more generally for corporate governance and executive compensation practices. Here we will mention four salient provisions.

First, Dodd–Frank requires 'Say on Pay' in US public companies. Shareholders of publicly traded firms are given the opportunity to cast an advisory non-binding vote on compensation. This provision is often referred to as 'Say on Pay' (Conyon & Sadler, 2010). The 'Say on Pay' vote is advisory and non-binding. It does not set limits on pay or the actual design of compensation. 'Say on Pay' will happen at least once every 3 years.[11] Firms in 2011 overwhelmingly endorsed executive compensation packages. Shareholders at over 98% of firms overwhelmingly endorsed compensation packages. The results, in this sense, look similar to those reported after 'Say on Pay' was introduced in the UK (Conyon & Sadler, 2010).

Second, Dodd–Frank mandates the Securities and Exchange Commission (SEC) to issue rules requiring that each member of a company's compensation committee is independent.[12] In determining a director's independence, companies will be required to consider relevant factors, including (i) the source of a director's compensation, including any consulting, advisory or other compensatory fee paid by the company to the director, and (ii) whether the director is affiliated with the company or any of its subsidiaries or affiliates. In addition, Dodd–Frank mandates standards for the hiring of external pay consultants. New listing standards will require the firm to demonstrate the authority of compensation committees to retain or obtain the advice of compensation consultants, independent legal counsel or other advisors. In addition, the compensation committee is responsible for the appointment, compensation, and oversight of the work a compensation advisor. Lastly, the Act requires companies to provide appropriate funding for the compensation committee to hire a compensation consultant or any other advisor.

Third, Dodd–Frank mandates proxy access. Companies must allow shareholders, either alone or as a combined group of shareholders, which have maintained a minimum of 3% ownership in the firm for 3 or more years to nominate up the 25% of the board on the annual proxy (Larcker & Tayan, 2011a). This regulatory feature is sometimes called 'shareholder democracy' because it allows shareholders of the firm to put in the proxy statement a director, or slate of directors, to run against the incumbent directors. This legislation allows shareholders potentially more say in the running of the firm than has been the case up until 2010, and is designed to benefit long-term shareholders. However, it is not clear that this legislation will be effective in promoting shareholder value. Indeed, some empirical evidence suggests that increases in recent regulation actually *destroy* firm value. Larcker, Ormazabal and Taylor (2011) conducted an event study of market reactions to proxy access events, probing how asset prices change in response to regulatory announcements. They found that events that were likely to lead to an increase in regulation had negative abnormal returns, and proxy access events that decrease regulation had positive returns. The authors take this as evidence that restrictive regulation can hurt firm value creation.

Fourth, the Dodd–Frank Act contained a compensation 'clawback' provision. In event that the company has to restate its financials because of material non-compliance with any reporting requirements under the securities laws, then the company will be able to recover from an executive officer who received incentive-based compensation (including stock options awarded as compensation) during the prior 3-year period the excess amount that the executive would not have otherwise received except for the misstated financial statements. These kinds of clawbacks were first mooted and then introduced in the Sarbanes–Oxley Act (2002), and then for firms covered by the Troubled Assets Relief Program (TARP). Clawback under Dodd–Frank, though, does not appear to require demonstrating that there was any wrongdoing by the affected named executive officer, and in this respect the act is different from Sarbanes–Oxley.

CONCLUSION

This chapter has discussed issues related to executive compensation, pay-for-performance, and the institutions of executive pay setting. The field of executive compensation is vast, and so naturally our analysis is constrained to a smaller set of more manageable issues. The chapter was motivated by the observation that executive compensation is a highly controversial issue. The media, policymakers, and some academics routinely criticize executive pay. These criticisms take many forms. However, prominent causes of concern are: first, CEO and executive pay is too high; second, CEO and executive pay is insufficiently linked to firm performance; and third, the institutions of executive pay setting (boards of directors, compensation committees, and consultants) have failed to stop managerial excess. In this chapter, we have reviewed these issues.

Section 2 discussed the theory of executive compensation. This is important for two reasons. First, although theoretical models often seem abstract, and it is often difficult to find tractable and neat solutions to the more complicated models, they have an important role to play in analysis. They force us to clearly state the underlying objective function that is being optimized, as well as assumed agent behavior. The objective function could be a shareholder value, or a more general stakeholder model. Second, we discussed the standard principal–agent model, where shareholders design contracts to maximize the residual claim (shareholder value) in the presence of a moral hazard. We illustrated the much-cited inverse relation between incentives and risk. However, what is important is that the formal modeling can be extended to incorporate other salient features to compensation research as required (e.g. performance measurement distortions, multiple tasks).

Section 3 described executive compensation contracts in practice and we suggest that understanding the components of pay matter. We highlighted that CEO pay is made up of non-risky pay (such as a guaranteed cash salary) and risky pay (such as annual bonus, restricted stock, and stock options). This structure is predicted by principal–agent theory. We discussed stock options at length. Options have interesting characteristics that provide highly geared incentives for CEOs to promote value creation. Some critics contend that options encourage too-risky behavior. We illustrated how one might think of this in terms of the relation between changes in the value of the option and the underlying volatility in asset prices (the option 'vega'). We also considered empirically how the landscape of executive pay is changing. We documented that CEO pay has increased over time, but in the last few years it has remained relatively flat in the United States. In addition, we showed that because CEOs build up a significant portfolio of firm-related equity, they have incentives that align their interests to shareholders. Differences between pay (or expected pay), while relevant for understanding what boards pay their CEOs in any given year, needs augmenting with this broader appreciation of total option and stock holdings when considering the real pay-for-performance sensitivities. In this sense, we think that there is ample evidence to suggest that executive pay is linked to firm performance. Indeed, the available empirical evidence shows that pay-at-risk forms the majority component of a CEOs annual package.

Section 4 discussed the institutions of executive pay setting. The 'black-box' model of executive pay determination assumed that shareholders directly set pay themselves. This is not the case. Boards of directors and compensation committees, in association with compensation consultants, set pay in reality. We addressed the general question as to whether boards, committees, pay consultants, proxy voting agencies, and regulations work together to optimize shareholder welfare. We found that the mechanisms of internal corporate governance were not, on average, fundamentally flawed. We documented that in Anglo-Saxon economies there is a high degree of transparency regarding board behavior, which can be easily accessed by investors. We documented, too, that boards are becoming more independent over time at the same time as executive pay has been increasing. This suggests that it is not lax boards leading to excess pay. We reviewed evidence on the effectiveness of boards, committees, and consultants. Although there is room for improvement, as technologies change and the benefits and costs of governance alter, the current system appears to be achieving its objective of safeguarding shareholder interests.

This brief chapter, then, has examined executive pay. The corporate governance landscape is frequently shifting. At the time of writing, new legislation in the guise of the Dodd–Frank Act promises even greater US corporate governance disclosure in relation to executive pay. This is likely to spawn a new set of studies on the efficacy of pay institutions.

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NOTES

1 This section draws on material from Steen Thomsen and Martin Conyon's forthcoming Corporate Governance book and a model in Conyon (2011).

2 We assume firm value, V, is the sum of two elements, effort (e) and luck (ε), and is non-separable: $V = e + \varepsilon$, where $\varepsilon \sim N(0,\sigma_\varepsilon^2)$.

3 Interested readers should consider advanced contract theory texts, such as Bolton and Dewatripont (2005) or Laffont and Martimort (2002).

4 Another way of saying this is that the elasticity of the call value with respect to the underlying price of the asset (the stock price) is greater than one.

5 The Black–Scholes pricing equation shows that the option value is positively correlated with the stock price. The change in the call value of the option with respect to the underlying price of the asset is given as $dc/dS = \delta = e^{-qT}N(d_1)$ and $0 < \delta < 1$. This is the *option delta* or *hedge ratio.* For the standard option defined above and granted at the money, the option delta is approximately 0.569, meaning that a dollar change in the stock price increases the value of the option by about 56.9 cents. Fundamentally, option pay is connected to firm performance. If the stock price increases to $110 (other things held constant) the option delta also increases. Now it is approximately 0.607, meaning that at the new price a dollar change in the stock price will increase the value of the option at the margin by about 60 cents. Geometrically, the line tangent to the option payoff curve, evaluated at each new stock price, becomes steeper as the underlying asset price increases. The behavioral consequence is that an option recipient has greater (financial) incentives to increase the stock price – this is precisely because the option payoff schedule is convex.

6 Using the values for the standard option defined earlier we can evaluate how changes in the firm's stock volatility alters the value of the option. Initially, we suppose that S = $100, X = $100, stock volatility = 30%, the risk-free rate = 2%, the maturity term = 7 years, and the dividend yield = 2%. As before, the value of the option is about $26.8. We now increase the stock volatility by 50% (from 30% to 45%), holding the values of the other variables constant. The value of the option increases from about $26 to approximately $39, an increase of about 45%. In mathematical finance, this is referred to the option 'vega', which is the derivative of the option value with respect to the volatility of the underlying asset. This example illustrates two points: First, the value of the stock option is positively correlated to firm risk, measured by the volatility of the stock price; second, the percentage increase in the value of the option is less than the percentage increase in the value of the volatility term.

7 This subsection draws upon research in Conyon (2011b).

8 Note this measure includes aspects of equity pay. Specifically, we used variable TDC1 from the Execucomp database.

9 Based on material contained in Conyon's review in the *Oxford Book of Capitalism* (2011b), and work that Conyon and Peck have carried out on compensation committees, remuneration committees, boards of directors and executive compensation outcomes.

10 http://www.issgovernance.com/proxy/advisory (accessed September 2011).

11 In the 2011 proxy season, firms will decide a separate non-binding resolution asking shareholders to determine whether the 'Say on Pay' voting will occur every 1, 2 or 3 years.

12 http://www.skadden.com/Index.cfm?contentID=51&itemID=2394 (accessed September, 2011).

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21

In the Name of Shareholder Value: How Executive Pay and Stock Buybacks are Damaging the US Economy

William Lazonick

INEQUITABLE AND UNSTABLE ECONOMIC GROWTH

The United States is the richest economy in the world. Yet in the 2000s the United States has been unable to deliver equitable and stable economic growth to its own population (Lazonick, 2009a: ch. 1). The national unemployment rate, which was over 6 percent in the 'jobless recovery' of 2003, exceeded 10 percent in the 'jobless recovery' of 2009. Even the jobs of well-educated and experienced members of the labor force have been vulnerable to downsizing and offshoring. Given that the financial meltdown of 2008 has not resulted in significant government regulation, there is reason to believe that financial chaos will return in the not-too-distant future.

The distribution of income has become increasingly unequal over the past three decades, with a disappearance of middle-income jobs (see, e.g., Autor et al., 2008; Warren, 2009). As shown in Figure 21.1, in the last half of the 2000s, the share of total income going to the top 1 percent of households rose to well over 20 percent (Saez, 2010).

On the basis of data for the top 0.1 percent of the income distribution of the United States for 1916–2000, Thomas Piketty and Emanuel Saez (2006: 202) observe in a paper entitled 'The Evolution of Top Incomes: A Historical and International Perspective' that '[s]alary income has been driving up top incomes and has now become the main source of income at the very top', and that, across the advanced economies over the last quarter of the 20th century, the income share going to the top 0.1 percent was largest in the United States.[1] Piketty and Saez (2006: 204) conclude this paper with the statement: 'Although cross-country analysis will always suffer from

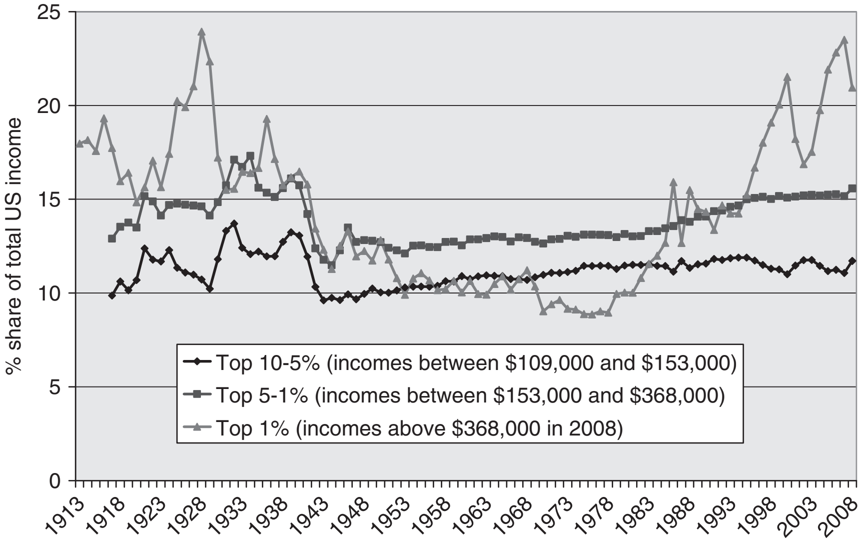

Figure 21.1 Shares of top income recipients in the United States, 1913–2008

Source: Saez 2010, http://elsa.berkeley.edu/~saez/

severe identification problems, our hope is that the database will renew the analysis of the interplay between inequality and growth.' Yet, as in their other work on concentration of income at the top in the United States, Piketty and Saez ignore the role of stock-based compensation in general, and stock options in particular, in driving the increases in the 'salaries' of the top income recipients.[2]

In this chapter I argue that a prime cause of the growing inequity and instability in the US economic system is the stock-based compensation of the executives who run the nation's leading industrial and financial corporations. In the 1980s and 1990s, agency theorists advocated this type of compensation as an incentive for corporate executives to 'maximize shareholder value' (MSV), and thereby improve the performance of the economy as a whole (see Jensen, 1986; Jensen & Murphy, 1990). In the next section of this chapter, I argue that the basic tenets of agency theory are contradicted by the theory of innovative enterprise (see Lazonick & O'Sullivan, 2000; Lazonick, 2002, 2010b, 2010c). Then I show that in the corporate economy of the United States, the implementation of the incentives advocated by agency theory for the sake of MSV have over the past three decades resulted in an explosion of top executive pay. I go on to document the importance of stock buybacks in the United States as an instrument for MSV that, by manipulating a company's stock price, helps to boost executive pay. Finally I contend that in the United States the use of stock-based compensation, and in particular stock options, to motivate corporate executives to have a strong personal interest in the performance of their companies' stock prices has resulted in not only an inequitable distribution of income but also reduced investment in innovation and generated unstable economic performance.

MAXIMIZING SHAREHOLDER VALUE

Since the early 1980s corporate executives have justified their stock-based compensation as well as the corporate financial behavior that increases it by the dominant ideology that the role of the corporate executive is to 'maximize shareholder value' (Rappaport, 1981, 1983). At the same time, through agency theory, academic economists have supported this ideology by propounding a shareholder-value perspective on corporate governance that is consistent with the neoclassical theory of the market economy (Fama & Jensen, 1983a, 1983b). Especially in the United States, MSV remains the dominant ideology of corporate governance not only in business schools and economics departments but also in executive suites and corporate boardrooms.

For adherents of the theory of the market economy, 'market imperfections' necessitate managerial control over the allocation of resources, thus creating an 'agency problem' for those 'principals' who have made investments in the firm. These managers may allocate corporate resources to build their own personal empires regardless of whether the investments that they make and the people whom they employ generate sufficient profits for the firm. They may hoard surplus cash or near-liquid assets within the corporation, thus maintaining control over uninvested resources, rather than distributing these extra revenues to shareholders. Or they may simply use their control over resource allocation to line their own pockets. According to agency theory, in the absence of corporate governance institutions that promote the maximization of shareholder value, one should expect managerial control to result in the inefficient allocation of resources.

The manifestation of a movement toward the more efficient allocation of resources, it is argued, is a higher return to shareholders. But why is it shareholders for whom value should be maximized? Why not create more value for creditors by making their financial investments more secure, or for employees by paying them higher wages and benefits, or for communities in which the corporations operate by generating more corporate tax revenues? Neoclassical financial theorists argue that among all the stakeholders in the business corporation only shareholders are 'residual claimants'. The amount of returns that shareholders receive depends on what is left over after other stakeholders, all of whom it is argued have guaranteed contractual claims, have been paid for their productive contributions to the firm. If the firm incurs a loss, the return to shareholders is negative, and vice versa.

By this argument, shareholders are the only stakeholders who have an incentive to bear the risk of investing in productive resources that may result in superior economic performance. As residual claimants, moreover, shareholders are the only stakeholders who have an interest in monitoring managers to ensure that they allocate resources efficiently. Furthermore, by selling and buying corporate shares on the stock market, public shareholders, it is argued, are the participants in the economy who are best situated to reallocate resources to more efficient uses.

Within the shareholder-value paradigm, the stock market represents the corporate governance institution through which the agency problem can be resolved and the efficient allocation of the economy's resources can be achieved. Specifically, the stock market can function as a 'market for corporate control' that enables shareholders to 'disgorge' – to use Michael Jensen's evocative term – the 'free cash flow'. As Jensen (1986: 323), a leading academic proponent of maximizing shareholder value, put it in a seminal 1986 article:

> Free cash flow is cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital. Conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free cash flow. The problem is how to motivate managers to disgorge the cash rather than investing it at below cost or wasting it on organization inefficiencies.

How can those managers who control the allocation of corporate resources be motivated, or coerced, to distribute cash to shareholders? If a company does not maximize shareholder value, shareholders can sell their shares and reallocate the proceeds to what they deem to be more efficient uses. The sale of shares depresses that company's stock price, which in turn facilitates a takeover by shareholders, who can put in place managers who are willing to distribute the free cash flow to shareholders in the forms of higher dividends and/or stock repurchases. Better yet, as Jensen argued in the midst of the 1980s corporate takeover movement, let corporate raiders use the market for corporate control for debt-financed takeovers, thus enabling shareholders to transform their corporate equities into corporate bonds. Corporate managers would then be 'bonded' to distribute the 'free cash flow' in the form of interest rather than dividends (Jensen, 1986: 324).

Additionally, as Jensen and Murphy (1990), among others, contended, the maximization of shareholder value could be achieved by giving corporate managers stock-based compensation, such as stock options, to align their own self-interests with those of shareholders. Then, even without the threat of a takeover, these managers would have a personal incentive to maximize shareholder value by investing corporate revenues only in those 'projects that have positive net present values when discounted at the relevant cost of capital' and distributing the remainder of corporate revenues to shareholders in the forms of dividends and/or stock repurchases.

During the 1980s and 1990s, maximizing shareholder value became the dominant ideology for corporate governance in the United States. Top executives of US industrial corporations became ardent advocates of this perspective; quite apart from their ideological predispositions, the reality of their stock-based compensation inured them to maximizing shareholder value. The long stock market boom of the 1980s and 1990s combined with the remuneration decisions of corporate boards to create this pay bonanza for corporate executives.

To some extent, the stock market boom of the 1980s and 1990s was driven by New Economy innovation. By the late 1990s, however, innovation had given way to speculation as a prime mover of stock prices. Then, after the collapse of the Internet bubble at the beginning of the 2000s, corporate resource allocation sought to restore stock prices through manipulation in the form of stock buybacks. This massive 'disgorging' of the corporate cash flow manifests a decisive triumph of agency theory and its shareholder-value ideology in the determination of corporate resource allocation.

Has this financial behavior led to a more efficient allocation of resources in the economy, as the proponents of maximizing shareholder value claim? Quite apart from the empirical evidence that I present later in this chapter, there are a number of critical flaws in agency theory's analysis of the relation between corporate governance and economic performance. These flaws have to do with (1) a failure to explain how, historically, corporations came to control the allocation of significant amounts of the economy's resources; (2) the measure of 'free cash flow'; and (3) the claim that only shareholders have 'residual-claimant' status. These flaws stem from the fact that agency theory, like the neoclassical theory of the market economy in which it is rooted, lacks a theory of innovative enterprise (see Lazonick, 2002, 2010b).

Agency theory makes an argument for taking resources out of the control of inefficient managers without explaining how, historically, corporations came to possess the vast amounts of resources over which these managers could exercise allocative control (see Lazonick, 1992). From the first decades of the 20th century, the separation of share ownership from managerial control characterized US industrial corporations. This separation occurred because the growth of innovative companies demanded that control over the strategic allocation of resources to transform technologies and access new markets be placed in the hands of salaried professionals who understood the investment requirements of the particular lines of business in which the enterprise competed. At the same time, the listing of a company on a public stock exchange enabled the original owner-entrepreneurs to sell their stock to the shareholding public. Thereby enriched, they were able to retire from their positions as top executives. The departing owner-entrepreneurs left control in the hands of senior salaried professionals, most of whom had been recruited decades earlier to help to build the enterprises. The resultant disappearance of family owners in positions of strategic control enabled the younger generation of salaried professionals to view the particular corporations that employed them as ones in which, through dedicated work effort over the course of a career, they could potentially rise to the ranks of top management.

With salaried managers exercising strategic control, innovative managerial corporations emerged as dominant in their industries during the first decades of the century. During the post-World War II decades, and especially during the 1960s conglomerate movement, however, many of these industrial corporations grew to be too big to be managed effectively. Top managers responsible for corporate resource allocation became segmented, behaviorally and cognitively, from the organizations that would have to implement these strategies. Behaviorally, they came to see themselves as occupants of the corporate throne rather than as members of the corporate organization, and became obsessed by the size of their own remuneration. Cognitively, the expansion of the corporation into a multitude of businesses made it increasingly difficult for top management to understand the particular investment requirements of any of them (Lazonick, 2004).

In the 1970s and 1980s, moreover, many of these US corporations faced intense foreign competition, especially from innovative Japanese corporations (also, it should be noted, characterized by a separation of share ownership from managerial control). An innovative response required governance institutions that would reintegrate US strategic decision makers with the business organizations over which they exercised allocative control. Instead, guided by the ideology of maximizing shareholder value and rewarded with stock options, what these established corporations got were managers who had a strong personal interest in boosting their companies' stock prices, even if the stock-price increase was accomplished by a redistribution of corporate revenues from labor incomes to capital incomes and even if the quest for stock-price increases undermined the productive capabilities that these companies had accumulated in the past.

Agency theory also does not address how, at the time when innovative investments are made, one can judge whether managers are allocating resources inefficiently. Any strategic manager who allocates resources to an innovative strategy faces technological, market, and competitive uncertainty. Technological uncertainty exists because the firm may be incapable of developing the higher-quality processes and products envisaged in its innovative investment strategy. Market uncertainty exists because, even if the firm succeeds in its development effort, future reductions in product prices and increases in factor prices may lower the returns that can be generated by the investments. Finally, even if a firm overcomes technological and market uncertainty, it still faces competitive uncertainty: the possibility that an innovative competitor will have invested in a strategy that generates an even higher-quality, lower-cost product that enables it to win market share.

One can state, as Jensen did, that the firm should only invest in 'projects that have positive net present values when discounted at the relevant cost of capital.' But, quite apart from the problem of defining the 'relevant cost of capital,' anyone who contends that, when committing resources to an innovative investment strategy, one can foresee the stream of future earnings that are required for the calculation of net present value knows nothing about the innovation process. It is far more plausible to argue that if corporate managers really sought to maximize shareholder value according to this formula, they would never contemplate investing in innovative projects with their highly uncertain returns (see Baldwin & Clark, 1992; Christensen et al., 2008).

Moreover, it is simply not the case, as agency theory assumes, that all the firm's participants other than shareholders receive contractually guaranteed returns according to their productive contributions. Given its investments in productive resources, the state has residual-claimant status. Any realistic account of economic development must take into account the role of the state in (1) making infrastructural investments that, given the required levels of financial commitment and inherent uncertainty of economic outcomes, business enterprises would not have made on their own; and (2) providing business enterprises with subsidies that encourage investment in innovation. In terms of investment in new knowledge with applications to industry, the United States was the world's foremost developmental state over the course of the 20th century (see Lazonick, 2008). As a prime example, it is impossible to explain US dominance in computers, microelectronics, software, and data communications without recognizing the role of government in making seminal investments that developed new knowledge and infrastructural investments that facilitated the diffusion of that knowledge (see, for example, National Research Council, 1999).

The US government has made investments to augment the productive power of the nation through federal, corporate, and university research labs that have generated new knowledge as well as through educational institutions that have developed the capabilities of the future labor force. Business enterprises have made ample use of this knowledge and capability. In effect, in funding these investments, the state (or more correctly, its body of taxpayers) has borne the risk that the nation's business enterprises would further develop and utilize these productive capabilities in ways that would ultimately redound to the benefit of the nation, *but with the return to the nation in no way contractually guaranteed.*

In addition, the US government has often provided cash subsidies to business enterprises to develop new products and processes, or even to start new firms. The public has funded these subsidies through current taxes, borrowing against the future, or by making consumers pay higher product prices for current goods and services than would have otherwise prevailed. Multitudes of business enterprises have benefited from subsidies without having to enter into contracts with the public bodies that have granted them to remit a guaranteed return from the productive investments that the subsidies help to finance.

Workers can also find themselves in the position of having made investments without a contractually guaranteed return. The collective and cumulative innovation process demands that workers expend time and effort now for the sake of returns that, precisely because innovation is involved, can only be generated in the future, which may entail the development and utilization of productive resources over many years. Insofar as workers involved in the innovation process make this investment of their time and effort in the innovation process without a contractually guaranteed return, they have residual-claimant status.

In an important contribution to the corporate governance debate, Margaret Blair (1995) argued that, alongside a firm's shareholders, workers should be accorded residual-claimant status because they make investments in 'firm-specific' human capital at one point in time with the expectation – but without a contractual guarantee – of reaping returns on those investments over the course of their careers. Moreover, insofar as their human capital is indeed firm-specific, these workers are dependent on their current employer for generating returns on their investments. A lack of interfirm labor mobility means that the worker bears some of the risk of the return on the firm's productive investments, and hence can be considered a residual claimant. Blair goes on to argue that if one assumes, as shareholder-value proponents do, that only shareholders bear risk and residual-claimant status, there will be an underinvestment in human capital to the detriment of not only workers but also the economy as a whole.

Investments that can result in innovation require the strategic allocation of productive resources to particular processes to transform particular productive inputs into higher-quality, lower-cost products than those goods or services that were previously available at prevailing factor prices. Investment in innovation is a direct investment that involves, first and foremost, a strategic confrontation with technological, market, and competitive uncertainty. Those who have the abilities and incentives to allocate resources to innovation must decide, in the face of uncertainty, what types of investments have the potential to generate higher-quality, lower-cost products. Then they must mobilize committed finance to sustain the innovation process until it generates the higher-quality, lower-cost products that permit financial returns.

What role do public shareholders play in this innovation process? Do they confront uncertainty by strategically allocating resources to innovative investments? No. As portfolio investors, they diversify their financial holdings across the outstanding shares of existing firms to minimize risk. They do so, moreover, with limited liability, which means that they are under no legal obligation to make further investments of 'good' money to support previous investments that have gone bad. Indeed, even for these previous investments, the existence of a highly liquid stock market enables public shareholders to cut their losses instantaneously by selling their shares – what has long been called the 'Wall Street walk'.

Without this ability to exit an investment easily, public shareholders would not be willing to hold shares of companies over the assets of which they exercise no direct allocative control. It is the liquidity of a public shareholder's portfolio investment that differentiates it from a direct investment, and indeed distinguishes the public shareholder from a private shareholder who, for lack of liquidity of his or her shares, must remain committed to his or her direct investment until it generates financial returns. The modern corporation entails a fundamental transformation in the character of private property, as Adolf Berle and Gardiner Means (1932) recognized. As property owners, public shareholders own tradable shares in a company that has invested in real assets; they do not own the assets themselves.

Indeed, the fundamental role of the stock market in the United States in the 20th century was to transform illiquid claims into liquid claims on *the basis of investments that had already been made*, and thereby separate share ownership from managerial control. Business corporations sometimes do use the stock market as a source of finance for new investments, although the cash function has been most common in periods of stock market speculation when the lure for public shareholders to allocate resources to new issues has been the prospect of quickly 'flipping' their shares to make a rapid speculative return. Public shareholders want financial liquidity; investments in innovation require financial commitment. It is only by ignoring the role of innovation in the economy, and the necessary role of insider control in the strategic allocation of corporate resources to innovation, that agency theory can argue that superior economic performance can be achieved by maximizing the value of those actors in the corporate economy who are the ultimate outsiders to the innovation process.

SPECULATION AND MANIPULATION IN THE EXPLOSION OF EXECUTIVE PAY

The ideology of maximizing shareholder value is an ideology through which US corporate executives have been able to enrich themselves. In this they were aided in the 1980s and 1990s by academic proponents of the ideology such as Michael Jensen, who argued that aligning the interests of top executives with those of public shareholders would provide a mode of resource allocation that would result in superior performance in the economy as a whole. The outcome has been an explosion and re-explosion of executive pay over the past three decades, fueled by stock-based compensation.

According to AFL-CIO Executive Paywatch (2009), the ratio of the average pay of chief executive officers (CEOs) of 200 large US corporations to the pay of the average full-time US worker was 42:1 in 1980, 107:1 in 1990, 525:1 in 2000, and 319:1 in 2008. Table 21.1 shows the average compensation of the highest-paid corporate executives in the United States, and the percent of that compensation derived from exercising stock options (the difference between the stock-option exercise price and the market

Table 21.1 Total compensation of top executives of US-based corporations, average for 100, 500, 1500, and 3,000 highest-paid executives, and the proportion of total compensation derived from gains from exercising stocks options, 1992–2009

	S&P 500 Index	*NASDAQ Index*	*NASDAQ/ S&P*	*Top 100*		*Top 500*		*Top 1,500*		*Top 3,000*	
				Mean $m.	*% SO*	*Mean $m.*	*% SO*	*Mean $m.*	*% SO*	*Mean $m.*	*% SO*
1992	100	100	**1.00**	22.7	71	9.2	59	4.7	48	2.9	42
1993	109	119	**1.10**	20.9	63	9.0	51	4.7	42	3.1	36
1994	111	125	**1.13**	18.2	57	8.0	45	4.3	35	2.9	29
1995	131	155	**1.18**	20.5	59	9.6	48	5.2	40	3.4	34
1996	162	195	**1.20**	31.8	64	13.7	54	7.1	47	4.5	41
1997	210	243	**1.16**	43.3	72	18.2	61	9.3	55	5.8	49
1998	261	300	**1.15**	76.9	67	26.8	65	12.5	59	7.5	54
1999	319	462	**1.45**	68.8	82	27.4	71	13.2	63	7.9	57
2000	341	614	**1.80**	103.7	87	40.3	80	18.6	73	10.8	67
2001	284	332	**1.17**	62.1	77	23.6	66	11.3	58	6.8	53
2002	237	252	**1.06**	37.3	57	16.7	49	8.6	43	5.4	38
2003	232	275	**1.18**	48.2	64	20.9	55	10.7	48	6.7	43
2004	272	330	**1.21**	54.4	75	24.5	62	12.8	55	8.0	50
2005	290	348	**1.20**	66.3	78	28.1	63	14.2	56	8.9	51
2006	316	463	**1.47**	67.1	68	28.9	58	15.0	51	9.5	46
2007	354	428	**1.21**	59.4	69	27.3	58	14.5	50	9.3	45
2008	291	356	**1.22**	39.1	62	16.5	48	8.3	38	5.0	33
2009	227	307	**1.35**	29.6	44	13.9	27	7.7	17	5.0	12

S&P 500 Index and the NASDAQ Composite Index set to 100 in 1992 for purposes of comparison.
Total compensation (TDC2 in the Compustat database) is defined as 'Total compensation for the individual year comprised of the following: Salary, Bonus, Other Annual, Total Value of Restricted Stock Granted, Net Value of Stock Options Exercised, Long-Term Incentive Payouts, and All Other Total').
Mean $m., mean compensation in millions of 2009 US dollars.
% SO is the percent of total compensation that the whole set (100, 500, 1,500, or 3,000) of highest-paid executives derived from gains from exercising stock options.
Note that company proxy statements (DEF 14A SEC filings) report the compensation of the company's CEO and four other highest-paid executives. It is therefore possible that some of the highest-paid executives who should be included in each of the 'top' categories are excluded. The mean compensation calculations are therefore lower bounds of actual average compensation of the highest-paid corporate executives in the United States.
Source: Standard and Poor's Compustat database (Executive Compensation, Annual); Yahoo! Finance at: http://finance.yahoo.com (Historical Prices, Monthly Data).

price of the stock on the exercise date). Also included in Table 21.1 are the S&P 500 Index (with over 80 percent of its component stocks being NYSE) and NASDAQ Composite Index to illustrate the positive correlation of stock-price performance with both the level of executive pay and the proportion of that pay derived from stock-option exercises. The impact of NASDAQ on executive pay was especially strong in the late 1990s when speculation drove stock prices, whereas companies listed on the NYSE as well as NASDAQ were engaged in large-scale stock repurchases that helped to push up the S&P 500 Index from 2003 to 2007.

As shown in Table 21.1, the average annual real compensation in 2009 dollars of the 100 highest-paid corporate executives named in company proxy statements was $20.6 million in 1992–1995, $77.8 million in 1998–2001, and $61.8 million in 2004–2007. As can also be seen in Table 21.1, large proportions of these enormous incomes of top executives have come from gains from cashing in on the ample stock-option awards that their boards of directors have bestowed on them.[3] The higher the 'top pay' group, the greater the proportion of the pay of that group that was derived from gains from exercising stock options. For the top 100 group in the years 1992–2008, this proportion ranged from a low of 57 percent in 1994, when the mean pay of the group was also at its lowest level in real terms, to 87 percent in 2000, when the mean pay was at its highest. In 2000 the mean pay of the top 3,000 was, at $10.8 million in 2009 dollars, only 10 percent of the mean pay of the top 100. Nevertheless, gains from exercising stock options accounted for 67 percent of the total pay of the top 3,000 group.

Note in Table 21.1 how the average pay of the highest-paid corporate executives has risen and fallen with the fluctuations of major stock market indices. In the 1980s and 1990s, as shown in Table 21.2, high real stock yields characterized the US corporate economy. These high yields came mainly from stock-price appreciation as distinct from dividends yields, which were low in the 1990s despite high dividend payout ratios.[4] With the S&P 500 Index rising almost 1,400 percent from March 1982 to August 2000, the availability of gains from exercising stock options became almost automatic. Given the extent to which the explosion in US top executive pay over the past three decades has been dependent on gains from exercising stock options, there is a need to understand the drivers of the stock-price increases that generate these gains.

The gains from exercising stock options depend on increases in a company's stock price. There are three distinct forces – *innovation*, *speculation*, and *manipulation* – that may be at work in driving stock-price increases. Innovation generates higher-quality, lower-cost products (given prevailing factor prices) that result in increases in

Table 21.2 Average annual US corporate stock and bond yields (%), 1960–2009

	1960–1969	*1970–1979*	*1980–1989*	*1990–1999*	*2000–2009*
Real stock yield	6.63	–1.66	11.67	15.01	–3.08
Price yield	5.80	1.35	12.91	15.54	–2.30
Dividend yield	3.19	4.08	4.32	2.47	1.79
Change in CPI	2.36	7.09	5.55	3.00	2.57
Real bond yield	2.65	1.14	5.79	4.72	3.41

Stock yields are for Standard and Poor's composite index of 500 US corporate stocks. Bond yields are for Moody's Aaa-rated US corporate bonds.
Source: Updated from Lazonick and O'Sullivan 2000: 27, using US Congress 2010, Tables B-62, B-73, B-95, B-96.

earnings per share, which in turn lift the stock price of the innovative enterprise. Speculation, encouraged perhaps by innovation, drives the stock price higher, as investors assume either that innovation will continue in the future (which, given that innovation is involved, is inherently uncertain) or that there is a 'greater fool' who stands ready to buy the stock at yet a higher price. Manipulation occurs when those who exercise control over corporate resource allocation do so in a way that increases earnings per share despite the absence of innovation.

Figure 21.2 charts the roles of innovation, speculation, and manipulation as *primary* drivers of US stock-price movements from the mid-1980s to 2010. In the last half of the 1980s, Old Economy companies that had run into trouble because of conglomeration in the United States and/or competition from the Japanese sought to manipulate stock prices through a 'downsize-and-distribute' resource-allocation strategy (Lazonick, 2004).

This redistribution of corporate revenues from labor incomes to capital incomes often occurred through debt-financed hostile takeovers, with post-takeover downsizing enabling the servicing and retirement of the massive debt that a company had taken on. In addition, from the mid-1980s, many Old Economy companies engaged for the first time in large-scale stock repurchases in an attempt to support their stock prices. In the 1990s and 2000s stock buybacks would become a prime mode of corporate resource allocation. The main, and for most major US corporations only, purpose of stock buybacks is to manipulate stock prices (Lazonick, 2009b).

While Old Economy companies were manipulating stock prices in the 1980s and early 1990s, New Economy companies such as Intel, AMD, Microsoft, Oracle, Solectron,

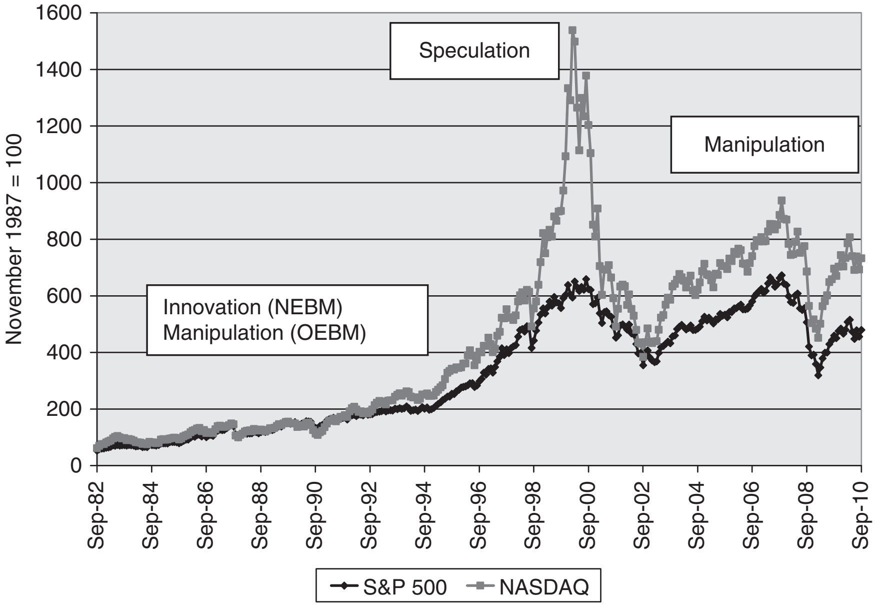

Figure 21.2 S&P 500 and NASDAQ Composite Indices, September 1982 to September 2010 (monthly data, standardized for the two indices to 100 in November 1987). In August 2009, the S&P 500 Index consisted of 500 stocks, of which 410 were NYSE and 90 NASDAQ; and the NASDAQ Composite Index consisted of 2,809 stocks

Source: Yahoo! Finance at: http://finance.yahoo.com (Historical Prices, Monthly Data).

EMC, Sun Microsystems, Cisco Systems, Dell and Qualcomm were reinvesting virtually all of their incomes to finance the growth of their companies, neither paying dividends nor, once they had gone public, repurchasing stock (Lazonick, 2009a: ch. 2). It was *innovation* by New Economy companies, most of them traded on NASDAQ, that culminated in the Internet revolution that provided a real foundation for the rising stock market in the 1980s and first half of the 1990s.

These New Economy companies had broad-based stock option programs that extended to non-executive employees. In the speculative boom of 1999–2000, the gains from exercising stock options of the average worker could be enormous. The most extreme example is Microsoft; in 2000 alone the gains across about 39,000 employees (not including the five highest-paid executives) averaged an estimated $449,000 (see Lazonick, 2009b). During the same year, the gains from exercising stock options of the five highest-paid Microsoft executives averaged $50.7 million – a ratio of 'top5' gains to average worker gains of 113:1.

In the late 1990s, speculation took over, driving the stock market to unsustainable heights. As Figure 21.2 shows, the speculation in companies listed on NASDAQ was much more pronounced than in the companies that make up the S&P 500 Index, over 80 percent of which are listed on the New York Stock Exchange (NYSE). In 2000 the average compensation of the top 100 NASDAQ executives was 19 percent higher than that of the top 100 NYSE executives, while in 2007 the compensation of the top 100 NYSE executives was 11 percent higher than that of the top 100 NASDAQ executives. In both years the proportion of the compensation that came from exercising stock options was higher for NASDAQ executives than for NYSE executives. Still, even for the NYSE executives, this proportion was 78 percent for the top 100 and 53 percent for the top 3,000 in 2000, and 65 percent for the top 100 and 43 percent for the top 3,000 in 2007. Whether their companies are listed on NASDAQ or the NYSE, stock options give the top executives of US corporations a huge personal financial stake in a rising stock market.

In the 2000s, the stock-option gains of these executives have come primarily through manipulation as distinct from innovation and speculation. The key instrument of stock-market manipulation is the stock repurchase. A stock repurchase occurs when a company buys back its own shares. In the United States, the Securities and Exchange Commission (SEC) requires stock repurchase *programs* to be approved by the board of directors. These programs authorize a company's top executives to do a certain amount of buybacks over a certain period of time. It is then up to the top executives to decide whether the company should actually do repurchases, when they should be done, and how many shares should be repurchased at any given time. Repurchases are almost always done as open market transactions through the company's broker. The company is not required to announce the buybacks at the time they are actually done, although since 2004 it has been an SEC rule that, in their quarterly financial reports, companies must state the amount of repurchases in the past quarter and the average purchase price.

Data on 373 companies in the S&P 500 Index in January 2008 that were publicly listed in 1990 show that they expended an annual average of $106.3 billion (or $285 million per company) on stock repurchases in 1995–1999, representing 44 percent of their combined net income. These figures represented a significant increase from $25.9 billion in repurchases (or $69 million per company) in 1990–1994, representing 23 percent of their combined net income. Yet in the late 1990s the stage was being set for an even more massive manipulation of the market through stock repurchases, especially from 2003. Figure 21.3 shows the payout ratios and mean payout levels for 437 companies in the S&P 500 Index in January 2008 that were publicly listed from 1997 through 2008.[5]

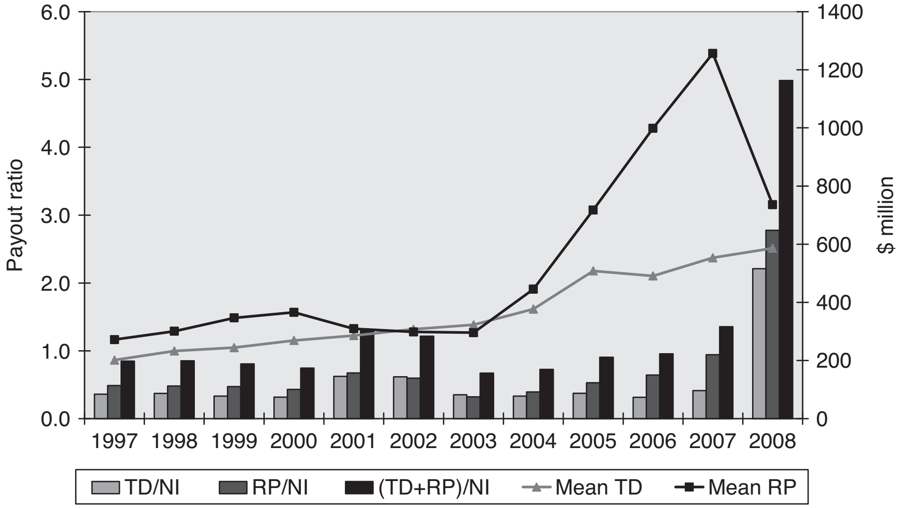

Figure 21.3 Ratios of cash dividends and stock repurchases to net income, and mean dividend payments and stock repurchases among S&P 500 (437 companies), 1997–2008. Data for 437 corporations in the S&P 500 Index in January 2008 publicly listed 1997 through 2008. RP, stock repurchases; TD, total dividends (common and preferred); NI, net income (after tax with inventory evaluation and capital consumption adjustments).

Source: S&P Compustat database (North America, Fundamentals Annual, 1997–2008); company 10-K filings for missing or erroneous data from the Compustat database.

From 1997 through 2008, these 437 companies expended $2.4 trillion on stock repurchases, an average of $5.6 billion per company, and distributed a total of $1.7 trillion in cash dividends, an average of $3.8 billion per company. Stock repurchases by these 437 companies averaged $323 million in 2003, rising to $1,256 million in 2007. Combined, the 500 companies in the S&P 500 Index in January 2008 repurchased $436 billion of their own stock in 2006, representing 64 percent of their net income, and $549 billion in 2007, representing 94 percent of their net income.

Figure 21.4 shows how the escalating stock repurchases from 2003 through 2007 helped to boost the stock market, driving the S&P 500 Index even higher in 2007 than its previous peak in 2000 before the 2008 financial debacle. In 2008 repurchases fell substantially for these 438 companies, constrained by a dramatic decline in combined net income from $583 billion in 2007 to $132 billion in 2008. Nevertheless, their combined repurchases only declined from $523 billion to $369 billion. As a result, the repurchase payout ratio more than tripled, from 0.90:1 to 2.80:1. In addition, these companies paid out $5 billion more in dividends in 2008 than in 2007, with the result that the dividend payout ratio leapt from 0.41:1 to 1.86:1. Allocated differently, the billions spent on buybacks could have helped stabilize the economy. Instead, collectively, these companies not only spent all their profits on repurchases but also ate into their capital.

Why do corporations repurchase stock? Executives often claim that buybacks are financial investments that signal confidence in the future of the company and its stock-price performance (Vermaelen, 2005, ch. 3; Louis & White, 2007). In fact, however, companies that do buybacks never sell the shares at higher prices to cash in on these investments. To do so would be to signal to the market that its stock price had peaked. According to the ‘signaling’ argument, we

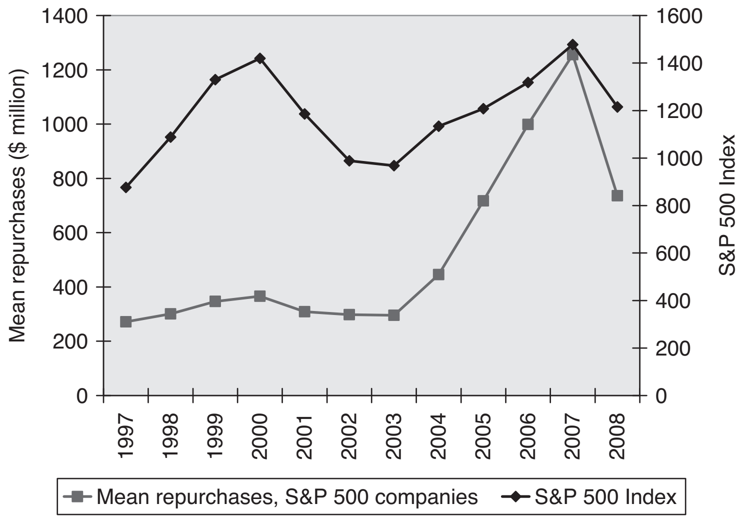

Figure 21.4 Stock repurchases by the S&P 500 (437 companies) and the movement of the S&P 500 Index, 1997–2008

Source: Standard and Poor's Compustat database (North America, Fundamentals Annual); Yahoo! Finance at http://finance.yahoo.com (Historical Prices, Monthly Data).

should have seen massive sales of corporate stock in the speculative boom of the late 1990s, as was in fact the case of US industrial corporations in the speculative boom of the late 1920s when corporations took advantage of the speculative stock market to pay off corporate debt or bolster their corporate treasuries (O'Sullivan, 2004). Instead, in the boom of the late 1990s corporate executives as *personal investors* sold their own stock to reap speculative gains (often to the tune of tens of millions). Yet, if anything, these same corporate executives as *corporate decision-makers* used corporate funds to repurchase their companies' shares in the attempt to bolster their stock prices – to their own personal gain. Given the extent to which stock repurchases have become a systematic mode of corporate resource allocation, and given the extent to which through this manipulation of their corporations' stock prices top executives have enriched themselves personally in the process, there is every reason to believe that, in the absence of legislation that restricts both stock repurchases as well as speculative and manipulative gains from stock options, executive behavior that places personal interests ahead of corporate interests will continue in the future.

The SEC has encouraged the combination of stock buybacks and stock options by relaxing its rules against stock-price manipulation. Under the Securities Exchange Act of 1934, stock repurchases can be construed as attempts to manipulate a company's stock price. In 1982, however, with the promulgation of Rule 10b-18, the SEC provided companies with a 'safe harbor' that manipulation charges would not be filed if each day's open-market repurchases were not greater than 25 percent of the stock's average daily trading volume and if the company refrained from doing buybacks at the beginning and end of the trading day (Hudson 1982). Indeed, analogous to the SEC's Rule 10b-18 of 1982, in 1991 SEC made a rule change that enabled top executives to make quick gains by exercising their stock options and immediately selling their shares. Under Section 16(b) of the 1934 Securities Exchange Act corporate directors, officers or shareholders with more than 10 percent of the corporation's shares are prohibited from making 'short-swing' profits through the purchase and the subsequent sale of corporate securities within a six-month period. As a result, top executives who exercised stock options had to hold the acquired shares for at least six months before selling them. In May 1991 the SEC deemed that the six-month holding period required under Section 16(b) was from the grant date, not the exercise date (Rosen, 1991). The new rule eliminated the risk of loss between the exercise date and the sale date, and gave top executives flexibility in their timing of option exercises and immediate stock sales so that they could personally benefit from, among other things, price boosts from buybacks.

There are a number of ways in which stock options as a mode of executive compensation can be abused. A company might reprice options that are underwater by canceling an existing option and replacing it with a new option with a lower exercise price (Chance et al., 2000; Ellig, 2007: 434–435). As a result, an executive may be able to reap gains from stock-option grants even when the company's stock price declines. In 2006 a scandal broke out over the practice of backdating stock options – that is, granting option awards today as if they were granted at an earlier date when the market price of the stock and hence the exercise price of the options were lower (Lie, 2005; Forelle & Bandler, 2006; Bernile & Jarrell, 2009). Abuses can also occur in the timing of the exercise of options. Given the fact that in the United States companies are not required to announce the dates on which they actually do open market repurchases, there is an opportunity for top executives who have this information to engage in insider trading by using this information to time option exercises and stock sales (see Fried, 2000, 2001).

The more fundamental problem with US-style stock options, however, is that they are unindexed; that is, they virtually never carry any performance criteria that would only permit an executive to gain from the exercise of stock options when the company's stock-price increases are greater than those warranted by productive performance (Bebchuk & Fried, 2004). As a result, an executive, or any other employee with stock options, can gain from a speculative stock market as distinct from an improvement in the company's productive performance. In addition, as I have argued, executives can augment their stock-option gains by allocating corporate resources to do buybacks, the sole purpose of which is to manipulate the company's stock price. Some of the stock-based compensation of US executives is undoubtedly attributable to innovation, although even then there is the question of whether the stock-based compensation that executives secure is equitable relative to other contributors to the innovation process. Be that as it may, since the last half of the 1990s it has been speculation and manipulation that have been the main drivers of the explosion in the pay of US corporate executives.

STOCK BUYBACKS AS 'WEAPONS OF VALUE DESTRUCTION'

My analyses of different industries (some of which I have studied in more depth than others) strongly suggest that the explosions in executive pay are coming at the expense of innovation and the upgrading of employment opportunities in the US economy. In what follows, I present some pertinent evidence from key sectors of the US economy (for elaborations, see Lazonick, 2009a, ch. 6; 2009b).

Among the biggest stock repurchasers in the years prior to the financial crisis were many of banks that were responsible for the meltdown and were bailed out under the Troubled Asset Relief Program. They included Citigroup ($41.8 billion repurchased in 2000–2007), Goldman Sachs ($30.1 billion), Wells Fargo ($23.2 billion), JP Morgan Chase ($21.2 billion), Merrill Lynch ($21.0 billion) Morgan Stanley ($19.1 billion), American Express ($17.6 billion), and US Bancorp ($12.3 billion). In the eight years before it went bankrupt in 2008, Lehman Brothers repurchased $16.8 billion, including $5.3 billion in 2006–2007. Washington Mutual, which also went bankrupt in 2008, expended $13.3 billion on buybacks in 2000–2007, including $6.5 billion in 2006–2007. Wachovia, ranked 38th among the Fortune 500 in 2007, did $15.7 billion in buybacks in 2000–2007, including $5.7 billion in 2006–2007, before its fire sale to Wells Fargo at the end of 2008. Other financial institutions that did substantial repurchases in the 2000s before running into financial distress in 2008 were AIG ($10.2 billion), Fannie Mae ($8.4 billion), Bear Stearns ($7.2 billion), and Freddie Mac ($4.7 billion). By spending money on buybacks during boom years, these financial corporations reduced their ability to withstand the crash of the derivatives market in 2008, thus exacerbating the jeopardy that they created for the economy as a whole.

Among the top 10 repurchasers of stock in 2000–2009 were five of the leading ICT companies: Microsoft (the #2 repurchaser with $103.6 billion in buybacks), IBM (#3, $80.4 billion), Cisco Systems (#4, $57.2 billion), Intel (#9, $50.5 billion), and Hewlett-Packard (#10, $48.5 billion). All of these companies spent more (and except for Intel much more) on buybacks than they spent on R&D in 2000–2009. In the 2000s, all of these companies have been globalizing employment, and profiting through the creation of high-tech jobs in lower-wage parts of the world such as China and India while using the profits of globalization to do stock buybacks at home (Milberg, 2008; Lazonick, 2009b).

Meanwhile, US high-tech companies lobby the US government for more public investment in the US high-technology knowledge base, even as the companies allocate their own profits to huge stock buybacks. For example, in the 2000s Intel along with the Semiconductor Industry Association (SIA) has been lobbying the US Congress for more spending on the National Nanotechnology Initiative (NNI). At a press conference that the SIA organized in Washington, DC in March 2005, Intel CEO Craig Barrett warned: 'U.S. leadership in the nanoelectronics era is not guaranteed. It will take a massive, coordinated U.S. research effort involving academia, industry, and state and federal governments to ensure that America continues to be the world leader in information technology' (Electronic News, 2005). In 2005 the annual NNI budget was $1.2 billion, just 11 percent of the $10.6 billion that Intel spent on stock repurchases in that year alone. Indeed, Intel's 2005 expenditures on stock buybacks exceed the total of $10.1 billion that was spent on NNI since its inception in 2001 through 2009.[6] Given the extent to which the ICT industry in general, and a company like Intel in particular, has benefited from decades of government investments in the high-tech knowledge base, one might ask whether a portion of the massive funds that Intel allocates to buying back its own stock could not be more productively allocated 'to ensure that America continues to be the world leader in information technology.'

Among the largest repurchasers of stock in the 2000s have been pharmaceutical companies. For 2000–2009 Pfizer was the #8 repurchaser with $50.6 billion in buybacks, Johnson & Johnson #13 with $35.5 billion, Amgen #20 with $25.8 billion, and Merck #32 with $18.7 billion. These and other US pharmaceutical companies charge higher drug prices in the United States than in other rich nations such as Japan, Canada, and France because, their executives argue, they need the higher earnings to fund their R&D efforts in the United States. Yet the very same companies do massive stock buybacks for the sole purpose of manipulating their stock prices. Meanwhile, the United States is the world leader in biopharmaceuticals in large part because of $31 billion per annum that the National Institutes of Health spend in support of the life sciences knowledge base, as well as numerous government subsidies to the pharmaceutical industry, including those under the Orphan Drug Act of 1983 (see Lazonick & Tulum, 2011). Instead of doing stock buybacks, the pharmaceutical companies could be contributing to the national life sciences effort, or lowering their drug prices to make their products more affordable to the American public.

There has been virtually no public policy debate in the United States over the practice of buybacks, its acceleration in recent years, or the implications for innovation, employment, income distribution, and economic growth. Exceptionally, in the summer of 2008, four Congressional Democrats took aim at stock repurchases by the big oil companies, after Exxon Mobil, by far the largest repurchaser of stock ($144 billion in 2000–2008), had announced record second quarter profits of $11.7 billion, of which $8.8 billion went to stock buybacks (US Congress 2008). In a letter to oil industry executives, the Congressmen asked them to

> pledge to greatly increase the ratio of investments in production and alternatives to the amount of stock buybacks this year and next by investing much more of your profits into exploration and production on the leases you have been awarded in the U.S., and in the research and development of promising alternative energy sources (US Congress, 2008).

Exxon Mobil did not pay much attention to this plea; in the last half of 2008 it repurchased another $17.5 billion for a total of $35.7 billion, or 79 percent of its net income, on the year. In 2009 Exxon Mobil did another $19.7 billion in buybacks, equivalent to 102 percent of its net income.

The United States has been engaged in a debate over healthcare reform, with the companies that provide health insurance in the forefront of opposition to progressive change, including the availability of a 'public option' that would provide households with an alternative source of health insurance to that offered by the business corporations. Among the top 50 repurchasers for 2000–2009 were the three largest corporate health insurers: UnitedHealth Group at #24 with $25.2 billion in buybacks (96 percent of net income over the decade), Wellpoint at #35 with $17.5 billion (92 percent), and Aetna at #49 with $10.4 billion (105 percent) (Lazonick, 2010a). Over this period, repurchases by the fifth largest insurer, Cigna, were $10.9 billion, or 111 percent of net income. Meanwhile the top executives of these companies typically reaped millions of dollars, and in many years tens of millions of dollars, in gains from exercising stock options. A serious attempt at healthcare reform would seek to eliminate the profits of these health insurers, given that these profits are used solely to manipulate stock prices and enrich a small number of people at the top.

FIGHTING FINANCIALIZATION

In the United States, the problem of exploding executive pay has been around for a long time, and virtually nothing has been done about it. Indeed, in his 2008 book, *Supercapitalism*, Robert Reich (2008: 105–114), former Secretary of Labor in the Clinton administration and in general a critic of 'financialization', justifies the explosion in executive pay by arguing that intense competition makes it much more difficult to find the talent who can manage a large corporation than it used to be. In an interview in February 2010, President Barack Obama was quoted as saying that paying top corporate executives in stock rather than cash is a 'fairer way of measuring CEO success and ultimately will make the performance of American business better'. Referring specifically to the outsized remuneration of Lloyd Blankfein, CEO of Goldman Sachs, and Jamie Dimon, CEO of JP Morgan, Obama went on to say: 'I know both those guys; they are very savvy businessmen. And I like most of the American people, don't begrudge people success or wealth. That is part of the free-market system.' (Kuhnhenn, 2010).

The one attempt in the 1990s by Democrats to control the rise of executive pay ended up doing just the opposite. In 1993, after Bill

Clinton became President of the United States, his administration implemented a campaign promise to legislate a cap of $1 million on the amount of non-performance-related, top-executive compensation that could be claimed as a corporate tax deduction. One perverse result of this law was that companies that were paying their CEOs less than $1 million in salary and bonus raised these components of CEO pay toward $1 million, which was now taken as the government-approved 'CEO minimum wage'. The other perverse result was that companies increased CEO stock-option awards, for which tax deductions were not in any case being claimed, as an alternative to exceeding the $1 million salary-and-bonus cap (Byrne, 1994, 1995).

A further irony of the Clinton legislation was that the high-tech lobby at the time was fighting against an attempt by the Financial Accounting Standards Board (FASB) to require companies to expense stock options. Especially for companies with broad-based stock option plans, this prospective regulatory change would have resulted in lower reported earnings that, it was thought, would result in lower stock prices. Hence, even though the proposed FASB regulation (which was ultimately decreed in 2004) would have reduced the corporate tax bill, corporate executives were against it. Why would these same executives have given much thought to the fact that there would be no corporate tax deductions for personal pay that exceeded the million dollar cap?

Then as now, it is futile to talk about placing restrictions on executive compensation without limiting the extent to which executives can reap gains from stock options that result from either speculation or manipulation. Besides making manipulative stock repurchases illegal, legislation is needed to place limits on stock-option grants to individuals and to make the gains from the exercise of stock options dependent on achieving a variety of performance goals, including first and foremost ongoing contributions to high-quality job creation in the United States.

Economic activity entails both the creation of value, as goods and services are produced, and the extraction of value, as goods and services are consumed. Investment in innovation creates the potential for higher standards of living for those who contribute to the innovation process. Inequity occurs when certain groups in the economy – for example, top corporate executives – use their control over resource allocation to extract more than they create. Instability occurs when this excessive value extraction undermines innovation, and with it the potential for higher standards of living for the broader population. It is my contention that in the United States in the 2000s the stock-based compensation of corporate executives has been a prime source of this instability, and the stock buyback has been their most powerful 'weapon of value extraction'. Indeed, my research suggests that, by undermining innovation, stock repurchases have become 'weapons of value destruction'. Corporate stock repurchases should be banned, and stock-based compensation should be controlled so that executives cannot gain from speculation on and manipulation of the stock market. If not, we can expect that executive pay will continue to explode, and that, for lack of innovation and high-quality job creation, American prosperity will continue to erode.

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NOTES

1 For data, 1916–2007, on the composition of the incomes of the top 0.1 percent in terms of salaries, business income, capital income, and capital gains, see Saez 2010, fig 4new.

2 In a paper on top incomes in Canada that refers to stock-based compensation, Saez and Veall (2005: 841) note: 'In contrast to the United States, on Canadian tax returns, profits from stock-option exercises can be separated out from wages and salaries.' For data that Saez adduces on stock-option remuneration as a share of total remuneration for the 100 highest-paid US CEOs, 1970–1999, see http://elsa.berkeley.edu/~saez/, Table B4(CEOs). For the reasons why most of the gains of executives from exercising stock options are, for taxation purposes, deemed to be personal income rather than capital gains, see Lazonick (2010c).

3 A stock-option award gives an employee the non-transferable right to purchase a certain number of shares of the company for which he or she works at a pre-set 'exercise' price between the date the option 'vests' and the date it 'expires.' Typically, in US option grants, the exercise price is the market price of the stock at the date that the option is granted; vesting of the option occurs in 25% installments at each of the first four anniversaries from the grant date; and the expiration date of the option is 10 years from the grant date. Unvested options usually lapse 90 days after termination of employment with the company.

4 In the 1980s, dividends paid out by US corporations increased by an annual average of 10.8 percent, while after-tax corporate profits increased by an annual average of 8.7 percent. In the 1990s, these figures were 8.0 percent for dividends (including an absolute decline in dividends of 4.0 percent in 1999, the first decline since 1975) and 8.1 percent for profits. The dividend payout ratio – the amount of dividends as a proportion of after-tax corporate profits (with inventory evaluation and capital consumption adjustments) – was 48.9 percent in the 1980s and 55.0 percent in the 1990s compared with 39.5 percent in the 1960s and 41.6 percent in the 1970s. From 2000 to 2009 the dividend payout ratio was 61.5 percent, including a record 70.4 percent in 2007.

5 I treat data for companies with fiscal years ending January 1 to June 30 as representing the previous calendar year, and for fiscal years ending July 1 to December 31 as representing the current calendar year.

6 The NNI budget was $1,554 million in 2008 and $1,695 million in 2009, and an estimated $1,781 million for 2010 (www.nano.gov/html/about/funding.html).

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22

Governance, Innovation and Finance

Ciaran Driver

INTRODUCTION

Examining the links between governance and innovation may seem a well-defined research area. But even as the object of study is named, questions begin to multiply. Why, for example is innovation a *governance* issue, rather than one, say of management or business strategy? Is it that the ownership structures of firms shape (or are shaped by) innovation so that we need to study industry evolution and ownership form in tandem? Or is it perhaps that the nature of the innovation process inside stable organisations requires a different form of governance than those devised either for contracted or directed tasks? These questions – essentially whether we are involved in a systems or a firm-based analysis of the links between governance and innovation give just an entry-level view of the breadth and complexity of the area, indicating that some initial ordering is necessary. In the remaining parts of this Introduction, I review some basic theories of governance and how they differ. This is followed by a section (Innovation), where the links between these governance theories and innovation are discussed. The next section selects a compressed number of issues on which there is some empirical evidence and reviews these, with closing comments provided in the concluding section (Discussion: What do we know?).

Governance discourses

The workhorse model of governance is the principal–agent approach (Eisenhardt, 1989). Here we review the model as a reference point for a set of alternative approaches that coexist in the literature. These alternatives share some features in common, and also with agency theory itself. By way of overview I have illustrated these interconnections showing only the most important, as in Figure 22.1.

Principal–agent

The main interest here lies in a hypothesised relationship between company performance and various ways of aligning the interests of

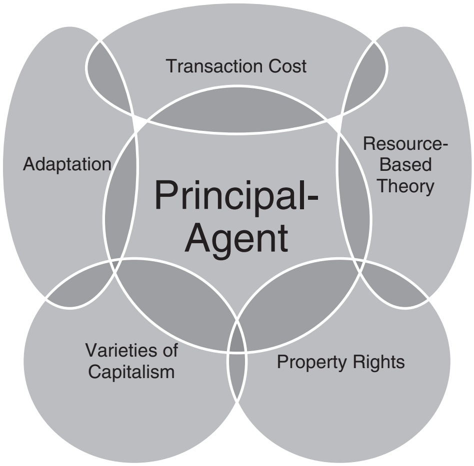

Figure 22.1 The model of governance: the principal–agent approach

contracted agents and contracting principals. Given difficulties in the principal inferring or observing effort, the agent may deviate from the contracted agreement or may take advantage of private (asymmetric) information before or after the contract is written. There can be no presumption that the parties will find an arrangement to reach the first best solution that would be possible in the absence of these distortions. Corporate governance is an institutional form that addresses this problem; the costs incurred in setting up these governance mechanisms form part of what are known as agency costs.

The purpose of governance is to ensure that performance net of agency cost is as close as possible to a first best outcome for all contracted or non-contracted parties (that would occur in the absence of agency costs). Because payment by results is usually problematic (due to the confounding of the output signal by random noise) some form of expensive monitoring or more usually an incentive system, involving risk for the agent, has to be devised. These incentives include familiar forms of profit sharing such as bonus payments, company shares and options and can include non-financial rewards such as career progression. Of these variants, more intense or 'high-powered' incentives are needed where risk-taking is central, as in the classic sharecropping problem with a risk-averse agent and a risk-neutral principal. There is therefore nothing much new in the application of agency theory to innovation as long as innovation is viewed as an input no different to other forms of risky effort that is required to be efficiently allocated and employed. We postpone the discussion of how different innovation is in that regard.

Transaction cost theory

Here we can identify a school of thought that takes the agency problem as a given, but which sees the firm itself as an institution to resolve this. The firm is identified as a governance structure in contrast to the market form of external contracting. There is a trade-off between using bureaucratic contracts and market contracts and the balance of advantage depends on the specific industrial context. Markets have the advantage where tasks can be rewarded transparently by high-powered contracts. Firms are needed where ambiguity and bargaining difficulties require direction of effort by rules and procedures and where, consequently, incentives are likely to be low-powered. Oliver Williamson, one of the main developers of transaction cost theory, puts it succinctly:

> Which way that trade-off goes depends on the attributes of transactions in relation to the costs and competencies of alternative modes of governance (1998, p. 44).

This view is compatible with an agency perspective – the markets/hierarchy distinction maps on to performance versus rules-based contracts – but it is not identical. Williamson criticises agency theory as too focused on efficient risk-taking rather than the choice of governance structure to deal with contract difficulties. There are implications for innovation in the transactions view, but it is not entirely clear what they are without further specification of the innovation process. Innovation is characterised *both* by the need for risk-taking *and* the presence of contracting hazards and, indeed, that is a very incomplete list of relevant considerations.

Resource-based theory

The resource-based theory (RBT) of the firm is often regarded as a theory of strategy rather than governance. It constitutes a firm-based theory of competitive advantage as contrasted with a structural one that gives more weight to the industry. Since the firm is thus led to define itself in terms of natural or created advantage (development of core competence), this involves a rival theory of the boundary of the firm to that of transaction costs and thus constitutes a governance theory of sorts, at least in respect of the decision between markets and hierarchical or hybrid forms. In contrast to a transaction cost view, this approach explains integration by the advantage of the monopoly position that is created and sustained by combining resources within the firm (Barney & Clark, 2007). This is contrary to Williamson, who dismissed this feature, given that '... few firms possess market power of a durable kind' (p. 33).[1] Insofar as it constitutes just an alternative to transactions costs, RBT is only tangentially related to governance. Other rival theories to transactions cost – e.g. that the boundary of the firm is determined by technological scale and scope – have not been regarded as issues of governance. But there is another side to RBT that justifies its place in governance discourse and that relates to its critique of the agency view.

For many resource-based scholars, it is *dynamic capabilities* that matter – the ability not just to offer a distinctive product or service but to develop new ideas and to shape the firm (Helfat & Teece, 2010; Pitelis & Teece, 2010). The firm is thus a governing structure for enterprise and innovation rather than, as in the agency approach, a structure for resolving conflict and reducing contract costs. In contrast to the agency focus on incentives and goal alignment, the main concern here is the coordinating role of the firm in growth. Of course, coordination by fiat is one dipole of transaction economics, but there it is treated as a *faute de mieux* (for want of a better alternative) of market failure caused by opportunism. For resource-based theorists, the coordination feature of the firm is a more positive and indeed a more problematic exercise involving planning in an uncertain world, shaping markets through investment and innovation (Chandler, 1992; Demsetz, 1993, 1997; Foss, Lando & Thomsen, 2000; Lazonick, 2010). The contrast with an agency view is that '... the emphasis is not just on protecting value but also on creating it' (Helfat & Teece, 2010, p. 28). There are implications here for the organisation of innovation.

Property rights

The property rights theory of *governance* (as opposed to economics more generally) concerns the appropriate form of ownership to encourage investment involving sunk cost. The aim is to prevent under-investment that may arise, for example, from bilateral dependence, as in co-located or vertically related transactions. The scope for market failure and dissipation of costs in such contexts is already familiar from the transaction cost approach. Also common to that framework is Williamson's view that market-based solutions are often ineffective because complex contracts are incomplete and can only be enforced by some form of fiat or exercise of power. The investment decision by all parties in the property rights model thus requires some way of predicting how the gains will be appropriated, if not by formal contract. The answer here lies in anticipated control rights (exclusion of use) arising from the assignment of ownership at the outset. This determines the power structure of any bargaining game that follows the commitment of irreversible resources. While the exact implications differ from model to model, the general thrust of the argument is that pre-assigned property rights are important in offering incentives to commit to specific investments (those that are sunk and have no alternative use). Ownership is thus determined by the need to offer an enforcement procedure for investments that might otherwise not take place. Unlike the resource-based view, which emphasises the benefits of monopoly, property rights theory stresses the danger of bilateral monopoly. Unlike the transaction cost approach, the issue is not just whether two firms should merge but which one should have control through ownership. And unlike principal–agent theory, the property rights approach is concerned with forward-looking investments, not with current performance.

What is distinct about the property rights model is its single-minded concern with the incentive to invest in such a context.[2] Indeed, this is the only possible inefficiency in the system, so that Williamson is driven to complain that in this theory 'management is never called upon to manage' (1998, p. 34). By ignoring all forms of output uncertainty, information deficiencies, and uncertain bargaining cost, it takes abstraction to the limit. Nevertheless, in addressing sunk costs, this focus of property rights theory clearly relates to the innovation agenda. Indeed, since much of innovation is investment in skills, the extension of the original model to include specific investments in human capital has been an important theme of the literature, leading to a consideration of the governance arrangements that would allow property rights for the providers of skilled labour. Such thinking blurs the distinction between principal and agent, given that both are now risk-takers in a context of incomplete contracts.

Varieties of capitalism

The focus so far has been on firm-level or transaction-level questions. A systems perspective offers a broader consideration of constraints and opportunities. The form of governance varies across countries, leading to a consideration of why this should be and how much convergence (to the Anglo-American form) is likely for those such as mainland Europe or Japan that currently have a distinct system (Clarke, 2007; Mallin, 2007). The historical origin of these differences is one strand of this literature: e.g. whether the variation is attributable to anterior legal or political distinctions, the stage of development of equity finance, and so on.[3] However, our interest in this chapter lies not in the origin of different systems but in the links to innovation as experienced by actors inside the firm. The innovation system reflects constraints and opportunities, e.g. in regard to finance. Patient (long-term) capital, an important facilitator of investment, is often thought to be a hallmark of systems of insider or block ownership. At the same time, however, equity capital is of the risk-bearing kind that new enterprise often requires.

Financial structure is not the only discriminant of capitalism. Labour law and customs that bear on representation and decision rights are also part of the differing governance frameworks. Such features influence (through the property rights channel) the willingness of employees to incur risk, commit to the firm and cooperate for change. As noted earlier, where contracts are incomplete, risk is shared and the concepts of agent and principal seem themselves to be ill-defined. Indeed the dominant version of stakeholding derives from an argument that agents are part-principals (Blair, 1995). This implies not only an entitlement to current profit share but also rights to the cumulative organisational capital of the firm.

Adaptation

Governance can be viewed as a system that allows firms to adapt to shocks or unanticipated threats and opportunities, where these are difficult to achieve by market means and require coordination or cooperation. Just as in the property rights approach where control rests with those making the most important investment for total returns to all parties, so in the adaptation approach, the power of arbitration is supposed to be placed in the hands of the party who will minimise dissipation of the surplus. The distinct feature of the adaptation concept is that it is *ex post*, i.e. no renegotiation of contracts are considered so that the *ex ante* decision simply relates to the rules of arbitration (Gibbons, 2005). Variation in adaptation procedures is one way of understanding the variety of capitalism literature. The arbitrator in the case of the Anglo-American model is the board of directors (with considerable variation in national corporate laws that set the context), while stakeholder systems are distinct and involve direct engagement with non-equity participants sometimes extending to the exercise of veto power. Adaptation may thus be interpreted narrowly as referring to codes of governance and board autonomy, or more broadly as part of the varieties of capitalism perspective.

INNOVATION

Innovation is often defined to be the commercialisation of new ideas but here I use it in a more inclusive sense to encompass the generation and development of new products or processes, since governance can be expected to affect both the input and the productivity of research effort. Innovation matters for firm performance in the same way as capital investment, training, information systems, distribution facilities and marketing. But there are important differences, at least in degree and possibly in kind. Human creativity is non-contractible to a larger degree than other inputs, given that input choices are often invisible and associated output gains from innovation and teamwork are highly uncertain, raising challenges for top-down direction and traditional governance mechanisms (Grant, 1996; Nickerson & Zenger, 2004; Asher, Mahoney & Mahoney, 2005). Furthermore, it is not only output value that is uncertain but also how the gains are to be divided (Coff 2010).[4] In this section I return to the six discourses on governance in Figure 22.1 and link each of them to the innovation process.

Principal–agent

Innovation disturbs the status quo and thus tends to widen the divergence of goals in the organisation, while at the same time blunting any tools to address the issue. The nature of innovation activity creates special difficulties for contract-based incentives. Innovation is characterised by the following:(a) high risk, meaning that it is costly to incentivise agents; (b) uncertain appropriability and multi-stage options, making it difficult to negotiate and renew contracts; and (c) lack of benchmarking, which inhibits performance observation (Holmstrom, 1989). Innovation may also be characterised by multi-tasking: e.g. between knowledge creation and knowledge sharing. Here, high-powered incentives run the risk of targeting what they can, but at the expense of other less measurable tasks (Milgrom & Roberts, 1992). High-powered incentives may also overlook the need for protection from short-term failure (Manso, 2011).

The use of monitoring as a complement to incentives is also problematic; the monitor has to have reasons to report truthfully: i.e. not to collude with agents to collect side-payments or other rents. Monitors, themselves, have to be highly incentivised, which means that they tend to be senior figures who are possibly remote from those monitored. This matters more in an innovation context with asymmetric information. Individual researchers or teams may be able to disguise some projects in favour of preferred ones.

The literature has explored possible perverse effect of excessive monitoring and control through the mechanism of reduced autonomy and discouraged effort (Baysinger, Kosnik & Turk, 1991). It appears that there may be an inevitable trade-off between permitting private benefits and dampening innovation. An implication of this is a certain degree of decentralisation of power (real authority) within organisations where the firm's objective is to encourage the discovery of new opportunities (Aghion & Tirole, 1997). Delegation offers agents the right to choose projects with attendant private benefits in exchange for information search to discover better projects. A problematic element in this model is the assumption that it is possible for senior managers to pre-commit, not to renege, something that may be called in question by executives (being themselves) subject to tight control by the board. Monitoring operates at different levels. For much of the agency literature, it is the relationship between knowledge workers and senior management that is important. But there is also another dimension – that between senior management and investors or their board representatives (Burkart, Gromb & Panunzi, 1997; Lazonick, 2008). Here the research issue is whether ownership structure matters, i.e. whether block ownership or other direct forms of control, such as buy-outs, private equity and hedge funds, can diminish asymmetric information problems and lead to gains for investors or whether they result in overtight control, which creates tension with minority shareholders and other stakeholders and focuses the firm away from innovation.[5]

Transactions cost

The transactions cost approach extends agency concerns to a broader concept of market relations versus administrative (internal) control. In Williamson's work, three determinants are identified: frequency, uncertainty and specificity. For innovation activity, all of these point in the same direction. Innovation is generally continuous or repeated, making integration worthwhile. Uncertainty is high for contracted research in terms of quality, timeliness, reliability, commercial applicability and confidentiality. Specificity also tends to be high for innovation, given that novelty implies thin markets with a small number of players. This specificity limits alternative use or resale and tends to confer hold-up power on the buyer and to raise the cost of bargaining. All of these features appear to favour integration. Nevertheless, as discussed under agency theory above, any difficulty in contractibility is likely to be replicated within the firm as a difficulty in incentive formation. Divergent goals, opportunism and asymmetric information present a considerable challenge for the integrated innovative firm. These features are said to distort allocation by ignoring uncertain technologies that are costly to incentivise and focusing on correlated projects that have easy comparators (Holmstrom, 1989). Indeed, Holmstrom almost rules out the possibility of large firms engaging in any effective form of innovation, arguing that the benefits of integration and bureaucracy are only available for production and marketing functions.

Resource-based view

This theory seems to belong to the interface of innovation and governance if for no other reason that it poses the question of how firms acquire capabilities. Internal organic growth is a large part of this, with occasional punctuations, as when firms radically change the business they are in. The dynamic capabilities branch of RBT emphasises the role of unique slack resource that may under certain future states of nature ensure competitive advantage. This is a governance concern because slack resources need to be defended; governing institutions need to be able to identify these from other forms of slack. Furthermore, the early stage building of option portfolios determines much of the distribution of future gains, so that early asymmetric information is more valuable than normal and complicates the task of governance (Foss et al., 2000; Coff, 2010). All of this approach seems to distance the governance of the RBT firm from the principal–agent view with investors in charge. With RBT it is hard to see the control of strategy being in hands other than organisational insiders who see the firm as more than the sum of its marketable parts.

Nevertheless, RBT is not just about organic growth; it is also linked to diversification so as to exploit capabilities where that cannot be achieved through alliances or licensing. Diversification also works in the opposite direction of providing new sources of capabilities. But such a dynamic view of the firm's competence trajectory may call into question the project of a common purpose within the firm. Capabilities are scarcely possible without a committed workforce, whose security needs to be protected in some way. RBT scholars argue that diversification can achieve this: 'a firm's equity holders have an interest in a firm pursuing a diversification strategy in order to induce employees to make firm-specific commitments' (Barney & Clark, 2007, p. 203).

Property rights

Under incomplete contracts, the owner of any input specific to the firm is vulnerable to hold-up (Hart, 1995). Anticipating this, knowledge workers may under-commit to firm-specific learning (Blair, 1995; Stout & Blair, 2001; Deakin, 2008). The original hold-up theory tended to exclude human assets, since they are inalienable (embodied) and so control over them cannot be negotiated away. Nevertheless some predictions are possible. If a knowledge asset is inalienable, the innovator should have ownership and control of the physical complementary (fixed) asset as well (Brynjolfsson, 1994). The reasoning is that the incentives to provide the physical asset are unchanged (where the physical assets are fully complementary to the innovation), while that for innovation will be increased. Relaxing this tight assumption gives a less determinate outcome, but the more indispensable the innovator is, the more likely the innovator will own the asset. Unfortunately, clear results disappear once many sources of knowledge are introduced.[6]

Other variants of property rights theory predict decentralisation of innovation activity within the firm:

> 'As the importance of human capital has grown, power has moved away from the top and is much more widely dispersed through the firm' Rajan and Zingales (2000, p. 202).

The reasoning is that increasingly thick global markets for skills makes it difficult to obtain specialised inputs that would be vulnerable to hold-up; restricting hierarchical power within organisations may be necessary so as to increase worker commitment by knowledge workers. Zingales (2000a) considers and rejects the solution that 'key workers should control the assets they work for …' (p. 1639). In his view, granting control rights to employees would *discourage* rather than *encourage* specific investments because control rights would be used to create a higher outside option to increase bargaining rights against other stakeholders (Rajan & Zingales, 1998). The organisational solution proposed is to support specialisation by access to complementary assets such as the knowledge base of a superior manager. The resulting arrangement is seen as a nexus of investments, i.e. a firms 'organisational capital' (Zingales, 2000a, p. 1646). However, the role of coordination in this framework is largely ignored, inviting the pessimism in Holmstrom (1989).

Varieties of capitalism

Whereas property rights theory aims to resolve incentives by an assignment of single control to one party, such a prediction does not easily generalise to knowledge inputs, at least in respect of large complex firms. In that case, shared control may be necessary to offer incentives both to the owners of fixed and knowledge capital. Shared control may simply involve informal or customary rights of consultation but may also extend to formal vetoes, as with employee voting representatives on company boards. The varieties of capitalism literature deal with such differences in laws and customs, including the effect on innovation capacity of different governance systems.

The logic of control rights has been worked out in models by Roberts and Van den Steen (2000) and Holopainen (2007). Workers choose a level of skills investment that is not subject to enforceable contract. Anticipated *ex post* bargaining over the surplus then determines the incentives to invest in this human capital h. Where h is financed by workers but is entirely firm specific, worker representation on the board confers control rights and increases the incentive to invest in h.

The model differentiates between specific technology (where specific skill is totally devalued on arrival of a new vintage) and general technology where that is not so. Under the specific technology, if the new vintage is adopted (probability = p), workers bargained wage is zero; otherwise (with probability $1 - p$), the wage depends on the bargaining power of workers in a Nash game to divide the surplus. General technology is advantageous to employees because it involves a skills' switching option in the event that a new vintage is adopted.

The model shows that a shareholder-oriented approach is biased, as it takes into account only the contribution to measured profit (total profit should include returns to all risky inputs), so that human capital may be under-supplied and specific capital may be favoured over general. Although the shareholder may have a private incentive to grant some bargaining power to workers so as to encourage human capital formation, this process has clear limits. For example, a stakeholder tradable veto over changing a specific technology involves a trade-off between increased incentives for human capital and a fall in profitability.

Given that stakeholder control potentially lessens shareholder protection, it may result in restricted access to external finance (Tirole, 2001, 2006). How serious this is for the firm depends on the economic context. The importance of external finance is controversial, given that most gross investment of corporations is funded from internal sources and under the control of management unless the board involves itself closely in allocation decisions. Furthermore, insofar as managerial teams engage in external technology sourcing, this is often done (via corporate venturing or strategic alliances) without necessarily raising public external funds. From an agency perspective, there is a worry that managers' internal allocation decisions will be inferior to market matching, but this is a point of contention in the literature (Stein, 2003).

The key attributes of a stakeholder model are some form of shared property rights. In the model above, this impacts on profits and thus potentially on unsecured sources of capital, an influence that may be reinforced if concentrated holdings give rise to hold-up fears by minority investors. The innovation consequences then depend on the relative advantage of engaged stakeholders versus the allocative speed of liquid capital markets; an untenured workforce and fast allocative speed is seen as favouring sectors undergoing radical transformation. In an extension to the debate, Tylecote (2007) argues that sectors (and sub-sectors) within each variety of capitalism need to be distinguished not just by degree of radical innovation but by characteristics such as ease of monitoring and payback periods that determine the appropriate structure of governance.

Adaptation

Adaptation is a form of governance that arbitrates in the face of unanticipated events or outcomes. In incentivising innovation, adaptation might appear less effective than formal property rights since reputation matters less when discount rates are high – as they tend to be when potential growth rates rise with innovation. Put differently, the temptation to renege is most powerful in an innovative climate, when the opportunity cost of compliance is high.

Adaptation institutions differ across countries; a climate of trust appears to have facilitated innovation in Japan, where corporate culture supported intrinsic motivation (Holmstrom, 1999a; Jacoby, 2005). Adaptation institutions differ not just across innovation systems but also in respect of codes of governance and board practices. Tightly constrained board norms may increase trust in respect of arbitrating disputes between broadly defined stakeholders.[7] These norms are not always captured in the varieties of capitalism literature as they tend to bracket, for example, the United States and the United Kingdom together and ignore important differences such as takeover defences that now constrain US firms to a greater extent and arguably increase innovation (Tylecote & Ramirez, 2006; Tylecote, 2007).

EMPIRICAL STUDIES

Empirical work on the links between governance and innovation stretches across many literatures. Here we contain the study by compressing the previous six topics into three reviews: principal–agent, integration, and governance systems. The first topic deals not only with standard findings on agency theory but also with its interaction with the provision of finance for innovation. The second topic concerns R&D decentralisation and is informed by transactions cost, resource-based theories and the property rights perspective, all of which share a concern with the boundary of the firm. Finally, we review empirical work on systems of governance and their connection with innovation. This encompasses the variety of capitalism literature but it seems natural to combine this with the adaptation approach, the operation of which is predicated on institutional arrangements and cultural norms such as the degree of trust.

Principal–agent, finance and innovation

Since agency literature normally focuses on performance, I begin with papers that study the effectiveness of governance in improving innovation outputs. The most common measure of such outputs is a patent count, sometimes weighted by citations. Here, governance is aimed at slack in the execution of innovation projects; better governance leads to decision makers applying more effort or risk to increase patents per unit of research resource.

In addition to output effects, another concern of agency studies is the impact of governance on innovation inputs such as research and development (R&D). One difficulty here is that there is controversy in regard to the maintained hypothesis. Agency models generally assume opportunistic action by managers, but these can consist in either empire building (over-investment) or shirking (under-investment). For capital investment studies, the former assumption is often maintained, but for R&D it is less clear-cut. Lerner, Sørensen and Strömberg (2008) argue for a focus on output or patent performance, rather than R&D, as the latter can be 'wasteful'. No doubt both output- and input-based measures have their problems, but one particular difficulty with patent studies is that they are biased towards codified rather than tacit knowledge and may thus avoid some of the more obvious difficulties of governance. There are worries too about the interpretation of patent data, given extensive debate on patent bias since Hall and Ziedonis (2001).

We now present and discuss three sets of hypotheses that the literature has attempted to test in respect of governance, finance and innovation.

Innovation outputs are improved by the adoption of good governance measures

Most of the testing here implies a model of incentives within the principal–agent paradigm or implies that ownership structure is important for directly monitoring the behaviour of managers. As discussed in Section 2 (Innovation), high-powered incentives are thought to be ineffective in such environments because of multi-tasking, asymmetric information and misalignment of risk attitudes. Perhaps, because of this, recent work has aimed to test the effects of various types of ownership structure.

Lerner et al. (2008) study the effects on patent performance of firms going private, obtaining varying results by sample, but with some evidence that private equity improves patent performance. There is, however, an unresolved selection problem in that the data cannot discriminate between the agency view and the prior selection by private equity investors of firms with good patent options. Other work has considered the effect of ownership structure on patents. Aghion, Van Reenan and Zingales (2009) show that citation-weighted patents for any given R&D level are higher under certain forms of institutional ownership, specifically those that tend to track indices as opposed to 'dedicated' or 'transient' investors. Given that managerial turnover is less sensitive to performance for institutional owners, they attribute this finding not to reduced slack but to the effect of monitoring on managers' security from short-term pressures. Nevertheless, this finding is surprising for the transient group; the authors' view is that for these investors, strong exit options facilitate performance.

Work on incentive structure has identified a role for compensation of chief executive officers (CEOs) on innovation output using National Bureau of Economic Research (NBER) patent data (Francis, Hasan & Sharma, 2009). In keeping with those who have argued for a more complex agency approach based on long-term rewards and protection against failure, they find a role for option-based compensation and golden handshakes (which ensure against failure) but not for performance-based pay.[8] In general, one worry about the empirical literature is that it pays insufficient attention to the channels of influence that are involved. From a resource-based theory perspective it would be more natural to think of the development of competences as an intermediate step to R&D productivity (Henderson & Cockburn, 1994).

As noted earlier, it is very difficult to draw firm conclusions from studies which focus solely on patent outcomes. Patents are codified assets that position the firm in the market for control. For a transient investor with a short-term horizon, this feature may dominate at the expense of allocating resources in other ways or in improving the firm in ways that are less visible. While pension funds (which correspond to the indexed investors in Aghion et al.) have been shown to favour internal innovation over acquisitions, professional fund managers 'prefer more immediate returns' (Hoskisson, Hitt, Johnson & Grossman, 2002, p. 710). The results, therefore, may say more about the aims of different investors than about the effect of governance on performance.

Innovation effort or allocation is improved by the adoption of good governance measures

In theory, the principal–agent task might be posed as one of preventing excessive R&D. This is not generally tested for because of a strong prior belief that managers tend to under-invest in R&D. The usual assumption in the literature is that managers are not taking on enough risk so that profitable R&D projects may be passed over or money will be allocated to projects with a worse risk-return profile than the owners would prefer (Hall, 1990; Eisenhardt, 1989). This seems especially likely where managers are highly mobile or have short tenures (Palley, 1997), where earnings management is practised (Bushee, 1998) or where the main role of R&D is to create non-specific absorptive capacity (Cohen & Levinthal, 1989). Good governance would aim to prevent this under-investment.

The evidence for a direct effect of governance reforms on R&D, whether due to ownership, board characteristics or incentives, is not consistent. In respect of ownership, there is some evidence of a positive effect on R&D of concentrated or institutional holdings (Hill & Snell, 1988; Smith, Madsen, & Dilling-Hansen, 2001; Lee & O'Neill, 2003; Munari & Sobrero, 2003a). The institutional results are difficult to interpret unless there is information on whether institutions are passive or exercise voice. Aghion et al. (2009) find a small and fairly weak effect of institutional ownership on R&D but they do not split this result by institution type as they do with their patent count analysis. Eng and Shackell (2001) show that there is heterogeneity in institution type in respect of whether they invest in R&D intensive companies and this endogeneity would need to be controlled for. The role of ownership concentration also appears to differ across countries, according to the national innovation system. Concentrated ownership appears detrimental to R&D for European companies but considerably less so in the UK where short-term pressures reflect a strong market for corporate control and a highly liquid stock market (Munari, Oriani & Sobrero, 2010). This echoes the finding of a positive effect of concentrated holdings on R&D in the United States but not in Japan (Lee & O'Neill, 2003).[9]

For managerial incentives Wu and Tu (2007) find that CEOs option-based compensation can increase R&D under high growth, but that does not extend to other types of incentive pay, consistent with Eng and Shackell (2001). Devers, McNamara, Wiseman and Arrfelt (2000) find an effect on CEO risk-taking but only for some forms of equity-based pay; Lhuillery (2009) does not identify a separate compensation effect on R&D.

In relation to outsiders on the board of directors, much of the evidence does not support a positive link with R&D. Hill and Snell (1988) and Baysinger et al. (1991) find negative relationships, while David, Hitt and Gimeno (2001) find no significant moderating influence of outsider executives on a positive role for institutional investors. Kor (2006) finds no effect for outsiders on R&D intensity or in countering the tendency of long-tenured management teams to avoid investment risk for uncertain long-term projects. Hoskisson et al. (2002) finds that outsiders on the board are associated with acquisitions rather than internal innovation. Lhuillery (2009) finds some support for a positive effect of governance principles on R&D intensity in a large sample of French firms, though not for board composition. The same is true of Lacetera (2001).

The provision of finance on good terms is facilitated by good governance

Agency effects are expected to operate both directly in respect of managerial private interests and indirectly in respect of the cost or availability of finance (Hubbard, 1998). Given asymmetric information between managers and investors, R&D projects will primarily be financed from internal funds according to the 'pecking order theory' (Myers, 2003; Frank & Goyal, 2008). Equity raising will be interpreted by financial markets as implying that firms are overvalued, for which reason a premium would be applied to any issue of shares, diluting existing holdings which managers are assumed to be most concerned with. This makes internal finance more attractive, particularly where debt capacity has been reached. Even where there is disagreement as to whether such signalling mechanisms are the main reason (Graham & Harvey, 2001; Campello et al., 2009), there seems little disagreement that internal finance is preferred by firms. Where there are more profitable opportunities than can be funded internally, this results in a finance constraint, indicating a potential positive effect of free cash flow on R&D expenditure. Indeed, the R&D equation may be more likely to exhibit a cash flow effect than fixed investment, given that intangible R&D has low collateral value to support. However, the situation is complicated by the intensity of specialised labour in R&D activities which makes for sluggish adjustment and which may explain the finding that the cash flow coefficient for R&D appears to be lower than for fixed investment (Harhoff, 1998; Hall, 2002).

The evidence in favour of any cash-flow effect for R&D is mixed (Bond, Harhoff & Reenen, 2003).[10] Previous results supportive of a link include Hall (1992) and Himmelberg and Petersen (1994). Cincera and Ravet (2010) suggest that financing constraints on R&D have appeared in Europe but not in the United States since 2000, whereas the results in Hall (2002) suggested a higher cash flow coefficient for the United States and the United Kingdom than elsewhere. A related finding in Bond et al.

(2003) suggests that, for the United Kingdom, cash flow is important for the decision to do R&D but not its intensity. Malmberg (2008) finds significance for cash flow on Swedish pharmaceutical company R&D at industry and firm levels using a two-year lag and a long data series over four decades. Ughetto (2008) finds an effect for Italian small and medium enterprises (SMEs); Canepa and Stoneman (2008) report a similar effect for UK firms for a broader category of innovation. Hyytinen and Toivanen (2005) identify a financial constraint by investigating the effect of R&D subsidies. However, Vecchi, Barrel, Becker, Schmidt-Ehmcke and Stephan (2007) find no evidence for interest rates or current profits in their industry-based analysis of the United Kingdom. Rogers (2006) infers a lack of financing constraints for large R&D spenders in the United Kingdom on the basis of comparative international R&D productivity. Brown, Fazzari and Petersen (2009) find no evidence for financial constraints for large hi-tech firms in the United States, only for younger growth firms. A similar lack of significance is found for the full sample of large UK firms in Driver and Guedes (2010), though the interaction of an index of tight governance indicates reduced sensitivity to cash flow, which the authors interpret as a reduction in autonomy for executives. Hillier, Pindado, de Queiroz and de la Torre (2011) in a cross-country study find that cash-flow sensitivity of R&D expenditure is lower under a bank-based financial system, high ownership concentration, minority shareholder protection, effective boards and a strong market for corporate control, all entered as a separate interaction with cash flow.

Integration and innovation

The evidence here is easiest to discuss from the starting point of a stylised transaction cost hypothesis.

Innovation is organised to reflect transaction cost

This hypothesis is familiar from what has been said earlier in respect of innovation being characterised by repeated engagement, high uncertainty and specific assets, all of which might favour internal development of complex innovation (Williamson, 1985). The reason for doubt, and thus the need for empirical testing, lies in the range of influences that are omitted from this consideration, including scale and scope as well as capability arguments.

One of the most important contributions on this subject is Odagiri (2003), who treats transaction cost and property rights under the same rubric in that they both involve incomplete contracts and opportunistic hold-up. He uses a series of case studies of cross-firm alliances by Japanese firms to distinguish between this approach and resource-based theory. On balance, he finds evidence in favour of the latter in that choice of alliances appear to be focused less on preventing opportunism and more on acquiring capabilities. A similar result is found in Love and Roper (2005) in a study of new product developments in UK, German and Irish manufacturing plants. However, other authors find evidence favourable to a transactions cost interpretation (Pisano, 1990; Sampson, 2004); a literature review shows asset specificity associated with internal development in all known studies of innovation assets (Stanko & Calantone, 2011) though the theories may of course be complementary (Barney & Clarke, 2007).

There are few clean results in this empirical literature that lend themselves easily to support for a particular view of governance or policy. Non-governance issues such as thickening markets for skills and other inputs, and opportunities to combine radical technologies encourage cooperation in the form of horizontal and vertical alliances. The impact of the resulting ‘open’ innovation is still to be determined but much seems to depend on the exact industrial context; external sourcing is most associated with imitative change (Leiponen & Helfat, 2010) and the exploratory stages of product development (Love & Roper, 2009).

Dis-integration is favourable for innovation

Decentralisation is predicted by property rights theory under incomplete contracts and inalienability of the assets (Brynjolffson, 1994). As reviewed earlier, in the simplest case, the knowledge worker is predicted to own the firm outright so that ownership concentration is reduced. Brynjolfsson also argues that opportunist forces are weaker in smaller firms, and incentives less problematic, so that even with multiple innovation inputs, the historical trend is expected to be towards dis-integration and 'an increased use of markets to coordinate economic activity' (p. 1655). This is also predicted by Holmstrom (1989), where he argued rather more narrowly that large firms could neither monitor innovation activities properly nor incentivise innovators enough to take on the high risk of failure. Innovation was thus said to require decentralisation (p. 326). Holmstrom found this to be congruent with the stylised fact that 'small firms have been responsible for a disproportionate share of innovations in the past' (p. 306).

Such views – of an inevitable tendency towards dis-integration of large firms' innovation activities – are more stylised than fact. For US firms generally, the distribution of firm size, for the 10-year period centred on the mid 1990s, is stable (Axtell, 2001). Not only has there been no general trend to smaller companies in the US but also concentration levels appear to have increased in the two decades from 1980 despite the influence of communication technology and increased trade, which were widely predicted to have the opposite effect (Pryor, 2001). Despite decades of research there seems no reliable evidence of a general nature linking innovation with size (Cohen, 1995). Recent evidence has shown that larger firms are more likely to be innovation-active but that intellectual property per employee is higher for small firms, findings that are compatible with many different explanations (Greenhalgh & Rogers, 2010).

Most likely there is a selection process at work so that the question of size and innovation needs to be assessed for different types of innovation activity. The key to understanding decentralisation of innovation may lie in the extent to which ideas can be codified because only then are they marketable. Biotechnology is the standard example where first-stage research is carried out by small start-start-ups and this is certainly helped by the codified nature of its science. In other industries such as engineering, ideas that have only been part-developed may have little market value because they are too specific or are characterised by secret or tacit knowledge. Mid-stage projects still contain option value but not, perhaps, marketable option value, so that internal development is needed. The literature often neglects the associated internal capital allocation process, which plays a far more significant role than start ups. (O'Sullivan, 2005; ICT, 2006; Hughes, 2007).

Innovation and governance systems

Governance differs for historical reasons across the world, depending on legal and political factors. This review focuses just on two differences in innovation systems that are directly related to innovation. We begin with the capital allocation process.

An important advantage of internal capital markets is the high-quality information available within the firm that enables a CEO to pick winners across divisions so as to restructure effectively (Allen & Gale, 2000; Stein, 2003). Internal capital markets have been argued to have special advantages under changing technologies, given that much new technology is secret and difficult to transmit across firm boundaries (Arrow, 1983; Liebeskind, 2000; Osterloh & Frey, 2006).[11]

An influential counter-argument has been put by Holmstrom and Kaplan (2001) and echoed in Pagano and Volpin (2008). Under unusually fast structural or technical change the potential for relatedness diminishes to the point where any advantage of internal allocation is cancelled by the need for resource building in new industries and firms.

This then becomes an explanation for increased shareholder orientation: ‘When it comes to moving capital long distances from declining industries to emerging industries’, markets do it more effectively than managers (Holmstrom & Kaplan, 2001, p. 137). The focus thus shifts to the ability of firms with growth prospects to attract external capital and to the role of governance in facilitating that task.[12] This contrasts with authors such as Lazonick (2010) who see the stock market as providing liquidity more than finance.

Holmstrom and Kaplan’s argument is also consistent with a varieties of capitalism perspective (Hall & Soskice, 2001; Hancke, 2009) that assigns radical and incremental technical change to the distinct spheres of liberal market economies (LMEs) and coordinated market economies (CMEs) as sketched in Table 22.1. The essential contrast between systems noted in the table is the existence of protection through ‘ownership’ for specialised labour providers in CMEs, favouring incremental innovation as opposed to the ease of redeployment of assets in LMEs, which might be thought to favour radical innovation.

Shareholder governance is seen as suited to an environment with significant scope for evolution of new technologies or de-maturing of older ones. Characteristics that facilitate shareholder orientation are low worker bargaining power and access to liquid external capital. A converse set of environmental characteristics is associated with stakeholder governance, where (mostly) incremental innovation is said to require skilled, secure and autonomous workers. The downside of this is argued to be slow consensus-building decision-making as compared with that in LMEs, where power is concentrated at the top of firms. Thus, the institutional structures of LMEs and CMEs are seen as corresponding to a comparative advantage for different forms of activity (Kay & Silberston, 1995; Hall & Soskice, 2001). Thus we have the following:

Economies characterised as LMEs will innovate more radically than those characterised as CMEs

While the logic of the varieties of capitalism position is attractive, the empirical testing has raised considerable doubt that there is a general mapping from the LME/CME dichotomy to the type of technological regime (Taylor, 2004; Akkermans et al., 2009). Other empirics are also instructive. If the historical difference between Europe and the United States is that the latter has allowed more transfer of resources across (heterogeneous) sectors, then a simple shift-share analysis of the productivity data should show an allocation advantage for the United States. This is exactly what the data do *not* show (Maudos, Pastor & Serrano, 2008). The US productivity advantage lies *within* sectors and in whatever starting composition it had before the 1990s.[13] As argued earlier, it may be a mistake to see the Anglo-American governance system as unitary. Tylecote and Ramirez (2006) suggest that differences between the US and UK national systems are important enough to explain the disadvantage of the United Kingdom in some high-technology sectors. Short-term pressures are argued to be more severe in the United Kingdom, first because traditional institutions are not minded to vote their share and also because of corporate takeover law. A further facilitator of short-term pressure is poor information on

Table 22.1 Varieties of governance

	Investment in specific human capital	*Proclivity to exploit new strategic opportunities*	*Facilitated by worker bargaining power being …*	*Capital market*
Shareholder governance	Low	Large	Weak	External
Stakeholder governance	High	Small	Strong	Internal

technology specifications; the United Kingdom lacks a set of informed analysts that is easier for the larger US market to support.

An important feature of governance of innovation systems that differs across national environments is the extent of relationship contracts. The Japanese system of supply-chain relationships was widely regarded, at least up to the 1990s, as an enabling feature in growth. Powell (1999) argues that something similar but distinct has been occurring in market economies such as the United States. The nature of the argument may be seen by contrasting the Holmstrom and Kaplan (2001) view of developments with those of Powell (1999) in the form of an influence diagram (Figure 22.2).

Whereas the Holmstrom and Kaplan view claims that LMEs market orientation in finance and labour allows for the reallocation that is necessary under fast technical growth, the story in Powell is distinct. Here the characteristics of LMEs that are important are more political than economic, viz fragmented national institutions (without strong interdependencies between financial, labour and cultural institutions), strong orientation towards global rather than national institutions and open to fast structural industrial change. It is these characteristics that allow the emergence of relational forms of governance – cooperating through informal exchanges – that displace internal hierarchical forms in large firms. According to Powell, the knowledge sectors increasingly resemble a network of treaties whereby spin-offs, start-ups and venture capital firms all relate to each other and to large existing firms in a way that encourages experimentation and reduces the cost associated with established firms and their 'expensive commitments', including exposure to financial and legal claims (Powell, 1999, p. 61). Yet, for Powell, the process is a 'double-edged sword' in that while it is predicted to improve trust and cooperation in knowledge industries, it may involve a race to the bottom in other sectors (Sennett, 2006).

The future of LMEs is relationship-based governance with benefits for innovation-intensive industries balanced by 'low-road' labour processes for other sectors

We have already discussed the tendency for outsourcing some R&D activities. It is not clear, however, that there has been any serious change in the proprietary way in which firms regard innovation as their own resource base. Indeed, it is not clear that there is any real basis for doing so. As Kraakman (1999) notes 'Even relational contracts require contracting parties with legal personality, assets and reputation' implying that the corporate form of governance is the only one available (p. 159). Nor is it clear that decentralisation of R&D is positive for innovation: privatisation and liberalisation appear to have been negative for R&D (Munari & Sobrero, 2003b; DTI, 2005) or resulted in a switch from basic to applied research (Calderini & Garrone, 2003). The telecommunication equipment firms that were forced to pursue fast external links rather than slower internal ones in the study by Krafft & Ravix, (2005) ultimately fared worse.

Figure 22.2 Governance of innovation systems: (a) Holmstrom and Kaplan (2001) vs (b) Powell (1999)

In any event, the association of LME institutions with external sources seems unwarranted. Non-formal long-term collaborative links in innovation between partners outside their group of firms have been found to have characterised German manufacturing firms to a greater extent than UK ones, where the advantage is with functional flexibility (Love & Roper, 2004, 2009). Whereas UK firms are more concerned to use external links to achieve short-term effects such as speed to market, the German approach has been more with risk-sharing, cost and the sharing of technical knowledge.

Insofar as the other edge of the sword is concerned, Powell's predictions have more force. One could perhaps say that trust in inter-firm relationships is increased at the same time as intra-firm trust is dissipated. Employees are now increasingly distrustful of their firms and often feel marginalised (Morris, Hassard & McCann, 2008). This matters because innovative activities require commitment by the workforce, whether the technology is imitative or new to the firm (Osterloh & Frey, 2000).

DISCUSSION: WHAT DO WE KNOW?

The three empirical areas surveyed above each reveal some basic consensus but also show how much remains to be understood. The *principal–agent perspective* is short of empirical evidence that incentives matter for innovation, which is not surprising given the complexity of the organisational framework. However, there does seem to be evidence that ownership in the form of hands-on governance can matter for patents. The problem here is that there are at least three interpretations of these findings. A principal–agent view would suggest that slacking is reduced under tight monitoring. A second view is that close monitoring improves risk-taking by offering assurance and security to knowledge workers. A third view is that while patenting might be increased by active monitoring, this may simply reflect a strategy choice of certain types of governance in particular product areas; market-oriented investors might seek to exercise options (too?) quickly to realise gains that will register in the share price.

More generally, in terms of transmission mechanisms for governance modes of operation, the empirics fail to settle important questions in respect of finance. If it is true that financial constraints do not operate for R&D, at least for large companies in the United States, is this because of a well-functioning capital market or because managers fear to expand innovation programmes internally, given increased performance-based monitoring by boards?

The empirical review of *integration* has identified support for theories based on asset specificity and capability building. But there seems no big story here – simply that these elements contribute along with other non-governance influences such as scale and scope to determine the level of concentration and the relative focus on decentralisation within and between firms. Predictions about changes in the size distribution of firms or changes in the corporate form do not seem to have been borne out by events. However, the locus of power over allocation has shifted from executive managers to finance markets, with the controversial result of a potentially destructive focus on disgorging the surplus through buybacks of shares and special dividends (Lazonick, 2008). Theory has yet to come to terms with the chasm between the financial market misallocation revealed by the credit crisis and the hubris in respect of external allocation that preceded it.

The market-centred view contrasts with a vision of the firm as an integrated body in which managers play the central task of coordinating innovation (Chandler, 1992; O'Sullivan, 2000; Lazonick, 2010; Pitelis & Teece, 2010). An extension of this argument is that ownership is not what matters to governance but whether the power and inclination to act rests with those dedicated to organisational and technical learning:

> ... the form of firm ownership is not the critical issue for understanding the type of strategic control that supports innovative enterprise. Critical are the abilities and incentives of those managers who exercise strategic control. Whether they are majority owners of the firm, state employees, or employees of publicly listed companies, one needs to know whether these strategic managers possess the cognitive capabilities to allocate resources to the innovation process, and whether their personal rewards from exercising strategic control depend on the firm's innovative success (Lazonick, 2010, p. 335)

There is a broad consensus building for the latter view, as the scale of market misallocation becomes clear and the importance of internal organisation more evident. However, the question of ownership form requires more debate, because the capacity to generate innovation and enterprise within firms may indeed depend on this. To be sure, there are varieties of governance for different circumstances and historical settings. But it is unlikely that innovation will be served by a combination of dispersed owners with outsider boards that rely on simple metrics; institutional funds that enforce short-term pressures; or governance structures that are too unbalanced to permit an adaptation role. We need to pin down more exactly which ownership and institutional forms are friendly to organisational learning in different contexts.

The *governance systems* approach to innovation faces severe empirical challenges because there is not enough data to identify the theories. We have few natural experiments of changing varieties of governance and have to rely on cross-sectional comparisons that reflect initial conditions and unobserved differences. Probably it is unwise to draw strong conclusions about innovation patterns across countries from these data. For example, case studies, show that radical technologies such as certain subsectors of biotechnology can flourish in different varieties of capitalism (Jong, 2009).[14]

One of the most important questions to be answered in the systems literature concerns the future of the large firm as a source of innovation. Increased technical complexity is calling into question the self-reliance of corporations and driving a trend towards cooperation with universities and other firms. We do not yet know whether this a process better suited to LMEs, as Powell (1999) has claimed, or whether the rise of inter-firm trust will be cancelled out by the parallel tendency of falling intra-firm trust. Organisational reforms for innovation in large firms is a governance rather than simply a management issue, though it is not always recognised as such (Foss, 2007).

If many of the issues reviewed in this chapter seem largely unresolved, this may be because the governance agenda to date has been unbalanced, allocating much of its fire power to issues that, while relevant, are narrowly focused on the problem of attracting external capital under asymmetric information or moral hazard. Here we have identified some broader questions concerned with the motivation of innovation search and the retention and allocation of internal funds. Among the policy alternatives in the literature to deal with these questions we find:

1 The board of directors should be reaffirmed in law as an arbiter to resolve issues between stakeholders.
2 Institutional investors who represent mass interests such as pension funds should become more active in company strategy.
3 Key stakeholders such as knowledge workers should be given veto powers over strategy that affects the company future.
4 Insider managers should be given more power but also with more transparency so that self-monitoring is encouraged.
5 Widespread profit sharing should be encouraged not only to incentivise but also to motivate innovation.

As yet, we do not seem able to discriminate between the effectiveness of these approaches.

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NOTES

1 This seems wrong by definition of capabilities and, in his later commentary on the competence perspective, Williamson (1999) but does not repeat the claim.

2 See the critique in Holmstrom (1999b). Hart and Moore (2007) move beyond their previous approach (which they now accept may in some respects be a poor description of what goes on inside the firm) and focus instead on ***ex post*** negotiations under uncertain states of nature with no sunk cost. A point contract with uncertain states of nature may result at time zero in no agreement to trade at time 1 and a state-contingent contract is impossible due to non-verifiability. An agreed contract range might then be superior, but at least one party may feel aggrieved at the outcome and 'shade' or perform poorly in the second stage. The wider the range, the more likely there is of trade but also the greater chance there is of shading. Hart and Moore derive some conditions under which integration would be favoured to ensure supply. See also Meccheri and Morroni (2010).

3 See La Porta, Lopez-de-Silanes, Shleifer and Vishny (2000), Carlin and Mayer (2000), Hall and Soskice (2001), Fagernäs, Sarkar and Singh (2008), Hancke (2009) and Aiguilera and Jackson (2010).

4 Gains are generally shared with external parties such as competitors, consumers and suppliers in ways that are difficult to internalise, so that innovation involves a regulatory or public governance dimension (Scherer, 1986).

5 Start-ups generally go public, often to avoid the excess control that would otherwise limit innovation (Myers, 2000).

6 Brynjolfsson is led in the direction of solutions such as (a) making previously inalienable human capital alienable (e.g. by innovations being codified rather than being in the head of the designer) and (b) by making more situations contractible by improvement in information that allows benchmarking, something that is said to be more feasible in small firms.

7 This is the approach recommended in Asher, Mahoney and Mahoney (1995) and Stout and Blair (2001). Rajan and Zingales (1998) argued that the shareholders themselves could play this arbitrating role, given their remoteness from production (p. 424). Zingales (2000b) later accepted the need for an independent body to act in the interests of the firm; see also Osterloh and Frey (2006).

8 This work controls for selection bias, but employs only pooled ordinary least squares (OLS) estimation. In a separate paper, Lerner and Wulf (2006) employ random effects estimation to test whether performance pay for corporate innovation heads increases patent awards and patent quality. The findings tend to support this, but some qualifications are needed. There was little time variation for the compensation variables given the short tenures of innovation managers. Furthermore, in the results, total compensation appears to be more significant than high-powered incentives, which raises questions for the agency view.

9 Ownership structure also impacts on R&D through appropriability for minority investors. R&D by French- and Italian-listed firms appears to be reflected in their share value but that is cancelled when a single shareholder owns more than a third of the firm, presumably reflecting minority shareholder concern (Hall & Oriani, 2005).

10 The interpretation of cash flow in input factor equations has given rise to extensive controversy over whether it can be interpreted in a straightforward way as representing a financial constraint (Cleary, Pavel & Raith, 2007). However, recent evidence shows that the original interpretation by Fazzari, Hubbard and Petersen (1988) may largely be valid (Angelopoulou & Gibson, 2009). For a conceptual discussion, see Coad (2007).

11 For various views, see Holmstrom and Kaplan (2001) , Stein (2003), Chirinko and Schaller (2004) and Driver and Temple (2010). Internal allocation has also worked well in Japan (Dore, 2000) and has been used to diversify out of declining industries. This contrasts with the United States, where utility companies were increasingly pressurised after 2000 to restrain unrelated diversification (Yokoyama, 2007).

12 Lysandrou and Stoyanova (2007) identify a good governance agenda, not as concerned with improving firm performance but as a programme for increasing the liquidity of shares.

13 Of course there are important differences in innovation outputs and R&D intensity between the United States and Europe, but these are largely related to the comparative industrial structure and beyond the scope of this chapter (Bulli, 2008; Montcade-Paterno-Castello, Ciupagea, Smith, Tubke & Tubbs, 2010).

14 There is an unresolved question over German biotechnology and similar high-tech industries where the limited success of the industry is put down to features that are imported from other systems, facilitating finance and fast labour allocation (Casper, 2009; Hancke, 2009).

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23

The Governance and Regulation of Complex Conglomerates

John H. Farrar

We live in an age of increasing complexity. Globalisation and the communications revolution have added to the complexity and interconnectedness and increased the speed of transactions. In the financial sector there is a rapidly changing marketplace, a complicated regulatory environment, fluctuating consumer demands and demographic shifts with an ageing population in most Western countries.

In the last 20 years there has been a strong movement in the public policy of Western countries towards deregulation and considerable faith has been placed in self-regulation. Thus, the modern concept of corporate governance can be seen as a series of penumbra of self-regulation surrounding basic legal regulation. Legal regulation covers basic company law and other legal restraints of directors and management teams. These include securities regulation and financial services law. Then there are stock exchange Listing Rules and statements of accounting practice. After this come institutional codes such as the UK Combined Code and the Australian Securities Exchange Corporate Governance Council's Principles and Recommendations. Companies often have their own codes and, on the outer penumbra, there is business ethics.[1] This results in a complex system which has not always proved to be effective. In a number of spectacular corporate collapses such as Enron and HIH, executives complied with systems of self-regulation but failed to observe basic fiduciary duties. Subsequently, the system of administrative regulation has been strengthened.

Groups of companies give rise to special problems of complexity in governance, authority and solvency in company law.[2] Cross-border activities complicate the matter further.[3] The global financial crisis has focused attention on complex financial conglomerates that combine banking, insurance and investment management.[4] These have to be considered in their own right in detail, as they are the subject of increasing prudential regulation that needs to have regard to their global activities and be subject to international cooperation. Banks are important to the economy in providing access to credit and, yet, are especially vulnerable as the crisis demonstrated. Complex financial conglomerates, which include banks, give rise to difficult problems.

THE DEVELOPMENT OF THE GROUP CONCEPT

Early company law did not recognise the corporate group. A company could not hold shares in another company, at least unless its constitution allowed it.[5] It was treated as a matter of *ultra vires*. New Jersey had the first legislation which expressly allowed this in 1888, although the charters of early railway companies sometimes provided for it.[6] The United Kingdom gradually recognised groups but did not work out the implications, except in respect of accounts.[7] Consolidated accounts were eventually required in the UK Companies Act 1948.[8]

Domestic company and insolvency laws adopt different and somewhat fragmented approaches to the problems of groups. US state case law pierced the veil more readily in group situations[9] and recognised equitable subordination of inter-group debts to external debts in bankruptcy.[10] These are case law measures of creditor protection. The German Aktiengesetz[11] contains special group provisions requiring control contracts and enhanced disclosure. These are mainly concerned with investor protection. An attempt to impose this approach on other member states of the European Union failed.[12]

New Zealand[13] and Australian[14] company law contain special provisions regarding directors' duties in group situations. Section 187 of the Australian Corporation Act 2001 only deals with directors of wholly-owned subsidiaries. It provides that a director of a corporation that is a wholly-owned subsidiary of a body corporate is taken to act in good faith in the best interests of the subsidiary if:

(a) the constitution of the subsidiary expressly authorises the director to act in the best interests of the holding company;
(b) the director acts in good faith in the best interests of the holding company; and
(c) the subsidiary is not insolvent at the time the director acts and does not become insolvent because of the director's act.

Section 131(2) of the New Zealand Companies Act 1993 contains a similar provision but Section 131(3) deals with a partly-owned subsidiary and requires consent of the other shareholders. Section 131(4) deals with a joint-venture company. The legislation also contains special insolvency rules, which will be discussed.

The Glass–Steagall Act in the United States restricted the growth of financial conglomerates but its repeal facilitated them.[15] The rise of financial conglomerates has taken place in other jurisdictions in the last 20 years.[16] This has contributed to systemic risk in the financial services sector and the problem has been compounded by cross-border activity and an ineffectual silo-like system of national and international regulation.

GROUP INSOLVENCY

Group insolvencies are often complex. Some members may be solvent, others insolvent. Often there have been inter-group transactions which are not always at arm's length. Group charges and cross-guarantees give rise to difficult problems of indemnification and subrogation. The traditional approach of the common law is to concentrate on the interests of each company and not have regard to the interests of the group as a whole. This is different from the ways in which modern management tends to think of the group as an enterprise. Some groups have very complex structures, often arising from a number of takeovers or mergers. All of these factors add to the problems. When the group has traded across borders, the unravelling has to take account of different systems of national insolvency laws. Even in the European Union this is difficult, as The Insolvency Regulation does not apply to credit institutions, insurance undertakings, investment undertakings which hold client assets or collective investment undertakings.

US Bankruptcy Law recognises not only piercing the veil and equitable subordination in group situations but also substantive consolidation in bankruptcy. The power of bankruptcy courts in the United States to make an order for substantive consolidation is not found in any express statutory authority, but is derived from the Bankruptcy Court's general powers in s 105 of the *Bankruptcy Code* 'to issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title'.[17] As the jurisdiction is derived from an equitable background, the United States bankruptcy courts, in determining whether to order consolidations, are guided by what is just and equitable in the circumstances.

Substantive consolidation has been recognised since the Supreme Court's decision in *Sampsell v Imperial Paper and Color Corp* in 1941.[18]

The effect of an order for substantive consolidation is that the assets and liabilities of different entities are consolidated and treated as one entity.[19] The consolidated assets create one fund from which all of the claims against the consolidated debtors are satisfied.[20]

> Substantive consolidation usually results in, inter alia, pooling the assets of, and claims against, the two entities; satisfying liabilities from the resulted common fund; eliminating inter-company claims; and combining the creditors of two companies for the purposes of voting on reorganisation plans.[21]

Although substantive consideration is functionally equivalent to a merger, there is no requirement of a shareholder vote. Likewise, there are none of the voting procedures that safeguard creditor rights in a scheme of arrangement under Australian Law.[22]

The court's power to order substantive consolidation is a flexible equitable jurisdiction. Thus, the Bankruptcy Court may order less than complete consolidation and may place conditions on the consolidation in order to protect the interests of specified creditors, or to effect an equitable remedy.[23]

Case law in the United States stresses the importance of effecting a result in accordance with common notions of fairness, while bearing in mind the cardinal rule of insolvency administration – that there should be equality amongst creditors of the same standing. It is stated that, notwithstanding their significant discretionary authority, courts must adhere to bankruptcy's two fundamental policies of fair treatment of creditors and strict observance of the priorities that exist between various creditor classes'.[24]

There are five factors which have appeared in recent cases.[25] These are:

- Whether the creditors dealt with the entities as a single economic unit and 'did not rely on their separate identity in extending credit'.
- Whether the affairs of the debtors are so entangled that consolidation will benefit all creditors.
- Whether there has been misappropriation of one entity's assets for the benefit of another entity.
- Whether one entity has acted as the alter ego of the other. Although this had been used as a justification, it is hard to distinguish the reasoning from that used to justify piercing the corporate veil.
- Other courts have favoured variations on the theme of a balancing test, which weighs up the costs and benefits of substantive consolidation. This has been favoured in particular by Eleventh Circuit courts.

On the whole, the US courts are conservative in the exercise of this jurisdiction.[26]

New Zealand and Irish law provide for contribution and pooling orders in the insolvency of related companies. In essence, the New Zealand legislation allows the court to make a contribution order on broad grounds in the case of insolvency of a related company and also provides for pooling orders in respect of insolvent/related companies. There are similarities between US consolidation and the New Zealand and Irish provisions and it will be possible to use the US case law in the New Zealand and Irish courts, although to date this has not been done. Recently, there have been a number of first-instance New Zealand decisions on the interpretation of the relevant sections.[27]

New Zealand courts have a wide discretionary power under the Companies Act to deal with related companies once *one* of the companies is placed into liquidation. The court can order that a related company contribute to the assets available for winding up or, if there is more than one related company in liquidation, the court can wind them up as if they were one company.[28]

It is clear that a pooling order is not merely an administrative or procedural order but is one which affects the substantive rights of those parties interested in the winding up of any company subject to such orders.[29]

The courts, in considering making a pooling order, must determine whether it is 'just and equitable' to make the order. Although the legislature has provided a number of factors for the court to consider, the circumstances which will amount to an order being just and equitable are unclear.

Australian law provides for a parent company to be liable for failing to prevent insolvent trading by a subsidiary.[30] Australia and the United Kingdom have not so far adopted contribution and pooling orders.

Since the global financial crisis, there has been considerable debate in the United States and Europe as to whether we need special rules for the resolution of the insolvency of large, complex, interconnected financial institutions.[31] This is one of the reforms of the Dodd–Frank Act and the UK Banking Act 2009, and will be discussed below.

COMPLEX CONGLOMERATES IN FINANCIAL SERVICES

A report by Deloitte, *Coping with Complexity: Leadership in Financial Services* in 2010 sets out a diagram of the financial services industry as a complex system (Figure 23.1).

The report also gives the examples of external and internal complexity and challenges to leadership (Figure 23.2).

Complex financial conglomerates are a result of deregulation and the commercial incentives of cross-selling, revenue synergies and brand reinforcement, together with new approaches to customer service in the Internet age.[32]

They give rise to considerable governance problems for boards seeking to monitor conflict of interest, manage risk and provide

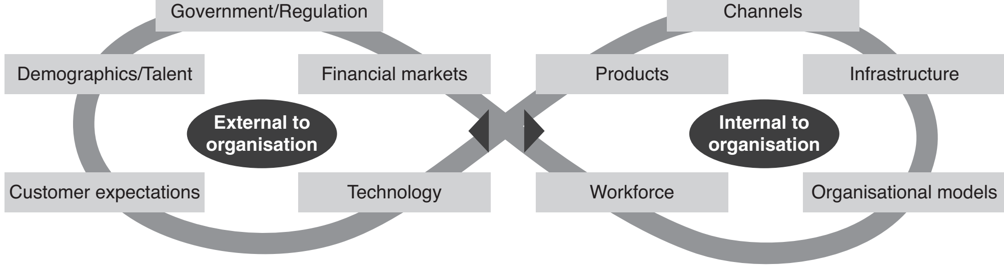

Figure 23.1 The financial services industry as a complex system

Source: Raghavendran, S., and Rajagopalan, P.S., Coping with complexity: Leadership in financial services, (C) 2010 Deloitte Development LLC, p. 2.

	Key characteristics	Challenges to leadership
External		
Government/ Regulation	• Government investments in companies • Increased domestic and global regulation • International Financial Reporting Standards	• Federal government becomes a key stakeholder • Changing regulatory guidance • Increased transparency and disclosure
Financial markets	• Accelerating financial innovation • Increased volatility and contagion • Globalisation of capital markets	• Hidden risks in financial innovation • Heightened focus on capital management • Changing investor profiles
Technology	• Advances in infrastructure for processing trades • Growing role in operational efficiency • Rapid pace of change	• Increased risk of technological breakdowns • Heightened risks from offshoring and outsourcing • Adaptation to technological change
Customer expectations	• Rising demand for innovative, customised products • Reduced risk and fervent search for greater return • Demographic shifts and globalisation	• Growing demand for product information • Attaining growth despite thinner margins • Improving customer experience
Demographics/ Talent	• Shrinking supply of core labour segments • Four generations in the workforce • Increasing technology fluency	• Managing succession planning • Changing demands for work-life expectations • Growing need for virtual and real-time communication
Internal		
Products	• Increased complexity of instrument design • Expanding, diverse customer needs	• Valuation and risk management • Guiding meaningful innovation
Channel	• Multiple and complex channel options • More channel partners and/or alliances	• Seamless channel integration • Increased reputational risks
Infrastructure	• Limitations of legacy systems • Rising demands of data management processes	• Systems integration and scaling • Information security
Organisational models	• Growing complexity of design dimensions • Consolidating and changing business models	• Overcoming coordination challenges • Flexibility and adaptation
Workforce	• Increasingly diverse and global workforce • Retiring baby boomers; rise of Gen X/Gen Y	• Management of diverse and global workforce • Changing expectations of employees

Figure 23.2 Examples of external and internal complexity and challenges to leadership

Source: Raghavendran, S., and Rajagopalan, P.S., Coping with complexity: Leadership in financial services, (C) 2010 Deloitte Development LLC, p. 3.

appropriate incentives for executives. Risks that can arise from membership of a conglomerate group include:

financial risks
reputation risks
moral hazard risks
operational risks
governance and strategic risks, resulting from diversity of the groups.[33]

Financial risks can arise from inter-group or third-party transactions. Reputation can be harmed by these and other activities, including the activity of an unregulated entity. Moral hazard may arise from excessive risk taking, relying on the support of other members of the group. Operational risks are internal matters which may affect other parts of the group. Governance risks arise out of the complexity of the activities and the difficulty of reconciling differing interests and responsibilities.

A typical complex group in the financial services sector is shown in Figure 23.3.[34]

Dr Fred Hu of Goldman Sachs has written:[35]

> These large financial holding companies assembled under one roof a wide array of financial activities, often with different business models and warring operating cultures, and become too complex and unwieldy to be managed well. Mixing different businesses, such as those of commercial

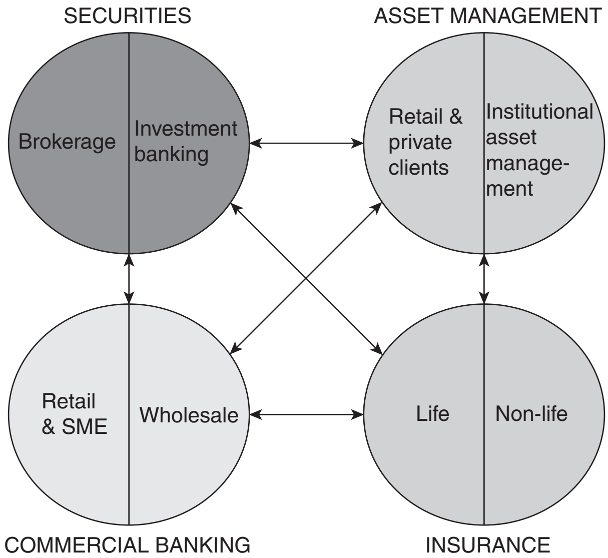

Figure 23.3 A typical complex group in the financial services sector

Source: see Note 34.

banking and investment banking, also allowed firms to exploit differences in rules (governing capital, accounting, and profit/loss recognition and so forth) as applied to different parts of the firm. Such intra-firm arbitrage across business activities naturally leads to risk flowing to where it is least monitored and where capital requirements are lowest. Without centralised consolidation of risk management and pricing, toxic asset problems can be left to fester until they suddenly implode to endanger the entire firm and the broader financial system.

Three recent cases illustrate the dangers of complex groups.[36]

- HIH group. This was a group, mainly in the insurance industry, which grew too fast and was badly managed with poor corporate governance. Its collapse had considerable social implications and led to a Royal Commission and criminal and civil penalty proceedings.
- AIG is an American insurer that was large but badly managed. It failed to control the shadow banking activities of its UK subsidiary and had to be bailed out by the US government.
- Lehman Brothers was a 158-year-old investment bank, which ran investment banking, sales, research and trading, investment management, private equity and private banking operations. It filed for Chapter 11 bankruptcy in September 2008 after suffering severe losses on subprime mortgage securities. It remains the largest bankruptcy filing in history, with the firm holding approximately US$ 691 billion in assets at the time. It is also arguably the most complex bankruptcy in history, with liquidators finding that the bank was a party to approximately 930,000 derivative contracts.[37]

THE REGULATION OF COMPLEX FINANCIAL GROUPS

The Australian Prudential Regulation Agency (APRA) divides up complex conglomerates for regulatory purposes as follows:[38]

Level 1 – standalone entities
Level 2 – single industry conglomerates
Level 3 – multi-industry conglomerates

APRA adopts three approaches to prevent the failure of complex conglomerates:

- disclosure;
- risk management;
- a backstop capital regime.

APRA's tactics are to empower the board, to adopt a pragmatic approach and to exercise flexible proactive supervision.[39]

In terms of disclosure, the aim is to ensure that there are no dark corners, all material businesses are covered (whether they are regulated or not) and that all material items in group activities are disclosed.

In terms of the board and risk management, the board has to sign off at Level 3 on a group capital management plan, a group risk management plan and on management incentives and pay. All outsourcing arrangements are to be subjected to appropriate due diligence and ongoing monitoring.

APRA's proposals are out for consultation, with the aim of adopting standards in 2011 to commence in 2012.

Charles Littrell of APRA in a presentation in Brussels on 7 June 2010 said:[40]

- Complex rules are not the right response to complex structures.
- We can firewall insurance companies – banks are much harder.
- We must be able to regulate holding companies.
- Boards should be empowered.
- Healthy information and risk management are at least as important as capital.
- Proactive supervision is critical.

Work is going on in the European Union to amend the 2002 Financial Conglomerates Directive[41] to enlarge the scope of supplementary supervision and the European Parliament has recommended work on a European Bank Company Law. The Commission has recently sought views on a possible EU framework to deal with future bank failures.

The Joint Forum on Financial Conglomerates (now simply the Joint Forum) has published a series of papers on supervision and regulation of financial groups and formulated principles, but there is still no internationally agreed comprehensive framework for the regulation of supervision of financial conglomerates.[42]

The Financial Stability Board has been addressing systemically important financial institutions (SIFIs)[43] and the moral hazards posed by them. The recommendations so far are as follows:[44]

- a resolution framework and other measures to ensure that problems concerning all financial institutions can be resolved safely, quickly and without destabilising the financial system and exposing the taxpayer to the risks of loss;
- a requirement that SIFIs and initially in particular global SIFIs (G-SIFIs) have higher loss absorbency capacity to reflect the greater risks that these institutions pose to the global financial system;
- more intensive supervisory oversight for financial institutions which may pose systemic risk;
- robust core financial market infrastructures to reduce contagion risk from the failure of individual institutions; and
- other supplementary prudential and other requirements as determined by the national authorities.

The Basel Committee on Banking Supervision is developing a methodology for the identification of banks that are systemically important from a global perspective. The International Association of Insurance Supervisors is involved in a similar exercise for the insurance sector. Work is also going on at the International Monetary Fund (IMF). One cannot have rule-based regulation without this being defined, but the very act of defining gives rise to arbitrage opportunities.

The regulatory system in the United States has been based around industry-specific federal supervisors, with additional supervisors at state level with poor coordination. There is ongoing debate about an improved system, with particular emphasis on 'systemically important financial institutions'. These are identified by the following characteristics:

- the financial system's interdependence with the firm;
- the firm's size;
- its level of leverage;
- its reliance on short-term funding;
- its importance as a source of credit and liquidity to other market participants.[45]

A recent article by Professor Lawrence J. White of New York University, 'US Financial

Regulation: A Hopeless Tangle, of Complexity for a Purpose' [46] describes the US system as follows:

- There are five federal regulators of depository institutions as well as one or more regulator in each of the 50 states. The states also regulate lenders and mortgage originators that are not depositories.
- There is a separate federal agency that has the responsibility for regulating Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System.
- There are two federal regulators of the securities markets and financial instruments, as well as 50 state regulators (and 50 state attorneys general, who are prepared to bring lawsuits against securities firms on behalf of their respective states' citizens).
- The regulation of insurance companies is exclusively the domain of the 50 states.
- Pension funds are regulated by two federal agencies, and, again, the 50 states also have a say.
- Consumer fraud in financial products can be the responsibility of yet another federal agency, as well as the 50 states.

There are overlapping responsibilities and jurisdictional disputes throughout this framework. The Dodd–Frank Act, which seeks to limit the damage caused by the failure of large financial institutions, enables the removal of the administration of an SIFI from court-supervised administration under the Bankruptcy Code to administration by the 'orderly liquidation authority' under the Federal Deposit Insurance Corporation.[47]

The United Kingdom also suffered financial market turmoil that necessitated prompt action for regulation of banks and the creation of special insolvency regimes for banks. This led to the Banking (Special Provisions) Act 2008, which was later replaced by the Banking Act 2009, whose key provisions came into force on 21 February 2009. This was part of a larger regulatory reform package. Key elements of the 2009 act are stabilisation options: transfers to a private sector purchaser, a bridge bank and temporary public ownership. The supervisory system is much simpler than the US model, with just one supervisor. There is a new regime for bank insolvency as well as a requirement of 'living wills'. The purpose of the latter is threefold:

- Pre-resolution to allow banks to restructure their operations before they get into difficulty;
- In-resolution to provide blueprints for break up;
- Post-resolution to smooth out problems in the aftermath of failure.

In essence it involves disclosure and a plan.

The two insolvency procedures – bank administration and bank insolvency – are new but not drastically different from existing insolvency procedures.

The objectives of the Financial Services Authority were redefined by the Financial Services Act 2010, but the coalition government intends to replace it by a Prudential Regulation Authority under the aegis of the Bank of England.

Work on complex conglomerates (particularly the banking aspects) is difficult because of their nature at domestic level. The problem is compounded at international level but in a globalised world the work must be carried out with a greater degree of urgency than seems to be currently happening. As Dr Hu has written, 'If we fail to understand the systemic implications of large complex financial firms, the global financial system will likely continue to be haunted by the 'too big and too interconnected to fail' syndrome for years to come'.[48] There is doubt as to the efficacy of the Dodd–Frank reforms[49] and the UK reforms[50] and whether any government agency has the sophistication to deal with a complex financial conglomerate in a crisis situation. There is an urgent need for a framework for international cooperation or coordination.[51] If we cannot have complete universalism, let us at least have some system of modified universalism dealing with cross-border cases on a case-by-case basis and using 'living wills' for those cases where universalism cannot be applied.[52] As it is, we seem to have 'wasted the crisis'.[53]

NOTES

1 See John H. Farrar, *Corporate Governance: Theories, Principles and Practice.* Oxford University Press, Melbourne, 3rd edn, 2008, Chapter 1.

2 See Farrar, op. cit., Note 1, Chapter 21, 'Use and Abuse of Corporate Groups'.

3 See Janet Dine, *The Governance of Corporate Groups.* Cambridge University Press, Cambridge, 2000, Chapters 3 and 5.

4 See Henry M. Paulson, Jr, *On the Brink*: *Inside the Race to Stop the Collapse of the Global Financial System*, Business Plus, New York, 2010, 74–75.

5 See Lord Cairns LJ in *Re Barned's Bank ex parte the Contract Corporation* (1867), LR 3 Ch 105, pp. 102–103 for an interesting discussion. See also *Seward Brice on the Doctrine of Ultra Vires,* Stevens and Haynes, London, 3rd edn, 1893, 132–133.

6 Public Laws of New Jersey, c. 269, 385 (1888). For detailed discussion, see *Blumberg on Corporate Groups.* Aspen Publishers, 2nd edn, 2009.

7 See John H. Farrar and B.M. Hannigan, *Farrar's Company Law.* Butterworths, London, 4th edn, 1998, Chapter 33.

8 Companies Act 1948, sections 150 et seq. See *Gower's Principles of Modern Company Law*, 4th edn by L.C.B. Gower, J.B. Cronin, A.J. Easson and Lord Wedderburn of Charlton, Stevens & Sons, 1979, 118. See also Companies Act 1929, ss 125–127 for limited recognition. Practice had preceded this for some time.

9 See R. B. Thompson, 'Piercing the Corporate Veil: An Empirical Study' (1991), 76 *Cornell Law Review* 1036.

10 See R. Clark, *Corporate Law.* Little Brown & Co, Boston, 1986, 2.3.

11 See Articles 319–327 AktG.

12 See *Farrar's Company Law* (Note 7), 33.

13 See John H. Farrar (general editor), *Company and Securities Law in New Zealand.* Thomson Brooker, Wellington, 2008, 14.2.5.

14 See *Ford's Principles of Corporations Law*, R.P. Austin and I.M. Ramsay (eds), LexisNexis, Chatswood, 14th edn, 2010, 8. 140.

15 See Oliver Chittenden (ed.), *The Future of Money*. Virgin Books, London, 2010, 32.

16 See W. Munchau, *The Meltdown Years – the Unfolding of the Global Economic Crisis,* McGraw-Hill, New York, 2010, 30 et seq.

17 See J.H. Farrar, 'Corporate Group Insolvencies, Reform and the United States Experience' (2000) 8 Insolvency Law Review, 148 on which this is based. See 11 USC, s 105, Supplement V 1987; Blumberg, on *Corporate Groups.* Aspen Publishers, 2nd edn, 2009.

18 313 US 215 (1941) For law review literature, see MacKinnon, 'Substantive Consolidation: The Backdoor to Involuntary Bankruptcy' (1986) 23 San Diego L Rev 203; Sargent, 'Bankruptcy Remote Subsidiaries: The Substantive Consolidation Issue' (1989) 44 *The Business Lawyer* 1223; Gilbert, 'Substantive Consolidation in Bankruptcy: A Premier' (1990) 43 Vand L Rev 207; Frost, 'Organisational Form, Misappropriation Risk and Substantive Consolidation of Corporate Groups' (1993) 44 Hastings LJ 449; Predko, 'Substantive Consolidation Involving Nondebtors' (1995) 41 Wayne L Rev 1741; and Kors, 'Altered Egos: Deciphering Substantive Consolidation' (1998) 59 U Pit L Rev 381.

19 *Chemical Bank New York Trust Co v Kheel* 369 F 2d 845 (2nd Circ 1966).

20 *Re Augie/Restivo Banking Co* 860 F 2d 515 (2nd Circ 1988), 518.

21 Ibid.

22 Kors, op. cit. Note 18, supra at Note 14.

23 *Re Continental Vending Machine Co* 517 F 2d 997 (2nd Circ 1975); *Re Parkway Calabasas Ltd* 89 Bankr 832 (Bankr CD Cal 1988).

24 *Re Gulfco Investment Corp* 593 F 2d 921 at 927; Berry, 'Consolidation in Bankruptcy' 50 Am Bankr LJ 343 at 371 (1976).

25 See J. H. Farrar, '*Corporate Group Insolvencies, Reform and the United States Experience'* (2000) 8 Insolvency Law Review 148, 150–152 for a detailed discussion.

26 Ibid 156.

27 See Farrar op. cit. (Note 1), 277–278, on which this is based. This analyses the cases. Ireland adopted the New Zealand provisions in the Companies Act 1990, Sections 140–141.

28 Originally added as ss 315A and 315B of the *Companies Act 1955* (now ss 245–246) and see also ss 271–272 of the *Companies Act 1993*.

29 See *Stewart Timber and Hardware Ltd (in liq.)* (1991) 5 NZCLC 67, 137.

30 See *Ford's Principles of Corporations Law*, op. cit., Note 14.

31 See Jeffery N. Gordon and Christopher Muller, 'Confronting Financial Crisis: Dodd–Frank's Dangers and the Case for a Systemic Emergency Fund' (2011), 28 Yale J. on Reg. 151, 166 which emphasises their dependence on collateralised short-term roll over financing, the devastation of the commercial paper market, margin financing and the fact that bankruptcy is not set up to resolve financial distress in a time of financial emergency.

32 See Deloitte, op. cit.

33 See Australian Prudential Regulation Authority Discussion Paper, *Supervision of Conglomerate Groups* (18 March 2010) 9.

34 Taken from Anthony Saunders, Roy C. Smith and Ingo Walter, 'Enhanced Regulation of Large Complex Financial Institutions', Chapter 5, in Viral V. Acharya and Matthew Richardson (eds), *Restoring Financial Stability: How to Repair a Failed System.* John Wiley & Sons, Hoboken, NJ, 2009, p. 146.

35 See Dr Fred Hu, in Oliver Chittenden (ed.), *The Future of Money*,Virgin Books, London, 2010, p. 32.

36 See John Trowbridge, 'The Architecture of Group Supervision', an APRA speech which will appear in C. Kemplar, M. Flamée, C. Yang and P. Windels (eds) *Global Perspectives on Insurance Today* (Palgrave Macmillan, London, 2010). See also Douglas Arner and Joseph Norton, 'Building a Framework to Address Failure of Complex Financial Institutions' (2009) 39 HKLJ 95. See also: http://www.canambar.com/articles/OTCDerivativeContracts.pdf; http://www.freshfields.com/publications/pdfs/2008/dec08/24712.pdf

37 http://www.canambar.com/articles/OTCDerivativeContracts.pdf

38 See Charles Littrell, 'The Australian Approach to Conglomerate Supervision', powerpoints from a speech in Brussels (7 June 2010).

39 Ibid and op. cit., Note 33.

40 See Note 38.

41 2002/87/EC.

42 See Note 33, 31–32.

43 See Financial Stability Board, *Guidance to Assess the Systemic Importance of Financial Instruments, Markets and Investments: Initial Considerations – A Background Paper,* October 2009 for the survey of views on this concept. See Arner and Norton, op. cit. (Note 36 *ante*).

44 Financial Stability Board, Report on *Progress Since the Washington Summit in the Implementation of the G20 Recommendations for Strengthening Financial Stability*, 2010, 6.

45 See Brad Gans, 'Regulatory Implications of the Global Financial Crisis', Institute for Law and Finance, Goethe University, Working Paper Series No.102, 05/2009,10.

46 Q Finance – Regulation Best Practice – see http:www.qfinance.com/home.

47 The Dodd–Frank Wall Sheet Reforms and Consumer Protection Act 2010 (Pub. L. 111–203, HR 4173), Title II. See David Skeel, *The New Financial Deal*, John Wiley & Sons, Hoboken, NJ, 2011, Chapters 7 and 8.

48 Op. cit., Note 34, 32.

49 See Jeffery N. Gordon and Christopher Muller, 'Confronting Financial Crisis: Dodd–Frank's Dangers and the Case for a Systemic Emergency Fund' (2011) 28 Yale J. on Reg. 151.

50 See Clifford Chance Briefing Note May 2009 – 'The Banking Act 2009: Implications for the Financial Markets, and HM Treasury', *A New Approach to Financial Regulation – Building a Stronger System* (Cm 8012, February 2011). See also David G. Mayes, *Banking Crisis Resolution Policy – Lessons from Recent Experience*, CESifo Working Paper No. 2823, October 2009, 19–27. This provides a useful summary.

51 See John L. Douglas of Davis Polk, 'Too Big to Fail – Do We Need Special Rules for Bank Resolution?' Institute for Law and Finance, Goethe University, November 2010, powerpoints; Skeel op. cit. (Note 47 *ante*) 177, 186. See also Arner and Norton, op. cit. (Note 36 *ante*), 128; Bank for International Settlements, Basel Committee on Banking Supervision, *Report and Recommendations of the Cross-border Bank Resolution Group*, March 2010, 34. For an earlier argument to this effect, see Hal Scott 'Multinational Bank Insolvencies: The United States and BCCI', Chapter 34 in Jacob Ziegel (ed.), *Current Developments in International and Comparative Corporate Insolvency Law,* Clarendon Press, Oxford, 1994, 733, 744–745.

52 See C.A.E.Goodhart, Foreword to *Cross Border Bank Insolvency*, edited by Rosa M. Lastra, Oxford University Press, Oxford, 2011, vii.

53 See Richard Portes 'Wasting the Crisis: The G20's Role in Financial Sector Reform',Global Asia, September 2010, 70, accessed from www.globalasia.org/V5N3_Fall_2010/Richard_Portes.html, downloaded 7 March 2011.

PART 7

Emerging Issues: Governance and Sustainability

Markets, Regulation and Governance: The Causes of the Global Financial Crisis

Thomas Clarke

INTRODUCTION

As the financialisation of the global economy has progressed in recent decades, it was punctuated by a series of financial crises. These crises included the early 1980s Third World debt crisis; the 1987 Black Tuesday market crash when global markets fell 20% in one day; the late 1980s unwinding of the junk bond fuelled merger and acquisition boom in the United States; the bursting of the Japanese bubble economy; the early 1990s crash of banks in three Nordic countries; the Savings and Loans crash in the United States; the 2001 NASDAQ crash; and the 2007–2008 global financial crisis. Yet it is important to realise that the most recent crisis proved qualitatively different from earlier episodes. This was the first truly global financial crisis impacting on all regions and countries: it involved the collapse or near collapse of many major financial institutions in a wide number of countries; demonstrated the ineffectiveness of all forms of existing regulatory apparatus, and it necessitated the intervention of internationally coordinated state action to salvage financial markets on a scale unprecedented (and unimaginable) in earlier times. This chapter will analyse the central causes and consequences of the global financial crisis, and highlight the systemic governance and regulatory failures that compounded the crisis.

The most severe financial disaster since the Great Depression of the 1930s exposed the dangers of unregulated financial markets and nominal corporate governance. The crisis originated in Wall Street, where deregulation unleashed highly incentivised investment banks to flood world markets with toxic financial products. As a stunning series of banks and investment companies collapsed in the United States and then in Europe, a frightening dimension of the global economy became fully apparent: a new world disorder of violently volatile markets and deep financial insecurity. Advocating systemic change, President Nicolas Sarkozy of

France proclaimed, 'The world came within a whisker of catastrophe. We can't run the risk of it happening again. Self-regulation as a way of solving all problems is finished. Laissez-faire is finished. The all-powerful market that always knows best is finished' (*Washington Post*, 28 September 2008), as if the flourish of presidential rhetoric alone could sweep away an enveloping, financially driven political economy.

The global financial crisis was a multi-dimensional, interconnected and systemic crisis. The G20 (Financial Stability Board), the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD), the European Union (De Larosiere Report), the United States (Dodds–Frank Act), the United Kingdom, Australia, and other countries' analysis and prescriptions recognise this was a systemic crisis requiring systemic solutions. Among the causes of the crisis were international macroeconomic imbalances, institutional and risk management failure, corporate governance failure and regulatory, supervisory and crisis management failure. Understanding the compounding impact of these interconnected series of failures is the key to understanding the scale and intensity of the crisis.

The prolonged systemic crisis in international financial markets commencing in 2007–2008 was also a crisis in corporate governance and regulation. The ascendancy of Anglo-American markets and governance institutions was based on the apparent sophistication and efficiency of this system in the management of finance and risk. However, risk was not hedged: it was deeply interconnected, international, and unknown. The market capitalisation of the stock markets of the world had peaked at $62 trillion at the end of 2007, but was in free fall by October 2008, having lost $33 trillion, over half of its value in 12 months of unrelenting financial and corporate failures. A debate has continued for some time about the costs and benefits of the financialisation of advanced industrial economies. The long progression of financial crises around the world serves as a reminder that the system is neither self-regulating, nor robust. The explanation of why investment banks and other financial institutions took such spectacular risks with extremely leveraged positions on many securities and derivatives, and the risk management, governance and ethical environment that allowed such conduct to take place, demands detailed analysis.

THE FAILURE OF ECONOMIC ORTHODOXY

Among the most worrying aspects of the recent global financial crisis was the systemic failure of modern economic orthodoxy to anticipate the crisis, to understand the enormity of the crisis, to appreciate its consequences, or to provide any meaningful remedies: 'Not only have economists as a profession, failed to guide the world out of the crisis, they were primarily responsible for leading us into it' (Kaletsky, 2009: 1). A re-evaluation of the conceptual fundamentals of economic analysis is required. The global financial crisis represents the most critical juncture since the post-Second World War period of economic growth and stability, variously negotiated by different forms of Keynesian and neo-liberal consensus.

A sense of the instability of market economies and their tendency towards recurrent crises was commenced by Marx, and continued in the work of Hilferding (1910), Keynes (1936), Polanyi (1944) and Minsky (1982) and others who commented on the increasing perils of the internationalisation of financial markets (Argitis & Pitelis, 2006, 2008). Keynes' emphasis that the liberalisation of financial markets, intensification of global finance, and reinvention of laissez faire policies lead to further economic and financial instability, led to the erection of the elaborate architecture of national and international financial regulation in the middle decades of the 20th century (Kirshner, 1999). However, for the last three decades this regulation has been energetically stripped away by financial institutions, regulators and governments infused with the convictions of the rational expectations hypothesis and efficient market hypothesis of the Chicago school of economics. This *global neo-classicism* (Schor, 1992), consisting of non-interventionist governments, unregulated financial markets and flexible exchange rates 'appears to have been associated with problems of capital flight, speculation, exchange rate volatility, instability, banking crises, contagion, macroeconomic policy ineffectiveness and poor employment and growth performance' (Argitis & Pitelis, 2008: 3).

The financial crisis has reminded the world of the extreme dangers of unregulated markets and institutions, and of the eternal importance of transparency, disclosure, risk management, effective regulation, and robust governance. Joseph Stiglitz recently emphasised the scale and interconnectedness of the problem with regard to major financial institutions:

1 Banks have consistently failed to fulfil their basic societal mission.
2 Banks have repeatedly been bailed out from bearing the consequences of their flawed lending.
3 Incentives within the financial system are distorted at both the individual and institutional level – at both levels private rewards and social returns are misaligned.
4 The financial sector has imposed large costs on the rest of society – the presence of externalities is one of the reasons why the sector needs to be regulated (Stiglitz, 2010).

IMPLICATIONS OF THE 2008 WALL STREET FINANCIAL CRISIS

> America's financial institutions have not managed risk; they have created it (Stiglitz, 2008a).

The apparent ascendancy of Anglo-American markets and governance institutions was profoundly questioned by the scale and contagion of the 2008 global financial crisis. The crisis was initiated by falling house prices and rising mortgage default rates in the highly inflated US housing market. A severe credit crisis developed through 2007 into 2008 as financial institutions became fearful of the potential scale of the subprime mortgages concealed in the securities they had bought. As a result, banks refused to lend to each other because of increased counterparty risk that other banks might default. A solvency crisis ensued as banks were slow to admit to the great holes in their accounts the subprime mortgages had caused (partly because they were themselves unaware of the seriousness of the problem), and the difficulty in raising capital to restore their balance sheets. As an increasing number of financial institutions collapsed in the United States, the United Kingdom, and in Europe, successive government efforts to rescue individual institutions, and to offer general support for the financial system, did not succeed in restoring confidence as markets continued in free fall, with stock exchanges across the world losing almost half their value (Figure 24.1).

Financial insecurity rapidly became contagious internationally as fears of a global economic recession became widespread and stock markets around the world crashed. This financial crisis was larger in scale than any crisis since the 1930s Great Depression, involving bank losses conservatively estimated in October 2008 by the IMF (2008) as potentially $1,400 billion, eclipsing earlier crises in Asia, Japan and the US (Figure 24.2). Martin Wolf was quick to realise the implications of the crisis, as he put it in the *Financial Times* (5 September, 2007):

> We are living through the first crisis of the brave new world of securitised financial markets. It is too early to tell how economically important the upheaval will prove. But nobody can doubt its significance for the financial system. Its origins lie with credit expansion and financial innovations in the US itself. It cannot be blamed on 'crony capitalism' in peripheral economies, but rather on responsibility in the core of the world economy.

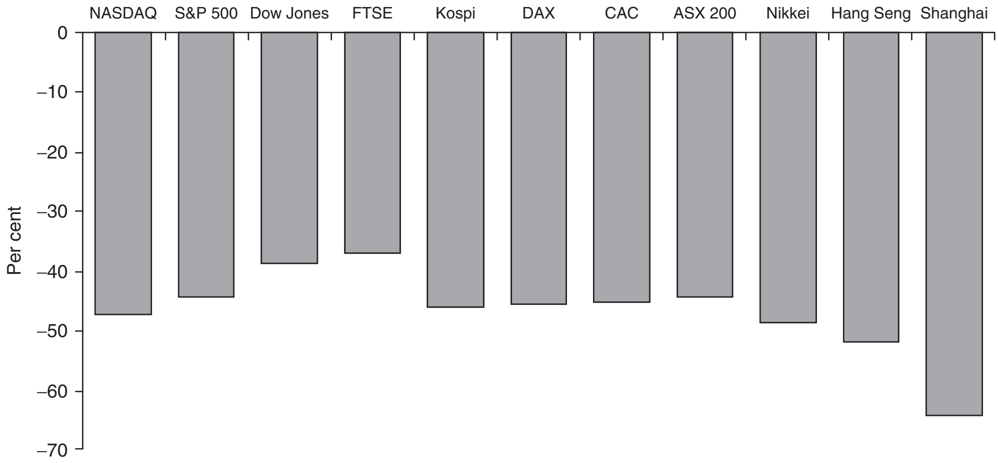

Figure 24.1 Collapsing stock exchanges in 2008 global financial crisis (year to 2 December 2008)

Source: Stock exchanges.

ORIGINS OF THE CRISIS

In the cyclical way markets work, the origins of the 2008 financial crisis may be found in the solutions to the previous market crisis. The US Federal Reserve under Alan Greenspan responded to the collapse of confidence caused by the dot-com disaster and Enron failures in 2001–/2002 by reducing US interest rates to 1%, their lowest in 45 years, flooding the market with cheap credit to jump-start the economy back into life. US business did recover faster than expected, but the cheap credit had washed into the financial

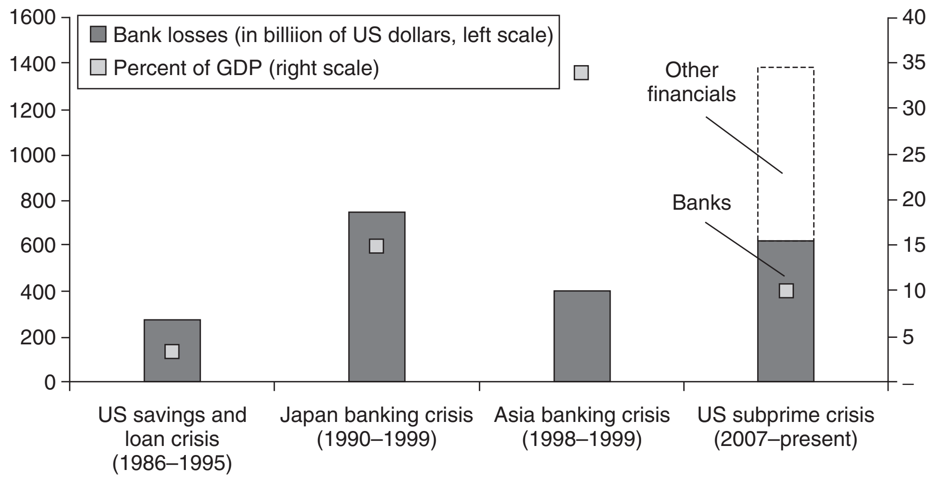

Figure 24.2 Comparison of international financial crises

Source: World Bank and IMF estimates.

Note: US subprime costs represent staff estimates of losses on banks and other financial institutions from Table 24.1. Asia includes Indonesia, Malaysia, South Korea, the Philippines and Thailand (IMF, 2008: 9).

services and housing sectors, producing the largest speculative bubbles ever witnessed in the American economy (Fleckenstein, 2008). The scene was set by the 1999 dismantling of the 1932 Glass–Steagall Act which had separated commercial banking from investment banking and insurance services, opening the way for a consolidation of the vastly expanding and increasingly competitive US financial services industry. Phillips (2008: 5) describes this as a 'burgeoning debt and credit complex':

> Vendors of credit cards, issuers of mortgages and bonds, architects of asset-backed securities and structured investment vehicles – occupied the leading edge. The behemoth financial conglomerates, Citigroup, JP Morgan Chase et al, were liberated in 1999 for the first time since the 1930s to marshal banking, insurance, securities, and real estate under a single, vaulting institutional roof.

In this newly emboldened finance sector the name of the game was *leverage* – the capacity to access vast amounts of credit cheaply to take over businesses and to do deals. The US National Commission (2011) on the financial crisis decried the culture of indebtedness that had pervaded the business community:

> In the years leading up to the crisis, too many financial institutions, as well as too many households, borrowed to the hilt, leaving them vulnerable to financial distress or ruin if the value of their investments declined even modestly. For example, as of 2007, the five major investment banks – Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley – were operating with extraordinarily thin capital. By one measure, their leverage ratios were as high as 40 to 1, meaning for every $40 in assets, there was only $1 in capital to cover losses. Less than a 3% drop in asset values could wipe out a firm. To make matters worse, much of their borrowing was short-term, in the overnight market – meaning the borrowing had to be renewed each and every day. For example, at the end of 2007, Bear Stearns had $11.8 billion in equity and $383.6 billion in liabilities and was borrowing as much as $70 billion in the overnight market (2011: xix).

Wall Street investment banks and hedge funds aparently flourished with their new found access to cheap credit. Exotic financial instruments were devised and marketed internationally: futures, options and swaps evolved into collateralised debt obligations (CDOs), credit default swaps (CDSs), and many other acronyms, all of which packaged vast amounts of debt to be traded on the securities markets. Abandoning their traditional financial conservatism, banks looked beyond taking deposits and lending to the new businesses of wealth management, and eagerly adopted new instruments and business models. As the IMF put it:

> Banking systems in the major countries have gone through a process of disintermediation – that is, a greater share of financial intermediation is now taking place through tradable securities (rather than bank loans and deposits). … Banks have increasingly moved financial risks (especially credit risks) off their balance sheets and into securities markets – for example, by pooling and converting assets into tradable securities and entering into interest rate swaps and other derivatives transactions – in response both to regulatory incentives such as capital requirements and to internal incentives to improve risk-adjusted returns on capital for shareholders and to be more competitive. … Securitization makes the pricing and allocation of capital more efficient because changes in financial risks are reflected much more quickly in asset prices and flows than on bank balance sheets. The downside is that markets have become more volatile, and this volatility could pose a threat to financial stability (2002: 3).

GLOBAL DERIVATIVES MARKETS

As the new financial instruments were developed and marketed, the securities markets grew massively in the 2000s, dwarfing the growth of the real economy. For example, according to the Bank of International Settlements, the global derivatives markets grew at the rate of 32% per annum from 1990, and the notional amount of derivatives reached $106 trillion by 2002, $477 trillion by 2006, and exceeded $531 trillion by 2008 (though gross market value is a small fraction of this) (McKinsey, 2008: 20). The supposed purpose of this increasingly massive exercise was to hedge risk and add liquidity to the financial system. Derivatives allow financial institutions and corporations to take greater and more complex risks such as issuing more mortgages and corporate debt, because they may protect debt holders against losses. Since derivatives contracts are widely traded, risk may be further limited, though this increases the number of parties exposed if defaults occur.

> Complex derivatives were at the heart of the credit market turmoil that rippled through financial markets in 2007, raising concerns about the financial players' abilities to manage risk as capital markets rapidly evolve. Unlike equities, debt securities and bank deposits, which represent financial claims against future earnings by households and companies, derivatives are risk-shifting agreements among financial market participants (McKinsey, 2008:20).

Because of this fundamental difference and indeterminacy, McKinsey did not include derivatives in their calculation of the value of global financial assets, an indication of the ephemeral quality of derivatives.

Yet, derivatives certainly have their defenders, who claim they make an essential contribution to international liquidity. A riveting analysis of the legacy of the former Chairman of the Federal Reserve in the *New York Times*, detailed how Alan Greenspan defended derivatives markets as an innovation helping to develop and stabilise the international financial system, 'Not only have individual financial institutions become less vulnerable to shocks from underlying risk factors, but also the financial system as a whole has become more resilient.' Others were less sanguine, and both George Soros and Warren Buffett avoided investing in derivatives contracts because of their impenetrable complexity. Buffet described derivatives in 2003 as 'financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal,' and pointed out that collateralised debt obligation contracts could stretch to 750,000 pages of impenetrable (and presumably unread) text (*New York Times*, 8 October 2008).

Greenspan was sceptical about successive legislative efforts to regulate derivatives in the 1990s. Charles A. Bowsher, head of the General Accounting Office, commenting on a report to Congress identifying significant weaknesses in the regulatory oversight of derivatives, said in testimony to the House Subcommittee on Telecommunications and Finance in 1994:

> The sudden failure or abrupt withdrawal from trading of any of these large U.S. dealers could cause liquidity problems in the markets and could also pose risks to others, including federally insured banks and the financial system as a whole. In some cases intervention has and could result in a financial bailout paid for or guaranteed by taxpayers.

In his testimony at the time, Greenspan was reassuring.

> Risks in financial markets, including derivatives markets, are being regulated by private parties. There is nothing involved in federal regulation per se which makes it superior to market regulation,

though he did accept derivatives could amplify crises because they connect together financial institutions:

> The very efficiency that is involved here means that if a crisis were to occur, that that crisis is transmitted at a far faster pace and with some greater virulence.

When the Commodity Futures Trading Commission, the federal agency which regulates options and futures trading, examined derivatives regulation in 1997, the head of the Commission, Brooksley E. Born said in testimony to Congress that such opaque trading might 'threaten our regulated markets or, indeed our economy without any federal agency knowing about it,' but she was chastised for taking steps that would lead to a financial crisis by Treasury officials (*New York Times*, 8 October 2008). The explosive potential of derivatives was always present, as the implosion of the hedge fund Long-Term Capital Management (LTCM) in 1998 revealed. With equity of $4.72 billion and debt of $124 billion LTCM had managed to secure off-balance sheet derivative positions of $1.29 trillion (mostly in interest rate swaps). The rescue of LTCM by a consortium of banks led by the Federal Reserve Bank of New York, in order to maintain the integrity of the financial system, was a harbinger of how a decade later on massive systemic financial risk taking would be rescued by governments after the event, rather than regulated by governments before the event.

THE SUBPRIME MORTGAGE DEBACLE

The subprime mortgage phenomenon demonstrated how unconscionable risks could be taken on by investment banks, concealed in securities, and sold on to other financial institutions that had little idea of the risk they were assuming. As Le Roy (2008) explains:

> 'The increasing complexity of securitisation and the change in lending practices to 'originate to distribute' led to acute moral hazard, where each participant in the mortgage chain was trying to make continuously greater returns whilst assuming that they passed on all the associated risks to other participants (Lewis, 2007; Ee & Xiong, 2008). Financial innovation was meant to distribute risks evenly throughout the financial system, thus reducing the risk for the system as a whole; however, increased risk tolerance, moral hazard and an insatiable thirst for return pushed all participants to borrow larger sums and to take increasingly bigger bets. The result was that whilst risk was dispersed for the individual players, it was amplified for the entire financial system (Lim, 2008)'.

The opaqueness and complexity of the financial instruments which served as a means to conceal the toxicity of the trillions of dollars of securities developed and sold by the investment banks returned to haunt them with the realisation that no international financial institution fully understood how much of these subprime assets were buried in their portfolios. With the growing possibility of counter-party failure, the credit markets seized up, and banks and other financial institutions began falling over as they announced huge write downs, not only in the United States but also in the United Kingdom, and throughout Europe (Table 24.1). Instead of risk being hedged, it had become interconnected and international, and unknown.

Table 24.1 Subprime losses by international banks (October 2008)

	Company	*Country*	*($US billion)*
1	Citigroup	USA	66.6
2	Wachovia	USA	52.7
3	Merrill Lynch	USA	54.6
4	Washington Mutual	USA	45.6
5	UBS	Switzerland	44.2
6	HSBC	UK	27.4
7	Bank of America	USA	21.2
8	JP Morgan Chase	USA	18.8
9	Morgan Stanley	USA	15.7
10	IKB Deutsche	Germany	14.7
11	Royal Bank of Scotland	UK	16.5

12	Lehman Brothers	USA	18.2
13	AIG	USA	16.8
14	Fannie Mae	USA	12.7
15	Deutsche Bank	Germany	11.4
16	Ambac	USA	10.3
17	Wells Fargo	USA	10
18	MBIA Inc	USA	9.4
19	Barclays	UK	9.2
20	Credit Agricole	France	8.6
21	Credit Suisse	Switzerland	8.1
22	HBOS	UK	7.5
23	Canadian Imperial Bank of Commerce	Canada	7.1
24	Fortis	Belgium / Netherlands	6.9
25	Bayerische Landesbank	Germany	6.7
26	Freddie Mac	USA	6.7
27	ING	Netherlands	6.5
28	Société Générale	France	6.4
29	Mizuho Financial Group	Japan	6.2
30	Dresdner Bank	Germany	5
31	Bear Sterns	USA	3.4
32	WestLB	Germany	3.1
33	BNP Paribas	France	2.7
34	UniCredit	Italy	2.7
35	Lloyds TSB	UK	2.6
36	Nomura Holdings	Japan	2.5
37	DZ Bank	Germany	2
38	Natixis	France	2
39	Swiss Re	Switzerland	1.8
40	HSH Nordbank	Germany	1.7
41	LBBW	Germany	1.7
42	Commerzbank	Germany	1.2
43	Mitsubishi UFJ	Japan	1.2
44	Sumitomo	Japan	1.2
45	AXA	France	1.1
	Total Losses		582.60

Source: Individual banks; central banks.

Meanwhile the Treasury and the Federal Reserve, who were the regulators with responsibility to supervise markets, were ill-prepared for the events of 2007 and 2008 according to the US National Commission (2011) into the financial crisis:

> They were hampered because they did not have a clear grasp of the financial system they were

> charged with overseeing, particularly as it had evolved in the years leading up to the crisis. This was in no small measure due to the lack of transparency in key markets. They thought risk had been diversified when, in fact, it had been concentrated. Time and again, from the spring of 2007 on, policy makers and regulators were caught off guard as the contagion spread, responding on an ad hoc basis with specific programs to put fingers in the dike. There was no comprehensive and strategic plan for containment, because they lacked a full understanding of the risks and interconnections in the financial markets. Some regulators have conceded this error. We had allowed the system to race ahead of our ability to protect it. … Just a month before Lehman's collapse, the Federal Reserve Bank of New York was still seeking information on the exposures created by Lehman's more than 900,000 derivatives contracts (2011: xxi).

US FINANCIAL INSTITUTIONS FAILURES

As financial institutions, overburdened with debt, desperately attempted to *deleverage* by selling assets, including the mortgage-backed securities, the cruel 'paradox of deleveraging' was exposed: that the fire-sale of assets simply drives asset prices down, and left the banks in an even worse position. (Paul Volker, the former President of the US Federal Reserve, who President Obama welcomed back as an economic adviser, once referred to 'the transient pleasures of extreme leverage'). Caught in these financial manoeuvres, one of the largest Wall Street investment banks Bear Stearns failed in March 2008, and, in a deal sponsored by the US Federal Reserve, was sold to JPMorgan Chase. With the collapse of a string of venerable Wall Street institutions, the US Treasury, Federal Reserve, and the Securities and Exchange Commission (SEC) were galvanised into action, and selectively nationalised those companies thought too vital to the US financial structure to allow to fail, arranged the sale of companies that could be salvaged, or allowed companies to collapse that were thought dispensable.

Though this was the greatest series of government interventions in US financial markets in recent decades, the New York Stock Exchange (NYSE) continued in free fall, and the whole of the US banking sector appeared vulnerable. When selective assistance did not resolve the problem, an enormous rescue operation offering up to $700 billion to buy up toxic securities from the financial institutions in order to restore credit markets was brought by the Bush administration to a Congress reluctant about rescuing Wall Street from its own folly. Finally, a heavily amended proposal was eventually passed through Congress on 3 October 2008 giving the Treasurer immediate access to $250 billion; following that, a further $100 billion could be authorised by the President, with Congress confirming the last $350 billion. Transparency details were required for each transaction, and a set of oversight mechanisms involving a Financial Oversight Board, Congressional Oversight Panel, and Special Inspector General of the programme. The Treasurer was required to obtain the right to purchase non-voting stock in companies that participated in the sale of assets, giving the government an equity interest in the companies. The Treasury was required to maximise assistance to homeowners facing foreclosure. Finally, companies participating in the scheme were prohibited from offering executives incentives to take excessive risks, or to offer golden parachutes to executives, and were given the right to clawback senior executive bonuses if they were later found to be based on inaccurate data. When stock markets opened the following Monday after the Act was passed, the Dow Jones was down 700 points, the FTSE down 7.9%, the DAX down 7.1%, and France's CAC 40 down 9%, revealing that markets were not going to be easily reassured, and the financial crisis was becoming internationally contagious.

EUROPEAN FINANCIAL INSTITUTIONS FAILURES

All over Europe as the contagion spread, the impact of the subprime crisis was wreaking havoc in financial institutions, threatening entire financial systems, and severely undermining the fragile unity of the European Union. The scale of the crisis for European financial institutions, relative to the size of the sector, was becoming almost as serious as for US financial institutions (Figure 24.3). The first tremors of the crisis were felt in the United Kingdom, which rivals the United States as the centre of the international financial system. Among the early casualties of the subprime crisis was Northern Rock, one of the largest mortgage lenders in the United Kingdom, which depended on the wholesale market for short-term credit. Northern Rock could not raise sufficient capital in September 2007, and after a run on the bank reminiscent of the 1920s, was effectively nationalised by the UK government trying desperately to contain an impending mass public financial panic (Klimecki & Willmott, 2009). As the credit crisis worsened for institutions used to relying on the wholesale market and interbank lending, a liquidity crisis gripped the major British banks, while their share prices collapsed. As panic selling continued on the London Stock Exchange with HBOS and Bank of Scotland shares losing 40% of their value in a single day's trading, the UK government intervened with a £500 billion (US$850 billion) rescue package for eight of the largest UK banks intended to restore stability to the system. This package consisted of up to £50 billion in capital investment for the banks in exchange for preference shares, short-term loans up to £200 billion from the Bank of England, and loan guarantees for banks lending to each other of up to £250 billion. The offer of assistance was conditional on restraint in executive incentives and rewards and on dividend payments, and that banks must be able to lend to small businesses and homeowners.

In other European countries the response to the crisis was largely managed on a national basis as financial institutions failed. Fortis, one of the world's largest banking, insurance and investment companies, was rescued by the Netherlands, who nationalising its Dutch operations, and France's BNP Paribas buying its Belgian and Luxemburg operations. Dexia, the Belgian financial

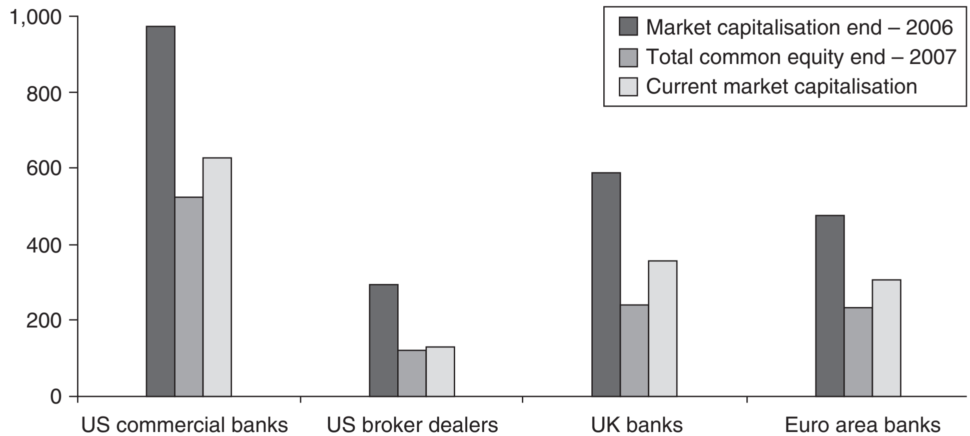

Figure 24.3 Market capitalisation and equity book values of financial institutions, 2006–2008 (US$ billion)

Source: Bloomberg L.P.

Note: US broker dealers include Lehman Brothers, Morgan Stanley, Goldman Sachs and Merrill Lynch. The other three categories – namely, US, UK and euro area banks – include institutions that have retail banking businesses in their respective regions (IMF, 2008: 22).

services company, was rescued by the French, Belgian, and Luxemburg governments. As the entire banking system of Iceland began to fail, the government invested €600 million for a 75% stake in Glitnir, the second largest bank. Finally, in Germany, the second largest property lender Hypo Real Estate received a €50 billion rescue coordinated by the government, including €20 billion from the Bundesbank.

The market capitalisation of the stock markets of the world had peaked at $62 trillion at the end of 2007, but was in free fall by October 2008, having lost $29 trillion, over half of its value in12 months of unrelenting financial and corporate failures (Figure 24.4). However, in an unprecedented effort to provide a coordinated response, the central banks of the major industrial powers simultaneously lowered interest rates, as it became clear that a systemic response was required to a systemic crisis. As the finance ministers of the G7 countries met in emergency session in Washington, Dominique Strauss-Kahn the head of the IMF insisted, 'Intensifying solvency concerns about a number of the largest US-based and European financial institutions have pushed the global financial system to the brink of systemic meltdown.' The G7 ministers announced a plan to free up the flow of credit, back efforts by banks to raise money and revive the mortgage market.

As the US Congress, the Financial Crisis Inquiry Commission (2010) revealed that the global financial crisis brought a tumultuous end to six years of galloping inflation in both financial institutions profitability, and in the inflation of the market capitalisation of the S&P 500 Index (Figures 24.5 and 24.6). The scale of the disaster, one sage commented, demonstrated the unerring capacity of Wall Street to have a once-in-a-lifetime catastrophe approximately every six years.

THE FINANCIALISATION OF THE GLOBAL ECONOMY

Directing markets was now a great deal more difficult, since financial markets have become much larger, interconnected and internationalised. A McKinsey survey illustrates how European capital markets are catching up with US markets (including equity securities,

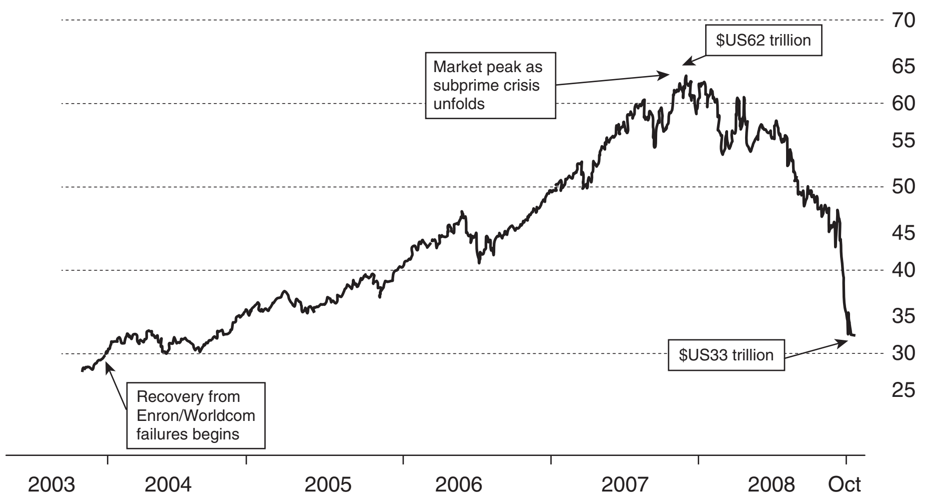

Figure 24.4 World exchange market capitalisation (US$ trillion)

Source: Bloomberg.

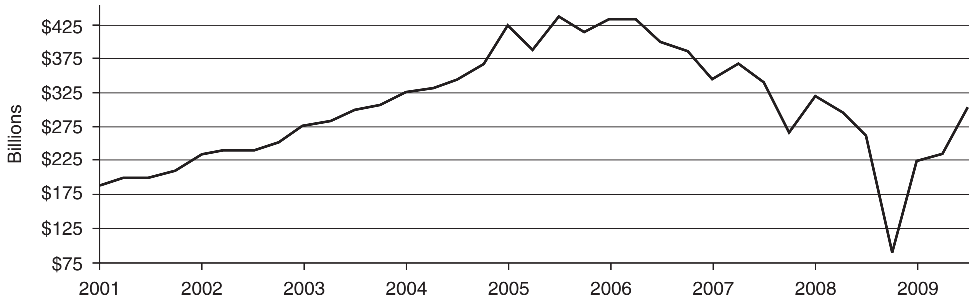

Figure 24.5 Corporate profits of financial industries (US$ billion)

Source: US Congress, Financial Crisis Inquiry Commission, 2010.

private debt securities, government debt securities and bank deposits):

> The United States remains the world's largest and most liquid capital market, with $56 trillion in assets, or nearly one-third of the global total. But Europe's financial markets are approaching the scale of the US markets. Including the United Kingdom, Europe's financial markets reached $53 trillion in 2006 – still less than the US total, but growing faster. Three quarters of the gain came from the deepening of Europe's equity and private debt markets. The eurozone's financial markets reached $37.6 trillion, the UK markets reached $10 trillion, and other Western European nations $5.6 trillion. Equally important, the euro is emerging as a rival to the dollar as the world's global reserve currency, reflecting in part the growing vibrancy and depth of Europe's financial markets. In mid-2007, the value of euro currency in circulation surpassed that of dollar notes in the world for the first time, and the euro has been the top choice in the issuance of bonds (McKinsey, 2008: 11–12).

Relative to gross domestic product (GDP), the financial sector in all of the industrial countries grew considerably in the last two decades of financial deregulation, innovation and globalisation. The size of financial assets in both the United States and the United Kingdom had more than doubled in 20 years. The massive growth of the UK finance sector and also the sustained growth of the European finance sectors involved the adoption of similar financial innovation and exotic instruments, as in the United States. British and European financial institutions had also succumbed to the temptations of high leverage (in some cases higher than the Wall Street investment banks), minimal risk management, and a fascination with the returns that new financial securities and speculative industries – most notably the property sector – might deliver. In the UK the financial sector

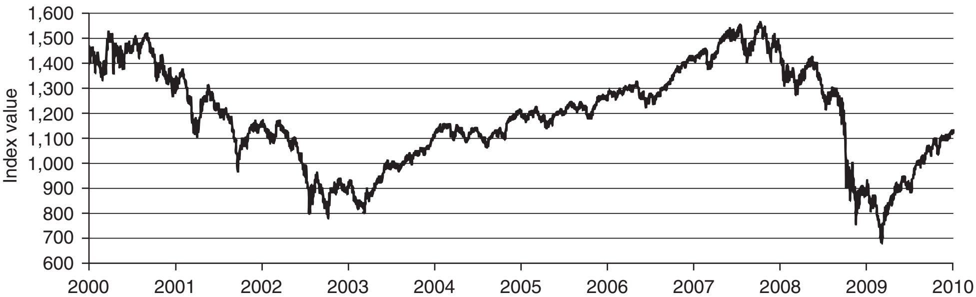

Figure 24.6 S&P 500 Index

Source: US Congress, Financial Crisis Inquiry Commission, 2010.

became gargantuan, with assets around nine times GDP (Figure 24.7), a multiple more than double that of the US finance sector. A concentration on financial services was considered in the United States and the United Kingdom as an essential part of the new economy, and was associated with rapid market growth, high profits and very high salaries for a privileged few dealing in the most exotic financial securities. London basked in its developing reputation as the financial capital of the world, and when annual bonuses were paid in the finance sector, property prices in central London (already now among the highest in the world) jumped again (City of London, 2008).

Fuelling the whole process of financialisation were volcanic eruptions of debt. When Alan Greenspan became Chairman of the Federal Reserve in 1987 public and private debt in the US totalled \$10.5 trillion, but after his departure in 2006 it had quadruped to \$43 trillion.

> Debt in record quantities had been piled on top of the trillions still extant from previous binges of the eighties and nineties, so that by 2007 the nation's overseers watched a US economy in which public and private indebtedness was three times bigger than that year's gross national product. This ratio topped the prior record, set during the years after the stock market crash of 1929. However, in contrast to the 1920s and 1930s when manufacturing retained its overwhelming primacy despite the economy's temporary froth of stock market and ballyhoo, the eighties and nineties brought a much deeper transformation. Goods production lost the two-to-one edge in GDP it had enjoyed in the seventies. In 2005, on the cusp of Greenspan's retirement, financial services – the new *ubercategory* spanning finance, insurance and real estate – far exceeded other sectors taking over one-fifth of GDP against manufacturing's gaunt, shrunken 12%. During the two previous decades (and only marginally stalled by the early 1990s economic bailouts) the baton of economic leadership had been passed (Phillips, 2008: 5).

A debate has continued for some time about the costs and benefits of the financialisation of advanced industrial economies (Martin, 2002; Epstein, 2005; Froud, Johal, Leaver & Williams, 2006; Erturk, Froud, Johal, Leaver & Williams, 2008; Froud & Johal, 2008; Langley, 2008). Competing definitions of 'financialisation' include:

- the ascendancy of 'shareholder value' as a mode of corporate governance (Aglietta & Reberioux, 2005);
- the growing dominance of capital market financial systems over bank-based financial systems;
- the increasing political and economic power of a particular class grouping: the *rentier* class for some (Hilferding, 1910/1981);
- the explosion of financial trading with a myriad of new financial instruments;

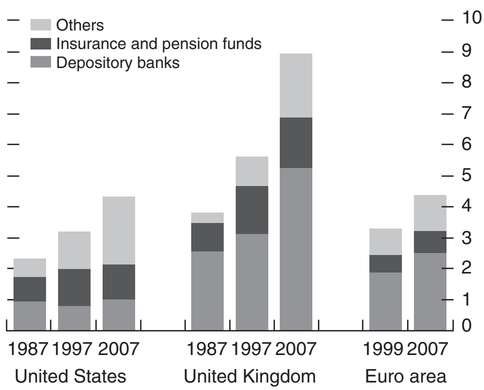

Figure 24.7 Scale of financial assets in multiples of gross domestic product

Sources: US Board of Governors of the Federal Reserve System; UK Office of National Statistics; European Central Bank; and IMF staff estimates (IMF, 2008: 68).

- the 'pattern of accumulation in which profit making occurs increasingly through financial channels rather than through trade and commodity production' (Krippner, 2005); and
- the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies (Epstein, 2005: 3).

There were many critics of financialisation, and the long progression of financial crises around the world served as a reminder that the system was neither self-regulating nor robust (Laeven & Valencia, 2008). However, few imagined that the international financial system might prove so wilfully self-destructive as this 2008 crisis revealed. 'You've seen the triumph of greed over integrity; the triumph of speculation over value creation; the triumph of the short term over long term sustainable growth' was the verdict of Australia's then Prime Minister, Kevin Rudd (*The Australian*, 6 October 2008). More forcefully still, the Archbishop of Canterbury Rowan Williams argued,

> Trading the debts of others without accountability has been the motor of astronomical financial gain for many in recent years. … The crisis exposes the element of basic unreality in the situation – the truth that almost unimaginable wealth has been generated by equally unimaginable levels of fiction, paper transactions with no concrete outcome beyond profit for traders. ... The biggest challenge in the present crisis is whether we can recover some sense of the connection between money and material reality – the production of specific things, the achievement of recognisable human goals that have something to do with a shared sense of what is good for the human community in the widest sense (*The Spectator*, 27 September 2008).

THE CORPORATE GOVERNANCE CAUSES OF THE CRISIS

The explanation of why investment banks and other financial institutions took such spectacular risks with extremely leveraged positions on many securities and derivatives, and the risk management, governance and ethical environment that allowed such conduct to take place is worth further analysis. Nobody imagined the scale of the tragedy that befell Wall Street's leading investment banks.

Deregulation

Financial institutions are critical to the operation of any economy, and traditionally subject to a framework of firm regulation; however, as the financialisation of the US and international economy proceeded, paradoxically, the regulatory touch lightened considerably. In the words of one US finance expert, in the years before the crisis,

> We were developing a system of very large, highly levered, undercapitalised financial institutions – including the investment banks, some large money centre banks, the insurance companies with large derivative books and the government-sponsored entities. … Regulators believe that all of these are too big to fail and would bail them out if necessary. The owners, employees and creditors of these institutions are rewarded when they succeed, but it is all of us – the taxpayers – who are left on the hook if they fail. This is called private profits and socialised risk. Heads I win. Tails, you lose. It is a reverse Robin Hood system (Einhorn, 2008a: 16–17; 2008b).

The abolition of the Glass–Steagall Act in 1999 paved the way for a regulatory loosening of the US financial system, enhanced in 2004 by a new SEC rule intended to reduce regulatory costs for broker-dealers that were part of consolidated supervised entities. Essentially this involved large broker-dealers using their own risk-management practices for regulatory purposes, enabling a lowering of their capital requirements (the core capital which a bank is required to hold to support its risk-taking activities and which normally includes share capital, share premium and retained earnings). In addition, the SEC amended the definition of net capital to include securities for which there was no ready market, and to include hybrid capital instruments and certain deferred tax assets, reducing the amount of capital required to engage in high-risk activities. Finally, the rule eased the calculations of counter-party risk, maximum potential exposures and margin lending, and allowed broker-dealers to assign their own credit ratings to unrated companies. Einhorn comments on this regulatory capitulation of the SEC:

> Large broker-dealers convinced the regulators that the dealers could better measure their own risks, and with fancy math, they attempted to show that they could support more risk with less capital. I suspect that the SEC took the point of view that these were all large, well-capitalised institutions, with smart, sophisticated risk managers who had no incentive to try to fail. Consequently, they gave the industry the benefit of the doubt (Einhorn, 2008a: 16; 2008b).

The verdict of the US National Commission (2011: xviii) was that 30 years of deregulation and reliance on self-regulation by financial institutions had stripped away the safeguards that might have helped avert the catastrophe:

> … There was pervasive permissiveness; little meaningful action was taken to quell the threats in a timely manner. The prime example is the Federal Reserve's pivotal failure to stem the flow of toxic mortgages, which it could have done by setting prudent mortgage-lending standards. The Federal Reserve was the one entity empowered to do so and it did not. The record of our examination is replete with evidence of other failures: financial institutions made, bought, and sold mortgage securities they never examined, did not care to examine, or knew to be defective; firms depended on tens of billions of dollars of borrowing that had to be renewed each and every night, secured by subprime mortgage securities; and major firms and investors blindly relied on credit rating agencies as their arbiters of risk (2011: xvii).

Ratings agencies

As international financial markets have expanded, the role of the credit ratings agencies (CRAs) have proved critical. The International Organisation of Securities Commissions (IOSCO) claims that:

> CRAs assess the credit risk of corporate or government borrowers and issuers of fixed-income securities. CRAs attempt to make sense of the vast amount of information available regarding an issuer or borrower, its market and its economic circumstances in order to give investors and lenders a better understanding of the risks they face when lending to a particular borrower or when purchasing an issuer's fixed-income securities. A credit rating, typically, is a CRA's opinion of how likely an issuer is to repay, in a timely fashion, a particular debt or financial obligation, or its debts generally (2003: 1).

Yet the question asked by everybody when the financial crisis erupted was how could asset-backed securities containing subprime mortgages and other high-risk debt possibly be given AA credit ratings by Standard and Poor's or Moody's? The answer was, again, that financial innovation had outpaced regulatory prowess. As the US National Commission (2011: xxv) into the financial crisis concluded:

> This crisis could not have happened without the rating agencies. Their ratings helped the market soar and their downgrades through 2007 and 2008 wreaked havoc across markets and firms. In our report, you will read about the breakdowns at Moody's, examined by the Commission as a case study. From 2000 to 2007, Moody's rated nearly 45,000 mortgage-related securities as triple-A. This compares with six private-sector companies in the United States that carried this coveted rating in early 2010. In 2006 alone, Moody's put its triple-A stamp of approval on 30 mortgage-related securities every working day. The results were disastrous: 83% of the mortgage securities rated triple-A that year ultimately were downgraded.

The ratings agencies instead of monitoring rigorously the growth of financial markets and instruments had become junior partners in this enterprise. Coffee (2006), in his critique of the failure of the gatekeeper professions in US corporate governance including auditors, corporate lawyers and securities analysts, raises the following issues regarding rating agencies:

1. Concentration Given the immense capacity of the ratings agencies to influence the fortunes of financial institutions and instruments in terms of the public perception of risk, they have maintained a highly profitable duopoly with Standard and Poor's Ratings Services and Moody's Investor Services, only recently joined by Fitch Investor services for specialised submarkets. The SEC has supported this entrenched market position, reinforced by a reputational capital only now being challenged.

2. Conflicts of interest Traditionally, the ratings agencies rated thousands of clients in the corporate debt business with little chance of being captured by single clients. As the importance of the structured debt market grew, there were only a few investment banks active, but the scale of the market grew exponentially. From the 1970s, the ratings agencies business changed from their revenue coming from subscribers for their ratings services, to their revenue coming from the issuers of debt products, creating a context for capture by client's interests.

3. Complex financial products Rating corporate debt utilising corporate financial history, audited financial statements, is less difficult than complex structured finance products issued by investment banks. Understanding the nature of the underlying assets and cash flows generated by these assets and the risks involved over time is a major undertaking. The ratings agencies deny any obligation to do due diligence on the portfolio backing structured finance products.

4. Timing and relevance Even if the ratings agencies were close in their original rating, they do not review how a debt product may change over time in different market conditions, and rating agencies were slow to downgrade subprime asset-backed securities (Coffee, 2006; Scott, 2008: 23–24).

The ratings agencies believed in the investment banks of Wall Street, and in their risk controls, and assumed that 'everything was hedged.' Though the CRAs do have the power to review non-public information to assess the credit-worthiness of institutions and securities, they did not have the inclination, manpower or skills to do this thoroughly in all cases, and they did not get paid until they gave a rating:

> The market perceives the rating agencies to be doing much more than they actually do. ... Had the credit rating agencies been doing a reasonable job of disciplining the investment banks – which unfortunately happen to bring the rating agencies lots of other business – then the banks may have been prevented from taking excess risk and the current crisis might have been averted (Einhorn, 2008a: 13; 2008b).

Risk management

Financial businesses activities in rapidly changing markets are highly sensitive to variance, and it might be expected that as the financial services industries have grown inexorably and financial products become more complex, that the sophistication of risk management techniques will have developed in parallel. However, the reality is that innovation in financial products has far exceeded the capacity of risk management measurement and monitoring tools to gauge risk. The most widely employed risk management tool is Value at Risk (VaR), which measures how much a portfolio stands to make or lose in 99% of the days. But, as Einhorn argues, this measure ignores what might happen at the moment of greatest risk:

> A risk manager's job is to worry about whether the bank is putting itself at risk in the unusual times – or, in statistical terms, in the tails of distribution. Yet, VaR ignores what happens in the tails. It specifically cuts them off. A 99% VaR calculation does not evaluate what happens in the last 1%. This, in my view, makes VaR relatively useless as a risk management tool and potentially catastrophic when its use creates a false sense of security among senior managers and watchdogs. This is like an airbag that works all the time, except when you have a car accident. By ignoring the tails, VaR creates an incentive to take excessive but remote risks (Einhorn, 2008a: 11; 2008b).

Yet VaR was the tool international finance industries relied upon in transactions involving billions of dollars. For example, UBS was the European bank with the largest losses from the crisis, involving the Swiss government and central bank providing an aid package of $59.2 billion to take risky debt securities from its balance sheet. In a report to shareholders published in April 2008, UBS laid bare the risk management failings that had led to such immense losses (though wealthy clients continued to desert the bank in droves, withdrawing $58 billion in the third quarter of 2008). The report highlights in worrying detail the incomplete risk-control methodologies, with market risk control (MRC) placing considerable reliance on VaR and stress limits to control the risks of the business, without implementing additional risk methodologies, or aggregating notional limits even when losses were made (2008: 13):

1. Mortgage portfolio trades were certified by the UBS investment bank's quantitative risk control,

> But with the benefit of hindsight appears not to have been subject to sufficiently robust stress testing. Further, the collateralised debt obligation desk did not carry out sufficient fundamental analysis as market conditions deteriorated … (2008: 30).

2. With regard to asset-backed securities trading also, there were incomplete risk-control methodologies:

> There was considerable reliance on AA/AAA ratings and sector concentration limits which did not take into account the fact that more than 95% of the asset-backed securities trading portfolio was referencing US underlying assets (i.e. mortgage loans, auto loans, credit card debt etc.) (2008: 32).

3. In fixed income there was a growth orientation:

> The investment bank was focused on the maximisation of revenue. There appears to have been a lack of challenge on the risk and reward to business area plans within the investment bank at a senior level. UBS's review suggests an asymmetric focus in the investment bank senior management meetings on revenue and profit and loss, especially when compared to discussion of risk issues. Business-peer challenge was not a routine practice in those meetings. … Inappropriate risk metrics were used in strategic planning and assessment. Investment Bank planning relied on VaR, which appears as the key risk parameter in the planning process. When the market dislocation unfolded, it became apparent that this risk measure methodology had not appropriately captured the risk inherent in the business having subprime exposures (2008: 34).

4. With regard to UBS group governance there was:

> Failure to demand a holistic assessment. Whilst group senior management was alert to the general issues concerning the deteriorating US housing market, they did not demand a holistic presentation of UBS's exposure to securities referencing US real estate assets before July 2007, even though such an assessment may have been warranted earlier in view of the size of UBS's real estate assets (2008: 35).

5. The report concluded with reference to risk control that there was over-reliance on VaR and stress:

> MRC relied on VaR and stress numbers, even though delinquency rates were increasing and origination standards were falling in the US mortgage market. It continued to do so throughout the build-up of significant positions in subprime assets that were only partially hedged. Presentations of MRC to UBS's senior governance bodies did not provide adequate granularity of subprime positions UBS held in its various businesses. No warnings were given to group senior management about the limitations of the presented numbers or the need to look at the broader contextual framework and the findings were not challenged with perseverance (2008: 39).

6. Finally, the report condemned the lack of independence and healthy scepticism in UBS governance:

> 'Fundamental analysis of the subprime market seems to have been generally based on the business view and less on MRC's independent assessment. In particular there is no indication that MRC was seeking views from other sources than business. … Further, risk systems and infrastructure were not improved because of a willingness by the risk function to support growth (2008: 39–40).

The US National Commission (2011: xviii) was convinced the dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of the financial crisis. The assumptions at the time were that the instincts for self-preservation within financial firms would shield them from excessive risk-taking without a need for regulatory restraint that might stifle innovation – the reality was very different:

> Too many of these institutions acted recklessly, taking on too much risk, with too little capital, and with too much dependence on short-term funding. In many respects, this reflected a fundamental change in these institutions, particularly the large investment banks and bank holding companies, which focused their activities increasingly on risky trading activities that produced hefty profits. They took on enormous exposures in acquiring and supporting subprime lenders and creating, packaging, repackaging, and selling trillions of dollars in mortgage-related securities, including synthetic financial products. … Financial institutions and credit rating agencies embraced mathematical models as reliable predictors of risks, replacing judgment in too many instances. Too often, risk management became risk justification (2011: xviii).

Incentivisation

The final and most critical part of the explanation of why investment banks and other financial institutions took such extreme risks with highly leveraged positions in complex securities, neglecting risk management, governance principles and often basic business ethics, was that *they were highly incentivised to do so*. Massively incentivised irresponsibility became the operating compensation norm in the financial community, as banks and fringe financial institutions chased the super profits available as global financial markets expanded exponentially:

> The management teams at the investment banks did exactly what they were incentivized to do: maximize employee compensation. Investment banks pay out 50% of revenues as compensation. So, more leverage means more revenues, which means more compensation. In good times, once they pay out the compensation, overhead and taxes, only a fraction of the incremental revenues fall to the bottom line for shareholders. The banks have done a wonderful job at public relations. Everyone knows about the 20% incentive fees in the hedge fund and private equity industry. Nobody talks about the investment banks' 50% compensation structures, which have no high-water mark and actually are exceeded in difficult times in order to retain talent (Einhorn 2008:11; 2008b).

The report on the vast write-downs at UBS examines how the compensation structure directly generated the behaviour which caused the losses, as staff were motivated to utilise the low cost of funding to invest in subprime positions. There were insufficient incentives to protect the UBS franchise for the longer term:

> It remains the case that bonus payments for successful and senior international business fixed income traders, including those in the businesses holding subprime positions were significant. Essentially, bonuses were measured against gross revenue after personnel costs, with no formal account taken of the quality and sustainability of those earnings (UBS 2008: 42).

The same recklessness regarding compensation practices pervaded Wall Street, as the US National Commission (2011: xix) commented:

> Compensation systems – designed in an environment of cheap money, intense competition, and light regulation – too often rewarded the quick deal, the short-term gain – without proper consideration of long-term consequences. Often, those systems encouraged the big bet – where the payoff on the upside could be huge and the downside limited. This was the case up and down the line – from the corporate boardroom to the mortgage broker on the street.

REGULATION AND GOVERNANCE OF FINANCIAL INSTITUTIONS

While the accumulated cost of the global financial crisis was being realised, the commitment to establish a new international financial regulatory framework increased. As the costs of all forms of intervention to alleviate the crisis by the US government ballooned out to US$7.7 trillion (including credit discounts, credit extensions, securities lending, term auction facilities, portfolio funding, money market funding, TARP, assistance to specific institutions, economic stimulus packages and homeowner assistance), the general market assistance and specific rescue packages for individual financial institutions amounted to almost US$11 trillion worldwide by October 2008 (Table 24.2). While these funds could be regarded as a temporary investment in the financial economy, with the hope of recouping much of the funds back at a later stage, this was an optimistic view when the crisis spread to other sectors of the economy. As the financial crisis impacted upon the real economy, the fears of a prolonged recession grew, with US industrial production falling further than it had for over 30 years. For example, the US automotive industry became increasingly precarious, announcing further major redundancies and looking for support from the federal government (including support from the assistance intended for financial institutions, since the automotive companies had also become finance companies). The International Labour Organisation in Geneva estimated that up to 20 million people in the world would lose their employment as a consequence of the financial crisis, and that for the first time in a decade the global total of unemployed would be above 200 million (*Associated Press*, 21 October 2008). The prospect of the whole world falling into recession at the same time became possible: something not witnessed since the 1930s.

There was a widespread sense that this regulatory failure of financial markets could not be allowed to occur again. The Chancellor of Germany, Angela Merkel, usually a stalwart ally of President Bush, derided the lack of regulation that, in her view, allowed the financial crisis to erupt in the United States and seep inexorably towards Europe. She reminded the German public that the United States and Britain rejected her proposals in 2007 for regulating international hedge funds and bond rating agencies. 'It was said for a long time, 'Let the markets take care of themselves,' ' Merkel commented. Now, she added, 'even America and Britain are saying, 'Yes, we need more transparency, we need better standards.' ' Germany's finance minister, Peer Steinbrueck, said that the 'Anglo-Saxon' capitalist system had run its course and that 'new rules of the road' are needed, including greater global regulation of capital markets (*Washington Post*, 28 September 2008). Gordon Brown, then the UK Prime

Table 24.2 Government support for global financial crisis 2008

	US dollars
Europe	$ 1.8 trillion
UK	$ 856 billion
USA	$ 7.74 trillion
Sweden	$ 205 billion
South Korea	$ 130 billion
Australia	$ 10.4 billion
Rest of the World	$ 105.12 billion
Total	$10.93 trillion

Source: Compiled from: BBC Credit Crisis: World in Turmoil. At: http://news.bbc.co.uk/2/hi/business/7654647.stm, ABC News, Tuesday 21 October 2008. At: http://www.abc.net.au/Reuters. At: http://www.reuters.com/article/forexNews/idUSTRE49J2GB20081020IMF Global Financial Stability Report October 2008. At: http://www.imf.org/external/pubs/ft/gfsr/2008/02/index.htm

Minister, and Nicolas Sarkozy called for a Bretton Woods agreement for the 21st century, aimed at rebuilding the international financial system.

A problem in devising a new financial regulatory architecture was that Bretton Woods in 1944, though it established the IMF and the World Bank, was essentially dealing with national financial markets. Digital and interconnected global financial markets presented a much bigger challenge. A series of measures were proposed by Gordon Brown:

1 Improving risk disclosure by financial institutions was fundamental, together with stricter rules on bank liquidity and leveraging.
2 Ensuring banks take bigger stakes in any loans they pass on to others through securitisation might constrain irresponsible innovations.
3 Establishing a central clearing house for complex derivatives could help to discipline their use.
4 Increased supervision and regulation might include new standards for off-balance sheet accounting, and supervision of the largest international banks and insurance companies.
5 Reforming executive compensation structures that encouraged excessive risk-taking, and aligning reward with long term value creation was another imperative.
6 Finally a capacity to police the potential for future dangers to the international economy, and the means of cooperation for future crises were important (*The Times*, 16 October 2008).

These principles for reforming international financial markets were broadly supported in Europe, and had public resonance in the United States, where it was argued that the rapid expansion of unregulated financial institutions and instruments from hedge funds to credit default swaps should be contained by extending financial reserve requirements, limiting leveraging and ensuring trading occurred on public exchanges (*Wall Street Journal*, 25 July 2008; IPS, 2008). With the international financial community still in a state of profound shock, and heavily dependent upon state aid, any protests about the dangers of over-regulation were muted. Adair Turner, head of the Financial Services Authority (FSA) in the UK (responsible for regulating financial institutions), commented,

> If a year and a half ago, the FSA had wanted higher capital adequacy, more information on liquidity, had said it was worried about the business models at Bradford & Bingley and Northern Rock, and had wanted to ask questions about remuneration, the fact is that we would have been strongly criticised for harming the competitiveness of the City of London, red tape, and over regulation. We are now in a different environment. We shouldn't regulate for its own sake, but over-regulation and red tape has been used as a polemical bludgeon. We have probably been over-deferential to that rhetoric (*Guardian*, 16 October 2008).

In this context, addressing the factors that foster sustainable wealth creation – Arvanitidis, Petrakos and Pavleas (2010), Pitelis and Vasilaros (2010), and the real economy vehicles and policies that help effect this objective, such as foreign direct investment (Piteli, 2010), and national regional systems of innovation (von Tunzelmann, Guenther, Wilde and Jindra, 2010) – seems to be more pressing and timely than ever before.

CONCLUSION

The global financial crisis reveals the systemic failure of corporate governance and regulation. The engine of unrestrained greed at the centre of the incentive system for both financial institutions and executives proved destructive of the entire system upon which it was based. The question is will the deference of boards of directors and regulators return when financial markets recover, and financial institutions and markets are free again to pursue their self-interest? An early indication of how entrenched the irresponsibility of the financial sector has become was the astonishing fact that the surviving US financial institutions were prepared to pay end-of-year executive bonuses of approximately equivalent to the billions of dollars of aid they had just received from Congress in 2008 and 2009.

While the US economy was collapsing around them, and the US public were becoming increasingly concerned how they might survive a severe recession, the executives of major banks seemed focused primarily on maintaining their bonuses and extravagant lifestyles.

The global financial crisis has critically undermined both belief in unregulated markets and economic orthodoxy. The proposition that prices are always right and markets self-correct is fatally wounded. Alan Greenspan himself admitted that the 'whole intellectual edifice' of the efficient market hypothesis was questioned in the summer of 2008. The failure of financial markets, institutions, regulation and governance demands a more critical analysis and intervention than has so far been considered in the deliberations of the G20 or national governments. The fact that financial institutions quickly returned to self-interested strategies soon after being rescued by public funds suggests few lessons have been learned from the crisis. The seeds of this financial crisis, together with the accompanying regulatory and governance failures, will likely bear fruit in crises to come.

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25

Corporate Governance and the Global Financial Crisis: The Regulatory Response

Alice Klettner

INTRODUCTION

Corporate governance regulation invariably follows the business cycle. In times of crisis and collapse there is public pressure to increase regulation in order to prevent similar problems occurring in future. When the economy is booming, serious consideration of corporate governance regulation is confined to the desks of company secretaries, regulators and interested academics. This is not to say that corporate governance practices are abandoned in good times, only that the status quo is accepted and there is less impetus for review and improvement (Clarke, 2004).

As discussed in detail in the previous chapter, 2008 brought a global financial crisis of proportions not seen since the 1930s. Huge financial institutions collapsed and governments had little choice but to bail them out. Poor corporate governance, misaligned incentives and deeply flawed business models were identified, in combination with weak regulation and excessive risk-taking, as the main causes of the crisis. Ordinary taxpayers had to pay for the consequences of the greed of a small handful of reckless individuals who had outwitted even themselves. The natural response post-crisis was pressure worldwide for governments to consider reform of corporate governance regulation in order to remedy the perceived problems or gaps. The public policy issue at stake was summarised neatly by Sir David Walker:

> The massive dislocation and costs borne by society justify tough regulatory action as is now being put in place to minimise the risk that any such crisis could recur. The context is a major asymmetry under which, from one standpoint, the liability of shareholders in major listed banks is limited to their equity stakes, while from the other standpoint, at any rate on the basis of recent public policy initiative and experience in the UK, the United States and elsewhere, the liability of the taxpayer is seen to have been unlimited (Walker, 2009: 6).

In terms of the overall agenda for regulatory reform, corporate governance was not the first priority of most governments. The immediate response in most countries was to take emergency measures to halt the spread of the crisis and strengthen financial sectors. Governments across the world were forced to rescue failing financial institutions and guarantee bank deposits. They then had to implement measures to induce economic recovery, primarily substantial stimulus packages. Only after these initial measures had been put in place was attention diverted to regulatory and financial market reform, including issues of corporate governance (Nanto, 2009, 2010).

This chapter details some of the regulatory responses that have been put in place post-crisis across the globe, including both international initiatives and more specific reform in Europe, the United States, the United Kingdom and Australia. As the crisis originated in the financial sector, much of the focus has been on reform of prudential regulation – rules regarding capital adequacy, liquidity, leverage ratios, etc. This chapter, however, will focus primarily on regulatory reforms that can be described as corporate governance reforms. Many of these have been triggered by problems identified in the financial sector but have much wider application. They tend to revolve around four overlapping issues – executive compensation, board effectiveness, risk management and shareholder engagement (OECD, 2010).

In reading this chapter and considering the emerging agenda for corporate governance reform, it is important to continue to question the need for change and the likely outcomes if reforms are misconceived. What is required is not necessarily more regulation, but *better* regulation. Public pressure for action to prevent future collapses can sometimes result in hasty and overly restrictive or costly regulation, as was demonstrated by the Sarbanes– Oxley Act of 2002 (Romano, 2005; Hill, 2005). In one of the first academic studies since the global crisis, Cheffins (2009) examined firms that failed in 2008 and concluded that in most of them corporate governance was working relatively well. On this basis he cautioned against unnecessary reform. However, acknowledgement that the mechanisms of corporate governance were in place, and that deliberate fraud was not a factor in most corporate collapses during the crisis, does not preclude the possibility that there were systemic misalignments in incentive systems and corporate objectives which overwhelmed governance mechanisms (Thomsen, 2009).

Adams (2009) and Erkens, Hung and Matos (2010) found that firms with more independent directors and/or more institutional shareholders did not necessarily fare better in the crisis. Their findings cast doubt on whether regulatory changes that increase shareholder activism and monitoring by independent directors will be effective in reducing the consequences of future crises. Indeed, Deakin (Chapter 5), Blair (Chapter 2), Useem (Chapter 6) and Biondi et al. (Chapter 7) argue in earlier chapters of this Handbook that the function of directors pursuing shareholder value on behalf of investors may have been a principal cause of the crisis, as firms were driven recklessly towards higher-risk strategies to release higher returns. Academic research recognising the complexity of corporate governance policy and practices was absent (or not considered) when the Sarbanes Oxley Act was drafted and in designing the next round of regulatory reforms the same mistake should not be made (Finkelstein & Mooney, 2003; Romano, 2005). The Organisation for Economic Co-operation and Development (OECD) has warned:

> In the rush to new legislation that might be underpinned by the imperative 'not to waste a crisis' there might be a tendency to not clearly specify the problem and whether the proposed legislation can address it in a cost effective manner (OECD, 2010: 6).

Given the seriousness of the global financial crisis and the complex and inter-related causes, there appears to have been a reluctance to respond too hastily and most countries have conducted comprehensive reviews or inquiries before venturing near the statute books.

GLOBAL CRISIS – GLOBAL SOLUTIONS

Although the 2008 crisis was generally agreed to have originated in the United States, it quickly spread across the globe and recession gripped many countries, both developed and developing. It became clear early on that an effective regulatory response would require international coordination. Reports and recommendations fast emerged from a multitude of international organisations, both public and private. Navigating this maze of policy suggestions was almost as difficult as assessing the causes of the crisis but equally important in understanding the reasons behind the reform agenda.

G-20

The institution that emerged as taking the lead in coordinating reform was the G-20. In fact, the G-20 itself was essentially formed to respond to the crisis, enlarging the G-8 to confront the global scale of the financial crisis. The G-20 is an informal but highly influential set of forums made up firstly of the Presidents and Prime Ministers, and secondly of the Finance Ministers and Central Bank Governors of 20 systemically important industrialised and developing economies. It was at the G-20's London summit in April 2009 that a 'global plan for recovery and reform' was set forth involving various pledges aimed at repairing the financial system and restoring confidence.

Prior to this, in October 2007 the G-7 had requested an analysis by the Financial Stability Forum (FSF)[1] of the causes and weaknesses underlying the financial turmoil that was then just beginning. The FSF's report 'Enhancing Market and Institutional Resilience' was published in April 2008 and proposed concrete action in five areas:

1 Strengthened prudential oversight of capital, liquidity and risk management.
2 Enhancing transparency and valuation, particularly in relation to the risk exposures of complex investments and financial products.
3 Changes in the role and use of credit ratings.
4 Strengthening the authorities' responsiveness to risks.
5 Robust arrangements for dealing with stress in the financial system.

Although this early report dealt mostly with prudential issues, the issue of risk management was starting to emerge as a more general corporate governance weakness. The FSF report linked the issue of risk management to a second corporate governance issue – that of executive pay:

> Compensation schemes in financial institutions encouraged disproportionate risk-taking with insufficient regard to longer-term risks. This risk-taking was not always subject to adequate checks and balances in firms' risk management systems (2008: 8).

The FSF Report recommended that compensation models be aligned more closely with long-term, firm-wide profitability and referred to the role of the board of directors and of the supervisory authorities in achieving this:

> A striking aspect of the turmoil has been the extent of risk management weaknesses and failings at regulated and sophisticated firms. While it is the responsibility of the firms' boards and senior management to manage the risk they bear, supervisors and regulators can give incentives to management so that risk control frameworks keep pace with the innovation and changes in business models (2008: 10).

At the London Summit in April 2009, the G-20 members agreed upon a series of regulatory measures and a new Financial Stability Board was set up as a stronger successor to the Financial Stability Forum which, together with the International Monetary Fund (IMF), was to monitor progress in implementing the new regime. The broad aims of the regulatory measures were:

- To reshape regulatory systems so that authorities would be able to identify and better take account of macro-prudential risks.
- To extend regulation and oversight to all systemically important financial institutions, instruments and markets, including, for the first time, hedge funds.
- To endorse and implement the FSF's principles on pay and compensation.
- To support the corporate social responsibility of all firms.

The main corporate governance aspect of the G-20 plan was the focus on remuneration policy which, as will be seen, had a strong influence on activity at a national level, particularly in the United States where there had been reluctance to regulate in this area. The FSF principles on pay and compensation, published in April 2009, which all countries agreed to implement, were intended to be applied to significant financial institutions. They require boards of directors to play an active role in the design, operation and evaluation of compensation schemes, including ensuring bonuses properly reflect risk. They also require firms to publicly disclose clear, comprehensive and timely information about compensation.

The next G-20 summit was in September 2009 in Pittsburgh. Progress against the April goals was reviewed and there was a strong feeling that the forceful response agreed in April had been successful but that the process of recovery and repair remained incomplete. The G-20 nations reaffirmed their pledge to ensure better regulation for banks and other financial firms, including reform of remuneration practices. The leaders' statement contained considerable detail on remuneration reforms, worth repeating as a summary of the issues at stake:

> Excessive compensation in the financial sector has both reflected and encouraged excessive risk-taking. Reforming compensation policies and practices is an essential part of our effort to increase financial stability. We fully endorse the implementation standards of the FSB aimed at aligning compensation with long-term value creation, not excessive risk-taking, including by (i) avoiding multi-year guaranteed bonuses; (ii) requiring a significant portion of variable compensation to be deferred, tied to performance and subject to appropriate clawback and to be vested in the form of stock or stock-like instruments, as long as these create incentives aligned with long-term value creation and the time horizon of risk; (iii) ensuring that compensation for senior executives and other employees having a material impact on the firm's risk exposure align with performance and risk; (iv) making firms' compensation policies and structures transparent through disclosure requirements; (v) limiting variable compensation as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base; and (vi) ensuring that compensation committees overseeing compensation policies are able to act independently. Supervisors should have the responsibility to review firms' compensation policies and structures with institutional and systemic risk in mind and, if necessary to offset additional risks, apply corrective measures, such as higher capital requirements, to those firms that fail to implement sound compensation policies and practices. Supervisors should have the ability to modify compensation structures in the case of firms that fail or require extraordinary public intervention.

OECD

The OECD's Principles of Corporate Governance are hugely influential as an indicator of accepted international best practice. They are one of the FSB's 12 key standards for international financial stability and form the basis for the corporate governance component of the World Bank's report on 'Observance of Standards and Codes of the World Bank Group'. As such, all countries take note of their content and tend to ensure that national codes are consistent.

On 18 March 2009, the OECD held a conference in Paris to discuss monitoring, implementation and enforcement of corporate governance as well as possible reforms and improvements to the OECD Principles in light of the crisis. Priority areas for reform were listed as including 'board practices, implementation of risk management, governance of the remuneration process and the exercise of shareholder rights.'

The OECD's deliberations were informed by three excellent reports produced by its Steering Group on Corporate Governance.[2] The first was Kirkpatrick's February 2009 report entitled, 'The Corporate Governance Lessons from the Financial Crisis'. This report placed a good deal of blame on boards of directors for failing to properly supervise risk management and incentive systems. It identified credit rating agencies, disclosure regimes and accounting standards as contributing to the problem but considered that a good board ought to have been able to overcome these weaknesses:

> [There were] significant failures of risk management systems in some major financial institutions made worse by incentive systems that encouraged and rewarded high levels of risk-taking. Since reviewing and guiding risk policy is a key function of the board, these deficiencies point to ineffective board oversight (Kirkpatrick, 2009: 3).

In this sentence Kirkpatrick nicely sets the scene for three of the areas of regulatory focus that have emerged consistently post-crisis: risk management, executive compensation and board performance. With regard to risk management, Kirkpatrick explains why it needs to be seen as a corporate governance issue and not reduced to an automated compliance process:

> The risk management systems have failed in many cases due to corporate governance procedures rather than the inadequacy of computer models alone: information about exposures in a number of cases did not reach the board or even senior levels of management, while risk management was often activity rather than enterprise-based. (2009: 2)

The corporate governance aspect of risk management focuses on the way in which risk information is used within a corporation, including its transmission to the board. The crisis revealed that some boards had no knowledge of strategic decisions regarding risk management and, therefore, no control mechanisms to oversee overall risk appetite. The firms that fared better were those that had a comprehensive approach to sharing risk information and more effective stress-testing using scenario analysis. The job for boards of directors is to ensure they are receiving all relevant information and that they understand the intricacies of the risks facing the company. Risk management is not only about reducing risk but also about deciding which risks are worth taking and which are not.

The second OECD report on governance and the crisis, published in June 2009, took into account both the Kirkpatrick Report and the results of the Paris Conference and summarised the key findings. In terms of regulatory reform, it concluded that there was no need to formally amend the OECD Principles of Corporate Governance: instead, there should be more support surrounding their implementation:

> The Steering Group's analysis of corporate governance weaknesses in remuneration, risk management, board practices and the exercise of shareholder rights concludes that, at this stage, there is no immediate call for a revision of the OECD Principles. In general, the Principles provide for a good basis to adequately address the key concerns that have been raised. A more urgent challenge for the Steering Group is to encourage and support effective implementation of already agreed standards (2009a: 7).

Consequently, the third OECD report published in February 2010, put forward a set of 'comments and emerging good practices' to seek to assist companies and policymakers to implement the OECD Principles more effectively. These were set out under the same four headings identified at the Paris Conference: remuneration, risk management, board practices and the exercise of shareholder rights.

With regard to remuneration, the Steering Group supported the FSB's Principles for Sound Compensation Practices and the Implementation Guidelines that form part of the Basel Committee's Core Standards (see below). The report noted that in the area of risk management a widely accepted and useful international standard was lacking (2010: 14). In terms of board performance, the report highlighted the fact that in many companies that fared badly in the crisis, boards were dominated by the chief executive officer (CEO), which 'stifled critical enquiry and challenge essential for objective, independent judgement' (2010: 17). Ultimately, however, the report concluded that:

> It appears difficult and perhaps impossible to find a 'silver bullet' in the form of laws and regulations to improve board performance. This leaves the private sector with an important responsibility to improve board practices through, *inter alia*, implementing voluntary standards (2010: 17).

It is disappointing but not surprising that the OECD came to this conclusion. The OECD Principles effectively sit at the pinnacle of corporate governance codes and have great influence across the globe. By delegating the responsibility of improving board performance to the private sector, the OECD has perhaps missed an opportunity to guide and encourage in this area even if prescriptive regulation is inappropriate. Research confirms that, although good board performance cannot be guaranteed by implementing the structures and frameworks recommended by corporate governance regulation, it is certainly aided by appropriate use of tools such as board committees, skills matrices and performance evaluation processes (Clarke & Klettner, 2010).

Basel Committee

In October 2010 the Basel Committee on Banking Supervision issued a final set of principles for enhancing sound corporate governance practices at banking organisations. The document effectively updates principles published by the Basel Committee in 2006 and uses the OECD Principles of Corporate Governance as a guiding force. The amendments focus on: (1) the role of the board; (2) the qualifications and composition of the board; (3) the importance of an independent risk management function, including a chief risk officer or equivalent; (4) the importance of monitoring risks on an ongoing firm-wide and individual-entity basis, (5) the board's oversight of compensation systems; and (6) the board and senior management's understanding of the bank's operational structure and risks. From this it is clear that the same issues of board performance, risk management and compensation are at the forefront of reforms.[3]

In terms of the bigger picture, the Basel Committee has been revising its rules on capital and liquidity buffers. However, as an article in *The Economist* (2010) rightly comments, 'this is Basel's third try at getting it right – How can we have any confidence that they will have more success this time?' The alternatives are to look at breaking up banks or having them run by the public sector, however, these are of uncertain benefit, leaving improved buffering as the generally preferred answer. Another theme of the reform agenda appears to be a reluctance to engage in radical reform rather than more incremental and piecemeal efforts.

Other international initiatives

Three further international reports published during the crisis are worthy of mention. One by the Bank for International Settlements (2009) dealt specifically with the governance of central banks. However, the chapter on risk management contained many useful ideas on strengthening non-financial risk management. The other two reports were industry-based initiatives by the International Institute of Finance (IIF, 2008) and the Counterparty Risk Management Policy Group (CRMPG, 2008). Both were proactive attempts at influencing and perhaps limiting the scope of regulatory reform. For example, the CRMPG Report (also known as the 'Corrigan Report' after the co-chair Gerald

Corrigan) commented that its core precepts and recommendations had the objective of forming 'a private initiative that will complement official oversight by insisting on industry practices that will help mitigate systemic risk' (CRMPG, 2008).

Interestingly, in February 2010, in his capacity as Chairman of Goldman Sachs Bank, Corrigan faced inquiry before the House of Commons Treasury Committee in London in relation to Goldman Sachs' involvement with currency swaps executed with the Greek government before Greece's descent into effective bankruptcy. Corrigan gave evidence that, 'With the benefit of hindsight, it seems very clear that standards of transparency could have been and should have been higher' (Dey & Rushe, 2010). However, the key message in his testimony was that these sorts of complicated deals had become commonplace: Greece was not the only country massaging public debt with the help of an array of international finance houses.

In a report for the OECD, Wehinger (2008: 17) labelled the IIF and CRMPG reports as 'the most pertinent proposals by the industry' and certainly some of their recommendations, particularly in the area of risk management and compensation policy, are reflected in post-crisis regulatory reforms. For example, the IIF's suggestions for improving the governance of risk management included:

- the promotion of appropriate risk culture;
- defining risk appetite;
- clarifying the role of the chief risk officer;
- integrating different risk management areas; and
- stress-testing outcomes.

In redesigning compensation policies, it was suggested that firms should:

- base compensation on risk-adjusted performance, and align incentives with shareholder interests and long-term, firm-wide profitability;
- ensure that compensation incentives do not induce risk-taking in excess of the firm's risk appetite;
- align payout with the timing of related risk-adjusted profit;
- take into account realised performance for shareholders over time in determining severance pay; and
- make the approach, principles and objectives of each firm's compensation policies transparent to stakeholders.

In short, the international consensus post-crisis across both the public and private sectors has been that risk should be better managed and compensation better aligned with firm performance. As will become clearer as we look at some of the national reforms taking place, active oversight by both company boards and investors is central in achieving these aims. Figure 25.1 demonstrates the four main areas of post-crisis reform and the central role of the board of directors in implementing improvements.

EUROPE

The financial crisis waged through Europe, leaving several countries on the verge of economic collapse and igniting resentment amongst the rest. It severely tested the commitment of the stronger economies to maintaining the euro zone and caused civil unrest in many member states for a variety of different reasons.

Iceland (not yet a full member of the European Union) was the first country to lose its government to the crisis, with the cabinet resigning in January 2009 after a $10 billion bail-out by the IMF and three months of public protests (Moody, 2009). Both Greece and Ireland had to be bailed out by EU–IMF funds, although their problems were slightly different. In Greece, government mishandling of the economy seeped into the banking system and locked it out of the markets whereas in Ireland the banking crisis overwhelmed what was otherwise a functioning economy (Aldrick, 2010). Portugal and Spain were also on the brink of

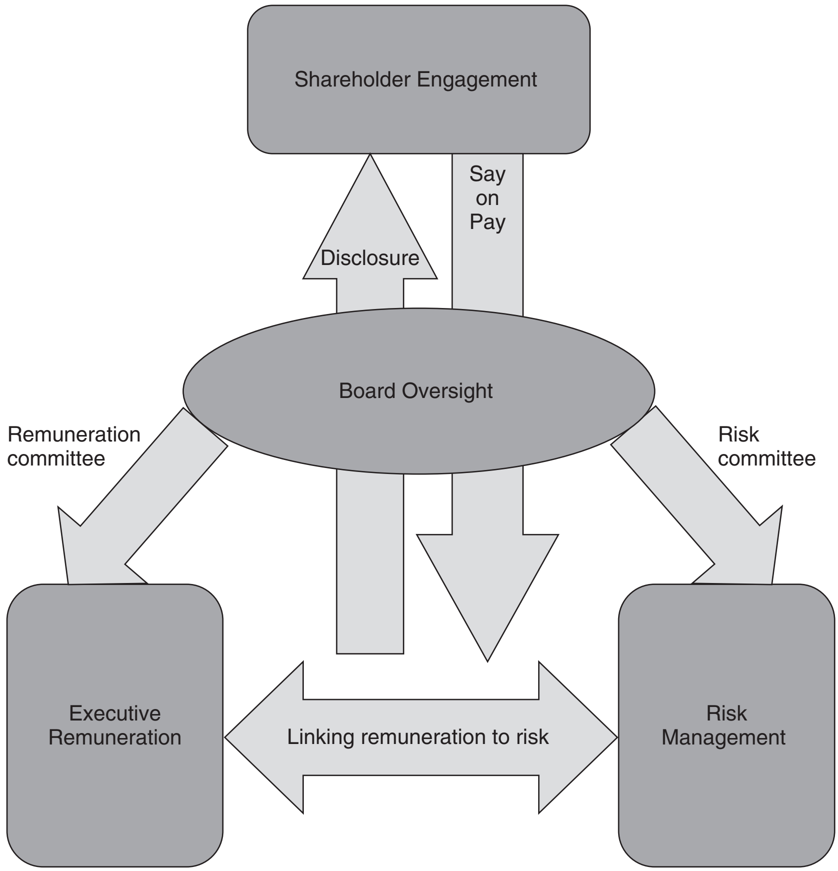

Figure 25.1 Strengthening corporate governance post-crisis

collapse, with Portugal a candidate for bail-out in 2011.

In the struggling economies, such as Greece and Spain, civilians protested at the severe austerity measures imposed, whereas in the larger nations, such as Germany and France, there was anger at the cost of supporting their neighbours. For example, in France, in a protest against the way President Sarkozy had handled the crisis, unions organised a widespread strike to demand the government make employment a priority, reduce the income gap and better regulate banks (Jolly, 2009). The social discontent was significant – workers at a tyre factory in northern France pelted managers with eggs after they were told it was closing and staff at a Sony plant in the southwest locked up their bosses for a night to demand more redundancy cover (Mackenzie, 2009).

However, as compared with neighbouring nations, France survived the crisis without major banking collapses, although the financial system was under severe stress. Regulatory reform in the area of corporate governance focused on risk surveillance and executive compensation. The boards of financial institutions must now have risk committees and there should be designated risk officers responsible for the risk trail. France has also taken measures to link variable executive compensation to risk factors in accordance with the FSB Principles for Sound Compensation (Maffei & Maffei, 2010).

In December 2010, the French crisis inquiry commission headed by socialist Henri Emmanuelli called for an end to the 'casino economy'. Its recommendations were seen as much more severe than the US Dodd–Frank Act but may not ultimately become law (Lubin, 2010).

In Germany, the first prominent victim of the crisis was IKB Deutsche Industriebank (IKB) which was rescued by the German banking associations, and partly sold to a private equity firm, Lone Star. The CEO of IKB was prosecuted for having misled the company's shareholders by pretending there was no liquidity problem shortly before IKB went insolvent. The case has raised questions about the level of understanding that should be expected of management board members in relation to the ever-increasing number of complex financial products developed by specialist employees. The question will ultimately have to be resolved, because at present:

> Under the German corporate governance regime, the supervisory board has to review whether the management of a financial institution has violated its duties when letting the institution slip into a fundamental crisis. If the supervisory board fails to bring a lawsuit against the management to recover part of the loss incurred by the bank, it may itself be liable. Many boards of German institutions presently find themselves in the uncomfortable position of having to perform that review and to decide whether to sue the existing or – more likely – former management (Haag & Mueller, 2010: 113).

IKB was the first German company to collapse, with Hypo Real Estate and several public and private banks following its lead. It became clear that the German supervisory authority BaFin did not have enough power to take action against supervisory board members who were incompetent or non-compliant with Germany's banking laws (in Germany most companies have two boards of directors – an executive, management board and a non-executive, supervisory board). The legal response took the form of the *Act on the Strengthening of Financial Market and Insurance Supervision* of 29 July 2009 which requires that members of the supervisory boards of financial institutions pass a 'fit-and-proper' test and limits the number of ex-managers on the supervisory board. Other legal changes focused on executive pay, requiring the supervisory board to link remuneration to both individual and company performance (Haag & Mueller, 2010).

Switzerland also suffered greatly in the crisis because of its position as an international finance centre and the size of its banking system – in 2007 the financial assets of Swiss banks were nearly seven times larger than the country's gross domestic product (GDP) (Pfenninger, 2010: 117). UBS and Credit Suisse Group strongly dominated the sector and UBS was eventually bailed out by the Swiss Government in 2008, with Credit Suisse raising capital from private backers in the Middle East (Schwartz, 2008). A 2009 OECD survey of Switzerland's economy examined the UBS case in detail and identified poor risk management and incentive systems as two of the major failings at the bank:

> … internal risk controls and reporting need to be strengthened by raising the accountability of senior officers and boards of directors, strengthening the independence of the risk management function within the bank, and by reducing reliance on external risk assessments by credit agencies. Equally important is the revision of performance based compensation schemes that have encouraged excessive risk taking (OECD, 2009b: 76).

Since the crisis, Switzerland has consolidated what were its Banking Commission and Insurance and Money Laundering authorities into a single regulatory body, the Financial Market Supervisory Authority (FINMA). Interestingly, this merger was planned long before the crisis and FINMA has a similar role to the UK's Financial Services Authority (FSA). Perhaps as a result of the UBS bail-out, FINMA was one of the first national authorities to take action on implementing the FSF's Principles for Sound Compensation Practices via a compensation circular that came into effect on 1 January 2010 (Pfenninger, 2010: 136).

As every member of the European Union has its own corporate governance regulation it is beyond the scope of this chapter to detail the reforms in every country. However, the crisis has refocused attention on the question of whether there ought to be further harmonisation of member states' corporate governance systems and perhaps introduction of pan-European corporate governance guidelines. The European Corporate Governance Forum was set up at the end of 2004 with the aim of encouraging coordination and convergence of national codes and reviewing the effectiveness of their enforcement. The Forum commissioned a comprehensive study of the effectiveness of the corporate governance framework of every member state, which confirmed that, despite differences in approach due to different legal traditions and ownership structures, the 'comply or explain' principle has become a pan-European mechanism that is generally effective (Riskmetrics, 2009).

Most national codes have some sort of inbuilt review mechanism, and post-crisis amendments were inevitable. For example, the German Code was amended in May 2010 to include recommendations on oversight of remuneration systems and composition of the supervisory board. There was specific encouragement to consider diversity and the selection of women. In France, the French Asset Management Association (AFG) issued the ninth version of its corporate governance recommendations in January 2011.

In June 2010, the European Commission published a green paper on 'Corporate Governance in Financial Institutions and Remuneration Policies' (European Commission, 2010a). The paper identified the corporate governance weaknesses revealed by the crisis as (1) insufficient board oversight, (2) risk management functions lacking in authority and independence and (3) shareholders who both failed to exercise their control over companies and at the same time encouraged risk-taking in order to improve short-term returns:

> Although corporate governance did not directly cause the crisis, the lack of effective control mechanisms contributed to excessive risk-taking on the part of financial institutions. The crisis revealed that boards of directors, like supervisory authorities, rarely comprehended either the nature or scale of the risks they were facing. In many cases, the shareholders did not properly perform their role as owners of the companies (European Commission, 2010b: 2).

The main themes here are risk management and oversight of risk by both boards and shareholders. The paper indicated that the Commission was considering possible action regarding the use of stewardship codes and other measures intended to motivate shareholders to engage with and monitor the financial institutions they invest in (Oulton, 2010). The Commission also indicated that it will initiate a review of corporate governance in listed companies more generally, with a green paper to be released in April 2011 focusing on three areas: boards of directors, shareholder engagement and the 'comply or explain' approach (European Commission, 2011).

As is often the case, the European response has been relatively slow to develop and has tested the ability of members to cooperate. Opinion was divided over the suggestion that the European Commission might introduce EU-wide corporate governance guidelines with the United Kingdom much less amenable to the idea than the rest of Europe (Smith & Tait, 2011). In any event, policies will have to be carefully crafted to mesh with the highly negotiated EU framework of Directives that already exists (Jackson, 2010).

UNITED STATES

It is widely accepted that the financial crisis originated in the US housing and mortgaging markets, with the first signs of its seriousness appearing in 2007. It soon spilled over to the credit markets, causing a liquidity crisis and ultimately the demise of investment banking in the United States and across the globe. Bear Stearns, Fannie Mae and Freddie Mac, Lehman Brothers and AIG all fell to the crisis, with all but Lehman Brothers being rescued by the US Government via a series of emergency schemes, including the Troubled Asset Relief Program (TARP) implemented by the Treasury under the *Emergency Economic Stabilization Act* of 2008 and the *American Recovery and Reinvestment Act* of 2009.

Legislative reform

A more comprehensive regulatory reform agenda for the United States was put forward by the US Treasury in early 2009. The White House website explained the four key elements of the reforms as follows:

1 *Holding Wall Street accountable*. Banks will no longer be permitted to own, invest or sponsor hedge funds, private equity funds or proprietary trading operations for their own profit, unrelated to serving their customers. Also, firms will not be permitted to grow so large that they become 'too big to fail'. Mechanisms will be put in place such that if any firm does fail in future it can be shut down by the government rather than being bailed out.
2 *Protecting consumers*. A single, independent consumer bureau will set and enforce consistent rules for the financial marketplace. This will replace the fragmented supervisory framework that left many mortgage lenders and brokers virtually unregulated.
3 *Closing the gaps in the financial system*. One of the greatest weaknesses in the financial system that led to the crisis was the risk that built up in the 'shadow banking' system where there was explosive growth in financial firms that acted similarly to banks but without the same oversight. One entity is to have the responsibility and authority for supervising the most complicated firms.
4 *Encouraging stable growth*. This comprises clearer accountability, stronger capital buffers, less concentration of risk and greater transparency in the derivatives market and working with the G-20 to promote long-term sustainable growth.

After the initial proposals, there followed a long process of debate that culminated in President Obama signing the *US Financial Reform Bill* on 21 July 2010 (Colvin, 2010). The legislation is entitled the *Wall Street Reform and Consumer Protection Act*, more commonly known as the *Dodd–Frank Act* after the chairmen of Congress who crafted the reforms. The Act is weighty, and even summaries of its provisions reach 200 pages. In addition, just before the bill was signed, Tahyar and her team from the law firm Davis Polk & Wardwell commented on the fact that the detail was yet to come:

> By our count, the bill requires 243 rulemakings and 67 studies. … U.S. financial regulators will enter an intense period of rulemaking over the next 6 to 18 months, and market participants will need to make strategic decisions in an environment of regulatory uncertainty (Tahyar, 2010).

With regard to corporate governance, the Act introduced some significant changes that impact on all public companies, not just the financial sector (Mayer Brown, 2010b). These include:

- 'Say on pay' – the Act introduces a non-binding shareholder vote on executive compensation.
- Increased disclosure on the relationship between executive compensation and the financial performance of the company, including policy on the recovery of incentive-based compensation (compensation 'claw-backs').
- Disclosure of the annual total compensation of the CEO. This must be compared in ratio form to the annual median total compensation of all other company employees.
- Disclosure of whether any employee or director is permitted to hedge any decrease in the market value of company equity securities.
- A requirement that compensation committees be composed entirely of independent directors.
- Disclosures regarding the independence of any compensation consultants employed.

- Disclosure of whether and why a company has chosen to combine or separate the roles of CEO and chairman of the board.
- A requirement that certain banks and financial companies establish risk committees.

Relatively early on in the process, a Congressional research paper commented that 'A large question for Congress may be how US regulations might be changed and how closely any changes are harmonized with international norms and standards' (Nanto, 2009, 2010). Interestingly, the introduction of better compensation practices came under the White Paper's 'Improve International Cooperation' section and was clearly a matter that may not have been included were it not for US involvement in the G-20:

> In line with G-20 commitments, we urge each national authority to put guidelines in place to align compensation with long-term shareholder value and to promote compensation structures that do not provide incentives for excessive risk-taking. We recommend that the BCBS expediently integrate the FSB principles on compensation into its risk management guidance by the end of 2009 (US Treasury, 2009: 85).

It is important to note what the Act does not do. The historical development of the US regulatory structure has resulted in the fragmentation of a complex pattern of competing regulatory authorities. There were calls for wide reform of this overall framework, including:

> … vastly expanding the Federal Reserve's power to oversee the health of the entire financial system, creating a single banking overlord, merging the Securities and Exchange Commission (SEC) with the Commodity Futures Trading Commission (CFTC), and launching a new consumer protection agency (Rucker & Younglai, 2009).

However, as a summary by law firm Mayer Brown (2010a) comments:

> The Dodd–Frank Act largely avoids the issue of comprehensive regulatory restructuring, effectively leaving untouched the existing hodgepodge of federal regulatory authorities, except that it will abolish the Office of Thrift Supervision (OTS), while creating yet another federal financial authority, a new financial consumer regulatory body that will have broad authority over US consumer financial services activities.

Figure 25.2 shows the existing range of supervisory authorities and the proposed changes.

Financial Crisis Inquiry Commission

On 20 May 2009, the *Fraud Enforcement and Recovery Act* 2009 was signed by President Obama and, amongst other things, it approved the creation of a commission of inquiry into the financial crisis. The Commission was given a wide-ranging remit to examine the role of US regulators and the prudential legal framework, along with companies' accounting practices, corporate governance, executive pay schemes and the use of exotic investment tools. Possible fraud, the controversial role of credit risk agencies and short-selling on the markets were also listed in the legislation for investigation. The Commission was modelled on the Pecora Commission which studied the 1929 stock market crash and eventually helped pave the way for the *Securities Act* of 1933, the *Securities Exchange Act* of 1934 and the creation of the Securities and Exchange Commission (SEC) in 1935. Thus, expectations were high in terms of its potential influence on regulatory reform.

The Commission became nicknamed the Angelides Commission, after the chairman, Phil Angelides. Its composition was set by the Act to comprise 10 members, appointed on a bipartisan and bicameral basis. The first public meeting of the Commission was held on 17 September 2009, followed by roundtable discussions in October and November. Public hearings were held throughout 2010: the first was on 13 January 2010, with the presentation of testimony from various banking officials. Subsequently, there were sessions concentrating on a variety of topics:

- February – forum to explore the causes of the financial crisis.

Banks	Insurance	Securities	Commodities	Consumers
Federal Reserve	State Insurance Regulators	Securities and Exchange Commission	Commodities Futures Trading Commission	Consumer Protection Agency
National Credit Union Administrator	National Insurance Office	State Securities Regulators		
~~Office of Thrift Supervision~~		Industry Regulatory Authority		
Federal Deposit Insurance Corp				
~~Office of Comptroller of Currency~~				
Council of Regulators				
National Banking Supervisor				

Figure 25.2 Proposed changes to US supervisory framework

Source adapted from Halime, Casey and Bond, 2009.

- April – subprime lending and securitisation and government-sponsored enterprises.
- May – the shadow banking system.
- June – credit ratings and the financial crisis.
- July – the role of derivatives in the financial crisis.
- September – too big to fail and the impact of the financial crisis.

Each of these inquiry sessions resulted in one or more draft reports and a final report was released in January 2011. The final report was very much a historical account of the causes of the crisis and did not make any policy recommendations or suggestions, thereby avoiding any conflict with the provisions of the *Dodd–Frank Act*. The report was strongly criticised in the media, partly because the commissioners were unable to agree on the conclusions, dividing along party lines, and also because the report was lacking in new information and analysis. Weil comments that the commission was bound to fail because of the fact it was set up by Congress as a bipartisan panel (rather than as a non-partisan investigation directed by seasoned prosecutors, like the Pecora Commission), plus it was given a relatively modest budget and short time-frame to complete its work (Weil, 2011).[4] Nevertheless, the report was well organised, comprehensive, and was generally seen to have long-term value as a record of the crisis.

UNITED KINGDOM

The first major sign of the financial crisis hitting the United Kingdom was the news in September 2007 that the high-street bank Northern Rock required emergency assistance from the Bank of England. This triggered a classic 'bank run', with queues of depositors lining up outside branches asking for their money back, stemmed only by the UK Government's decision to guarantee the bank's deposits. There was then a deceptively quiet period before several other banks had to be sold off or nationalised in the latter half of 2008, including Royal Bank of Scotland (RBS), and Halifax Bank of Scotland (HBOS) (McCormick, 2010: 56).

Turner review

In October 2008, when the scale of the crisis became apparent, the Chancellor of the Exchequer asked Lord Turner, in his capacity as Chairman of the Financial Services Authority (FSA), to explore the causes of the crisis and to make recommendations on regulatory and supervisory changes that could make the banking system more robust for the future. In March 2009, the FSA published the 'Turner Review of global banking regulation' together with a Discussion Paper that explored some of the key policy issues. Most of the report discussed necessary changes to bank capital and liquidity regulations and to bank published accounts. Of relevance, more generally, were the recommendations regarding:

- increased reporting requirements for unregulated financial institutions such as hedge funds;
- regulation of credit rating agencies to limit conflicts of interest and inappropriate application of rating techniques;
- national and international action to ensure that remuneration policies are designed to discourage excessive risk-taking; and
- major changes in the FSA's supervisory approach, with a focus on business strategies and system-wide risks, rather than internal processes and structures.

Relevant to corporate governance, the Turner Review identified many cases where internal risk management in financial institutions was ineffective, with boards of directors failing to adequately identify and constrain excessive risk-taking. Recommendations to combat these failings included:

- a more direct relationship between senior risk management and board risk committees;
- remuneration policies to take account of risk management considerations;
- improvements in the skill level and time commitment of non-executive directors; and
- more effective communication of shareholder views to non-executives.

The Turner Review did not probe these governance issues in depth because, in February 2009, the UK Government announced a review of bank governance led by Sir David Walker, and the FSA intended to take this review into account before issuing any specific proposals.

Walker review

In February 2009, Sir David Walker was asked by the Prime Minister to review corporate governance in UK banks in light of the financial crisis. In particular, he was asked to examine the four areas identified internationally as areas of corporate governance weakness contributing to the crisis, namely: risk management at board level; the links between remuneration and risk; board composition and performance; and shareholder engagement (Walker, 2009: 5). Preliminary conclusions were published in July in the form of a consultation paper and final recommendations released in November 2009.

The final recommendations of Walker's 'Review of Corporate Governance in UK Banks and Other Financial Industry Entities' were set out under five headings:

- board size, composition and qualification;
- functioning of the board and evaluation of performance;
- the role of institutional shareholders: communication and engagement;
- governance of risk; and
- remuneration.

There were recommendations aimed at improving the skills of non-executive directors through professional development to ensure that they are 'ready able and encouraged to challenge and test proposals on strategy put forward by the executive' (Walker, 2009: 15). The report acknowledged the pivotal role of the chairman of the board and suggested that chairmen be put forward for election on an annual basis. The Review also strongly recommended regular board evaluations and better disclosure to investors regarding such evaluation:

> The evaluation statement on board performance and governance should confirm that a rigorous evaluation process has been undertaken and describe the process for identifying the skills and experience required to address and challenge adequately key risks and decisions that confront, or may confront, the board. The statement should provide such meaningful, high-level information as the board considers necessary to assist shareholders' understanding of the main features of the process, including an indication of the extent to which issues raised in the course of the evaluation have been addressed. It should also provide an indication of the nature and extent of communication with major shareholders and confirmation that the board were fully apprised of views indicated by shareholders in the course of such dialogue (Walker, 2009).

The issue of providing meaningful disclosure, rather than a standard-form corporate governance statement, is not new. My own research suggests that investors place very little value on annual reports, preferring to assess board performance through direct communications with directors and, failing that, by looking at past board decisions and director profiles (Clarke and Klettner, 2010). In an interesting attempt to overcome the problem of 'boiler-plate' corporate governance statements, the Walker Review suggested that chairmen be encouraged by the regulator to write personal statements about board performance in annual reports:

> The board should undertake a formal and rigorous evaluation of its performance, and that of committees of the board, with external facilitation of the process every second or third year. The evaluation statement should either be included as a dedicated section of the chairman's statement or as a separate section of the annual report, signed by the chairman. Where an external facilitator is used, this should be indicated in the statement, together with their name and a clear indication of any other business relationships with the company and that the board is satisfied that any potential conflict given such other business relationship has been appropriately managed (Walker, 2009: 16).

With regard to risk management, the Walker Review suggested that boards should have risk committees separate to their audit committees, served by a chief risk officer who is independent from individual business units within the firm. It was also recommended that a dedicated risk report be provided to investors in the annual report.

On the much discussed issue of remuneration, the report suggested some changes to the FSA's remuneration code in terms of enhanced disclosure. It also strengthened the 'say on pay' vote by suggesting that if the vote on the remuneration report received less than 75% support, the chair of the remuneration committee should stand for re-election.

The last major recommendation of the Walker Review was that a formal Stewardship Code for institutional investors should be implemented by the FRC to improve shareholder engagement. This is discussed in more detail below.

FSA Code on Remuneration

Action by the FSA on the issue of remuneration commenced with a letter dated 13 October 2008 from the FSA to the CEOs of major financial institutions. This letter set out the FSA's concerns on remuneration policies and put forward some basic criteria for good and bad remuneration practice. The message was to encourage financial institutions to eliminate anything in the 'bad' list and move towards the practices included in the 'good' list. The letter was followed by a review of remuneration practices in a group of major banks and building societies.

In February 2009, the FSA published a draft Code on Remuneration Practices. The Code was designed to apply to large banks and broker-dealers but the FSA encouraged all firms to review their compensation policies in accordance with the Code. The Code was finalised in August 2009 and came into effect on 1 January 2010 as part of the FSA Handbook. Its application was narrowed so it only applies directly to 26 firms and it is less prescriptive regarding bonuses than originally proposed.

The general requirement of the Code is that 'remuneration policies must be consistent with effective risk management.' In order to demonstrate compliance with this general requirement, it is recommended that firms show that they have adopted the Code's 10 principles, which cover: the independence and skill of remuneration committees; procedures for setting remuneration with significant input from the risk management function; and risk-adjusted long-term performance measurement.

UK Corporate Governance Code

The Financial Reporting Council is the UK's independent regulator in the area of corporate governance. It monitors the operation of the Combined Code on Corporate Governance and, in March 2009, announced that the Combined Code would be subject to review. The FRC's review of the Combined Code was conducted in parallel with the Walker Review of Bank Governance, and the two were committed to share relevant research and other evidence.

As a result, a revised version of the UK Combined Code, now named the UK Corporate Governance Code, was published in May 2010. Many of the changes to the Code were specifically directed towards improving board effectiveness and performance. These changes are summarised as follows, together with their main aims:

- To encourage boards to be well balanced and avoid 'group think', there are new principles on the composition and selection of the board, including the need to appoint members on merit, against objective criteria, and with due regard for the benefits of diversity, including gender diversity.
- To promote proper debate in the boardroom, there are new principles on the leadership of the chairman, the responsibility of the non-executive directors to provide constructive challenge, and the time commitment expected of all directors.
- To help enhance the board's performance and awareness of its strengths and weaknesses, the chairman should hold regular development reviews with each director and board evaluation reviews in FTSE 350 companies should be externally facilitated at least every three years (FRC, 2010).

The new Code emphasises the need to follow the spirit, not only the letter of the Code. Chairmen are encouraged to report personally in their annual statements on how they have implemented the principles on the role and effectiveness of the board. The preface to the Code explains:

> Above all, the personal reporting on governance by chairmen as the leaders of boards might be a turning point in attacking the fungus of ''boiler-plate'' which is so often the preferred and easy option in sensitive areas but which is dead communication (FRC, 2010).

One of the major changes introduced is a requirement for directors of FTSE 350 companies to be re-elected every year. This is likely to make individual performance evaluation of directors more commonplace and hopefully more rigorous.

The revisions to the Code make clear the board's responsibility to define the company's risk appetite and tolerance. Also there are changes that stress the importance of ensuring executive remuneration is linked to long-term performance. In March 2011 the FRC published additional guidance on board effectiveness designed to assist companies in applying the Code. It emphasises the need to focus on behaviour rather than process:

> Boards need to think deeply about the way in which they carry out their role and the behaviours that they display, not just about the structures and processes that they put in place (FRC, 2011: 1)

Stewardship Code

Another interesting development stemming from the Walker Review was the introduction, in July 2010, of a UK Stewardship Code for investors which aims to enhance the quality of engagement between companies and institutional investors (FRC, 2010). The Code is intended to complement the UK Corporate Governance Code and, like the Corporate Governance Code, is designed to be applied on a 'comply or explain' basis. The Code comprises seven key principles, encouraging investors to monitor their investee companies and disclose their policy on discharging their stewardship responsibilities (including voting policy and guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value). Investors are encouraged to publish, on their websites, statements that explain the extent to which they have complied with the Code. The FRC website contains a list of all investors that have done this, together with links to their statements.

The reasoning behind the Code is the belief that institutional shareholders may have contributed to the crisis by being too short term in their investment policies. Fund managers, concerned with their own quarterly or annual numbers, contributed to the short-term, risk-indifferent behaviour of corporate managers. A second belief is that institutional shareholders failed to monitor their investments actively enough and, if they had done, they may have been better placed to prevent or mitigate the behaviour that led to the crisis. The Code, however, tends to focus on the second issue. It does not, for example, ask investors to make disclosures on investment philosophy or fund manager compensation (Heineman, 2010).

To some extent, the Code also ignores the realities of modern investing where ownership of shares is often fleeting and part of a diversified portfolio, the management of which may be outsourced. It seems the question that needs to be asked is whether we are on the wrong track in trying to encourage a stewardship role that no longer exists in its traditional form. Certainly it will be interesting to see how the Stewardship Code, the first of its kind worldwide, plays out and whether it throws further light on the monitoring role of institutional investors. The FRC has acknowledged that the Code will require further review and is investigating whether it ought to include disclosures on, for example, stock lending and voting of pooled funds.

Ultimately, it is the ordinary person on the street who wants his or her pension fund to do well but who has relatively little idea of how the money is being invested. The Walker Report stressed that 'there should be clear disclosure of the fund manager's business model, so that the beneficial shareholder is able to make an informed choice when placing a fund management mandate'.

Overall supervisory framework

Moving away from the narrow view of corporate governance reform, the overall supervisory framework, particularly for financial services, has been under review in the UK, and developments demonstrate the inevitable force of politics in regulatory reform (Hall, 2009). In July 2009, the UK's then Labour Government released a long-awaited, big-picture White Paper on financial regulation. The paper described the steps already taken by the government towards better regulation:

- the new Banking Act 2009, which gave the Bank of England powers to deal with failing banks;
- the Turner Review of global banking regulation;
- the Walker Review of corporate governance in UK banks;
- reform of the overall regulatory framework by giving the Bank of England a clear statutory objective to protect the stability of the financial system and supporting the FSA's internal reorganisation.

The White Paper went on to describe proposals for further reform. These included providing the FSA with a formal, statutory objective for financial stability and extending its rule-making and enforcement powers.

What Labour's paper did not do, to the disappointment of many, was to recommend a more radical shake up of the UK's tripartite supervisory framework.

The tripartite system involves a sharing of regulatory duties between the Treasury, the Financial Services Authority and the Bank of England. Regulatory and supervisory functions for all sectors, including both prudential and conduct-of-business issues, are combined in the FSA, while the Bank has overall responsibility for financial stability. However, each of the three bodies were accused of failing to do their job properly and communication between them was reportedly poor (Conway, 2009).

In a speech on 17 June 2009, the Governor of the Bank of England, Mervyn King, sparked a row between himself and the Chancellor, Alistair Darling. He stated in fairly blunt terms that the Bank had been given responsibility for keeping the financial system in good health but without the powers to actually do the job. Despite this criticism, Labour's White Paper failed to recommend significant changes, only going so far as to propose a new Council for Financial Stability to assist in bringing together the work of the three organisations and to oversee overall systemic risk. In Parliament, the Shadow Chancellor described the proposals as 'more of a white flag than a white paper' (Reuters, 2009).

A few weeks later, the shadow government released its own White Paper on financial regulation, setting out the Conservatives' plans if elected to government. They would abolish the FSA and the tripartite system and create bodies within the Bank of England responsible for macro- and micro-prudential regulation. The Conservatives did win the UK 2010 election by forming a coalition with the Liberals and, in July 2010, their proposed reforms were released for consultation. The Coalition Government intended to introduce legislation to implement its proposals in mid 2011, with the passage of legislation expected to take around a year. The new regulatory framework is anticipated to be in place by the end of 2012 and, as shown in Figure 25.3, will involve disbanding the FSA and creating:

- a new macro-prudential regulator, the Financial Policy Committee (FPC), established within the Bank of England;

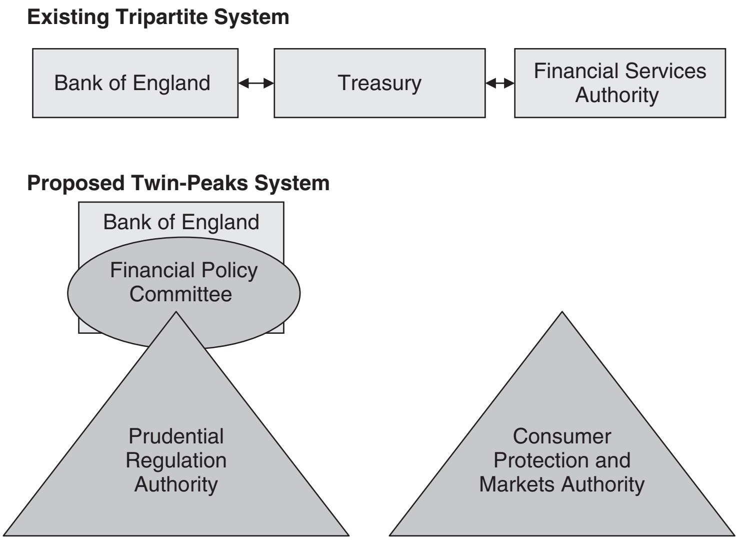

Figure 25.3 UK supervisory framework

- a new prudential regulator, the Prudential Regulation Authority (PRA), established as a subsidiary of the Bank; and
- a new conduct-of-business regulator, provisionally entitled the consumer protection and markets authority (CPMA) (UK Treasury, 2010).

Mervyn King (2010), clearly more happy about these arrangements, explained the proposals as two different but complementary perspectives: a bottom-up perspective, focused on setting institution-specific capital requirements, and an overall perspective with a set of system-wide capital requirements that vary over the economic cycle. He supported the separation of prudential regulation and consumer protection, explaining that the two require different skills and a different approach. Stripping the FSA of its prudential regulatory role will bring the UK system closer to the 'twin peaks' model of Australia, discussed below (Bates, 2010).

The House of Commons Treasury Committee initiated an inquiry into the proposals and published its findings on 3 February 2011. The main concern of the Committee was that new legislation should not be rushed and that the aim of introducing the new legislation mid 2011 might be too ambitious. The UK financial sector is estimated to have contributed about 10% of GDP in 2009 and employed just under a million people in June 2010 (UK Treasury, 2011). On this basis, the Committee considered any changes should be reviewed as a matter of priority and the costs of any new regulation be thoroughly investigated to avoid any unintended damage to the sector. Lastly, the Committee considered the report of the UK Banking Commission (see below) would be important in designing the new regulatory architecture.

UK Banking Commission

In addition to the regulatory reform proposals, in June 2010, the new Coalition Government launched an independent Banking Commission to examine the overall structure of the UK banking system. The terms of reference stated that the Commission was to, 'consider the structure of the UK banking sector, and look at structural and non-structural measures to reform the banking system and promote competition'.[5] The focus of the Commission was to be on reducing systemic risk, mitigating moral hazard and reducing the likelihood of firm failure. The Commission was made up of five, high-profile individuals including the chair, Sir John Vickers, former Bank chief economist. Commentary on the Commission has focused on their likely views on structural change:

> Much of the speculation surrounding the commission has focused on which way its members are likely to be inclined on the issue of the break-up of UK-based universal banks such as Barclays and HSBC, which both operate large, highly-profitable investment arms (Wilson, 2010).

Lord Myners, city minister in the last government, has urged the Commission to focus on boosting competition and to give consideration to splitting up one or both of Lloyds Banking group and Royal Bank of Scotland. His views are said to echo a growing belief that the Commission will focus more on the issue of high-street competition than the complex structural question of whether retail and investment banks, 'casino banks', should be allowed to remain under one roof as so-called universal banks (Jenkins, 2010).

AUSTRALIA

Australia's economy weathered the crisis somewhat better than other industrial countries, with all four major banks retaining an AA credit rating. There were a number of reasons for this, including the banks' experiences with earlier overseas adventures, their absorption in the resources boom in Australia and close prudential regulation by the Australian Prudential Regulation Authority (APRA). Since the Wallis Inquiry in 1996, Australia has followed a 'twin peaks' regulatory policy with APRA responsible for prudential regulation of the banks and the Australian Securities and Investments Commission (ASIC) responsible for corporate and market regulation (D'Aloisio, 2009).

However, gaps in this regulatory shield were exposed when Allco Finance, Babcock and Brown, ABC Learning, Opes Prime and a host of other finance and property companies collapsed as they were not subject to prudential regulation by APRA. Although these companies were regulated by ASIC, it was believed that, in non-prudential companies disclosure and transparency would permit the market to enforce proper conduct, so ASIC was not equipped to enforce capital adequacy or to regulate business models. In other words, the trouble arose in the grey area between Australia's two peaks.

In terms of corporate governance reforms, Australia has focused the bulk of its activity on the area of executive remuneration. APRA was asked to explore the issue of executive remuneration and excessive risk-taking in October 2008 and, after two rounds of consultation, changes to APRA's governance standards were put forward in November 2009, which came into effect in April 2010. The new standards were based on the FSF's Principles for Sound Compensation Practices. In addition, legislation came into force in November 2009 which reduced the cap on termination payments from seven times a recipient's total annual remuneration to one year's average base pay (this cap to be exceeded only where shareholder approval is obtained).

In March 2009, the Productivity Commission was asked by the Federal Government to undertake an inquiry into the current Australian regulatory framework surrounding remuneration of directors and executives. This request was triggered by the growing recognition internationally that remuneration practices were a contributing factor to the financial crisis.

> Unrestrained greed in the financial sector has led to the biggest global recession since World War II. It has now spread across the world and instigated significant slowdowns in the US, Europe, China and caused more than 50 banks to collapse and millions of jobs to be lost. There is significant community concern about excessive pay practices, particularly at a time when many Australian families are being hit by the global recession (Swan, 2009).

The Commission's main recommendations (released in January 2010) were that ASX 300 companies should be required to have a remuneration committee composed of at least three non-executive directors, including an independent chair and majority of independent members. Also, that executives should be prohibited from voting their shares in relation to the remuneration report and any related resolutions. The Commission accepted concerns that remuneration reports were becoming increasingly complex and suggested they should include a plain English summary and actual levels of remuneration received (rather than the accounting cost to the company). Lastly, the Commission put forward some interesting proposals to increase the bite of the non-binding shareholder vote on the remuneration report.

Australia introduced a 'say on pay' vote for shareholders in 2004–2005 broadly following UK arrangements introduced in 2002. Although non-binding, the vote enables shareholders to signal their support or disapproval of the remuneration policy of a company. The reasoning is that, although companies are not legally required to respond to a substantial vote against their remuneration policy, most organisations will be sensitive to shareholder opinion and will make changes. Also, the vote is seen to improve engagement between companies and shareholders prior to the annual general meeting (AGM), as companies attempt to gather support and pre-empt any problems by explaining their policies. Nevertheless, there were some examples of companies receiving consecutive 'no' votes at their AGMs and appearing to be resistant to change. The question of whether to make the shareholder vote binding on companies was considered at length by the Productivity Commission. The Commission's answer was a proposal for a 'two strike' mechanism whereby two consecutive 'no' votes (each above 25%) would trigger a resolution putting the entire board of directors up for re-election. The Government supported this proposal and legislation was introduced into Parliament in February 2011, with its reforms intended to take effect from 1 July 2011.

The Australian Government also put forward a proposal (not included in the Productivity Commission's report) for the 'clawback' of executive remuneration in the event that a company's financial statements are found to be materially misstated. A consultation paper was released by the Treasury in December 2010.

Outside of the topic of executive remuneration, the Australian Government asked the independent Corporations and Markets Advisory Committee (CAMAC) to investigate several aspects of corporate governance, some more directly related to the financial crisis than others, but all relevant to the reform of regulation.

First, in September 2008, CAMAC was asked to look at the issue of diversity on boards of directors, particularly the participation of women. Shortly afterwards, on 19 November 2008, CAMAC was asked to provide advice in relation to the effect of various market practices on the integrity of the Australian financial market. The Minister's letter to CAMAC stated that '[a]s a result of the global financial crisis and the related turbulence in Australian financial markets, the effect on the market of a number of practices has given rise to a significant degree of concern in the business, and broader, community.' CAMAC published its final report 'Aspects of Market Integrity' in July 2009. The report dealt with the following issues:

- directors entering into margin loans over shares in their company;
- trading by company directors in 'blackout' periods;
- spreading false or misleading information; and
- corporate briefing of analysts.

It recommended the implementation of clearance processes and restrictions on dealings by corporate officers by way of governance requirements set by the ASX Corporate Governance Council or in the ASX Listing Rules. Although CAMAC acknowledged the risk at private briefings of 'inadvertent selective disclosure of confidential price-sensitive information' it was agreed that these briefings provide a 'useful and probably necessary supplement to [companies'] formal disclosures' and therefore ought not be banned. Instead, CAMAC recommended that companies keep better records of briefings and use technology such as webcasts to disseminate the information more widely. These points have been incorporated into the suggested amendments to the ASX Principles (ASX, 2010).

Lastly, in August 2009, the Government asked CAMAC to review whether there ought to be more guidance for non-executive directors in Australia, in particular:

> whether the performance of directors would be enhanced by the introduction of guidance for directors, for example through a code of conduct or best practice guidance, by a relevant regulator; and if so what form that guidance should take (CAMAC, 2010: 85)

The financial crisis was not the only trigger for the review – in 2009 the Australian courts saw several cases examining the role and performance of directors which highlighted the lack of guidance in a legal sense.[6] Nevertheless, CAMAC's report, published at the end of April 2010, concluded that there was a significant amount of guidance already available to directors, even if not entrenched in law, and concluded:

> The Committee does not consider that the performance of directors would be enhanced by the introduction by a regulator of further guidance in the form of a new code of conduct or best practice guidance (2010: 79)

The report appeared to gain support for this conclusion from the OECD's decision not to amend the OECD Corporate Governance Principles. Nevertheless, CAMAC agreed that further attention should be diverted to the behavioural aspects of director performance and effectiveness by empowering directors to be more active, perhaps through professional development.

Review of ASX Principles

The ASX Principles of Corporate Governance apply to all companies listed on the Australian Stock Exchange via a 'comply or explain' mechanism, much like the UK Corporate Governance Code. They were reviewed end 2009/early 2010 and amendments to the Principles were announced on 30 June 2010. The amendments were designed to take into account the findings of three of the inquiries already mentioned: CAMAC's report, 'Diversity on Boards of Directors', March 2009; CAMAC's report, 'Aspect's of Market Integrity', June 2009; and the Productivity Commission's report, 'Executive Remuneration in Australia', January 2010. Thus, the amendments deal with diversity, remuneration, trading policies and investor briefings.

It is now recommended that all listed companies establish a diversity policy comprising measurable objectives, and disclose their progress in achieving these objectives. The expanded commentary on board diversity makes it clear that nomination committees ought to consider the issue of diversity in their succession planning, regularly review the proportion of women employed at all levels of the company and make recommendations to the board to address board diversity. Female directors make up at least 20 per cent of most boards in Australia, but not the boards of the top 200 companies on the ASX, where they account for just 8.7 per cent of directors (AICD, 2010). Boards are encouraged to disclose more information about their processes for selection of new members, including whether skills matrices are used. In terms of remuneration reforms, the ASX Principles now recommend that the remuneration committee is made up of a majority of independent directors.

CONCLUSION

The US Financial Crisis Inquiry Commission Report comes close to the central dilemma faced by regulators, 'to pin this crisis on mortal flaws like greed and hubris would be simplistic. It was the failure to account for human weakness that is relevant to this crisis' (2011: xxiii). Thus, although it is always true that it is impossible to legislate away crime and misbehaviour, there are ways and means of assessing and preparing for the risks that are posed.

As with most regulation, the emerging regulatory response to the global financial crisis can be thought of as a hierarchy of layers. At the top, international guidelines are being reviewed and updated and new initiatives such as the FSF's Principles for Sound Compensation Practices have been developed. These will influence and guide nations in the redesign of their domestic laws and regulations.

It is interesting to see the close parallels in the development of regulatory reforms across different countries, both in terms of implementing change and maintaining the status quo. In most countries, questions have been raised as to the overall supervisory framework for prudential organisations, financial services and large corporations. The fragmentation of supervisory bodies in the United States and the United Kingdom led to regulatory vacuums where unregulated firms were left to run wild. Despite calls for amalgamation in the United States, it seems that a multitude of supervisory bodies will remain, albeit with clearer mandates and some filling of gaps. Kregal discusses the history of the fragmentation of US financial supervision and explains that the reluctance to consolidate and extend regulatory mandates may be a consequence of the fact that:

> the history of financial regulation in the United States suggests that this would simply be a repeat of the reactions, by legislators and regulators, to two previous financial crises, neither of which proved durable or capable of providing financial stability (2010: 62).

The change of government in the United Kingdom has demonstrated that it can require political competition to change these high-level institutional frameworks. If the United Kingdom had not had a general election when it did, there would be no plans to change its tripartite system. As it is, the United Kingdom is likely to move towards a 'twin peaks' structure akin to that found in Australia and the Netherlands. These systems are seen as being some of the best regulatory regimes in the world, but still have their weaknesses (G30, 2008). Australia is facing the question of whether product-based regulation might leave less gaps than its current institution-based regulation (APRA's mandate covers only institutions defined as authorised deposit-taking institutions, general and life insurers and superannuation funds). As Kregal explains, leading up to the crisis there was 'no longer any precise relation between financial institutions and functions' – banks were carrying out both commercial and investment banking as were hedge funds and private equity firms. Thus, the question is not simply whether banking regulation should be unified or segmented, but how it should be segmented. At the time of writing, we still await the conclusions of the UK's Banking Commission on these issues. Overall, however, it seems that the significance of the crisis is unlikely to be reflected in the significance of reforms. It is hard to ascertain whether this is due to a lack of political drive for change or a genuine belief that the existing regulatory architecture was not at fault.

This chapter has aimed to focus on corporate governance, which was but one of many complicated and overlapping forces that contributed to the financial crisis. Nevertheless, isolating corporate governance is a valuable task, relevant to the corporate community in its broadest sense and not only the financial sector. The issues facing the overall regulatory system, and the prudential reforms ultimately put in place, will impact on how and who implements any corporate governance reforms but should not alter their substance.[7] The laws, rules and codes of most nations (certainly those based on the Anglo-American system) have been reviewed and amended with the aim of strengthening the weaknesses identified by the crisis. Reform has focused on four areas: executive compensation, board effectiveness, risk management and shareholder engagement. Table 25.1 summarises the reforms in each of the three countries examined in this chapter. In the United Kingdom, the focus was on board performance and shareholder engagement, whereas the United States has finally made moves to make remuneration systems more transparent (the United Kingdom led the way on this with the Greenbury Report of 1995 and Australia followed with legislative changes in 2004). In Australia, the financial crisis has led to some small but bold moves in strengthening diversity on boards and giving shareholders more power in relation to executive pay.

As Jennifer Hill has commented, it is executive pay that has become the Zeitgeist of the global financial crisis, with reform underway in jurisdictions across the world (2010). High salaries and incentive payments have been paid to corporate executives for many years and the disconnect between pay and performance has been queried with growing urgency. The issue was raised following the spate of corporate collapses in 2000–2001 but at that time regulatory reform focused on audit procedures and, although there were moves towards increased disclosure of remuneration information, there was no great change in corporate policies. Perhaps it is simply that it has taken a crisis of this magnitude to push the agenda to the next level. Nevertheless, progress is likely to be slow

Table 25.1 Corporate governance reforms: international comparison

	United States	*United Kingdom*	*Australia*
Remuneration	• Non-binding shareholder vote • Closer links to performance • Compensation 'clawback' • More disclosure of dollar amounts • Independent remuneration committees • Independent remuneration consultants	• Remuneration policies to be compatible with risk policies • Companies to consider 'clawback'	• Independent remuneration committees • Two strikes and out vote • Compensation 'clawback'
Risk management	• Risk committees	• Explanation of business model	
Board performance	• Justification of combined chair/CEO	• Triennial board evaluation by independent consultant • Individual director development reviews • Personal chairman statements • Leadership role of chair • Constructive challenge by non-executives • Expected time commitments • Selection processes and board composition	• Disclosure of diversity policy • Increased disclosure of board member selection processes including use of skills matrices
Shareholder engagement	• Non-binding vote on remuneration	• Stewardship Code • More engagement with non-executive directors	• Two strikes and out remuneration vote

and difficult to monitor. As the Australian Productivity Commission pointed out, remuneration reports can be complex and largely impenetrable to the average shareholder. The recommendations to incorporate risk factors and improve links to long-term value creation could complicate disclosures even further. Important in this context, is the role of the gatekeepers: the accountants, lawyers and rating agencies whose advice and assessment determine how well corporate governance regulation is implemented in practice (Coffee, 2006). Auditors were the focus of post-Enron reforms and this time around it has been the rating agencies and hedge funds that have been criticised. Remuneration consultants are likely to gain work post-crisis but will have to be careful to maintain independence from their clients.

An issue that has received almost as much attention as remuneration is the performance (or lack of performance) of boards of directors. The mysteries surrounding how boards of directors function in practice and how and why some boards are more effective than others are only recently being explored by researchers. Corporate governance codes have been revised post-crisis to enhance the guidance and recommendations on board roles, composition, skill set, renewal, succession planning and performance evaluation. There have been renewed attempts to define the responsibilities of the board, particularly in relation to overseeing risk appetite and remuneration schemes and providing constructive challenge. Awareness has been raised of the importance of ensuring that the board as a whole has the skills and information necessary to both monitor and advise the management team.

Chapter 13 discusses the now widely recommended practice of board performance evaluation. With the UK now recommending externally facilitated evaluations every three years, plus annual re-election of all directors, board members will be placed under ever-increasing scrutiny. Or will they? All of these requirements are effectively voluntary and disclosure regarding their implementation may continue to be minimal. The OECD has acknowledged the difficulty in regulating to improve board performance. Although my own research has revealed the importance of good structure and process, there still seems to be a certain amount of magic involved in achieving the optimal conditions for good decision making (Klettner, Clarke & Adams, 2010). Information flow is of course essential if a board is to have any chance of having a positive influence, as are the skills and experience necessary to fully understand the implications of that information. The factors that lead to the fostering of trust, mutual respect, honesty and constructive debate are much harder to pin down.

As my research with the Australian Council of Superannuation Investors has indicated, most boards have spent some time post-crisis, reviewing how their company has fared, how their risk management systems coped and where improvements might be made (Clarke & Klettner, 2010). This is corporate governance reform at the micro level, which will happen in good companies with well-performing boards. Our findings support Yong's prediction that:

> Post global financial crisis, many corporations will need to re-visit their strategic risks management process. This involves re-configuring the business model, reviewing the corporate structure and needing to have a less aggressive business model (2009: 160).

Legislative amendments continued to unfold through 2010–2011, and it will be many years before we can judge their effectiveness. Regulatory reforms have to continually respond to changing contexts and threats, and it remains difficult to anticipate the causes of the next major financial and corporate governance crisis. Whether regulation may be developed to prepare for the next cycle of crisis and reform, rather than simply respond to the last cycle, remains an open question.

NOTES

1 The FSF was set up by the G-7 in 1999 to bring together senior representatives of national financial authorities from 12 countries, international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank. Its membership was ultimately expanded to include all of the G-20 members.

2 The three reports are available at: http://www.oecd.org/document/48/0,3343,en_2649_34813_42192368_1_1_1_37439,00.html

3 Also, on 27 December 2010, the Basel Committee on Banking Supervision released for consultation their Pillar 3 disclosure requirements for remuneration which take into account the FSB's Principles for Sound Compensation.

4 Discussion of potential alternative structures for the Commission can be found in Glassman ME and Straus JR (2010) Proposals for a Congressional Commission on the Financial Crisis: A Comparative Analysis. In Scott HJ (ed.) *Global Financial Crisis.* New York: Nova Science Publishers.

5 Terms of reference available at: http://www.hm-treasury.gov.uk/d/banking_commission_terms_of_reference.pdf

6 For example *ASIC v Macdonald (No 11)* [2009] NSWSC 287 and *ASIC v Rich* [2009] NSWSC 1229.

7 Marion Williams (2010) gives a very useful summary of the numerous international organisations overseeing financial regulation.

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26

International Corporate Responsibility

Paul Redmond

In 2008 the United Nations Human Rights Council unanimously adopted the framework for business and human rights that had been proposed by the Secretary-General's Special Representative on that subject. The framework comprises three core interlocking principles: the duty upon states to protect against human rights abuses by third parties, including business corporations; the corporate responsibility to respect human rights; and the need for more effective access to remedies. This 'Protect, Respect and Remedy' framework is but the most recent in a series of initiatives by the United Nations to identify standards of corporate responsibility for global business. It builds upon private initiatives to design voluntary schemes for social and environmental responsibility in global business. This chapter is concerned with the network of civil regulation of global business that has emerged since the 1980s.

The international human rights system is the principal international legal mechanism regulating the negative social impacts of business activity. Human rights treaties are agreed internationally but implemented nationally: effective regulation depends on state rather than international implementation and enforcement. Globalisation challenges this state-based system. Business has become increasingly global under production systems that transcend state borders and this global reach has weakened the capacity of (and incentives for) states to regulate multinational business. Responding to this governance gap, firms, civil society and states, singly and in myriad collaborations, have created a complex web of civil regulation moderating the power of firms and markets and asserting the interests and values of affected communities. The United Nations' initiatives with respect to business and human rights complement this private regulation. Taken together, these elements represent a new model for global corporate governance whose integration with national corporate governance models is far from complete. This chapter surveys these developments in corporate responsibility standards and assesses the adequacy of these responses to governance deficits evident at the global level.

The chapter commences with foundational elements that set the context: the international character of modern business under globalisation, the application of the international regulatory regime for human rights protection to corporations, and the deficits in this protection (Section 1: Globalisation and Human Rights). Section 2 (Corporate Social Responsibility) surveys voluntary measures developed by business, civil society and government for firms to assure responsibility for their social and environmental impacts. Section 3 (Business Standard-Setting within the International Human Rights Framework) examines the United Nations 'Protect, Respect and Remedy' framework, particularly the corporate responsibility to respect human rights. Section 4 (Assuring Corporate Responsibility in Global Business: Regulatory Options) assesses the civil regulation and human rights networks as governance systems for responsible global business in the light of other regulatory options.

GLOBALISATION AND HUMAN RIGHTS

Corporations within the international human rights system

There has been a quiet revolution since World War II in the development of international human rights: that is, rights recognised by international organisations such as the United Nations or governments as deserving international protection as human rights. Human rights express universal entitlements to respect and dignity arising from our common humanity. The bedrock of these rights is the Universal Declaration of Human Rights (Universal Declaration), adopted by the General Assembly of the United Nations in 1948. The Universal Declaration expresses fundamental rights and freedoms and 'embodies the moral code, political consensus and legal synthesis of human rights' (ICISS, 2001: 2.16). Two broad streams of human rights are recognised in the Universal Declaration. One stream, further elaborated in the International Covenant on Civil and Political Rights (ICCPR), protects individual civil and political rights such as the right to life and liberty, freedom of association and of thought, conscience and religion, and protects against egregious harms such as torture and slavery. The second, further expressed in the International Covenant on Economic, Social and Cultural Rights, protects freedoms in the economic and social sphere, including conditions of work, the right to form and join trade unions, and the protection of children against exploitation. This covenant also expresses economic and social rights with a more collective dimension, such as the right to an adequate standard of living and rights to adequate food, housing, health, education and development. Although human rights are declared universal, indivisible and interdependent, there is inevitably a tension, ideologically rooted, between these two streams (Mutua, 2001: 217). The general prioritising of the ICCPR by Western democracies may be explicable in terms of its ancestry linkages to two landmark 18th-century statements of rights – the United States Bill of Rights and the French Declaration of the Rights of Man and the Citizen (Alston, 2009). There are additional, more specific, international and regional human rights instruments.

Human rights form part of international law – the law of nations. International instruments creating human rights are addressed to states on the ground, in the aftermath of World War II, that the state's monopoly of coercive power made it the principal threat to human rights, and in fidelity to the traditional conception of international law as the creation of states and the expression of their sovereignty (Oppenheim, 1920: 18–19). Unlike states, corporations do not possess international legal personality and may not therefore be a party to international human rights instruments Business corporations are, however, bound by those rules of international law that are directly applicable to natural persons, although these are for grave crimes only such as genocide, torture, slavery and forced labour, crimes against humanity and extra-judicial murder (Ratner, 2001: 466–467). Otherwise, international law does not apply directly to corporations and it is only in a few exceptional and limited circumstances that international human rights instruments apply directly to corporations and other firms (Ruggie, 2006: [60]). There is, however, no conceptual or technical barrier to international instruments imposing direct obligations on firms (Ruggie, 2006: 65). State preference remains for implementation and enforcement of international instruments at the national level, despite difficulties in respect of global actors. There is no international court or tribunal to adjudicate claims against firms for breach of human rights and few informal means such as might be invoked against states under the United Nations treaty monitoring system (International Council on Human Rights Policy, 2002: 99–116). Similarly, there are no international mechanisms to enforce the human rights obligations imposed on firms by states under legislation which implements the international treaty obligations they have assumed.

When states ratify an international human rights treaty, the instrument does not merely require them to respect and fulfil the rights expressed in the instrument in their own practice and that of their officials, but also to ensure the observance of the protected rights by third parties such as firms operating within their jurisdiction (Ruggie, 2007a: [7]–[17]). The precise scope of the state duty to protect, including the duty to ensure third-party observance, depends upon the terms of the instrument, although it may be that international law imposes a general duty upon state parties to protect treaty rights (Joint Committee on Human Rights, 2009: 11). The state duty to protect is discharged by enacting and enforcing legislation giving domestic effect to the treaty provisions and through appropriate policies, regulation and adjudication. States may be held responsible under international law for failure to discharge their duty to protect treaty commitments against breach by third parties such as companies (International Council on Human Rights Policy, 2002: 83–88).

Legal responsibility for human rights protection lies, therefore, at the national level. Human rights standards might be applied to firms through the state in which they are incorporated or headquartered (their home state) (*The Barcelona Traction Co, (Belgium v. Spain)* 1970 ICJ 3) or through the state in which they are operating (the host state). In practice, there is almost no home state regulation of offshore activity of firms, much less of their foreign affiliates. Effective responsibility for human rights protection rests with the host state and the first point of redress for victims is to its domestic law and courts. The leverage of host governments over firms is, however, weakened by economic globalisation: namely, by differences in relative economic size between state and firm, the increased mobility of investment capital and the resulting competition between potential host countries for lower regulatory barriers to foreign direct investment (see subsection below: The new conditions of global business). These power differentials, and the problems inherent in enforcing domestic laws against global firms, undermine the capacity of (and incentive for) developing country hosts to enforce any human rights commitments that they have assumed. This weakening creates particular difficulties in countries without a strong commitment to the rule of law or institutions to secure its observance. Of course, in many cases the developing state is strong and it is the disposition to human rights protection that is weak, and made weaker by globalisation'scompetitive auction for inbound investment.

Another consequence of the statist character of the international human rights system is that little guidance is given to firms regarding the norms that constitute their human rights responsibilities. The human rights standards contained in international instruments are addressed to state conduct. Firms are not states and have different functions; standards addressed to states require translation if they are to provide clear guidance to firms with respect to their conduct and responsibilities (Stephens, 2002: 34–35). That translation is effected incrementally through the network of civil regulation by voluntary codes for corporate social responsibility (see section below: Corporate Social Responsibility) and UN initiatives to assert and elaborate the corporate responsibility to respect human rights (see section below: Business Standard-Setting within the International Human Rights Framework).

The new conditions of global business

The character of modern globalisation

Ours is not the first global age or the first globally integrated trading system. Such claims might be made for the trading system opened up with the European discovery of the New World in the 15th century and for the global trading system based on the British Empire during the Victorian and Edwardian periods. The latter age, at least, saw the mass migration of peoples as well as of trade and investment (Kozul-Wright, 1995). This Victorian era of globalisation disintegrated, however, with the closure of trade routes during World War I, the Great Depression and resulting trade protectionism (Ferguson, 2005). The modern global age during the past half-century returns to earlier closer integration of people and countries in culture, communication and economic activity. Modern globalisation is based not in empire but in revolutions in information and transportation technology, and the international liberalisation of trade, investment and currency controls. Together these disparate developments have combined to allow the creation of modern global production and distribution networks and a global trading and investment system. Where economic activity was previously nationally constrained, increasingly it is global in character, jumping national borders.

Modern information and communications technology enables firms to operate globally through central coordination of business operations, facilitated by dramatic reduction in transportation costs flowing from shipping containerisation and the development of jet aircraft engines (Hummels, 2007). Globalisation permits firms to adopt new technologies and organise production networks on a global scale through management of a dispersed production network. Global production systems source components and locate stages of production to sites of lowest cost, with multi-country locations for different stages of production. For tradable goods and services, the issue is where to locate production facilities for maximum efficiency and lowest cost. That calculus has seen much manufacturing move from developed to developing countries, often through contracting relationships substituting for direct investment through foreign branches and subsidiaries. Firms are now part of global supply chains operating as global networks crossing national boundaries, often with limited control and responsibility for suppliers and producers. The components of these international production networks are highly mobile and relatively easily transferable.

Globalisation's consequences

Free trade enables poor states with low labour costs to exploit this natural advantage in global production networks (Baghwati, 2004). Foreign direct investment (FDI) is one of the most important means of promoting development in developing countries through job creation, technology transfer, knowledge and competence building, scientific advances, management skilling, integration with the global trade system and development of a more competitive private sector. All these effects boost economic growth, an important tool to combating poverty.

Yet there are also significant negative consequences of globalisation. When the United Nations and its human rights system were created, the state had few rivals. The position is radically different a half century later under globalisation. The international human rights system depends on state parties to enforce treaty protection. International production systems, with their disaggregation and global distribution of the elements of production, promote the mobility of investment capital. The threat of capital flight to a more accommodating jurisdiction is a constant for developing countries, driven by the economic calculus favouring relocation to lower-cost sites. The mobility that globalisation gives FDI, in the context of a competitive auction for investment capital, undermines host state capacity to enforce human rights protection and social standards since these impose costs on affected firms. Thus, states seek FDI by liberalising entry and operating conditions, guarantees and direct subsidies. These liberalising measures are rational responses to the competitive auction for foreign investment. These pressures are most clearly evident in the creation of export production zones in which local labour regimes are further attenuated in the interests of attracting international investment (Lang, 2010). In this competitive environment for FDI, these pressures towards cost reduction translate into downward pressure upon labour conditions, environmental protection, occupational health and safety regulation, and other protections that have cost imposts.

Recurrent corporate-related human rights abuses

Adoption of the new production methods has major human rights consequences. The opening up of the world economy has intensified global competition in production. Firms rely upon a vast array of subcontractors and partners with contract rather than ownership-based control over social and labour practices. Reliance upon supply chain sourcing also weakens the tie between firms, their management and home state since that corporate domicile is as substitutable as the factors of production: '[t]echnological and structural developments, combined with changes in the way in which global sourcing and distribution is done, have weakened and, in some cases, eliminated the identification of the management of a global enterprise with a given home country' (Tapiola, 2001: 2). And, of course, firms operate to a greater extent than before in countries where there is little respect for human rights or where its protection is subordinated to national economic development. The fact that child labour emerged in the first half of the 1990s as a major issue for global firms illustrates the change that has taken place: 'no-one who drafted or adopted [the principal intergovernmental standards of business conduct in the mid-1970s] thought that the world's leading companies would condone forced labour or child labour or crude forms of discrimination in employment' (Tapiola, 2001: 2).

Corporate operations and relationships now pose a distinct body of threats to human rights, either through firms' conduct or their complicity in the invasion of rights by others. The principal recurrent concerns are with labour rights (freedom of association and collective bargaining, the use of child labour and bonded or forced labour, and the provision of decent and safe working conditions), working in areas of conflict, the domestic allocation of revenues from corporate operations, bribery and corruption, the use of state (military) and private security forces to secure corporate operations, and ensuring respect for indigenous people's rights (Prince of Wales Int'l Bus. Leaders Forum & Amnesty Int'l, 2000: 8–61). A survey of corporate-related human rights abuses reported by non-governmental organisations (NGOs) concluded 'the extractive sector – oil, gas and mining – utterly dominates this sample of reported abuses with two thirds of the total. The food and beverages industry is a distant second, followed by apparel and footwear and the information and communication technology sector' (Ruggie, 2006: 24). In this survey, extractive industries also accounted for most allegations of the worst abuses; these were typically for complicity in acts committed by public and private security forces protecting company property, corruption, violations of labour rights and abuses in relation to local communities, especially indigenous peoples (Ruggie, 2006: 25). These abuses are most egregious where poverty, weak governance and current or recent conflict coexist in the host state (Ruggie, 2006: 30).

CORPORATE SOCIAL RESPONSIBILITY

Global civil regulation of business

The modern corporate social responsibility (CSR) movement is an apparent paradox, a self-imposed discipline assumed by firms that forgoes some of globalisation's freedoms. CSR initiatives have proliferated over the past two decades and it is unusual for a major corporation from a developed country not to have adopted a policy that addresses the negative social and environmental impacts of its operations and those of its supply chain. Firms make voluntary commitments dealing with labour standards and working conditions, respect for human rights, social and environmental impacts and corruption avoidance. Codes range from initiatives by individual firms, industries and sectors, to those created with wider stakeholder input and some with the further legitimacy of government participation. Other voluntary instruments cover reporting, compliance and verification. These commitments go beyond the firm's legal obligations; indeed, that is their ostensible purpose – to signify commitment to standards *beyond* those required by the legal systems of the countries in which they operate. They create a vast governance network of voluntary obligation, or 'soft law', embracing most industries and sectors of global business. This is not CSR as philanthropy but rather CSR as avoidance of social and environmental harm and responsiveness to the expectations of stakeholders, a new form of CSR (Vogel, 2005: 17–24).

This network is variously called 'private regulation' (Vogel, 2009), 'civil regulation' (Zadek, 2001), 'regulatory standard-setting' (Abbott & Snidal, 2009) and 'a new form of transnational regulation' (Abbott & Snidal, 2009a: 45). The term 'regulation' is justified as a descriptor since that these voluntary codes organise and control 'economic … and social activities by means of making, implementing, monitoring, and enforcing of rules', albeit that they are voluntary (Abbott & Snidal, 2009a: 45). Despite this regulatory function, the familiar term 'corporate social responsibility' (or CSR) is used here to refer to the network of unilateral and collaborative instruments that express voluntary standards of corporate responsibility in global business.

The network differs from the international human rights system in key respects. Thus, most CSR instruments are created from the 'bottom up' by firms acting alone or in some combination with civil society actors and, less often, states. They largely operate free of state support and their 'legitimacy, governance and implementation are not rooted in public authority' (Vogel, 2009: 153–154). Their sanctions are social or market-based penalties, not legal. In contrast to international human rights law, CSR instruments apply directly to firms and do so globally, not at the national level.

The international CSR movement represents a more complex reality of international relations, a dynamic of advocacy, negotiation and consensus-building between parties few of whom are recognised as participants in the formal, state-based model of international law. These players include firms and their industry and trade associations, civil society organisations and, to a lesser degree, governmental and inter-governmental organisations including the United Nations. The pressures to which firms respond with code adoption reflect the leverage of civil society organisations which seek to hold firms to higher standards of conduct in relation to labour, consumer, environmental and human rights issues. Non-governmental organisations typically are non-profits with a values-based agenda, including university endowment funds and faith-based organisations. Some are national in their reach; others are international but partner locally. Some focus on particular issues; others work across broader fields such as human rights or labour protection generally. These transnational advocacy networks, 'activists beyond borders' (Keck & Sikkink, 1998), partners in the 'NGO-industrial complex' (Gereffi, Garcia-Johnson & Sasser, 2001), occupy one corner of a 'governance triangle' with firms and states (Abbott & Snidal, 2009).

CSR codes generally impose costs on their adopter through higher labour, human rights or environmental standards. Why, then, are they so widely adopted? For some firms, codes represent a form of 'values entrepreneurialism' – achieving market advantage in competition for consumers or investors by signalling respect for higher standards (Steinhardt, 2001). In a few instances, industry-wide codes are adopted to forestall national legislation imposing more stringent standards (Vogel, 2009: 167–168). However, the prospect of such legislation or its enforcement is slight for most multinationals, especially in developing countries. A more probable explanation of code adoption lies in the 'demonstration effect' of regulatory failure in a specific area that triggers a voluntary response but one grounded in the threat or apprehension of campaign advocacy against the firm or industry. Thus, the Responsible Care health and safety code for chemical manufacturers was introduced after the Bhopal disaster at the plant of Union Carbide's Indian subsidiary in 1984; the thalidomide scandal, the Chernobyl nuclear disaster and the Exxon Valdez oil spill triggered like responses (Mattli & Woods, 2009: 22–25). Similarly, the emergence of abusive labour practices, the corrupt use of corporate royalty payments, and the financing of civil conflict from 'blood diamonds' prompted CSR initiatives in response to these demonstrated governance deficits.

Modern CSR flourished from the early 1990s among US-based clothing manufacturers and retailers following their adoption of global production methods using external contractors and suppliers. With increased social movement pressure for enterprise accountability, and the use of targeted 'naming and shaming' campaigns by NGOs, international firms felt exposed to the labour practices of foreign partners in the commodity or service chain. Key sensitivities remain concerning low wages, the use of child labour and suppression of trade unions. Targeted advocacy in the footwear and apparel industries around the issue of 'sweatshop' production has been decisive in CSR adoption, especially of the more exacting codes created with multi-stakeholder participation (Bartley & Child, 2010). From the firm's perspective, CSR may signify 'Crisis Scandal Response' as much as the normative expression of responsibility (Vogel, 2009: 169). This vulnerability of many large firms is reinforced by the high valuations placed upon intangible assets represented by branded products and services in their financial statements. Codes serve as tools to manage reputational and other non-financial risk. NGO advocacy extends beyond production: sustained campaigns against the lending practices of the major private banks financing large development projects led to the drafting and wide adoption of the Equator Principles imposing environment and social safeguards on project finance (O'Dwyer & O'Sullivan, 2010).

Corporate and industry codes of conduct

The earliest codes were individual company codes, adopted on the firm's own initiative. Most major firms and industries have now promulgated codes of responsible behaviour. It has been estimated that more than 3,000 global firms issue reports on their social and environment performance and that there are more than 300 industry codes expressing conduct standards adopted by member firms (Vogel, 2009: 158). Since there is no systematic reporting of codes, precise data on incidence and content is not available. However, an inventory taken in 2000 of 246 codes adopted by firms based in Organisation for Economic Cooperation and Development (OECD) member countries found that individual company codes were the most numerous, representing 48 per cent of all codes; codes issued by industry and trade associations were 37 per cent of the inventory and multi-stakeholder codes, adopted following wider consultation among those with an interest in a particular industry such as trade unions and NGOs as well as firms and their industry associations, represented 13 per cent of the inventory. Codes developed by international organisations represented a mere 2 per cent (OECD, 2000). Finally, there are numerous model standards, usually proposed by civil society organisations as benchmarks or frameworks for individual or industry codes.

Multi-stakeholder codes and labels

Collaborative governance by civil society and firms

The second stage of CSR development is represented by initiatives that involve collaboration between two or more of the 'governance triangle' parties. The most active collaboration has been between firms and NGOs. The garment and footwear industries are especially active in view of the dominance of branded products in those industries. The Ethical Trading Initiative is an alliance of UK garment firms, trade unions and civil society organisations to promote and certify compliance with its codes of practice for supply chain working conditions. Its US counterpart is the Fair Labor Association, a partnership between apparel and footwear firms, human rights NGOs, unions and consumer groups to govern labour standards in international garment and footwear production. Both were formed in the late 1990s with the support of their respective governments. The Forestry Stewardship Council (FSC) was created by a coalition of firms and NGOs after the failure of the 1992 Rio Summit to reach agreement on international forestry practices. The FSC has developed forestry management standards and certifies wood products for compliance.

Social labelling programmes developed by NGOs cover many food and consumer products and assure consumers about the conditions of production; firms collaborate by seeking certification for products sold with the label. Social labels explicitly signal ethical production and maximise prospects of a price premium. The labels variously certify the fairness of trade terms for agricultural producers (Fair Trade International) and the sustainability of fish product sources (Marine Stewardship Council), and assure against the use of child labour in manufacture (Rugmark). There is increasing resort in business-to-business dealings to the principal social labels with their global reach, reputation and transparency. Some European governments have introduced social labels, such as the German Blue Angel ecolabel introduced in 1978, and the European Union now regulates the use of ecolabels. The price premium reflecting higher production costs constrains market penetration for products in price-competitive markets and market share of socially labelled products is generally modest.

Collaborative governance between states and firms

State participation in voluntary programmes has mostly been with business rather than civil society, and has mostly been at the inter-governmental level. These codes do not generally provide for any enforcement. The principal example is the United Nations

Global Compact introduced in 2000 by the Secretary-General of the United Nations. Firms subscribe to the Global Compact by committing to 10 principles, including respect for international human rights; non-complicity in human rights abuses; freedom of association and recognition of the right to collective bargaining; the elimination of forced and compulsory labour and the abolition of child labour; the elimination of discrimination in employment; and support for a precautionary approach to environmental challenges. The Global Compact has over 8,700 corporate participants and other stakeholders and describes itself as the world's largest voluntary corporate responsibility initiative. Over 2,000 firms have been expelled for persistent failure to communicate progress in integrating the principles into their strategies and operations.

The Equator Principles set voluntary environmental and social standards for member banks in the financing of infrastructure projects. They draw upon the Performance Standards on Social and Environmental Sustainability created by the International Finance Corporation, the World Bank's financing arm. The United Nations Principles of Responsible Investment, an institutional investor initiative in partnership with the United Nations Environment Programme, promotes the recognition of economic, social and governance perspectives in long-term investment policy. Finally, the International Organization for Standardization (ISO), a network of the national standards associations of member countries, draws on private sector technical expertise to promulgate its widely accepted standards. Although its work is principally the development of technical standards, its environmental management standard ISO 14001, which allows for third-party certification, is widely adopted by firms. ISO 26000 provides guidance on putting social responsibility into practice in an organisation. It does not provide for certification of compliance by adopting firms.

Collaborative governance between states, firms and civil society

Three multi-stakeholder initiatives providing collaborative governance between states, firms and civil society stand out. They are specific in scope, voluntary and firm facilitative in their effect. Each responds to problems where agreement was reached on the need for protective standards or guidance. In each initiative, government played a key role along with firms and civil actors, and their relative success is explicable in terms of that contribution. They are true instances of collaborative governance.

The Voluntary Principles on Security and Human Rights (VPs) were developed in 2000 by the US and UK governments in collaboration with oil, mining and energy firms and human rights and corporate responsibility NGOs. The VPs respond to persistent claims of abusive conduct by security forces and contractors in clearing land for extractive projects and concerns of potential firm and officer exposure to accessorial liability. Major litigation was then pending against US and French multinationals alleging complicity in offences by the Burmese military in effecting land clearance for the Yandana gas pipeline. The VPs guide firms in the use of private contractors and military forces in circumstances that pose threats to human rights.

The Kimberley Process Certification Scheme (KP) is designed to stem the flow of funds to insurgent groups in Africa from the sale of 'blood diamonds', a problem that arose initially in Angola but spread to Sierra Leone and, in a different form, Zimbabwe. In 2000 the South African Government convened a process involving the principal diamond producing and trading countries, diamond producers and retailing firms, and NGOs. The parties agreed upon the KP, an import–export certification scheme under which exporting governments certify the origin and conflict-free status of rough diamonds. Exporting countries endorsing the KP agree to on-site monitoring of the certification process. Since participant countries may trade rough diamonds only with other members (this trade restriction has been authorised by the WTO), there is a strong incentive for producer membership and compliance with the KP for fear of effective exclusion from the principal world diamond markets. The concentrated nature of the diamond producing and retailing industries and their shared reputational stake strengthen the programme. Although there are repeated concerns with particular exporting countries, the KP is regarded as a relatively successful collaborative governance (Vogel, 2009: 172–173).

The Extractive Industries Transparency Initiative (EITI) is a global multi-stakeholder standard addressing the 'resource curse' where, paradoxically, in many countries abundant oil, gas and mineral resources coexist with low economic growth and human development and high levels of corruption. EITI was launched by the UK Government in 2002 shortly after the Angolan Government threatened to cancel BP's oil concessions when the company announced its intention to publish its royalty and tax payments there. EITI promotes revenue transparency from oil, gas and mining in resource-rich countries through reporting and verification of company payments and government revenues. In 2011, 22 countries were EITI candidates and 11 countries had achieved compliant status. Although many developed countries have indicated their support for EITI, Norway is the only one that has committed to implementing the standard in its own practice. Developed countries are not, however, EITI's primary target.

EITI shares the mission of extractive industry transparency with Publish What You Pay (PWYP), a coalition of over 300 civil society groups working in more than 55 countries. While PWYP supports EITI's country-by-country implementation, it considers that country-based implementation alone is insufficient for effective transparency (van Oranje & Parham, 2009: 54). It campaigns for mandatory disclosure of company payments: for example, through stock exchange listing rules, under a uniform global standard. Until recently, PWYP has had only modest success: few of the major oil and mining firms publish revenue payments made to governments on a per-country basis and, with the exception of Statoil, a private company majority-owned by the Norwegian Government, none of the state-owned extractives which are especially active in Africa. However, the Dodd–Frank Wall Street Reform and Consumer Protection Act, enacted by the US Congress in July 2010, effects a fundamental change. The Act requires all energy and mining firms registered with the US Securities and Exchange Commission (SEC) to disclose how much they pay to foreign countries for oil, gas and minerals. The measure covers hundreds of firms, including 90 per cent of the world's largest internationally operating oil and gas firms and eight of the world's 10 largest mining companies (Publish What You Pay, 2010). The United States is the only country to require such disclosure.

Inter-governmental international CSR standards

From the 1970s, there was a movement within the United Nations for a binding code of conduct for transnational corporations. While this movement ultimately failed (Muchlinski, 2000), it spawned two inter-governmental instruments establishing voluntary corporate standards with transnational effect: the International Labour Organisation (ILO) Tripartite Declaration Concerning Multinational Enterprises and Social Policy (MNE Declaration) and the OECD Guidelines on Multinational Enterprises (OECD Guidelines). The motives for their adoption were entirely different: the former to assist, and the latter to forestall, adoption of a binding UN Code of Conduct for Transnational Corporations (see subsection below: Attempts at a prescriptive international code for business). The ILO Declaration is collaborative in its design and implementation, since the

ILO is itself a tripartite body representing member governments, peak trade union bodies and employer associations; the OECD Guidelines were framed by states alone but now involve business, trade unions and civil society representatives in advisory roles.

The ILO Governing Body adopted the MNE Declaration in 1977, initially on the expectation that it would become the 'social chapter' of the UN Code of Conduct. The result is a set of voluntary recommendations addressed to firms concerning labour conditions. The MNE Declaration enjoins compliance with the several ILO conventions regarding employment protection, the conditions of working life, occupational health and safety, and standards of industrial relations. There is a procedure permitting workers' and employers' organisations to bring requests for interpretation in specific cases; the confidential procedure is rarely invoked, however, since it does not judge the conduct of individual firms or provide a remedy for those affected (International Council on Human Rights Policy 2002: 102–103).

The OECD Guidelines form part of the OECD's Declaration on International Investment and Multinational Enterprises. The OECD Guidelines were first adopted in 1976 with the objective of facilitating direct investment among OECD members while also establishing the position of the capital-exporting states as a draft Code of Conduct for transnational corporations was being discussed in the United Nations. The Guidelines are recommendations addressed directly to multinational enterprises operating in or from the 42 countries adhering to the Guidelines, and apply to their operations anywhere. They also apply to enterprises from a non-adhering state in relation to their operations in an adhering country, but not elsewhere (OECD, 2000: 14). The Guidelines do not extend, therefore, to firms from non-adhering countries in relation to their operations outside OECD-adhering countries, such as in developing countries. The Guidelines express voluntary principles and standards of responsible business conduct in areas such as human rights, employment and labour relations, environmental protection, information disclosure, combating bribery, consumer interests, science and technology, competition and taxation. Although the Guidelines are voluntary and not legally enforceable, National Contact Points (NCPs) in each adhering country provide a de facto grievance process for allegations of breach that leads to mediation but not adjudication. In the absence of other international remedy, there has been a resurgence of interest by NGOs in the OECD Guidelines and NCP process.

The OECD Guidelines are the only intergovernmental agreement on business standards of conduct endorsed by member states and the only multilaterally recognised framework that these developed country governments are committed to promoting (Norwegian Ministry of Foreign Affairs, 2009: 64). It is the only international standard that covers workplace, environmental and consumer health provisions. Although its NCP grievance mechanism is limited and uneven in national implementation, this is the only international CSR initiative with a compliance mechanism (Zerk, 2006: 277). The OECD Guidelines were revised in 2011 and its human rights provisions strengthened.

Assessing CSR as global governance

The state is the natural source of regulatory authority. There are, however, significant obstacles to effective governmental response to the social and environment problems posed by transnational production processes and global business generally. These include differences in the policy preferences of states and in their disposition and capacity for effective regulation. This applies especially among developing country host states where negative externalities are most evident and the impulse to, or capacity for, regulatory action to enforce social standards is weakest: many developing countries prioritise national economic development over social protection and the competitive auction for inbound investment weakens state capacity to impose social and environmental standards. CSR is a response to the 'structural imbalance between the size and power of global firms, and the capacity and/or willingness of governments to adequately regulate them' (Vogel, 2009: 160). CSR measures extend regulation to business practices in developing countries irrespective of the policy preferences of their governments or regulatory capacity.

Binding international regulation, by treaty and their inter-governmental organisation, would 'better match the scope of transnational production' (Abbott & Snidal, 2009a: 59). It would also offer consistent standards and protection against the threat of firm repudiation when the calculus of cost and benefit turns against CSR's voluntary commitments. There is, however, no present political force for binding international regulation and, even if there were, problems of uncertain ratification and weak state enforcement would persist (see section below: Assuring Corporate Responsibility in Global Business: Regulatory Options). CSR compensates in some degree for failure to enact binding regulation and, through soft law, enables developed states to assume some responsibility for offshore activities of their firms (Vogel, 2009: 185). In national contexts, voluntary corporate action to meet social expectations acts as insurance against legal regulation and accountability; in the global context, CSR flourishes precisely because of the weakness of much host state regulation and the absence of an international mechanism.

CSR has undoubtedly had some impact on business practices and ameliorated some of the negative consequences of globalisation and the liberalisation of trade and investment regimes even though its benefits defy easy assessment. How effective is CSR as a governance system setting, implementing and enforcing standards of business conduct in the global economy? What disciplinary power does it exert over firms? Is the international CSR movement a force that bears significant regulatory load and within what limits?

The drivers of international CSR

Since international CSR commitments are not legally binding, their force depends on the incentives that underlie them. While the relationship between corporate social and corporate financial performance is clouded by methodological difficulties, the best generalisation that appears to be supported by research evidence is that corporate social responsibility *of itself* neither promotes nor detracts from superior financial performance (Orlitzky, Schmidt & Rynes, 2003, Vogel, 2005: 16–45). Analysis of relative costs and benefits needs to be made at the level of the individual firm. Three categories of firms may be distinguished with respect to CSR's utility.

First, some firms, such as those in extractive industries, require government consent for projects and need to engage in consultations with affected communities. For these firms, a reputation for responsible practices is often advantageous but not at any cost. Second, for some firms CSR represents a strategic marketing choice to differentiate them from competitors in consumer markets, a form of social entrepreneurialism that competes for consumers or investors through signalled respect for social values and standards. Of necessity, if this strategy is to set the firm apart, it makes sense only if pursued by a minority of firms in a market sector where consumer sentiment significantly favours responsible production of goods and services. Both considerations are significantly limiting factors.

However, for the great majority of large firms the business case for CSR expenditures rests on the threat or prospect of campaign advocacy brought against them by NGOs for corporate irresponsibility, using the media to 'name and shame' and putting at risk the reputation of the firm and its products: the argument that CSR aids recruitment and retention of superior staff operates only within narrow limits (Vogel, 2005: 56–60).

The threat rests on assumed consumer preference for responsibly made products and the risk of consumer boycott. For these firms, CSR acts as a form of insurance against opprobrium rather than as a source of competitive advantage. Most multi-stakeholder codes have their origins in NGO campaign advocacy around a particular issue, firm or industry. Firms that sell directly to consumer markets have the strongest incentives to commit to voluntary standards, although many other Western firms are also susceptible to adverse media reporting and responsive to reputation and other non-financial risk management. In some developed countries code adoption may also reduce the risk of stronger mandatory domestic regulation, although that risk is not significant in relation to global business practices and does not explain code proliferation and the scale of voluntary adoption. CSR also has the advantage relative to governmental action that any import or other trade restriction imposed for code breach does not engage WTO sanctions, which apply only to the conduct of state parties. This is 'a major 'loophole' in international trade law – one that civil regulation has exploited' (Vogel, 2009: 167).

From another perspective, NGOs confer moral legitimacy upon firms who commit to CSR measures that the latter approve. Those measures provide some assurance that the firm's operations and values are consistent with the social norms and expectations of the firm's consumer, investor and other stakeholder communities. For NGOs the legitimacy of CSR measures depends upon the transparency of code commitments and accountability through implementation, monitoring and enforcement of undertakings. Concerns about either may result in the withdrawal of legitimacy and the perception that the CSR measure has merely a symbolic or appeasement function. The quality of CSR implementation, monitoring and enforcement is the weak point in much CSR and invites the continuing strategic judgement for NGOs as to when to confer, and to withdraw, legitimacy, returning to direct campaign advocacy against a firm (O'Dwyer & O'Sullivan, 2010).

For the vast majority of firms, the scope of NGO power to confer or withdraw legitimacy determines the business case for CSR. Firms undertake CSR commitments if it makes business sense for them to do so. The business case for CSR rests on the argument that a firm's profits will be maximised, at least in the medium to long term, if it voluntarily commits to avoiding social and environmental harms from operations. The case for CSR rests on this utility calculus. CSR does not ask firms to sacrifice profit for social goals but asserts that profit is secured only by responsible conduct that respects those goals. What is the strength of this argument and to which firms does it apply? We shall see that there are formidable obstacles to CSR's efficacy as civil regulation of global business practice.

Limits on CSR as effective regulation of international business

The business case for CSR rests on the sanction of the threat of loss of firm value through the willingness of consumers and investors to make the conditions of production a criterion in their decisions (FitzGerald, 2001: 14). However, consumer, investor and employee sentiment in favour of responsible production, and media interest in monitoring and reporting corporate irresponsibility, are easily overstated. Media attention to corporate irresponsibility is the fulcrum of NGO campaign advocacy and appears to have waned since the 1990s interest in 'sweatshop' abuses (Vogel, 2005: 109). Furthermore, studies in several countries indicate that the proportion of socially conscious consumers is much lower than responses to consumer surveys suggest and that their commitment is not at heroic levels (Devinney, Auger and Eckhardt 2010). CSR practices do not appear to have clearly demonstrated effects on the market share of a firm's products or its financial performance: 'of the myriad factors that affect corporate earnings, CSR remains, for most firms most of the time, of marginal importance' (Vogel, 2005: 73, 47–53, 93). For adopting firms, the code is liable to be passed over when it is judged unnecessary for brand value assurance or for competitive market advantage over rivals. Indeed, there is a danger faced by firms that seek to chart 'a proactive course in enacting human and labor rights protections that it can never fully satisfy its ideals … [so that firms] that claim to set a higher standard often suffer the perverse result of becoming the targets of criticism' (Compa & Hinchliffe-Darricarrère, 1995: 686). Competition in the marketplace remains the ultimate driver of firm conduct. The contest between code compliance and firm profits is not an equal one.

A second limit on CSR effectiveness is that the range of firms who are vulnerable to NGO advocacy, and for whom the business case for CSR might possibly be compelling, is limited to a narrow subset of firms – those producing branded products sold into markets with consumer sensitivity to the conditions of their production. Effectively, only European and North American markets show such sensitivity. This sensitivity may, on the basis of current practice, be further limited to specific industries such as apparel, footwear, athletic equipment, rugs and toys: such production represents 'virtual 'enclaves' in the global economy' (Vogel, 2005: 106). Production of unbranded goods for European and North American markets, and for all other markets including domestic developing country markets, does not appear to engage CSR drivers.

Third, the problem of the free rider weakens CSR's effectiveness as civil regulation. Where a CSR code's benefits accrue to the industry as a whole, the competitive cost advantage accruing to 'free riders' who share the benefits but not the costs of compliance undermines incentives for firms to commit. Where the nature of a business sector is such that the industry sinks or swims together in its response to some demonstrated governance failure, there may be strong incentives for full and enforced compliance with a voluntary industry response. This was evident in the threat posed to diamond producers and retailers by adverse consumer sentiment around 'blood diamonds' in the late 1990s. Commonality of interest in this highly concentrated industry ensured support from the principal firms and importing and exporting countries for the Kimberley Process and its certification scheme to assure against conflict zone sourcing. However, in situations where the industry is not so concentrated, as with the extractives industry, initiatives such as PWYP have attracted much less support. Where competitor firms are not subject to the same stakeholder incentives, the free rider problem weighs against code effectiveness. Thus, for firms from countries where domestic social and market norms do not drive CSR principles – for example, the growing number of transnationals from developing countries and state-owned enterprises operating transnationally – the incentives, and vulnerability to NGO advocacy, are fundamentally different to those of Western firms selling branded products. The problem of uneven incentives remains CSR's Achilles heel. Pressure to rein in the free rider and level the playing field sometimes prompts firms to seek mandatory regulation so that all competitors are bound to the same degree (Abbott & Snidal, 2009a: 60). These instances, however, are rare. More commonly, firms most exposed to civil society advocacy seek to deflect NGO criticism by setting a standard of conduct and seeking to impose it on all industry members. Thus, banks with a strong retail banking presence, and therefore greater vulnerability to negative consumer sentiment, played a leading role in creating the Equator Principles for private bank project financing and succeeded in attracting competitor support. However, with the later refusal of participating banks to create effective accountability measures, the initial appeasement of NGO concerns unravelled and NGOs attempted to withdraw the legitimacy initially conferred on the Principles and adhering banks (O'Dwyer & O'Sullivan, 2010).

Fourth, it is a measure of the poverty of the incentives for CSR that implementation – the monitoring, enforcement and external verification – of CSR measures is generally weak and 'represents a serious structural weakness' of CSR regulation (Vogel, 2009: 184). Surveys of CSR codes report the general absence of 'credible monitoring and verification processes' (Calder & Culverwell, 2005: 7). Few firms integrate voluntary codes into their core business and report upon performance against the standard, even for codes containing human rights commitments (Ruggie, 2007: 77, 78, 81). Indeed, the SA8000 labour standard for contractors is the only certifiable standard that includes international human rights and labour rights. The structure of global production poses particular problems for effective monitoring. Firms that source from factories that they own or from a small number of suppliers have greater monitoring capacity than those who use many scattered independent suppliers. For these latter suppliers especially, CSR certification is a burden since its benefits accrue to buyer firms but none of the costs as certification rarely commands a price premium in retail markets. Until responsibly made products command a price premium, the incentives for suppliers and buyers to invest in costly monitoring and verification of compliance will remain weak.

Fifth, the proliferation of voluntary codes – the 'almost bewildering array' of voluntary measures (Calder & Culverwell, 2005: 7) shaped only by the individual producer or collective industry interest – inhibits consensus on standards of conduct for international business. Multi-stakeholder codes do not presently fill this gap: many are ad hoc collaborations in response to particular problems. The closest to a comprehensive statement of corporate responsibility are the OECD and Global Compact principles, although these are expressed at a very high level of generality and fall short of comprehensive guidance to firms.

Sixth, CSR is largely driven by NGOs from developed countries and depends upon their capacity to engage media and wider social interest in corporate practices. Their priorities and capacity to attract media interest determine the contours of civil regulation through CSR. The adventitious quality of their concerns is revealed in the regulatory gaps such as environmental supply-chain management; in contrast, the use of child labour in developing countries is an issue that is much easier for NGOs to pursue in advocacy and has been a constant focus (Vogel, 2005: 138).

Weighing up CSR as global regulation

New forms of transnational private governance such as CSR are undoubtedly a constructive attempt to fill regulatory gaps at the global level. However, CSR also exposes the limits of the market system in promoting responsiveness to social norms. That should not surprise, because it is not the purpose of corporate activity to do so. There is an endemic conflict between the goals of profit maximisation and social protection. Corporate action to advance the latter is likely to aid profit maximisation only in the long term, and even then at the broad systemic level, apart from immediate marketing gains that individual firms might capture. The appeal of voluntary codes at the international level reflects the complexity of international lawmaking and enforcement, especially that directed at global actors not easily amenable to national or international controls. CSR compensates to some degree for the lack of an international mechanism for corporate responsibility. It needs to be assessed by reference not to an ideal model of effective governmental authority but to the limited regulatory options realistically available. CSR codes have raised labour, human rights and environmental standards in many developing countries; indeed, they sometimes provide the only effective form of business regulation (Vogel, 2009: 184–185). For developed states and inter-governmental organisations, soft law measures such as the Global Compact, OECD and ILO standards and the International Finance Corporation's Performance Standards avoid the more difficult challenge of legally binding regulation.

Private regulation of business works best when the state is involved: it is the participation of developed states that marks the most successful collaborative CSR initiatives such as the Kimberley Process, the Voluntary Principles and the resource transparency initiatives. CSR initiatives that rely solely upon market forces such as social labels have had much less success. The OECD Guidelines assume special significance because of their state-provided grievance mechanism. It is difficult not to agree with the UN Secretary-General's Special Representative for business and human rights that voluntary approaches:

> show some potential, despite obvious weaknesses. The biggest challenge is bringing such efforts to a scale where they become truly systemic interventions. For that to occur, states need to more proactively structure business incentives and disincentives, while accountability practices must be more deeply embedded within market mechanisms themselves (Ruggie, 2007: [85]).

BUSINESS STANDARD-SETTING WITHIN THE INTERNATIONAL HUMAN RIGHTS FRAMEWORK

Are the gaps and weaknesses of CSR solved by looking at corporate responsibility through a human rights lens? Respect for human rights is part of many CSR codes and policies and respecting human rights is clearly seen as integral to a firm's social responsibility. The European Commission stresses that 'CSR has a strong international human rights dimension, particularly in relation to international operations and global supply chains' (European Commission, 2001: 52). However, while CSR and human rights overlap, there are significant differences between the two domains, including difference in origin and purpose. Thus, international CSR is broader in the range of its concerns than human rights law – the OECD Guidelines, for example, include protection of consumer interests, science and technology, competition and taxation; nonetheless, core CSR concerns such as labour, environment and corruption are shared with human rights. Second, when states assume international human rights obligations, they also assume the duty to protect against breaches by firms and individuals (see subsection above: Corporations within the international human rights system). Entry into CSR commitments is voluntary and there is no international CSR mechanism outside of international human rights law for legal enforcement of standards. However, the forces undermining host state (especially developing country) capacity and incentive to protect human rights against foreign firms weaken these formal differences (see subsection above: The new conditions of global business).

There have been several attempts within the United Nations to frame specific human rights standards of responsibility and accountability for business. However, the first successful attempt was in 2008 when the Human Rights Council approved the 'Protect, Respect and Remedy' framework for the duties and responsibilities of states and firms with respect to human rights. The framework includes, as one of its pillars, the corporate responsibility to respect human rights. This section examines that responsibility and its relation with corporate social responsibility. It commences by looking briefly at unsuccessful antecedents.

Attempts at a prescriptive international code for business

In 1975 the United Nations established the Commission on Transnational Corporations to produce a draft Code of Conduct for Transnational Corporations. Developing countries were then concerned that the global organisation, economic power and technological capacity of transnational firms posed an economic threat to host states and a potential source of political interference in their domestic affairs; capital-exporting states were concerned with the protection of investments from expropriation and discriminatory treatment (Redmond, 2003: 96–97). However, by the 1980s both the political and economic tides had turned against those seeking strong international regulation of business. With the scarcity of investment capital following in the economic downturn that followed the debt crisis of the early 1980s, developing state priorities shifted from regulating foreign investment to attracting it. These competitive pressures for FDI were accentuated by trade and investment liberalisation. Impetus for a binding standard had subsided well before the formal suspension of negotiations for the Code in 1992.

Another initiative within a UN subsidiary body, the Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights, offered a set of principles responsibility for human rights impacts of business operations and relationships. Although the Norms were expressed not to be a treaty, they were declared to be 'non-voluntary' – no opt-in was required, and no opt-out was possible (Weissbrodt, 2008: 398). Although the Norms were, and still are, strongly supported by many civil society organisations, they were opposed by business and failed to attract political support within the United Nations (Weissbrodt, 2008: 383). They have no formal legal authority and represent a counterpoint model to the 'Protect, Respect and Remedy' framework. Indeed, opposition to the Norms led to the appointment by the UN Secretary-General in 2005 of John Ruggie as his Special Representative with a mandate to identify and clarify standards of corporate responsibility and accountability with regard to human rights. Ruggie had earlier been the principal architect of the UN Global Compact.

The 'Protect, Respect and Remedy' framework for business and human rights

Ruggie characterises the task of standard-setting as one arising from systemic global governance failure:

> the root cause of the business and human rights predicament today lies in the governance gaps created by globalization – between the scope and impact of economic forces and actors, and the capacity of societies to manage their adverse consequences. These governance gaps provide the permissive environment for wrongful acts by companies of all kinds without adequate sanctioning or reparation. How to narrow and ultimately bridge the gaps in relation to human rights is our fundamental challenge (Ruggie, 2008: 3).

The project of realigning economic forces and governance capacity is to be secured by '[e]mbedding global markets in shared values and institutional practices' (Ruggie, 2006: 18). These governance gaps should be addressed by states themselves within their own jurisdictions or by cooperation between them. His solution in the 'Protect, Respect and Remedy' framework rests on the 'bedrock' of strengthened state capacity to protect against corporate-related human rights abuse and strengthened voluntary corporate responsibility measures (Ruggie, 2008: 50). The UN Human Rights Council approved the framework and extended his mandate to develop guiding principles on the implementation of the framework. In 2011 the Human Rights Council approved the Guiding Principles on Business and Human Rights that Ruggie had developed; they do not create any new international law obligations (Ruggie, 2011: 6).

The first of the framework's three complementary principles is the duty of state parties to human rights instruments to protect against breach of those rights by third parties, including business: 'this requires taking appropriate steps to prevent, investigate, punish and redress such abuse through effective policies, legislation, regulations and adjudication' (Guiding Principle 1). This is the traditional statement of state resonsibility; this duty to protect is not shared by business. Ruggie proposes several strategies to strengthen state capacity to discharge the duty to protect (see subsection below: Strengthening host state capacity to protect against corporate-related human rights abuses).

Second, the responsibility (*not* duty) of firms is to respect human rights: that is, to avoid infringing on the human rights of others through their activities and value chain relationships, address adverse impacts with which they are involved and provide for appropriate prevention, mitigation and remediation (Guiding Principles 11, 13, 21). This responsibility, where it is not grounded in legal obligation, rests only upon social expectation.

The third principle requires states, as part of their duty to protect, to ensure an effective remedy is available for human rights abuses with their territory (Guiding Principle 25). The present 'incomplete and flawed' patchwork of remedies includes judicial, state-based non-judicial (such as national human rights institutions), company-level and multi-stakeholder, industry, and financier-sponsored mechanisms (Ruggie, 2008: 87). Firms should establish or participate in effective operational-level grievance mechanisms for individuals and communities who may be adversely impacted by their operations (Guiding Principle 30). Non-judicial remedies should meet criteria of legitimacy, accessibility, predictability, equity, rights-compatibility and transparency (Guiding Principle 31).

The corporate responsibility to respect human rights

Responsibility, not duty

The corporate responsibility approved by the Human Rights Council is to respect the human rights of those affected by the firm's activities. The responsibility rests on a social norm that is said to have acquired

> near-universal recognition by all stakeholders, including business … not [to] infringe on the rights of others. The responsibility to respect is the baseline norm for all companies in all situations Ruggie, 2009a.

The responsibility to respect includes both legal obligations and social norms and expectations:

> failure to meet this responsibility can subject companies to the courts of public opinion – comprising employees, communities, consumers, civil society, as well as investors – and occasionally to charges in actual courts. Whereas governments define the scope of legal compliance, the broader scope of the responsibility to respect is also defined by social expectations – as part of what is sometimes called a company's social license to operate (Ruggie, 2008b).

In contrast to the state *duty* to protect, the corporate *responsibility* to respect human rights does not derive directly from international law, whether in its customary form or from the terms of treaties. Rather, Ruggie asserts that the responsibility derives from the recognition and assumption of the responsibility by business itself, expressed through the ILO Declaration, OECD Guidelines, Global Compact and in company codes (Ruggie, 2008: 23). Indeed, Ruggie says that the notion that companies possess human rights responsibilities is 'not today seriously demurred from' (Ruggie, 2008a).

Despite the multiple connotations of the term 'responsibility' in different legal contexts, it is clear that the corporate responsibility to respect is not grounded in legal obligation beyond that arising from the domestic laws of the countries in which firms operate but 'refers to moral obligations and social expectations – not binding law' (Millstein Veasey, E.N., Goldschmid, et al., 2008). Despite the governing term 'corporate', the responsibility is expressed to apply to all 'business enterprises', regardless of legal form, size, sector, country of origin, ownership and structure; however, these factors and the severity of adverse human rights impacts may determine the 'scale and complexity' of the means by which the responsibility is discharged (Guiding Principle 14).

Ruggie does not address the relationship between the corporate responsibility to respect human rights and corporate social responsibility generally, except to distinguish the former from corporate philanthropy. However, the corporate responsibility to respect is seen as a specific, non-discretionary norm to be distinguished from voluntary initiatives subsumed under the broad umbrella of CSR. This distinction ensures that firms do not attempt to substitute charitable contributions for human rights compliance: there is no trade-off – respect all human rights (Guiding Principle 11, Commentary). The two concepts share a foundation in sensitivity to social expectation and, from an investor perspective, long-term risk management. The UK Joint Committee on Human Rights considered that greater clarity is needed on the distinction between them to 'reinforce the baseline [corporate] responsibility' with respect to human rights (Joint Committee on Human Rights, 2009: 124).

The responsibility enjoins firms to 'respect' human rights: '[this] essentially means not to infringe on the rights of others – put simply, to do no harm' (Ruggie, 2008: 24). Unlike the state duty, the corporate responsibility does not require firms to *protect* or *fulfil* human rights, only to *respect* them; the responsibility is to avoid harm from its own conduct, and does not extend, as the state duty does, to protect against third-party breaches or seek the progressive realisation of rights. The responsibility is, however, expressed to require firms to seek to prevent or mitigate adverse human rights impacts that are directly linked to their operations or business relationships even if they have not contributed to those impacts (Guiding Principle 13(b)). Ruggie contemplates that more than respect may, however, be required in particular contexts: for example, where firms perform public functions or operate in conflict zones that impose obligations to protect employees and perhaps communities affected by their operations (Ruggie, 2008: 24; Ruggie, 2009: 61–64). There are particular challenges and dilemmas for firms operating in countries without adequate governance, weak enforcement, and particularly in areas of conflict, widespread corruption or fragile and vulnerable natural environments. It has been urged that the responsibility extends beyond respect in situations when the company is operating in a region where the state is incapable of performing its functions or unwilling to do so (Institute for Human Rights and Business, 2009, Joint Committee on Human Rights, 2009: 94ff). The question is not elaborated in the Guiding Principles.

The content of the corporate responsibility

Ruggie set his face against a dedicated statement of corporate-related human rights standards on the grounds that there are 'few if any internationally recognised rights business cannot impact', and that any such statement would inevitably be incomplete and shortly outdated; instead, he asserts the corporate responsibility is to respect internationally recognised human rights instruments that the host state has ratified understood, 'at a minimum', as those expressed in the International Covenant on Civil and Political Rights, the International Covenant on Economic, Social and Cultural Rights and the ILO Declaration on Fundamental Principles and Rights at Work (Ruggie, 2008: 53, 24, 52; Guiding Principle 12). The responsibility applies independently of the particular human rights instruments that the host state has ratified. Human rights standards, however, are addressed to and concern state conduct; they require translation for economic actors who do not have the public interest obligations of states. Ruggie assumes that the 'Do no harm' direction sufficiently defines the scope of the responsibility to respect; it is not clear that it does.

The remaining element of the corporate responsibility to respect involves the internal systems by which firms are ableto assure themselves and others of their compliance with the responsibility. To 'manage the risk of human rights harm with a view to avoiding it', firms need a due diligence process with distinct elements – an explicit human rights policy, assessment of the human rights impacts of company operations, integration of human rights values and risk assessments into company culture and management systems, and tracking and reporting of performance (Guiding Principles 15–20; Ruggie, 2008: 56–64). However, Ruggie does not propose external verification of the company's human rights risk assessment or systemic integrity of its processes; external communication is indicated only where operations pose risks of 'severe human rights impacts' (Guiding Principle 21).

Evaluating the corporate responsibility to respect as civil regulation

Does the corporate responsibility to respect human rights repair deficiencies noted in civil regulation through corporate social responsibility? While the corporate responsibility possesses clarity in theory, its practical implications are uncertain. A United Kingdom Parliamentary committee commented that the responsibility 'requires a culture change' in the way that businesses think about their responsibilities: '[w]e see merit in the argument that business-led initiatives may achieve a credible and lasting change, but this is hampered by the perception that some businesses regard addressing human rights as little more than an exercise in 'good PR'' (Joint Committee on Human Rights, 2009: 119).

Corporate human rights policies are of recent origin – Shell was the first major company to adopt an explicit human rights policy, in 1998 after global criticism of its failure to intervene with the Nigerian Government to prevent the execution of the activist Ken Saro-Wiwa after an unreliable terrorism trial. Saro-Wiwa had been active in protest activity of the Ogoni people against Shell's Niger Delta operations (Khan, 2009: 176–177). Since then many firms have adopted codes of conduct that include human rights elements although it is not clear how many have done so and in what terms. The Business and Human Rights Resource Centre website lists over 270 firms with a formal policy statement explicitly referring to human rights. A survey of the Fortune Global 500 companies, the world's largest firms, found that 90 per cent of responding firms had an explicit set of human rights principles or management practices in place (Ruggie, 2006a). The 8,700 firms participating in the UN Global Compact subscribe to two principles relating to human rights but that commitment does not require an explicit human rights policy or other assurance mechanism.

Ruggie's own surveys do little to suggest that the corporate responsibility to respect is a norm actually shaping corporate conduct. First, the due diligence process that the Special Representative regards as essential to the credibility of corporate respect for human rights is largely absent or deficient, even in the largest global firms with the greatest reputational vulnerability; second, for major state-owned, and indeed, privately owned, enterprises based in emerging economies, the notion of corporate responsibility to respect is absent; third, the problem of the 'determined laggard', the firm that is indifferent to social norms or responsive only to its specific utility calculus, persists (Ruggie, 2007: 77–81).

A further concern is the failure to specify corporate-related human rights standards. As noted, Ruggie declined to formulate a specific statement of corporate-related human rights standards and asserts instead the undifferentiated corporate responsibility to respect all internationally recognised human rights. The United Kingdom Parliamentary committee observed that there is very little detail on what standards should apply to business conduct to ensure rights are respected (Joint Committee on Human Rights, 2009: 94). The role of the state in framing expectations is crucial in this contest of norms. The Parliamentary committee concluded that 'the highest priority is for the Government to make clear to UK business the human rights standards which business should meet to avoid human rights abuses occurring' (Joint Committee on Human Rights, 2009: 300). As Ruggie told the committee,

> government policies that are limited to advocating voluntary approaches to corporate responsibility for business often differ very little from *laissez faire*. … They are not really policies at all: they are just words on paper … at a minimum a policy needs to signal what is expected and then you go up from there, if you will, on a regulatory ladder (Joint Committee on Human Rights 2009: 197).

The absence of a set of corporate-related human rights standards is problematic on several counts. First, Ruggie has repeatedly emphasised the difference between state and firm in function and responsibility. Firms are 'specialised economic organs, not democratic public interest institutions' (Ruggie, 2008: [53]); their responsibilities are fundamentally different. Human rights instruments are directed to states and framed in terms of state conduct and responsibilities. The distinction between the state duty to protect and corporate responsibility to respect does not differentiate between the content of each obligation. Indeed, the drawn only adds to the complexity of discerning the distinct corporate standard.

Second, the absence of a statement of the specific human rights obligations of business impedes the development of a global consensus on standards, even a general standard that is not responsive to sectoral and other differences between firms. Ruggie has acknowledged the diversity of human rights standards that are referenced in corporate human rights policies and the variety, selectivity and hierarchy of rights recognised (Ruggie, 2006a: 7–8): '[t]he levels of support vary according to the type of right, with labor rights ranking highest. In contrast, some non-labor rights receive little or no attention' (Wright & Lehr, 2006: ix). The absence of an authoritative statement of human rights for business has the further consequence of encouraging opportunism and gaming of the human rights assurance process. Thus, Ruggie found in an earlier survey of large firms that:

> only a minority [of companies with codes] has a separate human rights instrument; and few of those adopt what the human rights community considers a 'rights-based approach.' Within such an approach companies would be expected to take the universe of human rights (as contained in the UDHR and related covenants and conventions) and work back from them to define corresponding policies and practices. In contrast, beyond the realm of legal requirements, companies that currently have human rights policies typically approach the recognition of rights as they would other social expectations, risks and opportunities, determining which are most relevant to their business operations and devising their policies accordingly. The latter model comes more naturally to business, but it also leads to variability in how rights are defined. Some of this variation may matter little. But there must be generally recognized boundaries around 'what counts' as recognition of any particular right, again reinforcing the desirability of clear and commonly accepted standards. (Ruggie 2006a: 8)

These powerful considerations, grounded in the Special Representative's own research, are not addressed in the framework model. If the corporate responsibility to respect is to become normative and prescriptive, to be engraved in corporate culture as the Special Representative seeks, it requires a clear corporate standard to which firms can be held accountable. The absence of such a standard is problematic.

ASSURING CORPORATE RESPONSIBILITY IN GLOBAL BUSINESS: REGULATORY OPTIONS

Despite their limitations, the new forms of transnational private governance are undoubtedly a constructive attempt to fill the major gap in regulation of business practices at the global level. There are dangers, however, in the creation of transnational obligations through private codes that operate independently of host states or in the face of their decision not to ratify or enforce the international standard applied by the voluntary code. Whether code content is driven by perceptions of consumer sentiment, civil society pressure or unaided corporate judgement, its legitimacy to determine appropriate levels of social, labour and environmental standards in host developing countries is contestable. The power that codes have to extend the reach of international standards would rest more securely and legitimately if grounded in international participation and consent: '[s] tandards that are intended to operate internationally should be multilaterally agreed, monitored and applied through procedures that are themselves transparent, accountable and socially responsible' (United Nations Conference on Trade and Development, 2001: 54). Addressing the problems of voluntary code implementation will not 'provide an adequate substitute for establishing a framework of accountability that extends across and beyond the corporate body' (Zadek, 2001: 211). What then are the other regulatory options available and their prospects of success?

Binding international regulation

One option is expand the scope and effectiveness of international regulation. As noted, there is no conceptual barrier to states holding firms directly responsible for violations of international law by imposing human rights obligations directly on firms and establishing some form of international enforcement regime. The political barriers, however, are formidable among both developed and developing countries as well as business. Such instruments would depend upon sufficient state ratification for commencement and effectiveness. The experience with the failed UN Code of Conduct for Transnational Corporations and UN Norms proposals is indicative of the obstacles and prospects of success (see subsection above: Attempts at a prescriptive international code for business). Intermediate steps towards international oversight include greater focus on corporate-related breaches by the UN treaty monitoring bodies overseeing the discharge of state duties under human rights instruments.

Strengthening host state capacity to protect against corporate-related human rights abuses

Strengthening host state capacity to discharge the duty to protect against breach of human rights instruments ratified by the state is one of the three pillars of the Ruggie framework. He has proposed strategies to this end, including greater guidance and support for states through cooperation and assistance at the international level, addressing deficiencies in the OECD Guidelines, and aligning state investment and human rights policies which often operate independently of each other to the detriment of the latter (Ruggie, 2008: 46, 48; Guiding Principles 8–9). Each of these strategies is desirable. But is there any reason to believe that they would cure the core problem of weak host state capacity where 'states are so weak or unwilling to protect human rights and corporations are so comparatively strong or conveniently transnational to evade human rights responsibilities' (Joint Committee on Human Rights, 2009: 94, quoting Ruggie's oral evidence; Ruggie 2008: 14)? The strategy appears to underestimate the core problem of host state capacity and incentive to discharge the duty to protect. In the endemic conflict between human rights and commercial claims and imperatives, when firms are pushed by powerful internal and external incentives to act in their commercial interests, the task of imposing other obligations upon them is poetically described as 'like painting on clouds' (Kinley, 2009: 178). In the major emerging economies such as the People's

Republic of China, India, Russia and Brazil, the challenge is more egregious both with respect to protecting inbound investment and with the offshore accountability of their own large transnational firms.

Increased home state effort to impose standards of offshore business conduct

There is disagreement as to whether international law requires home states to help prevent human rights abuses abroad by firms which they have incorporated or which are headquartered there or listed on their securities exchanges; there appears greater clarity around their right to do so, although the scope of the right is subject to an overall reasonableness test and does not involve intervention in the internal affairs of other states (Ruggie, 2008: 19). Ruggie has noted that home states of transnational firms are 'reluctant to regulate against overseas harm by [their] firms because the permissible scope of national regulation with extraterritorial effect remains poorly understood, or out of concern that those firms might lose investment opportunities or relocate their headquarters' (Ruggie, 2008: 14). Developing countries are often hostile to such regulation because of concern about the impairment of their sovereignty. Ruggie has left the issue of extended scope of the extraterritorial dimension unresolved – the Guiding Principles are silent with respect to the specific responsibilities of home states and reference to home states in the commentary is exiguous.

There is a powerful precedent for uniform home state regulation for the worst corporate-related human rights abuses in the regulation of bribery and corruption by OECD countries. The OECD Anti-Bribery Convention establishes legally binding standards criminalising bribery of foreign public officials in international business transactions. Adoption of the Convention, effected through national legislation, followed unilateral action by the United States in enacting the Foreign Corrupt Practices Act 1977. The Convention effectively assures a uniform regulatory environment between OECD countries in respect of competition by their firms for international business, although questions remain with respect to the quality of national enforcement. There are other instances of unilateral state action to regulate overseas activities of nationals, for example, in relation to sex tourism. In the corporate area, the other important remedy is the United States *Alien Tort Claims Act* 1789 which permits US courts to hear damages claims by aliens for violations of international law wherever committed.

No state has acted unilaterally to impose on its firms in their offshore operations standards comparable to those required of business domestically (McCorquodale & Simons, 2007; Seck, 2008, 2008a). In Australia legislative proposals from a minority political party in these terms were rejected in 2000 (McBeth, 2004). The obstacles to unilateral home state action are formidable, including concerns about how firms' behaviour overseas might be monitored by home states and the relevant standard of conduct to be applied to them if not domestic parity (Joint Committee on Human Rights, 2009: 204). Of course, issues of political will, grounded in the fear of competitive disadvantage to local firms, are no more tractable. The issue typically arises where a foreign parent operates offshore through subsidiaries and affiliates incorporated in the host state. There is a lesser level of difficulty in an intermediate level of parent-based regulation where the home state requires its locally incorporated parent companies 'to exercise oversight of its own subsidiaries, and it holds the parent company responsible, as opposed to directly reaching out into another country and legislating directly for the subsidiary' (Joint Committee on Human Rights, 2009: 204, oral evidence from Ruggie). Such regulation is less likely to affront host state sovereignty concerns.

Finally, Ruggie observes that the implications of corporate and securities laws for human rights 'remain poorly understood' (Guiding Principle 3, Commentary). He proposes that states foster domestic corporate cultures in which respecting rights is an integral part of doing business. This proposal would require changes to national corporate law and governance systems by encouraging sustainability reporting, redefining fiduciary duties of company directors and managers, and through increased shareholder engagement (especially through shareholder proposals) to empower investors responsive to human rights and reputational impacts (Ruggie, 2008: 30). This strategy reflects the decisive contribution that state involvement has made to the success of civil regulation initiatives (see above subsections: Assessing CSR as global governance and Evaluating the corporate responsibility to respect as civil regulation).

CONCLUSION

The global economy is populated by 80,000 transnational firms with 10 times that number of subsidiaries and millions of suppliers, and countless millions of national firms, mostly small to medium-sized enterprises. In this new global age, the dissolving national barriers to trade, investment and currency flow under regulatory liberalisation have profoundly changed the balance of power between nation-state and firm, weakening one and empowering the other. Globalisation integrates along the economic axis while simultaneously fragmenting along the political (Reinicke & Witte, 2000: 82). In this fragmented political realm, no legal mechanism regulates business activities that cross national boundaries and challenge the regulatory capacity and will of national governments. The OECD Guidelines are the only international standard that applies to cross-border transactions; its grievance mechanism is, however, a voluntary process and, if we apply the Ruggie criteria for remedies, the OECD Guidelines clearly fail (see above subsection: The 'Protect, Respect and Remedy' framework for business and human rights).

In this governance gap created by globalisation, two related bodies of voluntary civil regulation attempt to restore balance between the power of economic actors and the social institutions and communities they affect – the international corporate social responsibility movement and the development of norms of responsibility of firms for the human rights impacts of business operations and relationships. Both rely upon business self-restraint grounded in enlightened self-interest. There are, however, significant limits on the capacity of each to move markets and affect the balance of power between market and society in the global economy.

The international CSR movement consists of a plethora of codes and standards of responsible conduct that span most business sectors. They range from individual company and industry codes to a range of multi-stakeholder codes that reflect the collaborative governance of civil society, firms and states. The most successful initiatives are those with some government participation. CSR is now ubiquitous, 'the tribute that capitalism everywhere pays to virtue' (Crook, 2005: 3). Yet, *as regulation*, that tribute suffers the weakness of all voluntary offerings – vulnerability to rejection when its exactions are judged onerous or inconvenient. Its wellsprings lie in self-interest, and the limited scope of underlying incentives and sanctions is reflected in the weak monitoring and enforcement that characterise most CSR schemes.

The 'Protect, Respect and Remedy' framework for business and human rights approved by the UN Human Rights Council asserts the corporate responsibility to respect human rights. That responsibility has greater normative force as part of the international human rights system and sharper definition in its norms of responsibility. Like CSR, however, that responsibility rests principally on social rather than enforceable legal norms. There is an air of unreality around the asserted norms of the corporate responsibility to respect human rights and the state duty to protect, in view of the evident gap between the norms, the reality of firm and state practice and the lived experience of many affected communities. The corporate responsibility to respect 'requires a culture change' in the way that businesses think about their responsibilities, and business-led initiatives may well achieve over time a credible and lasting change; yet, the perception remains, as with CSR, that 'some businesses regard addressing human rights as little more than an exercise in 'good PR'' (Joint Committee on Human Rights, 2009: 119).

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Governance for Sustainability: Challenges for Theory and Practice

Suzanne Benn

INTRODUCTION

Corporate governance refers to the mechanisms and frameworks necessary for corporate decision-making. From the perspective of corporate sustainability and corporate social responsibility (CSR), however, governance refers to managing competing corporate interests for the organisation, for the wider good of society, and for the planet as a whole (Benn & Bolton, 2011). Despite the recent financial crisis, there is evidence that many senior managers continue to perceive good governance, CSR and corporate sustainability as fundamental to the long-term successful operations of any organisation. In the recent 13th Annual Global chief executive officer (CEO) survey by Pricewaterhouse Coopers, for example, more CEOs raised climate change investment during the crisis than reduced it and more than two-thirds thought such strategies would confer reputational advantages.

Several recent news items underline the need to explicate the relationship between governance and sustainability. In an April 2011 *Financial Times* article, various experts proffered opposing opinions on the new EFTSE4Good index series designed to give a more detailed understanding of how companies compare in terms of their governance and social and environmental practices (Smith, 2011). Some experts question investor use of such ratings, arguing the trend in capital markets is away from individual investors and towards hedge funds and flash trading, with the emphasis on achieving the highest return at the lowest risk. Other long-term investors opine that the scheme will usefully serve to identify companies exposed to human rights, environmental or corruption risks. What in fact both these points of view reflect is the interdependence of sustainability, good governance and effective risk management.

In another example, the BP oil spill has highlighted yet again the particular difficulties associated with managing or containing, predicting and costing environmental risk. There are now claims that the company statements concerning the quality of the clean-up cannot be believed, with scientists questioning their veracity and fears raised concerning long-term effects on human health (Crooks, 2011). We simply don't know the long-term impact on the ecosystem and upon the industries dependent upon it. While BP's share price has recovered to some extent, reputational costs cannot be so directly assessed and the company faces potential damages claims from the US Department of Justice to the tune of many billions of dollars.

According to an Accenture Report for the 2010 UN Global Compact, 93% of 766 CEOs of global companies surveyed in 2010 believed that sustainability issues will be critical to the future success of their organisations and 96% believed that sustainability issues should be fully integrated into strategy and operations (Accenture, 2010). Similarly, research conducted in 2009 by the Boston Consulting Group involving a global survey of 1,500 executives and 50 interviews reported a strong consensus that sustainability is having a material impact on how companies behave and plan to behave (Boston Consulting Group, 2009).

Admittedly, sustainability is a very broad term and different organisations from different sectors may have different interpretations. However, it is clear that many corporate managers now share an understanding that sustainability will increasingly be essential for value creation for the firm and that sustainability concerns are integral to corporate risk management. For the purposes of this chapter, the definition of corporate sustainability provided by the Dow Jones Sustainability Index is therefore relevant: 'a business approach that creates long-term shareholder alue by embracing opportunities and managing risks deriving from economic, environmental and social developments' (see http://www.sustainability-index.com/07_htmle/sustainability/corpsustainability.html). More widely, corporate sustainability can be thought of as the efficient use of resources and generation of wealth so as to contribute to a healthy economy, society and natural environment.

In this sense, three elements of sustainability are required for organisational effectiveness (Benn & Bolton, 2011). Economic sustainability refers to ensuring that the organisation is financially viable and, if a public company, that it makes adequate returns to investors. Social sustainability entails the corporation creating a supportive and developmental environment for staff while meeting the legitimate expectations of key external stakeholders. Environmental sustainability requires the organisation to eliminate any negative impacts on the natural environment and to actively contribute to the health of the biosphere (Dunphy, Griffiths & Benn, 2007). But as van Marrewijk (2003) points out, corporate sustainability is not a 'one size fits all' concept – how it is defined and therefore implemented is reliant upon the levels of development, awareness and ambition of organisations. A number of writers have addressed the problem of classifying corporate sustainability through a phased approach to the concept. Dunphy et al. (2007), for instance, distinguish the following developmental phases of corporate sustainability:

Phase 1: rejection.
Phase 2: non-responsiveness.
Phase 3: compliance.
Phase 4: efficiency.
Phase 5: strategic proactivity.
Phase 6: ideal phase of the sustaining corporation.

Progression between these phases towards sustainability is highly dependent on two factors: innovation and good governance. In this chapter, I focus on governance, aiming to identify the specific challenges that sustainability poses for the theory and practice of corporate governance and to suggest some ways forward to address these challenges.

Challenges of social and environmental governance

Governance of ecological and social problems prompts issues of control and coordination at other social, temporal and environmental scales (see, for example, Bressers & Rosenbaum, 2003; Dryzek, 2005; Eckersley, 2004). Environmental and social risks do not fit neatly within established governmental, temporal or geographic boundaries. The transport and disposal of toxic waste, for example, may raise governance problems at local, regional, national and international levels. Inter-governmental and inter-sectoral issues may also be involved and effects may extend well beyond the short term of the traditional political cycle.

Many argue our traditional theories of democracy are not equipped to deal with these issues, prompting the development of a number of more radical macro-governance theories (Benn & Dunphy, 2007) (see Table 27.1). Reflexive modernisation (Backstrand, 2003; Beck, 1992; Beck & Beck-Gernsheim, 2002; Beck, Giddens & Lash, 1994), deliberative democracy (Habermas, 1984; Miller, 1993), radical pluralism (Wenman, 2003); new institutionalism (March & Olsen, 1984; Peters, 1999), ecological modernisation (Mol & Sonnenfeld, 2000; York, Rosa & Dietz, 2003) and ecological democracy (Christoff, 1996; Dryzek, 2005) are just some of the political theories that have sprung up in attempts to address the governance of social and environmental risk more effectively and equitably.

In the next section I explore how governance theory at the organisational and inter-organisational level addresses the question of sustainability. To do this, I first examine whether leading concepts of mainstream management theory provide guidance for more appropriate models of governance and norms of management practice that will foster the transition to a sustainable society.

LEADING THEMES IN MANAGEMENT THEORY

Resource-based and strategic management theory

The history of management theory shows that cultural changes associated with globalisation and information flows have forced management theorists to gradually reconceptualise organisations as open structures. Leading this trend, contingency theory emerged in the 1960s as a situational, 'no one best way' approach which contrasts to the rigid 'one best way' and inward-looking principles of scientific management and Taylorism (see, for example, Pfeffer, 1982). Since then, strategic management theory, resource-based theory and stakeholder theory have increasingly dominated management theory. Much of the following discussion will focus on stakeholder theory, as it is this theory which most informs management practice concerning social and environmental issues.

Porter's ideas on strategic management, first developed in the late 1970s, continue to have enormous influence on management theory and practice. His 'five forces model', and the numerous other models of strategic management spawned since, largely focus on the company's external competitive environment (Porter, 1980). Although recent interpretations of strategic management theory explore CSR as a source of competitive advantage (Porter & Kramer, 2006), the relationship between this body of theory and ecological interests is very thin.

The traditional strategic management literature largely ignores ecological and democratic concerns (Bubna-Litic & Benn, 2003), not taking up the recent developments in political theory, such as ecological modernisation theory. This body of knowledge incorporates the principles of strategic management into its framework for integrating economic and environmental decision-making (Mol & Sonnenfeld, 2000). It draws on industrial ecology (Ehrenfeld, 2000) and natural capitalism models (Hawken, Lovins & Lovins, 1999) in order to argue corporations can pursue economic and environmental strategies simultaneously. Yet such approaches also have sustainability drawbacks as they rest upon technocentric principles, being little concerned with the principles of participatory or inclusive decision-making and neglecting the fact that people make technical solutions either work or fail.

The internal focus of resource-based theory, also highly influential on contemporary management practice, stands in contrast to the external focus of traditional strategic management. It highlights the need for a fit between the external business environment and internal organisational capabilities such as human resources. For instance, employee knowledge can become a key source of competitive advantage (Drucker quoted in Kochan, 2003). From the internal organisational perspective, resource-based theory can encompass democratic systems of governance. Engaging employees through representation and share ownership is seen as a means of preventing CEO excesses and expanding awareness of financial, human resource and reputational risk factors (Kochan, 2003). Positive community relationships and non-governmental organisation (NGO) partnerships are another way of developing a strategically important resource because such relationships give the corporation the 'licence to operate and grow' (Elkington, 1998). Through the lens of this theory, bridging relationships to external organisations and community bodies builds reputational and social capital – both tradeable resources (Adler & Kwon, 2002; Petrick, Scherer, Brodzinski, Quinn & Ainina, 1999).

The instrumental resource-based approach, however, has limited compatibility with a governance system grounded in ethical principles or one which gives an inherent value to the natural environment. Basically, both resource-based and strategic management theories assume that organisations, even non-profit organisations, are necessarily 'narcissistic and self-serving' (Starkey & Crane, 2003: 229). Both rest on the established parameters of development, growth, personal potential and technocratic innovation (Crane, 2000).

Stakeholder theory

Versions of resource-based theory have been merged with traditional CSR theories and reconceptualised as stakeholder theory (see, for example, Waddock, Bodwell & Graves, 2002; Warhurst, 2001; Zadek, 2001). The broadest definition of stakeholder is 'any group or individual who can effect or is affected by the achievement of the organisation's objectives' (Freeman, 1984: 46). In this vein, a successful organisation is one which at least satisfies but preferably adds value for all stakeholders, not just shareholders. Some writers have made serious attempts to conceptualise an ideal or an 'ecocentric' organisation which could also feature the natural environment as a key stakeholder (e.g. Dunphy et al., 2007; Starik & Rands, 1995). In general, these theorists argue for corporations to integrate a strong version of environmental sustainability into their business operations with clear consequences for their structures and operations. According to Shrivastava (1995: 130):

> Organisations in the ecocentric paradigm are appropriately scaled, provide meaningful work, have decentralised participative decision-making, have low earning differentials among employees, and have non-hierarchical structures. They establish harmonious relationships between their natural and social environments. They seek to systematically review natural resources and to minimise waste and pollution.

To be ecocentric also requires cultural change at the organisational level. Gladwin, Kennelly and Krause (1995: 899) argue the values required for the 'sustaincentric' organisation are: 'stewardship, equity, humility, permanence, precaution and sufficiency'. According to these broad versions of stakeholder theory, governance for social and environmental risk also involves organisations internalising all their social and environmental costs.

Limitations of stakeholder theory

Despite the claims for the importance of stakeholder engagement in creating sustainable organisations, stakeholder theory has a limited capacity to address the equitable management of risk. The theory does not really address how to operationalise a system of governance which will integrate the concerns of humans and non-humans as stakeholders. How should the interests of non-human stakeholders be represented for instance?

Another limitation relates to the contestation surrounding the interpretation of stakeholder. The traditionally accepted perspective is a narrow version of stakeholder theory based on concepts of agency theory and individualism, while a broader version is based on stewardship theory and the obligations of the collective (Sundaramurthy & Lewis, 2003). But governance, stakeholder and sustainability are loose terms, which, when used in conjunction, can make for ready appropriation by ideological or vested interests. Hence, we have the broad version of stakeholder theory espoused in the rhetoric of the 'win-win' business case for sustainability (see, for example, Grayson & Hodges, 2004; Warhurst, 2001). This interpretation tends to gloss over any conflict between economic development and strong sustainability values (Newton & Harte, 1997). One reason why the approach lacks a critical perspective on the power relations within and between stakeholder groups (Banerjee, 2003) is that the discourse has been taken up by numbers of consultants, many working in the public relations field (Beder, 2001). For these practitioners, differences in interests are to be smoothed out through consensus-based dialogue, although critics argue that such 'consensus' around sustainability or sustainable development is often dictated by the most powerful actors (Banerjee, 2003).

Another view, underpinned by market fundamentalism, is that good governance is about getting the best management of shareholder assets. According to Clarke (2004), this narrow stakeholder perspective is based on the individualist assumption that if systems of control are not implemented, managers will follow the characteristic human pattern of self-serving behaviour. On this shareholder-based view, broad stakeholder theory is limited by issues of multiple accountability and weakening agency (Bergkamp, 2002; Sternberg, 2000). If organisations are accountable to all stakeholders, so the 'narrow' stakeholder theorists argue, then genuine accountability is lost. As Bergkamp (2002: 147) puts the narrow stakeholder case:

> Measuring performance against a profit maximisation objective is relatively easy but measuring performance against the objective of balanced stakeholder benefits is fraught with difficulty.

Recently, however, the picture has become more complex. The finance model has been drawn in with concepts from resource-based theory to support the broad stakeholder argument. Blair (2004: 184) points out that the wealth-generating capacity of the firm is no longer so much 'the capital investments and entrepreneurial efforts of the investor'. In the contemporary firm, sources of competitive advantage are more likely to reflect the skills of employees and intangibles such a brand, reputation, strategic management of litigation issues and ability to communicate with customers and local communities.

This instrumental perspective on the broad stakeholder view reveals a problem common to both sides of the argument: neither address the ethical guidelines which could underpin a more inclusive and ecologically equitable management of risk (Grace &

Cohen, 1998). As Orts points out, some moral issues, such as the obligation to consider the impact of environmental risks on social groups and the environment, are 'more important than stakeholder theory can accommodate' (Orts, 2002: 228). This raises the suggestion that instead of the endless search for stakeholder priority we should be looking to set these issues in law in the form of concrete criteria for providing a 'license to operate' (Elkington, 1998). Others argue that these measures will only be meaningful if they emerge from the 'moral transformation' of corporate leaders – an issue which is not informed by the stakeholder concept (Crane, 2000: 673). Effective change may well depend both on rules and leadership.

In summary, I would agree with numerous other critics that narrow stakeholder theory rests on a base of market fundamentalism and individualism and hence has no means of addressing our sustainability-related concerns with governance. Neither does broad stakeholder theory, which promised some solutions, offer an operational framework for implementing an integrated perspective on governance for a sustainable society. It remains conceptually limited by the unwarranted pluralist assumption that all stakeholders can compete with equal resources in the decision-making arena. Governance systems across multiple and diverse stakeholders have been little analysed in terms of disparities of power between and within interest groups and how to manage them. As I have argued, power differences and ethical principles in the management of risk are often downplayed in an eager approach to get business on board the 'sustainability makes good business sense' bandwagon and issues of power are smoothed out in support for a consensus-based dialogue.

I conclude therefore that the leading traditions of management theory have real problems in contributing to how managers can deal with the competing interests associated with societal good, environmental protection, the distribution of environmental or social risk and economic viability.

EMERGENT THEMES IN MANAGEMENT THEORY

How therefore can we realistically address the issue of relations of power between and within diverse stakeholders groups? How do we give environmental concerns rights within the sphere of corporate decision-making? Marginalising political concerns by maintaining the narrow or shareholder perspective, for instance, or by implementing standardised operational systems, reflects a management determination to limit conflict, disorder and indeterminacy (Coopey & Burgoyne, 2000). Yet reducing disorder through reducing diversity can have major implications for the creative problem-solving required if solutions are to be found for challenging and seemingly intractable issues of social and environmental risk and sustainability (Backstrand, 2003; Vaughan, 1999). Traditional management theory fails to recognise that differences within and between stakeholder groups are better used to reach more creative solutions to social and environmental issues than ignored or marginalised.

In this section of the chapter, I point to some emergent themes which highlight the importance of diversity in both inter-organisational and intra-organisational relations. I also consider the leadership qualities required to determine value from these diverse relationships. I argue that these themes, while not nearly as well developed, show some correspondence with the more critical political theories set out in Table 27.1. This correspondence justifies our recommendation that these themes be incorporated into new inter-organisational models of governance that provide for the effective management of social and environmental risks.

Cultural framing and organisational change

Management theory has traditionally focused on cohesion and consensus. However, a

TABLE 27.1 Areas of correspondence between emergent bodies of theory

Key issue	*Emergent political theory*	*Key contribution*	*Emergent management theory*	*Areas of correspondence*
Cluster governance	Reflexive modernisation	A decentralised 'sub-political' arena enables reflexive and inclusive decision-making	Stakeholder interaction	Networks involving multiple stakeholders link different types of knowledge and facilitate knowledge development and diffusion
Decision-making based on high communication frequency	Deliberative democracy	Open and critical debate can increase awareness and the political efficacy of all participants	Narrative theory	Defamiliarising narratives and storytelling can develop a shared 'ecocentric' understanding across organisations
Leadership for diversity and flexibility	Radical pluralism	Non-hierarchical networks can support a multiplicity of meanings yet allow ongoing collaboration	Leadership styles	Complexity and 'feminine' leadership styles support enabling leadership and diverse understandings of values, knowledge, experience and opinions
Adaptiveness through cultural change	New institutionalism	Horizontal interactions reduce institutional resistance to change	Cultural framing	Cultural framing and analysis of stakeholder identity improves strategies for organisational change
Partnership formation	Ecological modernisation	Institutional innovation and knowledge development is enabled by government/ corporate partnerships	Bridging social capital	Open and reciprocal communication systems build trust and enable knowledge sharing between organisations
Reflexivity	Ecological democracy	Legislation needs to be precautionary and reflexive	Reflexive management	Reflexivity can be fostered through engaging in extra-organisational tasks

Modified from Benn and Dunphy (2007).

relatively recent interest in organisational culture is beginning to draw attention to the construction of stakeholder identity. This theme corresponds to the radical pluralist rejection of essentialist pluralist understandings of the stakeholder. The work of Howard-Grenville, Hoffman and Wirtenberg (2003: 70) shows that when they are setting their organisational agenda managers and change agents choose from an array of cultural frames in negotiating with other stakeholders on social or environmental initiatives. These cultural frames may change or be changed as a result of relationships if, for example, an organisation perceives itself under attack. This work highlights the importance of cultural determination of stakeholder identity and indicates its shifting and fluid nature.

This research also shows the importance of the cultural change agent in working with organisations to address social or environmental issues not previously seen as business priorities. The corporation, for instance, may be required by new legislation to share decision-making about risk with the wider community. It is important in this context for the change agent to recognise that the organisation is not monolithic in its interpretation of social and environmental initiatives, but may in fact include a number of different factions, functions or units whose cultural frames shape very different perspectives on social and environmental issues. Howard-Grenville, Hoffman and Wirtenberg (2003: 81) argue that selection of culturally appropriate language and other ways of communicating the issue at hand can 'stretch' frames already existent in the organisation to 'accommodate new issues and new approaches'. As they point out (2003: 70):

> While successful implementation of social initiatives involves moving the organisation beyond its current practices, it also must tap into accepted ways of representing problems and enacting solutions.

Narrative theory

Recent developments in narrative theory shed some light on the complex picture of organisational orientations towards social and environmental issues such as the internalisation of risk. Livesey's (2001) analysis suggests that eco or socially responsible discourse may have many layers of meanings and intentions. In embracing the discourse of community consultation or environmental reform, an organisation may be merely engaging in 'symbolic politics'; on the other hand, the new language may reflect a more genuine determination to reform practices. Importantly, Livesey's work shows that many unintentional and unpredictable results may result from an organisation engaging with the discourse of sustainability as a form of 'storytelling'. As well as shaping relationships with other stakeholders, the discourse may have the unintentional effect of an organisation developing a greener or more responsible culture. Used intentionally, then, green or socially responsible narratives can foster cultural change. Starkey and Crane (2003), for instance, claim that if used critically and in conjunction with defamiliarising narratives for change, 'green narratives' can enable the co-evolution of differing subgroup perspectives towards a shared and more ecocentric perspective within an organisation.

Multiple stakeholder interaction

Matten and Crane (2005) argue that the lessening influence of nation-states as a result of globalisation can increase the role played by corporations in the administration of citizenship, and conclude that political theory needs to examine multiple stakeholder interaction more seriously. In addition, some management theorists now recognise that diversity in inter-organisational relations encourages the development of reflexive practices and facilitates knowledge creation. Developing bridging social capital through developing diverse external ties is dependent on transparent and reciprocal communication processes between organisations. These organisations may be community groups, government or corporate organisations. The process of dialogue across corporate boundaries (Roberts, 2003) stimulates innovation and facilitates organisational learning (Adler & Kwon, 2002; Martin, Benn & Dunphy, 2007). Hardy and colleagues' research has shown that organisational interactions or relationships which are 'embedded' (i.e. characterised by interactions with third parties, representation and multidirectional information flows) and show deep involvement (i.e. have interactions between many levels of the collaborators) facilitate the generation of new practices, technologies or rules and the building of sustainable and distinctive capacities (Hardy, Phillips & Lawrence, 2003).

My own research has shown that inter-organisational relationships are more likely to be embedded if the multiple stakeholder arrangement includes community-based networks and that the inclusion of these networks facilitates the development of new practices useful in the management of environmental risks (Martin et al., 2007). One key reason behind this finding appears to be that the inclusion of the community-based networks enables the bringing together of different forms of knowledge, such as lay and expert knowledge. In a sense, the network enables the development of a shared perspective based on valuing different types of knowledge of environmental and social issues.

Leadership

Implementing sustainability is a highly complex task for organisations (and for wider society). It entails bringing together multiple actors and crossing numerous functional and disciplinary boundaries. Scholars of complexity leadership (e.g. Plowman, Solansky, Beck et al., 2007) model the contemporary organisation as a complex adaptive system, arguing that emergent rather than directive leaders who can embrace uncertainty are more likely to encourage new directions in such organisations. Some researchers of sustainability (e.g. Taylor, Cocklin, Brown & Wilson-Evered, in press) see the relevance of this work to the role of environmental leaders, arguing that the complexity of the sustainability challenge and the lack of definition of many associated issues call for enabling rather than directive approaches to leadership. Such leadership is more readily accommodated by a less rules-based approach to governance.

Further suggestions on the value of alternative leadership styles come from the body of research dealing with gender and diversity on leadership. 'Feminine' leadership, in particular, encourages a diversity of values, experiences and opinions and appears to have advantages in developing a communicative culture both within and between organisations (Benn, Dunphy, Griffiths & Ross-Smith, 2004b). In a major study of Australian senior managers, Ross-Smith and colleagues have shown that a developing critical mass of female managers results in changes in organisational practice such as more team-based work, less competitive behaviour, changes in styles of comm-unication and a more flexible culture (Ross-Smith, Chesterman & Peters, 2003). Leaders who value and can deal with diversity develop more communicative and flexible relationships between stakeholders, arguably a factor in the effective risk management and therefore good governance of sustainability.

If a less compliance-based approach to governance is to ensure the firm maintains sustainable business practices, it must embody the principles of reflexive regulation and enable reflexive management. Berry (2000: 11) points out that reflexive management requires leaders who are prepared to engage with both inter- and extra-organisational tasks, and in so doing 'combine private advantage with public acknowledgement of the obligation to engage in critical reflexiveness of values and beliefs, intentions and consequences'. To some extent these relationships are dependent on the formation of institutions such as self-regulatory reflexive legal frameworks and incentives (Orts 2002) designed to induce management to internalise their environmental risks and costs (Tirole quoted in Webb, 2004).

Organic governance

In summary, governance for the equitable and inclusive management of risk that will support sustainable business practices is posing new challenges for management theory. As Nobel Prize winner Professor Joseph Stiglitz (2004: 3) has put it: 'Good management is a public good. There is no perfect solution'. The shift is away from a single-minded emphasis on efficiency that dominated the governance interpretations of the 1990s. The contemporary organisation is more interconnected, less involved in linear cause–effect strategies and planning and more concerned with organisational qualities such as learning, adaptiveness and reflexivity than the traditional form (Clarke, 2004). 'Organic' or self-organizing systems of governance are more appropriate for the control and coordination of such forms. The organic or cluster model originally proposed by Potapchuk, Crocker and Schechter (1999: 221), for instance, is fluid, with multiple nodes, involving clusters of multiple stakeholders linked by informal and formal connections and employing deliberative processes in decision-making.

Synthesising political and management theory

In Table 27.1, I show that there are areas of correspondence between the emergent themes in political and management theory. I suggest these emergent concepts from management and political theory can be synthesised into governance systems that can coordinate multiple and diverse stakeholders and achieve full and open debate. Governance for reflexive management aims to achieve change by involving people in doing it.

I argue that the areas of correspondence mapped out in Table 27.1 can form the basis of a more productive model of governance that emphasises organisational leadership geared to diversity, communication, flexibility, reflexivity and inclusion. I argue that this model fosters the trusting relationships necessary for managing issues of environmental and social risk for the long term while taking into account real difference in the interests of stakeholders (Kochan, 2003).

REDESIGNING THE PRACTICE OF GOVERNANCE

In this section I provide some suggestions for the practical implementation of a form of governance which has the characteristics listed in the left-hand column of Table 27.1. My previous analysis of the shortcomings of traditional systems of democracy and theories of management has led me to conclude that more than just coordination and accountability are required for the effective governance of sustainability. A key requisite is the creation of decentralised arenas of decision-making, including community-based networks where new and creative solutions can be fostered. In these new units of governance, it is necessary to rethink decision-making, leadership, the role of the change agent in cultural change, the nature of partnership models and how reflexivity can be effectively encouraged. I now deal with each of these areas in turn.

The cluster approach to governance

Both reflexive modernisation and stakeholder interaction theories argue that decentralisation encourages inclusiveness. I argue that, in addition, embeddedness is a vital component. Embeddedness results from high levels of interaction and deep involvement in stakeholder relations and this facilitates the shared development of new practices, skills and techniques for dealing with risk issues. Where the cluster approach to governance has these characteristics, it avoids the top-down and inflexible approach which is incompatible with a reflexive, adaptive system (Potapchuk et al., 1999). The cluster-based model focuses on the development of networks or coalitions of those who are potentially at risk or critical to successfully ensuring that sustainable practices are instituted. A cluster can include organisations of all types as well as individual members of the community. In order to identify the boundaries of a cluster, it is necessary to define the nature of the risk, the scope of the risk, the relevant stakeholders (i.e. those potentially affected by the risk) and the extent of the risk to various stakeholders. This would not usually occur prior to the cluster coming into existence but would evolve as the relevant parties explore the nature of the risk – actual membership of a cluster can evolve over time, with the increasing definition and clarification of the issues.

There is a major challenge in the development of such networked clusters, where, say, the organisations are firms or not-for-profit organisations involved in ongoing and structured relationships (Jones, Hesterly & Borgatti, 1997). Coordination between autonomous organisations is difficult enough. But where there are issues of wide social and environmental risk to consider, the members of the 'network' may not be only discrete organisations. They may include, for instance, individual activist and diverse interest groups within a broader community which faces potential risk due to, for example, the building of a new chemical plant.

These difficulties suggest the need for negotiating, at an early stage of cluster development, the deliberative strategies that will be adopted. Issues here include deciding on whether to use direct or indirect representation of stakeholders, the appointment of a coordinator or coordinating group, choosing appropriate forms of communication within the networks, developing a timeline for the process and anticipated stages, gaining agreement to decision-making methods including how the final decision will be reached, providing for arbitration in case of failure to reach agreement (the citizen's jury is one method used by advocates of deliberative democracy) and designing support to overcome relative disadvantages of some stakeholders.

The diversity of ethical norms in such a cluster will require agreement on decision-making procedures. Potapchuk et al. (1999) suggest that there needs to be one coordinating entity to lead a cluster of organisations or individuals linked by both formal and informal governance structures. Ideally, prior agreement will take place on the coordinating entity and the rules for decision-making. There must be participation by all stakeholders in the problem definition process if the governance of inter-organisational or multiple stakeholder arrangements is to engender trust and go beyond the corporate drive to accumulate symbolic capital (Tsoukas, 1999). Participants need to acknowledge their mutual dependence and interconnectedness with each other in order to develop bridging social capital (Demirag, 2004). As I have discussed, this contrasts with the construction of stakeholder identity through heightening the sense of 'otherness' – a process which leads to the smoothing out of difference, lessens participation and, in the end, results in a less creative solution to the shared problem of sustainability.

Partnerships and governance

Numerous scholars and commentators now regard partnership as an aspect of good governance and define governance as a network- or partnership-based function – a definition that has particular relevance to corporations. Partnership is most commonly seen to deliver on the effectiveness element through providing extra resources such as skills and other forms of labour, although it may also promote inclusiveness, which is one of the values-based aspects of partnership. It can reduce barriers to institutional change such as conflict, ambiguity and ignorance. In this view, partnership contributes to governance effectiveness. Partnership structure is also crucial to governance outcomes such as legitimacy.

The setting of targets is an important factor in establishing these frameworks. Drawing from empirical research, Bressers and de Bruijn (2005) have shown that covenants and agreements with unclear targets are associated with significant transaction costs, and that voluntary agreements are most successful when embedded in linked policy approaches so that the business sector is delivered a coherent approach by government. In other words, target- setting for sustainability outcomes from partnerships needs to be made relevant in the wider context of sustainability policy-setting if it is to be seen as a legitimate aspect of governance.

To implement governance systems that support corporate sustainability and CSR objectives, the challenge is to balance self-organised, individually crafted governance arrangements with clear frameworks of control in order to alleviate problems noted with diffusion of power, vague goal-setting and lack of clarity in sustainability or CSR objectives. Other sustainability and CSR challenges that might be addressed through good governance include high costs, low levels of motivation and tensions that derive from different frameworks of responsibility and accountability between public and private sectors.

Business enters into partnerships that have social or environmental objectives partly as a result of external industry and market forces and partly to bolster internal resources and competitive strategies. Numerous benefits associated with more responsible corporate behaviour are claimed for partnerships. Those between business and government, for example, represent a new form of governance for CSR and corporate sustainability. Partnerships formed to promote sustainability or corporate responsibility goals are not a substitute for government regulation but they may be the only realistic first step towards effective governance until national and international government organisations can be involved. They can encourage the development of a set of accountability requirements that are shared by the company and key stakeholders, while allowing for some flexibility and certain economic efficiencies.

Thus, partnership initiatives boost legitimacy and act as significant contributors to strengthening society's perception of the corporation. By contributing to the relationships with technical expertise and financial resources, companies can leverage the experience, knowledge networks, know-how and legitimacy of being associated with the public sector. Partnerships can enable knowledge-sharing and a distribution of competencies across the contributing organisations, as well as allowing government participation in a relationship that is based more on discussion and trust rather than a more punitive mindset.

Such forms of governance are not without their critics. In particular, it can be argued that mechanisms to ensure accountability in networks are difficult to devise – beyond such measures as naming and shaming and peer evaluation (Arevalo & Fallon, 2008). Clearly, more research needs to be done to support claims made on behalf of partnerships between business and government as a form of governance.

Partnership research

In one partnership I studied, I explored participant perceptions concerning the governance of the Sustainability Advantage Program, administered by the Business Partnerships Division of the then Department of Environment, Climate Change and Water (DECCW), in NSW, Australia. The Sustainability Advantage Program aims to promote environmental sustainability within its business partners through voluntary agreements. The research involved 60 interviews and two surveys conducted over two years between 2006 and 2008 (Benn & Martin, 2008).

Key findings included that Program success was seen to derive from its operations as a 'learning network' rather than as a partnership. For example, in the qualitative data, success was linked with an approach that involved informal dialogue and inter-personal relationships rather than formal structures. This finding was supported by the quantitative data. In the first survey, several items related to structures and regulations used to manage the data in the form of two surveys. relationship were selected relatively infrequently (by between 7.7% and 17.3% of participants) as factors that led to the success of their relationship with the Program (Benn & Martin, 2008). The Program was perceived as involving informal 'collaborative' processes rather than the more formal processes associated with partnership. Hence, it was not the structure of the Program, but its processes and associated inter-personal relationships, that were associated with effectiveness (Benn & Martin, 2008). In both surveys the commitment of personnel was seen as the most important factor in delivering positive outcomes from the relationships. Rated only slightly lower than items related to commitment in both surveys were items involving having shared values and trusting relationships between organisations. Both the interviews and focus groups highighted the importance for this development of shared understandings and mutual trust, of a high level of inter-personal skills on the part of both government and participant representatives, as well as the facilitation of informal communication.

This research supports the work of other scholars who argue that the value of partnerships and networks as a means of governance rests on their ability to generate systems of dialogue and exchange that will enable and embed mutual respect and shared learning (Stoker, 2009).

Challenges for partners

There are numerous challenges in establishing and maintaining credible partnerships around corporate sustainability. Trust is clearly a key operating principle in any partnership, and trust takes time to develop. Governments may find it difficult to maintain high levels of scrutiny as they attempt to accommodate their business partners and build these high levels of trust and communication. Real and meaningful partnerships appear to require the development of social relations, through commitment and through establishing mutual understanding and consideration. To be effective, partnerships would appear to need clear, quantifiable goals, simple management structures and appropriate governance rules to consider the needs of external stakeholders. At their worst, partnerships may present some businesses without a commitment to sustainability (but perhaps with the intention of appearing to be green by employing a number of finely tuned skills in projecting this image), a way of obviating their responsibilities.

Business networks

Prompted by increasing concern over the negative impacts of global economic activity on the health of society and the planet, voluntary networks comprising organisations from different business and other sectors have emerged that are concerned with establishing an infrastructure to progress and standardise corporate sustainability and CSR initiatives. To some extent, these networks, such as those associated with the Global Compact and the Carbon Disclosure Project, attempt to redress the absence of a global structure that could provide internationally recognised governance for CSR. Industry-specific initiatives include the chemical industry's Responsible Care.

Yet, as Benn and Bolton (2011) point out, compared to an effective global governance system supported by democratic principles, such networks present many problems and inadequacies. Waddock (2008), for example, identifies two key problems with this emergent infrastructure and its multiple stakeholder's decision-making processes: first, there are a confusing array of behaviours and principles to be assessed; secondly, these networks tend to be driven by Europe and North America, raising issues concerning inclusiveness and the rights of indigenous peoples.

While much is made of the benefits of such partnerships and networks as a means of governance for sustainability and CSR, there are likely to be costs if the contributing organisations do not acknowledge the precise purpose of a partnership. A fundamental and recurring critique is that the voluntarism that underpins partnerships between businesses and governments risks reducing or compromising government scrutiny of business in the area of pollution and other environmental concerns. There is also considerable debate over whether voluntarism stimulates innovation more than stringent regulation, with evidence in the literature for both sides of the argument.

CONCLUSION

This chapter suggests that new themes in management theory are in step with political concepts that have emerged in response to sustainability challenges. This congruence lends support to models of corporate governance for sustainability that are less rules-driven, more reflexive and based in networks and partnerships rather than traditional compliance-based approaches that hinge on the narrow stakeholder view. This more collaborative and inter-organisational perspective on governance appears more relevant to contemporary organisations, facing responsibilities such as addressing issues of intergenerational equity and globalisation.

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Name Index

Adams, R.B. 13, 185–6, 190–1, 387, 390, 431–2, 438, 557
Aghion, P. 501, 505–6
Aguilera, R.V. 2–3, 5, 21–2, 198, 379–87, 390–1
Ahmadjian, C. 141, 388, 390
Almazan, A. 389
Almeida, H.V. 424
Anderson, R.C. 387, 396, 467
Anthony, R.N. 171, 173, 177
Ashby, W.R. 434, 444
Asher, E. 500, 513
Austin, R.P. 528

Bainbridge, S.M. 67, 100, 109, 390
Balduck, A. 288, 291
Baldwin, C.Y. 435, 481
Banerjee, S.B. 616
Banerji, A. 337, 340
Barclay, M.A. 285, 301–3, 305, 310, 316
Barnard, C.I. 256
Baysinger, B. 45, 218, 220, 223, 501, 506
Bazerman, M.H. 301, 442
Bebchuk, L.A. 23, 63, 68–9, 77, 109, 129, 136, 153, 186, 373, 377, 380, 387–8, 453, 466–7, 489
Bednar, M.K. 189, 354
Behan, B.A. 301–3, 306, 309, 311–13
Benn, S. 6, 29–30, 612–14, 618–20, 623–4
Bergkamp, L. 616
Berle, A.A. 1, 7, 42, 45, 55, 60, 97–9, 109, 138, 293, 385, 407, 409, 482
Berry, A. 528, 620
Bhagat, S. 109–10, 184, 186, 191, 390, 437
Bignon, V. 12–13, 159, 162
Bilimoria, D. 326–9, 352
Biondi, Y. 4, 12–13, 159, 162, 164, 557
Birley, S. 417
Bishop, K. 349
Black, B.S. 184, 186, 191, 443, 457–8, 460–3, 472
Blair, M.M. 2, 4, 7–8, 15, 25, 63–5, 67–72, 76, 101, 109, 116, 124, 219–20, 227, 233–6, 240, 258, 481, 499, 502, 513, 557, 616
Blumberg, P. 120, 528
Bolton, D. 612–13, 624
Bolton, P. 454, 472
Bonbright, J.C. 412
Bond, S. 506–7
Boyd, B.K. 224, 389, 407–8, 422, 466
Boyer, R. 160, 176
Branson, D.M. 2–3, 18, 20, 365, 376–7
Bratton, W.W. 8, 63, 65, 68–9, 75–6, 376
Bressers, H. 614, 622
Brown, G. 551–2
Brown, J.D. 299, 507
Brown, M. 566–7
Brown, W.A. 285, 290–1, 298
Brundin, E. 312
Bruton, G.D. 221
Brynjolfsson, E. 502, 508, 513
Bubna-Litic, D. 614
Buchanan, J. 128
Buchholtz, A.B. 382
Buelens, M. 288
Bulli, S. 513
Bullock, A. (Lord) 43
Burgess, J. 376
Burgess, Z. 334
Burgoyne, J. 617
Burkart, M. 501
Burke, E. 377
Burke, L.M. 347
Burke, R. 328
Burns, M.L. 217
Bush, T. 440
Bushee, B.J. 397, 505
Butler, H.N. 45, 185
Byrd, D.T. 188
Byrd, J. 186
Byrne, D. 352
Byrne, J.A. 492
Byron, C. 415

Cadbury, Sir Adrian 2–5, 32, 45–7, 50, 122, 127, 196, 213, 243, 257, 260, 263–4, 277, 279, 297, 367, 376, 384, 422, 429, 442
Cadman, B. 468
Calantone, R.J. 507
Calder, F. 599
Calderini, M. 510

Calderon, M.E.I. 418
Callen, J.L. 288
Camerman, F. 277
Camm, G. 271
Campello, M. 506
Canella, A. 256
Canepa, A. 507
Cannella, A.A. 258, 293, 345, 351–2, 356, 358
Cappelli, P. 151, 154, 471
Carlin, W. 513
Carney, M. 22, 409, 412
Carpenter, M.A. 221, 224–5, 345, 348–9, 355–6, 389
Cartelier, J. 177
Carter, C.B. 148, 295
Carter, D. 200, 289, 293, 295
Carter, D.A. 349
Carter, M.E. 468
Carvalho, A.G. 395
Carvalho, F. 113–14
Carve, J. 307
Carve, M. 307
Carver, J. & M. 307
Cary, W. 129
Casper, S. 514
Cassiman, B. 21, 381
Casta, J. 171
Castro, C.B. 257, 290
Certo 258
Chandler, A.D. 26, 498, 511
Chang, S.J. 413, 424
Charan, R. 18, 148, 200, 285, 289–90, 295–6, 304
Chatterjee, A. 204
Chau, T.T. 417
Cheffins, B.R. 376, 557
Chen, C.J. 222, 225
Chen, M. 257, 356
Chhaochharia, V. 142
Child, C. 591
Chirinko, R.S. 513
Cho, T. 257, 356
Chrisman, R.D. 94
Christensen, T.E. 481
Christie, M. 311
Christoff, P. 614
Chung, C.N. 391
Chung, H. 141
Chung, K.H. 406, 408–9, 412–13
Cincera, M. 506
Claessens, S. 109, 136, 410–11, 413
Clark, D.N. 435, 481, 498, 502, 528
Clark, R. 68–9, 77
Clarke, T. 1–2, 4–5, 17, 22–3, 26, 30, 75, 224, 235, 259, 262, 274, 276, 286, 291–2, 302–4, 306, 308, 311, 315–18, 407, 413, 443, 499, 507, 556, 561, 570, 580, 616, 620
Coad, A. 513
Coase, R. 1, 5, 100, 109, 113, 119
Coates, J.M. 327
Cochran, P.L. 45, 435
Cockburn, I. 505
Coelho, S. 77
Coff, R.W. 500–1
Coffee, J.C. 186, 217, 376–7, 395, 547–8, 579
Cohen, A. 186
Cohen, S. 617
Cohen, W.M. 505, 508
Colasse, B. 160, 171
Coles, J.L. 185
Collier, J. 287, 317
Collins, B.J. 219–20
Colpan, A.M. 21–2, 406, 408
Colvin, R. 566
Compa, L. 598
Conger, J.A. 221, 289, 291, 302–3, 308, 317
Conway, E. 573
Conyon, M.J. 24, 198, 453, 456–8, 460–2, 465, 467–9, 471–2
Corbetta, G. 416, 422
Core, J.E. 23, 185, 453, 458, 460–1, 464, 466, 471
Cornforth, C. 289
Corrigan, G. 561–2
Coughlan, A.T. 462
Coulson-Thomas, C. 290
Court, D.C. 145
Covin, J.G. 219–20, 225
Crane, A. 615, 617, 619
Craven, D.W. 434–5
Crocker, J. 620
Cronqvist, H. 136
Crook, J. 608
Crooks, E. 613
Crossland, C. 257, 358
Cuervo-Cazurra, A. 2–3, 198, 384–6
Culverwell, M. 599
Cyert, R.M. 188, 233, 349

Dacin, M.T. 260
Daily, C.M. 13, 109–10, 184, 189–91, 199, 221, 224, 239, 256, 258, 289, 293, 297, 332, 345, 352, 389, 467
Dallas, L.L. 73–5, 442
Dalton, D.R. 184–6, 191, 199, 256, 258, 293, 332, 345, 349, 351–2, 380, 389
Dammann, J. 94
Daniels, R. 388
D'Aveni, R.A. 422–3
David, P. 506
Davidov, G. 119
Davies, M. (Lord) 340–1
Davies, P. 3, 18, 121, 266, 311, 383, 390
Davis, G.F. 3, 24, 138, 141, 218, 262
Davis, J.A. 416–17, 420
Davis, J.H. 139, 187, 199, 212, 218, 220, 288, 434
Dawley, D.D. 290
De Grauwe, P. 277
Deakin, S. 3–4, 10–12, 113–14, 116, 118, 120, 125, 128, 131, 133, 385, 502, 557
dela Rama, M. 1–2, 21–2, 413

Demsetz, H.L. 16, 69, 109, 119, 233, 235, 240, 377, 387, 407, 498
Desender, K.A. 21, 379, 382, 387, 390
Dewatripont, M. 454, 472
Djankov, S. 385, 410
Donaldson, L. 187, 218–20, 288, 434
Driver, C. 25–6, 507, 513
Drucker, P.F. 48, 615
Dryzek, J. 614
Duke, L.J. 95, 109, 376
Dulewicz, V. 285, 290, 302, 307, 314, 317
Dunphy, D. 30, 613–15, 618–19
Durisin, B. 17, 258
Dyer, W.G., Jnr. 414, 420

Easterbrook, F. 64, 113, 115–16, 118, 130
Ehrenfeld, J. 615
Einhorn, D. 546–8, 550
Eisenhardt, K.M. 22, 33, 146, 258, 266–7, 348, 356, 389, 407, 496, 505
Eng, L.L. 506
Enriques, L. 76
Epstein, G.A. 545–6
Epstein, M.J. 289, 291, 299, 307

Faccio, M. 386, 412
Fahlenbrach, R. 123, 136
Fama, E.F. 2, 15, 33, 56, 66, 109, 116, 144, 185, 198, 210, 218, 223–4, 227, 234–6, 258, 350, 388, 407, 478
Farrar, J.H. 5, 26–7, 520, 528
Fazzari, S.M. 513
Fernandes, N.G. 456, 458, 462
Ferreira, D. 123, 186
Ferreira, M.A. 456, 462
Ferrell, A. 77, 129
Filatotchev, I. 221, 226–7, 235, 239, 349, 380, 383
Finkelstein, S. 184, 187–9, 200, 211, 222, 256, 291, 293, 345–7, 349–50, 356, 380, 422–3, 466, 557
Fischel, D. 64, 113, 115–16, 118, 130
Flynn, R.J. 297
Fondas, N. 326–7
Forbes, D.P. 184, 188–9, 199, 211, 219, 222, 224, 234, 239–40, 242, 258, 275, 289, 291, 346, 350–1, 354
Franks, J. 385, 390, 506
Freeman, R. 220, 615, 626
Frey, B.S. 73, 77, 508, 511, 513
Fried, J.M. 23, 186, 224, 380, 446, 453, 466–7, 489
Friedman, T. 370
Froud, J. 3, 206, 545

Gabrielsson, J. 15–16, 188, 219, 222, 226, 228, 233–4, 236–7, 239–42, 244, 289, 291, 301
Gardner, C. 97, 109
Garratt, B. 18, 285, 289, 304, 306, 311
Gerbing, D.W. 298
Gersick, K.E. 416–18, 420–2
Gibbons, R. 500
Giddens, A. 187, 210, 614
Gill, M. 297–8
Gillan, S.L. 108, 110, 136, 141, 397
Gilson, R.J. 384, 393–4
Gladwell, M. 45
Glassman, M.E. 580
Glick, W.H. 347
Golden, B.R. 190, 225, 345, 350
Goodstein, J. 224, 345, 350, 389
Gordon, J.N. 119, 528–9
Gore, A. 444
Graebner, M.E. 201, 212, 267
Granovetter, M. 376, 406, 409
Gray, Sir John 94, 374, 376–7, 616
Greenbury, Sir Richard 45–6, 257, 264, 278, 376, 429, 456, 467, 578
Greenspan, A. 536, 538, 545, 553
Groysberg, B. 326, 337, 340
Guay, W.R. 23, 453, 458, 460–1, 464, 471
Guillen, M.F. 412

Hall, B.H. 504–7, 513
Hambrick, D.C. 17, 184, 189, 191, 204, 211, 256–7, 259, 280, 345, 347–50, 356, 358, 380, 466
Hampel, Sir Ronald 45–6, 58, 257, 264, 302, 376, 429
Hansmann, H. 113, 115, 117, 368, 370, 376
Harrison, D.A. 347–8, 357
Harrison, J.R. 221, 223
Hart, O.D. 69, 114, 117, 398, 502, 513
Hartzell, J.C. 141, 464
Helfat, C.E. 25, 352, 498, 508
Heminway, J.M. 4, 9–10
Herbert, P. 285, 290, 302, 307, 314, 317
Hermalin, B.E. 184–6, 191, 199, 389
Herman, R.D. 288, 297–8
Hesterly, W. 434, 621
Hewlett, S.A. 330
Higgs, D. 46, 50–1, 197, 200, 202, 213, 265–6, 325–6, 332, 338, 429
Hikino, T. 21, 406
Hilferding, R. 534, 545
Hill, C. 505–6
Hill, J.G. 557, 578
Hillegeist, S. 468
Hillman, A.J. 15, 155, 184, 188–91, 199, 211, 219–20, 225, 235, 239, 256, 258–9, 285, 288–90, 293, 329, 345, 351–2, 389
Hilmer, F.G. 47, 153
Hoarau, C. 171, 176
Holland, T.P. 203, 298
Holmstrom, B. 69, 455, 500–3, 508–10, 513
Hopt, K. 384–6
Hoskisson, R.E. 152, 218, 220–1, 223, 225, 382, 407–8, 422, 505–6
Howard-Grenville, J.A. 618–19
Hu, F. 524, 529

Huse, M. 5, 15–17, 184, 188–90, 201, 219–21, 224, 233–7, 239–42, 244–6, 248–9, 258, 285–6, 288–91, 295–6, 301, 304, 306–7, 312, 326–7, 338, 345, 350, 353–7

Ibarra, H. 329–30, 332
Ijiri, Y. 160, 171, 173, 177
Iles, P. 349

Jackson, D.K. 298
Jackson, G. 3, 22, 380–1, 383–7, 390–1, 513
Jackson, S.E. 346–8, 356–7
Jensen, M.C. 1, 43, 56, 62, 64, 99, 109, 114, 185, 198, 210, 218, 235–6, 258, 293, 350, 389, 407, 434, 454, 478, 482
Johnson, J.L. 199, 221, 239, 289, 380, 490
Jones, T. 395, 434–5, 445
Joshi, A. 345, 347–8, 355–7

Kabbach de Castro, L.R. 21, 379, 384, 386
Kaczmarek, S. 16–17
Kang, E. 136
Kaplan, S.N. 177, 388, 454, 460–1, 464, 508–10, 513
Kaufmann, A. 15, 233, 236, 241, 397
Keck, S. 355–6
Kelly, M. 75, 77
Keynes, J.M. 534
Khanna, T. 391, 408, 411–12
Kiel, G.C. 18, 219, 224, 285–6, 288, 291, 293–5, 301–3, 305–11, 315–16
Kimino, S. 16–17
King, M. 47–8, 52–3, 287, 573–4
Kirkpatrick, G. 28, 183, 316, 560
Klettner, A. 17, 28, 75, 286, 291–2, 302–4, 306, 308, 311, 315–18, 561, 570, 580
Kor, Y.Y. 257, 290, 506, 528
Kosnik, R.D. 239, 350, 389
Kozul-Wright, R. 588
Kraakman, R. 113, 115, 117, 368, 370, 376, 384, 510
Krugman, P. 161
Kurzweil, R. 435

La Porta, R. 109, 384, 386–7, 390, 513
Laffont, J.J. 454, 472
Larcker, D.F. 185, 191, 460–1, 464, 469–70
Lawler, E.E. 221, 289, 291, 302–3, 308, 317
Lawrence, B.S. 347, 353–4
Lazonick, W. 4–5, 24–6, 203, 476–7, 479–81, 484–6, 489–93, 498, 501, 509, 511–12
Leblanc, R. 148, 208, 243–4, 258, 312
Lerner, J. 504–5, 513
Lewis, M. 15, 148, 187, 200, 211, 218, 220, 240, 331, 390, 469, 539, 616
Lhuillery, S. 506
Liebman, J.B. 460–1
Linck, J.S. 388–9
Littrell, C. 526, 529
Livesey, S. 619
Loewenstein, G.F. 442
Loewenstein, M.J. 5, 9, 95
Lorsch, J.W. 139, 148, 186, 189, 200, 219, 222, 289, 293, 295, 407

MacAvoy, D. 199, 211
Mace, M.L.G. 15, 200, 221–3, 234–5, 286, 350, 407
McFall, J. 255, 279
McNulty, T. 148, 184, 186, 200, 211, 222, 224, 240, 258–9, 271, 275, 290, 352, 356
Mangham, I.L. 256, 258, 266
Marnet, O. 110
Mason, P.A. 256, 347, 349–50
Maxwell, R. 7, 43–5, 260
Mayer, C. 390, 513
Means, G.C. 1, 7, 42, 45, 55, 60, 97–9, 109, 293, 385, 407, 409, 412, 482
Meckling, W.H. 1, 43, 56, 62, 64, 99, 109, 114, 185, 198, 210, 218, 235–6, 258, 293, 350, 389, 407, 434, 454
Milgrom, P. 21, 381, 455, 500
Milhaupt, C.J. 127, 376–7, 384
Milken, M. 44
Miller, E.S. 89, 94–5
Miller, T. 345, 350
Milliken, F.J. 184, 188–9, 199, 211, 219, 222, 224, 234, 239–40, 242, 258, 275, 289, 346, 348, 350–1, 353–4, 356
Millon, D. 109, 378
Milstein, I. 199, 211
Minichilli, A. 224, 234, 237, 239, 242, 245–6, 289, 301, 308, 350, 358
Minsky, H. 534
Monks, R.A.G. 56, 68, 79, 217, 235, 395, 433, 436, 443–4
Mooney, A.C. 184, 187, 200, 211, 222, 291, 293, 350, 557
Morck, R. 185, 386
Muller, C. 528–9
Murphy, K.J. 198, 456, 458–62, 468, 471, 477, 479
Murray, A.I. 257, 438
Myners, P. (Lord) 46, 51, 264, 429, 574

Nadler, D.A. 148, 287, 290, 302–4, 311, 318
Nicholson, G.J. 5, 18, 219, 285–6, 288–9, 291, 293–5, 298–9, 301–3, 305–10, 315–16
Nielsen, S.T. 5, 19, 239, 242, 345, 347, 349–50, 353–8
Nordqvist, M. 312, 415–16, 420

O'Connor, S.M. 436, 439–41
O'Neill, H.M. 201, 213, 505–6
O'Reilly, C.A. 348, 351, 353–4, 467
Orléan, A. 13, 162, 177
Ormazabal, G. 469–70

Orts, E. 617, 620
Osterloh, M. 73, 77, 318, 508, 511, 513

Pacioli, L. 39
Page, K.L. 434–5
Palepu, K. 391
Pape, J.C. 391–2
Paulson, H.M., Jnr. 159, 528
Pearce, J.A. 184–5, 187, 199, 218, 223, 234, 239, 289, 293–5, 318, 350, 354, 389
Peck, S.I. 24, 345, 453, 461, 465, 467–8, 472
Pelled, L.H. 347–8, 354
Peterson, C.A. 328, 332
Pettigrew, A. 59, 148, 184, 186, 200, 211, 220, 222–4, 234, 258–9, 266, 275, 312, 350, 352, 354, 356
Pfeffer, J. 187, 199, 235–6, 347, 352, 389, 614
Piketty, T. 73, 476–7
Polanyi, K. 377, 534
Porter, M.E. 237, 614
Posner, R. 66
Potapchuk, W. 620–2
Powell, W.W. 95, 152, 188, 422, 510–12
Power, M. 201, 213
Prowse, S. 391
Pugliese, A. 15, 17, 152, 188, 190, 218–19, 224, 227, 259, 275, 290
Pye, A.J. 5, 16–17, 189, 200, 202, 256–8, 266–9, 271–8

Radner, R. 434–5
Raghavendran, S. 523–4
Ragot, X. 12–13, 159
Rajagopalan, P.S. 523–4
Rajan, R.G. 69, 79, 390, 502, 513
Rebérioux, A. 8, 13, 162, 176, 545
Redding, S.G. 377
Rediker, K.J. 381–2
Redmond, P. 6, 29, 601
Reeb, D.M. 199, 387, 396
Reissing, E. 297
Rindova, V. 15, 224, 235, 240, 350
Robbins, G.E. 141, 388, 390
Roberts, J. 4–5, 14, 21, 153, 197, 200–3, 205, 207, 211, 213, 240, 258, 290, 312, 381, 500, 503, 619
Roe, M.J. 124, 129–30, 373, 376–7, 385, 388
Rogers, M. 507–8
Roh, H. 345, 348, 355–6
Romano, R. 109–10, 130, 261, 436, 440, 557
Roper, S. 507–8, 511
Ruggie, J.G. 29, 587, 590, 599–608

Sadler, G.V. 465, 468–9, 471
Saez, E. 73, 476–7, 493
Sales, A. 409, 413
Samra-Fredericks, D. 258, 312
Sealy, R. 5, 18, 328, 330–1
Seth, A. 381–2
Shackell, M. 506
Shapiro, A. 442
Shapiro, M.L. 68, 445
Sharma, P. 415–16
Shivdasani, A. 153, 388
Shleifer, A. 4, 67, 109, 380, 384, 387, 390, 396, 398–9
Siciliano, J.I. 350
Siems, M. 118, 385
Simons, P. 354, 607
Singh, V. 326–8, 331, 338, 345, 352, 389
Sivakumar, K. 202
Smith, A. 1, 7, 40, 55, 60, 293, 369–70, 528, 565, 612
Smith, Sir Robert 46, 51, 264, 429
Søland, A.I. 234, 237, 242, 244
Solberg, A.G. 326–7
Sonnenfeld, J. 221, 228, 285, 302, 304
Starks, L.T. 141, 397, 464
Stein, J.C. 503, 508, 513
Stiglitz, J. 186, 371, 374, 535, 620
Stiles, P. 184, 186, 200, 207, 224, 240, 258, 290
Stout, L.A. 8, 15, 63, 66–7, 69–72, 76, 101, 109, 160, 219–20, 227, 233–6, 240, 258, 502, 513
Stuart, S. 142, 147, 291–2, 369
Stybel, L.J. 287, 302–4, 306–7
Sundaramurthy, C. 15, 148, 187, 200, 211, 218, 220, 240
Sunder, S. 76, 176
Sykes, A. 436, 443–4

Tayan, B. 460–1, 464, 470
Taylor, B. 184, 186, 224, 470, 509, 620
Temple, P. 513
Thatcher, M. 260, 369
Thomas, R.S. 33–4, 73, 109, 473
Thomsen, S. 387, 391, 395, 397, 471, 557
Triana, M. 345, 350
Tricker, R.I. 2, 6–7, 153, 217, 286–91, 297, 302, 304, 309, 311, 313, 316, 318, 434
Tunny, J.A. 18, 285
Turnbull, N. 46, 122, 257, 264, 376, 429
Turnbull, S. 23, 428–32, 434–9, 443–6
Turner, A. (Lord) 28, 552, 569, 572
Tylecote, A. 503–4, 509
Tyson, D.L. 46, 51, 265, 283

Useem, M. 4–5, 11–12, 24, 124, 138, 148, 150, 152–4, 203, 218, 224, 351, 390, 557

Van den Berghe, L.A.A. 287, 290, 318
van der Laan, G. 13, 183, 188, 190, 358
Van Ees, H. 5, 13, 109–10, 183, 188, 219, 233, 237, 240, 291, 358
Verhovek, S. 376
Vinnicombe, S. 5, 18, 326, 334, 338, 345
Vishny, R.W. 4, 67, 109, 380, 384, 387, 390, 396, 398–9

Wachter, M.L. 8, 63, 65, 68–9, 75–6
Walker, Sir David 28, 197, 213, 265, 285, 290, 303, 311, 317, 429, 556, 569–72

Watkinson, H. (Lord) 43
Weick, K.E. 256
Weil, J. 142, 568
Weimer, J. 391–2
Weisbach, M.S. 136, 153, 184–6, 191, 199, 388–9, 466
Werder, A.V. 198, 256, 259
Westphal, J.D. 153, 184, 187–90, 199, 201, 212, 221, 224–5, 258, 289, 332, 345, 351–2, 354, 382, 389, 466–7
Whittington, R. 223, 257, 391
Williamson, O.E. 2, 109, 113, 118, 389, 434–5, 497–9, 501, 507, 513
Wood, B. 552
Wormser, I.M. 9, 94

Yafeh, Y. 408, 411–12

Zahra, S.A. 184–5, 187, 199, 218, 221, 223–8, 234–5, 239, 289, 293–5, 318, 350, 354, 389
Zajac, E.J. 184, 187–9, 201, 224–5, 256, 258–9, 332, 345, 350, 352, 380, 382, 466
Zattoni, A. 5, 15, 22–3, 186, 212–13, 218, 221, 224, 290, 293, 358
Zelechowski, D.D. 326, 328–9, 352
Zingales, L. 69, 113, 390, 434–5, 502, 513

Subject Index

INTRODUCTORY NOTE

References such as "178–9" indicate (not necessarily continuous) discussion of a topic across a range of pages. Wherever possible in the case of topics with many references, these have either been divided into sub-topics or only the most significant discussions of the topic are listed. Because the entire work is about 'corporate governance' the use of this term (and certain others which occur constantly throughout the book) as entry points has been restricted. Information will be found under the corresponding detailed topics.

ABA *see* American Bar Association
absolute powers 430, 433, 436
abuses 43–4, 50, 73, 120, 131, 443, 590
accountability 1–3, 5–7, 10–13, 17, 20–3, 53–5, 244–8
board 204, 326
chain of accountabilities 17, 272, 278
strategic value 15, 213
web of accountabilities 17, 272
accountants 12, 42, 96, 160, 172–3, 431, 436
and modelling 170–1
accounting 10, 12–13, 159–64, 170–1, 173–7, 279–80, 352–3
fair-value 159–62
historic cost 10, 12
information 160–1, 163–5, 171, 173–4
political economy of 174–6
principles 10, 47, 162–4, 173–4, 177
scandals 24, 152, 261, 469
standards 4, 45, 168, 173, 176, 256, 560
American 49–50
international 50, 176, 259, 269
systems 13, 161–2, 173, 175
valuations 163, 170–1, 176
active investors 266, 275, 278
activism, shareholder 56, 203, 277, 557
actual board effectiveness 197, 201, 211–12
adaptation 299, 383, 497, 500, 503, 524
and innovation 503–4
advisory roles 389–90, 398, 595
advocacy 3, 590–1, 599
NGO 591, 598
Africa 40–1, 593–4
agency 4, 11, 25, 57, 94–5, 199, 498
costs 63, 99, 109, 185, 464, 466, 497
dilemma 55–6
models 455, 459, 504
problems 1, 45, 55, 109–10, 185, 408–9, 478
theory 9–10, 13–15, 55–7, 217–19, 233–6, 407–9, 477–82 *see also* principal-agent theory
assumptions 203, 211, 274, 280
criticisms 56–7
agents of shareholders 11, 68, 76, 132
AGMs *see* annual general meetings
AIG (American Insurance Group) 62, 77, 144, 154, 410, 454, 490
ALI *see* American Law Institute
ambition myth 18, 330–1
American accounting standards 49–50
American Bar Association (ABA) 43, 68, 95
American corporate finance 377
American Economy 537
American Insurance Group *see* AIG
American Law Institute (ALI) 2, 45, 50
Americanocentric convergence thesis 367
announcement periods 105–6
annual general meetings (AGMs) 46, 51, 208, 276, 438, 465, 575
anti-shareholder devices 143
anti-takeover defences/devices 12, 126, 128–9, 137, 143
appointments 53, 87, 91, 187, 204, 332, 340–1
board 188, 332, 338, 340
APRA *see* Australian Prudential Regulation Authority
arbitration 500, 622

archival data 222, 224
archival studies 105
Arthur Andersen 49–50, 199, 261
Asia 21–2, 40, 368, 392, 407, 416–17, 535–6
ASIC *see* Australian Securities and Investments Commission
asset-backed securities 537, 547–8
asset partitioning 115, 132
asset prices 171–2, 471–2, 537, 541
  volatilities 171, 458–9
asset specificity 163, 507, 511
  and asymmetry 167–8
  and complementarity 167–71
asset valuation 164, 168, 174, 176
  rule 171, 173
asset values 163–4, 171, 174, 464, 537
  depreciation of 164, 172
assets 12–13, 115–18, 160–72, 174–7, 262–3, 414, 507–10
  accounting 166, 177
  complementary 169, 502
  financial 159, 174, 544–5, 564
  intangible 168, 170, 591
  underlying 117, 472, 548–9
ASX *see* Australian Stock Exchange
asymmetric information 23, 167, 170, 177, 185, 453–4, 500–1
asymmetry 176, 556
  and asset specificity 167–8
attorneys 20, 88–9, 153, 368, 373
audit committees 42–3, 45, 47, 50–1, 142, 152, 264
  shareholder 437–8, 441
audit firms 264, 429, 442–3
audit practices
  degrading of 438–40
  spread of unethical counterproductive 440–1
  superior 436–7
auditor independence 7, 376, 439
  impossibility 442–3
auditors 12, 20, 42–4, 50, 260–1, 436–7, 439–42
  external 23, 42, 51, 60, 110, 277, 442
audits 23, 29, 43, 47, 51, 201, 438–42
Australia 27, 44, 47–8, 50, 52, 373–4, 522–3
  corporate senates 437–8
  Corporations and Markets Advisory Committee (CAMAC) 286, 576–7
  Productivity Commission 575–7
  response to global financial crisis 574–7
Australian Council of Superannuation Investors 430, 580
Australian Institute of Company Directors (AICD) 445–6, 577
Australian Prudential Regulation Authority (APRA) 285, 303, 525–6, 574–5, 578
Australian Securities and Investments Commission (ASIC) 575, 580
Australian Stock Exchange (ASX) 52, 307, 373, 423, 575–7
  Corporate Governance Council 285, 287, 576
  Principles 576–7
Ayala Group 411–12, 418–19

backdoor convergence 371–3
bad faith 83, 92
balance of power 275, 278, 608
balance sheets 76, 159, 161–4, 166, 168, 172, 174–5
bank boards 188, 269, 338
Bank of England 124, 527, 542, 568, 572–3
bank ownership 387, 396–7
banking 5, 118, 123, 145, 262, 413, 527
  crises 173, 535, 562
  investment 525, 537, 566, 578
  systems 159, 255, 265, 275, 395, 537, 543
bankruptcies 27, 44, 49, 76, 89, 160–1, 521–2
banks 396–7, 525–7, 535–7, 539–44, 548–50, 566–70, 572–5 *see also* financial institutions
  investment 330, 534, 537, 539, 546, 548–50, 574
  merchant 275, 279
bargaining power 239, 503
Basel Committee on Banking Supervision 526, 580
  response to global financial crisis 561
Bear Stearns 490, 537
behavioral analysis 107
behavioral empirical research 107–8
behavioral processes 110, 188–9, 468
Belgium 40, 224, 287, 290, 339–40, 392, 540
benchmarking 246–7, 303, 310–11, 315, 500, 513
Berle & Means corporation 97–8 *see also* separation of ownership and control
best practices 22–3, 188, 212–13, 264–5, 287–8, 436–8, 443–4
  and absence of supporting theory for governance codes 434–6
  degrading of audit practices 438–40
  and dictatorship of majorities 437–8
  identification of good governance 433–4
  impossibility of audit and director independence 442–3
  limitations 428–46
  and limited liability 431–3
  and political origins of corporate concepts 430–1
  spread of unethical counterproductive audit practices 440–1
  superior audit practices 436–7
BGs *see* business groups
biases 97, 188–9, 249, 259, 288, 299, 310
  possible/potential 301, 313–14, 316
  unconscious 332, 337, 442–3
black boxes 19, 56–7, 244, 354, 454
Black-Scholes model 457–8, 460–3
blind spots 429–30
block ownership 423, 499, 501
board appointments 188, 332, 338, 340
  new 328, 341

board attributes 13, 185–7, 191, 293–5, 297
board behaviors 13, 19, 54, 56, 183–4, 244–5, 354
  actual 184, 186
board chairs *see* chairs
board characteristics 14, 20, 191, 222–4, 389, 505
board committees 51, 74, 110, 142, 208, 246–7, 367–8
board composition 13, 19, 45, 184–5, 227–8, 246–7, 357–8
board cultures 17, 202, 207, 240, 246, 268, 271–2
board directors *see* directors
board diversity *see* diversity
board dynamics 13, 19, 200, 203, 210–11, 225, 294
board effectiveness 13–14, 18, 183–92, 200–1, 265, 349–51, 357–8
  actual 197, 201, 211–12
  definition and measurement 288–93
  and diversity 350–3
  evaluating 191, 430
  improving 265, 571
  models 293–301
    BSAQ 298–9
    Governance Self-Assessment Checklist (GSAC) 297–9
    Nicholson and Newton's (2010) Board Roles 298–301
  reflections on research 189–92
board evaluations 16–18, 53, 152, 234, 244–8, 279, 285–319
  content of 244–5
  data sources 307–9
  definition and measurement of board effectiveness 288–93
  document review/analysis 313–14
  drawbacks/reasons not to evaluate 304–18
  effective 302, 309, 319
  framework 302
  implementation 317–18
  objective setting 306
  observation methods 312–13
  prevalence 286–7
  regulatory prescription and recommendation 286
  reviewers 315–16
  steps 247, 301–4
  systems 245–6
  techniques to be used 309–14
  tools 297–8
  trends 286–8
  what to do with results 316–17
  what to evaluate 306–7
  who to evaluate 314–15
board functions 137, 151, 153, 289
board independence 106, 185–6, 199, 226, 258, 380–2, 397–8
board-investor relationships 256, 277
board leadership 15, 213, 233–49, 311
  effective 234, 265
  structures 258, 380
board-management relationships 302, 305, 317
board meetings 147, 200, 205–9, 238, 241–3, 246–7, 311–12
board members 185–9, 217–19, 225–6, 234–7, 239–49, 296–9, 308 *see also* directors
  individual 188–9, 191, 248, 305
  new 45, 244–5, 337
board monitoring 221, 381–2
board performance 19, 288–91, 298–9, 301, 309, 560–1, 570
  contingent nature 292–3
  evaluation *see* board evaluations
board power 465–6
board practices 53, 137, 142, 202, 222, 383, 560–1
board processes 19, 108, 199–200, 206, 222, 353–4, 358
  modelling 199, 199–200
  qualitative studies 200–1
board relationships 13, 187
  dynamic of 13, 203, 210
board responsibilities 7, 47, 52, 277
board roles 6, 13, 201–2, 219, 289, 293–5, 297–8
board size 13, 184–5, 221, 223, 258, 269–70, 333–4
board structures 56, 114, 226, 244, 247, 270, 286
  and performance 120–4
  two-tier 43, 46, 119, 124, 126, 186, 375
board subcommittees *see* boards, subcommittees
board task expectations 246, 296, 308
board task performance 189, 245, 296, 308, 350
board tasks 234, 236–40, 244, 246–7, 289, 352–3, 357
  multiple 236, 351–3
boardroom culture 241, 244, 247, 279, 327
boardroom dynamics 219, 240, 258, 265, 306
boardrooms 18–19, 137, 147, 153–5, 241, 325, 351–2
  as venue for strategic decisions 147–50
boards *see also Introductory Note*
  active 219, 223, 249, 382
  bank 188, 269, 338
  behavior and process 188–9
  contribution to innovation and entrepreneurship 225–6
  contribution to strategy 218–25
  development of strategic role 207–10
  family-owned Asian business groups 421–4
  functions 136–55
  independent 106, 186, 395, 443, 468
  interactions 186–8
  leaders 234, 242–4
  main 42, 44, 208, 211, 269, 272, 465
  management 465, 564
  multiple 301, 388, 436
  non-profit 299, 318
  outsider 26, 512
  regulation of activities 244
  role 59, 198–9, 201–2, 212–13, 389–90, 396–8, 561–2
  single 436–7, 465
  structures 185–6
  subcommittees 208, 211, 218, 258, 270, 444, 456

supervisory 43, 119, 375, 432, 564–5
as teams 240–2
two-tier 43, 46, 119, 124, 126, 186, 375
unitary 43, 46, 59, 205, 436, 442, 444
bonuses 64, 188, 454, 456, 461–2, 541, 552–3 *see also* executive compensation
brands 145, 150, 171, 616
Brazil 98, 160, 373, 392, 394, 606
broker-dealers 546–7, 570
BSAQ 298–9
bundles of corporate governance practices 379–80, 385
Burma 392
business associations 97–8
business cycle 27–8, 31, 556
business groups (BGs) 20, 22, 177, 406–16, 419–21, 424 *see also* Asian family-owned business groups; complex conglomerates
definition 406–7
dominance and structure 409–12
business models 53, 77, 524, 537, 552, 558, 575
business networks 624
Business Roundtable 50, 68, 153
buybacks *see* stock buybacks

Cadbury Committee 45–7, 50, 122, 196, 213, 257, 263–4
Californian Public Employees' Retirement System (CalPERS) 48, 141
CAMAC *see* Corporations and Markets Advisory Committee
Cambodia 392
Canada 40–1, 47, 325, 328, 337, 392, 490
capital 40–1, 115–17, 128–30, 164, 170, 294, 537
cost of 76, 394–5, 478–80
external 41, 509, 512
financial 76, 545
human 290, 294, 328–9, 481–2, 499, 502–3, 509
investment 373, 587, 589, 601
social 239–40, 273, 408–9, 411, 615, 618
capital adequacy 28, 557, 575
capital gains 175, 493
potential 173–5
capital incomes 480, 485, 493
capital investments 500, 542, 616
capital markets 11, 22, 66, 132, 396, 398, 411
efficient 65–6
history 384–5
liquid 26, 503, 544
capital requirements 525, 537, 546, 574
capital structure 125, 275
capitalism 3, 21, 366, 369–70, 376–7, 391, 443
crony 409, 412, 535
embedded 369
fiduciary 443
financial 12, 162
varieties of 499–500, 502–4, 509
capitalization 164, 166, 170
market 138, 145, 257, 262, 332, 377, 542–3
cash flow 163, 165, 167–8, 170, 268, 507, 513
free 25, 478–9, 506
CBBGs *see* Control Based Business Groups
CDSs *see* credit default swaps
Centros Ltd 130–1
CEOs (chief executive officers) 141–3, 242–4, 351–2, 422–3, 453–6, 458–68, 470–1 *see also* CEs
CEO-board relationships 187, 222
compensation 454, 462, 464, 466–7 *see also* executive compensation
duality 186–7, 223, 422, 466
power 186, 356, 466
separation of board chairmanship and CEO role 46, 53, 57, 142, 207, 221, 258
wealth 461, 464
CEs (chief executives) 45–7, 147–9, 151–2, 202, 204–9, 268–75, 277–9 *see also* CEOs
divisional 268, 271
role 268–9
CFOs (chief financial officers) 149, 299, 330
CFTC *see* Commodity Futures Trading Commission
chain of accountabilities 17, 272, 278
chairs 202–11, 242–4, 314–16, 332–7, 339–41, 422–3, 569–71
leadership 242–3
non-executive 151, 206–7, 273, 422
passive 234, 248
role 207, 243, 258, 269, 274, 422
separation of board chairmanship and CEO role 46, 53, 57, 142, 207, 221, 258
change 256, 307–8, 318–19, 338–41, 459–60, 578, 618–19
cultural 615, 618–19, 621
fundamental 160, 187, 550, 594
organizational 617–18
pace of 325, 339
radical 173, 279, 340
regulatory 277–8
strategic 221, 224, 350, 354
technological 255, 275, 524
change agents 618, 621
charities 39, 60, 115, 261, 439
charter competition 129 *see also* regulatory competition
charters 40, 341, 430–2, 439, 446, 521
corporate 9, 94, 103, 431–2
cheap credit 536–7
check-the-box regulations 82–3
chief executive officer *see* CEOs
chief executives *see* CEs
chief financial officers (CFOs) 149, 299, 330
chief operating officers (COOs) 328, 330, 352, 419
chief risk officers 561–2, 570
child labour 589, 591–3, 599
Chile 392, 394
China 40, 155, 160, 384, 392, 394, 398
Cisco Systems 25, 377, 486, 490
Citigroup 25, 161, 489, 537

City of London 125, 129, 430, 545, 552
civil law countries 22, 384
civil regulation 30, 585–6, 588, 590, 597–9, 604, 608
civil society 585–6, 592–3, 602, 608
organizations 590–2, 601
clan control 21, 407
clawbacks 75, 470, 559, 576, 579
climate change 77, 259, 280
close corporations 95, 98, 100–1
clusters 620–2
CMEs *see* coordinated market economies
coalitions 185, 573, 592, 594, 621
of stakeholders 234, 236
Code of Corporate Governance *see* United Kingdom, Code of Corporate Governance
cognitive conflicts 200, 238, 241–2, 246, 290
cognitive diversity 19, 347, 357
cohesiveness 184, 200, 211, 238, 241–2
collaboration 108, 154, 187, 200, 220, 226, 592–3
collaborative governance 592–4
collateralised debt obligations (CDOs) 537
Colorado 85, 94–5
Combined Code 7, 46, 51, 53, 122, 264–5, 571
combined net income 486–7
Commodity Futures Trading Commission (CFTC) 538, 567
common law 20, 41, 54, 85, 89, 104, 432
countries 22, 366
systems 11, 117–18, 121, 129, 384
company boards *see* boards
company directors *see* directors
company law 3–4, 11, 54–5, 118–19, 123–4, 128, 131–2
company secretaries 147, 151, 202–3, 208, 271, 299, 314–15
comparative corporate governance 20–1, 59, 379–99
boards of directors 388–90
bundles of practices 380–3
legal environment 383–6
ownership structure 386–8
systems of corporate governance 390–4
compensation 141–2, 238, 469–70, 483, 550, 559, 566–7
annual 461–3
committees 45–6, 456, 465, 467, 469–72, 570–1, 579
consultants 24, 67, 465, 467–9, 471, 566
executive *see* executive compensation
competences 184, 234–5, 238–9, 245–6, 351, 421, 505
decision-making 239–40
function-oriented 239–40
negotiation 239–40
process-oriented 239–40
relational 239–40
competencies 16, 239–40, 290–1, 351, 498, 623
director 290–1
competition 2, 4–5, 29, 129, 137, 164, 204
regulatory 114, 120, 129
complementarity 21, 163, 176, 191, 380–3
and indivisibility 168–70
and specificity 167–71
complementary assets 169, 502
complementary information 13, 162, 175–6
complementary perspectives 110, 190, 574
complex conglomerates 5, 13, 26, 41–2, 54, 436
in financial services 520–1, 523–5
regulation 525–7
governance and regulation 26, 60, 520–7
complex entities 24, 26–7, 171
complex relationships 18, 23, 184, 292–3
complex risks 269, 538
compliance 13–14, 46–7, 196–9, 201, 207–9, 211–13, 592–5
costs of 261, 372, 503, 598
formal 196–8, 201, 205, 210, 212
reported 197–8
complicity 589–90, 593
comply or explain principle 196–7, 202–3, 214, 264–5, 333, 384, 386
composition, boards 13, 19, 45, 184–5, 227–8, 246–7, 357–8
concentration 42, 126, 129–30, 138, 349, 410, 412
of assets 12, 137
ownership 22, 382, 384–6, 394–5, 406, 408–10, 506–8
Conference Board 71, 74, 138–9, 151–2
confidentiality 202, 311–12, 315, 317, 396, 501
conflicts 54, 87, 184, 210, 391, 436–8, 440–4
cognitive 200, 238, 241–2, 246, 290
fundamental 190, 412, 442
potential 418, 467–8, 570
conformance 47, 52, 186, 203, 212, 296
conglomerates, complex *see* complex conglomerates
Congress 68, 439–40, 490–1, 538, 541, 543–4, 566–8
consensus-based dialogue 616–17
consent 86–7, 89–91, 521, 606
consolidation 26, 49, 89, 120, 522, 537
constituencies 6, 48, 71, 117–19, 132
non-shareholder 124, 128
consultants
compensation 24, 67, 465, 467–9, 471, 566
management 42, 145, 268
search 333–6, 340
consumer markets 596–7
consumer surplus 70
contagion 7, 524, 535, 541
Continental Europe 55, 116, 186, 384, 386, 390–1, 430
contingencies 13–14, 19, 210, 289, 293, 295, 383
continuity 7, 41, 115, 174–5
contract principle in jeopardy 92–3
contractarian theory 100–1
contracts theory 101, 109
contractual covenant of good faith 9, 83, 86, 92
contractual freedom 83, 89–90, 93

control 2–4, 97–101, 198–201, 210–11, 410–13, 432–8, 499–502
  architecture 435–6
  clan 21, 407
  effective 14, 211, 413
  family 387, 396, 407, 410, 440
  function 14, 199, 205, 213, 293, 351
  hierarchies 434, 445
  internal 52, 122–3, 197, 237–8, 242, 264
  managerial 98, 127, 416, 478–80, 482, 503
  non-executive 14, 211
  output 237–8, 240, 242
  rights 121, 374, 502–3
  role 15, 187, 210, 213
  shareholder 118, 132, 387
  strategic 240, 242, 480, 512
  tasks 236–7, 351, 354
Control Based Business Groups (CBBGs) 413
controlling shareholders 84–5, 99, 373, 383–4, 386–7, 390, 394
  efficient 393–4
convergence 3, 19, 160, 177, 365–7, 370, 373–6
  backdoor 371–3
  global *see* global convergence
  muted/blocked by path dependency and rent-seeking 373–4
  and property rights 374–5
  strong form 368
  taxonomy of convergence/divergence 375
cooperation 72, 76, 119, 188, 352, 500, 507
  and language 72–3
cooptation 184, 187, 223
coordinated market economies (CMEs) 26, 509
coordination 100, 160, 169, 184, 406, 498, 620–1
  managerial power of 119, 132
COOs (chief operating officers) 328, 330, 352, 419
corporate accountability *see* accountability
corporate boardrooms 107, 478, 550
  see boardrooms
corporate boards *see* boards
corporate charters 9, 94, 103, 431–2
corporate constitutions 437–8, 442, 445
corporate control *see* control
corporate directors *see* board members; directors
corporate entrepreneurship 217–18, 225–7
corporate failures 1–2, 20, 27, 222, 260, 428, 534
corporate forms 3, 99–100, 116–17, 120–1, 129–30, 406–7, 510–11
corporate governance *see Introductory Note*
corporate law 67–70, 76–7, 92–4, 109–10, 113–14, 117–21, 375–8
  principles 91–2
  regimes 10, 113, 118
corporate performance *see* performance
corporate-related human rights abuses 589, 601–2, 606
corporate-related human rights standards 603–5
corporate resource allocation 69, 478–80, 485, 488
corporate responsibility 6, 30, 43, 58
  international *see* international corporate responsibility
corporate secretaries *see* company secretaries
corporate senates 437–8
corporate social responsibility (CSR) 29–30, 102, 590–1, 596–600, 603–4, 608–9, 612 *see also* international corporate responsibility
  assessment as global regulation 599–600
  codes 591, 599–600
  drivers 596–7
  as global governance 595–6
  inter-governmental international standards 594–5
  limitations as effective regulation of international business 597–9
corporate stakeholders *see* stakeholders
corporate sustainability *see* sustainability
corporate values 11, 127–8, 273, 280, 407
corporations
  and firms 115–20
  government-owned 304, 315
Corporations and Markets Advisory Committee (CAMAC) 286, 576–7
corruption 59, 589–90, 594, 600, 603, 607
Council of Institutional Investors 50, 141
CRAs *see* credit ratings agencies
creativity 47, 145, 184, 238, 241–2
credibility 23, 116, 118, 208, 429–30, 604
credit 49, 115, 277, 434, 521, 537, 547–8
  cheap 536–7
  crisis 26, 123, 511, 535, 542
credit default swaps (CDSs) 537, 552
credit ratings agencies (CRAs) 287, 547–8
credit risks 161, 537, 547
creditors 11, 64–5, 70–3, 76–7, 115–18, 130–1, 522
crony capitalism 409, 412, 535
cross-shareholdings 412–13, 424
CSR *see* corporate social responsibility
cultural change 615, 618–19, 621
cultural framing 617–18
culture 3, 58, 197–8, 201, 211–12, 327, 370
  board 17, 202, 207, 240, 246, 268, 271–2
  group 14, 107, 210
  and women 327
current market prices 163, 165–6
  use in financial statements 171–4

debtors 39, 41, 522
debts 9, 41, 49, 161–2, 432–3, 537, 545–7
decentralization 501–2, 508, 511, 621
decision-making competences 239–40
decision-making groups 188, 256, 319, 350
defensiveness 203, 205, 211
Delaware 82–3, 87–8, 90–2, 94–5, 124, 129–30, 440
delegation 99, 115, 121–3, 305, 388, 444, 501
deliberative democracy 31, 614, 618, 622
democracy 30, 369, 432–3, 614, 621
  deliberative 31, 614, 618, 622
  industrial 42

demographic diversity 19, 347, 354
demographic similarity 187, 352
demographics 30, 338, 346–8, 351, 524
demography, organizational 347, 353–4
Denmark 130–1, 392
depreciation 163–6, 170, 177–8
  of asset values 164, 172
deregulation 49, 132, 260, 377, 395, 520, 546–7
derivative actions 70, 77, 87, 92, 367–8
derivatives 27, 534, 537–9, 546, 568
  contracts 538, 541
  markets 25, 490, 537–9, 566
developing countries 29, 327, 408–10, 588–9, 595–6, 598–600, 606–7
diamonds 593–4
dictatorship of majorities 437–8
direct investments 372, 482, 588, 595
  foreign 146, 552, 587–8
direct liabilities 83–4
director disqualification 122–3
director evaluations 5, 152, 286, 318, 429
  individual 287, 306, 316, 318
director independence 23, 43, 68, 110, 190, 286, 380
  impossibility 442–3
director monitoring of management 136, 153
  and board practices 142–3
director performance 430, 577
director primacy 67, 100–1
director roles 69, 147, 151, 154, 257, 266
directors 4–19, 40–50, 53–60, 66–77, 146–55, 299–306, 436–46 *see also* board members
  duties 6–8, 63, 65, 68–71, 73, 77, 121–2
    and global financial crisis (GFC) 62–77
  engagement in company practices 152–3
  executive 51, 118, 121–3, 152, 203–6, 208–9, 338–9
  female 326–7, 329, 332, 334, 337, 339–40, 350
  independent 89, 123–4, 148–9, 185–6, 367–8, 422–3, 442–4
  individual 14, 56, 151–2, 189, 291–2, 304–5, 313–16
  key 17, 272
  minority 189, 289, 355
  new 147, 150, 309, 333
  non-independent 141, 148–9, 151
  partnership criteria for evaluating 151–2
  partnership criteria for recruiting 150–1
  vigilance 12, 137, 144
  women 326, 333, 340, 345, 349, 352–7
directorships 42, 188, 228, 325, 330, 352, 388
disclosure 317, 380, 394, 396–8, 524–7, 566–7, 572
  balanced 52
discounted value 162, 164
discretion 68–70, 430
  management/managerial 11, 117, 185, 256, 382
disgorge 25, 478
dismissal 92–3
dispersed ownership 26, 191, 379, 382–3, 385–7, 390, 407
dispersed shareholders 225, 374, 390, 442
disqualification of directors 122–3
diversification 115, 120, 221, 225, 277, 482, 502
  market-wide 11, 123
diversified portfolios 387, 396, 572
diversity 3–4, 19, 238–40, 332–3, 345–58, 576–8, 617–22
  and board effectiveness 350–3
  and board processes and dynamics 353–5
  cognitive 19, 347, 357
  conceptualization 346–9
  context as moderator of effects 355–7
  demographic 19, 347, 354
  diversity theories 353–5
  and firm-level outcomes 349–50
  gender *see* gender diversity
  governance theories 350–3
  as multi-dimensional construct 346–8
  occupational 350, 357
  racial 350
  relations-oriented 19, 346, 350, 357
  research 346–8, 355, 357–8
  task-oriented 19, 345–6, 350, 354, 356
  task-related 349, 353
  team 346, 353–5
  theoretical framework of consequences 351
  theories and evidence 349–57
  TMTs 354, 356
  upper echelons theory 347, 349–50, 356
  as variety, separation and disparity 348–9
dividends 7, 40, 441, 457, 479, 484, 493
document review/analysis 313–14
Dodd-Frank Act 28, 74–5, 142, 386, 465, 469–71, 566–8
  and executive compensation 469–70
domestic business groups 22, 411–12
dominance 12, 94, 101, 137, 212, 227, 314
  managerial 219, 221, 223
dominant shareholders 99, 120, 386, 412, 437
dual functions 11, 136, 154–5
duality, CEOs 186–7, 223, 422, 466
Dutch East India Company 7, 40, 431
duties 76–7, 83–4, 88–92, 120–2, 124–5, 587, 600–2
  directors 6–8, 63, 67–9, 71, 73, 77, 121–2
  fiduciary 17, 53, 68–9, 77, 83, 88–91, 100
  of good faith 70, 90–1
  legal 54, 119, 122, 125, 305
  of loyalty 70, 89–92
  state 587, 602–3, 605–6, 609
dynamic capabilities 16, 25, 234, 239–40, 248, 498
dynamics 5, 10, 14, 19, 108, 173, 352–4
  board 13, 19, 200, 203, 210–11, 225, 294
  boardroom 219, 240, 258, 265, 306
  group 56, 220, 295–6, 313, 315
  inner 15, 222, 226–8
  of non-executive control 14, 211

earnings 12, 165, 173–6, 263, 268, 455–7, 485
  interpreting of 172–4
  management 67, 108, 110, 505

East India Companies 6–7, 40, 431–2, 436–7
ecological democracy 31, 614, 618
ecological modernisation 614, 618
Economic and Social Research Council (ESRC) 255, 257, 280
economic growth 1, 22, 44, 384, 415, 491, 534
economic performance 225, 428, 433, 478–9, 482
economic power 42, 545, 601
economic theory 10, 102, 108, 114, 116, 118, 164
economics and law 115–20
education 57, 238, 246, 270–1, 298, 328, 354–5
effective board conduct 17, 277, 279
effective board evaluations 302, 309, 319
effective board leadership 234, 265
effective boards 18, 183, 200, 288–93, 295, 507
effective control 14, 211, 413
effective corporate governance 19, 21, 110, 258, 285–6, 318, 379–81
effective evaluations 292, 302, 304, 317
effective risk management 571, 613, 620
effectiveness 17–18, 190–1, 265, 288–90, 292, 298–9, 381
  board 13–14, 18, 183–9, 288–95, 297–301, 349–51, 357–8
  governance 286, 299, 306, 382–3, 397, 504, 621–3
  organizational 307, 613
EITI *see* Extractive Industries Transparency Initiative
elites 256, 280, 346, 365–6, 375
embedded capitalism 369
embeddedness 17, 255, 260, 272, 275, 277, 621
empirical evidence 77, 103, 176, 222, 352, 443, 466
empirical research 97, 104, 108–10, 114, 223, 227, 348–9
  qualitative 107–8, 110, 200
  quantitative 10, 105–6
empirical studies 15, 72, 94, 123, 218, 356, 459–60
employee representatives 43, 126, 398
employees 23–5, 54–5, 63–5, 71–4, 77, 115–19, 382–3
employment 26, 60, 70, 119, 126, 219, 225
  laws 54, 114, 118–20, 129, 132
empowerment 219–20, 222, 226, 228
enforcement 29, 57, 125, 338, 591–2, 597, 599
  costs 57, 118
engagement 14, 17, 137, 206–8, 211, 265, 276
  non-executive 205, 211
  shareholder 5, 28, 262, 276, 557, 569–70, 578–9
enlightened shareholder value 11, 117, 132, 375
Enron 7, 19–20, 49–50, 62, 65, 77, 376
enterprises 8–9, 25–6, 58–9, 64–5, 69–70, 72, 431–2
  see also firms
  multinational 594–5
  state-owned 3, 373, 379, 398, 415, 598
entrepreneurship 221, 224–5, 227–8
  board contribution 225–6
  corporate 217–18, 225–7
environmental governance 30, 614
environmental initiatives 30, 618
environmental protection 30, 589, 595, 617
environmental responsibilities 6, 27, 30, 585
environmental risks 613–14, 616–17, 619–21
environmental standards 591, 596, 599, 606
environmental sustainability 30–1, 593, 613, 615, 623
environments 6, 108, 187–8, 220, 355–6, 375, 381–2
  changing 5, 147, 221, 239
  ethical 534, 546
  external 186–7, 226, 237, 294, 408, 424
Equator Principles 591, 598
equitable subordination 521–2
equity 2–3, 62–3, 90–1, 142, 456, 458–62, 537–9
  private 59–60, 277, 501, 505, 525, 564
ESRC *see* Economic and Social Research Council
ethical behavior 73–7
ethnicity 16, 18–19, 345–6, 351
EU *see* European Union
Europe 28, 142, 260, 337–8, 544, 551–2, 562
  Continental 55, 116, 186, 384, 386, 456, 499
European Central Bank 545, 580
European Commission 43, 159, 163, 565, 600
European financial institutions 541–4
European Parliament 12, 177, 526
European Union (EU) 27, 125, 129–31, 340, 368, 384, 521–2
evaluations
  board *see* board evaluations
  comprehensive 246–7
  director 5, 152, 286, 318, 429
  performance 75, 152, 579
  whole-of-board 304, 318
event studies 104–6, 108, 110
excessive risks 28, 65, 121, 144, 183, 524, 541
Execucomp database 461–3, 472
executive boards 43
executive bonuses *see* bonuses; executive compensation
executive committees 206, 329–30, 332, 334, 341, 465
executive compensation 12, 24–5, 141–3, 397–8, 453–72, 563, 566
  board power and independent directors 465–6
  compensation committees 24, 367, 454, 456, 465, 467, 469–72
  compensation consultants 24, 67, 465, 467–9, 471, 566
  and damage to US economy 476–93
  and Dodd-Frank Act 469–70
  incentive compensation 73, 382, 470, 566
  institutions of executive pay setting 24, 453–4, 456, 464–71
  pay-for-performance *see* pay-for-performance
  and proxy voting agencies 468–9, 471
  shareholder power and "say on pay" 464–5, 469, 472, 566, 570, 575
  and speculation/manipulation 482–9
  stock options *see* stock options
  theoretical context 454–5
  theory to practice 456–64
executive directors 51, 118, 121–3, 152, 203–6, 208–9, 338–9
executive incentives 4, 24–5, 143, 397, 542
executive labor market 23, 198, 453, 458

executive officers 149, 235, 326, 368, 407, 453, 470
executive options *see* stock options
executive pay *see* executive compensation
executive pay setting, institutions of 24, 454, 470–1
executive performance 14, 210, 212
executive remuneration 75, 262, 273–4, 276, 278, 368, 575–6
executive search firms 18, 147, 213, 341
executives 143–7, 150–5, 197–201, 205–12, 274–9, 458–9, 486–93
 senior 7, 18, 25, 51, 267, 347, 349
 top 137, 480, 483–4, 486, 489, 491
exercise prices 457, 489, 493
expenses 15, 23, 63–5, 68, 70, 371, 387
experience
 board 238, 240, 336
 management 149, 240
expertise 85, 121–3, 129, 151, 154, 185, 350–2
 financial 129, 265
exporting countries 593–4, 598
exposures 28, 41, 261, 299, 309–10, 436, 541
expropriation 374, 408, 601
extended team production approach 15, 233–6
external actors 185, 227, 235, 239, 245, 296
external auditors 42, 51, 277, 442
 independence 23, 60, 110
external board committees 246
external capital 41, 509, 512
external environment 186–7, 226, 237, 294, 408, 424
external facilitation 315–16, 570
external financing 396–7, 406
external legitimacy 198, 201, 212
 effects within boards 202–3
external markets 22, 408–9, 424
external parties 315–16, 318, 513
external perceptions 202, 204, 206, 310
external perspectives 189, 208, 237
 firm 234–5, 237
external pressures 15, 203, 212–13, 319
external relationships 184–5, 415
external reviews 286–8
external search consultants 326, 332–6, 340
external stakeholders 96, 101, 246, 613, 624
extra-organizational tasks 618, 620
Extractive Industries Transparency Initiative (EITI) 594

facilitation 315–16, 623
 external 315–16, 570
factor prices 480, 482, 484
failures
 corporate 1–2, 20, 27, 222, 260, 428, 534
 market 19, 30, 385, 498
 regulatory 27, 533, 551, 591
 of risk management systems 28, 560
 systemic 430, 534, 552
fair value 12–13
 accounting 10, 12–13, 159–62
 economic analysis of 159–78
families 3, 21, 387, 392–3, 410, 413–18, 420–2
 business 406, 414–19
 founder 409, 413
 legal 383–5
family boards 419, 423
family businesses/firms 21, 41, 387, 396, 407, 415–18, 420–1 *see also* family-owned Asian business groups
family CEOs 407
family control 387, 396, 407, 410, 440
family councils 418–19
family members 387, 416–18, 420–2
family-owned Asian business groups 406–24
 boards 421–4
 business families/family owners 415–21
 family councils 418–19
 financing 419–20
 professionalisation and professional management 420–1
 role of business group-owned banks 413–15
 sentimental value of ownership 416–17
 succession 417–18
family owners 386, 396, 406, 415, 421, 424, 480
family ownership 3, 373, 387, 396
 family-owned Asian business groups 406–24
family values 416–18
FASB *see* Financial Accounting Standards Board
FDI *see* foreign direct investment
FDs *see* finance directors
Federal Deposit Insurance Corporation 27, 527
Federal Reserve 536, 538–41, 545, 547, 567–8
feedback 18, 207, 285, 299, 302–3, 312, 316–17
fees 88, 468
female directors 326–7, 329, 332, 334, 337, 339–40, 350
female representation 327, 338
female role models 330–1
fictions 115–16, 546
fiduciary capitalism 443
fiduciary duties 17, 53, 68–9, 77, 83, 88–91, 100
Filipino business groups 411, 414
finance 10, 96–7, 104, 270, 481–3, 503–7, 509–11
 and innovation 504–7
 management of 27, 534
 provision of 504, 506
 role of 12, 162
finance directors (FDs) 202, 207, 268, 270, 442
finance literature 187, 384, 389
finance markets 26, 511
Financial Accounting Standards Board (FASB) 24, 159–60, 177–8, 492
financial assets 159, 174, 544–5, 564
financial bubbles 171–2
financial conglomerates *see* complex conglomerates, in financial services
financial crises 28, 123–4, 535–8, 550–1, 567–9, 575–6, 578 *see also* global financial crisis
Financial Crisis Inquiry Commission 543–4, 567

financial holdings 392–3, 482
financial innovations 524, 535, 539, 547
financial institutions 27–8, 533–9, 541–2, 546–7, 550–3, 556–60, 563–5
European 541–4
international 22, 539, 580
regulation and governance 550–2
systemically important 526–7, 550
financial instruments 5, 159, 161–2, 527, 537, 539
new 262, 537, 545
financial markets 2–3, 65–6, 160–1, 175–6, 533–4, 543–4, 551–3
international 27, 534, 547, 552
reform 28, 557
unregulated 533, 535
financial performance 136, 199, 202–4, 349, 353, 398, 596–7
financial products 161, 372, 527, 548, 558
financial regulation 384, 572–3, 578, 580
Financial Reporting Council (FRC) 51, 197, 261, 264–5, 268, 287, 570–2
financial risks 169, 174, 189, 524, 537, 539
financial securities 7, 63, 68, 165, 167, 545
Financial Services Authority (FSA) 28, 51, 527, 552, 564, 569–70, 572–4
financial stability 1, 266, 537, 559, 572–3, 578
Financial Stability Forum (FSF) 159, 558, 580
Principles 559, 564, 575, 577
financial statements, use of current market prices 171–4
financial systems 160–1, 525–6, 535, 538–40, 558, 566–7, 572–3
bank-based 507, 545
global 526–7, 543
international 27–8, 538, 542, 546, 552
financial valuation 12, 162, 168, 171, 177
financialization 21, 379, 533–4
fight against 491–2
of global economy 543–6
financing 3, 86, 396–8, 413–14, 419, 591, 593
constraints 506–7
external 396–7, 406
family-owned Asian business groups 419–20
firm external perspectives 234–5, 237
firm internal perspectives 234–7
firm-specific investments 10, 15, 65, 101, 236
firms 162–9, 379–83, 385–90, 394–9, 508–13, 585–600, 602–8 *see also* enterprises
and corporations 115–20
focus groups 107, 312, 623
forced labour 587, 589
foreign direct investment (FDI) 552, 587–8
India 146
foreign investors 139–40, 261–2, 372–3, 414–15
foreign ownership 139
restrictions 22, 411
formal compliance 196–8, 201, 205, 210, 212
formation 9, 88, 95, 131, 162, 176, 437
limited liability companies (LLCs) 86
founder families 409, 413
founders 7, 9, 41, 98, 115, 423
France 40–1, 47–8, 176–7, 340, 391–2, 396–8, 563
fraud 40, 62, 68, 85, 92–3, 130, 152
FRC *see* Financial Reporting Council
free cash flow 25, 478–9, 506
free markets 40, 54, 58, 338
freedom
contractual 83, 89–90, 93
degrees of 5, 190, 380, 399
of establishment 130–1
FSA *see* Financial Services Authority
FSF *see* Financial Stability Forum
function-oriented competence 239–40
functional background 345, 347–8, 354–5
functions 114–15, 118–19, 121–2, 137, 139, 151–3, 346–7
board 137, 151, 153, 289
control 14, 199, 205, 213, 293, 351
directors 12, 137, 557, 579
dual 11, 136, 154–5
managerial 119, 123
monitoring 10, 141, 153–4, 384
supervisory 422, 573
fund managers 204, 276, 414, 572
fundamental change 160, 187, 550, 594
fundamental conflicts 190, 412, 442
fundamentalism, market 616–17

G-20 369, 566–7, 580
response to global financial crisis 558–9
GAAPs *see* generally accepted accounting principles
gender-balanced boards 326, 333
gender diversity 19, 239, 334, 337, 345, 349–50, 352 *see also* women
and good governance 325–8
generally accepted accounting principles (GAAPs) 47, 49–50
generosity 238, 241–2
Germany 41, 48, 98–9, 366–7, 375, 391–3, 563–4
GFC *see* global financial crisis
global business 585–7, 590, 595–6, 600, 605
new conditions 588
Global Compact 593, 600–2, 613
global convergence 3, 20, 365–78
definition 366–7
detritus of globalization so far 370–1
embedded capitalism 369
individual versus society 369–70
moderate, nuanced convergence theses 371–5
reasons for failure of globalization to fulfil promise 371
reservations about globalization 368–9
reservations about strong form convergence thesis 368
taken to extremes 367–8

global derivatives markets 537–9
global financial crisis (GFC) 5, 7, 10–11, 19–20, 26–8, 52–3, 428–30
  Basel Committee response 561
  causes 533–53
  corporate governance causes 546–50
    regulatory response 556–80
  and directors' duties 62–77
  European financial institution failures 541–3
  European response 562–5
  failure of economic orthodoxy 534–5
  financialization of global economy 543–6
  G-20 response 558–9
  global derivatives markets 537–9
  global solutions 558–62
  OECD response 559–61
  origins 536–7
  regulation and governance of financial institutions 550–2
  subprime mortgage debacle 539–41
  United Kingdom response 568–74
  US financial institution failures 541
  US response 565–8
global financial system 526–7, 543
global governance 386, 595–6, 601, 608, 624
global markets 5, 12, 137, 533, 601
globalization 31, 286, 369–71, 374, 376–7, 490, 608
  consequences 588–9
  detritus of 370–1
  and human rights 586–90
  reasons for failure to fulfil promise 371
  reservations about 368–9
good faith 68–9, 71, 83, 88–91, 95, 119, 521
  contractual covenant of 9, 83, 86, 92
  duty of 70, 90–1
governance *see also Introductory Note*
  codes 7, 22–3, 52–3, 117–18, 287, 384–6, 428–30
    absence of supporting theory for 434–6
    around the world 47–8
    arrival 45–8
    good 188, 386
    UK *see* United Kingdom, Code of Corporate Governance
    United States 47
  collaborative 592–4
  committees 142, 147, 306, 367
  discourses 496–500
  environmental 30, 614
  frameworks 3, 123, 303, 499, 565
  global 386, 595, 608
  good 22–3, 386, 428, 433, 505–6, 612–13, 622
  and law 120–31
  models 3, 31, 99, 292–3, 368, 379, 395
  network 434–6, 438, 445
  origin of term 44–5
  relationship-based 3, 510
  systemic 27, 533
Governance Self-Assessment Checklist (GSAC) 297–9
Greece 562–3
Greenbury Committee 45, 264, 376, 456, 467, 578
group culture 14, 107, 210
group development, business 408–9
group diversity research 347–8, 357
group dynamics 56, 220, 295–6, 313, 315
group insolvencies 26, 521–3
group interviews 312
group think 332, 351, 571
groups
  complex *see* complex conglomerates, governance and regulation
  development of group concept 521
  stakeholder 46, 54, 58, 234, 280, 317, 616–17
growth 4, 7, 49, 187, 203, 225, 460–1
GSAC *see* Governance Self-Assessment Checklist

Hampel Committee 45–6, 264, 376
hard law 383, 385–6
hedge funds 55, 57, 59–60, 65, 387, 501, 578–9
hegemony, managerial 15, 222, 235
heterogeneity 14, 191, 354, 396, 506
Hewlett-Packard 25, 149, 490
hierarchies
  control 434, 445
  steep 186
Higgs Review 46, 50–1, 202, 213, 265–6, 325–6, 332
highest-paid corporate executives 483–4
historical-cost approach 10, 12, 159, 161, 163–7, 169, 171–6
history 27, 39–60, 109, 121, 365–6, 525, 577–8
  1970s 42–3
  1980s 43–5
  1990s 45–8
  advent of joint-stock, limited liability companies 41
  early 20th century 41–2
  evolution of corporate governance theories 53–9
  frontiers of corporate governance 59–60
  merchants and monopolists 39–40
  start of 21st century 48–53
holding companies 55, 59, 411–14, 418, 521, 526, 550
home countries 395, 587, 589, 607
homogeneity 325–6, 328
homosocial reproduction 332
Hong Kong 47, 139, 198, 367, 372, 410
  Stock Exchange 139, 372
host, state capacity 589, 602, 606
host states 587, 590, 600–1, 603, 606–7
hostile takeover bids 11, 114, 124–9, 368, 374, 398
HR *see* human resources
human capital 290, 294, 481–2, 499, 502–3, 509
  myth 18, 328–9
human resources (HR) 11, 128, 151, 237, 269, 381, 615
human rights 29, 77, 593, 595, 599–609, 612
  abuses 585, 589, 593, 601–2, 605–7
  and globalization 586–90

instruments 601, 603, 605–6
international system 585–7, 589–90, 600, 608
obligations 587, 605–6
policies 587, 595, 604–6
responsibilities 587, 602, 606
standards 587, 600, 603, 605
Human Rights Council 600–2, 608

IASB *see* International Accounting Standards Board
IASs *see* international accounting standards
ICCPR *see* International Covenant on Civil and Political Rights
ICSA *see* Institute of Chartered Secretaries and Administrators
IFRS *see* International Financial Reporting Standards
ILO *see* International Labour Organisation
IMF *see* International Monetary Fund
impression management 189, 201, 312
in-groups 72, 353
inbound logistics 237, 240
incentive alignment 381–2
incentive compensation 73, 382, 470, 566
incentive systems 28, 73, 75, 497, 552, 557, 560
and language 73
incentives 386–8, 397–8, 431–2, 454–5, 497–500, 502–6, 596–600
economic 71, 73
high-powered 67, 497, 500, 504, 513
tax 432, 443, 445
incentivisation 274, 501, 512, 550
inclusiveness 244, 621–2, 624
income distribution 476, 491
income statements 164–5, 168, 170, 178
incomes 57, 87, 116, 166, 175, 373, 476–7
capital 480, 485, 493
incomplete contracts 499, 502, 507–8
incorporation 7, 9, 41, 58, 67, 94, 129–31
incremental innovation 26, 509
independence 42, 54, 224–5, 293, 431, 443, 564–6
auditors 7, 23, 60, 110, 376, 439
board 106, 185–6, 199, 226, 258, 380–2, 397–8
directors 23, 43, 68, 110, 190, 286, 442–3
fetishization of 444
independent board members *see* independent directors
independent boards 69, 106, 185–6, 395, 443, 468
independent directors 89, 123–4, 148–9, 185–6, 367–8, 422–3, 442–4
boards of 20, 368
role 199, 407, 424, 454
India 40–1, 59, 146, 151, 155, 160, 340
individual director evaluations 287, 306, 316, 318
individual directors 14, 56, 151–2, 189, 291–2, 304–5, 313–16
individual interviews 311–12, 319
individual investors 138–9, 390, 397, 612
individual reputations 202–4
individualism 368–9, 616–17
indivisibility and, complementarity 168–70
Indonesia 368, 373, 375–6, 392, 394, 409–10, 536
industrial democracy 42
industrialism 6, 27, 30
industry codes 591–2, 608
inefficient markets 22, 411
information
accounting 160–1, 163–5, 171, 173–4
asymmetric 23, 167, 170, 177, 185, 453–4, 500–1
complementary 13, 162, 175–6
disclosure *see* disclosure
financial 395, 441
overload 435–6
Infosys Technologies 150–1, 372
infrastructure 237, 409, 524, 549, 624
initial public offerings (IPOs) 349
inner dynamics 15, 222, 226–8
innovation 22–6, 225–8, 481–2, 484–6, 491–2, 496–505, 507–13
board contribution 217, 225–6, 228
company 225–6
empirical studies 504–11
and finance 504–7
financial 524, 535, 539, 547
and governance systems 508–11
incremental 26, 509
and integration 507–8
internal 505–6
outputs 504–5, 513
and principal-agent theory 500–1, 504–7
process 480–2, 489, 492, 496, 498, 500, 512
radical 26, 503, 509
and resource-based view 501–2
systems 499, 504, 508, 510
and transaction cost theory 501
and varieties of capitalism literature 502–3
innovative enterprise 25, 477, 479, 485, 512
input-output studies 224, 226
insider ownership 221, 226, 395
insiders 66, 98–9, 160, 239, 313, 389–90, 438
insolvencies 26–7, 114, 118, 122, 131, 327, 522–3
group 26, 521
insolvency laws 118, 120, 122, 521
instability 160, 477, 492, 534–5
Institute of Chartered Secretaries and Administrators (ICSA) 265, 268, 290, 303, 314
institutional economics, new 2, 113–14
institutional funds 26, 48, 512
institutional holdings 138–9, 144, 505
institutional investing
rise of 138–9
unintended consequences of rise 144
institutional investors 48, 54, 137–9, 141–2, 265, 387–8, 397–8
impact 48
main goal 387, 397
responsibilities 51, 213
rising influence on corporate governance 139–42

institutional ownership 98, 105, 141, 202, 387, 397–8, 505–6
Institutional Shareholder Services 48, 150, 468
institutional shareholders 68, 126, 196, 276, 394, 557, 572
institutional voids 408–9
institutionalism, new 31, 614, 618
institutions of executive pay setting 24, 453–4, 456, 464–71
insurance 43, 120, 176, 443, 520, 545, 596–7
  companies 42, 138, 261, 387, 443, 527, 546
intangible assets 168, 170, 591
integration 21–2, 98, 104, 168, 190, 501, 588
  and innovation 507–8
Intel 25, 377, 485, 490
intellectual application 207, 212
intellectual capital framework 293–4
intentions 22, 77, 127, 142, 213, 594, 619–20
inter-governmental organizations 590, 596
inter-organizational perspective 31, 625
interest groups 54, 617, 622
interlocking ownership 413 *see also* cross-shareholdings
internal control 52, 122–3, 197, 237–8, 242, 264
internal innovation 505–6
Internal Revenue Service *see* IRS
international accounting standards (IASs) 50, 163–70, 176, 259, 269
International Accounting Standards Board (IASB) 159–60, 163–6, 168–70, 173–5, 177
international codes 4, 22
international comparisons 337–8, 391, 579
international corporate responsibility 29, 585–609 *see also* corporate social responsibility
  business standard-setting within international human rights framework 600–5
  globalization and human rights 586–90
  regulatory options 605–8
International Covenant on Civil and Political Rights (ICCPR) 586, 603
International Covenant on Economic, Social and Cultural Rights 586, 603
international financial markets 27, 534, 547, 552
International Financial Reporting Standards (IFRS) 12, 159–60, 177, 524
international financial system 27–8, 538, 542, 546, 552
international human rights system 6, 585–7, 589–90, 593, 599–600, 608
International Labour Organisation (ILO) 594–5
international law 586–7, 590, 602, 606–7
International Monetary Fund (IMF) 198, 369–71, 376, 526, 534–7, 542–3, 559
International Shareholder Services (ISS) 288, 469
internationalization 144, 221, 224, 396
internet 257, 263, 268, 273, 275, 366–7, 372
  bubble 24, 168, 479
interpreting of earnings 172–4
interviewees 201–2, 257, 260, 270, 278
interviews 107, 150, 201–2, 205–6, 266–8, 308–11, 336–7
  group 312
  individual 311–12, 319
invested capital 174, 413
invested cost 164, 166
investee companies 262, 265, 276, 443, 572
investment banking 525, 537, 566, 578
investment banks 330, 534, 537, 539, 546, 548–50, 574
investment capital 373, 587, 589, 601
investment companies 138, 167, 533, 542
investment management 148, 520, 525
investment portfolios 387, 397, 414
investment strategies 7, 63, 414, 480
investment trusts 55, 60, 261
investments 85–8, 116–17, 225, 387, 432–3, 480–2, 498–500
  capital 500, 542, 616
  direct 372, 482, 588, 595
  financial 478, 487
  firm-specific 10, 15, 65, 101, 236
  foreign direct *see* foreign direct investment
  government 490, 524
investors 88–91, 115–16, 201–5, 211–13, 275–6, 431–2, 436–41
  active 266, 275, 278
  financial 65, 175, 235, 394
  foreign 139–40, 261–2, 372–3, 414–15
  individual 138–9, 390, 397, 612
  institutional 48, 54, 137–9, 141–2, 265, 387–8, 397–8
  large 138, 228, 437
  long-term 57, 387, 396
  minority 372, 394, 412, 437, 503, 513
  passive 81, 86, 432
  personal 443, 488
  private-equity 149, 152
  professional 12, 137–9
  short-term 24, 154
IPOs *see* initial public offerings (IPOs)
irresponsibility, corporate 596–7
IRS (Internal Revenue Service) 81–3, 87, 94
ISS *see* International Shareholder Services
issuers 177, 394, 537, 547–8
Italy 39, 50, 173, 177, 224, 340, 391–2

Japan 127–8, 138–41, 167–8, 177, 398, 409–10, 540
  companies/firms 128, 141, 147, 388, 507
  shares 139–40
joint-stock companies 9, 40–1, 53, 115
joint-stock limited liability company 55, 60
joint ventures 55, 60, 169
juridical nature of the firm 113–32

key stakeholders 219, 317, 352, 512, 524, 615, 623
knowledge 122–3, 226–8, 236–7, 239–40, 248, 351–3, 618–20
  creation 500, 619

tacit 169, 244, 504, 508
workers 501–2, 508, 511–12
Korea 138–9, 376, 410

L3Cs *see* low-profit limited liability companies
labor rights 589–90, 599
language 70–4, 118, 184, 207, 289, 327, 619
and cooperation 72–3
and ethical behavior 73–5
and incentive systems 73
of team production 72–3, 76
language of shareholder primacy 72–4
Laos 392
Latin America 55, 392, 394, 423
law
and economics 115–20
and governance 120–31
lawsuits 77, 105, 368, 527, 564 *see also* litigation
lawyers 42, 81–2, 94, 96–7, 102–3, 106, 273
leadership 4, 6, 15–16, 305, 523–4, 617–18, 620–1
board 15, 213, 233–49, 311
development 147, 153
levels 327–8
organizational 31, 621
roles 71, 213, 233, 242, 279, 397
strategic 237, 346
styles 618, 620
legal corporate governance scholarship 102–3
legal duties 54, 119, 122, 125, 305
legal entities 6–7, 9, 41, 69, 116, 290, 442
legal families 383–5
legal model 11, 76, 114, 118, 120–1, 132
legal obligations 120, 208, 482, 590, 602
legal origin 384–5
legal personality 9, 115, 131, 510
legal research 103–4, 108
traditional 10, 104, 107
legal rules 100, 103–4, 113, 129, 373, 385
legal scholarship 69, 97, 103–5, 109
research methods and methodologies 103–4
legal systems 10–11, 20–1, 113–20, 376, 380, 384, 386
legitimacy 3, 22–3, 187, 237–8, 590, 597–8, 622–3
external 198, 201–2, 212
Lehman Brothers 24–6, 144, 154, 277, 490, 525, 541–2
lenders 86, 89, 317, 527, 547
Lenovo 148–50
liability 41–2, 81, 83–4, 88–9, 160–3, 433, 436–7
direct 83–4
enterprise 119–20, 132
limited 3, 8–9, 41, 81–4, 94, 115–16, 432–3 *see* limited liability
personal 41, 92, 94, 115, 121, 292
of shareholders 41, 432, 556
unlimited 9, 41, 81
liberal market economies (LMEs) 26, 509–10, 512
life cycle 293, 381, 409, 411
limited liability 3, 8–9, 41, 53, 58, 94, 115–16
and best practices 431–3
limited liability companies (LLCs) *see* limited liability companies
limited liability companies (LLCs) 7, 9, 39, 81–95
acts 82–3
contract principle in jeopardy 92–3
encroachment of corporate law 92
fiduciary duties 89–91
formation 86
future 91–3
limited liability 83–4
low-profit limited liability companies 87–8
membership interests and Uniform Commercial Code 85–6
nature 82–6
operating agreements 83, 86–90, 92–3
securities law issues 85–6
Series LLCs 88–9, 95
Special Purpose Entities (SPEs) 89
structure 86–7
variants 87–9
veil piercing 84–5, 92
limited partnerships 9, 81, 94
liquid markets 26, 54, 66, 438, 482, 503, 506
liquidity 13, 28, 159, 161, 387, 482, 557–8
crisis 542, 566
listed companies 22, 42–4, 46, 60, 121–4, 337–8, 395
boards of large 118, 207
litigation 90, 121, 128, 306, 593 *see also* lawsuits
LLCs *see* limited liability companies
Lloyds Banking Group 267, 269, 277, 339, 398
LMEs *see* liberal market economies
loans 44, 75, 87, 370, 439, 533, 542
logistics
inbound 237, 240
outbound 237–8, 240
London, City of 125, 129, 430, 545, 552
London Stock Exchange 2, 4, 46, 51, 196, 260, 275
long progression of financial crises 28, 534, 546
Long-Term Capital Management (LTCM) 261, 539
long-term incentive payouts 460–1, 463, 483
long-term incentive plans (LTIPs) 274, 277, 382, 466
long-term incentives 143–4, 274, 382, 460–3, 466, 483
long-term interests 53, 418
long-term investors 57, 387, 396
long-term share-value maximization 70–1
long-term shareholder value 567, 613
long-term value creation 248–9, 397, 559, 579
long-term viability 160, 162
losses 8–9, 81–2, 87–8, 160–1, 164–5, 536–8, 549–50
potential 57, 64, 88, 164–5, 175
record 171–2
low-profit limited liability companies (L3Cs) 87–8
loyalty, duty of 70, 89–92

LTCM *see* Long-Term Capital Management (LTCM)
LTIPs *see* long-term incentive plans
LTIs *see* long-term incentives

main boards 42, 44, 208, 211, 269, 272, 465
Malaysia 340, 372, 392, 394, 410, 536
management boards 465, 564
management consultants 42, 145, 268
management teams 123, 175–6, 203, 235, 520, 550, 579
management theory 30, 614, 614–21, 624
managements, responsibility of 47
managerial accountability 11, 122–3
managerial control 478–80, 482
managerial dominance 219, 221, 223
managerial hegemony 15, 222, 235
managerialism 100–1, 121
mandatory bid rule 124–5, 128
manipulation 66, 108, 127, 171, 484–6, 488–9, 492
marked-to-market valuation 12, 162
market-based model 19–20
market-based systems 20–1, 391
market capitalization 138, 145, 257, 262, 332, 377, 542–3
market conditions 548–9
market economies 30, 113, 478–9, 510, 534
  coordinated 26, 509
  liberal 26, 509–10, 512
market failure theory 408–9
market failures 19, 30, 385, 498
market forces 331, 432, 440, 466, 600, 623
market fundamentalism 616–17
market integrity 1, 577
market prices 49, 62, 66, 76, 162, 164–5, 176–7
  as benchmark 171–2
  current *see* current market prices
  spot 162, 176
market regulation 535, 537–9, 541, 543, 545, 547, 549
market risk control (MRC) 549
market valuations 163, 165, 176
market values 142, 159, 161–4, 168, 170, 172–4, 177
market-wide diversification 11, 123
marketing 145, 150, 237, 239, 435, 500
  costs 168, 170
markets 5–7, 65–6, 145–6, 172–3, 382–3, 391–3, 546–8
  capital 11, 22, 132, 373, 396, 398, 411
  consumer 596–7
  credit 539, 566
  derivatives 25, 490, 566
  equity 12, 20, 167, 183
  executive labor 23, 198, 453, 458
  external 22, 408–9, 424
  financial 2–3, 65–6, 160–1, 175–6, 533–4, 543–4, 551–3
  free 40, 54, 58, 338
  global 5, 12, 137, 533, 601
  inefficient 22, 411
  liquid 54, 66, 438
  managed by the market 139, 144
  open 457–8
  perfect 164, 166–7
  product 22, 380, 408–9
  stock 44, 48, 115, 478, 482, 486–7, 534–5
  strong 506–7
  subprime 257, 549
  unregulated 535, 553
Marks & Spencer 266–7, 270, 273
maturity 22, 415, 420–1
maturity term 457, 472
maximization
  profits 369, 385, 398, 599, 616
  of shareholder value 7–8, 25, 62–3, 68, 75–6, 387, 477–82
media 73, 145, 204, 257, 317, 453, 596–7
mediators 346, 350, 354
meetings 202–3, 238, 241–4, 247, 269, 271–2, 313–14
  annual general 46, 51, 208, 276, 438, 465, 575
  board 147, 200, 205–9, 238, 241–3, 246–7, 311–12
  investor 202, 275
members
  board 185–9, 217–19, 225–6, 234–7, 239–49, 296–9, 308 *see also* directors
  compensation committee 465, 467
  family 387, 416, 418, 420–2
  group 101, 349, 353
  individual 348, 621
  team 69, 71, 75, 101, 346, 349, 353
merchants 39–40, 431
mergers 42, 49, 77, 86–7, 90–2, 124–5, 521–2 *see also* takeovers
merit 304, 331–2, 340, 571, 604
methodologies 4, 9–10, 60, 97, 102–10, 260, 319
  research 102–3, 309
  risk-control 549
metrics 8, 15, 26, 63–4, 66, 110, 382
  single 8, 63–4, 66
Mexico 392–4
Microsoft 25, 377, 485–6, 490
mining 433, 589, 593–4
minorities 43, 54–5, 218, 317, 413, 419, 423
minority directors 189, 289, 355
minority investors 372, 394, 412, 437, 503, 513
minority shareholders 92–3, 95, 99, 124, 377, 383–7, 440
  protection 93, 128, 413, 507
misfeasance 84, 94
modelling
  and accountants 170–1
  of board processes 199–200
models 54, 97–9, 106, 113–14, 295, 454–5, 503–4
  accounting 160, 162, 171
  agency 455, 459, 504
  Black-Scholes 457–8
  of board effectiveness 293–301
  business 53, 77, 524, 537, 552, 558, 575

governance 3, 19, 100, 293, 379, 497, 614
legal 11, 76, 114, 118, 120–1, 132
market-based 19–20
organizational 523–4
role 289, 327, 331, 440
shareholder-oriented 20, 367–8
stakeholder 375, 503
standard 367–8
standard principal-agent 454, 470
strategic-partnership 137, 150–1, 153–4
theoretical 11, 24, 114, 470
valuation 163, 170, 176
moderators 243, 346, 351, 355–6
monitoring
board 221, 381–2
function 10, 141, 153–4, 384
management 11, 142, 144, 148, 382, 387
shareholder 11, 100, 138–9, 150–1, 153, 399
monitors
of management 11–12, 118, 121, 136–7, 398
shareholder 137, 147, 155
monolithic entities 14, 189, 191
monopolists 39, 130
monopoly 40, 54, 499
moral hazards 8, 99, 185, 366, 368, 455, 470
mortgage-related securities 547, 550
mortgages 535, 537–8
subprime 525, 535, 539, 541–3, 547
motivation 75, 225, 246, 290, 439, 512, 622
motivators 234, 238, 243, 248
MRC *see* market risk control
multi-stakeholder codes 592, 597, 599
multi-theoretical approaches 6, 258–9
multiple boards 301, 388, 436
multiple stakeholder interaction 619–20, 622
Myners Report 46, 264

NAPF *see* National Association of Pension Funds
narrative theory 618–19
NASDAQ 7, 20, 372, 483–6, 533
nation-states 9, 29, 366, 369, 608, 619
National Association of Pension Funds (NAPF) 48, 268, 438
National Conference of Commissioners on Uniform State Laws (NCCUSL) 82–3
nationality 18–19, 345–7
natural environment 613, 615
natural persons 116, 120, 587
natural sciences 433–4, 445
nature, juridical 10, 113–15, 117, 119, 121, 123, 131
NCCUSL *see* National Conference of Commissioners on Uniform State Laws
NEDs *see* non-executive directors
negotiation competence 239–40
Netherlands 40, 340, 367, 391–2, 540, 542, 578
network governance 434–6, 438, 445
networking 237, 240, 242, 269, 289
networks 42, 57, 64, 243, 590, 618–19, 621–4
of power 17, 272
social 16–17, 184, 259, 280, 290
new institutional economics 2, 113–14
new institutionalism 31, 614, 618
New Jersey 129–30, 521
new technologies 26, 277, 508–9, 588
New York Stock Exchange *see* NYSE
New Zealand 26, 224, 277, 337, 374, 521, 523
nexus of contracts 10, 64, 100–2, 109
NGOs (non-governmental organizations) 29, 60, 589, 591–3, 595–9, 615
Nicholson and Newton's (2010) Board Roles 298–301
nominal values 273–4, 436, 462–3
nomination(s) committees 45, 51, 142, 204, 244–5, 332, 335–7
nominations 51, 57, 210, 245, 247, 276, 437–8
non-binding shareholder votes 28, 75, 575, 579
non-compliance 57, 196
non-executive chairs 151, 206–7, 273, 422
non-executive control, dynamic of 14, 211
non-executive directors (NEDs) 121–2, 148–53, 197–213, 265, 269–75, 278–9, 330–5
independent 142, 149, 198
role 199, 208, 265, 269, 271, 326, 330
non-executives *see* non-executive directors
non-financial risk management 561, 597
non-governmental organizations *see* NGOs
non-hierarchical organizations 434–5
non-independent directors 141, 148–9, 151
non-profit boards 299, 318
non-profit corporations/organizations 39, 55, 288, 298, 326, 439, 445
non-shareholder constituencies 124, 128
nonfeasance 84, 94
norms 5, 71, 74, 129, 188–9, 601, 604–5
social 189, 259, 597, 599, 602, 604
Northern Rock 265, 542
Norway 19, 224, 287, 290, 327–8, 338, 340
not-for-profit organizations *see* non-profit corporations/organizations
nurtures 12, 162, 331
NYSE (New York Stock Exchange) 49, 74, 141–2, 371–2, 379, 484–6, 541

OBBGs *see* Ownership Based Business Groups
objectivity 166, 315–17, 335, 389
obligations 9, 24, 84–5, 88–9, 124–5, 605–6, 616–17
legal 120, 208, 482, 590, 602
observance 29, 587
occupational diversity 350, 357
OECD (Organisation for Economic Co-operation and Development) 1, 52, 198, 327, 418, 557, 559–62
Corporate Governance Principles 22, 307, 440, 559–61, 577
Guidelines 594–5, 600, 602, 606, 608

OECD (Organisation for Economic Co-operation and Development) (*Cont.*)
response to global financial crisis 559–61
Steering Group on Corporate Governance 52, 316, 560
Office of Thrift Supervision (OTS) 567–8
oil 81, 589, 593–4
oligarchic groups 391–3
open markets 457–8
openness 2, 31, 238, 241–2, 244, 248, 327
operating agreements, limited liability companies (LLCs) 83, 86–90, 92–3
opportunism 100, 198, 222, 235–6, 350, 382–3, 387
managerial 222, 236, 350
oppression 92, 95, 437
optimal contracting 23, 466–7
optimal designs 357, 454–5
options *see* stock options
ordinary shares 261, 457–9
organic governance 620
Organisation for Economic Co-operation and Development *see* OECD
organising 410–11, 424
organizational behavior 184, 233, 240
organizational capacity 115, 119–20, 132
organizational change 617–18
organizational demography 347, 353–4
organizational effectiveness 307, 613
organizational learning 26, 512, 619
organizational models 523–4
organizational outcomes 346–8, 354, 356
organizational performance 18, 256, 288–9, 293, 297, 301, 357
organizational structures 115–16, 131, 188
organizations 186–9, 236–7, 286–9, 302–8, 381–2, 612–13, 618–24
International 371, 558, 580, 586, 592
non-governmental 29, 60, 589, 591, 615
not-for-profit 39, 55, 621
OTS *see* Office of Thrift Supervision
out-groups 353
outbound logistics 237–8, 240
output control 237–8, 240, 242
outsider boards 26, 512
outsider systems 98, 390–1
outsiders 72, 89, 122, 239, 420–1, 466–7, 506
overload, information 435–6
owner-entrepreneurs 479–80
owners 41–2, 55, 115–17, 279–80, 410–12, 415–16, 420–2
controlling 398, 420
family 386, 396, 406, 415, 421, 424, 480
institutional 397, 505
ownership 2–4, 97–9, 116–18, 390, 395–7, 424, 498–9
bank 387, 396–7
block 423, 499, 501
concentrated 22, 382, 384–6, 394–5, 406, 408–10, 506–8
dispersed 26, 191, 379, 382–3, 385–7, 398–9, 407
family 3, 373, 387, 396, 416
form 26, 496, 512
insider 221, 226, 395
institutional 98, 105, 141, 202, 387, 397–8, 505–6
patterns 41, 60, 98, 373–4, 394
separation of ownership and control 4, 10, 97–9, 101, 109, 185, 479–80
state 338, 396, 398
structures 20–1, 59, 99, 109, 386–8, 390–1, 504–5
Ownership Based Business Groups (OBBGs) 413

Pacific Rim 366, 368
parent companies 26, 523, 607
partial bids 124–6
participant observation 246
participants 64, 75–6, 108, 308–9, 312–14, 539, 622–3
corporate 8, 62, 72, 593
market 167, 526, 566
participation 9, 15, 22, 220, 222, 241, 622
government 590, 608, 623
strategic 223, 237–8, 240, 242
partnering 148, 150, 154–5
roles 148, 150, 155
strategic 11, 136, 144, 148, 151–3
partners 9, 49, 58, 81, 89, 151, 591
business 623–4
strategic 12, 136–7, 144, 147, 154–5
partnership criteria
for evaluating directors 151–2
for recruiting directors 150–1
partnerships 9, 27, 49, 81–2, 94, 592–3, 622–4
challenges for partners 624
and governance 622–3
limited 9, 81, 94
research 623–4
strategic 149–50, 152
passive chairs 234, 248
passive investors 81, 86, 432
passive owners 98, 398
patents 170, 445, 504–6, 511
path dependency 373–4
pay-for-performance 53, 461–4, 470
link 453, 457
and US CEO pay 459–61
pay setting, institutions of 24, 453–4, 456, 464–71
pension funds 42, 44, 54, 57, 261, 264, 280
perceptions 4, 72, 189, 202, 205, 260, 310–12
external 202, 204, 206, 310
perfect markets 164, 166–7
performance
boards 19, 53, 201, 288–92, 298–9, 560–1, 570–1
company/corporate 12–13, 56, 136–7, 183–7, 190–1, 275, 297
director 430, 577
economic 225, 428, 433, 478–9, 482
evaluations 75, 152, 579

executive/management 14, 66, 123, 153, 210, 212, 297
financial 136, 199, 202–4, 349, 353, 398, 596–7
organizational 18, 256, 288–9, 293, 297, 301, 357
patent 504–5
price 73, 276, 327, 372
stock prices 8, 63, 73–4, 276, 327, 372, 484
and women 326–7
performance-related pay *see* pay-for-performance
personal investors 443, 488
personal liability 41, 92, 94, 115, 121, 292
personality 17, 57, 115–16, 239, 246, 279, 347–8
legal 9, 115, 131, 510
pharmaceutical companies 152, 490–1
Philippines 376, 392, 394, 409–11, 413–14, 418, 536
pipeline myth 18, 329, 329–30, 332
pluralism
radical 31, 614, 618
theoretical 14, 190, 218, 227
poison pills 68, 124, 126, 128–9, 143
political power 42, 431–2
political risk 414–15
portfolios 24, 48, 55, 175, 225, 388, 548
diversified 387, 396, 572
investment 387, 397, 414
Portugal 39, 430, 562–3
potential capital gains 173–5
potential conflicts 418, 467–8, 570
potential losses 57, 64, 88, 164–5, 175
potential profits 160, 173, 177
poverty 588, 590, 599
power differentials 349, 357, 587
present value 163–7, 171, 445, 457, 478–80
presiding directors 142, 151
pressures 10–11, 75, 124–5, 132, 142, 286, 589–90
external 15, 203, 212–13, 319
investor 202–3
public 388, 556–7
shareholder 124, 128, 132, 143
short-term 26, 505–6, 509–10, 512
prices 23–4, 64–7, 73, 75–6, 126–7, 161–3, 456–9
asset 171–2, 458–9, 471, 537, 541
equity 132, 460
factor 480, 482, 484
market 49, 62, 66, 76, 164–5, 171–2, 176–7
selling 163, 166–7
stock 65–7, 106, 457, 459, 472, 479–80, 484–5
primacy
director 67, 100–1
shareholder 8, 64–9, 71, 73–5, 98, 100–1, 109
primary drivers 217, 468, 485
principal-agent theory 185, 191, 454, 456, 470–1, 496–7, 499 *see also* agency theory
and innovation 500–1, 504–7
Principles for Sound Compensation Practices 560, 564, 575, 577
PRIs *see* program-related investments
private benefits of control 384, 394
private companies 40–2, 46, 55, 60, 130–1, 594
private enterprise 71, 74, 370, 433
private equity 59–60, 277, 501, 505, 525, 564
private governance 599, 605
process-oriented competence 239–40
process-oriented research 200, 258
processes
appointment 18, 325–6, 332
behavioral 110, 188–9, 468
board 19, 200, 206, 222, 319, 353–4, 358
governance 7, 50, 56, 275, 310, 318
team 347, 350, 353–4, 357
product markets 22, 380, 408–9
production, team *see* team production
productive capabilities 480–1
productive model of governance 31, 621
productive resources 478, 481–2
Productivity Commission 575–7
professional associations 22, 269, 377, 439
professional investors 12, 137–9
professional managers 85, 409, 414, 420–1, 424
professional service firms 331, 341
professionalization 22, 286, 420–1, 424
profit-and-loss statement 161–2
profits 11, 24–5, 49, 70, 72, 490–1, 493
maximization 369, 385, 398, 599, 616
potential 160, 173, 177
surplus 431–2, 446
unrealized 165, 173
program-related investments (PRIs) 87–8
promoters 81, 93–4
property owners 374, 482
property rights 116–17, 132, 377, 384, 408, 507
and convergence 374–5
theory 114, 117, 233, 235, 377, 498–500, 508
and innovation 502
Protect, Respect and Remedy framework 585–6, 600–1, 608
proxies 23, 51, 68, 71, 98, 347, 428
proxy statements 106, 470
proxy voting agencies 468–9, 471
prudential regulation 28, 521, 557, 573–5
psychometrics 297–8, 311, 314, 332
public announcements 105–6
public companies/corporations 10, 41–3, 46–7, 55, 98–9, 101, 124
public pressures 388, 556–7
public shareholders 387, 478, 482–3
public spotlight 275–6
publicly-traded companies, large 138, 143, 153–4
Publish What You Pay (PWYP) 594, 598
PWYP *see* Publish What You Pay

qualifications 152, 270, 351–2, 421, 561, 569
qualitative research 15, 104, 107–8, 110, 200, 210, 213
quantitative research 10, 104–6, 110

questionnaires 107, 247–9, 311, 319
quotas 333, 338, 340

racial diversity 346, 348, 350–1, 355
radical change 173, 279, 340
radical innovation 26, 503, 509
radical pluralism 31, 614, 618
ratings agencies *see* credit ratings agencies
RBT *see* resource-based theory
RBV *see* resource-based view
R&D 490, 504–7, 510–11, 513
  expenditure 224, 506–7
  intensity 506, 513
realizable value of firms 168, 171
recessions 262, 453, 459–60, 469, 551, 553, 558
recovery 28, 166, 543, 557–9, 566
  jobless 476
recruitment of directors 5, 51
reflexive management 618, 620
reflexive modernisation 614, 618, 621
reflexivity 31, 618, 620–1
reforms 22, 28–9, 376, 556–8, 565–7, 572–6, 578–80
  financial market 28, 557
  regulatory 10–11, 28, 75, 373, 557, 560–3, 577–8
  substantive 23, 202
regulators 160, 166, 260, 433–4, 527, 540–1, 576–8
  accounting 160, 177
  financial 429, 566
regulatory change 277–8
regulatory competition 114, 120, 129–31
regulatory failures 27, 533, 551, 591
regulatory reforms 10–11, 28, 75, 373, 557, 560–3, 577–8
relational competences 239–40
relations-oriented diversity 19, 346, 350, 357
relationship-based governance 3, 510
relationships
  board 13, 187
  board-investor 256, 277
  board-management 302, 305, 317
  business 570, 603
  CEO-board 187, 222
  complex 18, 23, 184, 292–3
  contractual 10, 56, 101
  external 184–5, 415
  trusting 31, 621, 623
reliability 165, 170–1, 173, 176, 279, 434, 501
reliance 104, 368, 397, 399, 526, 547, 549
remote shareholders 7, 42
remuneration *see* executive compensation
remuneration committees *see* compensation committees
rent-seeking 373–4
reported compliance 197–8
representations, executive 17, 270
repurchases *see* stock buybacks
reputations 64, 203–4, 210, 225, 246, 273, 596–7
  individual 202–4
research
  board 14, 190–1, 310, 349, 354–5
  diversity 346, 348, 355
  empirical 97, 104, 108–10, 114, 223, 227, 348–9
  governance 213, 346, 381
  legal 103–4, 108
  methodologies 102–3, 309
  qualitative 15, 104, 107–8, 110, 200, 210, 213
  quantitative 10, 104–6, 110
residual claimants 25, 62, 64, 76, 116–18, 478–9, 481–2
resource allocation 62, 69, 237, 478–80, 482–3, 485, 488
resource-based theory (RBT) 329, 409, 497–8, 501–2, 507, 614–16
resource-based view (RBV) 219, 222, 226, 228, 410, 499
  and innovation 501–2
resource dependence theory 10, 57, 190, 199, 235–6, 352, 389
resources 165–7, 170, 235–6, 240, 296–8, 478–80, 482
  critical 187, 219, 236
  human 11, 128, 269, 330, 334, 435, 615
  productive 478, 481–2
responsibilities 1–2, 4–5, 45–7, 58–9, 118–19, 602–5, 607–9
  board 7, 47, 52–3, 213, 277, 571
  collective 271, 302
  corporate 6, 30, 58, 585–6, 599–600, 602–5, 608–9
  environmental 6, 27, 30, 585
  executive/management 47, 205, 207
  of institutional investors 51, 213
restricted stocks 24, 456, 458–63, 471
revenues 82, 145, 162, 443, 548–50, 589
Revised Uniform Partnership Act (RUPA) 82, 89, 95
rhetoric 74–5, 184, 189, 201, 552, 616
risk assessment 174
risk committees 28, 563, 567, 569–70, 579
risk management 7, 28, 53, 524–6, 548–50, 557–8, 560–3
  effective 571, 613, 620
  functions 564–5, 571
  non-financial 561, 597
  systems 28, 558, 560, 580
risks 63–5, 119–20, 174–6, 538–9, 546–50, 558–63, 616–21 *see also* risk management
  associated 172, 539
  complex 269, 538
  credit 161, 537, 547
  environmental 613–14, 616–17, 619–21
  excessive 28, 65, 121, 144, 183, 524, 541
  financial 169, 174, 189, 524, 537, 539
  political 414–15
  potential 174, 622
  social 30–1, 614, 617, 621
  strategic 59, 212, 524
  systemic 27, 160, 521, 526, 559, 573

unique 15, 236, 241
unknown 27, 428
role models 289, 327, 330–1, 440
roles 3–6, 150–1, 198–202, 268–79, 305–8, 332–7, 421–2
advisory 389–90, 398, 595
board 6, 13, 144, 201–2, 289, 293–5, 297–8
CE 268–9
chair 207, 243, 258, 269, 274, 422
director 69, 147, 151, 154, 257, 266
executive 119, 421
non-executive directors 199, 208, 265, 269, 271, 326, 330
partnering 148, 150, 155
pivotal 202, 409, 415, 423, 570
service 199, 201, 211, 293
stewardship 212, 572
strategic-partnering 152, 155
strategy 187, 200, 223–4
symbolic 151, 303
RUPA *see* Revised Uniform Partnership Act

salaried professionals 479–80
salaries 64, 144, 454, 456, 458, 460–3, 492–3 *see also* executive compensation
sales 67, 98, 145–6, 148, 262, 489–90, 541
Sarbanes-Oxley Act (SOX) 50, 73–4, 261, 372, 377, 439–40, 469–70
Say on Pay 464–5, 469, 472, 566, 570, 575
scandals 44, 207, 213, 386, 389, 469, 489
accounting 24, 152, 261, 469
search consultants 326, 332–6, 340
search firms 18, 329, 333, 341
SEC *see* Securities and Exchange Commission
securities 47, 85, 165, 534–5, 539, 546, 548–9 *see also* stock buybacks; stock options
asset-backed 537, 547–8
financial 7, 63, 68, 165, 167, 545
mortgage-related 547, 550
Securities and Exchange Commission (SEC) 41–2, 68, 73–4, 439–40, 488–9, 546–8, 567–8
securities laws 44, 85–6, 97, 129, 132, 154, 176
security interests 85–6
selection 51, 103, 188–9, 208, 245, 267, 336–7
self-evaluations 286, 299, 307
schemes 246–7
self-governance 430, 433–4
self-interested agents 190, 218–20
self-regulation 46, 520, 534, 547
selling prices 163, 166–7
senates, corporate 437–8
senior executives 7, 18, 25, 51, 267, 347, 349
senior independent directors (SIDs) 51, 336
senior managers 47, 67, 74, 145, 186, 209, 501
senior risk 28, 569
senior women 328, 340–1
sensitivity 107, 132, 308, 398, 462, 598, 603
separation of board chairmanship from CEO role 46, 53, 57, 142, 207, 221, 258
separation of ownership and control 4, 10, 97–9, 101, 109, 185, 479–80
Series LLCs 88–9, 95
service roles 199, 201, 211, 293
share price performance *see* stock prices, performance
share-value maximization 62–3, 76
see shareholder value, maximization
shared understanding 310, 623
shared values 601, 623
shareholder activism 56, 203, 277, 557
shareholder audit committees 437–8, 441
shareholder control 118, 132, 387
shareholder engagement 5, 28, 262, 276, 557, 569–70, 578–9
shareholder interests 63, 101, 212, 234, 381–2, 454, 459
shareholder monitoring 5, 12, 136–55
intensification of 12, 137
and strategic partnering 153–5
shareholder-oriented model 20, 367–8
shareholder pressures 124, 128, 132, 143
shareholder primacy 8, 64–9, 71, 73–5, 98, 100–1, 109
language of 72–4
norm 8, 128
shareholder protection 47, 129, 169, 503
minority 93, 128, 413, 507
shareholder rights 9, 21, 52–4, 132, 141, 379, 560
shareholder value 3–4, 8, 10–11, 25, 143–4, 277–8, 470, 476–93
enlightened 11, 117, 132, 375
long-term 70–1, 567, 613
maximization 7–8, 25, 75–6, 387, 397, 477–82
doctrine 63–8
ideology 25, 480, 482
long-term 70–1
and stock buybacks 489–91
shareholder votes 53, 465, 469, 522, 566
non-binding 28, 75, 575, 579
shareholders 50–8, 67–72, 98–102, 115–19, 123–30, 436–45, 478–9
agents of 11, 68, 76, 132
common 63, 70
controlling 84–5, 99, 373, 383–4, 386–7, 390, 394
dispersed 225, 374, 390, 442
dominant 99, 120, 386, 412, 437
institutional 68, 126, 196, 276, 394, 557, 572
large 226, 390, 465
liability 41, 432, 556
minority 92–3, 95, 99, 124, 377, 383–7, 440
public 387, 478, 482–3
remote 7, 42
single 390, 410, 513
shirking 99–100, 504
short-term investors 24, 154
short-term pressures 26, 505–6, 509–10, 512
SIDs *see* senior independent directors

SIFIs *see* systemically important financial institutions
signals, social 71–3
Singapore 149, 367, 372, 410
single boards 436–7, 465
single metrics 8, 63–4, 66
single shareholders 390, 410, 513
size, board 13, 184–5, 221, 223, 258, 269–70, 333–4
skills 122, 207–12, 236–7, 239–40, 242–4, 333–4, 351
  audit 334, 336
  managerial 167, 409
  matrices 561, 577, 579
slate of directors 67, 470
SM Group 411–12
social capital 239–40, 273, 411, 615, 618
  bridging 619, 622
social, capital theory 408–9
social categorization 353–4
social cohesion 351, 369–70
social comparisons 353, 467–8
social context 72, 355
social dilemma games 72
social expectations 602–3, 605
social institutions 127, 424, 433, 444, 608
social labels 592, 600
social networks 16–17, 184, 259, 280, 290
social norms 189, 259, 597, 599, 602, 604
social order 368–9
social organizations 434–5, 444
social protection 596, 599
social psychology 184, 189, 256, 259, 280
social risks 30–1, 614, 617, 621
social signals 71–3
social standards 589, 593, 595
social value, total 8, 62–5
social welfare 385, 398
societal perspective 57–9
SOEs *see* state-owned enterprises
soft law 244, 260, 264–5, 383–6, 596
South Africa 47–8, 52–3, 287
South Sea Company 40, 432
SOX *see* Sarbanes-Oxley Act
S&P 500 142–3, 145–7, 387, 460–1, 464–5, 483–8, 543–4
Spain 39, 338–40, 379, 384, 392, 430–1, 562–3
special meetings 143, 246
Special Purpose Entities (SPEs) 49–50, 89
Special Representative 585, 600–1, 604–5
specificity 163, 166–8, 170–1, 174–6, 501, 507, 511
speculation 479, 482, 484–6, 488–9, 492, 535, 546
SPEs *see* Special Purpose Entities
spot market prices 162, 176
spot values 165–6, 168, 170
spotlight, public 275–6
stability, financial 1, 266, 537, 559, 572–3, 578
stakeholder groups 46, 54, 58, 234, 280, 317, 616–17
stakeholder model 375, 503
stakeholder theory 6, 69, 217, 220, 614–17
  limitations 616–17
stakeholders 15, 58, 69–71, 99–102, 173–6, 234–6, 615–22
  external 96, 101, 246, 613, 624
  key 219, 317, 352, 512, 524, 615, 623
  value-adding 236, 241
state duties 587, 602–3, 605–6, 609
state-owned enterprises (SOEs) 3, 373, 379, 398, 415, 598
state ownership 338, 396, 398
status quo 339–40, 412, 500, 556, 577
Steering Group on Corporate Governance 52, 316, 560
stewardship 3, 54, 57–8, 219, 222, 616
Stewardship Code 265, 276, 279–80, 565, 571–2, 579
stewardship role 212, 572
stewardship theory 10, 53–5, 101, 187, 199, 217, 227
  criticisms 54–5
stock-based compensation 477, 479, 483, 489, 492–3
stock buybacks 12, 24–6, 137, 511
  and damage to US economy 476–93
  as weapons of value destruction 489–91
stock markets 44, 48, 115, 478, 482, 486–7, 534–5
  liquid 482, 506
  speculative 488–9
stock options 24–5, 67, 456–63, 483–4, 486, 488–9, 491–3
  and asset price volatilities 458–9
  option grants 23–5
  option values 457–9, 472, 508
stock prices 65–7, 457, 459, 472, 479–80, 484–5, 487–91
  performance 8, 63, 73–4, 276, 327, 372, 484
stock repurchases *see* stock buybacks
stock volatility 457, 459, 472
stockholders *see* shareholders
strategic allocation 479, 482
strategic change 221, 224, 350, 354
strategic contributions 15, 218
strategic control 240, 242, 480, 512
strategic direction 5, 10–11, 14–15, 17, 30, 164, 272–3
strategic leadership 237, 346
strategic management 155, 223, 226–7, 233, 614–16
  theory 614–15
strategic participation 223, 237–8, 240, 242
strategic partnering 11, 136–55
  ascent 144–55
  and shareholder monitoring 153–5
strategic partners 12, 136–7, 144, 147, 154–5
strategic-partnership models 137, 150–1, 153–4
strategic partnerships 149–50, 152
strategic risks 59, 212, 524
strategic tasks 217, 220, 227, 290
strategic value accountability 15, 213
strategy
  board contribution 218–25
  roles 187, 200, 223–4
strong form convergence thesis, reservations about 368
strong incentives 390, 594, 598
strong markets 506–7

structural attributes 184, 186
subcommittees 208, 211, 218, 258, 270, 444, 456
subjectivity of valuations 164, 171
subprime mortgages 525, 535, 539, 541–3, 547
subsidiaries 60, 120, 131, 373, 412, 521, 607–8
substantive consolidation 26, 522
success 39–40, 199–200, 204, 414–15, 417, 606, 623
succession 160, 296, 417–18
supermajority votes 143
supervision 115, 326, 526, 552
supervisors 526–7, 558–9
supervisory boards 43, 119, 375, 432, 564–5
suppliers 54, 64–5, 72, 96, 115–16, 309–10, 599
surplus 11, 115–17, 132, 500, 503, 511
  consumer 70
  profits 431–2, 446
surveys 10, 17, 107, 311, 314, 585–6, 623
sustainability 6, 13, 27, 29–31, 58–9, 612–17, 619–25
  challenges of social and environmental governance 614
  corporate 30, 612–13, 622–4
  environmental 30–1, 593, 613, 615, 623
  governance for 612–25
  and management theory 614–17
    emergent themes 617–21
  redesigning the practice of governance 621–4
Switzerland 262, 392, 540, 548, 564
symbolic management 189, 212, 259, 280
synergies 167, 169
systemic crisis 534, 543
systemic failures 430, 534, 552
systemic governance 27, 533
systemic risks 27, 160, 521, 526, 559, 573
systemically important financial institutions (SIFIs) 526–7, 550

Taiwan 160, 409–10
Takeover Code 126, 129
takeovers 11, 25, 77, 105, 117, 132, 479
  hostile 11, 114, 124–9, 368
TARP *see* Troubled Assets Relief Program
task-oriented diversity 19, 345–6, 350, 354, 356
task-related diversity 349, 353
tasks 17–18, 223, 237, 242–3, 288–90, 307–8, 346
  board 219, 234, 236–7, 240, 246–7, 289, 352–3
  complex 24, 242, 346, 620
  extra-organizational 618, 620
  main 15, 217, 233, 236, 241
  multiple 350, 455, 470
  strategic 217, 220, 227, 290
tax incentives 432, 443, 445
taxes 88, 120, 371, 431, 461, 487, 550
TBA *see* Transaction Byte Analysis
TCE *see* transaction cost economics
team diversity 346, 353–5
team members 69, 71, 75, 101, 346, 349, 353
team processes 347, 350, 353–4, 357
team production 6, 15–16, 69, 75, 101, 236, 240–1
  approach 8, 70, 233, 236, 241, 244
    extended 15, 233, 235–6
  culture 240–2, 246
  language of 72–3, 76
  model 69–70, 76, 101
  theory 10, 101, 217, 233–5, 244, 248
teams 69, 71–2, 191, 240–4, 248–9, 348–9, 355–8
  executive 136, 206, 208, 212
  management 123, 175–6, 203, 235, 520, 550, 579
teamwork 200, 248, 305, 500
technological change 255, 275, 524
technologies 4–5, 26, 145, 149, 434–5, 503, 510–11
  new 26, 277, 508–9, 588
tensions 11–12, 96, 120–1, 124, 127, 132, 137
tenure 223, 347, 407, 441, 456
Thailand 287, 392, 394, 410, 536
theoretical models 11, 24, 114, 470
theoretical perspectives 9, 15, 57–8, 97–102, 165, 227, 408–9
theoretical pluralism 14, 190, 218, 227
third parties 49, 84, 86, 115–16, 118–20, 132, 587
threats 14, 28, 93, 100, 124, 589, 596–8
time commitment 53, 207, 265, 571
time myth 18, 331–2
TMTs *see* top management teams
Tokyo Stock Exchange 140, 147
top executives 137, 480, 483–4, 486, 489, 491
top management teams (TMTs) 19, 218–19, 223–6, 257, 345–50, 354, 356
  diversity 346, 354, 356
top managers 42, 50, 69, 218–19, 347, 388–9, 480
trade unions 55, 377, 586, 591–2, 595
traded companies/corporations 2, 67–8, 77, 386–7, 437
traders 9, 276–7, 279, 546
traditional legal research 10, 104, 107
Transaction Byte Analysis (TBA) 435–6
transaction cost economics (TCE) 57, 435
transaction cost theory 100, 109, 408–9, 497–9
  and innovation 501, 507–8
transaction costs 10, 113, 389, 408, 411, 497–8, 507
transnational corporations/firms 129, 131, 594–5, 598–601, 605–8
transparency 7, 22, 51, 54–5, 201, 244–5, 541
tripartite system 573, 578
Troubled Assets Relief Program (TARP) 470, 489, 551, 566
trust 55, 127–8, 305, 311–12, 408–9, 503–4, 622–4
trusted advisors 137, 146, 313
trustees 51, 54, 121, 264
trusting relationships 31, 621, 623
Turner Review 28, 569, 572
two-tier board structures 43, 46, 119, 124, 126, 186, 375
Tyco 50, 148, 227, 366, 368, 469
Tyson Report 46, 265

ULLCA *see* Uniform Limited Liability Company Act
unconscious bias 332, 337, 442–3

under-investment 498, 504–5
under-performing companies 388, 397
underlying assets 117, 459, 472, 548–9
undervaluation 168, 171
Uniform Commercial Code, and LLC membership interests 85–6
Uniform Limited Liability Company Act (ULLCA) 83
unincorporated companies/entities 82, 95, 432, 436
unitary boards 43, 46, 59, 205, 436, 442, 444
United Kingdom 373–5, 384–5, 441–4, 464–7, 507, 544–5, 577–8
- Accounting Standards Steering Committee 43, 58
- Cadbury Committee 45–7, 50, 122, 196, 213, 257, 263–4
- Code of Corporate Governance 14
  - compliance modes 196–214
  - dynamic of defensiveness 203–7
  - effects of external legitimacy within boards 202–3
  - formal compliance 198–9
  - research projects and interviewees 201–2
- Code on Remuneration Practices 570–1
- Combined Code 7, 46, 51, 53, 122, 264–5, 571
- corporate governance in practice 255–80
  - 1980s onwards 260–6
  - background and academic context 256–60
  - board and executive team responsibilities 272–5
  - investor-board relationships 275–7
  - research methodology 266–8
  - roles and relationships 268–72
- Economic and Social Research Council 255, 257, 280
- Financial Reporting Council (FRC) 51, 197, 261, 264–5, 268, 287, 570–2
- Financial Services Authority 28, 51, 527, 552, 564, 569–70, 572–4
- Greenbury Committee 45, 264, 376, 456, 467, 578
- Hampel Committee 45–6, 264, 376
- Higgs Review 46, 50–1, 202, 213, 265–6, 325–6, 332
- Institute of Chartered Secretaries and Administrators (ICSA) 265, 268, 290, 303, 314
- Myners Report 46, 264
- National Association of Pension Funds (NAPF) 48, 268, 438
- Northern Rock 265, 542
- response to global financial crisis 568–74
- Stewardship Code 265, 276, 279–80, 565, 571–2, 579
- Takeover Code 126, 129
- Turnbull Report 46, 122
- Turner Review 28, 569, 572
- Tyson Report 46, 265
- Walker Review 197, 265, 317, 569–72

United Nations 29, 445, 585–7, 589–90, 592–5, 600–1
- draft Code of Conduct for Transnational Corporations 594, 600
- Global Compact 593, 600–2, 613
- Human Rights Council 600–2, 608
- Protect, Respect and Remedy framework 585–6, 600–1, 608
- Special Representative 585, 600–1, 604–5

United States 47–50, 327–8, 365–72, 438–42, 464–9, 476–9, 489–93
- Business Roundtable 50, 68, 153
- Colorado 85, 94–5
- Commodity Futures Trading Commission (CFTC) 538, 567
- Conference Board 71, 74, 138–9, 151–2
- Congress 68, 439–40, 490–1, 538, 541, 543–4, 566–8
- corporate governance codes 47
- Council of Institutional Investors 50, 141
- Delaware 82–3, 87–8, 90–2, 94–5, 124, 129–30, 440
- Dodd-Frank Act 28, 74–5, 386, 465, 469–71, 523, 566–8
- economy 20, 25, 476, 489, 545, 553
- Emergency Economic Stabilization Act 176, 566
- Federal Reserve 536, 538–41, 545, 547, 567–8
- Financial Accounting Standards Board (FASB) 24, 159–60, 177–8, 492
- Financial Crisis Inquiry Commission 543–4, 567
- Institutional Shareholder Services 48, 150, 468
- IRS (Internal Revenue Service) 81–3, 87, 94
- limited liability companies (LLCs) *see* limited liability companies
- NASDAQ 7, 20, 372, 483–6, 533
- National Conference of Commissioners on Uniform State Laws (NCCUSL) 82–3
- New Jersey 129–30, 521
- NYSE (New York Stock Exchange) 49, 74, 141–2, 371–2, 379, 484–6, 541
- Office of Thrift Supervision (OTS) 567–8
- response to global financial crisis 565–8
- Revised Uniform Partnership Act (RUPA) 82, 89, 95
- Sarbanes-Oxley Act (SOX) 50, 73–4, 261, 372, 377, 439–40, 469–70
- Securities and Exchange Commission (SEC) 41–2, 68, 73–4, 439–40, 488–9, 546–8, 567–8
- S&P 500 142–3, 145–7, 387, 460–1, 464–5, 483–8, 543–4
- Troubled Assets Relief Program (TARP) 470, 489, 551, 566
- Uniform Limited Liability Company Act (ULLCA) 83
- Wall Street 28, 139, 469, 482, 533, 537, 543–4
- Williams Act 124–5

unlimited liability 9, 41, 81
unlisted companies 51, 411–12
unrealized profits 165, 173
unregulated markets 533, 535, 553

upper echelons 255–7, 259, 280
  diversity 347–8, 356
  theory 347, 349–50, 356
USA *see* United States
usual suspects 187, 222

valuations 161–3, 165, 167–73, 175–7, 524, 558
  accounting 163, 170–1, 176
  assets 164, 168, 174, 176
  financial 12, 162, 168, 171, 177
  marked-to-market 12, 162
  market 163, 165, 176
  models 163, 170, 176
  principles 164, 167, 171, 175
  subjectivity 164, 171
value-adding stakeholders 236, 241
Value at Risk (VaR) 123, 548–9
value chain approach 234, 237–8, 248
value creation 14, 75, 212, 397, 408, 470, 559
  and board leadership 233–49
  long-term 248–9, 397, 559, 579
VaR *see* Value at Risk
varieties of capitalism perspective/literature 499–500, 502–4, 509
veil piercing 84–5, 92, 522
  limited liability companies (LLCs) 84–5, 92
venturesome activities 225–6, 228
verification of market valuations 163, 176
veto powers 438, 500, 512
viability
  economic 30, 617
  long-term 160, 162
vigilance of directors 12, 137, 144
volatility 174, 394, 457, 459, 472, 537
voluntary codes 386, 588, 590, 599, 606
votes 51, 67, 437–8, 440–1, 445, 465–6, 575–6
  shareholder 53, 465, 469, 522, 566
voting rights 117, 125, 137, 438

Walker Review 197, 265, 317, 569–72
Wall Street 28, 139, 469, 482, 533, 537, 543–4
weak boards 389, 466
web of accountabilities 17, 272
Wells Fargo 489–90
Western economies 325–6, 328, 331–2
whole-of-board evaluations 304, 318
Williams Act 124–5
within-board dynamics 200, 211
women 18–19, 189, 239, 325–41, 349–50, 352–7, 576–7
  across the world 337–41
  and ambition myth 18, 330–1
  appointment of 333, 340
  and appointment processes 18, 325–6, 332–7
  and culture 327
  gender diversity and good governance 325–8
  and human capital myth 18, 328–9
  and performance 326–7
  and pipeline myth 18, 329–30
  senior 328, 340–1
  and time myth 18, 331–2
  wider business case 327–8
workers 24, 70, 115, 117, 369, 481–2, 503
workforce 327, 330–1, 523–4
World Bank 3, 369–70, 376, 410, 429, 440, 444
World Trade Organization *see* WTO
WorldCom 7, 19–20, 50, 62, 207, 261, 366
WTO (World Trade Organization) 368–71, 594