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Corporate Governance: A Summary Review on Different Theory Approaches

Zou Ping
School of Finance, Shanghai University of Finance and Economics, Shanghai, China
E-mail: zouping@mail.shufe.edu.cn
Tel: +8621-65904612; Fax: +8621-65904626

Cheng Wui Wing, Andy
Department of Economics and Finance, Hang Seng Management College, Hong Kong, China
E-mail: andycheng@hsmc.edu.hk
Tel: +852-26362420; Fax: +852-26325092

Abstract

Corporate regulation and governance must be targeted at curbing the delinquent activities of company directors. This meant an examination of the functioning of the boards of directors and brought the issue 'corporate governance' into a hot topic. In this study, various theories of firm relating to corporate governance are examined. Different legal system towards the implementation on corporate governance is evaluated. The protection of minority interests which regulated by the rule taken from the judgement in the case of Foss vs. Harbottle and under the derivation action are also examined. Globalization is bringing a new topic to the corporate governance arena. Corporations are no longer solely subject to the prioritised performance criteria of their country of origin and registration. State officers, regulators, stock exchanges, professional bodies and even institutional investors are driving development towards globalised capital markets, and as a consequence, also working in the direction of homogenizing corporate governance standards. After all, we need to take a balance among the amount of regulations, the cost of implementation and the social responsibilities into consideration. The current corporate governance agenda should include pro-active measures on how to enhance accountability.

Keywords: Corporate Governance, Economic Theory of Firm, Agency Theory, Stakeholder Concept, Harbottle Rules, Derivation Action
JEL Classification Codes: G300, G380

1. Introduction

The worries about the performance of publicly traded corporations have abounded for decades. Since the turn of the millennium, though, a confluence of events has served to focus the public eye on the prominent topic of corporate governance and its crucial importance to the world economics. Enron… Arthur Andersen… WorldCom… Adelphia… Tyco; these debacles and widely publicized scandals, on the heels of the bursting of the dot.com bubble, created an atmosphere of doubt and distrust among the investing public. Confidence failed in the ability of investors to make "informed" decisions, and the markets on which stocks of public corporations were traded faltered.

In response, the media, government, and various regulatory boards widened the scope of their scrutiny beyond the offending corporations. This meant an examination of the functioning of the boards of directors and brought the issue 'corporate governance' into a hot topic.

Since corporate governance was initially developed and implemented in the USA and then passed to the United Kingdom, the English term of what from the beginning was an Anglo-American phenomenon [1] has also been accepted in its international proliferation.

In order to understand the meaning of corporate governance let us begin with the purpose of it. The so-called Hampel Report in 1988 offers some help in this respect – already in its first sentence: 'The importance of corporate governance lies in its contribution both to business prosperity and to the accountability'. Thus, in one sentence, that British committee has captured the very essence of corporate governance.

Another definition given by Cadbury Report in 1992 – Corporate Governance is 'the system by which business corporations are directed and controlled'. However, this simple definition belies the range of theories and ideas which inform contemporary analyses of corporate governance and corporate governance system. The shareholder-director relationship has arguably become the locus of thinking about the governance of the corporation. To begin a discussion of corporate governance, we should first explore the topic of governance in relating to economic theory of the firm.

2. Literature Review

2.1. Economic Theory of the Firm

As democracy flourished in the United States, it created a context for the free-market economic system referred to as capitalism. The success of capitalism created opportunities for businesses to grow larger. One driver of this growth was the opportunity for investors to unite their capital to fund extensive projects and massive enterprises. These investors became owners of portions or shares of the businesses in which they invested, and have come to be known as shareholders. The larger businesses that were created could not be governed effectively by proprietors and partnerships for many reasons. In 1932, Berle and Means have termed this process 'the separation of the ownership and control'. Consequently, in the twentieth century, the publicly owned corporation emerged as the dominant legal form for business enterprises.

Colley, Doyle, Logan and Stettinius [2] suggested that the corporation has three distinctive features that make it an attractive form for defining the legal entity of a business – its unlimited life, the limited liability of the owners, and the divisibility of ownership that permits transfer of ownership interests without disrupting the structure of the organization.

Dechert re-emphasized the importance of the separate legal entity principle [3] to the development of the corporate governance. The Salomon case[1] was a struggle between form and substance; whether to interpret the law literally or whether to consider more its presumed spirit and intention. Since the Salomon case, the company as a vehicle for business enterprise has grown from strength to strength. The one-man private company (i.e. with two shareholders, one a nominee) became a commonplace and has been accepted without further question.

In 1897 the issue of limited liability and corporate personality was finally settled by the highest judicial body in the U.K. in the celebrated case of Salomon vs. Salomon. The House of Lords ruled that individuals could organize their affairs as they wanted and that if they chose to do so via incorporation they were entitled to the protection of limited liability as long as the incorporation was in accordance with the formal rules of the relevant legislation. The company and the member(s) were separate persons and the court was not entitled to look through this relationship on the basis of equity. Separate legal personality meant just that and it follows from the fact that a corporation is separate from its

[1] Salomon vs. Salomon and Co. Ltd [1897] AC22, House of Lords

members and as such they are not liable for its debts. The rule in this case has become a fundamental principle of modern English company law.

2.2. Agency Theory Approach

The explosion of interest in corporate governance, and the drive towards global standards in particular, are largely bound up with the recent spectacular increase in the concentration of shareholdings in the hands of large institutional investors. Over the past three decades, holdings of shares by insurance companies and pension funds have grown considerably at the expense of holdings by individuals in many developed economies. It is widely argued that this new concentration of shareholdings means that institutional investors now have both the ability and the incentive to monitor and discipline company manager; formerly, individual shareholders were thought to be too numerous and too widely dispersed to exert adequate corporate control, giving managers to the potential to become entrenched and able to act in ways that maximized their own utility.

Learmount [4] believed that this particular view of the compass of corporate governance is strongly informed by Anglo-American economic theories of the firm, especially ‘agency theory’, which explicitly casts managers as ‘agents’ for the shareholder-owners of companies. In its popular form, the stronger participation and influence of institutional investors in the affairs of companies is seen as the rightful reassertion of company control by its owners.

The principal assumptions underpinning agency theory, as this neoclassical economic theory is now best known, are that parties to a contract will act to maximize their own self interest, and that all actors have the freedom to enter into a contract or to contract elsewhere. ‘Agency theory’ explicitly casts management as ‘agents’ for shareholders (usually termed principals’), and their relationship is conceived to be a contractual one based on market exchange.

2.3. Stakeholder Concept or Organizational Approach

The ‘stakeholder concept’ to the firm is one framework that has been proposed by organizational researchers as an alternative to economic theories for thinking about the governance of corporation.

According to a study made by Colley, Doyle, Logan and Stettinius [2], all business organizations have multiple stakeholders whose needs must be considered to achieve sustainable success. In our current system, corporate directors are legally required to represent the best interests of the company’s shareholders, not those of all the various stakeholders. We frequently see in annual reports and press release the mantra that ‘the company’s goal is to increase shareholder value.’ It is true that shareholders generally invest in a business to make money on their investment, but the purpose of the investors should not be confused with the purpose of the business. It is in serving the needs of its stakeholders that most businesses find their purposes.

The needs of the stakeholders of a corporation might be viewed as a hierarchy. Starting from the top is the customer whose needs must be met with goods and or services that deliver competitive value by the company. The next level may be consists of employees who develop and operate the business processes. The needs for job security, acceptable working conditions and job satisfaction should be considered. Similarly, the needs of suppliers, distributors and creditors must also be considered to ensure they are to be reliable and committed. Thus, this is somewhat related to supply chains management. Furthermore, the business must meet the needs of the communities in which it operates. The term ‘corporate citizen’ is developed and it is expected the corporation to honour the laws, paying taxes, preserving the environment and participating in the governance of the community.

3. Anglo-American Model vs. Continental European Model

There are many different models of corporate governance around the world. These differ according to the variety of capitalism in which they are embedded. The liberal model that is common in Anglo-American countries tends to give priority to the interests of shareholders. The coordinated model that one finds in Continental Europe and Japan also recognizes the interests of workers, managers, suppliers, customers, and the community. Both models have distinct competitive advantages, but in different ways. The liberal model of corporate governance encourages radical innovation and cost competition, whereas the coordinated model of corporate governance facilitates incremental innovation and quality competition.

In the United States, a corporation is governed by a board of directors, which has the power to choose an executive officer, usually known as the chief executive officer. The CEO has broad power to manage the corporation on a daily basis, but needs to get board approval for certain major actions, such as hiring his/her immediate subordinates, raising money, acquiring another company, major capital expansions, or other expensive projects.

The board of directors is nominally selected by and responsible to the shareholders, but the bylaws of many companies make it difficult for all but the largest shareholders to have any influence over the makeup of the board; normally, individual shareholders are not offered a choice of board nominees among which to choose, but are merely asked to rubberstamp the nominees of the sitting board. Perverse incentives have pervaded many corporate boards in the developed world, with board members beholden to the chief executive whose actions they are intended to oversee. Frequently, members of the boards of directors are CEOs of other corporations, which some conflicts of interests.

4. Corporate Governance and Legal System

Different legal system has different approach towards the implementation on corporate governance. In the world, there are two major legal systems, namely: common law and civil law system.

4.1. Civil Law and Corporate Governance

Civil or civilian law is a legal tradition which is the base of the law in the majority of countries of the world, especially in continental Europe and the Japan, Latin America, and most former colonies of continental European countries. It is generally claimed that there is a more systematic guidance on corporate governance under the civil law system. The cconcept of codification developed especially during the 17th and 18th century, as an expression of both Natural Law and the ideas of the Enlightenment. The political ideal of that era was expressed by the concepts of democracy, protection of property, and of the rule of law. That ideal required the creation of certainty of law, through the recording of law and through its uniformity.

Another reason that contributed to codification was that the notion of the nation state, which was born during the 19th century, required the recording of the law that would be applicable to that state.

4.2. Common Law and Corporate Governance

The common law forms a major part of the law of those countries of the world with a history as British territories or colonies. It is notable for its inclusion of extensive non-statutory law reflecting precedent derived from centuries of judgements by working jurists.

Statutes which reflect English common law are understood always to be interpreted in light of the common law tradition, and so may leave a number of things unsaid because they are already understood from the point of view of pre-existing case law and custom. Since, historically, most countries received their law through colonial transplantation, law is considered to be exogenous to the analysis. Some economists have thus classified countries on whether they adhere to common law or whether their legal system is based on civil law and done empirical research finding correlations between economic indicators and that classification. The basic thrust of the theory is that common law, as opposed to civil law, is associated with more orientation towards institutions of the market (instead of state interventionism), which is why common law countries tend to be economically more developed.

While the theory originally started out in corporate law, where common law was found to be correlated with better shareholder protection and more developed financial markets, it is not surprised to see that common law provides a more flexible channel for corporate governance interpretation.

5. The Foss vs. Harbottle[2] Rule and Derivation Action

5.1. Foss vs. Harbottle Rule

In situations where a wrong was allegedly committed against a company, the protection of minority interests is regulated by the rule taken from the judgement of Wigram V-C in the case of Foss vs. Harbottle. The rule is prohibitive of the availability of minority actions, for as Wigram V-C made clear in his judgement, every individual shareholder must realize that becoming a member of a company, majority rule will, as in all other walks of society, prevail. In modern terms the rule of born of Foss vs. Harbottle can be stated in the following way:

"An individual shareholder has no absolute right to seek redress for a wrong purportedly committed against the company in which he is a member. The company in such an instance is the proper plaintiff to instigate such an action. Whether or not a company takes action will depend upon the will of the board of directors. Only in exceptional circumstances will the court interfere with a decision taken by the company to sanction the alleged wrongful act."

It is important to appreciate that whilst a company is solvent directors' duties are generally owed to the company (see Percival vs. Wright)[3] which means the shareholders (present and future) as a whole (see Re Pantone case)[4] and only in very limited circumstances where there is a special factual relationship between the directors and the shareholders in the particular case capable of generating fiduciary obligations do they owe duties to the members personally: see Peskin vs. Anderson.[5] Neither do they owe any direct fiduciary duty to an individual creditor (see Yukong Line Ltd vs Rendsburg Investments Corporation)[6]

As a result, where there is a breach of these duties, it is the company can bring a claim against the wrongdoing directors under the rule in Foss vs. Harbottle. A member may bring a derivative claim on the company's behalf only by showing that there was a 'fraud on the minority' and the wrongdoers were in control [5].

5.2. Derivation Action

Derivative actions are the route by which shareholders, usually minority shareholders, are able to enforce the company's rights where directors have breached their duties (since in these circumstances it is unlikely that the directors, who usually act on behalf of the company, will want to take action).Whether and, if so, in what circumstances a shareholder should be able to bring an action on behalf of his company (i.e. a derivative action) is an important aspect of the current debate in the UK, and other jurisdictions, about corporate governance [6].

In the typical shareholders' derivative action, shareholders demand that the corporation take action against directors, officers, or others for wrongdoing that has harmed the corporation. When the corporation refuses, the shareholders bring a derivative action against the alleged wrongdoers and join the corporation as a defendant. In effect, the shareholder claims to be acting on behalf of the corporation, because the directors and management are failing to exercise their authority for the benefit of the company and all of its shareholders. This type of suit often arises when there is fraud, mismanagement, self-dealing and/or dishonesty which are being ignored by officers and the board of directors of a corporation.

[2] Foss vs. Harbottle (1843) 2 Hare 461
[3] Percival vs. Wright [1902] 2 Ch 421
[4] Re Pantone 485 Ltd [2002] BCLC 266
[5] Peskin vs. Anderson [2001] 1 BCLC372, CA
[6] Yukong Line Ltd vs. Rendsburg Investments Corporation (No.2) [1998] 1 WLR 294

6. International Norms and Continuing Development – Germany, Japan and the New Chinese Environment

Dunne and Helliar [7] believed that virtually all developed countries have unique elements within their corporate governance systems, but most of the key differences are reflected in the three distinct types of model operating in the four richest countries in the world. The models are, first, the US/UK (or 'Anglo-Saxon') model, based around widely dispersed share-ownership, with significant shareholder activism (in terms of voice and/or exit) and a lively market for corporate control. Second, the model operating in Germany and many other continental European countries, where banks' crossholdings of equity and concerns regarding social responsibility are the dominant influences on the operations and internal control mechanisms of major firms. Third is the Japanese model, where national culture is reflected directly in the governance and ownership structures in place. In Japan the inter-relationships among firms extend beyond equity ownership to encompass working industrial relationships and the supply of raw materials; shareholder activism in the Western sense is virtually non-existent.

Chinese stock market development is now bringing with it a new era in Corporate Governance and, reflecting the nature of the nation's fast-growing capital markets, this appears to mirror Western notions of best practice more closely than it does Japanese norms. The German system is notable for the two-tier board structure that has been enshrined in law and practice for many years. Recent years have seen a raft of new statutory and voluntary legislation, notably the TransPuG[7]. The main practical effect of the new legislation is to require German boards to issue a statement outlining the extent of compliance with the Corporate Governance Code and any reasons for departures; the notes to the financial statements should then indicate that such a statement has been issued and made available to shareholders.

7. Conclusion

The trend of 'convergence' has been developing quietly. In UK and the USA, important corporate governance issues are of concern mainly to the actors directly involved, i.e. the institutional investors and other actors on the owner side and those accountable for the corporations – boards of directors and executive management on the corporate side.

A uniting feature for France, Germany and Japan is that further development and diffusion of good corporate governance principles will require massive political reform. However, the content of such political reform varies widely between countries. They also pay more attention to the stakeholder model.

However, globalization is bringing a new logic to the corporate governance arena. Corporations are no longer solely subject to the prioritized performance criteria of their country of origin and registration. State officers, regulators, stock exchanges, professional bodies and even institutional investors are driving development towards globalised capital markets, and as a consequence, also working in the direction of homogenizing corporate governance standards.

After all, we need to take a balance among the amount of regulations, the cost of implementation and the social responsibilities into consideration. Too loose a regulation, it will produce adverse effect on social responsibilities issues and lack of enough protection for minority interests, while imposing too tight governance, it will definitely affect the business activities of an organization. The strengthen of corporate governance is certainly necessary, particularly after the fall of large enterprises like the Enron and WorldCom. However, as Carlsson [1] mentioned it is even more important, now that the corporate governance agenda also includes pro-active ideas and measures on how to enhance accountability. May be we are just in the beginning, especially after the recent financial crisis.

[7] Transparency and Publicity Act and Corporate Governance Code, both issued in 2002.

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