UNITED NATIONS ECONOMIC COMMISSION FOR EUROPE
Geneva, Switzerland

DISCUSSION PAPER SERIES No. 2002.2

December 2002

CORPORATE GOVERNANCE IN THE UNECE REGION

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Paper commissioned for the Economic Survey of Europe, 2003 No. 1 by the secretariat of the United Nations Economic Commission for Europe.

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I Introduction

Corporate governance has become a subject of heightened importance and attention in government policy circles, academia, and the popular press throughout the UNECE region. Various reasons explain the current prominence of what many persons might otherwise consider an arcane and technical topic. The recent financial scandals affecting major American firms, such as Enron, WorldCom, and Arthur Andersen, and the resulting loss of confidence by the investing public in the stock market have led to dramatic declines in share prices and substantial financial losses to millions of individual investors. Both the public and the experts have identified failed corporate governance as a principal cause of these scandals. Since half of all adults in the United States own stock either directly or indirectly, corporate governance reform has become a highly charged political issue. The American Congress rapidly responded by passing the Sarbanes-Oxley Act of 2002[1], which the New York Stock Exchange quickly followed by adopting sweeping new rules for listed corporations,[2] thereby effecting the most significant reform in U. S. corporate governance since the creation of the country's securities regulation regime in the 1930's. Viewing the situation in the United States with alarm, European countries, mindful of earlier financial scandals of their own, are examining their own systems of corporate governance in an effort to guard against similar abuses.

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[1]Sarbanes-Oxley Act of 2002, H.R. 3763, 107th Cong. (2002).

[2] "Corporate Governance Rule Proposals Reflecting Recommendations to the NYSE Corporate Accounting and Listing Standards Committee, as Approved by the NYSE Board of Directors, August 1, 2002," *available at* http://www.nyse.com. The new standards are subject to approval by the U. S. Securities and Exchange Commission which had not formally approved them as of December 1, 2002.

Even before the recent scandals, significant efforts, propelled to a certain extent by earlier financial abuses, had been under way since the early 1990s within the OECD,[3] the European Commission,[4] and individual European countries[5] to understand the economic consequences of corporate governance and to formulate recommendations on appropriate governance structures and practices. In emerging market economies in Eastern Europe, experience over the last decade has clearly shown that successful privatizations and the development of vibrant private sectors depend to a significant extent on the existence of effective systems of corporate governance.[6] For example, the ability of "oligarchs" in

[3] Organisation For Economic Co-Operation and Development, *OECD Principles of Corporate Governance*, (endorsed by the Ministers at the OECD Meeting, 26-27 May 1999), Paris, OECD, 1999, also available at www.oecd.org. In the wake of the financial scandals in the United States and the growing international concern over corporate governance, the OECD Council at Ministerial level at its meeting of 15-16 May 2002, launched a new initiative to strengthen corporate governance. Its final communique stated: "…the OECD will survey developments in OECD countries on governance in the corporate and financial sectors, with a view to identifying lessons to be learned and the implications for the assessment of the OECD Principles of Corporate Governance as a bench mark." Available at www.oecd.org. The assessment is to be completed by 2004.

[4] See Weil, Gotshal & Manges LLP, on behalf of the European Commission, Internal Market Directorate General, *Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States* (January 2002) available at www.europa.eu.int/comm/internal_market/en/company/news/corp-gov

[5] In addition to numerous articles and studies, prestigious groups and organizations within individual countries produced over 30 recommended codes of best practices in corporate governance over the last decade. For a comprehensive listing of these codes and reports, see Weil, Gotchal & Manges, op. cit, supra note 4, at pp. 14-16.

[6]See Alexander Dyck, "Privatization and Corporate Governance: Principles, Evidence, and Future Challenges," *The World Bank Observer* 16, 59-84 (Spring 2001); Saul Estrin, "Corporate Governance and Privatization: Lessons from Transition Economies," 11 *Journal of African Economies* 28 (February 2002); Saul Estrin, "Competition and Corporate Governance in Transition Economies," *Journal of Economic Perspectives* 16(1), Winter 2002, pp. 101-124.

Russia to dominate and raid corporations and to engage in asset stripping and self-dealing at the expense of foreign and domestic investors was clearly due to systems of corporate governance that gave little or no protection to investors who were not insiders. Following rapid privatization in the Czech Republic, which gave insufficient attention to the protection of shareholder property rights, thousands of small investors sustained significant losses as "tunneling" by insiders stripped assets from privatized companies.[7]

More generally, the ability of countries to attract foreign capital is affected by their systems of corporate governance and the degree to which corporate management is compelled to respect the legal rights of lenders, bondholders, and non-controlling shareowners.[8] Individual and institutional investors will refrain from providing capital or will demand a higher risk premium for their capital from enterprises in countries without effective systems of corporate governance than from similar enterprises in countries having strong corporate governance standards.[9] One can also say that because of its role

[7] Magdi R. Iskander and Nadereh Chamlou, *Corporate Goverance: A Framework for Implementation* p.2, Washington, D. C.: The World Bank Group, 2000. See generally, Roman Frydman et al., *Corporate Governance in Central Europe and Russia* (2 vols), Budapest: Central European University, 1996.

[8] *OECD Principles of Corporate Governance, Preamble*: "If countries are to reap the full benefits of the global capital market, and if they are to attract long-term 'patient' capital, corporate governance arrangements must be credible and well understood across borders", note 3 at p.12. See also, Enrique J. Ruda-Sabater, "Corporate Governance and the Bargaining Power of Developing Countries to Attract Foreign Investment," *Corporate Governance* 8, 117-124 (April 2000).

[9] In a survey conducted in 2000, investors stated that all other things being equal they would be willing to pay more for a company that is well governed as opposed to one less well governed. McKinsey & Company, *Investor Opinion Survey on Corporate Governance* (June 2000).

in capital formation, corporate governance has important consequences for economic efficiency and growth.[10] Effective corporate governance imposes a discipline on firm managers to maximize returns to the firm. With the movement throughout the world toward the expansion of private sectors and the creation of more competitive market economies, effective systems of corporate governance are seen as a key variable enabling countries to derive real economic benefits from these fundamental economic changes.

Corporate governance also has diverse international implications. Companies that list their securities on foreign markets in order to gain access to new sources of capital subject themselves in varying degrees to the corporate governance standards of the countries where they are listed. In addition, one of the grounds upon which opponents of "globalization" have challenged multinational corporations, the prime movers of globalization, is that flawed systems of governance allow corporate decisions to be made without taking account of the interests of all "stakeholders," other than those of corporate managers and shareowners. One recent study[11] has also concluded that important international economic disputes, such as those within the European Union over the right of state-controlled public utilities to remain immune from takeovers, or the tensions between the United States and Japan over Japanese bank debts, arise out of corporate governance problems.

[10] *OECD Principles of Corporate Governance*, Preamble: "One key element in improving economic efficiency is corporate governance, …", at p. 11.

[11] James Shinn and Peter Gourevitch, *How Shareholder Reforms Can Pay Foreign Policy Dividends* pp. 5-6 (New York: Council on Foreign Relations, 2002).

In view of the current concern with corporate governance and its far reaching implications for economic activity, financial strength, and international relations, this Chapter considers the nature of corporate governance, the various models and forms that it takes in Europe and North America, and the challenges that it poses for economic and legal policy in the UNECE region.

II Defining Corporate Governance

The term "corporate governance" appears to have arisen and entered into prominent usage in the mid-to-late 1970's in the United States in the wake of the Watergate scandal and the discovery that major American corporations had engaged in secret political contributions and corrupt payments abroad.[12] Eventually it also gained currency in Europe as a concept distinct from corporate management, company law or corporate organization.

Scholars and practitioners of corporate governance give the term a wide variety of definitions. Economists and social scientists tend to define it broadly as "the institutions that influence how business corporations allocate resources and returns"[13] and "the organizations and rules that affect expectations about the exercise of control of resources in firms."[14] One noted economist has rather cryptically written that governance is "an

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[12] E. Norman Veasey, "The Emergence of Corporate Governance as a New Legal Discipline," *The Business Lawyer* 48, 1276 (1993).

[13] Mary O'Sullivan, "Corporate Governance and Globalization," *ANNALS, American Academy of Political Science* 570**,** 153-154 (July 2000).

[14] World Bank, *Building Institutions For Markets: World Bank Development Report 2002* p. 68.

institutional framework in which the integrity of the transaction is decided."[15] These definitions focus not only on the formal rules and institutions of corporate governance, but also on the informal practices that evolve in the absence or weakness of formal rules.[16] Moreover, they encompass not only the internal structure of the corporation but also its external environment, including capital and labor markets, bankruptcy systems, and government competition policies.

Corporate managers, investors, policy makers, and lawyers, on the other hand, tend to employ a more narrow definition. For them, corporate governance is the system of rules and institutions that determine the control and direction of the corporation and that define relations among the corporation's primary participants. Thus the United Kingdom's 1992 Cadbury Report 's often quoted definition is: " Corporate governance is the system by which businesses are directed and controlled."[17] As applied in practice, this narrower definition focuses almost exclusively on the internal structure and operation of the corporation's decision-making processes. It has been this narrower definition that has been central to public policy discussions about corporate governance in most countries. For example, the *OECD Principles of Corporate Governance* deal with only 5 topics: I. The Rights of Shareholders; II. The Equitable Treatment of Shareholders; III. The Role of Stakeholders in Corporate Governance; IV. Disclosure and Transparency; and V. The

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[15] Oliver E. Williamson, *The Mechanisms of Governance* 11 (New York: Oxford University Press, 1996).

[16] See, e.g., Alexander Dyck, note 6.

[17] Report of the Committee on the Financial Aspects of Corporate Governance (Cadbury Report), para. 2.5 available at < www.ecgn.org>

Responsibility of the Board.[18] At the same time, as will be seen, countries within the UNECE region have applied and elaborated upon these narrower definitions in different ways. This chapter will focus primarily on the formal rules and institutions of corporate governance in UNECE countries.

In the United States, corporate governance as a public policy issue originates in *The Modern Corporation and Private Property*, the classic work by Adolf Berle, Jr., a law professor, and Gardiner Means, an economist, first published in the 1932[19]. Berle and Means examined the growing concentration of economic power in the modern corporation and noted the rise of professional managers having operational control of large corporations but little or no ownership of the enterprise. They also pointed to the increasing dispersion of corporate shares among a growing number of persons, who, because they were numerous, widely scattered and had relatively small interests, were not able to exercise control over the corporation they owned. This divorce of ownership from control in the modern American corporation posed a challenge to the interests of

[18] The American Law Institute's *Principles of Corporate Governance: Analysis and Recommendations* (St Paul, Minn.: American Law Institute Publishers, 1994) takes a similarly restricted view of the subject's scope. The product of fifteen years of study by America's leading organization of lawyers, judges and law professors, it consists of over 800 pages and purports to provide a comprehensive statement of corporate governance in the United States. It consists of seven parts: I. Definitions; II. The Objective and Conduct of the Corporation; III. Corporate Structure: Functions and Powers of Directors and Officers; Audit Committee in Large Publicly Held Corporations. III-A Recommendations of Corporate Practice Concerning the Board and the Principal Oversight Committees; IV. Duty of Care and Business Judgment Rule; V. Duty of Fair Dealing; VI. Role of Directors and Shareholders in Transactions in Control and Tender Offers; and VII. Remedies.

[19] Adolf Berle, Jr. and Gardner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932).

shareholders. Berle and Means viewed corporate governance (a term that appears nowhere in their book) as a classical agency problem: how could corporate managers, as agents of the shareholders, be induced to manage corporate assets in the best interests of their principals?

Some scholars have come to dispute the applicability to countries outside of the United States of the Berle and Means model of the modern publicly traded corporation. Finding that dispersed share ownership is largely an American and British phenomenon, they have argued that because large publicly traded corporations in other countries, for example in continental Europe, Latin America and Japan, are to a significant extent run by control groups with substantial equity interests in the firm, the basic problem of corporate governance in those countries is to protect minority shareholders from expropriation by controlling parties.[20] Share ownership and therefore voting power in publicly traded corporations is more concentrated in continental Europe than it is in the United States and the United Kingdom. In addition, a larger percentage of the population is shareowners in the United States than in European countries. For example, whereas one half of all American adults directly or indirectly own corporate shares, only one in five Germans is a shareowner.[21]

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[20] *E.g.*, Rafael La Porta, Florencio Lopez-de-Silane & Andrei Shleifer, "CorporateOwnership Around the World," *Journal of Finance* 54, 471-517 (1999); See F. Barca and M. Becht, *The Control of Corporate Europe* Oxford: Oxford University Press, 2001;.Colin Mayer, Corporate Cultures and Governance: Ownership, Control and Governance of European and US Corporations (March 31, 2002) (unpublished paper, conference draft), *available at* http://www.ksg.harvard.edu/cbg/conferences/us-eu_relations/meyer_corporate_culture_governance.pdf.

[21] *New York Times*, September 29, 2002, p.WK 4.

The statistical patterns that emerge with respect to the concentration of corporate share ownership lead to the conclusion that within the countries of the UNECE region there are basically two different types of publicly traded corporation: the “manager-dominated model,” which prevails in the United States and the United Kingdom, and the “controlling shareholder-dominated model,” which prevails in most of the European continent. While this difference in share ownership structure is real and has a variety of implications for corporate activity, a central problem of corporate governance throughout the region nonetheless arises out of the separation of ownership and control underscored by Berle and Means. That problem is how to protect minority shareholders from those in control, whether the controllers are professional managers without substantial ownership interests who would manage the corporation largely in their own interests, or shareholders with a controlling interest who would enrich themselves at the expense and in violation of the rights of the minority.

The corporate governance problem identified by Berle and Means seventy years ago has not diminished in the United States since the publication of their seminal work. Indeed, as the ownership of corporate shares by American households, both directly and through financial institutions, has increased and spread dramatically throughout American society largely as a result of the privately funded nature of the U.S. retirement system, the principal concern of investors, practitioners and scholars of corporate governance in the United States has been how to protect the legitimate rights and interests of shareholders when faced with managers who control the corporation. The collapse of Enron and the financial scandals at other large American corporations have re-ignited public concern with the question of corporate governance in the sense of how to devise systems, rules and institutions that will induce corporate executives to manage corporate assets in the interests of the shareholders, rather than their own. The spectacle of certain Enron top managers emerging from their bankrupt corporation with substantial financial gains while investors and employee shareholders sustained large losses has only served to highlight the problems posed by the divorce of ownership from control in large American corporations and to focus renewed attention on the need to reform corporate governance.

Although the fundamental agency problem is still the same, what has changed since the time of Berle and Means has been the rise of institutional investors, propelled to a significant extent by the nature of the privately funded U.S. retirement system and the aging of the American population. The dispersion of share ownership, which served to render shareholders powerless, has been countered to some extent by the growing concentration of corporate shares[22] in the hands of mutual funds, pension funds, and other institutional investors who have shown increasing willingness to be strong advocates actively for shareholder interests and good governance within the corporations whose shares they manage. Institutional investors in the U. S. and the U. K. continue to view the corporate governance problem essentially as one of assuring that the corporation is

[22] It is estimated that out of the total market value of all publicly traded shares of $30 trillion in the United States at the end of 1999, $20 trillion was under some form of professional management. See website of the Social Responsibility Investment Forum at www.socialinvest.org.

managed in the best interests of its shareowners.[23] Indeed, since fund managers are compensated by how well they maximize shareholder value in relation to a stated "benchmark," they have powerful incentives to do so. For them, the principal focus of corporate governance is to define the relationship between the three primary participants in the corporation: shareholders, the board of directors, and company management.[24]

Many Europeans consider the traditional American definition of corporate governance, with its central preoccupation of protecting shareholder rights and interests, to be too narrow. For many persons on the European continent, particularly in France and Germany where share ownership is much less dispersed among the public than it is in the United States[25], the central preoccupation of corporate governance should not be the rights of shareholders in relation to managers, but rather the rights of the community in

[23] Many institutional investors prefer the term "shareowner" to "shareholder." The California Public Employees Retirement System (CalPERS), the largest public pension fund in the United States with assets of $143 billion and an active advocate of good corporate governance, has stated that "shareowner" is preferable because it "reflects our view that equity ownership carries with it active responsibilities and is not merely passive 'holding' shares." California Public Employees' Retirement System, *Corporate Governance Core Principles & Guidelines* April 13, 1998, *available at* www.calpers.org.

[24] Robert A. G. Monks and Nell Minow, *Corporate Governance* 1 (1995), define corporate governance as the "relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) shareowners, (2) management (led by the chief executive officer) and (3) the board of directors. See also California Public Employees' Retirement System, *Corporate Governance Core Principles & Guidelines* April 13, 1998, *available at* www.calpers.org., which explicitly adopts this definition.

[25] Rafael La Porta *et. al.,* note 20. See also, John C. Coffee, "The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications," *Northwestern University Law Review* 93, 641, 644-45 (1999).

relation to the corporation itself.[26] For Americans, corporate governance is about shareholders controlling managers for purposes of shareholder profit (managerial responsibility); for many Europeans it is about society controlling corporations for purposes of social welfare (corporate social responsibility). Thus unlike Americans who have tended to separate issues of corporate governance from corporate social responsibility, Europeans have joined the two themes in discussions about how corporations should be managed and regulated. The difference in definition and perspective on the nature and purpose of corporate governance makes it essential that in any trans-Atlantic dialogue on "corporate governance" the two sides recognize that at times they may really be talking about two different things.

Strictly speaking, corporate governance is a matter of vital concern for *all* corporations, large or small, publicly traded or privately held. In practice, both in North America and Europe, the policy discussion on corporate governance has focused almost exclusively are publicly traded companies because it is in these enterprises that failures of corporate governance have the most serious and far reaching consequences for the economies of the countries concerned. For this reason, this paper will examine corporate governance exclusively within in the context of corporations whose shares are publicly traded.

III The Sources of Corporate Governance

Discussions of corporate governance demonstrate two basic approaches to assuring managerial dedication to the interests of the corporation and its shareholders: the

[26] Margaret M. Blair and Mark J. Roe (eds.), *Employees and Corporate Governance* 164 (Washington, D. C.: Brookings Institution, 1999).

regulatory approach and the non-regulatory approach. The regulatory approach relies upon formal rules and institutions backed by the coercive power of the state's legal system. The non-regulatory approach, pointing to the costs of regulation, emphasizes the market mechanism and contractual arrangements, such the corporate control markets, incentive compensation schemes involving stock and stock options, and efficient capital markets, as means for inducing desired management behavior.[27] Both approaches are needed to achieve optimal systems of corporate governance, but an important question for policy makers is what is the appropriate balance. Until the recent financial scandals and their negative impact on securities markets, the non-regulatory approach had many advocates and even seemed be in the ascendancy. But the collapse of Enron has given new vitality to the regulatory approach as countries in North America and Europe focus renewed attention on shaping appropriate rules and institution of corporate governance. This paper is devoted primarily to a study of those rules, regulations and institutions.

The rules and institutions of corporate governance come from a wide variety of sources, both public and private. A primary source is the company or corporation law of the individual countries concerned. This legislation governs the creation, basic structure and primary rules of operation of the company, corporation, *société anonyme,* A*ktiengesellschaft*, or other corporate legal form that a firm chooses to take. It also states some of the basic rights of shareholders, including the right to vote, to receive

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[27] See, e.g. Ralph K Winter, Jr., "State Law, Shareholder Protection, and the Theory of the Corporation," *Journal of Legal Studies* 6, 251 (1977); Michael C. Jensen and William H. Meckling, "The Theory of the *Firm: Managerial Behavior, Agency Costs and Ownership Structure," Journal of Financial Economics* 3, 305 (1976); Henry G. Manne, "Mergers and the Market for Corporate Control," *Journal of Political Economy* 73, 110 (1965).

information about company matters, and to challenge management decisions in court. The nature of these rights varies significantly from country to country. Some countries within the UNECE region offer stronger protection to shareholders than others.[28]

In the United States, which has a system of federal law, each of the fifty states has its own corporation code. In addition, judicial decisions by state courts have developed important legal doctrines governing corporate behavior, such as "the business judgment rule" and the duties of care and of loyalty of corporate officers and directors. American state corporation laws are very similar, but not identical. Indeed, the corporate laws of certain states may favor one interest group over another. Throughout the twentieth century, individual American states, seeking to maximize revenues from corporate franchise taxes, competed to become state of Delaware is the legal home to about 60 per cent of the Fortune 500 companies,[29] the state of incorporation for U. S. companies. A winner in this competition, the small America's largest publicly traded corporations, because managers consider Delaware law to be favorable to their interests.[30] As a result,

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[28] See Rafael La Porta et al., “Law and Finance,” *Journal of Political Economy* 106, 1113 (1998) in which the authors evaluate the effectiveness of shareholder legal protection in 49 countries and conclude that countries with the common law legal tradition (e.g., the United States and the United Kingdom) provide the best legal protection to shareholders and those with the French civil law tradition (e.g. France, Italy and Spain) provide the worst.

[29] E. Norman Veasey, “The Defining Tension in Corporate Governance in America,” 52 *The Business Lawyer* 393, 401 (1997).

[30] Scholars do not agree as to whether Delaware law benefits shareholders or managers. For a review of the literature on this question, see Robert Daines, “Does Delaware Law Improve Firm Value?” Working Paper No. 159, November 1999, Center for Studies in Law and Economics, Columbia University, available at **http://www.law.columbia.edu/law-economicstudies/abstracts.html#159**.

the Delaware courts have been the sites of important corporate litigation over the years, and their decisions have been influential in shaping various doctrines of corporate governance.[31] *Traditionally*, Europe has not had a competition for corporations among countries to same degree as American states, and European law has tended to inhibit the kind of corporate mobility experienced in the United States.[32] However, the creation of the single European market may be leading to increased freedom of European firms to choose their country of incorporation regardless of the place where they do business.[33]

A second important source of corporate governance are national rules and regulations with respect to the sale, distribution and trading of securities involving the public. One basic goal of securities regulation in virtually all countries is to assure that investors receive adequate information about the corporation and its activities so that they may make investment decisions and exercise shareholder rights appropriately. As with corporation laws and codes, the extent of protection afforded to shareholders by securities legislation varies from country to country.

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[31] Similarly, the state of Maryland is home to many mutual funds, largely because mutual fund promoters consider that Maryland law facilitates the launching and management of mutual funds.

[32] John C. Coffee, Jr., "The Future of History: The Prospects for Global Convergence in Corporate Governance and Its Implications," *Northwestern University Law Review* 93, 641-651 (1999).

[33] See, e.g., *Centos,* European Court of Justice, Judgment of 9 March 1999, in which the court concluded that the Danish government could not prevent a private limited company formed in the United Kingdom by two Danish citizens for the purpose of avoiding Danish legal requirements on minimum paid-in capital from registering a branch to do business in Denmark.

Although the United States has no federal corporation law, federal securities laws, principally the 1933 Securities Act and the 1934 Securities Exchange Act, as well as the voluminous regulations issued by the U.S. Securities and Exchange Commission, are a central element of corporate governance for firms that raise capital from the public or whose shares are publicly traded. While still subject to individual state laws on many aspects of internal governance, publicly traded companies must at the same time respect the complex of Federal rules on a wide range of governance matters from informing shareholders about corporate activity to conducting audits of corporate accounts. The structure of federal law tends to give a high degree of uniformity to the systems of corporate governance of publicly traded corporations throughout the country. Federal legislation covering labor, anti-trust and taxation also have important consequence for American systems of corporate governance.

The principal source of corporate governance in Europe is the legislation of the individual European country concerned. Although European Union legislation does have an impact on certain aspects of corporate governance, it has not unified corporate governance practice to the same extent as U.S. federal law and regulations, together with stock exchange rules, have tended to unify American practices. Thus, there is a greater divergence on corporate governance rules among publicly traded European corporations than there is among their American counterparts.

In addition to the nature of the laws and regulations on corporate governance, one must also consider the quality of law enforcement in the countries concerned. The effectiveness of corporate governance legislation and regulation depends of course on the competence, integrity, and forcefulness of the courts and regulatory agencies in the countries concerned. On this issue, there are also significant variations among countries.[34] For transition economies in Europe, the development of effective securities regulation regimes poses a particular challenge due to their lack of experience, supporting institutions and trained personnel in this domain. Even in countries with a well-developed regulatory capacity, such as the United States, agencies regulating corporate governance constantly risk being influenced or "captured" to the detriment of shareholders and the public by the very corporations they are to regulate or by the political class that represents them.

The rules and decisions of certain private bodies, such as stock exchanges, professional accounting institutions, and industry organizations also influence corporate governance. Thus the rules of the New York Stock Exchange, which are subject to approval by the U. S. Securities and Exchange Commission, are obligatory for corporations whose shares are traded on the "Big Board."[35] In the wake of the Sarbanes-Oxley Act of 2002, the NYSE has adopted major rules changes on a wide range of corporate governance matters including audit committees, independence of directors, and the composition of boards of directors.[36]

[34] See Rafael La Porta et al, pp. 1141-1143, evaluating the effectiveness of enforcement in 49 countries.

[35] For the rules of the New York Stock Exchange applicable to listed companies, see, www.nyse.com.

[36] See footnote 2, above.

Accounting plays a vital role in corporate governance because it is fundamental to any disclosure regime concerning information about companies' activities. A strong disclosure regime is essential for the exercise of shareholder rights, for the monitoring of corporations, and for imposing discipline on management.[37] But without effective and uniform accounting standards and practices, meaningful disclosure cannot take place. For example, the lack of agreement within the American accounting profession as to the need to treat stock option grants to executives as a current expense led to an overstatement of the earnings of some corporations, thereby inflating the value of their stock on securities markets. As a result, the accounting rules and practices of professional organizations such as the Financial Accounting Standards Board (FASB) in the United States and the International Accounting Standards Board in Europe (IASB) are yet another important source of corporate governance.[38]

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[37] "The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company." Art. IV. *OECD Principles of Corporate Governance*, p. 21.

[38] All United States publicly traded corporations are subject to the accounting and auditing standards set down by the Financial Accounting Standards Board (FASB). At present, Europe has no single, agreed set of standards. As part of its efforts to create a single European market in financial services, the European Commission has directed that by 2005 most EU listed companies should prepare their financial statements using international accounting standards, which are now being formulated by the International Accounting Standards Board, a private group based in London. By 2007, all EU listed companies are to use common international standards. David Tweedie, "Tackling A Crisis in Financial Reporting," *European Business Forum*, issue 11, 19-21 (Autumn 2002).

An effective system of disclosure also requires the participation of organizations and individuals with sufficient expertise and a reputation for skill and honesty to evaluate and verify the information that is disclosed. In making investment decisions, shareholders rely on these "reputational intermediaries" which include auditors, credit rating agencies, financial analysts, and the financial press, whose capital is the reputation that they have developed for integrity. These individuals and organization are considered the "gate keepers" of the financial markets.[39] While in most cases they are paid by the very corporations they evaluate, the market assumes that they have less incentive to misrepresent the facts than their clients since their reputations, their basic capital, is at stake. Nonetheless, corporate managers do seek to influence these intermediaries and, as in the case of Enron and Arthur Andersen, occasionally do so successfully. As a result, systems of corporate governance also need to address the regulations and incentives affecting the gatekeepers. One important dimension of the Sarbanes-Oxley Act of 2002 and the recent amendments to stock exchange rules is to set down new regulations governing auditors.

Within the limits of law, regulations and the applicable rules of private bodies, corporations have discretion to shape their own internal mechanisms of corporate governance, including the terms of managers' contracts, the composition of corporate boards, and the internal structure of the corporation, to mention just a few. The degree of discretion varies from country to country. The traditional legal mobility of American

[39] John C. Coffee, Jr., "Understanding Enron: 'Its About the Gatekeepers, Stupid.'" *The Business Lawyer* 57,1403 (2002); Stephen Choi, "Market Lessons For Gatekeepers," *Northwestern University Law Review* 92, 916 (1998); Reinier H. Kraakman, "Corporate Liability, Strategies and the Costs of Legal Controls," *Yale Law Journal* 93, 857 (1984).

corporations from state to state and the broad discretion afforded corporate organizers tend to reflect the basic "enabling approach" (i.e., everything is permitted unless it is specifically prohibited) of American corporate law, as compared with the greater restrictions on mobility and discretion in Europe that reveal a more "mandatory" approach (i.e., everything is prohibited unless specifically permitted) that seems to characterize European corporate law and practice.

In order to influence the exercise of this discretion, industry groups and individual institutional investors have prepared codes, reports and statements of good corporate governance that they have presented to or pressed upon the management of corporations. In the United States, the Business Round Table, a leading organization of corporate executives, and institutional investors, such as the California Public Employees' Retirement System (CalPERS) and Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF), have been active participants in this movement. In Europe, during the 1990s various committees of eminent persons produced over 30 recommended codes of best practices in corporate governance, including The Cadbury Report (U.K., 1992), Viénot Reports I and II (France, 1995 and 1999), the Peters Report (Netherlands, 1997), and the Mertzanis Report (Greece 1999).[40] An important multilateral effort to define best practices in corporate governance for both Europe and North America is the Organisation for Economic Co-operation and Development's *Principles of Corporate Governance*, adopted in 1999.[41] None of these codes and reports

[40] See Weil, Gotshal & Manges, op. cit pp. 14-16.

[41] See above, note 3.

has mandatory effect, but they have served to heighten awareness of corporate governance issues, to establish goals toward which corporations should work, and to frame and influence discussion of corporate governance policies.

IV The Objectives of the Corporation

Any system of corporate governance must answer a fundamental question: what is the objective of the corporation and for whose benefit is it to be run? The countries of the UNECE region appear to offer two different answers to this question. In the United States and the United Kingdom, the formal rules of corporate governance provide that the purpose of the corporation is to bring profit to its shareholders. Thus the American Law Institute (ALI), after considering various formulations to accommodate social needs to corporate purposes, finally concluded in its *Principles of Corporate Governance*:

"…a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain."[42]

In other words, the purpose of the corporation under American law is to make profits and the beneficiaries of those profits are the shareholders.

At the same time, following American judicial decisions on the point, the ALI's *Principles of Corporate Governance* also states that a corporation 1) *must* obey the law to the same extent as a natural person; 2) *may* take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of its business; and 3) *may*, but is not required to, devote a "reasonable amount of resources" to public welfare,

[42] ALI, *Principles of Corporate Governance,* (St. Paul, Minn., 1994) sec. 2.01(a).

humanitarian, educational and philanthropic purposes, "… even if corporate profit and shareholder gain are not thereby enhanced"[43] (emphasis supplied) *Principles of Corporate Governance* gives only general guidance for determining the reasonableness of resources devoted to such purposes. It asserts that one important factor is the strength of the nexus between the use of corporate resources and the corporation's business, stating: "In general the greater the amount of corporate resources that are expended, the stronger should be the nexus."[44] Despite periodic challenges to business in the face of political and social events at various times over the years, the formal system of corporate governance embodied in the laws of the United States has unwaveringly and clearly stated that the objective of the corporation is to maximize profits for shareholders.

In the United Kingdom, the objective of the corporation is basically the same as it is in the United States. English law makes it clear that the shareholders are the owners of the company and that a company's board of directors is required to advance the interests of the shareholders as a whole.[45] Because of the centrality of shareholders' interests to corporate purposes, the prevailing model in both countries, which of course share the common law tradition, is often referred to as the "shareholder model of corporate governance."

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[43] ALI, *Principles of Corporate Governance,* (St Paul, Minn., 1994) sec. 2.01(b).

[44] ALI, *Principles of Corporate Governance* , vol. 1, p. 65.

[45] Weil, Gotshal & Manges, op. cit p.36.

Elsewhere in Europe, both law and policy recognize to varying degrees, that corporations also have the objective of advancing the interests of other persons and groups beyond the narrow category of shareholders. Such persons and groups, who may include employees, suppliers, creditors, civic organizations and the community at large, are usually referred to as "stakeholders." [46] As a result, these countries are said to have a "stakeholder model" of corporate governance. Their prevailing legal tradition is that of the civil law. Germany, with its system of codetermination granting employees a formal role in corporate governance, is often cited as the prime example of the "stakeholder model." Generally, such a model of corporate governance gives stakeholders a "voice" in firm management and seeks to accommodate their diverse interests in deciding upon corporate action.[47] Another manifestation of the stakeholder model in European and Japanese firms is the "relational board structure," which includes representatives of key constituencies, such as labor, lenders, and major customers or suppliers, whose positions on the board are a function of the corporation's special relationships with those constituencies and are unrelated to any shares they may hold in the firm.[48]

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[46] For example, the Recommendations of the Norby Commission in Denmark states that corporate governance comprises "the goals, according to which a company is managed, and the major principles and frameworks which regulate the interaction between the company's managerial bodies, the owners, as well as other parties who are directly influenced by the company's dispositions and business (in this context jointly referred to as the company's stakeholders). Stakeholders include employees, creditors, suppliers, customers and the local community." The Norby Commission, *Recommendation for Good Corporate Governance in Denmark,* Introduction, (December 6, 2001). ,www.corporategovernance.dk.>

[47] Sigurt Vitols, "Varieties of Corporate Governance: Comparing Germany and the U.K.", in Peter A. Hall and David Soskice, eds. *Varieties of Capitalism: the Institutional Foundations of Comparative Advantage* (Oxford University Press,1999).

[48] Alexander Dyck, "Privatization and Corporate Governance: Principles, Evidence and Future Challenges," *The World Bank Research Observer* 16, 59-60 (2000).

Debate about the relative merits of the shareholder and stakeholder models is long-standing. Both have both strong advocates and resolute opponents.[49] Shareholder model proponents argue that the corporation is best able to create the goods and services that society needs if it focuses on its primary function, which is to maximize gains to its shareholders. To force managers to deal with social considerations is to divert them from this task with a deterioration of results. They argue that stakeholder models undermine the notion of private property, enhance the power of executives by diminishing the power of shareholders to control them, and make corporate managers less accountable to shareholders. Professor Milton Friedman, a Nobel laureate in economics, condemned the idea forty years ago: "… few trends would so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility other than to make as much for their shareholders as possible. This is a fundamentally subversive doctrine"[50]

Stakeholder advocates, on the other hand, argue that the corporation, deriving special benefits and privileges from the community, for example limited liability of shareholders, legal personality, perpetual existence and access to public capital, must as a result take

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[49] See, e.g. Gerald Vinten, "Shareholder versus Stakeholder – is there a governance dilemma?" *Corporate Governance* 9, 36-45 (January 2001); Elaine Sternberg, "The Defects of Stakeholder Theory," *Corporate Governance* 5, 3 (January 1997).

[50] Milton Friedman, *Capitalism and Freedom* (Chicago: The University of Chicago Press, 1962, p. 133.

account of community interests in its decisions. As the American scholars Berle and Means wrote seventy years ago,

> "It is conceivable - indeed it seems almost essential if the corporate system is to survive - that the "control" [i.e. management] of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity."[51]

It is also argued that the stakeholder model facilitates the kind of long-term corporate strategy necessary for the welfare of the firm, rather than the short-term opportunistic corporate actions taken to satisfy shareholders in response to swings in volatile stock markets. In addition, the stakeholder model encourages beneficial investments in human capital by employees, suppliers and others to create value in the long run for the firm, investments that employees and suppliers would be reluctant to make in firms following the shareholder corporate model. On the other hand, it must be recognized that stakeholders will often exploit their positions to pursue their individual interests to the detriment of the firm. For example, the bankruptcy in late 2002 of United Airlines, the second largest airline in the United States, was due in part to the fact that it had the highest labor costs in the industry, a result attributable to a certain extent to worker representatives' holding three seats on its board of directors. Europe has also had its share of corporate scandals and failures. A shareholder model is no guarantee of effective corporate governance.

[51] Op. cit, p. 356**.**

Although the debate between advocates of the two systems has gone on for several years, it has gained renewed vigour in the wake of the American financial scandals of 2002. Europe's tendency to emphasize stakeholder interests may have allowed European corporations to avoid the head- long pursuit of maximization of shareholder value, the proclaimed goal of US corporations in the 1990s, which many persons think led to or at least facilitated the excesses of Enron, WorldCom, and other American corporations.

The preference for the shareholder as opposed to the stakeholder model of corporate governance appears to have some basis in the culture and public attitudes of the countries concerned.[52] One survey of 15,000 managers and employees in twelve countries asked respondent to choose whether: (1) the only real goal of a corporation is making profit; or (2) a company, besides making profit, has the goal of attaining the well being of various stakeholders, such as employees, customers, etc. The two groups with the largest percentage of managers and employees selecting profit as "the only goal" were Americans (40 per cent) and British (33 per cent).[53] One may therefore conclude that among industrialized countries, national culture in America and the U.K. are closest to the ideal of shareholder value maximization as a corporate goal. On the other hand, it should be noted, of course, that despite the large percentage in relation to other countries, 60 per cent of the Americans surveyed nonetheless considered that a corporation had

[52] See generally, Jeswald W. Salacuse, "Corporate Governance, Culture and Convergence: Corporations American Style or With a European Touch?" *Law and Business Review of the Americas* (Fall 2002).

[53] Charles Hampden-Turner and Alfons Trompenaars, *The Seven Cultures of Capitalism: Value Systems For Creating Wealth in the United States, Japan, Germany, France, Britain, Sweden and the Netherlands* p. 32 (Doubleday: New York, 1993).

other goals in addition to making a profit. Consequently, it would seem that the prevailing cultural values in the United States may not be completely in accord with the U. S. system's stated goal of corporate governance.

In order to align the interests of managers to the goal of shareholder value maximization, U. S. corporations have increasingly compensated their executives with stock and stock options, now a widespread phenomenon throughout American corporate life. As a result, management contracts and compensation schemes have become important instruments of governance in the modern American corporation. According to one study, the typical American corporation now allocates 1.4 per cent of its equity each year to executives and other employees.[54] In 2000, the value of options granted by America's 325 largest corporations nearly equaled 20 per cent of their pre-tax profits.[55] In certain companies stock options have given an incentive to management to manipulate earnings through questionable accounting and other practices so as to raise their companies' share prices long enough to sell their stock and thereby make substantial profits. It also leads to short-term perspectives on earnings at the expense of longer strategies that might yield greater benefits to shareholders. Equally important for managerial interests, stock has become the currency of corporate acquisitions and mergers. Thus a high stock price, presumably achieved to maximize shareholder value, also allows managers to substantially enlarge

[54] *Financial Times*, August 12, 2000.

[55] *New York Times*, March 23, 2002.

the corporate empires over which they preside and from which they derive substantial benefits.[56]

European and Japanese lack of enthusiasm for the shareholder model, as opposed to the stakeholder model of corporate governance, is clearly reflected in the survey mentioned above. Compared to the 40 per cent of American respondents who believed that the sole goal of the corporation was to make a profit, only 28 per cent of the Italians, 27 per cent of the Swedes, 26 per cent of the Dutch, 25 per cent of the Belgians, 24 per cent of the Germans, 16 per cent of the French, and just 8 per cent of Japanese had the same preference.[57]

The difference between the Anglo-American and continental European positions on corporate purposes may be explained to some extent by the greater emphasis placed by the former on the individual and by the latter on the community. In an extensive survey of individualism in 53 countries, one study found Americans to be the most individualistic, achieving an individualism rating of 91 out of a possible 100.[58] The cultural value of individualism, which accords the individual a central role in the scheme of things, is manifest throughout the American system with its emphasis on individual rights and the availability of individual legal remedies to enforce those rights. American law and

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[56] Mary O'Sullivan, "Corporate Governance and Globalization," ANNALS, American Academy of Political Science 570, 153, 168-169 (July 2000).

[57] Hampden-Turner & Trompenaars op. cit, p. 32.

[58] Geert Hofstede, *Cultures and Organizations: Software of the Mind*, 53 New York: McGraw-Hill (1997).

attitudes towards individual property rights and freedom of contract strongly reflect the American cultural preference for individualism. Transferred to the corporate arena, the law considers the individual shareholders as the "owners" of the corporation. As such they are legally entitled to all its fruits. The United Kingdom, sharing a common language, history, and legal tradition with the United States, also favours the shareholder model of the corporation. It had an individualism score of 89, ranking it third behind the United States and Australia.

The European continent tends to emphasize the role and importance of the community more than does the United States. Europe's emphasis on "social solidarity," its skepticism about the merits of unfettered competition, and the formal inclusion of labour in corporate management in some European countries all reflect the greater importance that European culture attaches to the community. American doctrines of "employment at will" and "freedom of contract," both reflections of strong individualistic values, contrast with German concepts of "labour rights" and "good faith" in contracting,[59] which reveal strong communitarian values. This difference is also found in attitudes toward competition. For example, in one survey whereas nearly 70 per cent of American managers believed that increased competition as opposed to increased cooperation among business would lead to greater benefits for society, only 41 per cent of German managers, 45 per cent of French managers, 39 per cent of Swedish managers and 24 per cent of

[59] See Steven Casper, "The Legal Framework for Corporate Governance: The Influence of Contract Law on Companies Strategies in Germany and the United States," in Peter A. Hall and David Soskice (eds*), Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* 387**,** 388 (1999).

Japanese managers had the same view.[60] In the individualism survey mentioned above, France and Sweden ranked 10th with scores of 71, Germany ranked 15 with an index of 67, and Spain ranked 20 with an index of 51. (Japan ranked 23 with an index of 46.)[61]

The greater importance of communitarian values in Europe would quite naturally lead to the belief that the corporation, as part of the community and benefiting from its position in the community, needs to take account of community interests, not just shareholder interests, in conducting its operations and distributing its benefits. The relative lack of dispersed share ownership among the public in most European countries, as compared with the United States and the United Kingdom, may reinforce this view. On the other hand, there is evidence that the stakeholder model, and particularly co-determination, makes it harder for shareholders to control management and that European managers manipulate the stakeholder model by playing off one set of stakeholders against another in order to advance managerial interests.[62] For example, one study of corporate governance and the role of banks suggests that affiliations between banks and their principal corporate borrowers in Germany and Japan often encourage excessive lending and deferred restructuring.[63]

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[60] Hampden-Turner & Trompenaars, op. cit, p. 71.

[61] Hofstede, op. cit p. 53.

[62] Katharina Pistor, "Codetermination: A Sociopolitical Model with Governance Externalities," in Margaret M. Blair and Mark J. Roe (eds.) *Employees and Corporate Governance* p. 190 (Washington, D.C.: Brookings Institution, 1999).

[63] David Weinstein and Yishay Yafeh, "On the Costs of a Bank-Centered Financial System: Evidence from the Main Bank Relations in Japan," *Journal of Finance* 53**,** 635-672 (1998).

The differing cultural views as to the objective of the corporation may account for some of the public protests against “globalization" that American corporations have encountered in Europe and elsewhere. Seeing the globalization movement led by American corporations whose declared governance system has the goal of seeking profits for shareholders without regard to other stakeholders, various groups are protesting against corporations that refuse to accommodate other stakeholder interests. A further point of friction may arise as a result of American institutional investors using their holdings in European and Japanese companies to press American notions of good corporate governance on European and Japanese managers. In November 2001, for example, the California Public Employees Retirement System (CalPERS), America’s largest public pension fund, allocated $1.7 billion of its investments specifically to pursue “active corporate governance strategies” in European and Japanese markets.[64] Good governance for U.S. institutional investors means the primacy of shareholder interests. Many multinational corporations are sensitive to cultural differences between the American and European views on corporate goals. For example during the 1990's, the mantra of "building shareholder value" was a proclaimed objective of many American corporations and was prominent in both their internal and external communications in the United States. These same corporations were much more circumspect in Europe, fearing that explicit statements in favour of maximizing shareholder value would antagonize

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[64] See “CalPERS Turns Up Corporate Governance Heat – Plan Calls For Efforts to Target Japanese and Continental Europe”, Press Release, November 15, 2001, *available at* www.calpers.org/whatsnew/press/2001.

European governments and labor unions that strongly believe that corporations should advance the interests of all its stakeholders.[65]

While the differences between the stakeholder and shareholder models are real, care should be taken not to over emphasize them for several reasons. First, in countries with a shareholder model, the management and board of directors of the corporation are required to obey the law, and numerous laws (for example labour and environmental legislation) exist to protect persons from adverse corporate actions, even though such persons are not technically designated as "stakeholders" and even though such legislation does not fit within the rubric of "corporate governance." Second, as will be seen, among the countries said to have a stakeholder model of corporate governance, there is wide variation in the extent to which such stakeholders actually participate in corporate governance. Thus, for example, in Austria, Denmark, Germany, Luxembourg and Sweden, the law gives employees, a key stakeholder group, in companies of a specified size, the right to elect some members of the company's supervisory board. In Finland, on the other hand, company articles *may* grant employees that right. In France when employee shareholding reaches 3 per cent, they may nominate one or more directors, with certain exceptions. But in all other European Union member states, again with certain conditions, only shareholders elect members of the company's board.

[65] Philippe Hasplespleigh, Tomo Nada and Fares Boulos, "Managing For Value: It's Not Just About Numbers," *Harvard Business Review* (July-August 2001) p. 67-68.

Third, there appears to be some convergence in corporate practice between the two models as a result of globalization and the listing by large corporations of their shares on the exchanges of other countries in order to widen their access to capital. The Organization for Economic Cooperation and Development (OECD), whose member countries include proponents of both shareholder and stakeholder models, faces this issue in its *Principles of Corporate Governance*.[66] The *Principles* seek to bridge the gap between the shareholder and stakeholder models of corporate governance by stating in articles I and II that corporate governance should protect shareholders' rights and should ensure the equitable treatment of all shareholders, but also stating in article III that "[t]he corporate governance framework should recognize the rights of stakeholders as established by law…"[67] The implication of this provision is that if a given stakeholder does not have rights established by law, the corporate management is not required to take account of them in its decisions.

Although American systems of corporate governance permit but do not require corporate boards and management to take account of social welfare issues in their decisions, various internal and external factors, such as pressure from labour unions, environmental groups, and non-governmental organizations, have induced corporations in individual cases to integrate social considerations in their decisions; however, this tendency by no means implies the kind of dilution of shareholder rights entailed by the extreme stakeholder model. Of particular note in this regard is the emergence of "socially

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[66] Op.cit., note 3.

[67] *OECD Principles of Corporate Governance*, op. cit p. 20.

responsible investing," by which investors instruct institutions managing their funds to take account of certain social criteria in making investment decisions. It is claimed that $2 trillion of U. S. investments in 2001 were subject to social responsibility criteria.[68] To some extent, this trend may represent a slight convergence of the differing American and European views on the purpose of the corporation. On the other hand, the growing influence of institutional shareholders and their increased assertiveness towards European managers may also represent a force for convergence and increased shareholder rights in Europe.[69]

V The Institutions of Corporate Governance

(a) **In General**

The institutions of corporate governance include both those that are external and those that are internal to the corporation. The external institutions include government regulatory agencies, stock markets on which corporations list their shares, and the courts that enforce remedies for violations of corporate governance rules. Thus both the U.S. Securities and Exchange Commission and the European Commission are in a real sense institutions of corporate governance. The internal institutions are the mechanisms within the corporation that determine how it is run. The external and internal organizations are linked since the internal mechanisms are to a large extent defined and determined by the external institutions. For example, law and governmental regulations specify the powers

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[68] See the website of the Social Responsibility Investment Forum at www.socialinvest.org.

[69] Mary O'Sullivan, "Corporate Governance and Globalization," 570 *ANNALS, American Academy of Political Science 570, 153*, (2000).

of boards of directors and supervisory boards, the rights of shareholders, and the obligations of managers. Thus the participants in a corporate enterprise, particularly one that solicits capital from the public, are not free to organize themselves any way they like, but must follow rules set down by legislative bodies, regulatory agencies, and stock exchanges. At the same time, all external systems of corporate governance leave certain governance matters to the discretion of the corporate participants themselves.

A fundamental and practical governance question for corporate managers, directors and lawyers is therefore: what matters of corporate governance are determined by external rules and what matters are left to the discretion of the internal participants? The scope of internal corporate discretion varies from country to country. For example, while Germany requires certain members of a corporation's supervisory board to be representatives of labour, American legislation has no such requirement, thus giving U. S. corporations broader discretion in the selection of directors.

Governance is about power, and the purpose of any system of governance is to determine how power is allocated and exercised. Within any publicly traded corporation in Europe or North America, there are potentially three institutional centres of power: 1. the board of directors or supervisory board; 2 the managers; and 3.the shareholders. These power centers are examined in turn.

(b) The Board of Directors and Supervisory Board

In all corporate governance systems in the UNECE region, a board, selected by shareholders and acting collectively, exists to make key corporate decisions and to supervise management. It is a central institution of corporate governance. Yet important differences in board structure, composition and powers exist among countries. One significant structural element to be noted at the outset is that whereas the United States and the United Kingdom's laws provide for a single board of directors, certain European countries, notably Germany, Austria, the Netherlands, and Denmark, require corporations of a certain size to have a two-tiered system consisting of a management board composed primarily of executives of the corporation and a supervisory board composed of non-executives elected by the shareholders and in some cases by the employees. The supervisory board selects the members of the management board and assures their accountability to corporate goals and governance regulations. In the other eleven EU countries, the unitary board prevails; however in five out of the eleven, a two-tiered system is optional.[70] For example, French law provides for such an option, but only about 20 per cent the Paris Stock Exchange CAC 40 and less than 4 per cent of all French *sociétés anonymes* have chosen to create one.[71] Those that have opted for the two-tiered structure are primarily multinational corporations whose shares are listed on foreign

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[70] Weil, Gotshal & Manges Study, Op. cit, p. 43.

[71] Franco British Law Society, "The Director's Liability Under French Law", Franco British Law Society Lecture, November 19, 2001 available at www.law.ed.ac.uk/legal connexion/researc/societes.htm . Law no. 66-537 of 24 July 1966, as amended, on commercial companies, gives French companies the option to create a two-tiered system consisting of a management board (*directoire*) and a supervisory board (*conseil de surveillance*) A few large, internationally listed companies, such as Peugeot, AXA and TotalFina have adopted the two-tier system.

markets and which raise capital from foreign sources. They apparently believe that the existence of a two-tiered structure gives their system of corporate governance increased credibility with foreign investors.

What the two-tiered system does is to separate the managerial and supervisory functions, usually combined within the unitary board system, into two distinct organs. The existence of a separate supervisory board serves to increase the independence of non-executive directors and to give them additional power in acting as an oversight body over corporate managers. In evaluating the advantages and disadvantages of the two systems, one study concluded:

> "The one-tier system may result in a closer relation and better information flow between the supervisory and managerial bodies; the two-tier system encompasses a clearer formal separation between the supervisory body and those being supervised. However, with the influence of the corporate governance best practice movement, the distinct benefits traditionally attributed to each system appear to be lessening as practices converge."[72]

In varying degrees, all systems of corporate governance of publicly traded companies give the board a central position of responsibility. Article V of the *OECD Principles of Corporate Governance*, states: " The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and its shareholders." The commentary to

[72] Weil, Gotshal & Manges Study, op. cit, p. 43.

this principle elaborates: " Together with guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance and achieving adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation."[73] Although the board has certain key managerial tasks, such as selecting and removing the company's chief executive officer and approving important transactions, the fundamental task of the board in a publicly traded corporation is oversight of the corporation's managers. In the words of one authority, the board's primary duty is "overseeing management's dedication to the polestar of profit maximization…"[74]

Efforts in recent years to reform corporate governance have focused primarily on structural means to strengthen the board's oversight role. In general, the challenge in designing systems of corporate governance has been to allow managers flexibility to conduct management operations in an efficient way but at the same time to establish processes that ensure managerial accountability to shareholders for accomplishing the stated corporate objective of profit maximization.[75]

If the board is truly to hold corporate managers accountable to shareholder interests, the members of the board must genuinely represent shareholders rather than management. Directors, of course, are elected by shareholders, but that process has traditionally

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[73] *OECD Principles of Corporate Governance*, op. cit p. 42.

[74] Ira M. Millstein, "The Responsible Board," *The Business Lawyer* 52, 407-409 (1997).

[75] ALI, *Principles of Corporate Governance*, vol. 1, p. 77.

resembled an election in a one-party state: management controls the voting process and chooses a single slate of nominees, most of whom are managers or have close relations with them. In recent years, good corporate practice has stressed measures to give corporate boards greater independence from management in the hope that the board would, as a result, represent shareholder interests more vigorously. Rather than enact legislation on these measures, the approach in the United States has been to develop codes of best practices and then, through pressure by institutional investors, industry groups, and stock exchanges to induce corporations to adopt them. In countries that require a separate supervisory board, legislation requires that it members should not be managers.

One principle that has found wide spread adoption in practice, although not in law,[76] is that a majority of the board of publicly traded corporations should consist of persons who are not themselves managers of the corporation. In 2001, for example, on the average board of Standard & Poor 500 companies 82 per cent of its directors were non-employees. As part of the post Enron corporate government reforms, the New York Stock Exchange in August 2002 adopted a new rule,[77] subject to SEC approval, requiring that independent directors comprise a majority of the board of directors of all listed

[76] U.S. state corporation laws do not set requirements for persons to serve on the board. The Investment Company Act, the law governing mutual funds, however, required that no more than 60 per cent of the board be "interested persons". An interested person has specified relationships with the managers of the fund. In 2002, the required percentage of "disinterested directors" was increased to a majority. Stock exchange rules also provide for a minimum number of non-executive outside directors for listed corporations. See www.nyse.com for the text of the Standard.

[77] See www.nyse.com for the text of the Standard

companies other than those in which a shareholder or group of shareholders possess voting control. In Europe also, there appears be a growing trend to include non-employees in corporate board membership and many of the European codes of best practice stress the importance of a board's "independence" from management. In 2001, 50 per cent of the members of an average board of a German DAX 30, 92 per cent of the members of the average board of a French CAC 40, 99 per cent of the Netherlands Top 21 boards, and 57 per cent of the United Kingdom's average FTSE 100 board consisted of non-employees.[78]

Not being an employee of a corporation is no guarantee that a director will be truly independent of management. A variety of other factors, such as family connections, financial relationships, and links to controlling shareholders can limit the ability of directors to act independently -- to be, in the words of the United States Supreme Court, "independent watchdogs."[79] Independence is a subjective matter. In order to provide some objectivity to the process, one organization[80] has developed a set of criteria to weigh board member's independence from management. They include: (1) not having worked at the company for at least the last three years; (2) not having personal financial relationships with the company; (3) not having familial relationship with management; and (4) not having a connection to major or controlling shareholders. When these criteria are applied, the percentage of boards with independent directors falls dramatically in the

[78] Davis Global Advisors, *Leading Corporate Governance Indicator 2001,* (Newton, MA, 2001) p. 31 (2001).

[79] Burks v. Lasker, 441 U. S. 471, 484 (1979).

[80] Davis Global Advisors, at www.davisglobal.com

United States to 69 per cent, in Germany to 50 per cent, in the UK to 39 per cent, in France to 25 per cent, and in the Netherlands to 7%.[81]

Ambivalence with respect to the independence of directors in the countries of the UNECE region is also reflected in the *OECD Principles of Corporate Governance*. Rather than set a firm rule that the board must consist of a majority of persons independent from management, it merely states in Article VE. that: “The board should be able to exercise objective judgment on corporate affairs independent, in particular, from management.” To implement this norm, it recommends that “boards should consider assigning a sufficient number of non-executive board members, capable of exercising independent judgement, to tasks [such as financial reporting and executive compensation] where there is a potential for conflict of interest.”[82]

The collapse of the Enron Corporation, a majority of whose board members were neither executives nor employees of the corporation, raises the question of whether still other mechanisms are needed to assure director independence. The failure of Enron directors to act as “independent watchdogs” may have been influenced by their social, political and personal connections to Enron management.

Other structural devices that have been introduced to strengthen the board’s oversight function include the establishment of specialized committees to conduct certain key

[81] Davis Global Advisors, op. cit p. 35.

[82] OECD, *Principles of Corporate Governance*, Art. V, p. 22-23.

functions. For example, as a result of the Sarbanes-Oxley Act of 2002, all publicly traded companies are to have an audit committee consisting of independent directors. However, Enron had a specialized audit committee of independent directors but it nonetheless failed to detect and correct accounting irregularities. Practice is also evolving whereby most companies have separate nominating and compensation committees. The basic thrust behind this movement is the belief that a specialized committee, known to the shareholders and particularly if composed of independent directors, is more able to perform these tasks effectively than if they are entrusted to the board as a whole, particularly, if that board includes representatives of management

(c) The Managers of the Corporation

If the selection of corporate directors resembles an election in a one-party state, the position of the chief executive officer (CEO) in the modern American corporation is like that of an autocrat. Indeed, like political systems dominated by the "cult of the leadership personality," it is not unfair to say that most American corporations manifest "a cult of the CEO." It is almost an article of faith of American business that the CEO, and the CEO alone, is responsible for the rise or fall of the corporation's fortunes. Popular and managerial opinion in the United States considers that Lou Gerstner single handedly turned around IBM, that Jack Welch built GE into a modern force all by himself, and that Sandy Weill alone created Citigroup. CEOs not only manage. They write books. They appear regularly on television. They are the superstars of American corporate culture.

In recognition of this role, American CEOs are paid extravagantly. The average CEO of a major American corporation received a record breaking $17 million in compensation in 2000. According to *Business Week*, the average American CEO made 42 times the average blue-collar worker's pay in 1980, 85 times in 1990, and 531 times in 2000. [83] While it is true that almost two-thirds of a CEO's pay takes the form of stock options, it is also true that the average American CEO earns almost twice as much as his or her counterpart in other OECD countries.

Despite effective performance on the part of individual CEOs, the American emphasis on the role and importance of the CEO may be attributed, at least to some extent, to its cultural value of individualism. Americans believe that organizational achievement is disproportionately attributable to the actions of the individual leader, rather than to the efforts of the group. From the Lone Ranger to Huckleberry Finn, American culture is filled with tales of the individual triumphant. In countries with a more communitarian culture, such as Germany and Japan, corporate management tends to be more of a group effort than in the United States, a factor that influences CEO compensation in relation to that of other executives and employees. Moreover, European and Japanese cultures with their emphasis on community values and their large number of family companies seem to give the European and Japanese CEO the status of a patriarch or father figure within the corporation, rather than the heroic standing that American culture gives to its own CEOs.

[83] See www.aflcio.org/paywatch/index.htm for more detailed information on the compensation of CEOs of American companies.

In view of the overwhelmingly dominant position given the CEO in American corporations, it is curious that both the formal and informal instruments of corporate governance have little to say about the CEO or other senior executives. Corporate codes and laws hardly mention them. The *OECD Principles of Corporate Governance*, while devoting specific articles to the board and shareholders, contains no comparable provisions with respect to the obligations of corporate managers. Informal statements of practice limit themselves to trying to create structures that will prevent or inhibit the CEO from dominating the board, whose basic function, after all, is to hold the CEO accountable. Thus for example, one emerging tenet of good corporate governance practice, advocated by certain groups, is that the CEO should not also serve as company chairman. Indeed, many advocates of good governance also favour a chairman who is an outsider, rather than a current or recent corporate executive. It is interesting to note that while the concept of the separate chairman and CEO is prevalent in many European countries, it is not common in the United States. For example, in 2001 only 19 per cent of S&P 500 companies had this type of arrangement, while 100 per cent of Germany's Dax 30, 90 per cent of UK's FTSE 100, and 100 per cent of Netherlands's top 11 did.[84] The American preference for combining both offices is no doubt strongly influenced by its cultural faith in the heroic individual, as well as claims of efficiency made on behalf of this type of leadership. Perhaps influenced by their own belief in the cult of the CEO and their own cultural preference for individualism, American advocates of corporate governance have not pressed as hard for this structural division as they have for other corporate governance devices.

[84] Davis Global Advisors*, Leading Corporate Governance Indicators 2001,* p. 38.

(d) Shareholders

The very structure of shareholder ownership can serve to facilitate or render more difficult the task of controlling managerial behavior. The existence of large shareholders, often with seats on the board, a characteristic of European corporations, makes it harder for managers to manipulate the machinery of corporate governance in their interests, for example by controlling the nomination of outside directors or dominating the internal auditing process, than in corporations, such as those in the United States, where shareholdings are widely dispersed and directors, although nominally independent, do not have substantial share holdings in the corporation and may have social or financial connections to management. Moreover, as long-term investors, large shareholders in corporation are in a position to check the tendency of managers to act opportunistically to raise the share price long enough to sell their holdings. The differing shareholder structure between the United States and Europe may explain in part why Europe in the last few years seems to have avoided the kind of failures of corporate governance experienced recently in the United States. On the other hand, Europe has had it share of corporate governance failures in the past, and the role of large shareholders has not always been benign. As indicated earlier in this chapter, one of the goals of effective corporate governance is to protect minority shareholders from abuse, whether from managers with little ownership interest or controlling shareholders who dominate management.

Some scholars have found that the reason for concentrated ownership of shares in many countries is the poor investor protection that those countries provide to share owners. Aware of poor legal protection, investors know that they must take a large equity position to be able to monitor management and thus protect their investment. Small investors, also knowing they have limited protection, are only willing to buy shares at a low price, a fact that makes issuance of shares to the public unattractive to the corporations.[85] The difference in retirement systems between the United States and continental Europe is also an important factor in explaining differing share ownership structure. The privately funded pension system in the United States encourages wide share ownership among the public, while the publicly funded system on the European continent doe not have the same effect.

With respect to the legal rights of shareholders, in both the United States and Europe, direct participation of shareholders in corporate governance is limited to (1) electing directors or members of the supervisory board and, (2) approving certain items that require shareholder approval. In addition, there are legal rights accorded to shareholders to act against corporate officers and directors. With respect to the first, a major difference between the U. S. and Europe concerns those countries, such as Austria, Denmark Germany, Luxembourg and Sweden, in which employees elect some members of the board. The effect of this concession to stakeholder participation is to reduce the influence of shareholders in the governance of the corporation in which they own shares.

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[85] Rafael La Porta et. al., "Law and Finance," *Journal of Political Economy* 106, 1113-1142 (1998).

With respect to items of corporate action subject to shareholder approval, there do not appear to be significant differences between U.S. and European corporations.[86] Within the United States, individual state laws grant shareholders, as owners of the corporation, the right to make decisions directly about certain key matters, such as mergers, affecting the fundamental interests of the corporation. The extent of these shareholder rights can vary from state to state and indeed from company to company by virtue of differing corporate articles and by-laws. The importance of these rights is seen in proxy fights for corporate control, most recently in 2002 in the battle between management and dissident shareholders of Hewlett Packard Corporation over approval of a $12 billion dollar merger between Hewlett Packard and Compaq, a battle that resembled a political campaign in the use of the media to influence shareholder votes. Corporate governance advocates are increasingly pressing corporations to grant shareholders the right to approve a variety of fundamental issues affecting the corporation, including stock options plans, and to have easy access to the proxy process. Once again the thrust is to involve shareholders in certain fundamental corporate decisions as a check on management action. These efforts represent a further attempt to affirm the role of shareholders as "owners," not merely stakeholders, of the corporation.

Various legal rules may affect the ability of shareholders to take action against the decisions of corporate officers and directors with which they disagree. These include the ability to vote by proxy, whether or not cumulative voting (which increases minority shareholders ability to elect directors) is permitted, the right to challenge corporate

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[86] Weil, Gotshal & Manges Study, op. cit, p. 38.

actions in court, the right to call an extra-ordinary meeting of shareholders and, perhaps most important of all, the extent of directors' and officers' fiduciary duty and duty of care to the corporation and the shareholders. Some studies have concluded that the common law legal tradition, which prevails in the United States and the United Kingdom, affords stronger legal protection to minority shareholders than does the civil law.[87] For example, the regulation of self-dealing by officers and directors is more stringent in the Anglo-American system of corporate governance than it is on the European continent, a specific illustration of the relative value placed on minority shareholder rights in the two systems.[88]

The legal rights of shareholders and the legal duties of officers and directors would have little effect on corporate behaviour without the existence of effective enforcement mechanisms. Governmental agencies have varying degrees of power to pursue enforcement against corporations, officers and directors, and they invoke them with varying degree of vigour. But in addition, there is another powerful mechanism that probably takes its most vigorous form in the United States and has no exact replica in Europe: the private right of action. The American system permits shareholders to sue directors and officers for injuries that they have sustained either directly by corporate action or derivatively, on behalf of the corporation, for injuries done to the corporation because of wrongful actions by its officers or directors. To facilitate such law suits, specialized law firms have arisen that carry forward the suit while assuming the financial

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87 Rafael La Porta et al.op. cit.

88 Luca Enriques, "The Law on Company Directors' Self-Dealing: A Comparative Analysis," *International and Comparative Corporate Law Journal* 2, 297-331 (2000).

risks entailed by litigation. Their incentive is to recover “attorney’s fees”, a portion of the settlement that the corporation is judged entitled to.

For many investors, the basic remedy and sanction for bad governance is to sell the stock of the offending corporation or not to buy it all. Nonetheless, particularly in the United States where corporate litigation is frequent, the existence of a legal remedy serves as one more factor, along with others, to exert discipline on corporate behavior. If the American style of corporate governance is to spread to Europe by reason of the pressure of capital markets and institutional investors, it must be asked whether shareholder litigation will be far behind. But without a culture that tends to favour private actions by aggrieved individuals, including shareholders, it is unclear whether private actions would evolve as effective deterrents to corporate misconduct in certain European countries.

One scholar has argued that dispersed share ownership in the U.S. and the U.K. is a product of effective legal protection that encourages investors to become minority shareholders.[89] If true, then this legal protection for minority shareholders is itself, at least to a certain extent, the product of a cultural preference by U.S. and U.K. courts and legislatures for the values of individualism.[90]

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[89] John C. Coffee, Jr., supra note 31 at 644.

[90] Jeswald W. Salacuse, “Corporate Governance, Culture and Convergence: Corporations American Style or With a European Touch?” *Law and Business Review of the Americas* (Fall 2002).

It may be difficult to transplant the U. S. shareholder rights model to Western Europe, where a tradition of equity holding by corporations from the same country and with ties to the CEO may stifle attempts by shareholders to curtail managerial decisions that they perceive as threatening shareholder wealth maximization.

VI Conclusion

Within the UNECE region, there are two basic models of corporate governance, the Anglo-American model and the continental European model. The two models are differentiated by several important factors discussed earlier. In very general terms, and while acknowledging exceptions to the pattern in individual countries, the two models of corporate governance can be summarized as follows:

ANGLO-AMERICAN **MODEL**	**EUROPEAN MODEL**
1. management dominated	1. controlling shareholder dominated
2. shareholder focused	2. stakeholder focused
3. wide public share ownership	3. narrower public share ownership
4. strong shareholder rights	4. weaker shareholder rights
5. unitary board structure	5. two-level board structure
6. single powerful leader	6.consensus or divided leadership
7. shareholder litigation culture	7. weaker litigation culture.

Models, of course, are merely intellectual constructs. They do not capture reality in all its complexity. Nonetheless, the seven elements indicated above represent important issues that differentiate and influence the various approaches to corporate governance within the

UNECE region. Significant and powerful forces, such as the need to access foreign capital markets, the pressure of institutional investors, and the drive to create a single European market in financial services may tend to foster a certain convergence among corporate governance systems in the region. But systems of corporate governance are not simply forms that can be replaced with ease.[91] Systems of corporate governance, like a society's other important institutions, contain its cultural values, values that it has come to believe, rightly or wrongly, are essential for social survival. For example, one cannot assume that American values of individualism will easily replace European attachment to community values.

Continually stressing the dichotomy between the "Anglo-American" shareholder corporate model and the European stakeholder model, however, may exaggerate the differences between the two systems of governance and overlook the impact of forces making for convergence, such as the activities of U. S. institutional investors in Europe and the listing of European corporations on American stock exchanges. While a sharp distinction between the two models may satisfy those with a penchant for dialectic thinking, it may also lead to a neglect of opportunities to bridge the differences and fail to notice the extent to which convergence may already be taking place. For one thing, the effort to make management, whether American or European, more responsive to other parties outside of management itself can only serve as salutary discipline on managers. The movement throughout the UNECE region toward more independent directors is also a step forward, whether the goal of the corporation is seen as shareholder profit or

[91] See John Coffee, op. cit. p. 646.

stakeholder benefits. The effort, now well advanced in Europe, to separate the positions of chairman and CEO, would probably be seen as beneficial by the shareholders of most American corporations. And finally a middle ground, a point of convergence between the stark shareholder model advanced by Americans and the extreme stakeholder model advocated by Europeans, may reside in the notion of "socially responsible corporate governance," a concept that seeks to bring together two important themes that really have not been joined thus far: corporate good governance and corporate social responsibility. Current discussions of corporate governance are taking place largely within the context of the developed economies of North America and Western Europe. But the subject of corporate governance is also of vital concern for transition economies. It should be an important element in their strategies for growth, financial strength, and productive private sectors, as they have learned from a variety of painful experiences, including failed privatizations during the 1990s. For the most part, the systems of corporate governance in transition economies remain works in progress. As the countries in central and Eastern Europe construct their own corporate governance systems, they should examine carefully and critically the entire experience of both North America and Western Europe. Rather than leap to a shareholder or stakeholder model or hastily choose a unitary or two-level board structure, each transition state needs to determine the system of corporate governance most appropriate to its own individual needs and circumstances. Organizations and individuals from western developed countries inevitably press for the adoption by transition economies of "best practices" in corporate governance, best practices that have invariably originated in their own home countries. Those best practices were of course the product of specific national experiences and cultures, factors that may make their adoption by a given transition economy inappropriate or at least difficult without significant adaptation. In evaluating foreign models of corporate governance, policy makers in transition economies would do well to remember that to a large extent western corporate governance systems have evolved over time as a response to periodic, specific financial crises in individual countries. While recognizing that those crises have come and gone, they should also remember that others, leading to still further corporate governance reforms, are probably yet to come.