Editorial
Corporate Governance – the subject whose time has come*

Corporate governance has been practised for more than a thousand years. Yet the study of the subject is less than a century old. Indeed, the phrase 'corporate governance' was not used until the 1980s.

The twentieth century saw massive growth in serious management thought: but corporate governance was overlooked until recently. Organisation theories have made great strides: but boards seldom appear on organisation charts. Strategic management has acquired great significance: yet the contribution of the directors is seldom mentioned. Important theoretical and practical insights have been developed for the management of finance, marketing, operations and every other aspect of the modern organisation: except for the role of the directors. Now all that seems to be changing.

The nineteenth century saw the foundations laid for modern corporations. This was the century of the entrepreneurs whose names became enshrined in the great companies they founded. The twentieth century became the century of management; the phenomenal growth of management theories, management consultants, even management gurus all reflecting a preoccupation with management. Now the new century promises to become the era of corporate governance – as the focus swings to the way power over corporate entities is wielded, made effective and legitimised.

Since its founding eight years ago this journal has used a broad definition of its primary focus: corporate governance is about the exercise of power over corporate entities. Now this theme has become one of the central issues in the running and the regulating of modern enterprise.

However, the underlying ideas and concepts of corporate governance have been surprisingly slow to evolve. The underpinning frameworks still owe more to mid-nineteenth century thinking than they do to the realities of complex modern business.

Corporate governance as old as corporate entities

Although the theoretical exploration of the subject is relatively new, the practice of corporate governance is ancient. Governance issues arise whenever a corporate entity acquires a life of its own, whenever ownership of an enterprise is separated from its management. The Merchant of Venice, in Shakespeare's play (Act 1 Scene 1), feared for the safety of his argosies sailing out of sight on the high seas. How is oversight to be exercised over those delegated the task of running the venture; how are the owners' interests to be protected; who sets the direction of the enterprise and ensures its accountability; how is power over the enterprise legitimised; to whom is a company accountable and, ultimately, responsible? Such questions are always crucial when rights and duties attached to investment and ownership cannot be applied directly. Corporate governance is about the exercise of such power.

A much quoted comment by Adam Smith shows that he understood the issue of corporate governance, even though he did not know the phrase:

> The directors of companies, being managers of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own.
>
> Adam Smith, *The Wealth of Nations 1776*

The classical concept of the company stems from legislation developed in the mid-nineteenth century. It was one of the finest systems man has ever designed. The key concept was the incorporation of a legal entity, separate from the owners, but which nevertheless had many of the legal property rights of a real person – to contract, to sue and be sued, to own property, and to employ. The company had a life of its own; the founders could transfer their shares, giving continuity beyond their life. Crucially, the owners' liability for the company's debts was limited to their equity investment. Yet ownership remained the basis of power. Company law became the underpinning of corporate governance.

The notion was elegantly simple and superbly successful, enabling the subsequent creation of untold industrial growth, employment and wealth around the world. Superb – but unfortunately the mid-nineteenth century model now bears about as much relationship to reality as a hang-glider does to a jumbo-jet. Yet the original corporate concept remains the essential under-pining of company law.

Initially, all joint stock, limited liability companies were public companies; that is their *raison d'etre* was to raise capital from the public, whose liability for the corporate debts would be limited. By the early twentieth century business people had recognised that the model could be used to provide them with limited liability in their family firm, even though they did not need to access capital from outside investors. The number of such private companies now incorporated in jurisdictions around the world far outnumbers the public companies which have the right to offer their shares to the public.

The separation of management from ownership

The early years of the twentieth century saw another significant development. In the United States and the United Kingdom, particularly, the shares of many public companies were now listed on various stock exchanges. Shareholders were becoming more numerous and geographically diverse. Their links with the management of their companies were becoming more remote.

Using data from companies in the United States, Berle and Means (1932) drew attention to the growing separation of power between the executive management of major public companies and their increasingly diverse and remote shareholders. They realised the significance of corporate power. They observed that:

> The rise of the modern corporation has brought a concentration of economic power which can compete on equal terms with the modern state – economic power versus political power, each strong in its own field. The state seeks in some aspects to regulate the corporation, while the corporation, steadily becoming more powerful, makes every effort to avoid such regulation...The future may see the economic organism, now typified by the corporation, not only on an equal plane with the state, but possibly even superseding it as the dominant form of social organisation.
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> (1932, revised edition 1967)

This was the first seminal work of corporate governance (though that was not a phrase Berle and Means used). Their work has also been among the most cited by contributors to this journal. Berle and Means left a vital intellectual inheritance for the subject. It is surprising that it was so long before it was taken up.

For the next forty years the work of directors and boards remained the province of jurisprudence, enlivened by anecdote and exhortation. Manne wrote in 1965 about mergers and the market for corporate control. In 1971 a pioneering work by Mace sought to discover what directors really did and in the process challenged the conventional wisdom:

> I found that boards of directors of most large and medium-sized companies do not establish objectives, strategies, and policies, however defined. These roles are performed by company management. Presidents and outside directors generally agreed that only management can and should have these responsibilities ... In most companies boards of directors serve as a source of advice and counsel, serve as some sort of discipline, and act in crisis situations if the president dies suddenly or is asked to resign because of unsatisfactory management performance ... (nor do they) ask discerning questions – inside and outside the board meetings. Board meetings are not regarded as proper forums for discussions arising out of questions asked by board members ... (further I) found that in most companies directors do not in fact select the president.
>
> Mace, Directors – Myth or reality, 1971

Significant developments in the 1970s

In the 1970s Pfeffer (1972) drew attention to the importance of the link between organisation, environment and board power. Three other significant developments occurred in corporate governance thinking: in the United States an emphasis on independent outside directors and audit committees, in Europe the promulgation of the two-tier board and on both sides of the Atlantic debates about stakeholder notions.

An increasingly litigious climate in the United States, with shareholders of failed companies seeking recompense from directors, boards and, in particular, auditors led to more emphasis on checks and balances at board level. Auerbach (1973) wrote of the audit committee as a new corporate institution. Mautz and Neumann (1970, 1977) discussed audit committees of the board and the Securities and Exchange Commission (1972) called for standing audit committees composed of outside directors. Moreover, outside directors were to be independent – with no relationship with the company, other than the directorship and, perhaps, an inconsequential share-holding, that could affect the exercise of independent and objective judgement. Such emphasis led to commentators such as Estes (1973) suggesting that outside directors were more vulnerable than ever.

In the UK, your editor (1978) undertook a study of British board structures, membership and processes, intending to advocate audit committees in the UK but concluding that, first, there had to be independent directors on the boards of British companies. Sir Brandon Rhys-Williams (1976) called for non-executive directors and audit committees, introduced a parliamentary bill *The Conduct of Company Directors* (1977) which ultimately failed. The European Economic Commission issued a series of draft directives on company law harmonisation throughout the member states. The fifth draft directive (1972) proposed that unitary boards, in which both executive and outside directors were responsible for seeing that the business was being well run and run in the right direction, be replaced by the two-tier board form of governance practised in Germany and Holland. In this form of governance, companies have two distinct boards, with no common membership; the upper, supervisory board being responsible for monitoring and overseeing the work of the executive board, which runs the business, and having the power to hire and fire its members.

The idea of the two-tier board idea was not well received in Britain, partly because it would replace what was seen, at least by directors, as a viable system of governance, but also because, in addition to the separation of powers, the directive included co-determination ideas practised in Germany, in which the company was seen as a sort of partnership between capital and labour, with the supervisory board comprising equal numbers of shareholder and employee representatives. The UK's response was the report of the Committee chaired by Lord Bullock. *The Report of the Committee of Inquiry on Industrial Democracy (1977)* and the research papers (1976) associated with it, were the first serious corporate governance study in Britain. The Committee's proposal, for a continuation of the unitary board, but with worker representative directors, was not well received in Britain's boardrooms either.

Meanwhile, a number of corporate governance problems featured in the reports of UK government inspectors appointed by the Department of Trade. Pergamon Press (1971) – in which the inspectors concluded that Robert Maxwell should not again run a public company (advice that was ignored, enabling him to build a media empire which collapsed dramatically twenty years later), Rolls Royce (1973), London and County Securities 1976), Lohnro Ltd. (1976) and others all added to the interest in the governance of companies.

The 1970s also saw a questioning of the role of the major corporation in society. Broadly, the argument was made that major companies have responsibilities beyond their duty to their shareholders. Given the scale and significance of such companies, it was argued, boards should report to and, possibly, be accountable to a range of stakeholders who could be affected by board decisions – customers, suppliers and others in the added-value chain, employees, the local community, and the state. In the United States there was an important dialogue between the American Bar Association, looking for an alternative basis of power over companies, and the Corporate Roundtable defending directors' conviction of the value of the existing model. Consumer advocate Ralph Nader offered a specification for a model corporation rooted in stakeholder thinking. Jensen and Meckling (1976), whose work was subsequently to become key in the development of agency theory, even asked whether the concept of the company could survive.

The debate was picked up in the United Kingdom. A committee of the Confederation of British Industries, chaired by Lord Watkinson (1973), reported on the wider responsibilities of the British public company. A PEP report by Fogarty (1975) discussed companies responsibilities and stakeholder participation. The Accounting Standards Steering Committee produced *The Corporate Report* (1975), a seminal paper which called for all economic entities to report publicly and accept accountability to all those whose interests were affected by the directors' decisions. The political implications of these proposals for the widening of accountability and control over companies, and the related erosion of managerial power, soon consigned this report to the top shelf.

Developments in the 1980s

In the 1980s broader stakeholder concerns became overshadowed by the market-driven, growth-orientated attitudes of Thatcher and Reganite economics. Directors' responsibility to increase shareholder-value was reinforced. The profit performance model became the basis for the privatisation of state run entities – rail, coal, electricity, gas, water enterprises were all privatised in the UK and, gradually, around the world. The threat of predators (often able to finance their hostile bids with readily available high risk, high rate 'junk' bonds) was presented as an essential incentive for strong board level performance.

In the mid-1980s further research was undertaken into what was to become corporate governance, for example, by Baysinger and Butler (1985) who looked at the effects on corporate performance of changes in board composition and Mintzberg (1984) who posed the question 'who should control the corporation?'. But the subject came centre stage, less as the result of academic, research-based deliberations, rather more as a result of official inquiries set up in response to the corporate collapses, perceived board level excesses and apparently dominant chief executives of the later part of the 1980s.

In Australia the names of Alan Bond, Laurie Connell of Rothwells and the Girvan Corporation were being associated with questionable governance practices. In Japan Nomura Securities and The Recruit Corporation were accused of dubious governance practices. In the United States the names of Ivan Boesky, Michael Levine and Michael Milken were to go down in the annals of corporate governance through the massive junk bond financed, insider dealing deals through Drexal, Burnham, and Lambert. In the UK corporate governance was the focus of the Guinness case and, subsequently, of the collapse of Robert Maxwell's companies. Boards dominated by powerful executive directors were seen to need checks and balances, particularly where the posts of chief executive and chairman of the board were combined and the outside directors were weak.

Developments in the 1990s – in practice and conventional wisdom

Led by developments in the United States, boards and their directors were coming under pressure from various sources – not least, institutional investors, investigative media, and the threat of litigation. Major institutional investors rediscovered investor power and became pro-active in corporate governance. Their power lay in the proxy vote and companies' need to influence their share price and to tap the ever-increasing pension funding and savings around the world. Expectations of institutional investors for adding shareholder value grew, along with the ending of corporate governance practices that benefited incumbent boards and reduced the probability of the company being subjected to hostile bid. In the United States, the directors of American Express, General Motors and IBM all had cause to regret the power of institutional fund managers to vote their shares against incumbent members of boards they considered to be performing badly.

In the United States, the UK and Australia organisations emerged to inform institutional fund managers on governance issues. Amongst institutional investors, the Californian State Employees pension fund (CalPers) was particularly active, producing Global Principles for Corporate Governance, intended to benchmark corporate governance practices in companies in their portfolio around the world. Other organisations published corporate governance In response some companies, such as General Motors published their own board governance guidelines.

In the UK thinking about corporate governance was much influenced by the report of the Committee chaired by Sir Adrian Cadbury (1992) [a member of this journal's editorial advisory board] on the financial aspects of corporate governance. The report's proposals and its code of best practice emphasised the importance of independent non-executive directors, with independence defined as 'independent of management and free from any business or other relationship which could materially interfere with the exercise of independent judgement, apart from their fees and share-holding'. Audit committees were advocated. Some critics of the report argued that the report went too far – the emphasis on the importance of non-executive directors would introduce the controls of the European two-tier supervisory board by the back door: others felt that the report did not go far enough – it lacked teeth by proposing de-listing rather than legally enforceable sanctions.

The Cadbury Report became significant in influencing thinking around the world. Other countries followed with their own reports on corporate governance. These included the Viénot Report (1995) from France, the King Report (1995) from South Africa, the Toronto Stock Exchange recommendations on Canadian Board practices (1995), the Peter's Report from the Netherlands Report (1997), and a Report on corporate governance in Hong Kong from the Hong Kong Society of Accountants (1996)]. As with the Cadbury Committee Report (1992), these reports were particularly concerned about the potential for abuse of corporate power. Similarly they called for greater conformance and compliance at board level, recommending the use of audit committees as a bridge between board and external auditor, the wider use of independent outside, non-executive directors, and the separation of the role of chairman of the board from chief executive. More checks and balances to avoid executive domination of decision-making and protect the rights of shareholders, particularly minority shareholders, was the theme.

An Australian Committee on corporate governance (1993), chaired by Professor Fred Hilmer of the Australian Graduate School of Management, however, advanced a view that added a new dimension to the conformance and compliance emphasis of the Cadbury and the other reports. Governance is about performance as well as conformance, the report argued:

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

They gave their report the splendid title *Strictly Boardroom* – after the film 'Strictly Ballroom', which portrays the world of competitive ball dancing, in which originality, creativity and innovation had been sacrificed to inflexible and inhibiting rules and regulations. This is the danger facing current governance practices, argued Hilmer, with conformance and compliance overshadowing improved corporate performance.

Some institutional investment organizations have also published codes. In the United States these include CalPERS (the California Public Employees Retirement Scheme), NyCERS (the New York City Employees Retirement Scheme) and SWIB (the State of Wisconsin Investment Board). CalPERS are now committed to exercising their influence internationally, through the promulgation of a global code of practice and producing specific recommendations on the changes they believe necessary in governance practices in Germany and Japan (essentially calling for more independent board membership to reflect outside shareholder interests).

Most recently, global policy institutions, including the World Bank, the UNDP, the Commonwealth XXX and the OECD, have become involved in the exploration of corporate governance issues and the promulgation of global codes of best practice. Nation states, particularly developing nations, they argue, need to bring their companies' and securities law and regulation into line with international norms, if they are to access global capital on the international capital markets and to meet the expectations of the international investment community.

But – why are they interested? Does it improve economies, benefit peoples? What is the real value of such codes? Better able to attract funds. CalPERS evidence of increased shareholder value after their interest. But what is the real value of higher market capitalisation – who benefits? Obviously the directors with suitably priced share options, typically the shareholders and, in the case of institutional investors, their own policyholders, shareholders, investors, pensioners and others involved. Left with the feeling here that politicians, civil servants making work, a new way to wield influence.

The OECD (the Organisation for Economic Co-operation and Development) proposed the development of global guidelines on corporate governance. The report, usefully, contrasts the strong external investment and firm corporate governance practices in America and Britain with those in Japan, France and Germany. In these countries other constituencies, such as employees, receive more deference, the regulatory structures tend to be less obtrusive, directors are seldom truly independent, and investors seem prepared to take a longer term view. But do such codes of practice provide benchmarks of best practice or are they merely the minimum acceptable level of conduct? Is there a proven link between compliance with codes of good practice and long-term corporate success? Empirical research to date is ambiguous. In fact most codes are based on the conventional wisdom in the board room of what constitutes good practice, not on empirically proven practices that are known to lead to effective performance and long-term corporate success.

Institutional investor corporate governance interactions with companies

Relationship investors, such as the LENS Fund and the Hathaway Fund in the United States, take major, long-term positions in companies, with the avowed intention of influencing corporate performance, through close involvement with the management, possibly a seat on the board. Recent links between CalPERS, the LENS Fund of the US and the Hermes Fund in the UK suggests further leverage of the corporate governance power of these institutions over corporate boards.

A further UK committee on corporate governance (1998), chaired by Sir Ronald Hampel, reported on the outcome of the Cadbury proposals and recommended a code of best practice that would combine previous codes. The report developed a set of 'principles of corporate governance'. As argued in our editorial at the time, these principles reflected current conventional wisdom. But, predictably, a committee comprised predominantly of directors of major public companies and their professional advisers saw no reason to criticise contemporary corporate governance, nor to advocate measures which might limit directors' power to make unfettered decisions or widen the scope of their accountability.

However, probably the most telling driver of change in corporate governance in the 1990s was the dynamic, flexible new corporate structures, often global, that were now replacing the stable, often regional, corporate groups of the post-war years – massively complex networks of subsidiary companies and strategic alliances with cross-holdings of shares, cross-directorships, chains of leveraged (and often public) funding, dynamic and ever changing operational and financial linkages throughout the added-value chain. Networks that operated in multiple jurisdictions, cultures and currencies; groupings with voracious appetites for growth. Top management of major corporations around the world was now wielding enormous power. Whilst claiming to reflect owners' interests, directors were seen to be pursuing their own agendas and expecting huge rewards – privileges reserved in earlier generations for aristocrats and kings.

Developments in the 1990s – in theory

Corporate governance, as yet, does not have an accepted theoretical base or commonly accepted paradigm. In the words of Pettigrew (1992), corporate governance lacks any form of coherence, either empirically, methodologically or theoretically with any piecemeal attempts to try and understand and explain how the modern corporation is run. Nevertheless the 1990s saw a dramatic surge in academic interest in the subject and the number and quality of published papers addressing related topics. That explains why a significant proportion of the works in this collection have been written within the past decade, despite the book being published in a series on the history of thought in management.

Some penetrating works were rooted in case research and personal experience: Lorsch [a member of this journal's editorial advisory board] with McGiver (1989) produced some powerful insights in their work *Pawns or Potentates – the reality of the American board*; Demb and Neubauer [a member of this journal's editorial advisory board] (1992) drew on European experience in their book *The Corporate Board – confronting the paradoxes*. Their key ideas are included in this collection. Monks and Minow [members of this journal's editorial advisory board] (1995) drew on their experiences as relationship investors and activists; whilst Monks (1998) made an informed and most outspoken criticism of the excessive power he alleges is held by American chief executives.

Many theoretical insights have been applied to research in the subject. Taking a human relations/sociological perspective Pettigrew and McNulty (1995) explored power and influence around the board room. From the viewpoint of jurisprudence in Australia and the UK, Stapledon (1995) explored the potential for institutional activism. Kay and Silbertson (1995) take the view of two Oxford economists. See also Kester (1992). The paper by Turnbull [a member of this journal's editorial advisory board] (1997:1) attempted to provide an overview of the state of the art in corporate governance theory.

But the most fascinating academic debate of the decade, one that is still totally unresolved, was between those who based their research on the concepts of agency theory and those who believe that theory is inadequate and based on a false premise on the nature of man. Stemming from the work of Coarse (1936), the concepts of agency theory were developed by researchers such as Williamson

(1979) and Fama and Jensen 1983. In essence, the theory presents the governance relationship as a contract between the director and the shareholder. Directors, seeking to maximise their own personal utility will take actions that are advantageous to themselves but detrimental to the shareholders. Consequently the transactions costs of appropriate checks and balances, such as disclosure to shareholders, the use of independent outside directors, audit committees and the separation of chairman and CEO, are desirable. Evidence of such actions is not hard to find anecdotally and serious scholarship has demonstrated linkages between various attributes of governance, such as board structure, the duality of chairman and CEO and director remuneration, and company performance. [For example Conyon, Gregg and Machin (1995)]

Critics of agency theory argue that the reality of governance involves inter-personal and political relationships that are just not reflected in the concept of a personal contract. Moreover, they suggest, the theory takes a rather low view of the nature of man – that he cannot be trusted. Stewardship theory, the alternative perspective, takes an altogether broader frame of reference, being based on the original and legal view of the corporation in which directors have a fiduciary duty to their shareholders to be stewards for their interests. This, they argue is clearly what most directors actually do. Moreover, other contemporary scholarship is discovering that not only does increasing governance conformance and compliance not add to corporate performance – it can actually detract. [Donaldson and Davies (1994)] Muth and Donaldson [a member of this journal's editorial advisory board] (1997) also challenged the shibboleths of agency theory, which underpin conventional assumptions about the benefits of checks and balances. Boards with well connected, executive directors perform better than those that meet the paradigms of conventional governance thinking, they found.

The philosophical debate

The UK Hampel Committee's dismissal of stakeholder notions – 'directors are responsible for relations with stakeholders, but are accountable to the shareholders' – undoubtedly reflects the conventional wisdom in boardrooms in both the UK and the USA. Despite the views in a report from the Royal Society of Arts, titled *Tomorrow's Company,* which advocated wider recognition of corporate responsibility to stakeholders such as suppliers, customers and employees. The issue has not been resolved.

Sternberg (1997) argues that stakeholder ideas are fundamentally flawed, strongly advocating the ownership rights perspective. Turnbull (1997:2) takes the opposite view, advancing the benefits of a broader cybernetic (and stakeholder) view. Stakeholder thinking continues to attract in a society in which expectations of companies are changing with growing demands for better consumer, environmental and societal behaviour. In fact, though often called stakeholder theory, such notions are better seen as a matter of corporate governance philosophy, being concerned with values and beliefs about appropriate relationships between the individual, the enterprise and the state.

The frontiers of corporate governance are being pushed out rapidly, just as the seriousness of governance issues increasingly challenges directors and boards, investors and regulators. Despite the evolution of thought traced in the readings in this collection, we are still using essentially nineteenth century thinking in the underlying concept of the corporation, which gives rise to governance in the first place. In a 1990 paper, your editor called for the highly successful, but now outgrown, concept of the corporation to be redesigned (Tricker, 1990). There is now a need for a taxonomy of companies which reflects the complex and diverse range of governance arrangements and structures around the world. We also need an appropriate conceptual framework that will adequately reflect the reality of governance. At the moment various theoretical insights cast light on different aspects of the play, highlighting some, leaving others in the shadow: we need a viewpoint that can light up the entire stage and all of the players.

The first review of corporate governance literature was published by Cochran and Wartick [both members of this journal's editorial advisory board] in 1988: it had just 102 annotated references. A list of the literature today would have as many pages!

The metamorphous of corporate governance has yet to occur. Present practice is still rooted in a nineteenth century legal concept that is totally inadequate in the emerging global business environment. Present theory is even less capable of explaining coherently the way that modern business is governed. What is needed is a vibrant alternative way to ensure that power is exercised, over every type and form of corporate entity and strategic alliance around the world, in a way that ensures both effective performance and appropriate social accountability and responsibility.

Unfortunately, the most likely driver of further rigorous development in corporate governance is likely to be the next round of alleged board level excesses and corporate collapses, whatever the causes.

Conclusions

Significant changes are taking place in the activities of institutional investors in their exercise of corporate governance power over companies. Does this represent a re-discovery of nineteenth century capitalism, when ownership was the basis of power, or is this shareholder activism of a different kind, in which case what may be the longer-term implications?

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*A new volume in the Ashcroft/Wiley History of Management Thought Series provides a collection of seminal papers on corporate governance. This editorial contains material from the editor's introduction to the book.
Corporate Governance; History of Management Thought (series editor Derek Pugh), Tricker, R. I. (editor), Ashcroft Publishing, Aldershot, UK, 2000.