Corporate Governance

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Abstract

'Corporate governance' rules define decisionmaking roles among various corporate stakeholder groups. There is disagreement as to the goals of corporate governance, with some advocating an exclusive focus on shareholder value while others advocate including the interests of other stakeholders such as creditors and employees. Major means used to advance the interests of shareholders and/or other stakeholders include the board of directors, shareholder voting, monitoring by various gatekeepers, fiduciary duty rules, and incentives created by various markets.

'Corporate governance' refers to the legal rules and institutional framework that structure decisionmaking within business corporations. Major groups, which may play roles within corporate governance include directors, officers, shareholders, creditors, and employees. Several bodies of law are implicated in corporate governance, above all corporate or company law, but also securities law as well as elements of tax, antitrust, contract, commercial, employment, and bankruptcy law. Several types of markets are also implicated, above all stock markets, but also other financial markets, managerial labor markets, and general labor markets.

Following a brief outline of the basic governance problem, this analysis of corporate governance begins by considering the various goals corporate governance may serve, seen through the light of a series of conflicts in the interests of different groups. It proceeds to consider the means of corporate governance, that is, various legal and nonlegal mechanisms, which help structure how decisions within corporations are made within the context of these competing interests. Corporate governance frameworks have not only major similarities across countries, but also significant differences. After considering these similarities and differences and a variety of recent developments, the analysis concludes with an overview of a longstanding debate over the extent to which different national frameworks are and should be converging over time.

The Governance Problem

In all but the simplest of businesses, the actions of a variety of types of persons must be coordinated: equity investors, employees, managers, creditors, suppliers, and customers, to name some of the most important. These persons could all coordinate their actions through simple spot markets, with constantly shifting prices for their products and services. However, in many cases people have found it useful to form a firm in which their actions are coordinated through the directions of managers (Coase, 1937).

The corporation has been the leading legal form used by business firms. It is not the only such form – partnerships also have a long history, and more recently a number of new legal forms have been developed, most importantly the limited liability company (Ribstein, 2009). Here, though, the focus is only on corporations. The equity investors in a corporation are called shareholders or stockholders. A corporation may have just one shareholder, or a small number of shareholders with no active market for their shares, or thousands of shareholders whose shares may be readily traded upon a public stock market. The practical governance problems a corporation is likely to face vary greatly with their ownership structure. In the late nineteenth century there began to emerge a type of corporation in which there were many shareholders who owned only a small fraction of the total shares, and no one person or group owned a controlling block of shares. In a seminal work, Berle and Means (1932) identified such corporations as creating a separation of ownership and control, and the problem of that separation has dominated American corporate governance ever since. However, such corporations remain rare in most countries, where the role of controlling shareholders is critical.

Corporate (or company) law provides the central legal framework for corporations. Most legal authority for running a corporation is vested in the board of directors. However, the board may, and in larger corporations almost certainly will, delegate that authority to a series of officers. Between them, the directors and officers are charged with management of a corporation. In doing their jobs, they must supervise the work done by the corporation's employees. They must also raise money through the issuance of shares or through various forms of debt, and then must manage relationships with the resulting shareholders and creditors. They must obtain needed goods and services from outside suppliers, and must find and satisfy customers who buy the goods or services, which the corporation produces. Thus, the actions of many different types of persons must be coordinated, and the interests of those different persons will often differ. The corporate governance framework provides both legal and nonlegal mechanisms by which these different groups are coordinated and their conflicts of interest managed. The traditional literature in corporate law and economics, following Berle and Means (1932), has conceived of this as an agency cost problem in which the temptation of managers to make decisions that benefit

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themselves rather than the corporation must be constrained (Jensen and Meckling, 1976).

Goals

In whose interests is and should a corporation be run? Given the many decisions that must be made within a corporation, and the many groups involved, that question could have quite a complex set of answers. A long-running debate tends to oversimplify the question into two alternatives: shareholders or stakeholders. That is, either corporations should be run to maximize the return to its shareholders, or else it should balance the interest of a variety of the groups mentioned above. The shareholder primacy view has come to dominate in the United States and to some extent other English-speaking, common law countries, while the stakeholder view dominates elsewhere. However, a more fine-grained understanding of the conflicting possible goals underlying corporate governance flows from considering a number of significant potential conflicts between the interests of various groups involved in corporations (Kraakman et al., 2009).

Shareholders vs Managers

Shareholders elect the board of directors, but then have little other formal authority in running a corporation, although shareholders do vote on a few major decisions such as amendments to the corporate charter, mergers, and dissolution. The board may in turn delegate much of its authority to various officers. By managers, I refer to both directors and officers. As noted in the discussion of Berle and Means above, where there are many dispersed shareholders, it will often be the case that no one shareholder has the incentive and the means to monitor the behavior of the managers. The managers may then be able to make decisions that benefit themselves at the expense of shareholders generally. This is the problem of the separation of ownership and control that is the central concern of American law for public corporations.

Controlling Shareholders vs Minority Shareholders

In corporations where one shareholder or a small group of shareholders owns enough shares that it can effectively choose on its own who will be on the board, the controlling shareholder has effective control over the corporation through its domination of the board. Moreover, if the control block is large enough, even on those matters in which shareholders do have a vote, the controlling shareholder may control enough shares to gain approval of measures without the support of other shareholders. In such corporations, the controlling shareholder may have the means and the incentive to dictate decisions that benefit it at the expense of other shareholders. In most countries, this is the dominant problem of corporate law, as in most countries almost all corporations have a controlling shareholder. Even in the United States, this conflict plays a major role in some parts of corporate law, most notably the law governing squeezeouts of minority shareholders.

Note that for most companies, one or the other of these first two conflicts will be a major concern, but not both. If there is no controlling shareholder, then this second conflict is not a problem. If there is a controlling shareholder, then in most instances that shareholder will have both the incentive and the means to monitor managers enough to significantly reduce the conflict between shareholders and managers. That conflict will not disappear – monitoring is costly and hence imperfect – but in such corporations the conflict is likely to be limited and manageable enough that it will not be a major focus of legal concern. In some unfortunate types of companies, though, both conflicts may be simultaneously severe. An important instance may be many state-owned enterprises (SOEs) in China (Yang et al., 2011). Most SOEs today have minority shareholders, but the dominance of a branch of the government makes those shareholders highly vulnerable to actions against their interest. And yet, agency problems such as corruption within the state itself will often leave the managers of SOE with much leeway to pursue their personal interests.

Shareholders vs Creditors

The legal recognition of limited liability for the shareholders of corporations creates a conflict of interest between shareholders and creditors. If a corporation does not fare well and does not have enough income or assets to repay its debts, in general its shareholders will not be held personally liable for those debts. This gives shareholders an incentive to induce the corporation to take on too much risk. Should highly risky actions lead to high profits, the shareholders, as residual claimants, are the main beneficiaries, while should those risky actions cause the corporation to go bankrupt, shareholders' losses are limited and much of the burden is borne by creditors. Creditors, in contrast, want the corporation to take on quite small degrees of risk – they care only that the business earn enough to pay them off, amounts earned beyond that do not benefit them.

Many mechanisms exist to address this conflict. Many of these are nonlegal self-help by creditors, such as loan covenants, monitoring before extending credit, staged credit, higher interest rates to compensate for credit risk, and so on. There are also many legal rules that exist to help protect creditors. Some of these are part of corporate law, including legal capital rules and the doctrine of piercing the corporate veil. Others are part of other areas of the law, including much of bankruptcy law, the law of secured transactions, and fraudulent conveyance statutes.

Shareholders vs Employees

Employees are the persons who do most of the actual work to carry out the actions of a corporation. Insofar as they are supposed to be advancing the ends of shareholders or of the other constituents, there is thus a classic agency problem, as employees may be able to act in ways that benefit themselves but not shareholders or the corporation. The risk of opportunism runs both ways, though. Especially insofar as employees have acquired firm-specific human capital, they will be interested in the long-run success of the business, as their alternative sources of employment will often be less attractive. Risks that look worthwhile to diversified shareholders with

limited liability may look much less so to employees whose livelihood is closely tied to the continuation of a particular business.

As noted above, American corporate law does little to either constrain or protect employees, outside of basic agency law. Other areas of law, especially labor, employment, and contract law, serve those purposes. However, employees are a significant part of corporate law in some countries, most notably Germany.

Other Stakeholders

The above four sets of conflicting interests set forth the constituency groups that play the biggest role in corporate governance. Yet, other groups may in some circumstances be relevant as well. A majority of states have enacted corporate constituency statutes, which allow boards to take into account the interests of groups other than just shareholders. In addition to creditors and employees as mentioned above, the other groups most frequently cited in constituency statutes include suppliers, customers, and the communities in which corporations are located.

Note that noncorporate business forms, particularly various forms of cooperatives, may make some constituency group other than shareholders, in effect the owners of the business. Constituent groups so empowered in cooperatives may include employees, suppliers, and customers.

Means

The previous section set out the main groups whose interests may be protected or balanced as a part of the system of corporate governance. This section considers major legal and nonlegal mechanisms by which those interests are protected or balanced.

The Board of Directors

The board of directors is the core locus of authority within corporations as a matter of law. Some justify this as the best way of protecting the interests of shareholders, who elect the board (Bainbridge, 2003), while others justify it as a way of balancing the interests of various constituencies (Blair and Stout, 1999). In practice, the traditional role of boards in public corporations was to provide strategic guidance and advice. In recent decades, there has been an increased focus on boards as monitors of the behavior of officers.

Along with the contemporary focus on the monitoring role of boards, have come the new best practices and then legal requirements that a majority of directors be independent of the corporation, aside from their role as directors. Exchange and securities rules specify who counts as independent, and also require committee to carry out various functions, including audit, compensation, and nomination committees. Controversy surrounds this move to a focus on monitoring and independence, with some arguing that boards have largely shown themselves unable to deliver on these new expectations (Fairfax, 2010).

Voting

The power of shareholders to direct corporate affairs through voting is limited. Shareholders elect directors (exclusively, outside of the codetermination context), and as noted above they vote on certain fundamental matters. But at least in the United States, shareholders vote on matters such as charter amendments, mergers, and dissolution only after the board has first voted in favor of a proposal. Thus, shareholders cannot initiate changes (although shareholders can act on some of these items in some countries without board approval). Moreover, traditionally the power to elect directors has been of limited use in public corporations, since most shareholders do not attend shareholder meetings but instead vote by proxy, and generally only the corporation itself finds it financially worthwhile to distribute proxy material. Thus, shareholders have traditionally only been able to vote on the slate presented to them by the board. The main context in which the shareholder's power to vote for the board has had value (in public corporations) is when there is a hostile takeover, so that bidders can acquire a controlling share and thereby take control. However, boards have been able to find highly effective defenses against takeovers, and for the most part American law has allowed those defenses (British rules have been less accommodating of takeover defenses).

More recently, certain institutional shareholders with an interest in active corporate governance have attempted to expand their ability to influence corporate behavior through voting. Their efforts are discussed below in the Recent Developments section.

Fiduciary Duty, Antifraud Rules, and Shareholder Suits

Shareholder suits against directors, and more rarely officers, are one of the major legal tools used to prevent and discipline misbehavior. Such suits are brought under both state and federal law. State law suits are brought to enforce the fiduciary duties that corporate law imposes upon officers and directors. Traditionally there were two main duties, the duty of loyalty and the duty of care. The duty of loyalty forbids managers from taking actions in which their personal interests differ from those of the corporation. The duty of care requires managers to gather adequate information before making decisions. The business judgment rule protects managers in care suits and makes liability extremely unlikely for such cases (Black et al., 2006).

In recent decades, state fiduciary duty cases have expanded beyond these traditional categories. Specialized standards of review have been developed where boards adopt antitakeover defenses, where they sell control of the corporation, and where they take action to limit the shareholder franchise. Delaware courts have also expounded upon the requirement to act in good faith as a way to review types of behavior that fall in between the categories of care and loyalty, notably including the decisions of boards to establish monitoring systems and the setting of executive compensation (Hill and McDonnell, 2012). Good faith is discussed further in the Recent Developments section below.

Federal law shareholder suits are brought under various antifraud rules of securities law, most commonly Rule 10b-5.

Federal courts made such suits easier to bring in the 1960s and early 1970s, but then started cutting back on this trend through a variety of opinions. Congress further tightened liability standards with the Private Securities Litigation Reform Act of 1995. However, shareholder litigation under both state and federal law still remains robust (Thomas and Thompson, 2012).

Gatekeepers

A variety of professionals function as corporate 'gatekeepers.' Gatekeepers monitor and collect information about a corporation and certify that information to investors and other outsiders. As such, they help reduce the problems of asymmetric information, which lie at the heart of the agency problems that are at the heart of the corporate governance problem (Coffee, 2006). Significant gatekeepers include auditors and accountants, lawyers, credit rating agencies, directors and officers' insurers, research analysts, and investment banks.

A variety of legal and nonlegal mechanisms work to give gatekeepers incentives to diligently gather and honestly disseminate information, although those mechanisms do not work perfectly. A leading nonlegal mechanism is reputation: being associated with a particular gatekeeper is more valuable if that gatekeeper has a good reputation for providing accurate information. Such a reputation allows gatekeepers to charge higher fees, thereby giving them incentive to continue to be honest and diligent. However, both internal agency costs within gatekeepers and potential one-time big payouts from dishonesty may undermine reputational incentives. Reputation and other nonlegal mechanisms are supplemented by various legal rules, which impose regulations on gatekeepers. These legal rules have evolved significantly in recent years, as discussed below in the Recent Developments section.

Markets

A variety of markets help shape patterns of corporate governance. Most crucial are stock markets. A classic element of corporate governance is 'the Wall Street Rule.' If shareholders are unhappy with the performance of a company with an active market for its shares, they can always sell their shares. This Wall Street Rule undermines some other governance mechanisms, notably shareholder voting – shareholders have less reason to engage in costly voting and monitoring if they can simply sell their shares when unhappy. However, the Wall Street Rule itself helps to discipline managers. If shareholder's selling leads to a lower stock price, a corporation will find it more costly to raise funds through new issuances. Perhaps more significantly, lowered share prices hurt managers personally insofar as a large part of their compensation is received through shares and options, as is true for most corporations today. A low share price also makes a corporation more vulnerable to a hostile takeover.

Other markets also help discipline managers. Bond markets are a more important source of funding than stocks for public corporations, so that variations in the price of a corporation's bonds can crucially affect its costs of capital. Various contractual and market features in credit markets help discipline managers (Whitehead, 2012). The managerial labor market also affects corporate governance: for managers who seek more prestigious and higher paying future jobs, earning a good reputation is important. Labor markets for lower level employees also play a role: a corporation with a reputation as a good employer will be able to attract new employees at lower wages. Product markets also play a role: a well-run company will be able to offer quality good or services at lower prices, and as a result improve its profitability, while poorly run companies ultimately face the threat of bankruptcy as customers move to competitors.

A key underlying element in debates over corporate governance concerns how well these various markets tend to function as disciplinary devices for corporate management. Those who argue for relatively light legal regulation of corporate governance believe these markets do a good job, and hence regulation should be enabling and limited (Easterbrook and Fischel, 1991; Romano, 1993). Those who believe in more extensive and mandatory governance regulation see greater imperfections in these markets, although they do not deny the value of them as elements of corporate governance (Bebchuk, 1989).

International Differences

Corporate governance structures and practices as well as laws differ systematically between countries. A major factor driving these differences is variations in typical shareholding patterns, although these differences in shareholding patterns in turn are reinforced by various practices and laws.

Anglo-American

As noted above, large public corporations with dispersed shareholders and no controlling shareholder became more widespread and dominant in the United States than in any other country. Such corporations are also common in the United Kingdom, and to a lesser extent also exist in Australia and Canada. Such corporations face the conflict between managers and shareholders generally to a more intense degree than other corporations, but do not face a conflict between controlling and minority shareholders. Corporate governance practices and laws in Anglo-American jurisdictions are thus more adapted to the former conflict and less to the latter than the laws of other jurisdictions.

Some believe that there is also a systematic difference between corporate governance in countries with a common law tradition as opposed to those with a civil law tradition. A large literature on law and finance has grown up exploring this hypothesis. This literature hypothesizes that countries with a common law tradition tend to provide stronger protections for investors. This protection leads to deeper and more developed financial markets, which in turn encourages stronger economic growth (La Porta et al., 2008). The theory is controversial (Armour et al., 2009).

Europe and Japan

Corporate governance in continental Europe and Japan is the flip side of the Anglo-American countries. Controlling shareholders exist in most companies, and most countries have

a civil law background. Two other characteristics are particularly noteworthy for the two leading countries in this category, Germany and Japan. First, banks play an important role in corporate governance, through share ownership, lending, and board membership. Second, employees have greater influence in corporate governance, either formally through codetermination in Germany or informally through the influence of senior management in Japan (Aoki, 1987).

Emerging Economies

With strong economic growth in emerging economies, especially China and India, corporate governance in those economies is of growing importance. The basic legal rules for the most part resemble those in more developed economies, although in many emerging economies the quality of court and agency enforcement is questionable. The general tendency is for controlling shareholders to be able to exploit their positions more fully in such economies, as both legal and nonlegal mechanisms provide weaker protections (Dyck and Zingales, 2004).

Corporate governance in China is of particular interest, both because of China's great and growing economic power and because of the still large role of the state (Yang et al., 2011). Many of China's largest corporations are SOEs, with a branch of the state as the controlling shareholder. Corporate governance challenges are heightened in such SOEs, as noted above. Even in nominally private corporations, informal state influence is strong, as the rule of law remains weak and patronage from state officials is important to protect companies from potential predation.

Recent Developments

In the last decade or two there have been a number of major developments in corporate governance, both in the United States and internationally. These developments affect all of the major means of corporate governance discussed above in Means section.

Institutional Shareholder Activism

A growing percentage of the shares of American public corporations are owned by institutions rather than individuals. Some types of institutions have engaged in forms of shareholder activism aimed at influencing corporate governance without trying to gain actual control of a corporation as in the older phenomenon of hostile takeovers. Union and public employee pension funds have been the traditional sources of such shareholder activism, although more recently some hedge funds have also become participants.

Activist shareholders have engaged in two basic kinds of formal campaigns, along with more informal attempts to communicate their opinions to managers. One kind of activism uses shareholder proposals under Rule 14a-8 to attempt to get shareholders collectively to express their opinions on a topic. Traditionally 14a-8 proposals have been nonbinding, although more recently shareholders have proposed bylaw amendments which if passed would be binding upon management. Shareholder proposals have covered a range of topics, from staggered boards to majority voting for directors to executive compensation to proxy access, among others. The other kind of activism attempts to elect shareholder nominees to the board. A major recent legal debate has concerned whether corporations must include shareholder nominees within the corporation's proxy material (so-called proxy access). The US law has not traditionally required proxy access. In 2010, the Securities and Exchange Commission (SEC) enacted a rule requiring proxy access, but it was struck down by the D.C. Circuit Court of Appeals. Currently proxy access is not required, although shareholders may propose bylaws that would require proxy access within a particular corporation. The Dodd-Frank Act added a new limited shareholder voting power: shareholders now have a nonbinding vote on the compensation of the top officers of a corporation. There is much debate over the effect and desirability of these forms of shareholder activism (Ferri, 2012).

Independent Directors

As noted in Section The Board of Directors, both exchange rules and securities laws impose independence requirement on directors of American public corporations. These requirements are recent developments. The exact definition of independence varies somewhat for each rule, but all require that a director not have been employed by the corporation within a certain period of time, and limit other financial ties to the corporation. These rules have been enacted in response to recent financial crises. The first sets of independence requirements were enacted in response to the dotcom crash of 2000. In 2002, the Sarbanes-Oxley Act required that boards have an audit committee which oversees the audit process, and that all members of the audit committee must be independent. In 2003, the New York Stock Exchange and Nasdaq imposed independence requirements for the directors of listed companies. These require that a majority of the board must be independent, and that companies must have compensation, audit, and nomination/governance committees composed entirely of independent directors. The last enactment requiring board independence is part of financial reform regulation enacted following the financial crisis of 2008. In 2010, the Dodd-Frank Act required that compensation committee members all must be independent.

The Rise and Fall of Good Faith

As mentioned in Section Fiduciary Duty, Antifraud Rules, and Shareholder Suits, Delaware courts over the past decade or so have paid increasing attention to the good faith requirement as an aspect of fiduciary duty. Several earlier developments encouraged plaintiffs to plead that defendants had acted in bad faith. If a plaintiff shows a decision or judgment was not in good faith, that decision loses the protection of the business judgment rule, which normally protects directors from liability. Moreover, behavior not in good faith is not covered by the exemption from personal liability that most corporations have adopted as allowed by section 102(b)(7) of the Delaware corporate law. Thus, if plaintiffs succeed in showing that behavior was not in good faith, they avoid two of the main obstacles that usually block them from holding directors

personally liable. Courts have thus had to define what is covered by 'good faith.'

In the *Disney* case concerning the compensation of Michael Ovitz, the court stated that "failure to act in good faith may be shown. . . where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties" (*In re Walt Disney Co. Deriv. Litig.*, 960 A.2d 27, 67 (Del. 2006)). Courts have also used the good faith rubric to analyze a board's duty to monitor behavior by lower level employees. The intentionality requirement in the *Disney* standard has proven to impose a very high barrier to finding directors liable (Hill and McDonnell, 2012).

Gatekeepers

Section Gatekeepers noted a variety of gatekeepers who play an important role in corporate governance. American legal regulation of these gatekeepers evolved significantly in recent years. Regulation of gatekeepers played a major role in the main statutory responses to the two financial crises of the 2000s.

The Sarbanes-Oxley Act, the legal response to the dotcom crash of 2000, focuses above all on gatekeepers. Outside auditors receive the greatest attention. The Act created a new independent agency to regulate auditors, the Public Company Accounting Oversight Board. It also required audit partners to rotate after five years, and limited the kinds of nonaudit services auditors could provide their audit clients. Sarbanes-Oxley required the SEC to promulgate new rules requiring lawyers to report securities law violations up the ladder within the hierarchy of their clients. Sarbanes-Oxley also led the SEC to promulgate Regulation AC, under which research analysts must disclose compensation received in connection with their recommendations.

The other, greater crisis of the 2000s was the 2008 financial crisis, and the legislative response was the Dodd-Frank Act. The main new gatekeeper regulation in Dodd-Frank concerned credit rating agencies, containing many relevant provisions. Administrative agencies are required to remove references to credit ratings from a variety of regulations. Rating agencies are now potentially more exposed to liability for mistakes in ratings. There are new internal control requirements, and a variety of new disclosure requirements.

Federalization

Rules affecting corporate governance in the United States have long been made at both the federal and the state law. However, the core laws creating and governing the corporate law, the basic corporation laws, are set at the state level. Corporations can choose to incorporate in any state, no matter how limited their economic involvement in that state. This has led to a long debate as to whether the competition for corporate charters has led to a race to the bottom (Cary, 1974) or to the top (Winter, 1977).

Until recently, federal rules affecting corporate governance were mostly limited to disclosure and antifraud rules in certain contexts surrounding the issuance and trading of securities. One longstanding exception to this limitation is the proxy voting rules, which have for decades played a major role in structuring shareholder voting procedure for public corporations. However, federal involvement in corporate governance became more broad and widespread in the 2000s with the Sarbanes-Oxley and Dodd-Frank Acts. The previous subsections detail how those acts have affected board independence, shareholder voting, and the regulation of gatekeepers.

OECD Principles

Internationally, one of the most salient recent developments has been the promulgation in 1999 and subsequent spread of the Organization for Economic Cooperation and Development (OECD) Principles of Corporate Governance (OECD, 2004). These principles contain broad standards which both companies and countries are expected to strive to meet. These standards are divided into six categories: ensuring the basic for an effective corporate governance framework, the rights of shareholders, the equitable treatment of shareholders, the role of stakeholders, disclosure and transparency, and the responsibilities of the board.

Convergence

A longstanding debate asks whether the corporate governance systems of different countries are tending to converge toward each other, and whether they should converge. Over time, different countries have been seen as providing the best model to which others do or should aspire. In the 1980s it was Japan; in the 1990s, it was the United States. Some have seen signs of significant convergence, either in legal form or in underlying functional reality (Kraakman et al., 2009). Others are more skeptical of the reality of convergence, or whether the question is even well-posed in the literature (Clarke, 2010). There is much debate as to how to measure the performance of different corporate governance systems. The debate reveals much normative disagreement as to what one should be trying to accomplish through corporate governance, as well as empirical disagreement as to what different systems actually do accomplish. It remains a mystery as to where the corporate governance systems of different companies and countries are headed.

See also: Agency Theory; Corporate Culture; Corporate Finance: Financial Control; Management: General; Stockholders' Ownership and Control.

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