Introduction

What Is Corporate Governance?

The tug of war between individual freedom and institutional power is a continuing theme of history. Early on, the focus was on the church; more recently, it is was on the civil state. Today, the debate is about making corporate power compatible with the needs of a democratic society. The modern corporation has not only created untold wealth and given individuals the opportunity to express their genius and develop their talents but also has imposed costs on individuals and society. How to encourage the liberation of individual energy without inflicting unacceptable costs on individuals and society, therefore, has emerged as a key challenge.

Corporate governance lies at the heart of this challenge. It deals with the systems, rules, and processes by which corporate activity is directed. Narrow definitions focus on the relationships between corporate managers, a company's board of directors, and its shareholders. Broader descriptions encompass the relationship of the corporation to all of its stakeholders and society, and cover the sets of laws, regulations, listing rules, and voluntary private-sector practices that enable corporations to attract capital, perform efficiently, generate profit, and meet both legal obligations and general societal expectations. The wide variety of definitions and descriptions that have been advanced over the years also reflect their origin: lawyers tend to focus on the contractual and fiduciary aspects of the governance function; finance scholars and economists think about decision-making objectives, the potential for conflict of interest, and the alignment of incentives, while management consultants tend to adopt a more task-oriented or behavioral perspective.

Complicating matters, different definitions also reflect two fundamentally different views about a corporation's purpose and responsibilities. Often referred to as the "shareholder versus stakeholder" perspectives, they define a debate about whether managers should run a corporation primarily or solely in the interests of its legal owners—the shareholders (the shareholder perspective)—or whether they should actively concern themselves with the needs of other constituencies (the stakeholder perspective).

This question is answered differently in different parts of the world. In Continental Europe and Asia, for example, managers and boards are expected to concern themselves with the interests of employees and the other stakeholders, such as suppliers, creditors, tax authorities, and the communities in which they operate.

Reflecting this perspective, the Centre of European Policy Studies (CEPS) defines corporate governance as “the whole system of rights, processes and controls established internally and externally over the management of a business entity with the objective of protecting the interests of all stakeholders.”[1]

In contrast, the Anglo-American approach to corporate governance emphasizes the primacy of ownership and property rights and is primarily focused on creating “shareholder” value. In this view, employees, suppliers, and other creditors have rights in the form of contractual claims on the company, but as owners with property rights, shareholders come first:

Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.[2]

Perhaps the broadest, and most neutral, definition is provided by the Organization for Economic Cooperation and Development (OECD), an international organization that brings together the governments of countries committed to democracy and the market economy to support sustainable economic growth, boost employment, raise living standards, maintain financial stability, assist other countries’ economic development, and contribute to growth in world trade:

Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.[3]

The Evolution of the Modern Corporation

Corporations have existed since the beginning of trade. From small beginnings they assumed their modern form in the 17th and 18th centuries with the emergence of large, European-based enterprises, such as the British East India Company. During this period of colonization, multinational companies were seen as agents of civilization and played a pivotal role in the economic development of Asia, South America, and Africa. By the end of the 19th century, advances in communications had linked world markets more closely, and multinational corporations were widely regarded as instruments of global relations through commercial ties. While international trading was interrupted by two world wars in the first half of the twentieth century, an even more closely bound world economy emerged in the aftermath of this period of conflict.

Over the last 20 years, the perception of corporations has changed. As they grew in power and visibility, they came to be viewed in more ambivalent terms by both governments and consumers. Almost everywhere in the world, there is a growing suspicion that they are not sufficiently attuned to the economic well-being of the communities and regions they operate in and that they seek to exploit their growing power in relation to national government agencies, international trade federations and organizations, and local, national, and international labor organizations.

The rising awareness of the changing balance between corporate power and society is one factor explaining the growing interest in the subject of corporate governance. Once largely ignored or viewed as a legal formality of interest mainly to top executives, boards, and lawyers, corporate governance for some time now has been a subject of growing concern to social reformers, shareholder activists, legislators and regulatory agencies, business leaders, and the popular press.

Shareholders, increasingly upset about outsized executive compensation deals and other governance issues, argue that too many boards are beholden to management and neglect shareholder interests. CEOs complain that having to play the "Wall Street expectations" game distracts them from the "real" strategic issues and erodes their companies' long-term competitiveness. Employees worry about the impact of management practices, such as off-shoring and outsourcing on pay, advancement opportunity, and job security. Meanwhile, outside stakeholders, focused on issues such as global warming and sustainability, are pressing for limits on corporate activity in areas like the harvesting of natural resources, energy use, and waste disposal. Increasingly, they are joined by civic leaders concerned by the continuing erosion of key societal values or threats to the health of their communities.

Behind these concerns lie a number of fundamental questions. Who "owns" a corporation? What constitutes "good" governance? What are a company's responsibilities? To shareholders? To other stakeholders, such as employees, suppliers, creditors, and society at large? How did Wall Street acquire so much power? And, critically, what are the roles and responsibilities of boards of directors?

About This Book

This book sets out to answer these kinds of questions and to provide a framework for analyzing today's corporate governance challenges. It is written for executives who wish to prepare themselves to work with or serve on a board of directors and seek to broaden their perspective from a focus on management to one on governance. It is organized in two major section, an epilogue, and appendices.

The first section looks at corporate governance from a macro perspective. In Chapter 1 "Corporate Governance: Linking Corporations and Society", we describe the U.S. corporate governance system and its principal actors and briefly survey the history of corporate governance in the United States, including the wave of governance scandals that occurred around the turn of the century. Chapter 2 "Governance and Accountability" delves deeper into the philosophical questions of ownership and accountability and asks, "Who owns the corporation?" It contrasts the shareholder and stakeholder perspectives and tries to find common ground between the two. Chapter 3 "The Board of Directors: Role and Composition" focuses on the role of the board and provides an overview of recent trends in board composition, structure, and leadership. Chapter 4 "Recent U.S. Governance Reforms" takes a close look at the flurry of reforms adopted in the last 10 years. This analysis shows just how much effective corporate governance depends on a delicate balance of power—among shareholders, directors, managers, and regulators—and on properly aligned incentives, clearly defined accountability and transparency, and last but not least, a steady ethical compass.

The second section takes a micro perspective and contains six chapters—each focused on major board responsibilities: Chapter 5 "CEO Selection and Succession Planning" discusses CEO selection and succession planning; Chapter 6 "Oversight, Compliance, and Risk Management" takes up a board's responsibilities in the areas of oversight, compliance, and risk management; Chapter 7 "The Board's Role in Strategy Development" focuses on the board's role in strategy development for the organization; Chapter 8 "CEO Performance Evaluation and Executive Compensation" deals with the issue of CEO performance appraisal and executive compensation; Chapter 9 "Responding to External Pressures and Unforeseen Events" describes the board's challenges in dealing with unexpected events and crises; and Chapter 10 "Creating a High-Performance Board" analyzes a board's most difficult challenge—managing itself.

The last section consists of an epilogue and looks at the future and deals with subjects that are just beginning to appear on corporate agendas. It analyzes the emerging global convergence of governance systems, requirements, and practices; it looks at the prospects of further U.S. governance reform; and it discusses the changing relationship between business and society and its likely impact in the boardroom.

Endnotes

1. Centre of European Policy Studies (CEPS; 1995), as reported in Shleifer and Vishny (1997).
2. European Corporate Governance Institute (1992).
3. Organization for Economic Cooperation and Development (OECD; 1999).
4. Agency theory explains the relationship between principals, such as shareholders and agents, like a company's executives. In this relationship, the principal delegates or hires an agent to perform work. The theory attempts to deal with two specific problems: first, that the goals of the principal and agent are not in conflict (agency problem) and second, that the principal and agent reconcile different tolerances for risk.