PRIVATE LAW

Creating the Responsible Firm: In Search for a New Corporate Governance Paradigm

By Peter Cornelius and Bruce Kogut

A. Introduction[1]

The term corporate governance has come to mean many things to many people. One important reason is that views continue differ as to the fundamental question of the role the firm. While some believe that corporations can contribute best to society if they do what they do best, namely to provide high quality goods and services to the marketplace, for others corporate responsibilities are much broader.

B. Shareholders v. Stakeholders?

How companies are governed is, however, a different issue. A dominant view of corporate governance is the primacy of the *shareholder's* interestes in the residual profits of a firm and hence a right to exercise control over management. Traditionally, the widely held firm, the "Berle and Means firm," represents the standard assumption for the formulation of the corporate governance problem – that weak, dispersed shareholders have to deal with self-interested management.[2] To many investors, fund managers, and investment managers, the meaning has essentially remained unchanged: this is how companies treat shareholders, particularly minority shareholders. As Mark Möbius, of Templeton Asset Management, puts it:

"Once a fair treatment of the shareholder is in place, and once shareholders have their proper share in deciding the future of the company in which they are invested, other interests will fall into place since issues such as treatment of labour, care for the

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[1] This paper is a slightly different version of a presentation delivered by Peter Cornelius at the Second European Corporate Governance Conference held in Brussels on November 28-29, 2002. The paper is based on the forthcoming study CORPORATE GOVERNANCE AND CAPITAL FLOWS (New York: Oxford University Press), edited by the authors of the present paper.

[2] *See*, Adolf Berle and Gardiner Means, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

https://doi.org/10.1017/S207183220001573X Published online by Cambridge University Press

environment, and other social issues, will take their rightful place as crucial issues that impinge on the company's success." [3]

This right to control has a clear logic. Since the *shareholder* is the last claimant to profit, he or she should have the right, and has the incentive, to monitor management. The argument of Berle and Means, made in the 1930s, is that American firms have largely dispersed shareholders who cannot closely monitor the firm. However, there are mechanisms by which delegates can be appointed to serve this role. These include the appointment of directors to the board, the right to call shareholder meetings, the requirement of external auditors to verify reports, and covenants that require shareholder votes for certain measures, such as mergers. In fact, these rights are often weaker than stated, but in all, they represent the rights of *shareholders* to govern the firm.

The Enron scandal reflects, from this view, the peculiar weakness of the American financial system: many owners but few guards. Recent analyses have stressed the weakened incentives for "gatekeepers" of auditors and analysts.[4] The larger issue is, however, whether there is a chronic problem in *stakeholder* oversight. The dilemma is the classic Berle and Means observation: under dispersed ownership, who controls management?

For many countries, this dilemma does not arise because shares are held by a concentrated number of shareholders. In many stock markets, the capitalization of shares is controlled by a few families or business groups. In this environment, the problem shifts from the American problem of managers uncontrolled by shareholders to minority investors exploited by large shareholders. From this perspective, it may be correct to conclude that the Enron scandal is peculiar to the American system. However, the *shareholder* perspective would nevertheless ruthlessly point to abuse of minority investors as a critical weakness hindering equity market development elsewhere.

By contrast, the *stakeholder* theory is the prevailing spirit of most corporate governance laws in the world, despite its controversial status in the United States and in stock market based economies. Perhaps because of this controversy, the United States in particular has been leading the international debate between

[3] Mark Möbius, *Corporate Governance: Responsibilities of Fund Managers and Institutional Investors*, *in* CORPORATE GOVERNANCE AND CAPITAL FLOWS IN A GLOBAL ECONOMY (Peter K. Cornelius and Bruce Kogut eds., forthcoming).

[4] *See, e.g.*, John C. Coffee, Jr., *What Caused Enron?: A Capsule Social and Economic History of the 1990s*, *in* CORPORATE GOVERNANCE AND CAPITAL FLOWS IN A GLOBAL ECONOMY (Peter K. Cornelius and Bruce Kogut eds., forthcoming).

https://doi.org/10.1017/S207183220001573X Published online by Cambridge University Press

shareholder and *stakeholder* positions, beginning with the important debate between Berle and Dodd in the early 1930s regarding the social responsibility of the firm.[5] The stakeholder theory argues that many entities in society should have a voice in the governance of a firm: workers, environmentalists, community organizations. Of course, in many countries, this theory is enacted into law, such as the "*Mitbestimmung*" (workers codetermination) law in Germany requiring worker representation in supervisory boards of large public cooperations. Even in the United States, boards of directors are not directly liable to shareholders, but to the long-term interest of the firm. Boards actively pursue directors who contribute *diversity*, short-hand for representing different racial and social perspectives.

Since the 1930s, the *stakeholder* view of the firm has known many reincarnations, including a theory of strategic management. One of the most prominent proponents of the stakeholder view, Professor Margaret Blair at the Brookings Institution, argues that employees embody human capital, some of which is "firm specific" and that cannot be transplanted to other firms.[6] As a result, they are *de facto* investors in the company. It is also in the company's interest to recognise the value of their employees as capital. "The rhetoric of 'ownership' (…) subtly redefines corporations in terms of the presumed property rights of one class of participants in the firm, thereby adding a tone of moral superiority to the idea that corporations should be run in the sole interest of shareholders that is not implied by the nexus of contracts theory alone…Corporate employees (…) make investments in specialized knowledge and networks of relationships needed in their jobs as well as in developing a reputation within the firm for working hard…If the firm does well, the employee hopes to benefit from these specialized investments over the long term as the employee earns promotions and the firm continues to pay salaries, bonuses and retirement benefits."[7]

Professor Mary O'Sullivan at INSEAD expresses a similar view, namely that corporate governance practices influence the capabilities of firms.[8] Since firms are 'learning organisations', the evolution of competitive advantages is not indifferent to the governance of the firm and, in particular, to the role of workers in this

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[5] *See*, A. A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARVARD LAW REVIEW 1049 (1931); E.M. Dodd, *For Whom are Corporate Managers Trustees?*, 45 HARVARD LAW REVIEW 1145 (1932).

[6] *See*, Margaret M. Blair, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY (Washington, D.C.: The Brookings Institution).

[7] Margaret M. Blair, *Shareholder Value, Corporate Governance and corporate Performance: A Post-Enron Reassessment of the Conventional Wisdom*, *in* CORPORATE GOVERNANCE AND CAPITAL FLOWS IN A GLOBAL ECONOMY (Peter K. Cornelius and Bruce Kogut eds., forthcoming).

[8] *See*, Mary O'Sullivan, *Employees and Corporate Governance*, *in* CORPORATE GOVERNANCE AND CAPITAL FLOWS IN A GLOBAL ECONOMY (Peter K. Cornelius and Bruce Kogut eds., forthcoming).

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governance. Firms develop their advantages in reference to competition in their industries and to the institutional demands of their environments (such as labour law or financial markets). Corporate governance is thus not simply the perspective of top management; it is the framework by which corporations develop their competence and capabilities. *Stakeholder* involvement guides this development and hence is more than just an additional monitor or gatekeeper added to the board of directors.

C. Enron - and Beyond

Both the traditional view of *stakeholders* and the Blair/O'Sullivan version speak directly to the Enron case. Due to the collapse of Enron and Andersen, hundreds of thousands of workers lost their jobs. Many, but far from all, found comparable employment elsewhere. Moreover, the Enron employees lost much of their pension investments that were heavily concentrated in investments in Enron stock. The *stakeholder* perspective would suggest that workers deserved representation in the board (or relevant oversight committees) in order to safeguard their human capital and pension investments.

But the *stakeholder* approach doesn't stop there: To others, corporate governance concerns the behaviour of corporations in their community regarding the environment, treatment of child labour, and so on. While non-governmental institutions have remained at the forefront of the corporate responsibility debate, others have increasingly begun to embrace a broader *stakeholder* view as well. One example is Michael Philipps, the chief executive officer of Frank Russell, an institutional investment advisor and asset manager, who stated:

> *"The time has come for companies to show that they are good corporate citizens, pursuing a value-centered approach. Companies must take a share of the responsibility for attempting to redress some of the great humanitarian challenges. The CEOs of companies should be willing to look shareholders in the eye and tell them: "We are not seeking financial return maximisation and mere compliance. We aspire to a higher, more complex set of values and, yes, there may be a small reduction in shareholder return as a result."* [9]

Countries differ in their cultural and historical backgrounds and their political conditions. As a result, corporate governance systems can be expected to continue

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[9] Michael J. Philipps, *Corporate Values, Enterprise Risk, and the Board*, *in* CORPORATE GOVERNANCE AND CAPITAL FLOWS IN A GLOBAL ECONOMY (Peter K. Cornelius and Bruce Kogut eds., forthcoming).

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to differ, too.[10] One system need not dominate another; they correspond to different national preferences and industrial composition. However, for a given form, there exist specific practices that are better than others. Corporate governance as practice – as opposed to a corporate governance systems – may be defined as follows: Corporate governance practices are those rules that apply to specific financial markets and organizational forms and establish the rights of owners, and the information and mechanisms at their disposal, to control management and employees. These practices for the public firm include the determination of the board of directors and its powers and voting rules, protection of minority investors, the publication of audited accounts, covenants restricting managerial actions such as the sale of assets, and the distribution of profits. Such practices will differ among partnerships, limited liability companies, and other organizational forms.

Notwithstanding important differences between corporate governance systems, good corporate governance may be perceived as a necessary, but not a sufficient condition for corporate responsibility. Corporate responsibility requires good governance, but it requires more than that. Having in place the right board, a high degree of transparency, and mechanisms that ensure shareholder rights and especially the protection of minority shareholders, does not represent a guarantee that the company actually behaves in a socially and environmentally responsible manner. Conversely, without these ingredients, it is hard to expect companies to act responsibly.

Although the debate over corporate responsibility has remained highly controversial, corporate codes of conduct on human rights, labour standards, and environmental performance are proliferating. In 2001, for example, not fewer than 24 companies from 13 countries joined the World Business Council for Sustainable Development, including such prominent players as Allianz, Honda, ING, Coca-Cola, and L'Oreal.[11] In 2002, the World Economic Forum launched a task force on Global Corporate Citizenship, which, in partnership with the Prince of Wales International Business Leaders Forum, developed a joint statement stressing three points:[12]

"First and foremost, our companies' commitment to being global corporate citizens is about the way we run our own businesses. The greatest contribution we can make to development is to do business in a manner that obeys the law, produces safe and cost

[10] For a detailed discussion, *see*, Lutgart van der Berghe, CORPORATE GOVERNANCE IN A GLOBALISING WORLD: CONVERGENCE OR DIVERGENCE? A EUROPEAN PERSPECTIVE (2002).

[11] *See*, http://www.wbcsd.ch/aboutus/members.htm.

[12] *See*, http://www.weforum.org/pdf/GCCI/GCC_CEOstatement.pdf.

https://doi.org/10.1017/S207183220001573X Published online by Cambridge University Press

effective products and services, creates jobs and wealth, supports training and technology corporation and reflects international standards and values in areas such as the environment, ethics, labor and human rights.

Second, our relationships with key stakeholders are fundamental to our success inside and outside our companies.

Third, ultimate leadership for corporate citizenship rests with us as chief executives, chairmen and board directors…Some of us will use the terminology of corporate citizenship, others of corporate social responsibility, ethics, triple-bottom line or sustainable development, but we believe in the core principles and actions required are the same. First, provide leadership. Second, define what it means for your company. Third, make it happen. Fourth, be transparent about it."

The list of signatories include business leaders from a wide range of industries and many different countries representing various levels of economic development; suggesting that the corporate ethics crusade has become a global phenomenon. Have they just reacted to growing pressure by nongovernmental organizations (NGOs), activist shareholders, and portfolio managers of socially responsible investment funds, as Ethan Kapstein has recently argued? [13] "Morality is the attitude we adopt towards people we don't like," Oscar Wilde once said, and there exist numerous examples that NGOs have put rising pressure on companies to change their business practices 'voluntarily'. That this pressure can be very powerful can hardly be disputed.

One important factor that has certainly contributed to the new attitude of many CEOs is increased globalization. Globalization creates new opportunities for business. The private sector enjoys growing freedom, because with its rapidly growing edge in technology, organisation and resources, it is in a position to benefit from the opening of markets. But there is no free lunch: more freedom calls for more responsibility. Clients, consumers, shareholders, and others realize that globalization raises new questions about a company's impact on society at large. Higher standards for responsible business conduct – often beyond legal requirements – are being demanded. Politics and civil society are sending out increasingly strong signals of discontent, mistrust, or at the very least skepticism.

But apart from reacting to growing pressure, it has been argued that it pays to be 'green' and to act in a socially responsible manner. If that's true, it makes a lot of

[13] *See*, Ethan B. Kapstein, *The Corporate Ethics Crusade*, FOREIGN AFFAIRS, September/October, 2001, pp. 105-119.

https://doi.org/10.1017/S207183220001573X Published online by Cambridge University Press

sense for companies and investors to genuinely embrace corporate social responsibility as an integral part of doing business.

Unfortunately, the case that corporate responsibility outperforms – "doing good while doing well" - is not easy to make. On a risk-adjusted basis, the Dow Jones Global Index and the Dow Jones Sustainability Index have essentially shown the same performance over the last 5 years.[14] There are numerous studies for individual industries and even for countries providing evidence for the claim that environmental performance is correlated with economic performance.[15] Whether there is a causal relationship from environmental performance to economic performance is, however, much more difficult to establish.

Although socially responsible investment (SRI) is increasingly becoming mainstream, that doesn't mean that economic and financial performance no longer matters. Opening a 250 million dollar SRI fund to other investors, *ABP*, the largest Dutch pension fund, made clear that they will not be abandoning fundamental financial analysis. "There is no room for socially initiated investments if such investments do not meet the return requirements."[16]

The crux of the matter is, however, that financial analysis continues to be based on traditional accounting practices that do not reflect social or environmental issues. Today's typical corporate sustainability report resembles the front half of an annual report to shareholders. It relates anecdotes and facts about particular initiatives, indicating that the firm is managerially astute and socially well-meaning. It does not, however, contain much information that is comparable across firms or that can be integrated with the financial reports. This omission from the front half of the annual report to shareholders is inconsequential because of the presence, in the back half of the report, of audited data constructed according to accounting principles, which themselves are generally understood and thought to be broadly replicable across firms.

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[14] For a detailed analysis, *see*, Alois Flatz, *Corporate Sustainability and Financial Indexes*, *in* ENVIRONMENTAL PERFORMANCE MEASUREMENT. THE GLOBAL REPORT 2001-2002, pp. 66-81 (Daniel C. Esty and Peter K. Cornelius eds., 2002).

[15] *See, e.g.*, Frank Dixon, *Financial Markets and Corporate Environmental Results*, *in* ENVIRONMENTAL PERFORMANCE MEASUREMENT. THE GLOBAL REPORT 2001-2002, pp. 54-65 (Daniel C. Esty and Peter K. Cornelius eds., 2002); Daniel C. Esty and Michael E. Porter, *Ranking National Environmental Regulation and Performance: A Leading Indicator of Future Competitiveness?*, *in* THE GLOBAL COMPETITIVENESS REPORT 2001-2002, pp. 78-101 (Michael E. Porter, Jeffrey D. Sachs, Peter K. Cornelius, John W. McArthur, and Klaus Schwab eds., 2002).

[16] *ABP to Open $250m SRI Fund to Other Investors*, FINANCIAL TIMES – SUPPLEMENT ON FUND MANAGEMENT, p. 1 (October 28, 2002).

https://doi.org/10.1017/S207183220001573X Published online by Cambridge University Press

If firms and governments are serious about sustainable development, their most pressing job is to make progress in designing similar structures for the reporting of data relevant to sustainability. Comprehensive compilations of potential externalities like those advocated by the *Global Reporting Initiative* are part of this agenda, but a necessary complement is the development of pricing systems for the externalities, positive and negative, that are most likely to have significant effects on the outcomes of the tests for sustainability.[17]

If business executives are really worried about sustainability, they should examine those parts of their operations in which social and private costs may diverge widely, those parts of their operations in which a large fraction of profit is resource rent, and those parts of their operations that are only marginally profitable. Firms whose current operations benefit from unsustainable environmental subsidies in the form of inefficiently lax regulation are no different from those that benefit from more direct government handouts: they should be thinking about how they will make a transition to activities that are sustainable in the traditional business sense of the term.

[17] On this debate, *see*, Forest Reinhardt, *Tests for Sustainability*, *in* THE GLOBAL COMPETITIVENESS REPORT 2002-2003 (Peter K. Cornelius ed., forthcoming).

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