Focus on corporate governance

The recent collapse of Enron has revived interest in the subject of corporate governance. How are our large corporations run, by whom, and for whose benefit? What obligations do they owe their shareholders, workers, customers and society at large? While attention so far has tended to focus on Enron, many are beginning to argue that corporate governance in general needs to occupy a more prominent position in our thinking. In this article, Hank Boerner defines corporate governance, traces its origins back to the early twentieth century, and discusses the issues that matter most today.

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Corporate governance is a term that has come to be used frequently in the business and popular press, most recently because of Enron's collapse. Robert Litan, a leading economic scholar with the Brookings Institution in Washington DC, described that scandal as "a massive

failure in the governance system." But what exactly is "the governance system"? What does "corporate governance" mean?

The OECD defines corporate governance as a "system by which corporations are directed and controlled. This includes the specific distribution of rights and responsibilities among the board, managers, shareholders and other stakeholders." TIAA-CREF, the largest pension fund in the US, defines its own aproach more broadly:

> As responsible, long-term investors, we recognise the overriding interest that our economy and society have in the long-term development and vitality of our public corporations. TIAA-CREF believes that certain principles are the hallmark of an equitable and efficient corporate governance structure. Good corporate governance must be expected to maintain an appropriate balance between the rights of shareholders (owners) and the need of management and the board to direct the corporation's affairs free from distracting short-term pressures.

The fund's trustees have outlined a number of issues, beyond structure, management and organisation, by which the corporations it invests in are to be judged. TIAA-CREF's influence is very powerful in the US: both corporate managers and corporate governance advocates listen to what it says, as do corporate responsibility activists.

Governance and accountability

The above definitions of corporate governance reflect an important division that has emerged in the past decade in what is generally known as "the corporate governance movement". Traditional corporate governance advocates tend to focus on issues relating to internal governance: the composition and compensation of the board of directors, shareholder voting rights, managers' stock option plans, and other similar topics. The OECD statement is typical of this approach.

Other advocates - not necessarily shareholders - focus on the general behaviour of corporations. The views of these activists generally take into account wider social and political issues. This approach can be termed the "corporate accountability movement."

Throughout the 1990s, the two groups often joined forces in an effort to

change corporate behaviour and make managers and boards more accountable, both to shareholders and stakeholders.

Undoubtedly, if corporate leaders listen to anyone, it is likely to be large, institutional investors and powerful corporate governance advocates presenting demands for internal governance reform and changes to some aspects of external behaviour. However, non-governmental organisations (NGOs), not-for-profit groups and some for-profit organisations can also influence corporate governance, particularly when they focus on high-profile corporate issues, and on well-known corporations.

External campaigners most commonly focus on issues relating to corporate behaviour, such as the effect of a company's products, services or marketing activities on consumers or the environment; how minorities or women are treated by employers; international issues (doing business in certain nations); and pricing practices for vulnerable populations (such as pharmaceutical pricing and the elderly).

Corporate governance advocates are likely to be concerned by the kind of pressure activists apply and by how external criticism affects either the top or bottom line. With the example of seeling baby food formulas to mothers in developing nations, such sales could be an important source of revenue, and perhaps an important component of a company's profits. They could also be a reflection of the "values" expressed by the company's managers. The outcome of the struggle between a corporation and its critics would ultimately affect the fortunes of shareholders.

Corporations are being lobbied by an ever-broadening range of groups, both about matters relating to traditional corporate governance and wider issues of social responsibility. Nowadays, for example, an investor from a religious order might address issues relating both to corporate governance and social accountability by asking a major retailing organisation to implement and monitor an overseas supplier code of conduct, and to link executive pay to the progress the company makes in such a policy.

Given this changing environment, it is not always easy to sort out the most critical issues from inside the corporation. Managers and boards often ask, "Who are these people? And what do they want?" The answer is that most pressure groups demand greater accountability in the

boardroom, and a demonstration of greater responsibility in the marketplace. Both kinds of group believe that, in the end, good behaviour will increase shareowner value.

A brief history of governance

The emergence of corporate governance issues parallels the rise of the modern corporation. "Joint stock companies", usually chartered by governments, were created in the 1800s. In the US, the break-up of the giant Standard Oil Trust in the early 1900s was an early development in the areas of corporate governance and social responsibility. The modern, industrialised US economy developed as small entrepreneurial enterprises evolved into very large stockholder-owned corporations: General Motors, General Electric, RCA Corporation. Shareowners in these companies demanded a voice in company affairs - after all, they "owned" a share of the enterprise. In democratic nations, "owners" are also "voters", and even the powerful and autocratic carmaker Henry Ford was challenged by his early shareholders (who in fact had very few legal rights compared with contemporary investors).

Legislation in 1933 and 1934 gave shareholders a voice in corporate affairs, and certain rights as "owners". In recent years, corporate governance advocates - particularly public employee pension fund investors - have tended to focus on issues such as greater independence for the board of poorly performing companies, and the quicker removal of underperforming chief executive officers. Pressure applied by advocates and large institutional investors have resulted in changes of leadership at several major companies. In the early 1990s, of a number of high profile chief executives, including the heads of General Motors, IBM, Westinghouse, Eastman Kodak and American Express, were replaced.

The initial focus on lagging financial performance and the compensation packages of chief executives broadened throughout the 1990s to include a wider range of "social" concerns, including such issues as workplace diversity, glass ceilings for women, human rights abuses, sweatshop conditions, pollution, environmental degradation, the overseas sales of military goods, youth access to tobacco, and employee codes of conduct.

In 2001, shareholder measures were introduced in the US to address clean energy, genetically engineered agricultural products, products

containing the PVC compound, equal opportunities, drilling for oil in the Arctic National Wildlife Refuge in Alaska, predatory lending, mandatory reporting on greenhouse gas emissions, overseas contractor employment (for example, slave labour, prison labour, child labour, pay scales), and workplace violence.

Public institutional investors continue to focus on traditional corporate governance issues. These include board endorsement of the CERES Principles on socially responsible behaviour; efforts to create more diverse and inclusive boards of directors; the freezing of executive pay during periods of downsizing; and the creation of board-nominating committees to encourage independence.

Many issues are now being debated in the arenas of social responsibility and corporate accountability. Shareholder resolutions currently address investment in tobacco companies; sales of baby food formula overseas; the manufacture of chlorine-free paper; female promotion policies; living wages for foreign workers; prohibition of child labour; the purchasing of goods from offshore sweat shops; workplace diversity; abolishment of racial discrimination practices; greater workplace safety; board and executive suite diversity; fair lending practices; protection of international human rights; and prohibition of business with dictatorships (eg. Myanmar).

Conclusion

The modern corporate structure was defined by Adolf Berle and Gardiner Means of Columbia University in the 1930s, in their seminal work ***The Modern Corporation and Private Property***. They recognised the separation of control and ownership, and said that the stockholders surrendered "disposition of use of the enterprise to those in control" (by which they meat senior managers and the board). Addressing the future of the US corporation, Berle and Means also said: "This [corporate] system bids fair to be as all-embracing as was the feudal system of its time. [It] demands that we examine both its conditions and its trends, for an understanding of the structure upon which will rest the economic order of the future." That examination continues with great vigour in the 21st century.

Further reading

Robert Monks, chairman of Lens Investment Management in Portland, Maine, and Nell Minow, head of The Corporate Library, have produced several important books on the subject, notably ***Corporate Governance*** and ***Power and Accountability***. Also of interest is Monks's ***The Emperor's Nightingale***.

Amy Domini, creator of the Domini 400 Social [Responsibility] Index and founder of Domini Social Investments, has recently published ***Socially Responsible Investing: Making a Difference and Making Money***. Her previous book, ***Investing for Good***, is also still in print.

The Unseen Revolution - How Pension Fund Socialism Came to America, by the management guru Peter Drucker, was first published in 1976 but is scheduled to be reprinted shortly.

As noted, ***The Modern Corporation and Private Property*** by Adolph A. Berle, Jr and Gardiner C. Means, remains the authoritative work on the subject. The fifth edition (1939) is still in print. Any discussion of corporate responsibility issues ought to start with this book.

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