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978-1-108-96542-2 — The Evolution of Corporate Governance
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1 Introduction

The phrase 'corporate governance' came into prominence in the 1990s, following the publication in the United Kingdom of the Cadbury Report[1] (1992). The research journal *Corporate Governance – An International Review*[2] was founded in the same year. But the need for corporate entities to be governed can be traced far back into the history of trade: back through the regulation imposed by the United States Securities and Exchange Commission[3] since 1934, the brilliant invention of the limited liability company in the nineteenth century, which led to the burgeoning vast, complex and rapidly changing world of corporate governance today, right back to medieval times when promoters of a venture had to delegate supervision to others.

This Element traces the evolution of the concept of corporate governance from those early times to its present-day role of setting objectives, strategies and policies, supervising management and ensuring accountability that are essential in every corporate entity. Economic history, culture and even religion will be shown to have influenced the development of approaches to corporate governance around the world.

Previous attempts to chart the evolution of corporate governance have tended to cite research papers published in refereed journals, often those published in the USA. This produces a myopic perspective because, to date, research has brought few changes to corporate governance practice around the world. As will be shown in this Element, significant change to corporate governance policies and practices have been responses to perceived needs, often reflecting economic failure or corporate collapse.

Although many of the underlying legal concepts of corporate governance still owe more to their mid-nineteenth-century origins than to the realities of complex, modern business situations and risks, developments have often been responses to corporate collapses rather than developments in theory. Nevertheless, the range of theoretical insights will be considered; and contemporary frontiers of the subject identified.

This Element reviews the way corporate governance has evolved over centuries to this day. It endeavours to identify the cause of significant changes in corporate governance policy and practice, as well as topics

[1] Cadbury, Sir Adrian (1992) *The Financial Aspects of Corporate Governance: a Report of the Committee on Corporate Governance*. Gee & Co., London.

[2] *Corporate Governance – An International Review*, Volume 1, Number 1, January 1993, Blackwell Publishers, Oxford.

[3] The Securities Exchange Act (1934) Pub.L.73–291, 48 Stat. 881, to regulate the governance of companies listed on US stock markets and the trading of their shares, bonds and debentures.

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that are on the frontiers of the subject. The development of theory about corporate governance is discussed, with its recognition as a subject worthy of serious study. The lack of clear corporate governance paradigms is considered, and a call made for a philosophy of this important new subject.

2 The Origins of Corporate Governance

Corporate Entities Have Always Been Governed

Chaucer (*c.*1343–1400) was the first to record the word 'governance'[4] although he was not sure how it should be spelled.[5] At that time, of course, it was a city or state that needed governing. Nevertheless, although the use of the phrase 'corporate governance' is recent, the need for governance of trade ventures is ancient. Shakespeare (1564–1616) understood the challenge. Antonio, his Merchant of Venice[6], agonised as he watched his ships sail out of sight, knowing that his fortune was now in the hands of others.

Whenever a principal relies on agents to look after his interests, governance issues arise. This agency dilemma has long been recognised. Shareholders in a company elect their board directors to look after their interests. Members of professional bodies elect their council. Members of a club appoint their committee. All corporate entities need a governing body nominated and elected in line with that organisation's constitution.

These governing bodies have a variety of names. For companies it is usually the board of directors. For other organisations it may be the 'council' or the 'committee'. The Bank of England has a 'Court', reflecting its ancient origins. Oxford colleges, with classical simplicity, often call their governing body 'the governing body': surprisingly not '*corpus governate*'.

Corporate Governance in the Seventeenth and Eighteenth Centuries

Economic competition accompanied by political and military strife, grew during the seventeenth century between Britain, Holland, Portugal and Spain, each with ambitions of empire. In 1600, the East India Company was created with a monopoly over all trade between England and Asia, under a royal charter granted by Queen Elizabeth I. The Company was a joint-stock company, with over 1,000 stockholders, who elected a governing board of twenty-four directors each year. The company traded principally with India

[4] Troilus and Criseyde. [5] 'gouernance' or 'governaunce'.
[6] Shakespeare, William (1598) *The Merchant of Venice, Act 1 Scene 1* 'In sooth, I know not why I am so sad . . .'.

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and China in cotton, silk, tea and opium, at one time administering parts of the British Indian Empire with its own private army.[7] The Dutch East India Company was granted a charter by the Republic of the Netherlands in 1602 to run Dutch colonies and to trade with Asia.[8] The Dutch West India Company was chartered in 1621, to run the slave trade between Africa, the Caribbean and North America. The Hudson Bay Company received its royal charter in 1670, when Prince Rupert, cousin of England's King Charles II, wanted to pursue fur trading in what is now Canada.

In 1711 a company was incorporated in England to trade with Spain's South American colonies, mainly in slaves. The story of the South Sea Company marked a turning point in public attitude to corporate business. In 1718, King George 1 became a governor of the company, bringing prestige and public confidence. In 1720, the British House of Lords incredibly gave the South Sea Company a monopoly on the premise that the company would guarantee the British national debt. Massive speculation in the company's shares followed. Then the bubble burst. Members of the British aristocracy lost their fortunes, banks failed, while directors of the company were imprisoned and their wealth confiscated. The Chancellor of the Exchequer was found to have taken bribes to promote the company's stock. There was a public outcry about such speculation and excessive corporate risk-taking.

The evolution of corporate governance has since been influenced by other examples of dubious business models and unrealistic risk-taking, as we shall see in Enron[9] following the global financial crisis (2007–10)[10].

Adam Smith (1723–90), a moral philosopher at the University of Glasgow, often considered the father of modern economics,[11] commented on corporate behaviour offering a classic corporate governance perspective:

> The directors of companies, being the managers of other people's money rather than their own, cannot well be expected to watch over it with the same anxious vigilance with which [they] watch over their own.

[7] Stern, Philip (2019) English East India Company-State and the Modern Corporation: the Google of its Time? in T. Clarke, J. O'Brien and C. O'Kelley, *The Oxford Handbook of the Corporation.* Oxford University Press, Oxford, 75–92.

[8] Frentrop, P. (2019) The Dutch East India Company: the First Corporate Governance Debacle, in T. Clarke, J. O'Brien and C. O'Kelley, *The Oxford Handbook of the Corporation*. Oxford University Press, Oxford, 51–74.

[9] Enron was a major US energy company that metamorphosed into a financial institution, trading energy futures without the board realising that the company's risk profile had changed fundamentally.

[10] When companies failed and banks had to be bailed out by governments.

[11] Smith, Adam (1776; 1976) *The Wealth of Nations*, rev. ed., George J. Stigler (ed.). University of Chicago Press, Chicago.

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The Invention of the Limited Liability Company

As the eighteenth century moved into the industrial revolution of the nineteenth, there were only three basic structures available to a business, other than corporations created under charter from the monarch or the state: a sole trader; a partnership; or through an unincorporated corporate entity. In each of these structures, creditors could pursue their debts with the owners. This could mean that ultimately anyone investing in a business faced bankruptcy. In those days, failure to meet your debts was a crime, which could lead to debtors' prison, with the possibility of the family being sent to the parish workhouse.

Clearly, unless you were directly involved in controlling the enterprise, there was little incentive for sleeping partners or non-management investors to risk their capital. Yet this was exactly what was needed by businesses in a period of economic growth, generated by the industrial revolution. Firms needed external capital to expand faster than the founders' capital and ploughed-back profits would allow. Moreover, an emerging middle class had funds available. What was needed was a means of investing in a business without becoming responsible for its debts.

A form of corporate incorporation that limited the liability of investors for a company's debts was created in France in 1807 – the *Société en commandité par Actions*.[12] However, in the French model the protection of the law only applied to external investors *not* involved in the management of the enterprise. Executive directors and managers holding shares were still vulnerable.

In Britain, the need for a form of incorporation that could raise capital without exposing the investors financially grew. Parliament debated the issue and there were calls for the creation of an incorporation that followed the French design. However, the Limited Liability Act (1855)[13] gave limited liability to *all* shareholders, whether they were involved in the management of the company or not, although the records of the parliamentary debates suggest that some Members of Parliament thought they were adopting the French model. The Companies Act (1862)[14] reinforced this form of corporate incorporation.

The joint-stock limited liability company became one of the most successful systems ever designed. Under the dictates of company law, a legal entity is created distinct from its owners. This corporate entity has many of the legal rights of a real person: to contract; sue and be sued; own property; and employ people. However, the shareholders only risk their equity investment. They are

[12] Freedeman, Charles E. (1979) *Joint-Stock Enterprise in France 1807–1867 – From Privileged Company to Modern Corporation*. The University of North Carolina Press, Chapel Hill, NC.

[13] The Limited Liability Act, 18 and 19 VICT. a. 183.

[14] The Companies Act, VICT CAP.LXXXIX 7 August 1862. 'An Act for the Incorporation, Regulation, and Winding-up of Trading Companies and other Associations.'

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not responsible for corporate debt, unlike the owners of an unincorporated entity.

A company has a life of its own, giving continuity beyond the life of its founders. Shares in the company can be bought and sold. Nevertheless, share ownership is the basis of power over a company. In principle, shareholders elect their directors. Those directors owe a duty of stewardship to their shareholders to whom they are accountable.

The huge success of this opportunity to incorporate companies with limited shareholder liability led the writers of the Savoy operas, Gilbert and Sullivan (1893)[15] to satirise the trend in their opera *Utopia, Limited*.

> All hail, astonishing fact,
> All hail, invention new,
> The Joint Stock Company Act of Parliament Sixty-two.
> And soon or late I always call for Stock Exchange quotation.
> No scheme too great, and none too small for companification.

In America, some states enacted laws to facilitate the incorporation of companies. In the years following the American Civil War (1861–5), many companies were incorporated, some quite significant in the railroad, steel, manufacturing and other major industries. The New York Stock Exchange was founded in 1817 and Wall Street traded shares in these new public companies, raising capital to fund their growth. But the investors' liability was not yet limited. Most state company law regulated companies tightly, requiring each company to describe its objectives and, significantly, to give it a finite lifespan. A further restriction was that one company could not own another.

Subsequently, state constitutions were amended and laws rewritten to be more amenable to increasingly powerful companies. Shareholder limited liability was introduced. Charter battles were fought to allow corporate groups, in which companies could own other companies. Eventually, corporate charters no longer limited the range of companies' activities and their lifespans.

In 1918, in what is often considered a landmark case,[16] the right of individual states to regulate institutions in their jurisdiction was challenged at the federal level. The courts in the state of New Hampshire had revoked the Royal Charter given to Dartmouth College by King George III of England. But the US Supreme Court overruled the lower courts. Many states saw this as a federal attack on state sovereignty and rewrote their laws to circumvent the Dartmouth ruling (Friedman 1973).[17] To this day companies in the United States are

[15] Gilbert, Arthur and Sullivan, W. S. *Utopia, Limited*, D'Oyly Carte Opera Company, 1893.
[16] *Trustees of Dartmouth College* v. *Woodward* (1819).
[17] Friedman, Lawrence M. (1973) *A History of American Law*. Simon and Schuster, New York.

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incorporated at the state not the federal level. But state company laws vary, which is why many US companies incorporate in the state of Delaware, a jurisdiction supportive of corporate entities.

In the late nineteenth and early twentieth centuries, the British Empire spread the concept of the limited liability company around the world. The company laws of Australia, Canada, some Caribbean islands that are now tax havens, Hong Kong, India, Malaya (now Malaysia), New Zealand, Singapore, South Africa and some other African countries still reflect those origins; although subsequently their company law evolved to meet local circumstances. However, even today, case law made in courts throughout the British Commonwealth of Nations may provide precedents in other member countries, and some retain the ultimate right of appeal to the British Privy Council. Hong Kong, which became a Special Administrative Region of China in 1997, still retains its British-orientated legal system and company law, although the right of final appeal has shifted from London to Beijing.

The basic idea of the limited liability company was starkly simple and proved superbly successful. Industrial innovation and expansion, growth in employment, and economic wealth followed worldwide. However, the success of the simple mid-nineteenth-century model led to growing complexity, although the original corporate concept still underpins contemporary company law.

3 The Development of Corporate Governance in the Twentieth Century

Inter-war Years: Private Companies, Top Management Domination

Originally, all joint-stock limited liability companies were public companies. In other words, they were incorporated to raise capital from the public. By the early twentieth century, however, it was recognised that the model could be used to give limited liability to family firms and other private enterprises, even though they did not need access to external capital. Today, of course, private companies vastly outnumber public companies.

Directors also realised that companies could acquire shares in other companies and, if they held the majority voting equity, control them. This led, in economically advanced countries, to complex groups in which the holding company owned a pyramid of subsidiary companies held at different levels.

The ownership of companies listed on stock markets had also changed. In the early days, shareholders tended to be wealthy individuals who could attend or be represented at shareholder meetings. But by the early years of the twentieth century things were changing. As many listed companies became large and

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complex, so did their shareholder base, which could now be numerous and geographically widespread. Private investors were being overshadowed by institutional investors: pension funds, financial institutions, hedge funds and private equity firms. The objectives of these investors differed in both their strategic time horizons and their expectations about dividends and capital growth. Chains of financial intermediaries could also stand between companies and their investors. Shareholders in major companies had become distant from the boardrooms of the companies they owned.

Using data from companies in the United States, Berle and Means (1932)[18] 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, observing 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.

Berle and Means' work made a seminal contribution to corporate governance thinking; although that was not a phrase they knew. But it was to take a long time for their intellectual inheritance to be recognised. For the next forty years, the work of directors and boards remained the province of jurisprudence, enlivened by anecdote and exhortation.

The 1970s: Audit Committees, Two-tier Boards and Stakeholder Responsibilities

In 1971, a pioneering work by Mace[19], based on research in US companies, tried to establish what directors really did. His findings challenged conventional wisdom:

> 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.

[18] Berle, Adolf A. and Means, Gardiner C. (1932) *The Modern Corporation and Private Property.* Macmillan, rev. by Adolf Berle (1967), Columbia University, Harcourt, Brace and World, New York.

[19] Mace, Myles L. (1971) *Directors: Myth and Reality.* Division of Research, Graduate School of Business Administration, Harvard University, Boston, MA.

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> The business literature describing the classical functions of boards of directors typically includes three important roles:
>
> 1. establishing basic objectives, corporate strategies, and board policies;
> 2. asking discerning questions;
> 3. selecting the president.
>
> [Instead] 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.
>
> A second classical role assigned to boards of directors is that of asking discerning questions – inside and outside the board meetings. Again, it was found that directors do not, in fact, do this. Board meetings are not regarded as proper forums for discussions arising out of questions asked by board members.
>
> A third classical role usually regarded as a responsibility of the board of directors is the selection of the president. Yet it was found that in most companies, directors do not in fact select the president, except in . . . crisis situations.

Interest in the work of boards of directors developed further in the 1970s. In the United States, in 1972, the Securities and Exchange Commission required listed companies to create audit committees as standing committees of the main board comprising independent outside directors. These audit committees were to provide a bridge between the external auditor and the main board, ensuring that directors were made aware of any issues that had arisen between the auditor and the company's finance department. Mautz and Neumann (1970, 1977)[20] discussed the practicalities of audit committees being introduced in the United States. Auerbach (1973)[21] described these audit committees as: 'a new corporate institution'.

In the United Kingdom, Tricker (1978)[22] studied board membership in British companies, intending to advocate audit committees for the United Kingdom. However, he found that although many listed company boards *did* have non-executive directors, they tended to be a minority and the concept of director independence was not understood. The conventional wisdom seemed to

[20] Mautz, R. K. and Neumann, F. L. (1970) The effective corporate audit committee. *Harvard Business Review*, November/December, 57–65.
Mautz, R. K. and Neumann, F. L. (1977) *Corporate Audit Committees: Policies and Practices.* Ernst and Ernst, New York.

[21] Auerbach, Norman E. (1973) Audit committees: new corporate institution. *Financial Executive*, September, 96–7,102, 104.

[22] Tricker, R. I. (1978) *The Independent Director: a Study of the Non-executive Director and of the Audit Committee*, Tolley with Deloitte, Haskins & Sells, London.

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be that while non-executive directors could provide useful inputs to board discussions, their role was not to provide a check on the executive directors. Consequently, Tricker concluded that audit committees, based on the US model, would not work in the United Kingdom. Sir Brandon Rhys-Williams, a British member of parliament, did call for non-executive directors and audit committees in the United Kingdom, a proposal that led to a green paper – *The Conduct of Company Directors* (1977) – and a parliamentary bill calling for audit committees. It failed in parliament.

In the United States, an increasingly litigious climate saw shareholders seeking recompense from directors, boards and auditors of listed companies and auditors for alleged losses they had incurred. Auditors were particularly at risk, because it was thought that their indemnity insurance provided a 'deep pocket'. The focus on board-level checks and balances increased.

The European Economic Community (EEC),[23] trying to harmonise company law throughout all member states, issued a series of draft directives. The EEC draft fifth directive (1972) proposed that unitary boards, with both executive and non-executive outside directors, used in the United Kingdom and elsewhere in the EEC, be replaced by two-tier boards, as used in Germany and Holland.

In the two-tier board system, companies have two distinct boards. The upper supervisory board has only non-executive directors, who monitor and oversee the work of the lower executive board, which is comprised entirely of executive directors, who run the business. No common membership is allowed. The supervisory board has the power to hire and fire members of the executive board.

The EEC proposal for two-tier boards was not well received in Britain. First, it was argued, at least by directors, that unitary boards worked well. Second, the EEC directive also called for worker directors on the supervisory board. This followed the idea of co-determination, a long-standing tradition in Germany. In this model, the company was thought of as a social partnership between capital and labour with the supervisory board made up of equal numbers of representatives of the shareholders and the employees.

The United Kingdom's response was the report of a committee chaired by Alan Bullock,[24] Master of St. Catherine's College Oxford. *The Report of the Committee of Inquiry on Industrial Democracy (*1977*)*[25] and the research papers (1976) associated with it reflected the first serious proposals on board structure in Britain. The committee proposed a continuation of the unitary board, but with

23 Subsequently the EEC became the European Union (EU).
24 Later to be Sir Alan then Lord Bullock.
25 *Committee of Inquiry on Industrial Democracy (the Bullock Report)*, Hansard, 23 February 1977, volume 380, cc179–355.

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some directors representing the employees of the company, elected through their trade unions. The Bullock Report was also not well received in British boardrooms and was not pursued.

During the 1970s, reports from inspectors appointed by the UK Department of Trade suggested corporate governance problems, although that phrase itself was yet to appear. The report into Pergamon Press (1971) concluded that founder Robert Maxwell should not again run a public company; advice that was subsequently ignored, enabling him to build a media empire that collapsed dramatically twenty years later. Other inquiries, which examined board-level problems at Rolls Royce (1973), London and County Securities (1976) and Lonrho Ltd (1976), added to the interest in the way companies were governed, although commentators at the time wrote about the way they were managed.

Another striking development during the decade of the 1970s was the questioning of the social responsibility of business in society. Broadly, the concern was whether major companies had responsibilities beyond their legal duty to their shareholders. It was widely recognised that all companies had to satisfy their customers and, in the process, provide employment, opportunities for suppliers, and contribute to society by paying their taxes. But the classical nineteenth-century model of the joint-stock limited liability company was unequivocal: the prime duty of directors was to their investors, who had elected them, and to act as stewards of those shareholders' investment.

However, given the scale and significance of many companies, some argued that directors should report to and, some believed, be accountable to a range of stakeholders who could be affected by board decisions – customers, employees, suppliers and others in the supply chain, the local community and the state.

The American Bar Association, which had been considering alternative bases of power over companies,[26] clashed with the Corporate Roundtable, which represented directors, who were convinced of the merits of the existing stewardship model. Jensen and Meckling (1976),[27] in an article that was to provide the foundation for corporate governance agency theory, questioned whether the classical concept of the company could survive.

In a much quoted and sometimes misquoted paper, Friedman (1970)[28] claimed in the title of his paper that:

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[26] Small, Marshall L. (2011) The 1970s: the committee on corporate laws joins the corporate governance debate, The Model Business Corporation Act at Sixty, *Law and Contemporary Problems*, 74(Winter), 129–36, Duke University, Durham, NC.

[27] Jensen, Michael C. and William H. Meckling (1976) *Theory of the firm: Managerial behavior, agency costs and ownership structure,* Journal of Financial Economics, Volume 3, Issue 4, October 1976, Pages 305-360

[28] Friedman, Milton (1970), The social responsibility of business is to increase its profits. *New York Times Magazine*, September 13.

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