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Corporate governance in a radically changed world – a fresh look at the Rhineland model

by Richard Tudway

The collapse of the global financial system raises critical issues in corporate governance, particularly in Anglo American jurisdictions. The global financial crisis, triggered by events in the US and the UK, has destroyed global wealth and output on a huge scale. In spring 2010, world stock markets recorded an astounding $20tr loss in value from highs of some $61tr in December 2007 (World Federation of Exchanges, March 2010). OECD growth slumped in the immediate aftermath of the crisis but has since recovered, though very slowly as growth in advanced economies is expected to remain broadly unchanged at 2.5% in 2011 according to the IMFs *World Economic Outlook*. Recent data on the US and the UK may yet herald a slide back into recession. Indeed, according to the OECD September forecast, the annual rate of growth in the G7 countries will fall to around 1.5% in the second half of 2010, a full percentage point lower than its forecast in May 2010. In the case of the US, fears that weak employment numbers in September may foreshadow a double-dip recession have prompted further quantitative easing by the Federal Reserve. The *Made in America* financial crisis and the role of the Anglo American model of corporate governance urgently needs to be re-examined.

This model has indeed spectacularly failed to protect shareholder wealth, its professed primary intention since, under Anglo American corporate law, directors are portrayed as having a first duty to protect shareholder value. Workers' capital (the pension funds of working people that are invested by institutional investors into stock markets) has been squandered also. The prospects for many millions of working people have also worsened. The sense of public outrage is understandable. Yet, despite the promises of politicians and policymakers that *things will be changed*, it seems that, far from changing, things are returning to *business as usual*. The bankers are back in the saddle. Generous bonuses are being paid. The boards of many bank and non bank corporations alike in Anglo American jurisdictions have learnt little from the damage that has been inflicted, and the reasons that explain it.

If politicians won't act, then global trade unions must press resolutely for change. Bank and non-bank corporations alike have to be properly, effectively, independently and transparently supervised. Drawing strength from the excellent co-determination habits of Rhineland democracies (Germany and other democracies that border the Rhine) and others (notably Sweden and other Nordic countries), the autocratic, non-inclusive style of Anglo American unitary board governance arrangements has to be challenged. To drive home the argument, trade unions need to be able to prove that independently supervised corporations are better at protecting both worker prosperity and shareholder value.

The voice of working people has to be taken into account in the supervision of the world's largest corporations. Democratic self-determination at the work place demands no less. This is the only way that the wrecking instincts of personal greed can be controlled. The well rehearsed argument that independent supervision will stifle innovation (because decisions would never get taken and business opportunities would be lost) is self-serving propaganda. Commercial risks are, of course, unavoidable - they can never be eliminated. The role of supervision is to ensure that significant risks are thoroughly and objectively assessed (while there is evidence that bank failures in the US and Britain occurred because the advice of risk managers was suppressed) before workers' capital and their livelihoods are endangered by reckless, unsupervised and unaccountable decisions. Here it is important to remember that all information provided by corporations in Anglo American jurisdictions is *ex post* – after the event.

To get the debate moving, the OECD has to challenge the 'hidden agenda' which still stifles the debate on corporate governance; the OECD Framework of Corporate Governance and Roundtable discussions have ignored warnings in the past. There is an urgent need to look openly and objectively at alternatives to the now discredited Anglo American model. In doing so, it is crucial to ensure that the interests of workers and all legitimate stakeholders are properly represented. The GLU and its associates need to focus research on how different governance structures rank in terms of protecting corporate wealth. The Anglo American shareholder value model has been extensively researched. In contrast, the stakeholder model has not (Allen and Gale, 2002). The research needs to develop appropriate methods for assessing short and medium term performance in the largest publicly traded corporations, according to the governance model in use.

The Anglo American model relies critically on the neoclassical *Arrow-Debreu* theorem and efficient markets hypothesis. In the first instance this demonstrates that **if**[1] the objective of the corporation is to maximise the value of its shareholders, and this is achieved, then it is said to be Pareto optimal (i.e. its behaviour is beneficial to all, even outside the corporation). The issue of income distribution in society is otherwise settled by progressive taxation. This leaves company directors with the clear duty to maximise shareholder value[2] . The pursuit of that objective, it is argued, will in turn promote efficient resource allocation, as posited in the efficient markets hypothesis. In contrast, corporation law in Rhineland jurisdictions is clear in stating that the objective of larger corporations is to promote interests that are wider than simply those of the shareholder. Stakeholder concerns thus become a central feature of board behaviour, decision making and investment. Research should examine the consequences if the objective of the corporation is not exclusively to promote shareholder value. According to Allen and Gale (*op. cit.*), over 80% of managers surveyed in Germany, France and Japan agreed that stakeholder interests are more important than shareholder interests. In contrast, more than 80% of British and American managers surveyed saw shareholder interests as being the most important interest.

Whilst the stakeholder model has been politely dismissed by a generation of Anglo American corporate financiers, corporate legal theorists and financial analysts, the tide is now turning. There is an increasing awareness that the Anglo American model of corporate governance fails to meet its single declared objective – maximisation of shareholder value. At the same time, it compromises the longer term investment of other stakeholders, most notably working people. Time has now come to change corporate governance for the benefit of all. The debate has to be opened up and the evidence independently evaluated.

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[1] The significance of the **if** is that if the proposition can be effectively contested then the force of much of the argument is lost. The truth of the matter in law is that in Anglo American jurisdictions the fiduciary duty is to the company, a separate legal entity, and **not** to the shareholders, which radically changes the justification for its particular portrayal.

[2] The unclear distribution and supervision of power between directors and managers in Anglo American jurisdictions is a natural consequence of the evolution of the doctrine of *separation of ownership from control*, over which there is no effective countervailing influence by absentee landlord institutional investors who have no long term interest in the corporation in which they are invested.

Reference:

Allen, F. and Gale, D. (2002), *A Comparative Theory of Corporate Governance*, Wharton Business School

Further Reading:

Tudway, R. (2009), Evidence to the OECD's Corporate Governance Steering Group Roundtable, available at: (http://www.global-labour-university.org/fileadmin/GLU_Column/further_readings/RT_evidence_to_OECD_Roundtable.pdf)

Tudway, R. (2002), The Juridical Paradox of the Corporation, *International Corporate Law Annual*, Vol 2