

Re-inventing the limited-liability company

Corporate Governance – an international review

ABSTRACT

Research issue/Question: The evolution of corporate governance thinking and its implications for theory building. The 19th century concept of the corporation still underpins corporate governance practice today: if the company was re-invented to meet contemporary circumstances, what might it look like today?

Research Insights/Findings: The original corporate concept was superbly simple and brilliantly successful. Subsequently, the growing diversity of corporate objectives, confused ownership structures, and complex corporate groups, has led to abuse. Society has lost the control which it originally demanded for the right to incorporate companies in which shareholders' had no liability for corporate debts beyond their equity stake. Faced with government bail-outs of failing companies, allegedly excessive executive remuneration, and a growing concern for corporate social responsibility and sustainability, the time has come to rethink the rationale, the purpose and the governance of the joint-stock, limited-liability company.

Theoretical/Academic implications: This paper has been written in response to the editor's initiative to seek contributions that might provide alternative theoretical insights into corporate governance issues. By taking an historical, evolutionary perspective, this paper looks at corporate governance through a different lens than those of agency theory, stewardship theory or the growing philosophical interest in corporate social responsibility. The primary theoretical call is for a taxonomy of corporate entities that differentiates them according to the way that power is exercised over them. The paper also highlights three unresolved paradoxes in corporate governance orthodoxy: governance by principles or rules, independent directors' ignorance of the business, and the unitary board's dual responsibility for both performance and conformance.

Practitioner/Policy implications: The paper offers an alternative paradigm for the governance of corporate entities introducing the concepts of the Governing Body, the Executive Management and Stakeholder Liaison Groups. It is also suggested that external auditors should report to regulators not directors. The underlying argument is that limited liability is a privilege granted by society not a right: what society grants, society can take away if it is not satisfied with the way companies are managed or governed.

Keywords: Limited-liability, corporate taxonomy, evolution of corporate governance, auditors' responsibilities, Governing Body, Executive Management, Stakeholder Liaison Groups.

INTRODUCTION

The invention of the limited liability company in the mid-nineteenth century has led to the formation of vast amounts of capital, the generation of countless jobs, and the creation of incredible worldwide wealth over the years.

However, the creators of the original idea recognized that limiting the liability of shareholders for their company's debts was a significant concession by society. So companies' powers were strictly restricted. Single entities were incorporated with clear and limited objectives. The company promoters, directors, officers and shareholders had to be declared, and public annual reports and returns were required. The directors' accounts were audited by shareholders' audit committees.

But today, the original concept has become debased. International groups of companies operate through vast pyramids of subsidiary and associated companies, some enjoying the secrecy of haven jurisdictions. Others operate through complex networks of cross-holdings and joint ventures. Some use chains of public companies to leverage the financial advantage of those at the head of the chain. Companies' memoranda of association now provide multiple objectives; indeed some jurisdictions require no declared objectives at all. The reporting of public, listed companies has become vastly complicated. Remuneration consultants gear-up top executive remuneration. Auditors are effectively appointed by and report to the directors. And corporate regulators constantly battle to stay ahead of schemes devised by companies' lawyers and accountants to circumvent disclosure and tax rules.

But society is no longer satisfied. Criticisms include apparent greed and excessive director rewards, erosion of shareholder value, the abuse of power by directors, and corporate failures culminating in the need for governments to bail out companies. The growing interest in corporate social responsibility reflects societies' unease with the potential power of corporate entities.

The response of this paper is not to propose curbs on board-level powers or to call for further regulation and the strengthening of governance codes. Rather, the way the original concept of the corporation has evolved and changed is studied, which leads to a call for the re-invention of the corporate concept relevant to contemporary circumstances. The theoretical stance is that of the historian or evolutionary theorist, rather than of the lawyer or financial economist.

The potential contribution of this paper towards a general theory of corporate governance is a call for taxonomy by corporate types, with species and sub-species differentiated by their governance attributes; in other words by the way that power is or could be exercised over them.

The paper also offers an alternative corporate governance paradigm introducing concepts of the Governing Body, the Executive Management and Stakeholder Liaison Groups in lieu of the classical processes and structures. The alternative model would shift power back towards shareholders could reduce alleged excesses including top management remuneration and improve shareholder value. It is also argued that external auditors should report to the regulators not the directors.

Overall, this paper calls for scholars, regulators and practitioners to re-invent the limited-liability company. Such re-thinking would need to be backed by legislation and, of course, would meet enormous resistance supported by the lobbying power of interested parties, using shareholder funds to protect their vested interests. But the overall argument of this paper is simple: limited liability is a privilege granted by society, it is not an automatic legal right. What society gives society can take away. Unless companies meet societies' expectations, investors should again become liable for their companies' debts.

The theoretical orientation of this paper

As Pettigrew (1992) wrote:

“Corporate governance lacks any form of coherence, either empirically, methodologically or theoretically with only piecemeal attempts to try and understand and explain how the modern corporation is run.”

Nearly twenty years later, authorities still call for reliable global governance theory. Carver (2010), Judge (2010)

Stewardship theory lies at the heart of corporate governance, taking a legal perspective of the corporation, emphasising directors' fiduciary duty, acting in the best interests of the shareholders as stewards of their funds. The theory is rooted in the original belief that directors of limited companies can be trusted. Barney and Hesterly (2008). The stewardship view is central to company law.

Agency theory takes an alternative view: directors are agents of the shareholders but will maximize their own personal utility to the detriment of shareholders' interests. Jensen and Meckling (1976), Jensen (2000) Anecdotal evidence is not hard to find. This theoretical construct, with its statistic relevance, has dominated corporate governance research to date, and has been the methodology adopted in the majority of papers published in this journal.

More recently, stakeholder theorists have questioned the legal duty of directors to act solely on behalf of the shareholders, and call on companies to recognize a duty to act in the interests of other stakeholders potentially affected by their actions. McWilliams and Siegal (2001). Since this theory calls for the rethinking of the place of companies in society, it might more appropriately be called stakeholder philosophy.

In an endeavour to throw fresh light on the subject, this paper takes a different perspective. Tracing the historical development of corporate governance thinking, practice and regulation over time provides an alternative theoretical insight. Such an evolutionary approach reflects Dawkins (1976) suggestion that culturally-determined ideas can be transmitted from person to person. Dawkins suggested that the development of ideas is analogous to the natural selection, replication, and mutation of physical genes. He coined the word 'memes' to cover such transferrable ideas. Poor ideas become extinct, successful ones propagate and spread. So it is with corporate governance, this paper argues.

In methodological terms, the paper adopts a process approach (Pettigrew, 1979 and 1997; Langley, 1999). In other words, theory is developed from an understanding of how situations come to be constituted, reproduced and adapted as ongoing processes (Langley, 2007). As Pettigrew (1997) explains the 'processual' approach enables the exploration of:

... "human conduct and organizational life and to embed such dynamics over time in the various layers of context in which streams of activity occur."

This paper adopts such a process and evolutionary approach, tracing the development of corporate governance ideas, practices and regulation both longitudinally and geographically. This approach identifies current frontiers and posits possible further developments.

THE EVOLUTION OF CORPORATE GOVERNANCE

The early stages – merchants and monopolists

Although the phrase 'corporate governance' did not appear until the 1980s, the agency issue has long been recognized. Shakespeare (1596) understood it. Antonio, his Merchant of Venice, agonized as his ships sailed out of sight, the success of the venture and his fortune entrusted to others.

During the 17 and 18th centuries, the growing European empires - Holland, Portugal, Spain, and increasingly England - competed both economically and militarily around the world. Frequently the state or the crown chartered companies, to trade with those empires. Royalty, members of the aristocracy and rich merchants often invested. Again, they were faced with the agency problem, not least because of poor communications.

In 1600, England's Queen Elizabeth 1 granted a Royal Charter to the "Governor and Company of Merchants of London" to trade with the East Indies" giving the Honourable East India Company a monopoly over trade between England and Asia. The East India Company was a joint-stock company, with over 1,000 stock-holders who elected a governing body of 24 directors annually. The company was a powerful force for nearly three centuries, trading with India and China in cotton, silk, tea and opium. At one time the company administered parts of the British Indian Empire and ran a private army. The company was finally wound-up in 1874. The Hudson Bay Company was created by Royal Charter in 1670

In 1602 the Republic of the Netherlands granted a charter to the Dutch East India Company to colonize and trade with Asia. The Dutch West India Company was chartered a year later to run slaves from Africa to the Caribbean and North

America. Both companies were joint-stock companies, issuing stock to their investing stock holders.

Predictably, the success of corporate ventures allied with poor corporate governance led to unrealistic expectations and subsequent corporate collapses, sometimes associated with fraud.

In 1720 the British House of Lords gave a monopoly to the South Sea Company to trade with Spain's South American colonies. Unbelievably, the company agreed to under-write the British national debt, which led to massive speculation in its stock. Then the bubble burst. Many of the investors lost their fortunes, the directors were arrested, and their wealth confiscated.

Just as today, voices were raised against such corporate excesses and risks. Adam Smith (1759, 1776), a moral philosopher at the University of Glasgow, considered by many to be the father of modern economics, argued that society benefitted as individuals pursued their own self-interest, because the free market then produced the goods and services needed at low prices. But, like many academics today, he was suspicious of businessmen. His well known comment offers a classic corporate governance perspective:

"The directors of companies, being managers of other people's money rather than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a co-partnery frequently watch over their own. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."

The mid-19th century - the limited-liability company is invented

At the start of the 19th century the only way for individuals to invest in business was as a sole-trader, in a partnership, or as a shareholder in a joint-stock company. If a business failed its creditors could pursue the owners into bankruptcy, which could then lead to debtors' prison for the investor and the work-house for his family. This was clearly a disincentive to invest, unless one had direct oversight of the business activities. But firms needed external capital. This was a period of great economic growth, generated by the industrial revolution.

The French were the first to create a form of corporate incorporation, which restricted shareholders' liability. From 1807 the Société en commandité par actions limited the liability of external investors, but maintained the executive directors' personal exposure to corporate debt. These regulations were tightened in 1856.

Meanwhile in Britain, the need for companies to access capital without exposing external investors to the threat of bankruptcy was debated in Parliament. Some Members of Parliament called for a form of incorporation that mirrored the French system. But in the event the British Companies Acts of 1855 and 1862 gave limited liability to all shareholders, whether they were involved in the management of the company or not.

It was a brilliant invention. The company was a legal entity with many of the attributes of a real person: it could contract, employ, own assets, incur liabilities, yet the shareholders were no longer responsible for the company's debts. Its existence

was independent of the shareholders and its shares could be sold. Nevertheless, ownership remained the basis of power over the company. The shareholders appointed the directors, who reported to them. That underlying concept is still the underpinning of all modern companies though the reality is now very different.

The opportunity to incorporate companies which limited shareholder liability proved very successful. The writers of the Savoy operas, Gilbert and Sullivan (1893) satirised the trend in their opera *Utopia Ltd.*

*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!*

For the next fifty years companies were incorporated as public companies to raise capital. Each company was a stand-alone entity. There were mergers and amalgamations, but rather than form corporate groups, typically a new company was formed to take over the assets and liabilities of the merging companies, which were then wound up.

The late 19th and early 20th centuries – corporate groups and private companies

Around the turn of the century, it was realised that limited companies could own shares in other limited companies. The corporate group had arrived, with a holding company and chains of wholly or partly-owned subsidiaries. Another development in the later years of the nineteenth and early twentieth centuries was the incorporation of companies, not to raise capital, but to provide the protection of limited liability to family firms and new entrepreneurial manufacturing businesses. This trend was recognized in Britain by the Companies Act 1907, which introduced the concept of the private company, with fewer restrictions on disclosure since it was restricted in size and not allowed to raise funds from the public. Today, of course, the number of private companies far exceeds those incorporated as public companies.

The original nineteenth century concept of the limited-liability public company, with ownership at the heart of power over the company had now been diluted.

The early years of the twentieth century saw some significant economic problems around the world. But the growing size of corporate enterprises and the increasing number, geographical spread, and diversity of their shareholders' interests led to a shift of power from the shareholders towards the boardroom. In their seminal study, still one of the most cited works in the corporate governance lexicon, Berle and Means (1932) demonstrated this shift of power in large United States corporations. They expressed concern about the growing power of large companies in society, 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.”

Economic problems, the need to restore shareholder rights, and perhaps reign in overly-powerful corporations led to the creation of the US Securities and Exchange Commission (SEC) in 1934, providing some protection for investors at the Federal level, even though US corporations could, and still can, only be incorporated at the level of an individual state.

The 1970s - audit committees, industrial democracy, and corporate accountability

Interestingly, following the Berle and Means study, little interest was shown in the governance of companies for nearly another fifty years: the focus swung towards management. But in 1972, the SEC required US listed companies to create a standing audit committee of the main board, composed of independent outside directors, to act as a bridge between the external auditor and the main board, ensuring that directors became aware of any issues that arose between the auditor and the company's finance department. A similar proposal for the UK in a Parliamentary Bill in 1977 failed because, although many listed companies had non-executive directors, they tended to be in a minority and the concept of independence in directors did not exist. (Tricker, 1978)

During the 1970s, the European Economic Commission (EEC) issued a series of draft directives seeking company law harmonisation throughout the member states. The draft fifth directive, in 1972, proposed that the unitary board system, in which the board of directors had both executive and outside members, be replaced by the two-tier executive board and supervisory board governance system practised in Germany and Holland, in which the supervisory board monitors and oversees the work of the executive board, which runs the business. The German supervisory board also reflected the concept of co-determination, with equal numbers of employee and shareholder representative members. The British response was a report by Lord Bullock (1977), which suggested that the unitary board should continue, but with worker directors elected by the employees. Neither the EEC's directive nor the Bullock proposals were well received and neither was accepted.

The 1970s also saw calls in both the United States and Britain for a rethink of the place of large corporations in society, a call which was to disappear during the free-market years of the 1980's, only to reappear more recently as an interest in corporate social responsibility.

The 1980's and 1990's – corporate abuse and corporate governance codes

In the early '80s, concerns about the way companies were controlled and held accountable were over-shadowed by their commercial success. But later in that decade the phrase 'corporate governance' appeared. Although it has to be admitted that developments in the subject were responses to corporate collapses, board level

excesses, and dominant chief executives and chairman, rather than the result of academic, research-based deliberations.

In the United States, the investment house Drexel, Burnham, Lambert was investigated by the SEC in 1986 and accused of insider trading, stock manipulation and failure to disclose ownership. According to the court papers, Michael Milken, head of its junk-bond department, had a secret agreement with Ivan Boesky, another name to go down in corporate governance history, to exchange insider information and hold stock for each other in violation of securities law.

In Australia, a 1989 report from the National Companies and Securities Commission, on the collapse of Rothwells Ltd. a listed financial institution, commented that “at no time did the board perform its duties satisfactorily.” The stock market collapse in late 1987 provided the catalyst that finally brought the company down, though earlier the auditors had refused to sign the 1988 accounts, and the official report disclosed “massive private drawings and failure to disclosure loans to directors”.

In Japan, Nomura Securities was accused of having too close links with their regulator, having offered well-paid sinecures to senior bureaucrats on retirement (called *amakudari* – literally descent from heaven). Lavish payouts to major institutional clients to cover losses and links with a *yakuza* underworld syndicate were also alleged.

In the UK, Robert Maxwell built up a massive publishing empire during the '80s despite an admonition never to run a public company again that he had received in the 1970s from government inspectors. The Robert Maxwell Group plc owned nearly half of two other listed companies – the Maxwell Communication Corporation plc and the Mirror Group Newspaper plc. Maxwell dominated both these companies and their directors, resenting any form of criticism. In 1991, he drowned in suspicious circumstances, leading the banks to call in the company's massive loans. An inquiry into the failure to do so discovered that Maxwell had secretly withdrawn hundreds of millions of pounds from his companies' pension funds to save his companies from bankruptcy.

Such scandals and the abuse of board-level power around the world led to calls for a rethink of the way companies were directed and held accountable at the top. Corporate governance codes appeared. The UK's Cadbury Report (1992) on the financial aspects of corporate governance was the first. This was soon followed by codes of good practice or principles of corporate governance in many other countries, reflecting similar concerns and offering common solutions typically based on what was considered good practice such as:

- the wider use of independent non-executive directors
- the introduction of an audit committee of the board
- the division of responsibilities between the chairman of the board and the chief executive
- the use of a remuneration committee of the board to oversee executive rewards

- the introduction of a nomination committee with independent directors to propose new board members
- reporting that the corporate governance code had been followed or, if not, explaining why

By contrast, corporate governance practices in the United States tended to reflect the requirements of the SEC and states' company laws. This reliance on mandatory corporate governance through the law, rather than the discretionary 'comply or explain' approach of codes elsewhere, was reinforced in 2002 by the post-Enron Sarbanes Oxley Act.

As well as producing the first corporate governance report, Britain has subsequently produced more than any other country:

- Cadbury Report (December 1992)
- Greenbury Report (July 1995)
- Hampel Report (January 1998)
- UK Combined Code (1998)
- Turnbull Report (1999 revised October 2005)
- Higgs Report (January 2003)
- Smith Report (July 2003)
- Tyson Report (June 2003)
- Revised UK Combined Code (July 2003)
- Myners Report (December 2004)
- Revised UK Combined Code (June 2006)
- The UK Corporate Governance Code (June 2010)

These codes, too, have influenced further development of codes in other countries.

The phrase 'corporate governance' also arrived in the 1980s and was quickly adopted world wide. Cochran and Wartick (1988) published an annotated bibliography of corporate governance publications: it had 74 pages. Today, Google accesses over 12 million references to corporate governance and Bing 23 million. Research into corporate governance also began to develop in the late 1980s. Corporate Governance – an International Review was founded in 1992.

The late 20th century – complex corporate groups, complex ownership relations

In the later part of the twentieth century, multi-national companies expanded dramatically, both through internal growth and external merger and acquisition. Many groups of companies now operated globally and had become complex from a governance perspective. Some had massive pyramids of wholly or partly-owned subsidiaries and associated companies held at many levels, but with each member company incorporated as a legal entity, with its board of directors, auditors, and reporting and filing requirements. Other groups were organized in networks of complex cross-holdings, sometimes as the result of joint ventures or mergers and acquisitions, sometimes for strategic reasons (as with the Japanese *keiretsu*), and a few, possibly, to benefit from taxation benefits or the advantage of limited disclosure.

Another governance arrangement, found in Italy, Hong Kong and some other jurisdictions, was the creation of chains of listed companies. Lead shareholders could then leverage financial control over the other companies in the chain and,

consequently, exercise operational control over companies lower in the chain, whilst holding only a small fraction of their voting equity. Some companies had also been listed on exchanges around the world. Whilst in some countries, particularly China and Russia, this was the era of the privatization and partial listing of state enterprises.

By the late 20th early 21st centuries shareholders had lost significant power over widely-held public, listed companies. No longer were they appointing directors. The nomination process in many countries had been usurped by incumbent directors, and the appointment process a façade with proxy votes. Institutional investors now held a significant proportion of the shares on many exchanges, but calls on them to exercise more governance power seldom carried real weight. Sovereign funds from export-benefitting and oil rich countries were also now investing in companies in other countries. Further diversity was added as some exchanges introduced secondary boards to invest in smaller, riskier ventures, typically with new and sometimes relaxed listing rules.

Moreover, strings of agents often now stood between the ultimate owner of a share and the company in which those funds were invested: brokers, agents, sponsors, institutional investors, pension funds, hedge funds. All had the potential to filter relations between company and its ultimate owners.

All this is a far cry from the original corporate concept of the limited-liability company which has been debased, diluted, and distorted: although the essential idea that shareholders' liability for their companies' debts remains limited.

The central argument of this paper

The central thesis of this paper is that in the 19th century society permitted the creation of the joint-stock limited-liability companies but constrained their activities. Today, society is no longer satisfied with their behaviour. Evidence is widespread:

- widespread questioning of tax-payer support for failing financial and manufacturing companies. Many people see no reason for tax-payers to be liable for corporate debt, just because these companies are 'too big to fail'
- perceptions of top management greed, excesses, and the dilution of shareholder value
- calls for controls on allegedly excessive top management remuneration, including golden handshakes, golden parachutes and equity linked performance bonuses, particularly where they seem to be rewards for failure
- cases reported of top management domination and abuses of power
- calls for stakeholder involvement, CSR and sustainability, with many companies responding in their corporate governance reports
- a growing emphasis in corporate governance on enterprise risk management and ethics

The nineteenth century of the limited liability company created a corporate governance system in which companies met the responsibilities that society then recognized. So why not make companies responsible for meeting the requirements

that society now recognizes? Incorporating a company with limited liability means meeting societies' demands or accepting responsibility for the company's debts.

In other words, if a company wants limited liability it must meet societies' expectations and play by their rules. Limited liability is a privilege not a right: what society gives it can take away. Power in society should be exercised through its legislators not by companies through their directors.

Re-inventing the limited liability company – the need for a taxonomy

However, before such thinking could be developed, a significant dilemma remains. The classification of corporate entities has not changed for over 100 years. Around the world, limited companies are still divided into just two categories: public and private. As we saw, the original conception, in the mid 19th century, was for the public company that could invite the public to subscribe for its shares. Then in the early twentieth century, the private company was created, one which was not allowed to invite public investment.

Today that is a totally inadequate categorization of corporate entities. Before we can pursue the radical suggestions in this paper we need a taxonomy or classification scheme that distinguishes different species and sub-species of corporate entity. Too many different species are currently treated as though they were homogeneous.

The way that power is, or could be, exercised over companies could provide a way to differentiate ownership and governance structures. What different types of company might a legislature recognize if the limited company was to be re-invented today?

Further research will be needed to develop a tenable taxonomy of corporate entities, but the following may trigger some thoughts:

Public companies

- Public companies listed on a stock exchange

 - Widely held listed companies

 - Listed companies dominated by one or a group of shareholders

 - Listed companies dominated by another listed company

 - State chartered companies with minority shares listed

- Public companies not listed on a stock exchange

Private companies

- Holding (parent) companies

- Subsidiaries of another company

 - Wholly owned subsidiaries

 - Partly owned subsidiaries

 - Associated companies dominated by another company

- Private equity firms incorporated as companies

- Joint venture companies

- Private company held by family interests

Partnerships, trusts and co-operatives

- Partnerships without limited liability

Partnerships with limited liability
Private equity firms
Hedge funds
Sovereign funds

Such a categorization would need to cover all types of corporate entity in every jurisdiction, including, for example, South Korean chaebols, Japanese keiretsu and Italian chained companies. It would need to include entities in different cultures, with different legal systems, institutions, and regulatory bodies. It would also need to embrace every feasible ownership structure including, for example, sovereign funds, hedge funds, and co-operatives. There also seems little justification for excluding other corporate types such as NGOs, charities, professional bodies and not-for-profit organizations.

As with all eco-systems, diversity tends to be useful. The rich variety of governance and organizational forms shown above suggests that the frontiers of corporate diversity, far from converging, are evolving and multiplying fast. Indeed it has been suggested¹ that the era of the listed, public company has reached its zenith. Nevertheless, such companies still form the backbone of investment around the world, and are the corporate governance form considered further in this paper. Other researchers need to pursue the governance of alternative business forms.

Re-inventing the limited liability company - companies in society

Before a satisfactory corporate governance model can be developed a fundamental issue needs to be resolved: how does society believe power should be exercised over companies in their midst? The economic, social and political context is certainly vastly different from that of the nineteenth century when the limited company was first invented. The scale, diversity and significance (both positively and negatively) of companies are of a different order. A discussion is needed on the rightful place of companies in society.

Such a discussion has already begun as can be seen in the widespread interest in corporate social responsibility and sustainability. The work of the Tomorrow's Company organization has been pursuing related issues for some years (<http://www.tomorrowscompany.com/aboutus.aspx>). Obviously, the dimensions of such research and the ensuing debate are vast and, hopefully this journal and its readers can make a major contribution.

Re-inventing the limited liability company – resolving three paradoxes

Before the company can be re-invented for the 21st century three corporate governance paradoxes also need to be resolved. These might be called the principle or rule paradox, the ignorance of independence paradox, and the conformance/performance paradox.

The principle or rule paradox. Many commentators refer to the 'Anglo-American' approach to corporate governance. They contrast the unitary board, which has both executive and non-executive directors in the Anglo-American common law

jurisdictions, with the two-tier, supervisory and executive boards of the Continental European and other civil law countries.

But in reality there are fundamental differences between American and British concepts of corporate governance. The under-pinning of American corporate governance is mandatory governance determined by law: follow the legal requirements or risk the penalties. By contrast the basis of corporate governance in Britain and other countries, whose company laws reflect earlier British influence, rely on a discretionary approach of governance by principle: comply with the code or explain why not.

Some years ago there was a widespread belief that corporate governance around the world would gradually converge on the American model, not least because the world needed access to American capital. That is no longer the case. So the paradox remains unresolved.

The performance/conformance paradox. The second paradox relates specifically to unitary boards which are responsible for ensuring both the performance of the enterprise and its conformance. In other words, the board is expected to be involved in strategy formulation and policy making, whilst also supervising management performance and ensuring accountability. It has been suggested that this means the unitary board is effectively marking its own examination papers.

Of course, the two-tier board structure avoids this problem by having the executive board responsible for performance and the supervisory board for conformance, with no common membership allowed.

To overcome the apparent dilemma of the unitary board, corporate governance codes call for independent outside (non-executive) directors to play a vital role. Independence is precisely defined to ensure that these directors have no interest in the company that might, or might be seen, to adversely affect genuine independent objective judgement. The percentage of independent board members on the board is specified. Audit, remuneration and nomination committees of the board must be mainly or wholly comprised of independent, outside directors. But that leads to the third paradox.

The independence paradox. The definition of independence in most corporate governance codes is exhaustive. To be considered independent a director must have no relationship with any firm in the up-stream or down-stream added-value chain, must not have previously been an employee of the company, nor be a nominee for a shareholder or supplier of finance to the company. Indeed, the definition of independence is so strict that an independent director who has served on the board for a long period is often assumed to have become close to the company and no longer independent.

Herein lays the independence paradox. The more independent a director is, the less he or she probably knows about the company or its industry. The more a non-executive director knows a company's business, organization, strategies, markets, competitors, and technologies, the less independent he or she may be. Yet

such people are exactly what top management needs to contribute to its strategy, policy making and enterprise risk assessment.

Similar questions can be raised about an independent chairman of the board. Most codes call for a separation between chairman and chief executive. Even in the United States, where the roles have traditionally been combined in a single powerful figure, there have been calls for them to be separated.

Re-inventing the limited liability company – a new paradigm to rebalance power

This paper focuses on the governance of the listed limited-liability company. The paradoxes need to be resolved in a re-engineered governance structure.

In formulating a new corporate governance paradigm the legitimate interests of the following need to be recognized:

- the executive management of the enterprise
- the investors in the voting entity
- all added-value stakeholders, including employees, those in the up and down-stream added-value chains, and the suppliers of debt finance

The governance model will also need to satisfy both legal requirements and cultural expectations of the states in which it operates.

What might the listed limited-liability company look like if re-invented to meet contemporary circumstances and expectations? In describing the new framework, concepts such as 'board of directors', 'supervisory boards', or 'committees' are avoided because they come heavily laden with pre-conceptions and prejudices. Instead, consider the following framework that introduces new names for the structures designed to meet the interests of the three legitimate interest groups listed above.

The **Executive Management** is the top management group of the organization, headed by the chief executive and containing the executives in the top management team. These would be the executive directors in many companies today. The Executive Management could be supplemented by external, non-executive members to provide additional experience, relevant knowledge and business support. They would not need to be independent in the conventional sense.

The role of the Executive Management would be to run the enterprise, developing its strategies, creating its policies, and achieving the aims and performance goals agreed by the Governing Body.

The Executive Management would have no independent outside members. The non-executive members of the Executive Management would provide the deliberations and decisions of executive management with valuable information and insights, based on relevant knowledge of the business and its industry, bringing an independence of mind, but not the independence of ignorance. In essence the Executive Management would consist of the chief executive and the top executives plus informed non-executive members to supplement their work.

Many boards of directors today are, in effect, self-appointed, self-rewarding and self-perpetuating elites. Separating the roles of the Executive Management from those of the Governing Body would avoid such situations.

The role of the **Governing Body** would be to meet shareholders' interests. Essentially, this is an investor board, with its members nominated and elected by the shareholders. In a widely-held listed company the institutional investors would probably play a significant role. In a dominated listed company the dominant interests would take the lead but ensuring that minority interests were protected. In a family company the family shareholders, probably advised by a family council, would take the lead but again protecting minorities.

The Governing Body would have the power to:

- appoint and reward the chief executive
- approve top management remuneration
- receive reports from the auditors
- approve strategies and policies, ensuring subsequent conformance
- ensure that risk management and other control systems functioned
- approving financial policies, fund raising, and dividend policy

In fulfilling this role, the Governing Body would fulfil the roles of the present audit, nomination, and remuneration committees. Separating the responsibilities of the Executive Management from those of the Governing Body overcomes the independence and performance/conformance paradoxes discussed above.

Critics of this structure might argue that these proposals introduce the Continental European two-tier board. Not so. There are no employee members, no German co-determination, and no Dutch socially responsible members. Shareholder power would be restored to the owners

Increasingly, the added-value stakeholders, including employees, entities in the up and down-stream added-value chains, and suppliers of debt finance are recognized as inherently part of corporate governance. Sound corporate governance recognizes their legitimate, long-term interests in relations with the company.

Stakeholder Liaison Groups are the third element in the proposed new corporate governance framework.

A Stakeholder Liaison Group could be formed to cover social responsibility and sustainability issues over and above the interests of the legitimate employee and added-value stakeholders.

Stakeholder Liaison Groups would work with both the Executive Management and the Governing Body providing three-way communication on matters of mutual interest. These groups would have no executive powers to intervene in company affairs beyond those provided by law.

Re-inventing the role of auditors

As we have seen, in the original 19th century model of the limited-liability company the state permitted incorporation of limited-liability entities provided

safeguards were met to protect society. Auditors, appointed from amongst the shareholders, reported to them that the directors of their company had faithfully recorded the company's financial situation and demonstrated their stewardship over its assets.

Then the accounting profession emerged. Small firms at first but, as companies grew in scale and complexity, they grew larger. Mergers enabled them to grow further. By the end of the twentieth century the world's major listed companies were audited by just five vast, international accounting firms, which became four on the collapse of Arthur Andersen, following their involvement in the Enron debacle. These accounting firms are major businesses, offering products and solutions, with partners judged by fee generation, growth and profit performance.

Serious questions have to be asked about the auditors' position. Who are their real clients: the directors or the shareholders? The *de jure* response that the client is the company and that somehow this means the body of shareholders will no longer wash. The *de facto* reality is that the client is the board, backed up by the board's audit sub-committee. Is this satisfactory? What are the alternatives?

Some have suggested opening the market for audit, with second tier firms playing an increasing role in the audit of major listed companies. But financial markets like the assurance they think they get from an audit opinion signed by one of the big four firms. Others have proposed further rules to regulate auditors' activities, including the US Sarbanes Oxley Act (SOX), for example. But SOX has proved more expensive and less effective than expected, as we see from the subsequent collapse and bail-out of financial institutions.

The proposal in this paper is that auditors are appointed by and report to the regulators as well as the Governing Body. It is the state that permits companies to incorporate, and the state that is responsible for protecting the interests of investors, creditors and other stakeholders. The regulatory organizational structures already exist to manage such a relationship. The regulators, working with the shareholders in general meeting, would appoint, re-appoint or if necessary replace the auditors, agree their fees and receive their reports. The company would, as now, bear the costs.

In this way cosy relationships between directors and auditors would be avoided. If auditors reported to the regulator rather than the directors, a new mind set would be needed. Moreover, shareholders would have a direct line to their auditors.

Conclusion

The central argument of this paper is that the original concept of the limited-liability company was brilliantly simple and successful, but over time has become corrupted. Ownership was the basis of power in the original model. But power has swung from the owners to the boardroom. Companies can now be vast, complex and lacking transparency. The joint-stock limited-liability company needs to be re-engineered to reflect contemporary circumstances.

First, taxonomy of corporate types is needed to differentiate the many different power structures that now exist. Second, there is a need to rethink the purpose and place of companies in society. Thirdly, some paradoxes involving director independence, the role of the unitary board, and whether corporate governance should be by principle or rule, need to be resolved.

A new corporate governance paradigm was then proposed, with a tri-partite balance of authority and power: the Governing Body, the Executive Management, and Stakeholder Liaison Groups. It was further proposed that external auditors report to the regulators as well as to the Governing Body. These are radical proposals. Further research, review and discussion are obviously essential, which would generate further ideas.

Some will argue that the ideas are too radical: the corporate world would never accept them. The debates in the British Parliament in the mid-nineteenth century show that not everyone was happy then with the original idea of limiting shareholders liability for the debts of their companies. In fact, that is the lever that society still holds. Limited liability is a privilege granted by society not a legal right. What society grants through its legislators, society can take away. If companies do not meet societal expectations and demands, there is no need for further rules and regulations: the shareholders should again become liable for their company's debts.

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