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Corporate Governance Facing Corporate Social Responsibility : Solving Challenges in the 21st Century

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1. INTRODUCTION

Company Governance amounts to the way Companies are managed, structured, and how they interact with their environment. This definition entails that Corporate Governance must deal with a number of contradicting and even conflicting interests; must offer some help in their identification and – should it be deemed necessary – seek to resolve them.

Companies are not single actors but creations of the law that are deeply influenced by people and societies' problems, successes, tensions and evolution. The expansion of security markets, the ubiquity of Information Technologies, the financial scandals of the early XXIst Century such as Enron, Worldcom, Parmalat, Credit and subprime crises, Lehman Brothers Crises, General Motors and other automobile industry failures, etc., have had strong impact both in our societies and in Modern Corporate Governance. They have not – however – made obsolete the debates about what should be the ideal shareholder structure; shareholder-management relationship; or what are the conflicts of interest that arise as a consequence of Corporations' development. Classical theories, together with new scenarios set the foundations for a renewed conception of modern Corporate Governance.

Culture is often invoked as a reason for differences in Corporate Governance in different legal systems. Its features are related with the concept of path dependency, which impacts upon Countries' choice of Corporate Governance. This has been underlined by prominent comparative legal science scholars (Cary, 1974; Romano, 1993; Hierro Anibarro, 1998; and 2007, Pérez Carrillo, 1999, 2005 and 2009). In order to encourage conducting business through Companies, legislators need to establish social institutions to support them. Cultural values are deeply rooted in individual's minds and in social institutions, so a Corporate Governance system that is compatible with social preferences in other areas (most importantly, legal areas) is more likely to be useful and ef-

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ficient in a particular society. On the negative side, deeply rooted cultural values may make difficult reforms, even if they are much needed.

Among the consequences brought in by the turning of the Century, we find that Companies, Investors, Regulators and even the society claim the need for more transparency, accountability of business; investor protection and on reinforcing the Responsibility of Companies towards the Communities in which they develop their businesses. Decision making by Companies is a process influenced by all these facets.

2. THE CORE OF CORPORATE GOVERNANCE: THE RELATIONS BETWEEN MANAGERS, OWNERS AND STAKEHOLDERS

A classical debate of Corporate Governance is the relationship between management and owners; this is between ownership and control. The description of this dichotomy is set in the early years of XXth century and in particular in the influential works of Berle (Berle, 1932), Dodd (1932) and other Professors of the time. Berle's followers consider shareholders interests to be paramount of Corporations' goals. In this line of thought, shareholders' interests are understood as the increase in value of their shares and this trend usually serves as the foundation for management actions to improve investments return in the short term.

These theories tend to be linked to the idea that Shareholders wealth maximisation results automatically in benefits for all the society; and that markets can achieve perfect distribution of wealth (Drucker, 1994). Their philosophic foundations are rooted in the Utilitarism. In Bentham, who advocated the pursuance of self-interest to maximize utility, or in John Stuart Mill, who, however recognised that some self interested actions could have detrimental effects on others. Adam Smith's economic theory is the most cited for a similar strategy. He considered that businesses act in a self-interested manner, that the market place regulates their behaviour and that its "invisible hand" ensures social benefit.

From the point of view of Company management, shareholder theories imply that the management, Directors and Officers act as agents of the shareholders. This is based on the acknowledgement of the separation between ownership and control, and entails that agents (management, Directors and Officers) should use the funds at their disposal for the maximisation of their principals' interest (shareholders). As shareholders invest to maximize their own results, managers, Directors and Officers as their agents must target that aim. It is also recognised that shareholders should have rights to determine how their property is used. It is assumed, that there are information asymmetries between the principal and the agent, and that managers, Directors and Officers are in a position that allows them to pursue their own interests. To balance power with duties, Anglo-Saxon countries developed the idea that managers have *fiduciary* duties to owners.

This Theory was the most influential in Anglo-Saxon countries, mainly in US and has had a strong impact in the definition of their Corporate Governance systems. Nowadays its influence has expanded worldwide.

Shareholder theories could seem to be opposed to social ideals. However, modern academics point out that this is not necessarily so, and that, on the contrary, early liberal authors' may have been overstated to support strong purely sort term capitalists-shareholders- theories (Sen, 1987). Modern market theorists explicitly acknowledge that business must act fairly within the legal and general framework, thus respecting competition and rule of law (Friedman, 1962 Hernandez, Rodriguez, 2009).

Other relationship, which is also important for today's Corporate Governance is that of shareholders (owners of the issued shares of the corporation) and other stakeholders (interested parties coming from a varied number of constituencies such as employees, citizens of the community where the Corporation interacts, etc). In this context have grown the so called stakeholder theories of corporations. Advocates of these theories consider that decision-making processes within corporations need to receive the influence of various constituencies. This line of thought is often regarded as a fairly recent, and Freeman is generally cited as its champion. From a philosophical standpoint, Kant can be seen as providing foundations.

These theories are based on the identification of many different sections within society to whom Companies may have some responsibility; and on the prediction of how they should operate in order to care, not only for their shareholders economic profitability, but also for others'. Some consider this approach close to civil democracy in so far as each group is considered equal to the other (Goia, 1999; Sternberg,1994); others argue that its implementation would demand great efforts to identifying stakeholders and determining which should receive what portion of management efforts (Cooper, 2004). Leading authors on management strategies point at the fact that to achieve a correct and efficient balance, Companies are to obtain positive valuation from 4 perspectives: customer's; internal's; innovation-learning perspective; and financial perspective (Kaplan, Norton, 1992; Kaplan, Norton, 1996).

A question much debated in relation with stakeholder's theories is whether management is to be accountable to absolutely all those interested(Sternberg, 1994). This subject has been used to criticise Stakeholders theories on the grounds that if Directors are accountable to all, they become accountable to none, and Stakeholders theories can be interpreted as a means for management to avoid scrutiny.

3. GOVERNANCE, DECISION MAKING AND THE INTEREST OF SHAREHOLDERS

Stockholders are owners of the corporation but they do not possess *per se* much direct decision-making authority. If we are to determine the relevance of shareholders within the Company, it is necessary to differentiate among:

- *Majority control holders*. They hold more that a *50% of shares in the Company* (what is extremely unlikely in listed companies) they control decision the making process and appointments to the Board.
- *Shareholders with a minority control* are able to exercise power over company decisions above their percentage holding, – given the lack of internal opposition able to balance their influence. Some of these minorities commit themselves to the long-term development of the company, and are known as "*inner circle*" shareholders. They are particularly active in continental European countries, with a tradition for block controlling shareholders (families, banks, etc.).

– *Other long term minority shareholders,* do not belong to the inner circle but remain in shareholding to obtain a return to their investment. They help in granting stability to the company.
– *Other minorities – long term private investors or sort term private investors* – have extremely reduced power to intervene or influence management.
– *Institutional Investors*. After the 2World War Institutional Investors have progressively acquired bigger proportions of capital and the potential for a leading role in management control. Institutional investors hold substantial financial resources obtained from their own private investors, trade in different corporations and are not a homogeneous category on their own.

Significant changes have taken place in the equity market over the last 30 years.

Private shareholding is in decline, whilst control of equity by institutional funds has increased particularly after 1970 (Graved, 1995) . Small equity investors face many risks. They may be taken advantage of in a number of ways by those in control of the Company (Boards or largest shareholders). They may be subject to waste of corporate resources without either benefiting themselves, nor having a real possibility of influencing decision making processes.

Institutional investors have growing influence in Corporations. This has been facilitated by low transactions costs; by the increased level of direct contact with companies; and by the concentration of investment as more liquid Institutional Investors and Funds are focusing their portfolios in a fewer number of corporations. Closer contact with companies and their boards allow Institutional Investors some of the mechanisms needed to optimise their investments, without a need for disinvesting or *voting with their feet*. Being better informed and having greater shareholders influence, investment risk is effectively reduced. Fund managers may concentrate their share in companies they favour, to benefit from the resources that they are able to apply to investment and corporate oversight. This is, largest fund managers have the power to influence management, but their interest is limited. Only when the size of their investment forces direct involvement; large shareholders are likely to participate rather than doing the *wall street walk*. However this growing influence, still to date, most companies are not subject to Institutional Investors' interference into management by them, at least not most of the time.

4. GOVERNANCE, DECISION MAKING AND THE INTEREST OF STAKEHOLDERS

The debate on how can shareholders have more influence on management is parallel to the debate on whether, who and how can other interested parties have a greater say in Corporate Governance (García Vidal, 2006). This has also occupied much of the academics works in the last decades. Policy makers employ a confusing array of terms to point at this discussion: Stakeholders' theories, Corporate Social Responsibility., Corporate citizenship, corporate accountability, or triple bottom line (of environmental social and financial reporting All these nominations serve, in general terms, to the acknowledgement that "*the private corporation has responsibilities to society that go beyond the production of goods and services at a profit, and that (to)… the idea that a corporation has a broader constituency to serve than shareholders alone*" (Buchholz-

Rosenthal, 2002). USA Corporate Social Responsibility has been defined as "business decision making linked to ethical values, compliance with legal requirements and respect for people, communities and the environment.. For an European Definition,: "*voluntary integration by business' commercial activities of social and environmental concerns* (European Commission, 2006).

Stakeholders' interests influence all aspects of a company's operations: increasingly consumers want to buy products from companies they trust, suppliers prefer to work with Companies they can rely on; employees want better to labour for Companies they respect; large investment funds seek to support firms that they see as socially responsible. From this perspective, it could be deduced that balance between the different groups of stakeholders is essential to the long term viability of the Corporation, and that stakeholder's perspective would result in shareholder maximization value. However, not all stakeholders are to be situated at the same level, and their interests cannot be granted the same relevance over the decision making process.

- *Customers and clients* are stakeholders whose satisfaction is a great challenge as no Company can create wealth for its shareholders without a stable and growing revenue base, which come from customers. Investments in customer satisfaction does not lead to conflict with maximizing long term Company viability and shareholder value.
- *Suppliers* are crucial to developing and implementing strategies that generate long-term income. Attempts to pay prices that are below market levels are likely to lead to supply disruptions or quality problems. Modern management systems are based upon working with each supplier to improve quality, and on coordinating delivery-production schedules to minimize cost and inventory. Those exercises help in raising long term value for shareholders (Torres Carlos, 2006; Fernández-Albor Baltar, 2001; Framiñán Santas, 2001).
- *Workers* performance can be directly translated into superior value creation. Companies that under pay their employees or do not fully utilize their talents will not be able to create the maximum value for shareholders. On the contrary, employees' perception of the Company they work for influence their job satisfaction and their intentions to leave the organization . The costs of turnover, especially of good performing workers is high . Actions taken relative to improve the labour environment have direct effects on the economic profitability of the organization (Riordan et alt 1997; Ferreiro Regueiro, 2009; Maneiro Vázquez, 2009).
- *Environment* is considered as another element which needs to be taken into account when adopting decisions as, only environmental friendly sustainable industry strategies are capable of providing for long term growth.
- *Human Rights* Corporate accountability to society has been raised to the attention particularly after recent corporate scandals investors have suffered losses. Further, attention has been directed to abuses committed by Companies, particularly by big transnational corporations. At the international level, some are vindicating the need to reinforce the protection of human rights by Companies (Dhir, 2006; Ruiz Miguel, 2009).

The definition of stakeholders is wide and not all authors include the same categories. It is difficult ton establish priorities. However, advocates of these theories counterbalance difficulties with the argument that when the decision making process is controlled by one set of stakeholders, others diminish their cooperation. Therefore, they say, Corporations' acknowledgement of their Social Responsibilities can be very satisfactory for Shareholders long term interests.

A positive relationship between social responsibility and financial success has been evidenced in accordance with empirical research (Preston, O'Bannon, 1997; Riahi-Belkaoui, 1991) . Companies that can demonstrate social responsibility through their reports or disclosures are said to gain recognition and a favourable reputation in the long term. Once established, this will lead to benefits such as positive employee relations, easier access to credit, products being perceived as reliable, and customer and supplier loyalty. Corporate behaviour will become inevitably linked to product image, so that a company's social identity will be as important as its brand identity

Codes of Good Corporate Practice including those drafted by shareholder groups, such as the International Corporate Governance Network ("ICGN", 1998), agree that: *'active co-operation between corporations and stakeholders' is essential in creating wealth, employment and financially sound enterprises over time… performance-enhancing mechanisms promote employee participation and align shareholder and stakeholder interests*" (OECD 1999).

5. THE CHALLENGE FOR CORPORATE GOVERNANCE IN THE 21 ST. CENTURY: DECISION MAKING AND BALANCING INTERESTS

As we have seen, Corporate Governance involves organising and priorising a variety of interests. Decisions adopted by corporations will be much influenced by the way those interests are structured. We have seen that stakeholders theories *may not conflict* with shareholders'. *Nevertheless, a policy to protect shareholders' rights and to respect stakeholders' position is difficult to implement. This is a great challenge for XXI Century law theorists, legislators and regulators.*

Disperse ownership of Company shares such as that prevailing in USA brings a primary need to balance owners and managers rights and powers. Concentrated shareholdings as are found in Europe imply certain misbalances between big owners and minority shareholders. Corporate governance must deal with different conflicts of interests. From a comparative perspective, laws vary considerably in their attitude to resolving these Corporate Governance challenges. Answers can be found in internal governance mechanisms (empowering shareholders, etc), and external governance instruments such as regulation (Kordel, 2008).

In the last ten to fifteen years, shareholder protection and involvement has improved across the globe (Siems, 2009). There is a growing debate, particularly in USA and Europe, on whether Corporate Governance systems are advancing in a way towards convergence, or whether in the future we shall see greater divergence in the ways how shareholders' rights are dealt with. The answer to this question is not easy. Path dependency will possibly always remain, however legal systems can learn from each other, particularly in a globalised world with interrelated financial, commodities, services and products markets. Each legal system will need to evolve and to adapt their Corporations' decision making processes to achieve a better balancing of evolving interests; and they need to do so in a way that allows for sustainable growth. The challenges of balancing interests comprise at least the following issues:

A) LACK AND MISUSE OF INFORMATION

Asymmetry in information impedes the development of organisations to their optimal point (Akerlof, 1970). For Corporate systems to function correctly it is necessary to prevent asymmetries and also to offer incentives for gathering information. Many aspects of modern regulation over the globe are oriented precisely to limiting or reducing asymmetries of information.

The primary legal doctrine directed towards avoiding conflict issues is that of fiduciary duties of Officers and Directors to the Company and its shareholders. Within those, the duty of loyalty, requires the directors not pursue their own interests over those of the company and its shareholders. It is intended to cover a very wide range of possible applications.

Central concerns of shareholders have to do with self-enrichment by those in control. This type of behaviour is possible because of the position that some (manages, Directors, inner circle shareholders, related parties, etc.) hold in relation with the Corporation: its business opportunities, information, etc.

Although information has generally a positive effect it can be used as an instrument to unduly benefit certain market agents by opposition to others. As we have seen, there are various types of shareholders. There are relevant asymmetries between big/block investors, and small investors in relation with their access to information. The possibility also exists for board members to abuse their positions, even if they do so appearing to provide for wider interests such as stakeholders.

Information may reduce the areas of vulnerability of shareholders and also of stakeholders. If it is accepted that shareholder's long term interests coincide with those of most stakeholders; information and transparency serves both.

B) INFORMATION AND INSIDERS

Top management, Board members, large block holders, or inner circle shareholders frequently have greater access to non-public information than others. When large shareholders have board representation, this becomes unavoidable. Even where the large holder lacks formal board representation, it may often benefit from selective disclosures by management. In either case, disclosure of information to large block shareholders raises serious insider trading concerns.

Insiders' access to information puts them in a position to extract (for themselves or for others') undue benefits through conducts such as insider trading, whistle blowing, taking advantage of corporate opportunities, etc. A deeper analysis of these conducts leads to their definition as an offense against the corporation or/and to the market. In either case rules such as the "disclose or abstain" seek to create a levelled playing field in a way that outsiders and insiders can access the same information.

C) DISCLOSURE

Disclosure to the shareholders and to the market has long been a key mechanism to improve Company Law and Corporate Governance. Disclosure to all stakeholders is less developed and, in some instances may even be prohibited (trade secrets, patents, etc.). Disclosure rules are designed primarily to provide the capital markets with financial information about firm performance, and they are also effective to avoid conflict of interest transactions.

Corporate governance and disclosure regimes are closely related, as disclosure is a powerful means for fighting agency and conflict of interest problems. Accounting standards and Securities regulation play a central role in determining the scope of disclosure in this regard. The first clearly mandatory disclosure regulation was approved in 1907 by the New York Stock Exchange, at a time when disclosure did not occupy a preeminent space. At the time, federal legislator and also the exchanges saw State laws as deficient. In fact, Berle's influential writings pointed very much by that perception. Disclosure to current shareholders (not just to external buyers) was federalized by the 1934 Act. (Mahoney, 1997).

The relatively rapid convergence of World wide accounting standards limited the impact of pre-existing country-specific cultural values. This does not mean that the cultural diversity has disappeared, but that it is loosing part of its impact on disclosure practices. The trend towards a greater transparency and disclosure was made particularly evident in the aftermath of the big early XXI Century's scandals.

Nowadays, Companies are required to disclose information beyond financial statements (forward-looking information, immediate disclosure of material events, breakdown of top-management remuneration, identity and intentions of shareholders who cross certain holding thresholds, etc.) It is generally acknowledged that (among other questions*) Shareholders should have proper notice of resolutions…*, that *…Shareholders should have adequate information on all directors and resolutions*, and that *…disclosure about the directors and the board is critical in enabling shareholders to form a proper judgment when voting.* Areas of full disclosure should include: The cycle of board and committee meetings; The availability of the terms of reference for the board and the committees; Directors' attendance record at board and committee meetings held during the year; Training provided and required for directors, and a record of who has completed this; Procedures and responsibilities for succession planning; Full biographies for all directors including dates of appointment, ages, career history prior to and in the company (in the case of executive directors), current and recent other directorships as notified to Companies House, and significant positions in public, commercial and political life. Any regulatory or statutory breaches of professional conduct should be reported in full; The main terms of each director's service contract or other contractual terms or letters of appointment. (PIRC, 1993).

Disclosure issues are critical to Corporate Governance and to empower shareholders to strengthen their position. It is widely recognised that *Corporate Governance is an issue of concern to a wide audience since it relates to the exercise of power and the success of business and the wider economy that involves consideration of the range of relationships entered into by* companies… Corporate governance is an issue of concern to a wider audience… since it relates to the exercise of power and the success of business and the wider economy. PIRC considers that corporate governance involves consideration of the range of relationships entered into by companies. Although the prime focus is on the board and accountability to shareholders, directors should identify their key stakeholders, and should report on and be held accountable for the quality of these relation-ships since they underpin long-term business success (PIRC, 1993).

D) SHAREHOLDER ACTIVISM, STAKEHOLDERS'S INTERESTS AND THE DECISION MAKING PROCESSES.

Shareholder voting is an integral component of corporate governance. From a managerial perspective, active shareholder involvement in corporate decision making could be perceived as a breach to the authority in the Board of directors. However, shareholder activism does not necessarily mean eroding Boards' power. It simply implies that management decisions can be reviewed. The core of shareholders activism is shareholders' vote and the right to propose issues to the General Meeting.

Different to shareholders activism, but related to the relationship with other constituencies holding interests in Good Corporate Governance, Corporate Social Responsibility matters seem to be more heavily entrenched in European's Legal Systems than in North America. European binding laws in employment, labour co determination, product labelling or environment provide for compulsory taking into account of some stakeholder's interest. Over and above binding laws, Corporate Social Responsibility practices are high on the EU agenda. Also, European Codes of Conduct "widely recognises that corporate success, shareholder profit, employee security and well being and the interests of other stakeholders are intertwined and co-dependent. This co-dependency is emphasised even in codes issued by the investor community".

6. CONCLUDING REMARKS

I. Company Governance can resolve corporate problems in different ways. A number of factors such as economic climate, financial environments, liquidity of the stock market, industrial organization, and politics, strongly impact upon the way followed to resolve them. Among these factors, and embracing them, culture and tradition are constantly mentioned by comparative corporatists as elements that create dependence and that together with the need for wealth maximisation and market forces influence upon country's choice of corporate law in the XXI Century. *Differences remain, although globalisation and securitisation of the economies contribute to a certain convergence in the way different Countries change their Corporate Governance traditions.*

II. Shareholders theories and stakeholder theories of Corporate Governance have been presented as opposed and conflicting. However, deeper analysis shows that their ultimate results do not need to be conflicting. Stakeholders' theories contain prescriptions for corporations to pursue ends that go beyond the short tem benefits of shareholders. Taking into account stakeholders interests, corporate governance maximises long term interests of the company and its shareholders. However the difficulties for a cooperative approach that harmonises stakeholders and shareholders interests, the rewards are very substantial. *Shareholders long term interest in cooperation with stakeholders' can help to reconcile economic, social and environmental objectives. Both need to be taken into account within Companies. How to introduce these considerations into each legal system is a challenge for XXI Century Corporate Governance.*

III. Disclosure and cooperation can be perceived as the key elements for future developments of Corporate Governance. Difficulties for shareholders to participate in corporate decisions have been described at length over the yeas by many analysts. Some of them relate to the privileges of insider's, lack of disclosure, costs of activism, etc. Over the world, insider abuses have been prohibited and disclosure practices have become compulsory. Governments, legislators and regulators in their quest to strengthen their capital markets embrace this evolution. This is the way corporate governance seems to be evolving. Division between management and ownership; or between blockholders and small owners are facts. They give way to possible conflicts but it also have positive consequences such as the professionalism of management; or active shareholders.

As mechanisms to improve disclosure and to minimise conflicts of interests and abuse of position are reinforced, and as Companies act in accordance with strategies for sustainable growth we are likely to see more a cooperative development of Corporate Governance.

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