CHAPTER II
CORPORATE GOVERNANCE: AN INTERNATIONAL PERSPECTIVE

2.1 Introduction
2.2 Models Of Corporate Governance
2.3 Shareholders Monitoring
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2.5 Corporate Governance and Take-over
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"Societies throughout the world organise their economic life according to one of the three basic types of systems: free enterprise, central state control on mixed state and private enterprise."

2.1 INTRODUCTION

This chapter attempts to present the various models available for governing the companies across the world. The different models available can be arranged in a continuum. At the one end of the continuum lies the Anglo-American Model and at the other end lies the German Model. In between lie the models adopted by different countries.

2.2 MODELS OF CORPORATE GOVERNANCE

The history of corporate governance is as old as the origin of the modern corporation. It has assumed a sense of renewed urgency with the rise in the rate of cross border trade and commerce as well as the shrinking of distance and time due to advances in IT. Thus although the concepts are not new, technological advances have made renewal imperative.

Current discussions among legal scholars, economists, and management analysts phrase the fundamental corporate governance issue as a conflict between “contractarian” and “communitarian” viewpoints. To put it simply, is the modern corporation primarily a private entity, or is it essentially a public actor, with corresponding authority and responsibility? Critics often allege that many corporate advocates want it both ways, attempting to combine the freedom and flexibility of a private person with the status and power of a public authority.²

The power struggle involves different stakeholders. A stakeholder is one who is affected by a corporation’s policies and actions. Shareholders, employees, management, Government, Board of Directors, customers and the society at large are some of the groups which have either a direct or indirect stake in the company. The ongoing debate in the corporate circle universally is whether shareholders shall be empowered to govern the company or all the stakeholders are given the right to govern the company. It is a tug-of war between two approaches, viz., contractarian or communitarian.

The contractarian/private-entity perspective relies on the assumption that a corporation is a voluntary association of natural persons (or their designated representatives) and that all other persons and entities engaging in contact with the corporation do so voluntarily as well. According to this conception, the status of every party in the corporate network is ultimately inherent in each individual’s citizenship and personhood, and it is up to the parties themselves to devise mutually acceptable terms of collaboration – or else to withdraw from the relationship. If the shareholders bear the residual risk in this set of voluntary contractual arrangements, then they are correspondingly entitled to any residual rewards that may arise. The rights and obligations arise only on account of contract entered by the parties concerned. Therefore, as per the contractual rights only the status of the party has to be decided.

The contract between the company and a shareholder gives rise to him the status of the owner of a company. As owners, shareholders have a vital stake in the company. They have taken the risk and invested their money in the company. They are the residual claimants of the company. It is therefore,

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reasonable that they should have an important voice in the governance of the company.\(^5\)

The duty of the Board of Directors starts and ends with an obligation to earn profits. According to Milton Friedman, it is not their job to be good citizens in the community. The business owes shareholders the duty of maximisation of their wealth. Since 1930s, the model has been refined to reflect the fragmented nature of share ownership. The central relationship in this form of capitalism is said to be between the principals (shareholders) and the agents (Board of Directors).

Under this approach, the shareholders are the supreme body to govern the company. This is also called as Anglo-American Model, which is prevalent in U.K., U.S.A., India and other English speaking nations. The Anglo-American Model is the market driven one. The market provides the necessary facilities to set right the management which is performing not to the desired level. The individual shareholders need not take pain in changing the management. The market dictates the management either to improve the performance or to leave the seat for the suitable candidate. If the management fails consistently, the price of the shares of the company will be considerably cheaper. The cheap shares will induce an outsider to take over the company by acquiring the necessary number of shares from the open market to control the management. On the other hand, good performance is normally associated with rising prices in the share market. Hence, the attempt to take-over the management through this route becomes more costlier and may become futile if challenged in the annual general meeting. In the seventies, such an attempt was made by Swaraj Paul to take over the management of DCM and Escorts Limited, though it was a futile attempt. In the recent years, India Cements Limited acquired the control of Rasi Cements Limited through this route. In the new millenium, Arun Bajoria of

Calcutta is making an attempt to acquire the control of Bombay Dyeing and another predator Dalmia of New Delhi is attempting to take Gesco Limited, the subsidiary of the former Great Eastern Shipping Corporation of India. Stock exchange is the vehicle through which corporate governance is carried out. The market mechanism, through the take-over route takes care of the shareholders who are the real owners but cannot exercise such an amount of control on the management. This is one side of the coin in the debate of corporate governance.

The other side of the coin, known as Stakeholders Approach or Model dilutes the board constitution by giving representation not only to shareholders but also different stakeholders. Contrary to the Contractarian view expressed in the support of shareholders approach, stakeholders model treats the company as "the communitarian or public-actor". This approach views the corporation as a social institution operating under a grant of special status and authority from the host society. Hence an obligation imposed upon the company to owe the society which has given to its birth.

According to the systems theory, all living organisms (systems) interact with each other and are affected by their host environments. Under the Communitarian view, the company will act in ways that are supportive of the goals and norms of the host society that has granted it the privilege of operation as an entity with special legal status – limited liability and indefinite life. Hence it concludes that the community, besides the shareholders should be given representation in the governance of the company. The different stakeholders are to be given representation in the governance of the company.

One of the arguments in favour of granting the right of governing the company to the shareholders is that they are the risk takers. This argument seems to be misleading in the light of present day environment. In U.K., more

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than 60 percent of the shares are owned by financial institutions and a further of 20 percent by foreign institutional investors. The investment by these institutions has been highly diversified. In the event of bankruptcy, the institutions as they have diversified their investment, is not at all so risky as perceived and demanded by the contractarians. At the same time, the dividends in general are flexible upwards and increasingly inflexible downwards. So equity delivers an income return that looks more fixed than residual.\(^9\) Hence the governance of the company need not be entrusted to the shareholders only.

The communitarian point of view is that employees should also be considered a part of the owners of a company. The status of employees are more vulnerable. They argue that like shareholders, employees also make substantial firm-specific investments. Without such employee learning, the company’s other investments in fixed assets would not be as valuable as they are supposed to be. Hence, employees too should have a say in the legal structure of corporate governance.\(^10\) Employees are a source and repository of human capital. In a modern society, human and social capital is often more scarce and vulnerable than physical or financial capital. They conclude that the balance of risk and reward is unfairly tilted in favour of capital. The wisdom of this policy is widely debated. On the one hand, employee representation may help to improve worker-manager relations, thereby decreasing strikes and other worker disruptions and increasing worker productivity. On the other hand, some believe that it skews company policy in favour of workers as opposed to shareholders and lowers company efficiency and growth.

Maximising returns to shareholders may be logically correct focus for the managers in the 19\(^{th}\) century world where competitive advantage was derived substantially from the use of physical assets and cheap labour. However, it

looks both crude and anachronistic in the light of present day society, where human resources are more valuable than physical resources. As a result in U.K., since the amendment of Companies Act in 198, directors have been required to take into account the interest of the employees. Hence, the shareholders exclusive rights have been deprived of to the residual assets of the company on liquidation, which was granted in the earlier version of Companies Act. However, there is no corresponding change in the Indian Companies Act.  

The financial institutions and the creditors are also interested in the well being of the company because their funds are at stake, though not in the form of capital. Hence to protect their investments, they also require representation in the governance. The model which gives recognition to the stakeholders are called as Stakeholders Model. The stakeholders approach demand board representation to major stakeholders groups including employees, consumers, minorities in the society, women, environmentalists and the general public. The objective is to allow affected groups to participate significantly in decision making. As Prof. John Kay has argued, the role of management in a system is that of a trustee. The task is to balance the interests of all the stakeholders in the long terms interests of the company. Where the interest conflicts, a natural outcome, the conflict is not resolved by putting the shareholders’ interests first, but by exercising professional judgement.

Thus, the advocates of stakeholders approach argue that this approach is well designed to address the requirements of a world in which competitive advantage derives increasingly from implicit contracts. It is a view of the firm which emphasises the value of the trust in business life and recognises the

12 Ibid.
importance of such qualities as loyalty and commitment which cannot be explicitly priced. Such a high-trust framework is conducive to long-term behaviour.\textsuperscript{15}

Basically, corporate governance structure may support either shareholders model or stakeholders model or a hybrid of these two models. The models can be compared to a scale, where at the one end lies the shareholders model and at the other end is the stakeholders model. As the scale moves towards the stakeholders model, more and more involvement of stakeholders in the decision making process. Initially the labour side may be given representation. Gradually, the creditors may also be involved. If the necessity arises the minority can also be given representation. Customers interest also can be taken care of by inducting suitable persons in the board. Depending upon the need, the socio-cultural, political and economical background a via media can be struck.

Each board model evolved in a country, is in many ways a unique outgrowth of country-specific economic, political, historic, and cultural factors, and it is neither desirable nor possible to "import" an entire model into another country. In some cases, it a historical accident, as in India. In spite of the fact, such analysis helps to isolate certain characteristics of particular system that can be incorporated in the governance pattern of the companies in a country.

The final shape of the board will not emerge at the stoke of the brush. It is not a one time process. It is an evolutionary process. The Germany is adopting the stakeholders approach. It is not the result of a momentary decision made in the 20\textsuperscript{th} century. It is deep rooted in its social fabric. The seeds of labour participation in the supervisory board were sown as early as 1830. The origin of labour participation goes back to 1830, long before the fateful 1860s.

\textsuperscript{14} J.Kay and A.Silberston, “Corporate Governance”. National Institute of Economic Revenue, August, 1995.
when the German Union movement started and Karl Marx published Das Kapital. It is the result of an idea suggested by a law Prof. Robert Von Mohl who proposed joint negotiations of employers and worker groups on employees suggestions for improvement of working conditions.16

If the classification is attempted on the criterion of shareholders or stakeholders model, countries like U.S.A., U.K., India, Canada, and Egypt follow shareholders model, where the board is constituted by the shareholders. The shareholders are empowered to hire and fire directors. In Egypt, for example, the general body meeting of shareholders can dismiss any of the board members, even if this is not included in the agenda.17 Whereas countries like Germany, Denmark, and Hungary follow the stakeholders model where the board is constituted not only by the shareholders but also by different stakeholders like employees, and creditors.

The governance structure can also be discussed from another angle, viz., whether the board is a two-tier or one-tier structure. If the companies are managed by a single body, it is customary to call such board as Unitary Board in contrast to the two-tier board, where two bodies are involved in the management of the company. India, U.S.A., U.K., etc. are following unitary board model compared to Germany, and Netherlands where they are adopting two-tier board structure. Yet there are certain countries which permits the companies either to have a unitary board or two-tier board, as in the case of France.

Yet another way of looking at the corporate governance system is whether the board is an oversight board as in the case of Germany or insider board as in the case of Japan. In the case of an oversight board, the board is fully independent. All the members of the board of outsiders. Under the insider model, all the directors of the board are full time directors. The board in

17 The International Handbook of Corporate governance, International Thomson Business Press, London.
different countries adopt either a pure model like insider or oversight board model and certain countries adopt a hybrid version where the directors can be either whole time as in the case of insider board or part-time directors like oversight boards. Oversight bodies, no matter how well-designed, will not function adequately if the members lack competence and are not held to high standards of fiduciary responsibility. U.S.A., U.K., and India are some of the examples of the countries which follow a hybrid version.

The decisions regarding the shareholders or stakeholders model, unitary or two-tier board, insider or oversight board are normally not at the discretion of the companies. The statute governing the corporations will define rigorously which set they have to follow. If at all any flexibility is there, it is only because of the freedom granted by the statutes as in the case of France, permitting the company either to have unitary or two-tier board structure. Similarly in India, the board can be constituted either as an insider board or outsider board, i.e., all directors are non-executive directors. The following paragraphs present how the boards are constituted in different parts of the world especially U.S.A, Japan and Germany, besides some reference to the Central and East European countries.

2.2.1 Anglo-American Model

Among the countries which follow the Anglo-American Model, the model followed by U.S.A., is a typical one. The American corporate governance structure is a typical system followed in many of the English speaking nations including U.K. There is an established corporate law in each State, unlike in India where the uniform company law is followed throughout India. It is a central subject. In the United States of America, there are fifty states. Correspondingly, each state has its own corporate law. Some states are more prolific, and has been given registration to more corporations than other states. Although New Jersey initially set precedent in this respect, Delaware is currently
the most prolific corporation-begetter. Nearly half of the 1000 largest corporations are legally domiciled in Delaware. Nearly one-fourth of Delaware's entire annual revenue comes from corporate franchise and business income taxes.\(^{18}\)

The U.S.A., is adopting the shareholders model with respect to the constitution of the board. In an American company, the shareholders are the supreme authority. They constitute the Board of Directors and entrust the control and management to them. The Board of Directors is responsible for establishing corporate objectives, developing broad policies and selecting top-level personnel to carry out these objectives and policies. The board also selects the Chief Executive Officer (CEO) and entrust to him the day-to-day administration. However, the board is accountable for the results of the CEO. Most of the companies in the U.S.A., have oversight board, but not a pure one. It is a mixed board, i.e., hybrid of oversight board and insider board. A typical American board comprises both executive as well as non-executive directors. The structure of the board is single-tier.

Though the CEO looks after the day-to-day affairs of the company, most of the board of American companies frequently use committees for making vital decisions. Thus separate committee for fixing the remuneration of the officers of the company will be constituted under the title Remuneration Committee. The Board of Directors appoints various committees and in turn they report to the Board of Directors. The following committees are usually formed in an American company. Table:2.1 shows the importance of various committees in the governance of American companies.

Table: 2.1
Role of Committees in Corporate Governance in U.S.A.

<table>
<thead>
<tr>
<th>Name of the Committee</th>
<th>Percentage of companies in which the committee is functioning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive committee</td>
<td>78</td>
</tr>
<tr>
<td>Audit committee</td>
<td>97</td>
</tr>
<tr>
<td>Remuneration committee</td>
<td>82</td>
</tr>
<tr>
<td>Ethics committee</td>
<td>6</td>
</tr>
<tr>
<td>Public affairs committee</td>
<td>11</td>
</tr>
</tbody>
</table>

Source: Lester B. Korn and Richard M. Ferry, Board of Directors, Thirteenth Annual Study, New York, Korn/Ferry International

Of all the committees which are in use today, the Audit Committee plays a significant role. It is a must for a company listed in New York Stock Exchange. An Audit Committee is constituted by the Board of Directors and the terms of reference is also fixed by the Board of Directors. However, the members of the Audit Committee should be independent directors and should have exposure in the financial accounting and management area.

Although members of the board are elected by the shareholders, boards of U.S.A., companies have often been seen as partners of incumbent management rather than protectors of shareholders' rights. For example, management maintains significant power over the board through its ability to recommend board candidates during elections (as most proxy voters follow management's recommendations). In recent years there has been a stronger push, particularly from larger institutional shareholders, to appoint more independent members to corporate boards, and much of the literature in the U.S.A., on corporate governance emphasises this as a primary direction of reform in the future.

Board activism is a recent phenomenon in America, in which a board of directors monitors and controls the conduct of the day-to-day management. So
far, they have been yes men for the present incumbent management, especially CEO. In fact, it is a rare case for a board of directors to dismiss a poor performing CEO in the past, on the basis of assessment of management operations. However, recent happenings were epoch making one where the incumbent management is dismissed by the oversight board, really an oversight boards work. In General Motors, IBM, Kodak, etc., the CEOs were dismissed during 1992-1993 for their poor performance.

Yet another feature to attract the researchers throughout the world is compensation package. The compensation payable the members of the Board of Directors is not a controversial issue. The membership to the Board of Directors is a matter of prestige. Hence remuneration does not matter much. However, the remuneration to CEO and other executive officers attract wide attention. The shareholders are the competent authority to fix the remuneration. Normally, the shareholders rely upon the management’s report. Moreover, the proposed packages on which they are voting are often so complex that assessment of their value is difficult. Recent studies indicate that there is a relationship between management turnover, managerial compensation and firm performance.

Shareholders vote on managerial compensation in the U.S.A., and Japan, but Supervisory boards determine the salaries of German managers. Recent research appears to indicate that management turnover, and to some extent managerial compensation, does bear some (albeit limited) relation in all three countries to firm performance (particularly if such performance, whether measured through stock price or through earnings, is negative).

Another contrasting feature in an American company is the system of proxy voting. The role of financial institutions and proxy voting plays an effective role in improving the system of Corporate governance. One cannot boast much of the shareholders’ activism in U.S.A. Besides the Securities Exchange Commission, the counterpart of SEBI, is a powerful authority, whose role is instrumental in improving the Corporate governance.
Another notable feature in the corporate governance system in U.S.A., is that the system is market driven. When a company fails to perform well, naturally the share prices will dip in the market. If the performance of the company is poor because of the inefficiency of the management, then the relative cheapness of the share price tempts other entrepreneurs, here afterwards referred to as acquirer, to take over the control and the management by acquiring the shares at a cheaper price in the market. Institutional investors also play a vital role in such take-over battles. If the existing management fails to deliver the results, they will dispose shares. Usually, the holding of the financial institutions will be considerably higher. Therefore, whoever wants to take over the control of the target company can easily acquire shares in bulk from the financial institutions. The financial institutions who have not disposed the shares will support new management if they feel that the new group will deliver the results. In this way, the securities market imposes a discipline on managers by exposing their companies to possible take-over and themselves to likely replacement. Thus, the system is rightly called as market driven. That very discipline creates complex conflicts of interest, however, between managers, directors, and shareholders. Managers are typically against involuntary take-over, because they are likely to lose their jobs. Shareholders can benefit from such take-over, however, if the new managers are more efficient; empirical studies of mergers and other acquisitions show that most take-over result in rising share prices. Directors are caught in the middle; they also risk losing their positions on the Board if the take-over succeeds, but their fiduciary duties and often their day-to-day interests are clearly tied to those of the shareholders they represent.19

Another remarkable feature in the American model is there is no statutory stipulation in the corporate laws of various states for the appointment of

auditors. Hence shareholders will not appoint statutory auditors. Perhaps, the absence of this mechanism is instrumental in the introduction of audit committee in, as early as 1978. A typical American governance structure is shown in Figure 2.1.

2.2.2 German Model

Joint stock companies are in existence since 1870 in Germany. Various corporate forms are available, but the most popular form is Aktiengesellschaft or AG. A German company is managed through a system of committees consisting of two tier. Two committees are constituted for this purpose. The upper tier is known as supervisory board (in German language it is referred to as Aufsichtsrat) and the lower tier as management board (Vorstand in German language).

Figure 2.1
Governance structure of a typical listed company in U.S.A.

The Joint Stock Company Act of 1965, which covers most of the corporate forms of business in Germany, empowers the supervisory board to constitute the management board and to oversees the management board’s work. It is the superior body. Unlike in India the size of a German board, Aufsichtsrat, is not defined by it the Articles of Association. It depends upon the number of employees, with a minimum of three members.

In German model, the supervisory board or Aufsichtsrat is constituted both by the shareholders and employees. Equal representation is given both to the shareholders as well as employees. Once the board is constituted, the first agenda will be election of a Chairman of the board. It is a key post. The chairman of the board enjoys an extra vote, which can be used whenever a tie occurs. The chairman is to be elected by two-thirds majority. If a candidate fails to win the required majority, the members representing the shareholders will elect the chairman of the board and the members belonging to the employees group will choose the vice chairman. Therefore, though both capitalist as well as workers have been given equal representation, by virtue of the casting vote enjoyed by the chairman, the ultimate power lies with the shareholders.

Shareholders will elect the required number of members for the Aufsichtsrat in their general body meeting. However, the contribution of the employees towards the Aufsichtsrat is not so simple. All classes of employees send their representatives to the Aufsichtsrat. Blue-collar workers, white-collar employees, upper-middle managers will select their representatives. Besides union representatives will also send their representatives to the Aufsichtsrat. The process of electing the employees representative is so complex that the Government’s election rules for electing the representatives of the employees, weighs over three pounds.

Supervisory board members are not full time members. A minimum of four board meetings shall be conducted in a year. It is usual for the supervisory
board members to have contacts and consultation with the management board members individually. The minimum size of the board stipulated under the Companies Act is three. The articles of association of the company may cast additional duties upon the supervisory board over and above the responsibility fixed by the Companies Act. A typical supervisory board is empowered to have veto power over major capital spending projects, closings or movements of plants, company bond issues and the appointment of upper-middle managers. The Aufsichtsrat is responsible for accounts and dividend. However, it cannot take day-to-day management powers from the management board.

The Aufsichtsrat elects the members of the Vorstand or management board, by two-thirds majority. If they fail to select a member by the required majority, a four member committee will be constituted, again equal representation of shareholders and workers in the committee. The committee will be given a month's time to suggest an acceptable candidate. After a month, once again, the board will repeat the exercise for the election of the member, for which a fresh polling is conducted. A simple majority may be sufficient now for electing the member of Vorstand. The chairman should not exercise his vote in the second election. If the board fails to elect a candidate in the second election also, a third election will be conducted at which the chairman can cast his vote, naturally in favour of shareholders. This complex procedure is adopted only for electing the members of Vorstand. For other businesses a simple majority may be sufficient.

The company law gives the management board the legal duty to run the day-to-day affairs of the company and to represent the company in dealings with third parties. The Vorstand is headed by a chairman, sometimes called as a speaker. The leader of the Vorstand is not a boss but a “first among the equals”. The law does not empower him to overrule the majority of his board colleagues when disputes arise. The Vorstand consists of highly paid executives who serve renewable terms of up to five years. Each Vorstand member has responsibility
for a special area of company operation. The deep involvement of the Vorstand
members in company affairs gives them a specialised knowledge that usually
weights the scales in their favour when it comes to a contest of wills with the
supervisory board. The Vorstand can appeal any veto of the aufsichtsrat to the
shareholders meeting. The shareholders meeting may overrule such a veto by
passing a special resolution. However, this possibility is only theoretical. Such
meetings are held very rarely.

The German accounting and auditing practices require companies to
make provisions for various short-term and long-term risks, which is not in
vogue unless and otherwise the risk is materialised in our country. such
liabilities are shown as contingent liabilities.

The system of corporate governance in Germany is much less market
driven. In a majority of the companies listed on the German Stock exchange, a
single owner held more than 50 per cent shares. The corresponding figure in the
USA was 5 per cent. At the end of 1993, private households held only 17 per
cent of outstanding equity shares of joint stock companies listed on the German
Stock Exchange, compared to 49 per cent in the USA. Since the shareholding
is much concentrated and individual shareholders also deposit the shares with
the financial institutions, the voting pattern is significantly different in German
companies compared to other countries like U.S.A., or India. The financial
institutions while casting the votes as proxies for the individual shareholders
have to cast the votes in accordance with the instructions given by the individual
shareholders. The governance structure has an in-built mechanism of checks and
balances. As various stake-holders like shareholders, employees, financial
institutions are entering the Aufsichtsrat itself, the information asymmetry
among the various stakeholders is much less compared to other countries.

KRS Murthy, “Corporate Governance Worldwide”, Management Review, Vol.8 No.3 & 4, July-
Ownership of property in Germany is seen as imposing concomitant duties for its use for the public weal. There is an instance when the board of a company in Germany did not permit the management to use the insurance money from a plant which caught fire for improving production in another place. The board successfully got the money deployed for the community, which suffered on account of the fire in the plant. The involvement of German industry in creating educational infrastructure through technical apprenticeships is another instance of government-industry co-operation in practice.\textsuperscript{21} A typical corporate governance structure of a company with a supervisory board of strength 20 is given in Figure 2.2.

2.2.3 Japan Model

Corporate governance was not a popular term among Japanese business society until a few years ago. It, however, has become a hot topic and a requirement today as one of the needs to establish global standards in the business world, not only in Japan but the entire world.

There are two types of companies in Japan, viz:

(i) Small sized limited liability company (Yugen Kaisha) and

(ii) Limited liability company (Kabushiki kaisha), usually abbreviated as KK.

The KK is the most common type of company listed in stock exchanges. The law governing the KK is Limited Liability Company Law (Yuen Kaish Ho). In addition to this, a company has to adhere to the provisions of Securities and Exchange Law, if it is a listed company.

\textsuperscript{21} Ibid.
FIGURE 2.2
Corporate Governance Structure in Germany
(with a supervisory board of size 20)

Jobholders
- Elect Labour's Supervisory Board Representatives
- Through electors or directly

Shareholders Assembly
- chooses capital side of Supervisory Board, has decisive voice in many questions.

Electors

Constitution of Supervisory Board

Labour
- 10 members
  (7 from within company, 3 union representatives)
- Members include at least
  1 blue collar, 1 white collar, 1 managerial jobholder

shareholders
- 10 members, including Chairman, who has casting vote

Supervisory Board chooses, Overseas Management Board.

Management Board
- Handles day-to-day administration

Source: James C. Furlong, Labor in the Boardroom The Peaceful Revolution, Dow Jones Books, New Jersey
The Limited Liability Law divorces the management from the shareholders as in the other countries like India and elsewhere. Shareholders are the supreme authority in a company. The shareholders elect a team in the annual general meeting, the Board of Directors (torishimariyaku-kai) and entrust the management to them. In turn the Board of Directors elect an operational team (daihyo torishimariyaku) to which the day-to-day administration is entrusted. The chief of the operational team is called as President. Designations like chairman, senior managing director and managing director are prevalent in a company. However, a president is the supreme authority in a daihyo torishimariyaku.

A director can hold office for a period of two years, subject to re-election for the subsequent terms. A director can hold office for any number of terms, without any restriction by re-election.

The day-to-day administration shall be carried on by a team of directors elected from among themselves. Such elected directors are designated as representative directors (daihyo torishimariyaku). The team of directors is lead by a representative director designated as President. The number of representative directors vary from company to company depending upon the size and nature of the business.

Unlike other western countries, the audit function considerably varies in Japanese Law. As already mentioned a Limited Liability Company has to satisfy the provisions of Limited Liability Law, Commercial Code as well as Securities and Exchange Law. As per the provisions of the Commercial Code, the financial statements of a company should be reviewed by a statutory auditor. A statutory auditor shall not be an employee of that company. However, there is no stipulation in the code regarding the qualification of the statutory auditor. Neither he should have a professional qualification nor any previous accounting experience. The term of the statutory auditor is three years.
In addition to the statutory auditor, the shareholders must appoint an independent auditor in the annual general meeting. The independent auditor should be a CPA or an Audit Corporation. The independent auditor must express his opinion about the accounts maintained by the company.

Besides, the Securities Exchanges Law (SEL) stipulates that the accounts of a listed companies should be audited by either a CPA or an Audit Corporation. This auditor should express whether the accounts are maintained in accordance with the accepted accounting principles, accounting standards and SEL regulations. This report is considered to be the supplementary information of the annual accounts and reports submitted.

Though legally, the company is managed by the board and the board is selected by the shareholders in the annual general meeting, in reality it is closer to the German model, where all the stakeholders have a vested interest in the functioning of the company. Corporate governance in Japan is not focused on the board of directors of the company. The Japanese concept of obligation to company, country, family, and their willingness to follow a consensus, makes the system's accountability easier and one based on trust. The system's dynamism is derived from cross holdings and networks among companies in the group. Moreover, the post II World War Japanese economy compelled all the Japanese companies to contribute towards the reconstruction of the nation which was completely collapsed. In that process they have ignored the differences of different stakeholders like labour, employees, customers and creditors. All were united in the building up of the nation. The seeds of growth in Japan can be traced in the ashes of the II World War. This attitude of all the stakeholders is instrumental in rebuilding the nation within a short span of time. Another noteworthy phenomenon is that all the companies will be conducting their annual general meeting in the month of June and that too the duration of the meeting will also be longer. Fig.3 exhibits the corporate governance structure of a Limited Liability Company in Japan.
This practice of conducting the meeting of the different companies simultaneously throughout the nation can be attributed to the shareholders' activism.

2.3 SHAREHOLDERS MONITORING

Shareholders monitoring is an essential ingredient of corporate governance under the shareholders model. The shareholders are the appointing authority of the Board of Directors. They have the power to hire or fire the directors. Therefore, the effective functioning of the shareholders model depends upon the effective monitoring of the performance of the Board of Directors, i.e., the management of the company to whom the Board of Directors have entrusted. If the management fails to perform, the shareholders should...
change the Board of Directors. The change of the Board of Directors or the management is the result of such monitoring. But this is not possible by the active shareholders even. Normally, the institutional investors will be on the sides of the management. At the most, they can have their influence felt in the executive suit.

(The shareholders monitoring can be either passive or active. Passive shareholders rely on "exit" as their main discipline on managers, while active shareholders rely more heavily on "voice". The U.S. model, for example, is heavily weighted towards "exit," while the German and Japanese models rely more on "voice." In the UK, organisations like PIRC and other organisations effectively exhibiting the shareholders strength by actively participating in the annual general meeting.

In Central and Eastern Europe, where stock markets are poorly developed exit route is unlikely to be an efficient option for some time to come as the markets are not so much developed and at the same time the ownership pattern is also not scattered. Thus, active shareholders monitoring is likely to be one of the most important modes of corporate governance in the near term.

In both Germany and Japan, shareholder suits are much rarer. In Germany, there are no legal restrictions on such suits, but the awareness of shareholder rights has developed more slowly than in the U.S.A., due to the large role of the banks. Furthermore, in their capacity as liaison between shareholding clients and companies, banks control the flow of information between the two, thereby checking shareholder litigation. Under Japanese law shareholders may sue their managers and directors.

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2.4 INTERNATIONAL PERSPECTIVES

Managers in a market economy face a wide array of constraints, both economic and legal, facing managers as they carry out their jobs. On the economic side, product markets and the desire to avoid bankruptcy clearly constrain managerial behaviour. Capital markets exert discipline on managers of those firms that must raise money externally. Labour markets constrain managers to the extent their jobs are contestable or they expect to seek other employment in the future. On the legal side, government regulations and laws of fiduciary responsibility can constrain managerial behaviour. A further and very powerful, constraint on managerial behaviour is the cultural norm of commercial behaviour prevailing in an economy.

If one analyses the boards of different countries, different picture emerges. Many countries follow a hybrid variety of the practices depending upon their social, political, economical environment as well as their requirement. U.S.A., follows the shareholders model for the constitution of the board, by embracing the unitary model, with a hybrid model of oversight board and insider board. U.S.A., boards are typically composed of both inside officers as well as outsiders, while Japanese boards are composed entirely of insiders. The board (U.S.) appoints the chief executive officer of the company, who in turn appoints other officers. In addition to selecting (and dismissing) management, the board approves major decisions, such as declarations of dividends, corporate borrowing, and other business strategies. It also approves proposals for mergers, sales of substantial corporate assets, and dissolution, which are then subject to shareholder vote.

Similarly Japan, legally speaking, adopts the shareholders model, i.e., the board members are selected by the shareholders. However the practice is different. Informally they follow the stakeholders approach. The Japanese boards are constituted on the basis of insider model, with a single-tier board.
Although the formal Japanese oversight structure resembles that of the U.S.A., the balance of power between managers and shareholders in Japan appears in reality to be closer to that of Germany, rather than that of U.S.A. Again, shareholders are not mere abstractions but are clearly represented in their various representatives, who are not as psychologically, socially, or financially dependent on the CEO as in the U.S.A.

Germany follows a two-tier model, the upper tier is called as supervisory board and the lower tier is referred to as management board, with stakeholders model giving representation to different stakeholders like shareholders, employees, financial institutions. It is following a pure oversight board. Each German corporation has a management board and a supervisory board. The former is responsible for running the company on a day-to-day basis, while the latter is composed exclusively of outsiders. Unlike in the U.S.A., members of the management board may not sit on the supervisory board, and vice versa. The supervisory board has two main responsibilities--to supervise the management board and to appoint all of its members (not just the chief officer) for five-year terms. The members of the management board may be fired only for just cause and thus maintain a fair amount of independence in their day-to-day decision making. Much of the independence of German supervisory boards arises from the more concentrated patterns of ownership in German firms. Because supervisors are elected by shareholders, and banks control many votes, banks typically have one or more appointees (often the chairperson), who are viewed as direct representatives of those banks. Similarly, under the policy of "codetermination," employees are entitled to elect one-half of the supervisory board. These appointees are neither beholden to management nor loyal to a diffuse, abstract shareholder body. As a result, their loyalties are concentrated and concrete, which insures greater independence from management. In most cases no single shareholder has absolute control, but a coalition of independent shareholders does.
Bulgaria and France has a hybrid system, in that a joint stock company can have either a "two tier" system (management and supervisory boards) or a more simple "one-tier" system (a board of directors only). Romania differs from the others in that its company law does not provide for a supervisory board, although its "Board of Administration" may delegate some of its powers to a managing committee, thus in effect creating a system somewhat like the two-tier system.

Central and Eastern European (CEE) countries' companies are new generation companies, compared to the countries which have been taken for the discussion in the preceding paragraphs, viz., U.S.A., Germany and Japan. The CEE countries are new entrants to the market driven economy model. The private sector concept itself is new to them. Now they are in the process of establishing Corporate governance procedures. The following paragraphs are devoted for the discussion of Corporate governance practices in CEE countries.

In the Central and East European countries, where shareholding is concentrated in the States Control, the problem faced by them is relatively new in the literature of Corporate governance. The degree of concentration of ownership tends to affect the monitoring of management. At present, the shares are in the hands of the Government. With the privatisation programmes, countries are likely to face new problems vis-à-vis Corporate governance. If a country carries out a mass privatisation programme, there is a chance of wide distribution of ownership of shares. Otherwise, chances are there for the concentration of ownership. How to maintain efficient corporate governance while moving away from central administrative control towards widely dispersed ownership is a central issue throughout the region.23

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The prevailing governance systems in different parts of the globe are largely untested in the CEE context because of the small size of the private sector in general and the particular shortage of widely held medium-and large-sized private companies. A number of countries in this region have opted for independent oversight bodies either with or without supervisory boards or auditors or both. They draw a clear line between management and oversight board by eliminating overlapping membership in the two bodies. Some try to accommodate the interests of workers through allowing them representation on supervisory boards. Fortunately for these countries a wealth of information is available on the basis of which they can model their Corporate governance structure. Yet it is unclear whether the provisions will be successful in leading to independent and effective corporate governance. It is an untested water. A major lesson from the U.S.A., German, and Japanese is that the efficacy of oversight bodies depends largely on their degree of independence from management as well as the ownership pattern.

If shareholding or share voting rights (via proxies) are relatively concentrated, then members of oversight bodies are likely to be more independent from management. In the event of dispersal of ownership, the general trend throughout the universe is, the small shareholders as well as the institutional shareholders trust the incumbent management. Therefore the effectiveness of the Corporate governance structure which these countries have evolved is related to the pattern of concentration of ownership.

Another contingency to be faced by this model is the availability of the suitable and trained personnel to the board. Relative to the sharply rising demand resulting both from privatisation and from "corporatisation" in theses countries, there is a severe shortage of persons in CEE countries who have the requisite knowledge to be effective board members. Although time, experience, and training will help ameliorate this problem in the medium-term, it will seriously affect prospects for effective corporate governance in the short run.
Limiting the number of members of boards to the minimum allowable by law and including some foreigners as members can help. Allowing people to serve as directors on several boards may also help, but this advantage must be weighed against two potential disadvantages: (1) conflicts of interest that could arise if one person were serving on the boards of competing companies, and (2) the collective disincentives for strong and honest oversight that could arise in an entrenched body of interlocking directorates.

With regard to standards of conduct, the powers of managers and members of oversight boards need to be moderated to prevent self-dealing and protect the rights of minority shareholders and the general public. In most market economies, managers and directors are held to a general standard of reasonable care, but the extent to which this standard is enforced depends on a variety of factors, including culture and access to information on managerial or supervisory behaviour. Among the advanced market economies, law suits alleging fiduciary irresponsibility have been most common in the U.S.A., and many have been related to take-over battles in which shareholders believed their interests were being sacrificed to those of incumbent managers and directors. It will not be out of place to mention the phenomenon of golden parachutes, which is practised at the time of take-over battles. When top level managers think that their company might be the target of a take-over attempt, they frequently persuade the Board of Directors to grant them a guaranteed severance package of salary and benefits in case they lose their jobs after the take-over. The former chairman of Revlon floated to earth under his golden parachute worth $35 million after Pantry Pride took over the company. He was joined in the skies by the his close associates. The SEC chairman estimated that by 1984 over 1,000 corporations had installed similarly but less lucrative arrangements for their top officials. It is a question of fairness in spending shareholders’ money for these purposes. One editorial stated, “allowing top officers to write themselves company-paid insurance policies in case somebody grabs off the company – or
even threatens to – is an abuse of management prerogatives and a misuse of shareholders assets”. 24

CEE countries have generally followed the German model of stakeholders approach because of their political ideology. The CEE countries, which are following till recently the communist principles, are naturally attracted by the labour participation at the board level. Thus they have preferred the German model to the U.S.A. model. Moreover, the share markets of the CEE countries are not so much matured when compared to the U.S. market. The share markets of Germany are less developed as compared to U.S. Therefore, from many angles the German model fits their environment well and hence they would have adopted the German model.

Control over the selection of board members greatly affects their independence. The company laws of CSFR, Hungary and Poland allow both the board of directors and the supervisory board to be elected directly by shareholders, arguably making the board of directors less directly accountable to the supervisory board.

In the CSFR and Polish cases, the company bylaws may change this by providing (as in Germany) that the supervisory board elects and dismisses the members of the board of directors, and in Poland the supervisory board may suspend "for serious reasons" members of the board of directors elected by the general meeting. Bulgaria follows the German model of its two-tier system, providing that members of the management board are elected and recalled by the supervisory board. In all of the two-tier systems, persons cannot serve on both boards simultaneously. In Romania, in contrast, the head of the managing committee must also be a member of the administrative board.

An additional issue is the role of workers in the constitution of the Board of Directors. CSFR and Hungary follow the German model of codetermination

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in large companies (defined as those with over 50 and 200 employees, respectively) by giving employees the right to elect one-third of the supervisory board compared to the German model where the workers have an equal right in the supervisory board representation.

One trend is noticeable universally if one goes through the trend in corporate governance practices. In U.S.A., where the shareholders model is prevalent, gradually they are moving towards the stakeholders model. The practice of Employees Stock Ownership Plans (ESOP) is more prevalent in knowledge based companies in India and all types of companies in the U.S.A.

Hence through the ESOP the employees will also become the owners. Naturally they can also participate in the management, i.e., they can also elect the Board of Directors. Therefore the shareholders model is getting diluted. It is moving towards the stakeholders model by involving employees in the constitution of the board, by virtue of their shareholders capacity. Table 2.2 portrays the prominence of ESOP popularity in U.S.A.

Table 2.2

<table>
<thead>
<tr>
<th>Company</th>
<th>Number of Employees</th>
<th>Percentage of Stock owned By Employees</th>
<th>Number of Employees Representatives of Board of Directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chrysler</td>
<td>59,000</td>
<td>15</td>
<td>1</td>
</tr>
<tr>
<td>Eastern Air Lines</td>
<td>37,000</td>
<td>25</td>
<td>4</td>
</tr>
<tr>
<td>Weirton Steel</td>
<td>8,700</td>
<td>100</td>
<td>3</td>
</tr>
<tr>
<td>Hyatt Clark Industries</td>
<td>1,500</td>
<td>100</td>
<td>3</td>
</tr>
<tr>
<td>Interstate Motor Freight</td>
<td>1,500</td>
<td>45</td>
<td>2</td>
</tr>
<tr>
<td>Pan American Air Lines</td>
<td>27,000</td>
<td>10</td>
<td>1</td>
</tr>
</tbody>
</table>

Similarly, the countries which have embraced the stakeholders model are gradually moving towards the shareholders model. In Germany, for example the interests of the shareholders are often subordinated to those of creditors and employees. German industry enjoyed the benefit of subsidised lending rates. In Japan, listed companies invested in each other’s shares not to secure high returns on their investment but to cement stakeholders relationships and to protect themselves from hostile take-overs. Income returns on equity were very low by global standard. The interests of the workers were considered to be paramount in both Germany as well as Japan, where the countries faced total destruction during the II World War. They are in process of rehabilitation. Hence, there is a reciprocal understanding between the owners, employees and the creditors.

With the dawn of globalisation, the pressure to enhance equity returns is causing cross-subsidies and cross shareholdings unravel. To that extent, the stakeholders economies are now moving towards the shareholders economy. Thus, universally one can notice the convergence of the Corporate governance culture among different nations.

2.5 CORPORATE GOVERNANCE AND TAKE-OVER

The market for corporate control has been very active in the U.S., particularly in the 1980s. In contrast, hostile take-overs have been rare in Japan. The reason is partially legal in nature. Although Japanese take-over rules are modelled on those of the U.S., certain legal provisions inhibited hostile take-over activity throughout the 1980s. For example, Japanese boards of directors were entitled to defend against take-over attempts by issuing low-priced shares to friendly companies ("white knights") in order to dilute the percentage of the hostile buyer without sacrificing practical control of the company. No shareholder vote was required for such move. Although such defensive moves are no longer possible, with the impact of globalisation where the national laws
are getting more and more synchronised with international laws, take-overs will probably continue to be rare for structural and cultural reasons.

On the structural side, the large percentage of shares owned by long-term shareholders with close business ties to the company makes many buyouts prohibitively costly. On the cultural side, it is thought that a hostile take-over would destroy the target company’s sense of "wa" or internal harmony, making it difficult to integrate the target into the acquiring "keiretsu".

Similarly, hostile take-overs have been less common in Germany than in the U.S.. The reliance of German firms on debt rather than equity financing has had two major implications: first, companies have tended not to look to equity markets for capital, which reduced turnover in the stock market generally; and second, powerful bank holdings and proxy voting strength have dissuaded investors from seeking control. Also, Germany was known for having the toughest anti-take-over devices in all of Europe. The picture may now be changing slightly, as German take-overs appear to be on the rise.25

2.6 CONCLUSION

This chapter elaborated the different corporate governance models available in the world. Basically there are two models viz., Anglo-American Model and German Model. All other models are in between these two models. Shareholders monitoring an essential feature in the corporate governance mechanism is also discussed. There is a link between take-over and the corporate governance. This link is also highlighted.