LAYING THE GROUNDWORK FOR ECONOMIC GROWTH

Ira M. Millstein

Solid corporate governance is becoming increasingly crucial to attracting investment capital. Developing countries in particular stand to gain by adopting systems that bolster investor trust through transparency and rule of law.

Photo above: Investors grant the power to run the corporation to the board of directors, a group of people entrusted with the task of making decisions in the best interests of the company and all its investors. © Jose Luis Pelaez, Inc./CORBIS

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Corporate governance is entering a phase of global convergence, driven by the growing recognition that countries need to attract and protect all investors, both foreign and domestic. The equation is clear: global capital will generally flow at favorable rates to where it is best protected, but will not flow at all or will flow at higher-risk rates where protections are uncertain or nonexistent.

In many countries whose legal systems are rooted in British common law, the interests of shareholders are held to be paramount in most corporate decisions. However, this has not been the case throughout the rest of the world—at least not until now.

Countries that have traditionally fostered notions of partnerships between management, employees, and other stakeholders, have other social priorities, or have mixed government-private ownership arrangements are now recognizing investor protection as an important signal to potential capital providers. This is especially the case for developing countries. They need to demonstrate adoption of corporate governance principles so as to foster investor trust and attract capital, which will in turn lead to investment and economic growth. Of course, these principles need to be tailored to fit local needs—one size

will not fit all. But there are certain fundamentals that cannot be ignored.

Corporate governance comprises a combination of regulatory rules and private sector-driven guidelines. In countries with more sophisticated financial markets, corporate governance rules and structures are contained in laws protecting property rights and shareholder rights through legislation, accompanying regulations, judicial decisions, and stock exchange listing rules. This is the essential enabling governmental infrastructure. In addition to formal rules, corporations adopt best-practice principles and guidelines, which are continually being developed by the private sector and academia in response to prevailing market conditions and investor demands. Developing countries need to take both elements—governmental infrastructure and best practices—into account.

The Role of the Corporation

Understanding corporate governance requires an understanding of the concept of the corporation and the position it occupies in the business world. This understanding will demonstrate why corporate governance, as I have described it, is essential to legitimizing the corporation's role in society and providing a vehicle for economic growth.

The corporation is an entity created by law. It has existed in some form or another for hundreds of years, and its essential features have stayed virtually the same over that whole period.

One of the most important features of a corporation is limited liability, which allows people to invest money or other property in the corporation without any of their other personal assets being placed at risk in the event the company fails. This money is locked away in the company, and investors are denied any sort of meaningful access to it. For example, they cannot demand that the company pay a dividend or give back any of the capital. Their capital is at risk because while the investors profit if the corporation succeeds, they can lose it all if the corporation fails. After contributing money or other property to a company, investors are issued shares, which represent the entitlement to a reward for assuming this risk. In most cases, shares are freely transferable, so shareholders can sell their shares to other investors. Or they can "walk away" from a corporation entirely if they wish.

Another key feature of a corporation is perpetual existence. The corporation's ability to continue indefinitely gives stability to the enterprise by ensuring that businesses can survive their founders.

The corporation became the dominant form of business organization in response to a need for growth capital. It is the most efficient way to amass large amounts of capital. Shareholders are able to invest in companies without risk of personal liability and do not need to rely on the reputation or trustworthiness of their fellow investors as they would in a partnership. They can also spread their risk by investing in a number of different companies, with the aim of maximizing their overall return.

The Board of Directors

In exchange for the benefits of limited liability, perpetual life, and transferability of shares, investors grant the power to run the corporation to a group of people entrusted with the task of making decisions in the best interests of the company and all of its investors, not just a particular segment of investors. In this way, the corporation is not directed by special-interest investors, and the shareholders are protected against one another's unique agendas. This group of entrusted people, elected by shareholders, is called the board of directors.

Much of the law regulating corporations relates to the board of directors, with many of the specific rules designed to foster investor confidence that directors will do the right thing. The board is responsible for managing or directing the business and affairs of the company. In practice, the board delegates its authority to make day-to-day decisions concerning the operation of the company to full-time employees. Boards appoint a chief executive officer (CEO) to coordinate and oversee these management efforts, and the CEO, in turn, is empowered to hire the top managers.

But the interests of shareholders, directors, and managers can sometimes conflict. For instance, some shareholders may wish to receive a dividend, while other shareholders and management may prefer to reinvest profits and promote internal corporate growth. The board is required to manage these conflicting interests by making decisions in the best interests of the company and all of its shareholders.

Converging Models of Corporate Governance

In many common-law countries, shareholders are the constituents to whom directors have primary regard in the decision-making process. Other countries such as

France, Germany, and the Netherlands have historically placed emphasis on the interests of other stakeholders, including employees, creditors, customers, suppliers, and the community in which the corporation operates. The current corporate governance climate is tending toward convergence of these models.

Investor interests are increasingly paramount as a result of the global nature of modern investments, the rise of the institutional investor as a dominant player, and the related focus on protecting investment—regardless of where the corporate headquarters are located. Moreover, corporate boards are increasingly aware of the need to treat nonshareholder constituents fairly and have regard for their interests so that the corporation can succeed financially, as well as live up to the demands for social responsibility placed on it by those stakeholders and others. The convergence is thus from both sides. For example, when Johnson & Johnson, a pharmaceutical manufacturer, immediately and voluntarily removed all possibly tampered-with bottles of Tylenol from distribution, it showed responsibility beyond the bottom line.

Accountability to shareholders and the other stakeholders is assured by a set of duties—spelled out to one degree or another in many developed countries—with which directors must comply in making decisions. These duties are known as fiduciary duties. They include the duty to exercise care, the duty to be loyal to the company, the duty to be candid and transparent, and the duty to act in good faith. A breach of any one of these duties can result in potential director liability to either government regulators or shareholders. In the United States, for example, shareholders may institute lawsuits against directors in their own right or on behalf of the company to gain redress for an alleged breach of fiduciary duty. Such cases abound in the United States, as witness the host of shareholder suits against Enron, Tyco, and WorldCom, among many others. Some suits have merit and some not, but the possibility of such suits is a strong motivation for better director performance.

Shareholders can also do the "Wall Street walk" and sell their shares if they are unhappy with what is happening at the company. And regulators can step in for more egregious behavior. In other countries, the existence and enforceability of these directors' duties vary significantly. But it is also becoming clear that duties without enforceability may be hollow.

Risk Taking and Accountability

It might be reasonable to wonder whether directors would be comfortable making decisions that might result in good returns to the company but that are either inherently risky or uncertain. The law assists directors in this regard by freeing them of liability for their decisions, provided they act in good faith and with care and diligence. In the United States, for example, this is achieved by means of court-made law. In addition, companies can assume the costs of defending directors who act in good faith, and they can also purchase insurance to cover such costs. All of this works together with the duties outlined above to reduce the risk of mistakes without sacrificing economic efficiency in decision making.

To illustrate, consider this scenario: The board of a gold mining company is deciding whether to purchase an expensive license to prospect in an area that has a 20 percent chance of yielding valuable gold deposits. A risk-averse group of directors might reject the opportunity if there were a possibility that shareholders could sue them if it were discovered that there were no deposits. Decisions such as those, at an aggregate level, would be disastrous for business because fearful directors might make many economically inefficient decisions. Once the specter of personal liability is removed, those same directors should be more likely to make more efficient decisions. This overall system protects directors under what is known as the business judgment rule. Courts will protect directors who use business judgment in good faith and with care and diligence.

Nourishing Investor Trust

The legal requirements relating to directors form part of a larger framework aimed at nourishing investor trust in the corporate form. Many of these are structural in nature, including those ushered in by the corporate governance reforms of recent years, such as mandatory director independence, committee structures requiring independent directors to meet alone without management present in order to discuss frankly and openly whatever they wish, and an active audit committee.

Recently, the corporate governance movement has begun to focus on other ways of bolstering the integrity of directors and managers. For instance, U.S. Securities and Exchange Commission Chairman William Donaldson has emphasized the importance of directors and senior management setting the right tone at the top in terms of high ethical standards. Going forward, the

corporate governance movement will be striving to find directors with a moral compass who are endowed with qualities revered by 18th-century economist Adam Smith, such as prudence, justice, beneficence, temperance, decency, and moderation. Boards comprising people possessing at least some of these qualities should foster investor trust in the board and the corporation. Moreover, directors with a demonstrable moral compass should be more inclined to make risky but efficient decisions, since courts will be less likely to impose liability upon such persons.

The existence of a solid corporate governance regime will be important to an individual investor's decision whether to buy shares in a company. Investors are unlikely to want to commit their funds to a corporation whose board and management cannot be trusted to do the right thing for all the shareholders. The decision of each potential investor to invest or not invest in a company can be aggregated at the national level to illustrate the importance of corporate governance on a macro scale. If a country or region has a demonstrable governance infrastructure, public and private, its overall economy will benefit from increased local and domestic investment.

Brazil's Experience

Recent reforms in Brazil provide a useful illustration of how investor trust in the integrity of the corporation as an institution can be a crucial ingredient in the growth of capital markets. A reform program was begun at the Brazilian stock market in October 2000 after years of stagnation. In less than a year, a second market, called the Novo Mercado, was launched. The Novo Mercado prescribes strict corporate governance standards as a prerequisite to listing and has been successful in attracting investment. Corporate governance measures such as those instituted by the Novo Mercado strengthened investor confidence in the integrity of the corporate form and those who are overseeing their investment. For instance, rules regulating transactions involving a conflict of interests have promoted a transparent environment and well-informed market participants. In addition, governance measures that protect the rights of shareholders have ensured that directors and managers are accountable to investors.

The Novo Mercado demonstrated the importance to investors of openness, transparency, and the existence of good corporate governance. The lesson is not restricted to countries with stock exchanges—it applies to any corporation and country seeking new capital for growth from the increasingly sophisticated global capital markets. And it applies equally to other providers of capital such as banks, which can improve their local economies by improving both their own corporate governance, thereby attracting deposits, and the governance of borrowers, by extending loans to those borrowers with demonstrable good governance.

Developing countries can look toward corporate governance models such as those in place elsewhere in the world for guidance in crafting and instituting local corporate governance rules and principles. In the global capital market, these rules and principles can serve to bolster investor trust in the local corporate form that will ultimately lead to economic growth and prosperity. ■

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