

# **Corporate Governance in the Aftermath of the Scandals: The EU Response and the Role of Ethics**

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**by**

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## **Abstract**

The purpose of this Thesis is to study corporate governance and its regulation in the aftermath of the scandals that have taken place in the United States and in Europe during the last few years. Corporate governance is a vibrant and constantly changing area of law and the adoption of a regulatory framework must be carried out with both an institutional and dynamic approach.

Following the wave of scandals and collapses, corporate governance has topped every agenda and has become one of the most discussed topics worldwide. The focus so far has been placed just on the rules, while the role of ethics has been significantly undermined. The Sarbanes-Oxley Act was the American response to the voices asking for strict rules and severe penalties. The European Union has adopted a more cautious and liberal approach, choosing the path of harmonisation and convergence. The Action Plan represents the roadmap for the future, but it is still not clear what exactly the form of corporate regulation in the European Union will be in the following years.

This Thesis explores the recent reforms and provides some thoughts on the nature of the regulatory response that the EU needs to adopt, in order to provide a protective shield against fraud and mismanagement. Self-regulation proved to be insufficient, while regulatory competition and reflexive harmonization are examined as alternative choices. Rules and regulations are important, but do not suffice to solve all corporate governance problems and prevent corporate scandals. No corporate governance reform will be successful unless ethics do become an integral part of modern business strategy, creating a ethical corporate culture, and if all the actors involved do not change their philosophy regarding how they make business.

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## **INTRODUCTION**

*'Corporate governance is what you do with something after you acquire it. It's really that simple. Most mammals do it. (Care for their property.) Unless they own stock [...] It is almost comical to suggest that corporate governance is a new or complex or scary idea. When people own property they care for it: corporate governance simply means caring for property in the corporate setting'.<sup>1</sup>*

### **Thesis' aim**

As the above phrase implies, it is almost comical to suggest that corporate governance is a scary idea. It may be a complex concept, as it covers a large number of issues from different disciplines and a variety of approaches have developed to facilitate its understanding, but it is definitely not scary, even though 'its inherent processes have not yet been fully identified and analyzed'.<sup>2</sup> It is true that it has been a catchphrase and a much discussed topic during the last few years, but, surprisingly, it has not always been a commonplace term. In fact, 10 to 15 years ago there was no evidence to suggest that it would attract the public interest and dominate the headlines of legal, business and financial newspapers to the extent it has. There had been a long period of financial stability and there was no apparent need for any discussion of regulation or reforms. However, the situation changed dramatically towards the end of the 20<sup>th</sup> century. A series of financial scandals and corporate collapses took place in the USA and in Europe, resulting from the failure of the commercial world to keep up with the pace of corporate development. This failure revealed that the corporate governance regulatory structure was defective and inadequate for the purpose of maintaining an environment of security, growth and prosperity. This realization had a deep impact on the psychology of all involved parties, namely investors, legislators,

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<sup>1</sup> Sarah Teslik, former Executive Director of the Council of Institutional Investors, available in the website: <http://corpgov.net/library/definitions.html> .

<sup>2</sup> Ali, P. and Gregoriou, G., *International corporate governance after Sarbanes-Oxley*, John Wiley and Sons, New Jersey, 2006, pg. 66.

corporate executives and the general public. Inevitably, corporate governance attracted a lot of attention and was at the top of every agenda concerning itself with the best and most efficient regulatory framework.

The aim of corporate governance is ‘to devise specialized systems of incentives, safeguards and dispute resolution processes that will promote the continuity of businesses that are efficient in the presence of self-interested opportunism’.<sup>3</sup> ‘Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The interests of the companies should be kept in balance with those of the society and a set of devices needs to be developed to facilitate fairness, economic growth and innovation. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources’.<sup>4</sup>

As Martin Lipton said ‘each generation must conduct the corporate governance debate within the parameters set by the prevailing manifestation of corporatism’.<sup>5</sup> To date, thousands of pages have already been written, with the aim of aiding comprehension of the implications of corporate governance and to formulate recommendations on suitable governance structures and practices. Scholars and academics, governments and legislators, managers and directors are all worried and they are involved in this on-going discussion, with view to finding the right answer to the questions of how best corporate to regulate governance, and what regulatory measures will form a protective shield for companies worldwide against fraud, dishonesty, mismanagement and corruption.

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<sup>3</sup> Kester, C., ‘Industrial Groups as Systems of Contractual Governance’, (1992), 8(3) Oxford Review of Economic Policy 24.

<sup>4</sup> Cadbury, Sir, A., Foreword, in Claessens, S., *Corporate Governance and Development*, Global Corporate Governance Forum, Focus, 1, 2003, pg. vii.

<sup>5</sup> Lipton, M., ‘Corporate Governance in the age of Finance Corporatism’, (1987) 136 University of Pennsylvania Law Review 1, pg. 3.

The answer is not easy to find. Most countries around the world have specific legislation on company law, which deals with a wide range of issues for all types of companies. The result is, in general, satisfactory, in the sense that people are able to choose the best available business structure for their activities. Yet, still corporate governance must be the subject of separate regulatory initiatives, as it is a very sensitive and problematic area of law and general company law rules alone cannot provide adequate protection. Corporate governance is a very broad term; it covers all aspects of the operation of companies as economic entities and it expands to their members both horizontally and vertically, as it embraces the role and responsibilities of each one of the members as well as the interaction and the relationships among them. It is, therefore, tremendously difficult for a legislator to be able to create a piece of legislation that will deal with all these issues and will provide efficient solutions. There is a long list of problems that need to be solved before such legislation reaches the drafting stage. For example, should a universal legislation be adopted or should each country be free to develop its own domestic laws? Is it possible to achieve a certain degree of harmonization among these domestic laws? What about countries with dissimilar legal systems (i.e. civil law and common law countries) or with company legislation based on the one-tier or the two-tier model? Who will monitor the compliance? Who will be responsible for the continuous updates that are required? What about efficiency, effectiveness and legitimacy?

A relevant legal framework exists in almost every country in the world, along with plenty of different types of regulation, which are regularly updated, as the vast majority of countries have created or adopted corporate governance codes and regulations. A wide range of proposals have been adopted throughout the years, reflecting several techniques and rationales, in order to improve and modernize this framework. However, this method has not produced the much-expected results. Perfect regulation has yet to be discovered and probably

never will be, but the existing legal regime has not proved satisfactory. Its flaws have resulted in scandals and collapses as well as loss of money, jobs and confidence. It is obvious that there is a missing link in the regulatory chain. Such a link would enable corporate governance standards to be raised and would smooth the process of minimizing the costs and maximizing the benefits.

### ***Research Questions and Methodology***

The focus of this Thesis is, first of all, to look for the missing link between corporate governance regulation and efficient corporate performance. The lesson that the past experience has taught us is that this link will not be found in the letter of the law. In other words, there is no need for more regulation or for new rules. It is true that until now the emphasis has fallen entirely on rules. Good rules are definitely a good starting point, but again it is too simplistic to argue that the problems of corporate governance will be resolved just by regulation. It would not be so difficult to set up another committee and ask for a new Code or a new set of rules. However, by adopting this approach, we would simply do ‘the same old thing a little bit better’ and ‘go a little further along a dreary road’.<sup>6</sup> Following its creation and the proper advertisement, everybody would feel relieved and confident that the wounds of corporate governance regulation have been healed. Unfortunately, there are no guarantees that this can happen.

Modern companies and their members need to change the way they are doing business. New laws, stricter fines and more formalities will not provide a viable solution, if they do not bring a new corporate philosophy. Fraud, corruption and dishonesty have become part of the current philosophy of doing business. Accountability, integrity and diligence should replace them to become the cornerstones of the new philosophy, otherwise the

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<sup>6</sup> Beckett, S., ‘Three Dialogues’, in Cohn, R., (ed), *Disjecta: Miscellaneous Writings and a Dramatic Fragment*, Grove Press, New York, 1983, pg. 139.

situation will not change. It is imperative to reinforce the ethics of the modern companies, as there can be no adequate solution without respecting ethics. Until now, the focus of every reform or new initiative was just on the rules and the role of ethics was consequently undermined. Companies, like human beings, are complex, impulsive, self-serving and unpredictable, so any framework should be specially tailored to these characteristics. Legal provisions provide the guidelines and create the pathway, which companies should follow. The people, who represent the companies and are responsible for taking decisions, must follow a moral code as well as a corporate governance one. Moreover, any new proposal should combine three elements: lessons from the mistakes made in the past, identification of any deficiencies of the present system and a concise plan for the future. Ethics have a dual function in the corporate governance mechanism. They play a fundamental role in any necessary reforms of, or amendments to, the current legislation and they are also a key part of any future initiative. Ethical standards can bridge the gap between corporate regulation and corporate performance, by providing the link that will connect and bind rules together with corporate success. Accordingly, such standards should be included in any future plan, because they can significantly contribute to the improvement of corporate governance regulatory framework. Their absence from the recent initiatives was an omission, and is one of the reasons why these initiatives were not completely successful.

The collapse of Enron and the string of corporate failures in the US and in Europe made it clear that we actually hit the bottom. Companies were unprotected, investors were losing their funds, employees were losing their jobs, and the public was losing its confidence. There was no more room for experimentation. The United States of America and Europe became the centre of attention, as they both were hit by the wave of scandals that crashed down on the world of modern corporations, and so they both reacted accordingly. Both jurisdictions came up with a full plan of action, becoming role models for both developed and

developing countries alike. Their reaction and initiatives have seen them become international pioneers in the area of corporate governance.

The USA was the first country that felt the devastating consequences of the scandals. While the business world was expecting its reaction, the US government made a clear choice regarding its regulatory direction. The Sarbanes-Oxley Act (hereinafter, referred to as SoX) is the depiction of the American approach of strict state regulation. It came as no surprise that they made that particular choice. The USA is a federal state with a strong central government that makes the call for, and is responsible for, all the problems of the country. Moreover, it is widely considered to be the most powerful country in the world and, as such, plays a leading role in the international political and economic scene. Consequently, the rest of the world expects the USA to ‘lead the effort to improve regulation and supervision around the world’<sup>7</sup>, keeping a close eye on the decisions and choices the Americans make, because they may have an effect on other nations as well. The power of the American currency, in combination with the influence of the United States on certain countries, both developing and developed, highlights the level of interdependence of the world economy. Such interdependence is also apparent under the present financial crisis.

In this context, given the atmosphere of panic and the calls for a decisive reaction following the shocks of Enron and WorldCom, the choice was for new and stringent regulation, based on effective monitoring, strict enforcement and severe penalties. It is also worth mentioning that a similar choice was made during the Great Depression of 1929-1933. Whether or not the SoX was the right choice for the USA or not is an issue that will be discussed in the following chapters. For the time being, it is enough to say that it has several flaws and it is still debatable whether it can ensure that fraud and scandals will not happen again, or at least in the near future. At the same time, the SoX has several positive features,

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<sup>7</sup> Geithner, T. and Summers, L., ‘A New Financial Foundation’, The Washington Post, Monday, June 15, 2009, available in the website: [http://www.washingtonpost.com/wp-dyn/content/article/2009/06/14/AR2009061402443\\_pf.html](http://www.washingtonpost.com/wp-dyn/content/article/2009/06/14/AR2009061402443_pf.html) .

which can be isolated and taken into consideration for future initiatives, both American and international.

Nowadays, in the era of globalization, economic integration, and multinational companies, corporate governance has become a subject matter with international character and cannot be conceived as a strictly domestic issue, isolated from the international developments. Therefore, it cannot be reasonably expected of the USA to deal with the problem of corporate governance regulation without the help or the cooperation of other countries. America has great experience in dealing with crises, something that can prove to be extremely valuable, but the European Union has its own dynamic and can make a valuable contribution to solving this problem, despite the fact that it has a totally different legal environment to that of the USA. The US and the EU, despite their differences in terms of law and regulation, can still influence and interact with each other. This close relationship can also go beyond the borders of company law and spread into other fields. For these reasons, it is extremely interesting to look into the European legal order and examine its correlation and level of inter dependence with that of the American.

Europe was drawn into the centre of the crisis not long after the USA, with corporate scandals and collapses occurring in countries like Italy and the Netherlands. The European Union did not follow the US strategy and no new regulation was introduced. Instead, the EU chose a less strict approach and continued its way down on the path of harmonization of law, introducing a Communication for modernising company law and enhancing corporate governance in the European Union (hereinafter referred to as the Action Plan).<sup>8</sup> The majority of the analysts and scholars were surprised by this choice, as it was anticipated that the EU would join the USA in the crusade against corporate misconduct. But, if we take a closer look, it is not surprising that the European response was so radically different from that of the

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<sup>8</sup> European Commission, Communication 0284/2003 'Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward', available in the website: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52003DC0284:EN:HTML>.

USA. The EU is a union of countries that is now developing into an influential entity. Its Member States still need time to find the appropriate balance of powers, resolve their differences, i.e. cultural, social, political, historical, linguistic etc, and develop a common consciousness. There is no central government and all decisions are taken collectively, applying the majoritarian principle. Europe's capital market is characterized by a 'high degree of state protection and fragmentation'.<sup>9</sup> This fragmentation renders the decision-making process inflexible and time-consuming. The Action Plan represents an ambitious initiative specially designed for the EU legal reality, following its long-term harmonization strategy. It attracts our attention because it is a well-thought out proposal, but it is not the EU's last word in the discussion of corporate governance.

This Thesis originally set out to assess the Action Plan on a similar basis to that of the SoX, with a view to determining whether or not it was the right choice. However, along the way it became clear that it would be too simplistic to talk about the correct, or the best, choice and it would be better to reformulate the research question. The focus of this Thesis therefore concentrates on what is the ideal regulatory solution for the EU based on the current situation and the future perspectives. In other words, the second research question is what is the best regulatory solution for Europe following the implementation of the short, medium and long-term goals of the Action Plan? Basically, the answer to this question is closely related to the answer of the first research question regarding the link between corporate regulation and sound corporate governance. If the missing link is found, then it would be possible to determine what the right regulatory choice is, in particular, for the EU and also for the rest of the business world in general.

The EU legislator has started a colossal attempt to harmonize the laws of the Member States, with the intention of creating a 'Common Community [now Union] Law, which can

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<sup>9</sup> Lannoo, K., 'The Emerging Framework for Disclosure in the EU', (2003), *Journal of Corporate Legal Studies*, vol. 3, No. 2, pg. 337(38).

be applied directly in all Member States'.<sup>10</sup> This Common Law cannot be created from scratch. It will be based on existing laws, rules, regulations and practices, drawn not only from the Member States, but also from any other country in the world. This is not an easy task, because the law is more than just the letter of the provisions. As Legrand described it, law is an 'indissoluble amalgam of historical, social, economic, political, cultural and psychological data, a compound, a hybrid, a 'monster', an outrageous and heterogeneous collage'.<sup>11</sup> The idea is not to reinvent the wheel, but to critically evaluate the existing legal order, update it and supplement it, in order to create a compilation of rules that will be efficient for the European Union.

The best illustration is the Chinese legal reform at the beginning of the century. The People's Republic of China decided to modernize its legal system and update it according to the requirements of the 21<sup>st</sup> century. They kept the foundations of the Chinese legal traditions and drew upon a wide range of influences, from Hong Kong and Taiwan to the UK and Germany, in order to make the essential additions and amendments, where necessary.<sup>12</sup> Remarkably, the Chinese were not biased towards the West and allowed not only Eastern influences, but also American and European ones, in their attempt to keep up the pace of the recent economic and social developments. The roots of this technique can be traced back to the Greeks and the Romans, who were checking the laws of other cities looking for a model of laws that were worth enacting in their own country.<sup>13</sup>

However, it is not a simple process as the legal system of each country is unique. It is a legal phenomenon and reflects its individual social, historical and political characteristics. There are examples of countries with similar or even common characteristics and thus similar

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<sup>10</sup> See above, note 8, pg. 88.

<sup>11</sup> Legrand, P., 'How to Compare Now', (1996), *Legal Studies*, Vol. 16, No. 2, 236.

<sup>12</sup> Among others, Wan, Y., *Chinese Legal Reform*, European Institute of Japanese Studies East Asian Economics and Business Series, Routledge, London and New York, 2002.

<sup>13</sup> De Cruz, P., *Comparative law in Changing World*, Cavendish Publishing Ltd, 2<sup>nd</sup> ed., London and Sydney, 1999, pg. 20.

legal systems, but these common features highlight the singularity of each country. Thus, any attempt of law transferring or ‘transplanting’<sup>14</sup> is doomed to failure, if it is not properly planned, organized and implemented. It requires knowledge ‘not only of the foreign law, but also of its social, and above all, of its political context’, otherwise it becomes an abuse.<sup>15</sup> That’s why it is wiser to argue that a country’s legal system can be used only as a model or as a point of reference. It can offer suggestions and ideas for solutions, and can even ‘liberate one from the narrow confines of the individual systems’<sup>16</sup>, but anything more than that should be done only under the right circumstances. As Legrand indicated, ‘law does not exist in a vacuum, it operates within a society’.<sup>17</sup> This is also justified by numerous examples of countries which have adopted foreign legislation without any process of adaptation, apart from translating the relevant provisions.

The ‘candidate’ rules should be carefully and critically examined first. The focus shifts away from the examination of proposed solutions and onto specific problems. Under the microscope, we put the spirit, the functions, and the essence of the rules. This is a comparative study. As Wilson argued, ‘comparative studies have been largely justified in terms of the benefit they bring to the national legal system’.<sup>18</sup> One must assess to what extent it would be possible to transplant effective legislation to a country in order to assist it in successfully reforming its economic system.<sup>19</sup> Montesquieu was totally against the viewpoint that ‘the law of a country could serve that of another at all’.<sup>20</sup> Although, he was characterized

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<sup>14</sup> See Watson, A., *Legal Transplants: An Approach to Comparative Law*, Scottish Academic Press, Edinburgh, 1974, pg. 21.

<sup>15</sup> Kahn-Freund, O., ‘On Uses and Misuses of Comparative Law’, (1974) *Modern Law Review*, 37, pg. 27.

<sup>16</sup> Kamba, W. J., ‘Comparative Law: A Theoretical Framework’ (1974), *International and Comparative Law Quarterly*, Vol. 23, Issue 03, 485, 492.

<sup>17</sup> Legrand, see above note 11, 238.

<sup>18</sup> Wilson, G., ‘Comparative Legal Scholarship’ in McConville, M. and Chui, W. H. (eds), *Research Methods for Law*, Edinburgh University Press, 2007, pg. 87.

<sup>19</sup> Legrand, note 11 above, 234.

<sup>20</sup> Stein, E., ‘Uses, Misuses - and Nonuses of Comparative Law’, (1977) 72 *Northwestern University Law Review*, pg. 199, referring to Montesquieu, *De L'Espirt des Law (The Spirit of Laws)*, Livre I Gallimard, Paris, 1749, reprint, JP Mayer and AP Kerr (eds), (1970), Book I, Chapter 3.

as ‘the first of all comparative lawyers’<sup>21</sup>, he was of the opinion that the ‘transfer of laws across cultural boundaries constitutes “*un grand hazard*”’.<sup>22</sup> Years later, scholars appear to be a bit less assertive. During the 1970s, Stein used an example from medicine and talked about the transplantation of an organ, which is medically achievable, but there is always a risk of it being rejected by the new body. The same can happen with a rule, which can be rejected by a foreign environment.<sup>23</sup> During the same period, Kahn-Freund dealt with legal transplantation from another perspective. According to him, ‘the question is in many cases no longer how deeply [the transplanted rule] is embedded, how deep are its roots in the soil of the country but who has planted the roots and who cultivates the garden’.<sup>24</sup>

Nowadays, there is a more liberal approach. There is no criticism against countries following the example of legislative initiatives of other countries or against countries transplanting laws. The European Union is the most recent example of a ‘legal regime’ trying to find a regulatory equilibrium. Its multiplicity together with the lack of supranational identity constitutes a big obstacle to any attempt for harmonization or unification of law. This is why the USA becomes part of the equation. The comparison with the US is not intended to be comprehensive and exhaustive. The objective is not to make a comparative analysis of the US and EU jurisdictions. The comparison will display some common features and will provide a better understanding of the law-making process. At the same time, the findings of any differences will facilitate the identification of the particular problems that Europe is facing as well as the distinctive characteristics of the EU legal order that may lead to the adoption of different regulatory solutions. Furthermore, the US has more advanced and well-developed legal structures and lessons can be taken from them. So far, ‘a good part of the European reforms have been patterned after US corporate and securities law’, but this time

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<sup>21</sup> Kahn-Freund, note 13, above, pg. 6.

<sup>22</sup> Gillespie, J., ‘Transplanted Company Law: An Ideological and Cultural Analysis of Market Entry in Vietnam’, (2002), *International & Comparative Law Quarterly*, Vol. 51, 644.

<sup>23</sup> Stein, note 19 above, *ibid*.

<sup>24</sup> Kahn-Freund, note 15, above, pg. 13.

the aim is not the adoption of ‘US-style solutions’.<sup>25</sup> ‘The attempt to create one legal order for Europe should not be an exercise concerned exclusively with European needs, but should be approached from a global perspective, bearing in mind the law in the US and the non-Western legal cultures’.<sup>26</sup> At the end of this process, they will single out the pieces of this gigantic universal legal jigsaw that can become part of the European legal order.

The EU legislator has put all the existing legal systems in a process of assessment and evaluation. Evaluation of legislation is a quite complex undertaking. Apart from the effectiveness and efficiency of the rules, it also involves the implementation and their actual impact on the people to whom it is addressed. An assessment of the intended goals and objectives takes place for it to become clear whether these have been attained. The investigation must go deep to a level at which the sources of the law can be examined. The aim is to correct any mistakes, improve the quality of the rules and the implementation process. This is the first stage. The next stage is even more challenging, as the legislators have to consider the right method of improvement. They build on the findings of the evaluation and take all the necessary measures so that legislation can achieve its objectives. Several methods can be used for the improvement, from simple additions to total reform. The adopted or formulated solution, irrespective of ‘whether it is transplanted from a particular national law, melded from various national approaches, or is a purely anational creation, must form part of a coherent whole’.<sup>27</sup> In the case of the EU the challenge is double, as the goal is not only to improve corporate governance legislation, but also to integrate this process into the general harmonization project.

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<sup>25</sup> Enriques, L. and Volpin, P., ‘Corporate Governance Reforms in Continental Europe’, (2007) in Clarke, T. and Chanlat, J.F. (eds), *European Corporate Governance: Readings and Perspectives*, Routledge, UK, USA and Canada, 2009, pg. 267.

<sup>26</sup> Mattei, U., ‘The Issue of European Civil Codification and Legal Scholarship: Biases, Strategies and Developments’, (1998), 21 *Hastings International and Comparative Law Review* 883.

<sup>27</sup> Kenny, M., ‘Globalisation, Inter Legality and Europeanized Contract Law’, (2003), 21 *Pennsylvania State International Law Review*, 578.

If we focus on the issue of corporate governance, a similar technique is necessary. Most of the developed countries tried to solve the problem of regulation individually, hoping to find the right regulatory formula. Each country has created the legal environment that would afford adequate protection to its businesses. It is overly simplistic and pointless to start arguing whether the American model is ‘better’ than the German or the English one. Before regulatory competition pushes forward any of these models, regulation was influenced by the *laissez faire* principle. Special committees and expert groups were appointed to create codes of best practice with a view to addressing any deficiencies in, and improving, every country’s governance systems.<sup>28</sup> It was a form of ‘voluntary means for innovation and improvement of governance practices’.<sup>29</sup> Self-regulation was obviously a more liberal and noninterventionist solution and became dominant during the last part of the 20<sup>th</sup> century. Despite its warm welcome and the promising prospects, it proved to be insufficient to prevent fraud and mismanagement. As a result, at the dawn of the new millennium the business world was still recovering from the falling-domino effect of the recent scandals, companies were looking for a protective shield and the public wanted reassurances that such scandals would not happen again.

Facing such a challenge, there is no room for conflicts. Corporate governance is a playing field where there should be fair rules and where nationalism does not play any role. Harmonization is compatible with this perspective, as it respects all national traditions and uses the existing fragmentation in a positive way. The common characteristics and a careful selection of some outstanding national rules can act as the soil for the cultivation of a harmonized legal system, but its realization will definitely take time. It would be ideal if it were possible to have the same applicable legislation for all companies all around the world. This would mean fewer formalities, less interpretation problems, increased legal certainty and

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<sup>28</sup> Zatoni, A. and Cuomo, F., ‘Why Adopt Codes of Good Governance? A Comparison of Institutional and Efficiency Perspectives’, (2008), *Corporate Governance*, vol. 16, No 1, pg. 2.

<sup>29</sup> *Ibid.*

probably a better quality of regulation. But unification is a luxury that we cannot afford. Consequently, it needs to be clear to everyone that an international SoX or a World Action Plan is not really the missing link between corporate regulation and optimal corporate governance. It would be rather simplistic or not sufficiently ambitious to admit that we are just looking for the best combination of rules. Apart from the difficulties of creating such pieces of legislation and the possible reluctance of the national governments to get involved in a process like that, there are two more reasons why it is essential to be more reflective.

First of all, when we want to achieve harmonization or convergence of law, we have to bear in mind that the imposition of the same laws in all countries does not guarantee uniformity. We may measure the degree of convergence by having as a criterion the uniform results achieved following the application of the law. It is also worth mentioning that mere imposition of laws does not lead to the establishment of a healthy legal system. There are plenty of examples in history where a particular legal system was imposed by an emperor or a king to its tributaries, such as the law of the Roman Empire. Cicero was in favour of uniformity and he believed that ‘there shall not be one law at Rome, another at Athens, one now, another hereafter, but one everlasting and unalterable law shall govern all nations for all time’.<sup>30</sup> However, the uniformity that Cicero had in mind was an imposed one and is totally different from the uniformity that is achieved following a successful legislative scheme or reform. In other words, one of the factors, if not the most crucial one, that contributed to Cicero’s uniformity not standing the test of time was the non-voluntary process of implementation of the rules. When the Roman Empire lost its power and influence, uniformity ceased to exist.

Secondly, such a mentality overlooks the true nature of law; it ignores the concept of law as culture. It is almost impossible to accurately define the concept of legal culture as it is

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<sup>30</sup> Cicero, *De Republica*, 3.22.33.

something totally intangible and, despite the numerous attempts at a precise definition, it still remains ambiguous and confusing. Lawrence Friedman, the acknowledged father of the term<sup>31</sup>, defined it as ‘the attitudes, values and opinions held in society, with regard to the law, the legal system and its various parts’<sup>32</sup>, while John Bell defined it as ‘a specific way in which values, practices, and concepts are integrated into the operation of legal institutions and the interpretation of legal texts’<sup>33</sup>. Even now, the controversy still remains. For the purposes of this Thesis, these definitions are a useful the starting point. Law is more than a set of rules, so ‘the question is not simply what the law *was*, but what the law *meant* to the communities that engaged with it and lived within it’.<sup>34</sup> Law is a way of reading reality, of making sense of it.<sup>35</sup> In this context, it is wrong to focus on the black letter of the law and overlook what is hidden between the lines, namely the social, political, economic and ethical reality as well as the environment, in which the law was created.

Taking all the above into consideration, regulation is a two-sided coin. On the first side, it appears as a form of limitation that restricts the free conduct of companies, while on the second side it appears as a necessary prerequisite for the accomplishment of all corporate goals. Focusing only on one of the sides would be a rather narrow-minded approach to adopt. Regulation can be both a barrier and a necessity for all companies and the capital markets as a whole. Regulators must strike a reasonable balance between freedom and control, autonomy and regulatory framework, costs and benefits. This task becomes more difficult when the legislation under review aims to have international effect or to harmonize several existing

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<sup>31</sup> Nelken, D., ‘Using the Concept of Legal Culture’, (2004), Australian Journal of Legal Philosophy, vol. 29, Center for the Study of Law and Society Bag Lunch Speaker Series, paper 20, pg. 7, available in the website: <http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1051&context=csls>.

<sup>32</sup> Friedman, L., *Law and Society: An Introduction*, Prentice-Hall, New Jersey, 1977, pg. 76

<sup>33</sup> Bell, J., ‘English Law and French Law – Not so different?’, (1995), 48 C.L.P. pg. 70.

<sup>34</sup> Foster, H., Berger, B.L. and Buck, A.R., ‘Introduction: Does Law Matter? The New Colonial Legal History’ in Foster, H., Berger, B.L. and Buck, A.R., (eds), *The Grand Experiment: Law and Legal Culture in British Settler Societies*, UBC Press, Toronto and Vancouver, 2008, pg. 4.

<sup>35</sup> Bell, J., ‘Chapter Five: Civil Law Tradition’ in, N., HD (eds), ‘A Fresh Start for Comparative Legal Studies? A Collective Review of Patrick Glenn's Legal Traditions of the World, 2nd ed., Journal of Comparative Law, 1 (1). pg. 130, available at: <http://www.thejcl.com/pdfs/twining.pdf>.

rules. Corporate governance regulation is not an exception. The creation and the establishment of an efficient and effective legal framework is the objective of all legislators worldwide. The EU is in the process of giving its final response to the corporate scandals that hit the business world. This response has to be compatible with the European legal reality, but must also be in line with the American and international standards. That's why there should be room for influences, 'loans' or transplants that will facilitate the process of improvement and harmonisation of the law.

As it has become apparent, the answers to the two questions that this Thesis poses are not straightforward, but they are interrelated. They both support the overarching thesis that ethics can be not only the missing link for the future of corporate governance, but also the key for the successful reform of the existing regime. In order to justify this overarching thesis, an attempt will be made to provide a clear answer to both questions about the missing link between corporate regulation and sound corporate governance and about the ideal regulatory solution for the EU based on the current situation and future perspectives. In this way, the importance of ethical standards will be highlighted and, at the same time, the process of resolving the problem of the future of EU corporate governance will be put in motion. This attempt will take the form of a progressive route, which follows the steps of both the United States and the European Union along the pathway of corporate governance regulation. More specifically, for the first question the history of corporate governance and securities regulation will be examined, in order to develop an understanding of how corporate governance has been perceived throughout the years. Then, the most notable corporate collapses will be re-investigated, with the aim of identifying the real causes and their outcomes. Finally, the reactions will be scrutinised, so as to shed light on the legislators' insights and objectives before the introduction of new legislative measures. By following this approach, it will be clearer what the gaps in the corporate governance systems were, what

caused the disasters, whether these scandals could have been avoided and, finally, whether the legislators' responses were enough. In this way, we will be able to offer a convincing answer to the first research question. Building on this answer, we will follow a similar path in our effort to make a valid assessment of the regulatory future of the EU. The outline of the most noteworthy regulatory initiatives in Europe, in combination with an analysis of the generative factors and the causes of the collapses of the European companies, will illuminate the European perception of corporate governance and its pathology. Subsequently, the characteristics of the European legal system will be considered, with the intention of determining what the aims and objectives of the EU legislators and policy-makers should be for the future. After going over the options that are available for the EU and bearing in mind the answer to the first question, this Thesis will illustrate what the future of EU's regulation should look like, by demonstrating what the symptoms of the past crises were, what the flaws of the existing regime are and what still needs to be done for the EU to create a complete and efficient corporate governance regulatory system. This Thesis does not intend to give an outline of the best corporate governance regulation. The focus is not on the end result; it is on the process of improving the existing structure by reinforcing the foundations and putting stable connections between each level. Only in this way will there be guarantees that the scandals will be hopefully eradicated and ethics will become part of the culture that defines corporate objectives and business philosophy.

### ***Thesis' structure***

Following the methodological approach discussed above, the Thesis is divided into six chapters. The structure of the chapters is as follows:

Chapter 1 provides an overview of corporate governance as a term from both an etymological and a historical perspective. The discussion begins from the genesis of the

company, the theory of the corporation and the objectives of the corporate form. Then it moves to regulation and explains the need for and the creation of the first forms of company/corporate law. The meaning of corporate governance cannot be properly explained without setting out what is really considered to be good corporate governance. Following the initial background information, it is necessary to shed some light on all the parties involved in this corporate governance system. Given the fact that all the groups are interdependent and their conduct affects and influences each other, it is constructive to illustrate their role, their duties and their responsibilities. In this way, it will become more easily understood how the whole mechanism functions. At this point, self-regulation will enter the discussion, as it was the dominant corporate governance system before the wave of scandals. Self-regulatory corporate governance is a system based on freedom of choice, autonomy and self-determination. Corporate governance will not be investigated as a theory; instead its practical application will be examined.

Since one of the points of reference regarding corporate regulation is the European Union, self-regulation will be evaluated on the basis of its compatibility with the European Internal Market. The Single Market, in which the principle of freedom of movement for people, services, and capital is central and poses a great challenge for modern corporate governance. Any adopted regulation should not undermine the development of this distinctive legal environment.

Chapter 2 focuses on the issue of corporate governance regulation within the European single market. Regulatory competition and harmonization of law are explored as possible methods for the successful development of such regulation. The Court of Justice of the European Union, showing remarkable activism, redefined through its case law the term 'free movement' for companies in the EU and set new standards for re-incorporations and transfer of a company's seat. Freedom of movement brings regulatory competition and

company law found itself in the quest for the optimal regulation that will balance all the conflicting interests. Regulatory competition is not necessarily unwanted as ‘antithetical to the common market’.<sup>36</sup> It provides an additional motive for improvement and ‘stimulates legislators to compete to provide the best solution’.<sup>37</sup> When competition does not define the role of the governments and fails to strike the balance between race to the top and race to the bottom, harmonization enters the discussion. As Europe is a unique battleground, harmonization is the ‘facilitative force in the creation of an area characterized by a free market economy that allows for the free flow of goods and services’.<sup>38</sup> An attempt will be made to assess whether harmonization, based on cooperation, coordination and mutual recognition, is the most feasible solution in order for the EU to overcome obstacles such as language problems, cultural and political differences, and even tax barriers. Given the fact that harmonization of company law has often proved to be rather inflexible and time-consuming, the theory of reflexive harmonization has emerged and attempts to find the middle ground between excessive state regulation and complete deregulation. The chapter aims to determine whether this newly-developed theory has the potential to create a level playing field for all companies within the EU internal market.

Chapter 3 is rather explanatory in nature, detailing the scandals which took place in the US and in Europe and set the alarm bells ringing, indicating that it was time for action. It is extremely useful to consider what the real causes behind the scandals were and what triggered this chain-reaction. The examination starts with the two most prominent American collapses, Enron and WorldCom, before crossing the Atlantic to tell the story of Parmalat. It is also enlightening to go through the chronicle of these scandals, revisit the crime scene and use the findings, in order to avoid repeating the same mistakes. The chapter concludes with

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<sup>36</sup> Gopalan, S., *Transnational Commercial Law*, WS Hein & Co, New York, 2004, pg. 125.

<sup>37</sup> *Ibid.*

<sup>38</sup> Mattei, U., ‘Efficiency and Equal Protection in the New European Contract Law: Mandatory, Default and Enforcement Rules’, (1999), 39 *Virginia Journal of International Law* 537, 547.

an examination of the post-scandals era, in an attempt to give an answer to the questions about the timing of the scandals and their rapid spread that was likened to a domino effect.

The subsequent two chapters deal with the American and European response to the wave of corporate scandals. Chapter 4 provides a detailed discussion of the Sarbanes Oxley Act, one of the most sweeping and, at the same time, controversial reforms in legal history. There are particular difficulties in making an assessment of the SoX, because it is a relatively new initiative and only time will show whether it has been successful or not. A brief examination of the history of securities regulation in the United States will also give us a more complete picture of the American legislative tradition and will partly justify the choice of the SoX as a regulatory response, before concluding with a final assessment of the Act.

Chapter 5 explores the European response on two levels, both national and pan-European. Before giving an in depth analysis of the initiatives, the chapter outlines the aims and objectives of the EU and its Member States, with the purpose of understanding why the response was so different. Then it progress to consider the High Level Group of Company Law Experts and the proposed Action Plan. This was the initial response of the Union not only to the calls for action in the aftermath of the scandals, but also to the SoX. An attempt will be made to analyze the reasons behind the EU's decision and the subsequent benefits or detriments. It represents a totally different school of thought in the area of corporate regulation, as the EU has chosen to follow a course of action closer to the needs and the characteristics of its Member States.

Chapter 6 takes a more critical look at the aforementioned initiatives and attempts to make an assessment of the future - the day after tomorrow - if we suppose that the SoX and the Action Plan represent the future of corporate governance regulation. This assessment does not imply that the two initiatives will end up as failures and the main objective of the Thesis is not to propose any new regulatory projects or plans as alternatives. The USA has invested

too much in the SoX and the government will defend it against any criticism, whereas the EU will give equal support to its decision not to follow the American example. The reasons behind these decisions, and the ulterior motives, are not so important; what really counts is the end result. Everybody will be judged upon their choices and the consequences that follow.

Finally, chapter 7 will conclude the Thesis, by summarizing the most important points of the discussion, highlighting the role of ethics in the modern corporate governance structure. The USA and the EU still have a long way to go until they achieve their goal of creating a healthy and ethical environment for their companies, away from the shadows of fraud, mismanagement and poor regulation. Nevertheless, it is essential to assess the future of corporate governance, re-define the *modus operandi* of companies and add ethical standards to the equation together with corporate performance and regulation.

## **CHAPTER 1**

# ***INTRODUCTION TO ETHICAL AND FUNCTIONAL CORPORATE GOVERNANCE***

Corporate governance is a very wide and complex subject and it tends to become even more complicated, while modern companies grow rapidly. Despite the fact that it has become a buzzword nowadays, its core remains hidden under many layers of complexity. Most of the efforts to conceptualize its history and structure have failed, as companies should not be examined in isolation from their institutional environment, without considering issues such as corporate accountability, legitimacy of corporate power, standards of internal governance, and the decision-making process.<sup>1</sup> All these issues need to be considered, before making any attempt at discussing the ethical character of modern corporate governance and its functionality.

This chapter, will therefore, serve two purposes: first, it will go over the impressively rich history of the term, in order to point out its true nature and discover the roots of the controversies surrounding it; and secondly, it will examine the structure of modern companies, in order to shed light on the relationship between all corporate actors, the ways in which they interact, their objectives, and their motives. This analysis will be used as a pathway towards the heart of the decision-making process of a company, where the influence of ethics meets the authority of the rules. There lies the solution to the problems of modern corporate governance.

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<sup>1</sup> Sutton, B. (ed), *The Legitimate Corporation: Essential Readings in Business Ethics and Corporate Governance*, Basil Blackwell Ltd, Oxford and Cambridge MA, 1993, pg. 8.

The chapter will first touch upon corporate governance from an etymological perspective. To begin with the definition and the etymology, the term ‘corporate governance’ is derived from an analogy between the government of states and the governance of corporations. The first issue that needs to be resolved is the real meaning of governance for the purposes of this research and its differentiation from the term ‘government’.

### **(I) Governance**

The term ‘governance’ was first introduced by Plato in his influential work, ‘*The Republic*’ in approximately 380 BC. Plato’s approach was purely theoretical, as his work was about justice, poetry and philosophy. Etymological research reveals that governance has the meaning of steering, although governance nowadays is used as a synonym for authority and control. Nonetheless, it encircles steering, guiding and manoeuvring. To be more specific, it can be illustrated as a mixture of leadership, management, organization, regulation, decision-making, and supervision. The term ‘governance’ was initially used with the same meaning as government and the boundaries between the two terms were not clearly defined. Government differs from governance as it involves political power and its exercise. Weber, one of the most popular sociologists, compared it in his famous lecture, *Politics as a Vocation*, with ‘a monopoly on the legitimate use of physical force (violence) within a given territory’.<sup>2</sup> That was the case until the 1980s. It then became clear that governance is a broader and rather multi-functional term, which can be found in the literature of almost all social sciences. According to Roderick Rhodes, the concept of

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<sup>2</sup> Available in the website: [http://www.ne.jp/asahi/moriyuki/abukuma/weber/lecture/politics\\_vocation.html](http://www.ne.jp/asahi/moriyuki/abukuma/weber/lecture/politics_vocation.html)

governance is currently used in contemporary social sciences with at least six different meanings: the minimal State, corporate governance, new public management, good governance, social-cybernetic systems and self-organized networks.<sup>3</sup> The essence of governance is not just the rules. It is found in the personality of all the involved actors as well as the relationships between them. Creating the rules and setting up the legal framework is significant, but rules cannot be seen isolated from their social environment, which influences both their application and enforcement.

Governance is really about creating an environment of enterprise and best professional practice to extract the maximum long term value from a commercial enterprise.<sup>4</sup> It is related to consistent management, cohesive policies, processes and decisions that define expectations, grant power, or verify performance.<sup>5</sup> It aims to assure that an organization produces a worthwhile pattern of good results while avoiding an undesirable pattern of bad circumstances. As a process, governance may operate in any organization of any size, and it may function for any purpose, for good or evil, for profit or for free.<sup>6</sup> This is the point where governance is linked with organizations. A bond is created between steering and management. The concept of authority and control is enhanced with power and influence. Governance is a valuable asset for organizations, because it creates a pathway to the future. A strong future may be achieved by

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<sup>3</sup> Rhodes, R., 'The New Governance: Governing Without Government' (1996), *Political Studies*, Vol. 44, No. 4, 652.

<sup>4</sup> Bain, N. and Band D., *Winning ways through Corporate Governance*, MacMillan Press Ltd, London, 1996, pg. 173

<sup>5</sup> Testimony of Alfred Grasso, President and CEO of MITRE Corporation, to the Committee on Homeland Security and Government Affairs on the subject of 'Off-line and Off-budget: The Dismal State of Federal Information Technology Planning', available in the website: [http://hsgac.senate.gov/public\\_files/GrassoTestimony.pdf](http://hsgac.senate.gov/public_files/GrassoTestimony.pdf)

<sup>6</sup> Available in the website: [http://www.confertis-consulting.com/index.php?option=com\\_content&task=view&id=257&Itemid=475](http://www.confertis-consulting.com/index.php?option=com_content&task=view&id=257&Itemid=475)

continuously steering towards a vision and ensuring that day-to-day management is always aligned with the organizations' objectives.<sup>7</sup>

## **(II) Corporations**

Governance takes a more precise form when it is associated with organizations. It is no longer so broad, as corporations<sup>8</sup> are legal entities with a particular structure and pre-defined objectives. At the same time, governance of corporations maintains the same degree of complexity, because corporations carry the characteristics of the participating individuals. Chief Justice John Marshall made a noteworthy attempt at drawing a portrait of a corporation in 1819. In his words, 'a corporation is an artificial being, invisible, intangible, and existing only in the contemplation of the law' and continued by adding that 'among the most important [of its qualities] are immortality, and if the expression be allowed, individuality; properties by which a perpetual succession of many persons may be considered the same, and may act as a single individual...'.<sup>9</sup>

It can be argued that companies existed, even in a premature form, in ancient Greece and Rome. It was not until the end of the first millennium that corporations started to develop some of the characteristics that modern corporations have. Both in the United Kingdom and the United States the predecessors of the modern multinational corporations were ecclesiastical, municipal, and charitable bodies and non-business entities such as charities, churches, cities and boroughs.<sup>10</sup> The Dutch East India Company

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<sup>7</sup> Available in the website: <http://governance.tpk.govt.nz/why/why.aspx>

<sup>8</sup> As it is common in the literature, the terms 'corporation', 'firm' and 'company' will be used interchangeably.

<sup>9</sup> *Trustees of Dartmouth College v Woodward*, 17 U.S. 518 (1819).

<sup>10</sup> Solomon, L., Schwartz, D., Bauman, J. And Weiss, E., *Corporations: Law and Policy: Materials and Problems*, 4<sup>th</sup> ed., West Group, Minneapolis, 1998, pg. 1 and 4.

is frequently referred to as the first recorded instance of a non-financial company with more than 1000 investors.<sup>11</sup> The growth and evolution of corporations has been rapid since then and they currently look nothing like the body (*corpus*) of individuals that it used to be during the medieval times. More precisely, it was after 1860 when the modern era of corporation began. Incorporation with limited liability was granted in the UK in 1862, in France in 1863, and in Germany in 1884. The transformation was the result of the combination of a number of factors, such as the spirit of deregulation and the operation of the capital markets. The United States proved to be the perfect environment to host and support the development of what is now called ‘Modern Corporation’.

There were several reasons why such a transformation took place. One of the most important is the economic reality. Modern corporations form an integral part of the foundations of the world’s economy. Capitalism is an economic system that provided a shelter for the first modern corporations. Economic liberty, less state intervention, market power, and free trade created an environment which significantly contributed to the development of the corporate form. Nowadays, 150 years later, corporations still continue to grow. The result is the establishment of multinational corporations. These powerful giants represent the latest version of capitalism. The theory that Adam Smith introduced in 1776 – ‘the system of natural liberty’- has evolved and bears little resemblance to the archetype. Society has progressed and changed along with people’s lives and values have also changed, so corporations were obliged to follow this evolution and adapt to the new standards. The importance of modern corporations for world economy is self-evident, but we should not overlook their significance for society as well. They have become part of

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<sup>11</sup> Among others, Frentrop, P., *A History of Corporate Governance 1602-1622*, Deminor, Brussels, 2003, pg. 46 and Clarke, T. (ed), *Theories of Corporate Governance: The philosophical foundations of Corporate Governance*, Routledge, London and New York, 2008, pg. 2.

our social lives, given their large number, their resources, and their universal and multicultural characteristics. Multinational corporations, for example, enter an underdeveloped country and change the social reality. The impact of this entry on the local economy is remarkable and can lead to strong influence and control over the country. It is like a coin with two sides, one positive and one negative one. Corporations employ a large number of native workers, they bring new technologies, and they improve the living conditions of the population. In return, they take advantage of the low cost of production and make a profit through the exports of goods. There are examples, where a corporation is wealthier and more powerful than the country itself.

Another significant reason for the rapid growth lies in the five defining characteristics of every corporation: a separate legal personality; limited liability of the shareholders; delegated (centralised) management; transferable shares; and (shared investor) ownership.<sup>12</sup> These characteristics make corporations look like the ideal vehicle for the organization and management of productive activity. Productive activity involves the participation in community activities and the relevant contribution from the corporations in the activities in which they are engaged in. Modern corporations must be able to ‘effectively perform their role as national productivity-enhancing economic actors’.<sup>13</sup>

However, the aforementioned characteristics also generate some tensions as well. As a result, a form of regulation would be essential to help corporations achieve their goals, minimize the conflicts among all the participants and, generally, create a business

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<sup>12</sup> Hansmann, H. and Kraakman, R., ‘The End of History for Corporate Law?’, (2001), *Georgetown Law Journal*, Vol. 89, No. 2, 439, 443.

<sup>13</sup> Fratianni, M., Saroni, P. and Kirton, J., (eds), *Corporate, Public and Global Governance: The G8 contribution*, Global Finance Series, Ashgate Publishing Ltd, UK and USA, 2007, pg. 4.

environment of equality, competition and transparency.<sup>14</sup> Such regulation is introduced by governments and this statement does come in conflict with the principles of capitalism and the *laissez-faire* theory – application of the law of supply and demand, limited state interference and the process of free competitive -. Regulation is not imposed and thus does not constitute a type of state interference. The ‘government’s job is not to regulate corporations and manage their affairs, but to protect their rights’.<sup>15</sup> Corporations are privately created entities. They are created by or under the authority of national legislation, but their foundations are the rights of the members.<sup>16</sup>

Therefore, the right formula needs to be found so that, on the one hand, the conduct of corporations will be regulated and, on the other hand, the rights and interests of the members will be respected. However, finding the right formula is not an easy and undemanding process. The imposition of legal controls on corporations has always been a thorny issue with numerous conflicts and controversies. Corporations, as it is easily assumed, ‘make every effort to avoid such regulation, while they steadily become more powerful’.<sup>17</sup> At the same time, a total absence of regulation is not a choice, as it would likely lead to unsatisfactory results. There are people who believe that the law should never interfere with the freedom of business people to make any contracts they choose, or people who reject any mandatory rules of company law.<sup>18</sup> Despite that, it is also accepted that there should be some ‘rules, which companies have to adopt in order not to fail in a

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<sup>14</sup> Kraakman, R., *et.al*, *The Anatomy of Corporate Law: A Comparative and Functional Approach*, Oxford University Press, Oxford and New York, 2004, pg. 17-18.

<sup>15</sup> Available in the website: <http://www.capitalism.org/faq/corporation.htm> .

<sup>16</sup> *Ibid*.

<sup>17</sup> Berle, A. and Means, G., *The Modern Corporation and Private Property*, MacMillan, New York, 1939, pg. 357.

<sup>18</sup> French, D., Mayson, S., and Ryan, C., *Mayson, French and Ryan on Company Law*, 25<sup>th</sup> ed., OUP, Oxford and New York, 2008, pg. 29.

competitive market'.<sup>19</sup> In any case, the true role of corporate law is to actively promote and encourage enterprise by making it easy to start and run companies while maintaining adequate safeguards against abuse.<sup>20</sup>

### **(III) Corporate law**

Corporate law is the law that attempts to make ends meet. The law which regulates the conduct of all corporations sets the basic guidelines, and creates the skeleton, upon which corporations are allowed to build. Every country should have a special legal framework based on fairness and transparency, which would serve as the leading authority for all the corporations registered in its territory. Its creation, though, is an enormously difficult task due to the complexity of the subject matter. There are so many issues that are controversial and conflict-ridden. Montesquieu was the first one to look at law through a comparative pair of eyes, and expressed his belief that laws depict the spirit of nations, and hence are closely linked to their geographical, cultural, sociological, economic and political elements.<sup>21</sup> The difficulty increases if the boundaries of corporate law are expanded and the target is the creation of an international common framework. Law, in general, exists and is designed to serve the needs of the society in any given period of time. It is more than a lifeless chain of words; it reflects the political and social situation of the society and must be dynamic and non-static. Corporate law

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<sup>19</sup>Ibid., pg. 30.

<sup>20</sup> Trade and Industry Committee, *The White Paper on Modernising Company Law*, London, July 2002, Cm 5553-I, part I, para 3, available in the website: <http://www.publications.parliament.uk/pa/cm200203/cmselect/cmtrdind/439/439.pdf>.

<sup>21</sup> See Montesquieu, *The Spirit of Laws*, Livre I, Gallimard, Paris, 1749, reprint, JP Mayer and AP Kerr (eds), 1970.

falls within this description as well and that's why there are so many variations from country to country.

Corporate law, in its broadest sense, takes in the whole framework within which companies operate. That framework is partly set by the law, partly by the participants themselves, and more widely by the market.

Firstly, Company Law is not simply the formal law which consists of the relevant legislation i.e. the Companies Act or the provisions of Codes (in non-common law countries) together with the large volume of delegated legislation that supplements it. It includes various rules, codes, practices, and statements of principle, which are binding mostly because they are generally accepted by business community.<sup>22</sup> While the legal requirements on companies are relatively predictable<sup>23</sup>, the boundaries of corporate behaviour, set by the participants and the market, are continually shifting.

Secondly, companies have always been in favour of adopting voluntary codes of conduct. Self-regulation allows flexibility and discretion in the application of the rules. There is no model or stereotype for such codes, thus there are plenty of variations concerning the format and the content. The most 'popular' issues that these codes cover are: conflicts of interests; fairness; transparency; accountability; and compliance. The listing rules, through which listed companies are regulated, are also included. The majority of self-regulatory attempts are 'reactive and not proactive'<sup>24</sup>, but they have been more than welcome by the business society. The only defect is their self-regulatory

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<sup>22</sup> 'Company Directors: Regulating Conflicts of Interest and Formulating a statement of Duties', (1999), Law Commission No 201 and Scottish Law Commission No 173, Cm 4436, pg. 8, available in the website: <http://www.lawcom.gov.uk/docs/cp153.pdf> .

<sup>23</sup> Prentice, D.D. and Holland P.R.J., *The Oxford Law Colloquium- Contemporary Issues in Corporate Governance*, Clarendon Press Oxford, Allen and Overy, Oxford and New York, 1993, pg. 46.

<sup>24</sup> Proctor, G. and Milles, L., *Corporate Governance*, Cavendish Publishing Limited, London and Sidney, 2002, pg. 78.

nature, in terms of compliance, as they are purely voluntary, and we will revisit this issue in the relevant chapter.

Thirdly, market forces can also produce efficient regulation. Theoretically, the market will make all the efficient arrangements, so as to offer a fair and well-organized business environment. Such arrangements, in theory, are much more effective than any legislation because the market can fulfil a meaningful monitoring role and, at the same time, can act as a deterrent to poor management. In practice, though, due to the fact that the market cannot replace management, such mentality can bring the opposite result, as it weakens the importance of compliance and accountability. As such, the cooperation of all the corporate actors is more than necessary. Thus, when externalities make market regulation insufficient, the available solution is either internalisation or centralisation, but certainly not deregulation. As Birkmose states, ‘deregulation can lead to regulation of a lower quality than is demanded by the companies’.<sup>25</sup>

The vast majority of the corporate governance literature that has appeared over the past two decades is mainly concerned with the analysis of control structures designed to protect and advance the interests not only of the stakeholders, but of the management as well.<sup>26</sup> Optimal structures depend on institutional conditions, so it goes beyond any shadow of a doubt that the controls may need modification as those conditions constantly change.<sup>27</sup>

In addition to the needs of society, corporate law should be able to follow all the new developments. As stated above, it is an illustration of the society on a given period of

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<sup>25</sup> Birkmose, H., ‘The European Harmonisation Process’, (2006), 17 *European Business Law Review* 1078-9.

<sup>26</sup> Mumford, M., ‘Corporate Governance and Financial Distress: When structures have to change’, (2003), *Corporate Governance*, Vol. 11, No. 1, pg. 53.

<sup>27</sup> *Ibid.*

time, but social structures are not fixed. Accordingly, apart from the obvious elements of efficiency and effectiveness, responsiveness is also an essential requisite. In its traditional form, corporate law fails to provide a solution to the contemporary problems of the business world. Modern corporations, especially multinational ones, which have affiliated corporations or branches all around the world, pose questions and challenges which traditional corporation law is not designed to cope with. In addition to that, this ‘multi-nationality’ uncovers the conflict between national jurisdiction and international law about which is the better choice of forum. The same conflict takes place concurrently also among national legal systems about which one is superior or more efficient. In order to avoid such dilemmas, legislators are currently facing the following challenge: since corporations have become multinational, a reasonable degree of convergence is essential. In fact, it looks like a puzzle: how can we combine governance, corporations and law? Is it possible to isolate these characteristics of corporate law and create a collection of rules specially designed for regulating the operation and performance of modern corporations worldwide? The solution for this puzzle can be found by combining the two aforementioned terms: ‘corporate governance’.

#### ***(IV) Defining corporate governance***

Although we have already discussed the origins of its two components parts, the use and full meaning of this term has been a source of controversy. The most controversial of the two components has proven to be the second component, governance. This is most likely to be due to its allusion to government, which brings a public element

into a domain that is essentially considered private.<sup>28</sup> The precise term ‘corporate governance’ seems to have been used first by Richard Eells, to denote ‘the structure and functioning of the corporate polity’.<sup>29</sup> Since then corporate governance has been a dominant policy issue in the developed market economies. In the transition economies it took some time for corporate governance to climb the ladder of policy priorities, but since the mid-‘90s it has been one of the most hotly contested issues. In the wake of the Asian Crisis, corporate governance has also become a catchword in the development debate.<sup>30</sup>

It is indeed quite a complicated task to define such a wide term as corporate governance, because it potentially covers a large number of distinct legal and economic phenomena. Each adopted definition basically reflects the special interest of its creator in the field of corporate governance, because every rigorous analysis needs a good definition as a starting point. The ‘absence of any real consensus’<sup>31</sup> on the definition is indicative of the complexity of the subject matter. This definitional richness reveals the fact that the notion of corporate governance is perceived differently from one country to another. The priorities in the debate on the management and control of corporations vary, and its intensity and nature are also different depending on the country in which it is taking place.<sup>32</sup> Apart from a geographical and historical relativity, the discussion is also

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<sup>28</sup> Lannoo, K., ‘A European perspective on Corporate Governance’, (1999), *Journal of Common Market Studies*, Vol. 37, No.2, pg. 271.

<sup>29</sup> Eells, R., *The Meaning of Modern Business: An Introduction to the Philosophy of Large Corporate Enterprise*, Columbia University Press, New York, 1960, pg. 106.

<sup>30</sup> Berglöf, E. and von Thadden E.L., ‘The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries’, (1999), Working Paper No 263, pg. 5, available in the website: <http://eres.bus.umich.edu/docs/workpap-dav/wp263.pdf>.

<sup>31</sup> Keasey, K., Thompson, S. and Wright, M., *Corporate Governance: Economic, Management and Financial Issues*, Oxford University Press, Oxford and New York, 1997, pg. 7.

<sup>32</sup> Center for European Policy Studies, ‘Corporate Governance in Europe: Report of a CEPS Working Party’, (1995), CEPS Working Report No. 12, pg. 2

relative to the academic discipline in which it is studied. To illustrate this point, the literature of law focuses on the powers and duties of several actors involved in the corporate governance system. Economists, in contrast, examine how to minimize the conflicts of interest between these actors (mostly between management and shareholders), so that a company can be financed and run in the most efficient way.<sup>33</sup> It is more important to ensure that ‘the suppliers of finance to corporations will get a return on their investment’.<sup>34</sup> Finally, for the discipline of management corporate governance is about performance and finding ways to have efficient internal structures within a company.

A widely used definition, which has successfully stood the test of time, is that corporate governance is ‘a system of rules, which determine how companies are directed and controlled’<sup>35</sup>, as it organizes the structures and the mechanisms that are responsible for the running of a company. Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance ‘also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined’.<sup>36</sup> The three key words are compliance, accountability and ethics. In the vast majority of definitions, corporate ethics are omitted and this makes every corporate governance definition look incomplete. Companies are expected, apart from achieving their medium or long-term goals, to create and maintain a respectable business reputation

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<sup>33</sup> Ibid., pg. 4.

<sup>34</sup> Shleifer A. and Vishny R., ‘A survey of Corporate Governance’, (1997), The Journal of Finance, Vol. 52, No 2, pg. 737.

<sup>35</sup> Report of the Committee on the Financial Aspects of Corporate Governance - Cadbury Code (December 1992), section 2.5. Available at: <http://www.cg.org.cn/theory/zlyz/cadbury.pdf>.

<sup>36</sup> Organisation for Economic Co-operation and Development, ‘OECD Principles of Corporate Governance’, 2004, Preamble, pg. 11, available in the website: <http://www.oecd.org/dataoecd/32/18/31557724.pdf>

and to make a positive effect on the community and their working environment. This is what constitutes good corporate governance.

### ***(V) Good corporate governance***

As the Cadbury Committee argued in 1992, the essence of any good corporate governance system is to allow companies enough freedom to grow and evolve, but, at the same time, exercise that freedom within a framework of effective accountability.<sup>37</sup> In particular, good corporate governance should provide proper incentives for the board and management to pursue objectives that are within in the interests of the company and the shareholders and should also facilitate effective monitoring.<sup>38</sup> It is a question of finding the right balance between being competitive and remaining accountable. Good corporate governance also underpins market confidence, integrity and efficiency, and hence promotes economic growth and financial stability.<sup>39</sup> To put it differently, it presupposes rigorous supervision of the management of a company, so that carrying out the business is done competently, with consistency and with due regard to the interests of all parties involved or affected; it aims to create the conditions for the transparent, decent and effective operation of the company, the improvement of accountability, the prevention of malpractice and the efficient safeguarding of the shareholders' investment. The existence of good governance structures adds real value to a company and increases its prospects for greater achievements. It is not only a matter of putting restrictions on a company's conduct; it is really about creating an environment of high standard performance and a culture of ethical principles.

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<sup>37</sup> Cadbury Code, see above, note 35, para. 1.1.

<sup>38</sup> Ibid.

<sup>39</sup> Berglöf, E. and von Thadden, EL., see above, note 30, pg. 6.

The importance of good corporate governance is established not only on a theoretical context, but it can also be seen on the results of empirical research. A survey conducted by the Economist Intelligence Unit in 2001 indicates that more than 80 per cent of European and US institutional investors said they would pay more for companies with good governance.<sup>40</sup> Similarly, another survey conducted by the Economist Intelligence Unit indicated that 70 per cent of international executives believe that the perception of good governance standards has a positive impact on stock prices, and 79 per cent stated that a negative impact would occur if the perception is poor.<sup>41</sup> It is no surprise that 77 per cent admitted that corporate governance is indeed one of the priority.<sup>42</sup>

At this point, it is interesting to identify the reasons why corporate governance has become so prominent recently, despite the fact that its significance was already widely known before.

The first apparent reason is the wave of corporate scandals and failures. The United States of America became the centre of the world interest after the collapse of Enron in late 2001. Enron can be illustrated as just the tip of the iceberg, which suddenly reached the surface of the ocean and became noticeable. Inevitably, the investors as well as the public's confidence collapsed like a tower made of cards and the issue of corporate governance returned to the top of the agenda.

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<sup>40</sup> Mintz, S., 'Corporate Governance in an International Context: Legal Systems, Financing Patterns and Cultural Variables', (2005) *Corporate Governance*, vol.13, No. 5, 584.

<sup>41</sup> Economist Intelligence Unit, *Corporate Governance: Business under Scrutiny*, (2003), pg. 18, available in the website: [http://www.kpmg.com.mx/gobiernocorporativo/libreria\\_gc/gobierno-control/Controles%20Internos/Business%20under%20scrutiny.pdf](http://www.kpmg.com.mx/gobiernocorporativo/libreria_gc/gobierno-control/Controles%20Internos/Business%20under%20scrutiny.pdf).

<sup>42</sup> *Ibid.*, pg. 20.

Apart from the corporate scandals in the United States, there are several other reasons. The past two decades have been characterized by a worldwide wave of privatization and takeovers in combination with a tendency towards the deregulation and integration of capital markets. Globalization and market integration in combination with new ownership structures create new challenges for regulators. The underpinnings and objectives of regulation seem to change rapidly, so regulatory coordination needs constant enhancement and regulatory practice further strengthening.<sup>43</sup> Furthermore, global competition not only among capital markets, but also in the product market has been fuelled by rapid technological changes and innovations. Companies are forced to focus on maximizing asset efficiency and shareholder value in an attempt to access funds and increase their opportunities. As a result, corporate governance has been highlighted as one of the most burning issues both in a legal and financial context.

In Asia, the prevalence of family ownership, government interference, and relationship-based transactions, in combination with weak legal systems and law enforcement resulted in agency problems. Problems like the large deviations between control and cash flow rights and a low degree of minority rights protection. Conventional corporate governance mechanisms such as takeovers and boards of directors were not strong enough to relieve such problems. The group business and cross-holding structure further complicated the situation. Weak corporate governance inevitably led to poor firm performance and risky financing patterns. As a result, these circumstances became factors conducive to macroeconomic crises, like the 1997 East Asia crisis.<sup>44</sup> Similarly, in the

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<sup>43</sup> Spatt, C., 'Speech by SEC staff: Regulatory Competition, Integration and Capital Markets', (2006), available in the website: <http://www.sec.gov/news/speech/spch102306cc.htm>.

<sup>44</sup> Fan, P., 'Review on Literature and Empirical research on Corporate Governance', (2004), Monetary Authority of Singapore, Financial Service Group Training Unit, Staff Paper No. 29, pg. 5.

emerging economies of Eastern Europe, experience has shown that successful privatizations and the development of vibrant private sectors depend to a significant extent on the existence of effective systems of corporate governance. In Russia and the Czech Republic, there were plenty of cases where asset stripping and self-dealing had become a common practice due to little or no protection of investors and shareholders by corporate governance systems.<sup>45</sup> Evidently, corporate governance has important consequences for economic efficiency and growth especially for countries without strong corporate governance standards, which are determined to attract foreign capital and change their economic structure.

In summary, corporate governance is a dynamic field of study with wide social and economic implications. It should become a priority for every country to minimize the risk of having more and more companies on the verge of collapse due to bad governance. The recognition that good and ethical corporate governance should become a priority will initiate a process of constant improvement, as it will help in raising the standards and making existing structures more effective.

Modern corporate governance is essentially about promoting corporate fairness, transparency and accountability, not only about being profitable at any cost. To once again quote the words of Shleifer and Vishny, corporate governance does not deal only with the 'ways in which suppliers of finance to corporations assure themselves of getting a return on their investment or just with how the corporate owners can be confident that

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<sup>45</sup> Selacuse, J, 'Corporate Governance in the UNECE region' (2002), United Nations Economic Commission for Europe, Discussion Paper Series No. 2002.2, pg. 4, available in the website: <http://www.unece.org/ead/misc/Salacuse.pdf>.

the corporate managers will deliver a competitive rate of return'.<sup>46</sup> The focus is currently on the enhancement of shareholder value and responsiveness to the needs of stakeholders. For a better understanding of how the corporate governance mechanism works, it is necessary to analyse the role of managers, directors, shareholders and stakeholders especially in relation to the company's business strategy and long-term performance. More concretely, it is of critical importance to examine not only the relationships among these groups, but also the relationships within these groups.

## **(VI) Corporate actors**

Corporate governance is affected by the relationships among participants in the governance system, since 'the essence of governance is found in the relationships between the various participants in determining the direction and performance of the companies'.<sup>47</sup> The participants can be better examined in three layers. Starting from the top, in the first layer there are the shareholders and the board of directors. Next, there is the management of the company. Finally, the last layer includes the stakeholders, the most divergent and perhaps the most controversial group of all.

All these groups are mutually interdependent. Directors rely on shareholders to maintain their investment in the company and exercise their powers in respect of decision-making reserved for them in a favourable manner. Shareholders rely on directors to manage the company competently, without taking personal benefits, loyally and on the basis that so far as practicable shareholders are kept in the picture about any matter which

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<sup>46</sup> Mathiesen, H., *Managerial Ownership and Financial Performance*, PhD dissertation, series 18, 2002, Copenhagen Business School, Denmark, pg. 45.

<sup>47</sup> Bain, N. and Band D., see above note 4, pg. 2.

is relevant to them.<sup>48</sup> Likewise, such inter-reliance exists between the board of directors and the management, as both groups can influence the company's strategy and financial performance. On the other hand, the relationship between management and shareholders differs from country to country. The UK system, for example, is more shareholder-friendly than in the US as it allows more freedom and more power of intervention for the shareholders.<sup>49</sup> That's why it is fundamental for every corporate governance structure to clearly define the roles of management and the board of directors. At the same time, shareholders should be aware of their role, their rights, and responsibilities, while stakeholders should realise that they are able to put their own bricks in the building of corporate policies and strategies.

***(i) Shareholders: Agency theory - Separation of ownership and control***

The first group is the shareholders, who are recognised as being the real owners of the company. Shareholders own the shares of the company's stock and they are considered to be on the top of the corporate hierarchy. Despite their centrality in the corporate structure, shareholders nowadays are dispersed and they exercise little control over corporate management.<sup>50</sup> In fact, each individual shareholder, particularly in large companies, holds just a small percentage of the total issued shares of a company. Moreover, small traditional companies, family business and entrepreneurs had to follow the new developments and were unavoidably transformed. Groups of companies and

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<sup>48</sup> OECD, see above note 36, pg. 67.

<sup>49</sup> Among others, Bebchuck, L., 'The Case for Increasing Shareholder Power', (2005), 118 Harvard Law Review, 883-917.

<sup>50</sup> Prentice, D.D. and Holland, P.R.J., 'Aspects of Corporate Governance Debate', in Prentice, D.D. and Holland, P.R.J. (eds), *Contemporary Issues in Corporate Governance*, 1993, Clarendon Press Oxford, Allen and Overy, Oxford and New York, pg. 27.

multinational corporations, which represent the modern business models, are far more complicated structures, while management and administration is more demanding and capital requirements became excessive. As a result, the founders could no longer run their companies. It was time to find the right people to carry out this job. Inevitably, the control<sup>51</sup> has left their hands and has been vested in managers. The managers were professionals with the appropriate skills, special knowledge and expertise. They had studied and were trained to perform their duties, so they seemed ideal for the post.

This phenomenon is called separation of ownership and control. To use different terms, it is the separation of the ‘decision and risk-bearing functions’ or the separation of the ratification and monitoring of decisions from the initiation and implementation of the decisions.<sup>52</sup> Such separation inevitably results in a gradual reduction in the power and interest of the shareholders and a respective gradual enhancement of the managerial powers and authority. The vast majority of academics share the same opinion that separation allows companies to go one step further from sheer profit-maximization. However, some scholars believe that the board of directors can become, ‘for all intents and purposes, a self-perpetuating oligarchy’<sup>53</sup>, probably stating their disagreement with the significance given to this separation. The big question is whether these variations are in fact working in favour of or at the expense of the company or its shareholders.

This delegation of powers was the right decision in the long run, but initiated a long-lasting discussion about the agency problem and its suggested solutions. The agency theory was developed during the 1970s and took its name from the relationship between

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<sup>51</sup> Control is defined with respect to the majority voting rule.

<sup>52</sup> Fama, E. and Jensen, M.C., ‘Separation of Ownership and Control’, (1983), *Journal of Law and Economics*, volume 26, 302, in Keasey, K., Thompson, S. and Wright, M., (eds), *Corporate Governance*, Vol. II, Edward Elgar Publishing Ltd, UK and USA, 1999, pg. 81.

<sup>53</sup> Prentice, D.D. and Holland P.R.J, see above, note 23.

shareholders and managers. This is an agency relationship, a contract under which one or more persons (the principals(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.<sup>54</sup> The company was described as a nexus of contracts. It is in fact a collection of implicit and explicit agreements among all the factors of production, a set of 're-negotiated contracts, contrived by an aggregation of individuals each with the aim of maximizing their own utility'.<sup>55</sup> The theory became dominant at the end of the 20<sup>th</sup> century. The shareholders are the 'principals', who invest their funds and expect profit. The managers are the 'agents', who make use of the invested funds and are expected to generate returns. However, there are some flaws.

The division of roles inevitably creates tension, which is based on the different incentives, motives and expectations of the capital holders on the one hand and the managers on the other hand. Conflicts of interest imply that there are business relationships, current or prospective, which could impair the independent approach of investors. To put it differently, business relationships can, directly or indirectly, make them less willing to control or limit managerial discretion. The discovery of interest conflicts between owners and managers can be traced back to Adam Smith. In a famous, and now often-quoted passage, he said that '[T]he directors of such [joint stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery watch over their own.

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<sup>54</sup> Jensen, M. and Meckling, W., 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure', (1976), *Journal of Financial Economics*, vol. 3, issue 4, 308.

<sup>55</sup> Learthmount, S., 'Theorizing Corporate Governance: New Organisational Alternatives', (2002), ESCR Centre for Business Research, University of Cambridge, Working Paper No. 237, pg. 3.

Negligence and profusion, therefore, must always prevail'.<sup>56</sup> Berle and Means expanded this argument and suggested that the shareholders, by delegating powers to the managers, 'have surrendered the right that the company should be operated in their sole interests'.<sup>57</sup> Managers are paid to take decisions and they have discretion over what criteria they will use. Without discretion, it would be impossible to talk about any form of agency relationship. In an ideal world, principals and agents will have a harmonious co-operation, because their interests are aligned and agents will always make the right decision without abusing their discretion.

According to the stewardship theory, the above statement is not utopic. This new theory is based on the assumption that managers are not opportunistic and self-interested agents, but good and co-operative stewards, who will act in the best interests of owners. The ultimate goal is to create a viable and successful company, as this would satisfy all interested parties.<sup>58</sup> This means that, even if the interests of the principal and the steward are not aligned, the steward places higher value on cooperation than defection.<sup>59</sup> The justification provided is that the stewards protect and maximize shareholders' wealth through firm performance, because, by so doing, the steward's utility functions are maximised.<sup>60</sup> It is not clear whether such a theory can be applied successfully in practice, again due to the unpredictability of human nature, but if this scenario becomes reality, the benefits for the companies will be at a maximum.

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<sup>56</sup> Smith, A., *The wealth of the nations*, Cannan ed., 1904, (1<sup>st</sup> edition 1776), pg. 164-5.

<sup>57</sup> Berle, A. and Means, G., *The Modern Corporation and Private Property*, Harcourt, Brace and World Inc, New York, 1967, pg. 311.

<sup>58</sup> Donaldson, L. and Davis, J.H., 'Agency Theory or Stewardship Theory: CEO Governance and Shareholder Returns', *Australian Journal of Management*, Vol. 16, No. 1, 49-64.

<sup>59</sup> Davis, J.H., Schoorman, F. and Donaldson, L., 'Stewardship Theory of Management', (1997), *Academy of Management Review*, Vol. 22, No 1, pg. 23.

<sup>60</sup> Davis, J.H., Schoorman, F. and Donaldson, L., 'Stewardship Theory of Management', in Clarke, T., (ed), *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance*, Routledge, London and New York, 2004, pg. 121.

However, reality is a bit different, as people are not robots and their behaviour can be unpredictable. Managers are likely to let their personal interests be their guide and shareholders have no guarantee that their interests will be promoted. There are plenty of examples where managers preferred to maximize their own utility instead of the best interests of the company. It is also quite common to have conflicts of interest, when managers may have personal goals that compete with the goal of maximization of shareholders' wealth. Conflicts of interest imply that there are different incentives, motives and expectations of the capital holders on the one hand and the managers on the other hand. There are plenty of ways to prevent these conflicts, or at least to minimize their effect. It requires active monitoring and control, initiatives, performance bonuses and, sometimes, fines and penalties. All these monitoring and control mechanisms are not free and generate the collectively called agency costs. They are the costs incurred by the principals by imposing internal controls to keep the agents' self-serving behaviour in check. The primary objective of the agency theory is to minimize these costs.<sup>61</sup> As stated above, the control cannot be total, because in this case there will be no delegation of powers and, thus, no real separation of ownership and control. Managers are supposed to use, but not to abuse, the authority that was delegated to them by the shareholders.

The agency theory deals with the relationship and the interaction between the principals and the agents and highlights the tension between the two groups. It does not give an answer, though, to one of the most crucial questions: whose interests should companies serve? There are four different theories dealing with the question of which is the best approach to this problem. Each of them introduces a model that appears to give the most suitable explanation, if not a solution, emphasizing the latent tension between

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<sup>61</sup> Jensen, M.C. and Meckling W., note 54 above, 357.

shareholders and stakeholders. Although, at first glance they seem to be rather conflicting or maybe competing, if they are used collectively, they can be more functional than they are separately.

The challenge of corporate governance reform is to create an environment in which shareholders and managers are encouraged to share long-term performance horizons'.<sup>62</sup> Managers usually connect the share price with shareholders' benefit and refrain from long-term investments due to high risk. The separation of ownership and control is important inasmuch as it may allow managers to deviate from shareholder value, i.e. profit-maximization'.<sup>63</sup> Corporate goals should be defined more widely than shareholders profits and there should be some 'explicit recognition of the well-being of other groups having a long-term association with the company'.<sup>64</sup> After all, above all the aims of an organization, the satisfaction of the shareholders' interests and the maximization of their value should not be the only priority. Stakeholders represent a wider and more social perspective, under which a company aims not only to fulfil the shareholders' interests, but also the interests of the members of the broader external environment, who are interested - have a stake - in a company's performance. Once again, this where ethics play a significant role, because a profitable company is not necessarily unethical and there are no moral restrictions for successful companies, as long as their goals do not conflict with the moral standards of our society.

Under such circumstances, the theory that a company is a 'nexus of contracts' comes to the surface again. These contracts essentially define the framework, within

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<sup>62</sup> Keasey, K., Thompson, S. and Wright, M, (1997), 'Introduction: The Corporate Governance Problem-Competing Diagnoses and Solution' in Keasey, K., Thompson, S. and Wright, M. (eds), *Corporate Governance: Economic, Management, and Financial Issues*, OUP, New York, 1997, pg. 3.

<sup>63</sup> Ibid., pg. 5

<sup>64</sup> Ibid., pg. 9.

which all actors of the ‘game’ are allowed to move. The source of the problem lies on the functional division of roles. The need for monitoring is justified because managers are agents who make use of the resources invested by the investors, and it is possible for them to serve their own ends instead of achieving the company’s purposes established by the shareholders. ‘The shareholders choose the destination, the directors determine the route and the executives drive the car’.<sup>65</sup> Nobody can claim that there will be no agency problems or that there will be no conflicts between the decision group and the control group, but at least they set up the ground rules. After all, as is commonly accepted, companies have all the characteristics of a living person, who evolves and undergoes constant change. Therefore, the implementation of any approach is not always smooth, while the results are, by no means, definite or predictable, especially in countries with dissimilar systems, legal history, tradition and historical background.

At this point, it would be useful to analyse the role of the management of the company. The management represents the directing mind of the company, which is responsible for the decision-making process and controls its operation. In this way, we will have a complete picture of the phenomenon of separation of ownership and control.

### ***(ii) Management of the company***

The quality of its management is ‘of cardinal importance in any business’.<sup>66</sup> Management does not represent the evil, but professional managers often have the burden of proof that they are not the best illustration of short-termism. Most of the time, managerially controlled companies tend to shorten the horizon of their investment

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<sup>65</sup> Sternberg, R., *Corporate Governance: Accountability in the marketplace*, The Institute of Economic Affairs, United Kingdom, 1998, pg. 31.

<sup>66</sup> *Flancharid Corp.*, 42 SEC 163, 169 (1964).

decisions, because managers want to boost their reputation by making profit or by bringing success in short periods of time. There are exceptions, of course, who are not so myopic and narrow-minded, but performance bonuses and lucrative wages can easily (mis)lead a company's strategy in the direction of opportunism. In support of this argument, it can be said that reputation is the most important asset they have, so it is vital to protect it by holding appropriate ethical and professional values.<sup>67</sup> They should be aware that their job involves dealing with the unexpected, taking risks and making the right decisions. They are under constant evaluation, in the sense that their performance is assessed by the outcome of their decisions. They are paid for their leadership and their capability to perform well under pressure. However, they are not responsible for all the illegalities or immoralities of their companies. Their basic responsibility is to implement the strategy, which is designed by the directors, and to pursue the objectives set by the shareholders. They simply need to realise that they also have the duty to safeguard the welfare of the company, coordinate stakeholders' interests and manage the affairs of the company with morality and responsibility.<sup>68</sup>

### ***(iii) Board of Directors***

One of the most significant internal mechanisms for the reduction of the agency problems between managers and shareholders is the board of directors. The standard provision in most sets of articles of association of companies is that 'the business of the company shall be managed by the directors'. The power given to the directors by the

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<sup>67</sup> Bain, N., and Band, D., see above, note 4, pg. 171.

<sup>68</sup> Evan, W. and Freeman, R.E., 'A stakeholder Theory of the Modern Corporation: Kantian Capitalism', in Chryssides, G.D. and Kales, J.H. (eds), *An Introduction to Business Ethics*, Thompson Learning, London, 1993, pg. 261-2.

shareholders is coupled with the duty to exercise that power sensibly and prudently. It may be for this reason that the standard of competence required of directors is constantly increased. Directors are often illustrated as the guardians and the protectors of good governance, but they are not only watchdogs. Directors are stewards acting on behalf of the shareholders. They are entitled to make honest use of, and they are accountable for, the funds entrusted to the corporation. They are also obliged to follow the necessary procedures that are set to assure accountability and disclosure of the manner in which management performs its stewardship.<sup>69</sup>

Part of their role as stewards is to keep the balance between managers and shareholders. Their mission is to be the legal representatives of the shareholders and at the same time to monitor, evaluate and reward the managerial performance. As a matter of fact, the board of directors often incorporates elements of connecting link, controlling mechanism, and internal safeguard. From the aforementioned consideration, it follows that directors are not responsible just for pressing the alarm button in case of emergency, but also for detecting, identifying and, if possible, preventing any potential problem or danger. For directors to perform their role properly, they need to be equipped with the appropriate weapons. Their duties are in effect their armoury. Any discussion on the role of directors in corporate governance would be incomplete without touching upon the issue of directors' duties, especially after the radical changes that the Companies Act 2006 (hereinafter CA 2006) brought about.

Prior to the introduction of CA 2006, there were two categories of duties, the fiduciary and the common law duties. Their categorisation was based on two equitable principles, the principle of fiduciary duty and the common law of negligence. CA

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<sup>69</sup> Com. Print, Committee on Banking, Housing and Urban Affairs, 94<sup>th</sup> Congress, 2<sup>nd</sup> Session 1976.

codified these principles and created seven general duties.<sup>70</sup> After this development, directors in the UK entered into a new era.

According to Easterbrook and Fischel, ‘the fiduciary principle is an alternative to elaborate promises and extra monitoring’.<sup>71</sup> Thus, directors' duties were owed to the company and not to any particular shareholder, and this affords protection of the board from undue shareholder interference. Fiduciary duties were originally created as a counterbalance for the directors’ extended powers and discretion. Evidently, fiduciary duties cannot on their own fully ensure that directors will act responsibly or that they will not abuse their position, although that was the courts’ intention. Disclosure plays a noteworthy role. Disclosure simply means the reporting of company data and information. Sufficient information is a necessary prerequisite for any kind of control procedures. Each company, though, should have a responsible information policy, because unlimited disclosure can potentially have even worse results. It is quite a demanding task to draw a line between disclosure and secrecy, especially if somebody intends to achieve it through the introduction of disclosure or secrecy rights-duties.

The common law duties, such as the duty of loyalty and the duty to act in good faith, were transformed into statutory duties. Most of the new statutory duties are similar to the old common law ones. One noteworthy change can be found in section 172 and the duty to promote the success of the company. Section 172 requires from the director to act in the way he ‘considers, in good faith, would be most likely to promote the success of

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<sup>70</sup> The seven main general duties owed by directors to a company are as follows: to act within powers; to promote the success of the company; to exercise independent judgment; to exercise reasonable care, skill and diligence; to avoid conflicts of interest; not to accept benefits from third parties, and to declare interests in proposed transactions or arrangements with the company sections (sections 171-177 CA 2006)

<sup>71</sup> Easterbrook, F., and Fischel, D., *The Economic Structure of Corporate Law*, Harvard University Press, London, 1991, pg. 92.

the company for the benefit of its members as a whole'. The definition of success is not included in the new section and, as a result, every company can adopt its own definition and focus on different levels of short-term or long-term success. The section also includes a list of factors to be taken into consideration for any directors' decision. This non-exhaustive list can be useful as guidelines, but once again leaves plenty of room for flexible interpretation, as it includes the short and long-term consequences of business decisions, the desirability of maintaining high standards of corporate business conduct, the impact of the company's operations on the local community and the environment and the need to foster the company's relationships with suppliers and customers. This list of factors is considered to be the vehicle by which the concept of the enlightened shareholder value is introduced in the UK legal order, but this issue will be further discussed below in the relevant section about the corporate objective.

Traditionally, directors were not expected to be extremely skilful or expert. It was supposed that values such as critical thinking and sound judgement are not reflected by academic degrees. Influential contacts and ambition were definitely useful, but they were not among the top directorial qualities. On the contrary, they have always been expected to be motivated, loyal and devoted to their duties. All directors should be able to commit themselves effectively to their responsibilities. An essential quality was the ability to ask the right questions and to be able to assess the answers given, to be able to predict the long-term consequences of decisions, and to challenge risky decisions. Furthermore, good inter-personal skills and business experience were indispensable abilities for a good director, but they were not to be found in any book nor can be taught at any university;

these are inherent virtues. Hence, a good director should combine elements of a representative, a steward, a trustee and a watchdog.<sup>72</sup>

Directors, when exercising discretion, were expected to act in accordance with what they personally think it is the best for the company. As it is apparent, such a criterion is purely subjective and it is extremely challenging to have conclusive proof of breach of this duty. The reason is that ‘no matter what the courts believe, their judgement must be based on what each director may considered to be the best interest of the company’<sup>73</sup>, as long as such judgement is independent. The absolute discretion allowed by the courts to directors does not always offer immunity. For example, a director acting honestly but not in the best interest of the company is in breach of duty. Directors’ duties are not only expressed in terms of results, but also in terms of behaviour as well, although there are strong objections surrounding this matter.<sup>74</sup> It is indeed quite complicated to try to transplant discretion into any legal standards. It seems like looking to find the balance between autonomy and absolutism, or between prudence and gross abuse.

One of the most challenging tasks for directors nowadays is to avoid conflicts of interest. Any personal interest inconsistent with their duties is an obstacle and can deter them from promoting the interests of the company. That does not necessarily mean that a director cannot have any relationship with the management or the company. It just means that any relationship should be known and explained, for the reason that being a director creates plenty of opportunities for personal gains and profits. As a result, the dilemmas are constant, the temptation to take advantage of these opportunities is big, and that is why sometimes the role of a director becomes an onerous responsibility.

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<sup>72</sup> Sternberg, R., see above note 65, pg. 31.

<sup>73</sup> Lord Greene in *Re Smith & Fawcett* [1942] Ch 302, 304 CA.

<sup>74</sup> Among others, Kubler, F., *Gesellschaftsrecht*, C.F. Muller, Heidelberg, 1981.

Nevertheless, there is always the other side of the story. Directors, as an integral part of the company's structure, play a significant role in its performance. Acting *bona fide* and to the best of their ability is actually a one-way obligation. They do not have an alternative option; they do not have a choice. At the end of the day, they are strictly liable for all the losses resulting from breach of their duties, at the same time as profit maximization is the only way they can get any kind of reward in return. At present, there is still an ongoing discussion over whose interests the directors ought to take into account: the shareholders' interests only; the stakeholder interests; or both? Normally, this should not have been a topic of discussion, as directorship is supposed to be a public responsibility. The traditional view is that directors, especially in publicly held companies, are primarily accountable to the company's shareholders, but some innovative theories have recently been developed which argue that directors should take into consideration other interests as well. Still this cannot be considered as an onerous obligation, at least in advance. These so-called wider social responsibilities would place extra weight on the directors' shoulders and it is truly doubtful whether they are willing to carry it. It is not accurate to say that directors and/or managers are accountable to every single group involved, and to the same extent. It would be difficult, if not impossible, for directors to equally consider and balance all interests. Such a duty, if imposed, would be unbearable. Their responsibilities are 'to ensure that the corporation remains loyal to its corporate purpose, to exercise prudential judgment, and to demonstrate moral courage in carrying out these functions'.<sup>75</sup> They must be able to take ethical and responsible business decisions with fairness and integrity, following the letter

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<sup>75</sup> Gregg, S., *Corporations and Corporate Governance: A Return to First Principles*, The Centre for Independent Studies, Sydney, 2001, pg. 16.

of the law, acceptable business practices, as well as the spirit of the rules. There has to be a line drawn between loyalty to the company and action against the laws and values of the society in which the company must operate.<sup>76</sup>

At this juncture, stakeholders become part of the discussion as to whether or not shareholders should have a ‘wider vision beyond pure profit maximization’.<sup>77</sup>

#### ***(iv) Stakeholders***

To fully explore the debate regarding all the players involved in the corporate governance game, it is necessary to highlight the rights of stakeholders.

Stakeholders constitute a *sui generis* group of people, in the sense that it is extremely wide, its members are dispersed all around the world, are vulnerable, and have special interests. Their position is similar to shareholders, but they need more protection. They have limited, or often no, regular access to information about the companies and their conduct. Participation in the corporate governance process requires sufficient and reliable information. Information is the lifeblood of good governance as long as it is of sufficient quality, given at a time when it is relevant, useful, and in a form that is accessible to its recipients.<sup>78</sup> In this context, the CLR Steering Group recommended the inclusion of an ‘operating and financial review’ in the annual report of every public and large private company.<sup>79</sup> That review should contain issues, which are ‘universally relevant to an understanding of company performance’,<sup>80</sup> such as the company’s business

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<sup>76</sup> Gellerman, S.W., ‘Why “good” managers make bad ethical choices’, in Andrews, K. R. (ed.), *Ethics in practice: Managing the Moral Corporation*, Harvard Business School Press, Boston, 1989, pg. 25.

<sup>77</sup> Proctor and Milles, see above, note 24, pg. 187.

<sup>78</sup> Ibid, pg.152.

<sup>79</sup> See Modern Company Law: Final Report, Vol. 1, Summary of Recommendations.

<sup>80</sup> Final Report, para 3.39.

strategy, development of the company's business over the previous financial year, and events, trends, or factors that may affect the future performance of the business.

Due to their position, stakeholders should have an efficient means of defence against any violation of their rights. Their rights are established either by the law - employment and contract law - or by agreements and should be respected, or at least assurance should be given to stakeholders that their interests will be taken into account. Respect does not mean that all companies should just become more socially responsible. It means taking into consideration all the possible effects of the company's conduct, for example the environment, giving equal opportunities to anyone, who wants to express his concerns about the company's practices, for example the employees, and providing effective redress when stakeholders' rights are in danger.<sup>81</sup> It is too strict to say that mistakes are forbidden, but mistakes, under these circumstances, can easily cause serious physical harm, loss of money and, generally, can have a deep impact on certain categories of people. The challenge for Company Law Review is to implement its recommendations in an effective way that is beneficial for the performance of the company. It is not sufficient to only address the failings and the problems; the objective should be to make stakeholders feel that their company considers the wider public good.

Stakeholders symbolize the ethical dimension of modern corporate governance. They should remind everybody that there are also moral obligations and ethical responsibilities, apart from business transactions, profits, and financial interests. This does not imply that business should have only moral motives. Directors are essentially the moral leaders of a company and, consequently, they have to be able to keep the

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<sup>81</sup> Charkham, J., *Keeping Better Company: Corporate Governance Ten Years On*, Oxford University Press, Oxford and New York, 2005, pg. 402.

company loyal to its corporate purpose, to exercise prudential judgement, and to demonstrate moral courage in carrying out their duties.<sup>82</sup> The actions of a company have a reasonable effect on people, the environment, and society in general. It is a matter of balance, but not between being ethical and becoming insolvent. If a company cannot be run ethically, arguably it should not be run at all.<sup>83</sup> In any case, ethical values like conscience, integrity, accountability and fairness, when properly established, will result in benefits to all that definitely outweigh any costs. Ultimately, business will not be interested in business ethics unless it is proven that it is prudent and profitable.<sup>84</sup>

After analysing the role of all the actors involved in the corporate governance system, it is time to discuss the scope of corporate objectives - a rather confusing issue. The discussion is about how corporate governance is understood and whose interests the corporate management should promote. Academics have expressed a great number of different views on this issue; therefore, the clarification of the corporate objective behind management decisions is extremely important, because it is more than a competition between profits and ethics.

### ***(VII) Corporate Objective***

Until the 1980s there was a cliché repeated in the chairman's speech at almost every Annual General Meeting of public companies: 'this company recognises that it has duties to its members, employees, consumers and to the nation'. At a certain point, it was

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<sup>82</sup> Cregg, see above, note 75, pg. 45.

<sup>83</sup> Charkham, J., see above note 81, pg. 21.

<sup>84</sup> Davis, P., and Donaldson, J., *Co-operative Management*, 1998, New Harmony Press, United Kingdom, 1998, pg. 77 and 82.

considered somewhat anachronistic and it was modified.<sup>85</sup> Until now, several different approaches have been adopted regarding the objective that companies pursue or should be pursuing and there is no doubt that the corporate purpose is indeed an ‘extremely varied, inclusive and open-ended’ concept.<sup>86</sup>

In May 2000, the European Association of Security Dealers included in its ‘Corporate Governance Principles and Recommendations’ the aspect that directors must act in the interest of the company and its shareholders as a whole, but also went one step forward by adding that stakeholders’ rights should be respected and their concerns addressed.<sup>87</sup> Two years later, the High Level Group of Company Experts repeated that shareholders should ensure that management pursues and remains accountable for their interests, but also mentioned creditors and made suggestions for their protection.<sup>88</sup> After two more years it was the OECD Corporate Governance Principles, which, after reminding that directors should act in the best interest of the company and its shareholders, pointed out that the interests of the stakeholders should be taken into account with particular emphasis placed upon the effective enforcement of creditors’ rights.<sup>89</sup> Finally, in 2005 the International Corporate Governance Network clearly asserted that the objective of the corporation, the overriding one, should be to optimize over the long term the returns to its shareholders and, where other considerations affect

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<sup>85</sup> Davies, P., *Gower and Davies: The Principles of Modern Company Law*, 8<sup>th</sup> ed., Sweet and Maxwell, London, 2008, pg. 376-7.

<sup>86</sup> Clark, R., *Corporate Law*, Little Brown, Boston, 1986, pg. 17. See also Blair M. and Stout L., ‘Specific Investments and Corporate Law’, (2006) 7 *European Business Organization Law Review* 473.

<sup>87</sup> Goldschmidt, L. and Becht, M., ‘EASD Corporate Governance Principles and Recommendations’, May 2000, EASD Recommendation No. 00/01, pg. 18, available in the website: <http://ssrn.com/abstract=248089>.

<sup>88</sup> High Level Group of Company Experts, Final Report On A Modern Regulatory Framework For Company Law in Europe, November 2002, at 47, 87-88, available in the website: [http://ec.europa.eu/internal\\_market/company/docs/modern/report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf).

<sup>89</sup> OECD, *OECD Principles of Corporate Governance*, 2004, at 21, 24, 48, 58, available in the website: [http://www.oecd.org/document/49/0,2340,en\\_2649\\_34813\\_31530865\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/49/0,2340,en_2649_34813_31530865_1_1_1_1,00.html)

this objective, they should be stated and disclosed.<sup>90</sup> As a result of this diversity and lack of unanimity on corporate objectives, a polarization has been created. On the one hand, we have countries like the United States and - until recently - the United Kingdom supporting that managers should act exclusively in the economic interests of shareholders, while countries like Germany and Japan were in favour of a more pluralistic stakeholder-orientated corporate objective. The ascertainment of the corporate objective is one of the 'most important theoretical and practical issues confronting us today.'<sup>91</sup> Academics, practitioners, executives, investors and all sorts of stakeholders have been trying for years to find the right answer to the dilemma about the actual objective of modern companies: Shareholders' or Stakeholders' Welfare Maximisation?

Before attempting to examine the two existing theories, the shareholder value theory and the stakeholder value theory, it is worth mentioning that both models have their pros and cons and the choice between the two should not take the form of a 'right or wrong' choice, as it is determined by numerous factors, which can be different for every country. Corporate success is an amalgamation of elements like cooperation, integrity, team spirit, trust, and a credible commitment to the team. All these principal elements are more than essential for the promotion of productive and profitable corporate performance. However, the aforementioned ascertainment is fundamental as it will show which model of governance is more efficient, the duties / responsibilities imposed on all corporate actors and the type of legislative / regulatory reforms that is required for the solution of all corporate governance problems worldwide.

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<sup>90</sup> ICGN, Statements on Global Corporate Governance Principles, July 2005, at1.1-1.2, available in the website: [http://www.ecgi.org/codes/documents/revised\\_principles\\_jul2005.pdf](http://www.ecgi.org/codes/documents/revised_principles_jul2005.pdf).

<sup>91</sup> Walsh, J., 'Introduction to the 'Corporate Objective Revisited' Exchange', (2004) 15 Organization Science 349 at 349.

### ***(i) Shareholder value theory***

To begin with, shareholder value theory puts weight on the long-term economic value of the company. The main objective behind corporate decisions should be the promotion of shareholders' interests. Shareholders are considered to be the true owners of the company and they have the strongest incentive to monitor the activities of the board as well as the general behaviour of the company. Therefore, their protection and the enhancement of their investment should be the overriding objective, because if management is allowed or required to pursue any social purpose, managerial accountability to shareholders cannot be secured and shareholders' property rights will be damaged.<sup>92</sup>

As Blair points out, a 'conventional wisdom' was developed among 'economists, finance theorists, corporate legal scholars and policymakers around the globe that shareholder value should be the single, guiding principle of corporate governance, and that, to support this goal, enhanced investor control and oversight should be encouraged'.<sup>93</sup> Such superiority was based on the argument that shareholders have no contractual entitlement to dividends or capital gains; these will be available only if the board carries out the company's business successfully. By contrast, the stakeholders of the company enter into contracts which offer substantial protection to them.<sup>94</sup> Unavoidably, stakeholders and corporate social responsibility became a secondary issue,

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<sup>92</sup> Letza, S. and Sun, X., 'Corporate Governance: Paradigms, Dilemmas and Beyond', (2002), Poznan University Economic Review, vol. 2, No 1, pg. 45, available in the website: [www.puereview.ae.poznan.pl/2002v2n1/03-letza.pdf](http://www.puereview.ae.poznan.pl/2002v2n1/03-letza.pdf).

<sup>93</sup> Blair, M., 'Shareholder Value, Corporate Governance, and Corporate Performance: A Post-Enron Reassessment of the Conventional Wisdom', in Cornelius, P.K., and Kogut, B., (eds), *Corporate Governance and Capital Flows in a Global Economy*, Oxford University Press, New York, 2003, pg. 56.

<sup>94</sup> Davies, P., see above, note 85, pg. 376.

when the discussion was on what business is about. Albert Dunlap's phrase encapsulates the essence of shareholder value theory during the 1990s. "The most ridiculous word you hear in boardrooms these days is 'stakeholders'. Whenever I hear that word, I ask 'How much did they pay for their stake? Stakeholders don't pay for their stake. Shareholders do'.<sup>95</sup> Perhaps Chainsaw Al's statement was a bit of an exaggeration, but it highlights the fact that there was only one corporate objective and in any case multiple objectives were not welcome. Obviously, he had embraced Friedman's theory that 'there is only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays in the values of the game'.<sup>96</sup>

Shareholder value theory thus created a new ethos for business and became extremely prominent especially during the second half of the 1990s. It can be argued that shareholder supremacy has been the cornerstone of the Anglo-American corporate governance paradigm. In the United States, in particular, the courts affirmed the importance of maximizing shareholder value from the very early stages. In *Dodge v Ford Motor Co*<sup>97</sup>, it was outlined that 'a business corporation is organised and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend . . . to other purposes'.<sup>98</sup> Gradually, all other purposes disappeared and there was a general reluctance in companies' boardrooms to accept that the decision-making process should not be entirely linked with shareholders interests and profit maximization. Alastair Ross Goobey, the hugely influential UK fund

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<sup>95</sup> Dunlap, A.J., *Mean Business: How I Save Bad Companies and Make Good Companies Great*, Times Business Books, New York, 1996.

<sup>96</sup> Friedman, M., *Capitalism and Freedom*, Chicago University Press, Chicago, 1962.

<sup>97</sup> *Dodge v Ford Motor Co.*, 170 N.W. 668 (Mich. 1919)

<sup>98</sup> *Ibid.* at 664.

manager, was of the opinion that ‘as soon as you set more than one benchmark by which you will be judged, there is diffusion of effort and almost guaranteed disappointment’, while Matthew Bishop, Business Editor of *The Economist*, argued in 1994 that ‘making bosses accountable to many stakeholders might make them accountable to none, as there would be no clear yardstick for judging their performance’.<sup>99</sup>

During the dominance of this theory, share prices reached extremely high levels and the role of managers dramatically changed. The agency theory<sup>100</sup> was developed to illustrate the relationship between shareholders and directors. Directors are the agents of the shareholders and are employed to run the company’s business for the shareholders who do not have the time or ability to do so, and it is the shareholders who are best suited to guide and discipline directors in the carrying out of their powers and duties.<sup>101</sup> However, the agency theory was severely criticized and its conclusions were challenged. There were reservations, concerning the ability of shareholders to discipline directors<sup>102</sup> or the theory’s applicability in modern companies<sup>103</sup>. Dodd, for example, expressed the view that managers are in fact free from any substantial supervision from shareholders by reason of the difficulty which the modern shareholder has in discovering what is going on and taking effective measures even if he has discovered it.<sup>104</sup> This view is also in line

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<sup>99</sup> Kay, J., ‘A Stakeholding Society – What Does it Mean for Business?’, (1997) *Scottish Journal of Political Economy*, Vol. 44, Issue 4, 425 at 430.

<sup>100</sup> Among others, Jensen M. and Meckling, W., ‘Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure’, (1976) 3 *Journal of Financial Economics* 305; Easterbrook and Fischel, D, see above, note 71, pg. 36-39; Fama E. and Jensen, M., ‘Separation of Ownership and Control’, (1983), 26 *Journal of Law and Economics* 301; Fama, E., ‘Agency Problems and the Theory of the Firm’, (1980) 88 *Journal of Political Economy* 288.

<sup>101</sup> Matheson J. and Olson, B., ‘Corporate Law and the Long-term Shareholder Model of Corporate Governance’, (1992) 76 *Minnesota Law Rev* 1313 at 1328.

<sup>102</sup> Keay, A., ‘Company Directors Behaving Poorly: Disciplinary Options for Shareholders’, (2007) *Journal of Business Law* 656.

<sup>103</sup> Frug, G., ‘The Ideology of Bureaucracy in American Law’, (1984), 97 *Harvard Law Rev* 1276 at 1307.

<sup>104</sup> Dodd Jr, E.M., ‘For Whom Are Corporate Managers Trustees’, (1932), 45 *Harvard Law Rev* 1145.

with Berle and Means' assertion that shareholders 'surrendered a set of definite rights for a set of indefinite expectations'.<sup>105</sup>

Even if we accept that there was no general consensus about shareholder primacy, in practice managers were most times keen on protecting shareholders' interests, preferably large shareholders, since they were the only ones who could potentially become a threat to their jobs. Apart from the threat of replacement, directors had to consider another threat: if shareholders interests were not adequately protected, then they could withhold capital and refuse to invest.<sup>106</sup> The result was the retention by shareholders of a rather anachronistic perception that companies, especially public ones, should be run predominantly, if not exclusively, in their interest.<sup>107</sup>

Despite the fact that shareholder value theory was presented as the dominant theory and the advocates of shareholder primacy were talking about a widespread normative consensus<sup>108</sup>, the first cracks had started to be detectable in its foundations. It was that time when more and more complaints were expressed about the fact that stakeholders had been victimised by the excessiveness and short-termism of managers.

The managers' objective was no longer the success of the company, but the maximum cash flow. The pressure for high financial returns was increasing and they were trying to make the most out of the liquidity of the stock markets in order to keep the stock price high and get more and more money as bonuses. Concentration of power in their hands in combination with the gradual dissolution of companies' internal system of

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<sup>105</sup> Berle, A.A. and Means, G.C., *The Modern Corporation and Private property*, Hacourt Brace, 1932.

<sup>106</sup> Bainbridge, SM., 'In defence of the Shareholder Wealth Maximization Norm: A Reply to professor Green', (1993), 50 *Washington and Lee Law Review* 1423.

<sup>107</sup> Kershaw, D., *Company Law in Context: Text and Materials*, Oxford University Press, Oxford, 2009, pg. 325.

<sup>108</sup> Hansmann, H. and Kraakmann, R., 'The End of History for Corporate Law', (2001), *Georgetown Law Journal* 89, 439-468. See also, Gilson, S. 'Separation and the Function of Corporation Law', (2005) *Stanford Law and Economics Olin Working Paper* No 307.

checks and balances allowed the managers to aim for short-term gains, in order to cash out their stock options as quickly as possible. This is how manipulation of prices and book cooking became a part of business terminology. Managers took advantage of their powers to the detriment of shareholders and stakeholders, but instead of focusing on the fraudulent personality of these managers, it would be more useful to continue with the examination of the shareholder value theory. The reason is that shareholder value theory does not limit the managers' powers and discretion at all; it reinforces them. Berle and Means had already pointed out the inevitability of this outcome more than 70 years ago. They had claimed that shareholder value theory is mistaken and leads to a dead end. Shareholders have lost control over their companies, because they have traded it for liquidity and the prospects of increased profits. Positive laws cannot give them back the control. Courts do not have the capacity to judge for themselves the merit of managers' decisions, while gatekeepers, most of the times, can only monitor a company's behaviour ex post and fail to guarantee the transparency of capital markets.<sup>109</sup>

Capital markets are unstable and can be manipulated, so companies are vulnerable, when their managers show blind confidence in the markets, not to mention when they confuse shareholder value maximization with misappropriation of wealth. At the same time, shareholders' interests were also at stake. By impeding a company's ability to make credible commitments not to expropriate stakeholders, the mechanisms which bind managers to shareholder value, created an environment in which companies were less able to establish an effective basis for long-term productive results.<sup>110</sup> The case

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<sup>109</sup> Aglieta, M. and Reberioux, A., *Corporate Governance Adrift: A critique of Shareholder Value*, Edward Elgar, Cheltenham and Massachusetts, 2005, pg. 261-2.

<sup>110</sup> Armour, J., Deakin, S. and Konzelmann, S., 'Shareholder primacy and the Trajectory of UK Corporate Governance', (2003), *British Journal of Industrial Relations*, 41:3, pg. 541.

studies, discussed in Chapter 3, illustrate the point that shareholder value theory ended up being too narrow in focus. The stories of Enron, WorldCom and Parmalat show that if everything is reduced to a matter of profit, shareholder value tends to ignore reality because it is not only the interests of shareholders that are at stake.<sup>111</sup> In other words, it cannot ‘do justice to the panoply of human activity that is value creation and trade, i.e., business’.<sup>112</sup>

At this point, it would be useful to consider one of the misconceptions that exists concerning corporate objective and shareholder value theory.

In a market economy a company’s objective is to maximize profits. This is an undisputed fact. However, this is where the misconception starts: the above objective does not imply that companies must be managed and directed in the exclusive interest of its shareholders. It means that companies should maximize long-term returns to the shareholders, but no more than that.<sup>113</sup> In the USA, the biggest supporter of the shareholder value theory, none of the states has a statute that imposes a duty on companies to maximize profits at any cost or that makes profit-maximization the sole purpose of the companies.<sup>114</sup> In Delaware, the land of incorporations, the courts have, through their case law, have also explicitly state that ‘stockholder interests’ are ‘not a controlling factor’.<sup>115</sup> The statutes provide that the company’s management team and directors have the duty to comply with the law, even if that means that they are losing

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<sup>111</sup> See Freeman R. E., Wicks A. and Parmar, B., ‘Stakeholder Theory and “the Corporate Objective Revisited”’, (2004) 15 Organization Science, 364; Allen W., Jacobs J. and Strine, L., ‘The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide’, (2002) 69 UChi Law Rev 1067 at 1083

<sup>112</sup> Wood, D.J. ‘Corporate Social Performance Revisited’, (1991) Academy of Management Review, Vol. 16 No. 4, 691-718 at 695.

<sup>113</sup> Hansmann and Kraakmann, see above note 108 at 439.

<sup>114</sup> Elhauge, E.R., ‘Sacrificing Corporate Profits in the Public Interest’, (2005), 80 New York University Law Review 733-869 at 738.

<sup>115</sup> *Unocal Corp. v Mesa Petroleum Co* 493 A.2d at 955.

money or they may have reduced profits. This means that there is no legal duty or exclusive obligation for profit-making. The shareholders do have primacy over stakeholders and their interests remain predominant, but managers have to weigh the interests of other constituencies against shareholder profits in operational or corporate control transactions.<sup>116</sup> Of course, other constituencies' interests will be considered only if, and to the extent that, the protection of those interests promotes the interests of the shareholders.<sup>117</sup>

The term 'profit' has not been correctly interpreted, as it is not synonymous with shareholders' dividends. In other words, profit does not belong exclusively to the shareholders. This can be the case in single-person or entrepreneurial companies and perhaps in old-fashioned / traditional family businesses, where the share of total revenues come back to the entrepreneur-manager-capitalist-worker.<sup>118</sup> In listed or multinational companies, profit is a rather impersonal concept and belongs to the corporation.<sup>119</sup> Shareholders in fact end up receiving only a part of the share that comes back to the company, following the payment of salaries and all other obligations. Moreover, it is also common practice to have this surplus invested in the company for further expansion, instead of paying it as dividends to the shareholders.

A counterargument from the side of the supporters of shareholder value (and another misconception) is that shareholders deserve to play a central role within the company, because of the risk that they take. They are the actual risk-bearers of the

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<sup>116</sup> Elhauge, see above note 114.

<sup>117</sup> Davies, P., 'Enlightened Shareholder Value and the New Responsibilities of the Directors', (2005) Inaugural WE Hearn Lecture, University of Melbourne Law School, pg. 5

<sup>118</sup> Aglietta and Reberieux, see above, note 109, pg. 33.

<sup>119</sup> Bernstein, P., 'Profit Theory – Where do we go from here?' in Blumner, S., *Readings in Microeconomics*, International Textbook Company, Scranton, 1969, pg. 243.

company and thus they deserve to have extensive powers and should take precedence in the distribution of any profits. Such priority is based on the fact that they have no binding contract with the company for receiving wages or any kind of remuneration, nor have they any form of security like the creditors. As Easterbrook and Fischel pointed out, shareholders are the residual claimants to the firm's income and that's why they have voting rights unlike creditors and employees accompanied with the appropriate incentives to make discretionary decisions.<sup>120</sup>

Nevertheless, even if we accept that the risks taken by shareholders are relatively high and they need special arrangements, a right to control the decision-making process of the company is not justified. First of all, their liability is limited to the value of the amount they have contributed to the capital of the company, so their potential losses can reach the maximum amount of their initial contribution without affecting their personal or family assets. In addition to this, the trade-able nature of their assets, in combination with the growing liquidity of stock markets, provides them with a capacity for exit and diversification, a privilege that employees do not enjoy.<sup>121</sup> Actually, it would not be an exaggeration to argue that the workers and other employees in general bear the greatest risk for the simple reason that they have no power to influence the decision-making process of a company or even to make their voice heard. Scholars had recognized this inequality before the end of the previous millennium, but nobody supported the groundbreaking idea of giving rights of control over the board of directors to the employees as well as the shareholders.<sup>122</sup> Employee representation based on the German model of

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<sup>120</sup> Easterbrook and Fischel, see above note 71, pg. 67-68.

<sup>121</sup> Aglietta and Reberieux, see above, note 109, pg. 35.

<sup>122</sup> Among others, Romano, R., 'Corporate Law and Corporate Governance', (1996), *Industrial and Corporate Change* 5, 277-339 at 293; Blair, M., *Ownership and Control: Rethinking Corporate*

corporate governance was not such a popular idea so as to be included in the reform proposals.

This is how the need for an alternative theory was developed, away from the standards of the shareholder value theory. The company was seen as a constituted entity, the interests of which the directors and managers should protect instead of focusing on the interests of just one of its constituents. Shareholders could not have a central role within their companies at the expense of employees and other stakeholders. The primacy of shareholders was partially challenged and Zingales, in 2000, was one of the first to renounce the shareholder value theory and affirm that ‘in the current environment, the primary goal of a corporate governance system should be to protect the integrity of the firm’.<sup>123</sup> None of the proposals suggested that the shareholders’ interests should be excluded from the focus of the directors and managers, but there was a growing trend for a new theory that would combine and amalgamate the interests of all the main stakeholders, including shareholders. There was no valid reasoning to support the exclusivity of shareholders and the time had come for corporate governance to become more pluralistic.

In this respect, companies should retain their autonomy from shareholders and managers’ task should be to promote the collective interest of the company. Corporate management should seek to serve interests extending well beyond those of shareholders. Such effective protection could be offered by incorporating the aforementioned groups within the company’s governance structure. The old theories were regarded as ‘outdated,

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*Governance for the Twenty-first Century*, Brookings Institution, Washington, DC, 1995; Williamson, O. and Bercovitz, J., ‘The Modern Corporation as an Efficiency Instrument: The Comparative Contracting Perspective’ in Kaysen, C. (ed), *The American Corporation Today*, OUP, Oxford and New York, 1996, pg. 327-55.

<sup>123</sup> Zingales, L., ‘In Search of New Foundations’, (2000), *Journal of Finance* 55, 1623-1653 at 1645.

over-abstracted, over-static and far removed from the modern business environment and social reality'.<sup>124</sup> Inevitably, a new theory was created. It was the stakeholder value theory, which promotes stakeholder primacy and focuses on the stakeholders' welfare maximization.

### ***(ii) Stakeholder value theory***

The seeds of this theory can be traced back to the 1930s in the famous Dodd – Berle debate about the role and purpose of companies.<sup>125</sup> Berle suggested 'that managerial powers are held in trust for stockholders as sole beneficiaries of the corporate enterprise'<sup>126</sup>, while Dodd was of the opinion that the company should be viewed 'as an economic institution which has a social service as well as a profit-making function' and that company directors are 'guardians of all the interests which the corporation affects and not merely servants of its absentee owners'<sup>127</sup>.

The benchmark text for the stakeholder approach is the study undertaken by Freeman in 1984 describing partners (stakeholders) as 'any group or individual who can affect or is affected by the achievement of the organization's objectives'.<sup>128</sup> However, the vagueness of the definition of stakeholders as 'groups in relationships with an organization'<sup>129</sup> attracted severe criticism for broadening the scope of stakeholders and,

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<sup>124</sup> Letza, S., Sun, X. and Kirkbride, J., 'Shareholding versus Stakeholding: A Critical Review of Corporate Governance', (2004), *Corporate Governance*, Vol. 12, No. 3, 243.

<sup>125</sup> See on this topic Clarke, A.D., 'The Models of the Corporation and the Development of Corporate Governance', (2005), available in the website: <http://www.austlii.edu.au/au/journals/BondCGeJ/2005/2.pdf>.

<sup>126</sup> Berle, A., 'Corporate Powers as Powers in Trust' (1931) 44 *Harv L Rev* 1049.

<sup>127</sup> Dodd, see above note 104 at 1148 and 1157.

<sup>128</sup> Freeman, R.E., *Strategic Planning: A Stakeholder Approach*, Pitman Publishing, Boston, 1984, pg. 46.

<sup>129</sup> Thompson, J.K., Wartick, S.L. and Smith, H.L., 'Integrating Corporate Social Performance and Stakeholder Management: Implications For a Research Agenda in Small Business', (1991), *Research in Corporate Social Performance and Policy*, Vol.12, 207 at 209.

as Sternberg maliciously noted, it included ‘Everyone, everything, everywhere’<sup>130</sup>. She also added that it is ‘deeply dangerous and wholly unjustified’, on the basis that it ‘undermines private property, denies agents’ duties to principals, and destroys wealth’.<sup>131</sup> Despite a certain degree of ambiguity in defining the groups of stakeholders, which can create significant problems in implementation<sup>132</sup>, there are several interesting aspects that need to be considered and, most importantly, it introduced a radically different approach in the corporate object discussion.<sup>133</sup>

For the stakeholder value theory the company is by nature a partnership. It associates stakeholders, who must actively participate in the definition and the control of the company’s objectives, because their involvement constitutes a risk and this risk cannot be contractualized.<sup>134</sup> Apart from that, this theory aims at bringing democracy into the companies and advocates collective interests, common goals, and coordination of all parties involved. Stakeholder value theory does not assume that shareholders should be set aside or that their interests should be sacrificed in the name of stakeholders’ primacy. Stakeholder primacy basically supports the inclusion and broader accountability of all parties that can affect or be affected by a company's activities, as no group that has contributed to corporate success should go unrecognised.<sup>135</sup> Evidently, the objective of company law should be modified to accommodate a wider range of interests. The stakeholder model has been successfully implemented in Germany and Japan. Employees

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<sup>130</sup> Sternberg, E., ‘The Defects of Stakeholder Theory’, (1997), *Corporate Governance: An International Review*, Vol. 5 Issue 1, pg. 4.

<sup>131</sup> *Ibid.*, pg. 6 and 9.

<sup>132</sup> See Dodd, E., ‘Is Elective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?’, (1934) 2 *U Chi L Rev* 194 at 199.

<sup>133</sup> Beauchamp, T.L. and Bowie, N.E. (eds), *Ethical Theory and Business*, 5<sup>th</sup> ed., Prentice Hall, New Jersey, 1997, Ch 2. Also Plender, J., *A Stake in the Future: The Stakeholding Solution*, Nicholas Brealey, London, 1997.

<sup>134</sup> Aglietta and Reberieux, see above, note 109, pg. 266.

<sup>135</sup> Dean, J., ‘Stakeholding and Company Law’ (2001), 22 *Company Lawyer* 66 at 67.

in Germany and key stakeholders in Japan have representatives, who participate in the decision-making process and have the right to raise their voice supporting their rights. The company is 'a constellation of cooperative and competitive interests possessing intrinsic value'.<sup>136</sup>

Stakeholder value theory encourages long-term strategy and investment, by promoting ethical, social and environmental responsibility. Such a perspective emphasizes responsibility over profitability and sees companies primarily as coalitions which must serve all parties involved. The success of the company is dependent on the satisfaction of the stakeholders. Stakeholder management is seen both as an end and as a means.<sup>137</sup> As Carroll illustrates in his book, companies must live up to four levels of responsibility: economically, be profitable and satisfy consumer demand; legally, obey the law; ethically, do what is fair and just and avoid harm; and philanthropically, be involved in charitable giving and community activity.<sup>138</sup> The focus is no longer on short-term gains; for example, share price is a rather unreliable indication for the assessment of a company's performance. Companies must make profit in order to achieve their goals, but the survival of a company has to be placed above all. There are groups of people who work together and co-operate towards the common goal, and for that reason it is essential to continue working in an environment of trust, transparency, and accountability. Strong supporters of the stakeholder model consider it as the implementation of a truly caring type of management. They believe that modern society is calling for an increased sense

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<sup>136</sup> Donaldson T. and Preston, L., 'The Stakeholder Theory for the Corporation: Concepts, Evidence, Implications', (1995), 20 *Academy Management Review* 65 at 66.

<sup>137</sup> 'Emphasizing Responsibility over Profitability: Explaining Stakeholder Value Perspective', available in the website: [www.12manage.com/methods\\_stakeholder\\_value\\_perspective.html](http://www.12manage.com/methods_stakeholder_value_perspective.html).

<sup>138</sup> Carroll, A., *Business and society: Ethics and stakeholder management*, 2<sup>nd</sup> ed., South-Western Publishing, 1993, pg. 32-33.

of community, so those in business must understand the needs all companies have and attempt to meet those needs as much as possible. If this means that they make what traditional management theory says is a bad decision, then so be it. In a changing society, managers must be prepared to change in all areas, not just those dealing with the market.<sup>139</sup>

Clarkson argued that ‘the economic and social purpose of the corporation is to create and distribute wealth and value to all its primary stakeholder groups, without favouring one group at the expense of others’.<sup>140</sup> In theory, no group has, by definition, priority over the others. However, it would be an exaggeration to argue that companies should be accountable to every single stakeholder for ever. Stakeholders have no immunity or privileges. Stakeholder theory simply claims that companies, while pursuing their primary objectives, have to take into account the legitimate interests of stakeholders. Social responsibilities represent the direct opposite of the ‘egocentric’ and not altruistic motive of mere profit maximization and no director should turn a blind eye to them.

Despite the high expectations, not even this new theory seems to offer a satisfying solution. Many arguments have been put forward against it questioning the possibility of formulating a comprehensive stakeholder model. There have been numerous objections, even in the countries which have adopted the aforementioned model. Germany and Japan do not face the danger of an economic breakdown, but they have been experiencing financial ailments. Analysts believe that both countries are about to, or will soon, abandon the stakeholder value theory for a more shareholder-orientated model.

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<sup>139</sup> Burton, B. and Dunn, C., ‘Stakeholder Interests and Community Groups: A New View’, (1996), International Association for Business and Society Annual Meetings, available in the website: <http://www-rohan.sdsu.edu/faculty/dunnweb/pubs.iabs96.html>.

<sup>140</sup> Clarkson, M., ‘A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance’, (1995) 20 Academy Management Review 92 at 112.

Standing back and trying to gain some sense of the general trend, one might say that the major factor creating instability at the basis of the stakeholder model are the conflicts of interest. Stakeholders' interests do not exist in isolation. They are evolving, they vary from one company to another, and they are affected by the prevailing ideology, politics, culture, and performance of the business. Big and well-established companies are better placed to implement and benefit from stakeholder value than small or newly formed companies. The relevant stakeholders also vary from one company to another.<sup>141</sup> Thus, there is no clear answer to the question of how directors will discriminate between the legitimate competing interests of all different stakeholders.

Stakeholder theory grants extensive powers to managers as the only restraints to their decision-making freedom come from forces outside the company, i.e. the financial markets, the market for corporate control (e.g., the market for hostile takeovers), and, when all else fails, the product markets.<sup>142</sup> In addition, there are no guidelines and no code of conduct for managers and directors. As Jensen puts it, 'there is simply no principled way within the stakeholder construct that anyone could say that a manager has done a good or bad job'.<sup>143</sup> Yet another question, which is difficult to answer, is how can the board of directors ensure that all stakeholder groups are represented on it? Even if they are not all represented, how the board can guarantee that all interests are taken into account, and that no groups are shown preferential treatment? Ultimately, one individual can be potentially affected in the capacity of different stakeholders.<sup>144</sup> For instance, an

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<sup>141</sup> Kiarie, M., 'At crossroads: Shareholder Value, Stakeholder Value and Enlightened Shareholder Value: Which Road Should the United Kingdom Take?', (2006), *International Company and Commercial Law Review*, Vol. 17, No.11, 339.

<sup>142</sup> Jensen, M.C., 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function', (2001) in Andriof, J., et al (eds), *Unfolding Stakeholder Thinking*, Greenleaf Publishing, 2002, pg. 14.

<sup>143</sup> *Ibid.*

<sup>144</sup> Sternberg, see above note 130, pg. 5.

employee can simultaneously be a shareholder, a consumer, or can be affected by the environmental impact of the company.

Having more than one interest means that this person will sooner or later be faced with the problem of deciding between them. To paraphrase the old adage, ‘when there are many masters, all end up being short-changed’.<sup>145</sup> Without the clarity of a mission provided by a single-valued objective function, companies embracing stakeholder theory will experience managerial confusion, conflict, inefficiency, and perhaps even competitive failure.<sup>146</sup> Correspondingly, when there are conflicts of interests, a choice has to be made and the stakeholder theory offers no help in making that choice.<sup>147</sup> There is ‘no ‘clear yardstick by which to judge their performance’.<sup>148</sup> As a result, this leads to the potential for directors to engage in opportunistic behaviour, namely taking the chance to benefit themselves at the expense of others, because they essentially end up accountable to no one.<sup>149</sup> A total lack of equitable control can lead to fraudulent practices because, as Berle and Means have noted, managers can ‘serve their pockets better by profiting at the expense of the company than by making profits of it’.<sup>150</sup>

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<sup>145</sup> Jensen, M.C., ‘Value Maximization, Stakeholder Theory, and the Corporate Objective Function’, (2001), 14 *Journal of Applied Corp. Fin.* 8 at 9.

<sup>146</sup> Sternberg, see above note 130, pg. 9.

<sup>147</sup> Black, A., Wright, P., Bachman, J. and Davies, J., *In search of shareholder value: Managing the drivers of performance*, Pitman Publishing, United Kingdom, 1998, pg. 14.

<sup>148</sup> Final Report of the Committee on Corporate Governance (Hampel Report), January 1998, para 1.17, available in the website: [http://www.ecgi.org/codes/documents/hampel\\_index.htm](http://www.ecgi.org/codes/documents/hampel_index.htm).

<sup>149</sup> Key, A., ‘Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model’, (2008), *Modern Law Review*, Vol. 71, Issue 5, 663 at 676. See also, Easterbrook and Fischel, see above note 71, pg. 38.

<sup>150</sup> Banks, E., *Corporate Governance: Financial Responsibility, Controls and Ethics*, Palgrave MacMillan, New York, 2004, pg. 23.

### ***(iii) Enlightened Shareholder value***

After the stakeholder model failed to make the expected impact and bring radical changes in the modern corporate world, there was uncertainty regarding the outcome of this ‘conflict’ between shareholders and stakeholders. Macey has said that no company can sustain the abstract goal of shareholder wealth maximisation or the broad stakeholder model.<sup>151</sup> According to Company Law Review Steering Group (CLRS), stakeholder theory ‘would dangerously distract management into a political balancing style at the expense of economic growth and international competitiveness’<sup>152</sup>, while the UK Secretary of State for the Department of Trade and Industry, Patricia Hewitt, admitted that the primary goal is to make a profit for their shareholders, certainly; but the days of this being the whole answer to the question, *what are companies for*, are long gone.<sup>153</sup>

A number of alternative theories started to be developed, with a view to creating either a new improved theory or a compromise between shareholder value and the stakeholder model. Another solution would be to come up with a refinement of the shareholder value theory as this was the prevailing theory, at least until the wave of scandals at the beginning of the 21<sup>st</sup> century. The most challenging option would be an attempt to bridge the gap between shareholder and stakeholder theories and develop a hybrid theory, which would optimize corporate performance. The difficulty was not only in the development of the appropriate characteristics of the ‘new’ theory, but also in its legal construction, which would combine elements from both models and would guarantee ‘justice for all’ without restraining the ‘individual liberty’ of shareholders. The

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<sup>151</sup> Macey, J. ‘Convergence in Corporate Governance’, (1999), 84 Cornell Law Rev 1166 at 1172.

<sup>152</sup> ‘Modern Company Law for a Competitive Economy: The Strategic Framework’, (February 1999), pg. 44 quoted in Talbot, L.E., *Critical Company Law*, Routledge Cavendish, New York, 2008, pg. 151.

<sup>153</sup> Williams, C.A. and Conley, J.M., ‘An Emerging Third Way?: The Erosion of the Anglo-American Shareholder Value Construct’, (2004), UNC Legal Studies Research Paper No. 04-09, pg. 29.

most ambitious and, at the same time, promising outcome of such a process is the so-called enlightened shareholder value approach.

Enlightened shareholder value (ESV) is intended to apply as a generic statement of duties for directors of companies of every size.<sup>154</sup> As vividly stated by the Committee on Trade and Industry, the ESV approach towards defining directors' duties maintained that the primary duty of a company director was to maximize value for the company's shareholders. However, it added that other relationships were also significant in this and hence needed to be taken into account when deciding how to carry out this primary duty. The interests of employees, customers, suppliers, and local residents, as well as the environmental impact of the company's activities and its good standing in the eyes of the public, all had to be considered when judging what was in the interests of shareholders.<sup>155</sup> It is hard to imagine a successful company with disappointed customers, disaffected employees and suppliers unwilling to do business with it. Even if we go back in time and remember the words of Bowen LJ in 1883, who said that 'the law does not say that there are to be no cakes and ale except such as are required for the benefit of the company'<sup>156</sup>, it is obvious that directors always had the discretion to take account of stakeholders groups when promoting the interests of the company.

Sir Adrian Cadbury was the first to speak about finding the 'equilibrium' among all the competing considerations: long-term and short-term notions of gain, cash and accounting concepts of value, democracy and authority, power and accountability.<sup>157</sup> In

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<sup>154</sup> Committee on Trade and Industry, Sixth Report, 2001, pg. 11.

<sup>155</sup> Ibid, pg. 13.

<sup>156</sup> *Hutton v West Cork Railway Co* (1883) 23 ChD 654, CA.

<sup>157</sup> Monks, R. and Minow, N., *Corporate Governance*, 4<sup>th</sup> ed., John Wiley and Sons, UK, 2008, pg. 75.

his classic book<sup>158</sup>, he identified three levels of company responsibility. The primary level comprises the company's responsibilities to meet the material obligations to shareholders, employees, customers, suppliers and creditors, to pay taxes, and to meet its statutory duties. The second level includes the direct results of a company's actions in carrying out their primary task, regarding for example the environment and the community's human resources. The last level includes the interaction between the company and the society in a wider sense.

ESV has the advantage that it does not require any changes in the current company law framework. At first glance, it may look like a sort of compromise, but in fact it is not. It is a positive step away from strict and inflexible shareholder primacy. It signals a brand new area in company law regulation, without deviating from the existing models. Profit maximisation remains the objective of the company, but is subject to developing relationships of trust with shareholders, as this is the best way to ensure sustainability and secure overall prosperity and welfare.<sup>159</sup> ESV retains a director-centric character and gives directors a broad discretion to add stakeholders' interests and other broader factors to the 'traditional' shareholders' interests. It is neither altruistic nor wealth-sacrificing theory; it just places its focus on generating long-term shareholder wealth through investor and management attention to the company's impact on extended stakeholder constituencies.<sup>160</sup> Therefore, the main difference between ESV and shareholder value is that there is a change of perspective from short-term to long-term shareholder value theory.

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<sup>158</sup> Cadbury, A., *The Company Chairman*, Director Books, Hertfordshire, 1990.

<sup>159</sup> Gamble, A. and Kelly, G., 'Shareholder value and the Stakeholder Debate in the UK', (2001), *Corporate Governance*, Vol. 9, Issue 2, pg. 111.

<sup>160</sup> Harper Ho, V., "'Enlightened Shareholder Value": Corporate Governance Beyond The Shareholder-Stakeholder Divide', (2010), pg. 36, available in the website: [http://works.bepress.com/virginia\\_ho/2](http://works.bepress.com/virginia_ho/2)

Simultaneously, ESV supports the interests of all stakeholders, even indirectly, but does not lean towards the stakeholder value theory. The difference with the stakeholder model is that ESV regards shareholder interests as prevailing, while stakeholder value contends that neither party should have an automatic priority over the other. Stakeholders do not obtain extra privileges or enhanced powers. For example, employees do not get seats on the board of directors. Stakeholders' interests become part of the decision-making process, but they do not actively participate in it nor do they have a direct voice or the opportunity to express their views. Directors should be able to balance the competing interests for the benefit of all contributors and not just shareholders.<sup>161</sup> The instruction for fair balancing between the interests of different stakeholders is to focus on the long term shareholder value.

The best illustration is section 172 of CA 2006. It replaced the old duty to act in the company's best interests and requires a director to act in the way he considers, in good faith, would most likely promote the success of the company for the benefit of its members as a whole. The non-exhaustive list of factors to be taken into consideration adds an element of corporate social responsibility. Directors are encouraged to look beyond the myopic, short-term financial goals. The advocates of ESV argue that the role of directors is not transformed to something totally different than before; they just have to become more enlightened. What really changes is the decision making process and, more concretely, the criteria they use for making up their minds. The aim of the reform was to create clear signposts for directors which would enable them to steer the company in the

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<sup>161</sup> Ibid.

interests of wider concerns, without the previous undue focus on the short-term and narrow interests of the members.<sup>162</sup>

In practice, however, it is not always easy to strike the balance in practice, because within a board there are pressures coming from different directions and the duty of good faith can be easily discharged. Despite these doubts, ESV provides a good starting point because, as mentioned above, the stakeholder value offers no such guidance and directors will, for the first time in the history of UK company law, be required to consider wider stakeholder interests when making decisions. Unlike with Dodd's model, directors are now required to only consider the interests of other stakeholders and only when in honest pursuit of the promotion of the success of the company for the benefit of its members.<sup>163</sup>

From the foregone analysis, it appears that a polarization has been created of theories, resulting in an academic conflict between the supporters of the two models. Normally, an exchange of ideas opens new channels of communication and leads to finding solutions. Currently, such disputes do not contribute to finding the right approach or creating the best theory. Actually, it is rather confusing to talk about the shareholder model against the stakeholder model. In such cases, consensus is the answer. At the end of the day, the key objective of all healthy organizations is to create a framework which is 'economically, ethically and socially responsible and sustainable'.<sup>164</sup> Even the Hampel Report, which is considered to be an endorsement of shareholder value, mentions stakeholders' interests as relevant to the company's success together with the

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<sup>162</sup> Talbot, see above, note 152, pg. 150-1.

<sup>163</sup> Ibid., pg. 152.

<sup>164</sup> Hermes Principles by Hermes Pensions Management Limited, October 2002, available in the website: <http://www.hermes.co.uk>cg>policies> .

presentation and the enhancement of the shareholders' investment.<sup>165</sup> By adopting measures necessary to maximize corporate value, a company can advance the interests of stakeholders as well as the interests of shareholders. It also adds value to the society in which it operates. John Kay pointed in the right direction by saying that it is sensible to consider adapting the corporate model to reality 'rather than reality to the model'.<sup>166</sup>

ESV should not be rejected *a priori*, because it points in the right direction. The basic concept behind its emergence of ESV was to the creation of a strong combination of the two existing models, a hybrid with superior characteristics. It is erroneous to criticize ESV as a mere re-branding of a shareholder value adapted to placate the increasingly concerned stakeholder community.<sup>167</sup> It is definitely more than that. It puts emphasis on the long-term sustainability of the firm and the need for relationships of trust, while maintaining efficiency and accountability accruing from the profit maximization goal. In this way, it provides a superior and more adaptable theory; a model which is flexible, adjustable to the needs of the market, and makes the company attractive to investors. It is essential for modern companies to embrace a stronger stakeholder perspective given the changing nature of the firm. Along these lines, ESV ensures that both shareholders and stakeholders are happy with the outcome. Stakeholders' interests are taken into consideration significantly more than before, and shareholders continue to have profit maximization as their main goal. In other words, ESV has the potential to kill two birds with one stone.<sup>168</sup>

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<sup>165</sup> Smerdon, R., *A Practical guide to corporate governance*, 2<sup>nd</sup> ed., Sweet and Maxwell, London, 2004, pg. 10.

<sup>166</sup> *Ibid.*, pg. 8.

<sup>167</sup> 'Response of the CORE Coalition to the 2005 Company Law White Paper: Delivering Company Law for all Stakeholders', available in the website: <http://www.dti.gov.uk> .

<sup>168</sup> Kiarie, M., see above, note 141 at 342.

ESV is indeed likely, in practice, to achieve more than the two other theories, but it will definitely take time. It would be really premature to rush on to consider ESV as a panacea, because it still needs further improvements and refinement. Moreover, it does not have to be the final word in this discussion. Keye has talked about the Entity Maximisation and Sustainability Model (EMS), which focuses on an objective, instead of people or certain groups. This model has two elements, firstly, a commitment to maximise the entity, and secondly to sustain the company as a going concern.<sup>169</sup>

Entity maximisation does not focus solely on profit maximisation, for it encompasses such things as augmenting reputation, which can be seen as the most important intangible asset of a company.<sup>170</sup> Directors do not have to engage in active balancing between investors' interests as their aim is to maximise entity wealth: to increase the overall long-run market value of the company as a whole. Therefore, the balancing is not of interests, but of courses of action, and it has a clear goal, namely the maximisation and sustainability of the entity.<sup>171</sup> A similar theory, 'Team Production' (TP), was developed a few years earlier in 1999 by Blair and Stout, but differs from EMS in that it requires, without any guidance, directors to look after the investors' interests (team members).<sup>172</sup>

Kay in 2002 claimed that the challenge was – and is – to develop a genuinely inclusive capitalism, that involves differences in the way companies behave, markets operate and business is regulated. In his model, 'shareholder return is the result, not the

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<sup>169</sup> Keye, see above, note 149 at 679.

<sup>170</sup> See Dean, J., *Directing Public Companies*, Cavendish, London, 2001, pg. 107

<sup>171</sup> Keye, see above, note 149 at 687.

<sup>172</sup> Blair M. and Stout, L., 'A Team Production Theory of Corporate Law' (1999), 85 Va LR 247 at 258-259. See also Alchian, A., and Demsetz, H., 'Production, Information Costs and Economic Organization', (1972), 62 American Economic Review 777.

objective, of successful business; in which securities markets are mechanisms for financing and refinancing companies rather than hyperactive casinos; in which employees and investors have the common objectives of satisfying customers and outperforming competitive products; in which the regulation of business, like law in general, is designed to enforce on a minority the behaviour which most people adopt naturally'.<sup>173</sup>

The aforementioned theories and models are definitely useful and thought-provoking contributions. There is room for improvement and the greatest challenge is to provide a clear answer on how each one of them could be enforced in practice and how they could have a positive influence on the transformation of the corporate decision-making process.

In a few words, the debate on the merits of being on one side or another of this great divide or taking the third new way has been, and will no doubt continue to be, long and hard, 'with predictions that one arrangement would triumph over the other' in a fast-changing world.<sup>174</sup> The ESV approach is a good basis for further discussions and it represents a hybrid model, which, if properly developed, can become functional and workable. Once directors and managers are convinced that such prescriptions are not 'wet, woolly and vacuous'<sup>175</sup>, the road will be open for the creation of well-governed companies, capable of achieving long-term success and truly sustainable development; companies which will aim 'to satisfy customers, increase employee responsibility and empowerment and create stable, trust-based supplier relations, all with a view towards

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<sup>173</sup> Kay, J., 'Stakeholding Misconceived', *Financial Times*, 12 February 2002, available in the website: <http://www.johnkay.com/2002/02/12/stakeholding-misconceived/>

<sup>174</sup> Davies, P., *Introduction to Company Law*, Clarendon Law Series, Oxford University Press, Oxford-New York, 2002, pg. 281.

<sup>175</sup> Kay, J., *The Business of Economics*, Oxford University Press, Oxford, 1996, pg. 86.

generating value for the firm in the long run'.<sup>176</sup> Until then, the discussion about the most appropriate form of corporate governance and the attempts to influence what corporations do and how they distribute the surplus they generate will continue.

### **(VIII) *Non-regulatory corporate governance***

The ongoing debate on the corporate objective issue shows the intention of the national governments to leave some space to the companies to make their own decisions about their priorities, their objectives and goals. It seems to be the most prudent choice, as politicians should allow entrepreneurs to organise their conduct, as 'catalysts for economic change'<sup>177</sup>. The courts have also adopted the same approach and show a remarkable reluctance to interfere in the internal affairs of companies as long as they are acting within their powers.<sup>178</sup> This flexible approach, as reflected in the wording of s. 172 CA 2006 which provides directors with indicative factors to be taken into consideration without any formal sanctions, bears a resemblance to self-regulatory provisions.

Self regulation is often criticized for its inherent lack of legal sanctions for non-compliance and the absence of strict enforcement mechanisms. However, this argument does not fit well in this context, as we overlook the fact that self-regulation includes a tacit motive for compliance: the avoidance of the imposition of future legislative control

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<sup>176</sup> Pichet, E., 'Enlightened Shareholder Theory: Whose interests should be served by the supporters of Corporate Governance?', (2008), pg. 13, available in the website: <http://ssrn.com/abstract=1262879>

<sup>177</sup> Deakins, D. and Freel, M., *Entrepreneurship and Small Firms*, 5<sup>th</sup> ed., McGraw Hill, Berkshire, 2009.

<sup>178</sup> It is the 'internal management rule', introduced in *Foss v Harbottle* (1843) 67 ER 189. Although the principle aims at protecting the minority shareholders of companies, it reveals the courts' intention to refrain from making the companies' internal affairs subject of litigation.

and state regulation. Self-regulation is the alternative of centralised regulation and state intervention. Sinclair has characterized it as regulation ‘in the shadow of law’.<sup>179</sup>

Corporate structure is the key for the success or the failure of corporate governance systems in creating companies which are able to meet competition and promote economic growth. The distribution of roles and responsibilities has decisive importance for the performance of companies worldwide. This also affects the ability of all countries to attract foreign investors and capital especially in a business environment characterized by increased international antagonism, instability, and uncertainty. Governmental interventionism was never welcome and it was always accompanied by the fear of over-regulation. Self-regulation was considered to be a shield that would protect companies from additional duties and obligations as well as from demanding new regulations. Companies were inspired by a diffused trend for economic liberalism and profit maximization. Such broad-mindedness was reflected on a self-regulatory, self-governing and self-enforcing governance framework, which emerged in the vast majority of developed countries, mainly in Europe during the last part of the 20<sup>th</sup> century.

But what exactly is self-regulation? The first part of the term implies that those who are subject to the regulation also develop and enforce it. In other words, self-regulation refers to regulation not imposed by the government following the relevant procedures. The creation of a self-regulated market environment was based on codes of conduct, codes of best practice, governance guidelines and reports. Such codes and guidelines were a set of best practice recommendations regarding the behaviour and structure of a company. They were initially designed to address deficiencies in the

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<sup>179</sup> Sinclair, D., ‘Self-Regulation Versus Command and Control? Beyond False Dichotomies’, (1997), *Law & Policy* Vol. 19, No 4, 529.

corporate governance system by recommending a comprehensive set of norms for the role and composition of the board of directors, relationships with shareholders and top management, auditing and information disclosure, as well as transparency and accountability.<sup>180</sup> Their main objective was to fill in the legislative gaps. Corporate governance is an extremely wide, not easily defined, and complicated area of law. The vast majority of the relevant rules can be found in statutory instruments like company law rules and security regulations. Given that complexity, the aims and the goals of the self-regulatory initiative must be clear and well-defined in advance. The strength of this system lies in its voluntary character. When there is consensus, or when a choice is deliberate, implementation and monitoring becomes much easier.

Focusing now on corporate governance, self regulation has the form of voluntary codes that have the status of recommendations and their principal role is the setting of minimum standards. The creators of such codes were influenced not only by the ‘endogenous need to increase effectiveness and hence compensate for potential deficiencies in the corporate governance system, but also by exogenous pressures to introduce practices that are socially legitimate or widely perceived as appropriate and effective’.<sup>181</sup> The choice of self-regulatory codes of corporate governance offers flexibility and adaptability, as the rules can always be changed, supplemented or replaced if they prove to be ineffective and insufficient. This means that rules are not so rigid and the creators are constantly in search of the best solutions. Amendments and additions can easily be made at any time, especially in response to unforeseen circumstances, and that

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<sup>180</sup> Aguilera, R. and Cuervo-Cazurra, A., ‘Codes of Good Governance Worldwide: What is the Trigger?’, (2004), *Organization Studies* 25(3), 420.

<sup>181</sup> Tolbert, P. and Zucker, L., ‘Institutional Sources of Change in the Formal Structure of Organizations: The diffusion of Civil Service Reform, 1880–1935’, (1983), *Administrative Science Quarterly* Vol. 28, Issue 1, pg. 22–39.

fact underlines the responsiveness of the codes to the contemporary and constantly changing needs of the markets. However, this reactive character of self-regulation was often used as an argument against it, because self-regulation cannot be proactive.

It is hard to assess the effectiveness of the codes in advance, because it is not only a matter of compliance, but also of enforcement and monitoring. Companies must respect the applicable rules and should be able to justify any deviation from them. Their success and effectiveness is guaranteed only if the provisions are adopted whole-heartedly by all those who are directly involved.<sup>182</sup> The board of directors is usually responsible for the company's corporate governance structures and compliance with any relevant code. Codes can be used by companies as an incentive to grow towards better governance practices, without having to revolutionise their internal structures and procedures.<sup>183</sup>

Compliance, in this context, was purely voluntary and not mandated by law. In other words, the aforementioned rules of conduct were non-binding from the beginning. All rules are mostly accompanied by a 'comply or explain' rule, which is used as a safety valve. 'Comply or explain' basically indicates a requirement for obligatory disclosure of the level of compliance. To be more precise, companies are formally obliged to disclose any deviations from the code provisions. The basic concept is that as long as the market is fully informed of the non-compliance with the suggested rules of conduct, market forces will automatically cause the quality of a company's disclosure (or lack of information) to affect the price of its stock.<sup>184</sup> There are no legal sanctions. All the

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<sup>182</sup> Proctor, G. and Milles, L., see above, note 24, pg. 124-5.

<sup>183</sup> Wymeersch, E., 'Corporate Governance Codes and their implementation', (2006), Law in Transition, European Bank for Reconstruction and Development, pg. 60.

<sup>184</sup> Abarca De Espinosa, M., 'The Need for Substantive Regulation on Investor Protection and Corporate Governance in Europe: Does Europe needs a Sarbanes-Oxley', (2004), Journal of International Banking Law and Regulation, 19(11), 419.

necessary sanctions will be imposed by the market itself, because markets may regulate themselves under efficiency provisions. In that sense, these codes could be considered as market led, rather than self-regulatory, as the effectiveness of their external monitoring would depend on the overall efficiency of the market and on the leverage the market can exercise.<sup>185</sup> In addition, provided that self-regulation under the referred ‘comply or explain’ rule may only impose on companies further disclosure requirements and not particular substantive requirements, at the end of the day, self-regulation is equivalent to full disclosure of listed companies.<sup>186</sup>

Thus, according to this theory, no further legislation is required. A form of delegation of functions seems to have taken place. As self-regulating legislators, companies would initially devise their own regulatory rules; then as self-regulating executives, companies will monitor themselves for non-compliance; and, finally, as self-regulating judges, companies would punish and correct episodes of non-compliance.<sup>187</sup>

Another argument in favour of the non-regulatory approach of corporate governance was the belief that substantive obligations will probably deter the markets, will probably increase costs, distrust and bureaucracy, and will impede the flow of information. Under the EU proposals, ‘before adopting regulatory solutions, it is necessary to consider the feasibility of market based responses’.<sup>188</sup> In effect, as Ribstein points out, ‘it was markets and not regulators that uncovered the problems and adjusted the share prices of offending companies, while years of regulation of securities

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<sup>185</sup> Wymeersch, E., ‘Enforcement of Corporate Governance Codes’, (2005), European Corporate Governance Institute, Law Working Paper N° 46/2005, pg. 20.

<sup>186</sup> Abarca De Espinosa, see above, note 182, 424.

<sup>187</sup> Ayres, I. and Braithwaite, J., *Responsive Regulation: Transcending the Deregulation Debate*, Oxford Socio-Legal Studies, Oxford University Press, Oxford and New York, 1992, pg. 103.

<sup>188</sup> Ribstein, L., ‘Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002’, (2002), Iowa Journal of Corporate Law, Vol. 28, No. 1, pg. 53.

disclosures and membership of boards of directors failed to prevent the frauds'.<sup>189</sup> This aspect is in line with the view that market participants are generally better informed and motivated than regulators.

As a result, the best solution, which was singled out, were governance guidelines issued by associations of directors, corporate managers and individual companies. The creators were usually characterized as 'experts', not so much due to their scientific background, but mostly to their practical experience. These experts offered inside knowledge and expertise, in an attempt to successfully deal with all the issues and the needs of a particular company or profession. On certain occasions, codes of conduct were introduced on a voluntary basis. They were not legally binding and there were no specific enforcement techniques, as they were created without the co-operation, or even the support, of any public authorities. Such guidelines simply reflected an individual company's efforts to improve its own governance capacity, and included practical rules and suggestions / recommendations based on the creators' views on how the issue of corporate governance should be tackled. But, even in certain circumstances, some of them managed to have wide influence. Successful and effective guidelines are always an example-to-follow for all companies. Therefore, enforcement takes place through a series of instruments, especially based on the company's reputation and standing in the financial markets.<sup>190</sup> A well-known example is the General Motors Board Guidelines. Institutional investors encouraged and tried to motivate other companies to adopt similar guidelines.<sup>191</sup>

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<sup>189</sup> Ibid.

<sup>190</sup> Wymeersch, see above, note 183, pg. 4.

<sup>191</sup> Gregory, H., 'Overview of Corporate Governance Guidelines & Codes of Best Practice in Developing & Emerging Markets', (1999), pg. 2, quoted from *The World Bank, Corporate Governance: A Framework for*

In the United States, federal legislators were reluctant to impose substantive obligations regarding the way companies were to be managed. They were afraid that this could deter local companies from going public, and foreign corporations from searching for funding in the United States. As Lowenstein notes, ‘ever since the internationalization of the markets became a reality, regulators have been grappling with the fundamental issue of balancing concerns about improving the competitiveness of their own national markets with their responsibility to protect investors’.<sup>192</sup> As expected, the dilemma between market competition and investors’ protection led to the absence of federal governance substantive laws. The reason for that choice is that such laws would sooner or later impose burdensome obligations on issuers and would end up restricting the success of the US capital markets.

The situation was radically different in the United Kingdom. Britain has been perceived as a ‘haven for self-regulation’ and it was after the establishment of the industrial society during the 19<sup>th</sup> century that many recognizably modern systems of self-regulation became established for the first time.<sup>193</sup> The development of the self-regulatory governance framework in the UK took place through various reports which were concentrated on issues concerning the mechanics of controlling the boards of companies and their directors, preventing fraud, improving information about companies, and

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*Implementation* (1999), available in the website: <http://www.systemiclogic.net/artifacts/PUB/governance/gcgfbooklet.pdf>.

<sup>192</sup> Lowenstein, L., ‘Financial Transparency and Corporate Governance: You Manage What You Measure’, (1996), *Columbia L. Rev.*, Vol. 96, No. 5, 1335.

<sup>193</sup> Bartle, I. and Vass P., ‘Self-Regulation and the Regulatory State: A Survey of Policy and Practice’, (2005), Centre for the Study of Regulated Industries, Research Report 17, University of Bath, *Public Administration*, Vol. 85, Issue 4, 885 at 900.

making boards of directors more accountable to shareholders.<sup>194</sup> The main difference between these codes and the codes of conduct described above is that in UK their operation was monitored by the government.

The first self-regulatory initiative in the UK was the report of the Committee on the Financial Aspects of Corporate Governance (the Cadbury Report) in 1992, to which a Code of Best Practice was attached. This was further developed through a series of reworking including those of the Greenbury Committee (the Greenbury Report) in 1995 with its recommendations on executive pay and directors' remuneration. It was then decided that all the previous governance recommendations should be reviewed and brought together in a single code. The work was carried out by a Committee on Corporate Governance under the chairmanship of Sir Ronald Hampel. The ensuing Final Report Committee on Corporate Governance (the Hampel Report) in 1998 was the basis for the subsequent Combined Code on Corporate Governance. The Hampel Report reflected the idea that the UK corporate governance system was efficient and only a few additions were necessary. In this respect a number of provisions were added relating to internal control and the responsibility of institutional investors in making sure that the code is respected by firms, and the independence of auditors.<sup>195</sup>

In parallel, the Combined Code was created in 1999. It was the consolidation of the three previous codes, combining both principles and provisions. The Combined Code has been updated several times and is still applicable today. It is worth mentioning that it

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<sup>194</sup> The Institute of Directors, 'Corporate Governance in the UK', IOD Fact sheet, pg. 1, available in the website:

[http://www.iod.com/intershoproot/eCS/Store/en/images/IOD\\_Images/pdf/UKCorporategovernance.pdf](http://www.iod.com/intershoproot/eCS/Store/en/images/IOD_Images/pdf/UKCorporategovernance.pdf).

<sup>195</sup> Lannoo, K., see above note 28, pg. 283.

is appended to the Listing Rules of the Financial Services Authority.<sup>196</sup> Unfortunately, the results were not those expected, as the Report in effect gave little guidance on the scope and extent of internal controls. Consequently, the Institute of Chartered Accountants in England and Wales, backed by the London Stock Exchange, formed a working party to study the matter of internal control, resulting in the Turnbull Report in 1999. The report had the title: ‘Internal Control: Guidance for Directors on the Combined Code’ and it was a guide for directors of listed companies. It was focused on financial reporting and it provided guidance to directors for the prevention of fraud and the improvement of internal controls and audits. In 2002, the Department of Trade and Industry asked Derek Higgs to look at the role and effectiveness of non-executive directors. The outcome was a report, known as the Higgs Review, which was published in 2003. At the same time as Higgs was reporting, the Financial Reporting Council had asked a group chaired by Sir Robert Smith to issue a report with recommendations for audit committees. It was the period soon after the collapse of Enron and Arthur Andersen. The Smith Report, taking account of both the Higgs Review and the EU Commission Recommendations on Auditors' Independence<sup>197</sup>, was published in July 2003.

As a final point, it must be noted that the Cadbury, Greenbury and Hampel codes have now been replaced by the Stock Exchange’s Combined Code and the City Code on Takeovers and Mergers. All the UK reports and codes have adopted the ‘comply or explain’ approach. Although only quoted companies with a full London Stock Exchange

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<sup>196</sup> Blowfield, M., Blowfield, M. and Murray, A., *Corporate Responsibility: A critical Introduction*, Oxford University Press, Oxford and New York, 2008, pg. 217.

<sup>197</sup> Commission of the European Communities, *Commission Recommendations, Statutory Auditors' Independence in the EU: A Set of Fundamental Principles*, Official Journal of the European Communities, L191/22, Brussels, 2002, available in the website: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:191:0022:0057:EN:PDF>

listing are obliged to report on how they apply the Code principles and whether they comply with the Code provisions and, where they do not, explain their departures from them, the Code has had a noticeable wider impact on governance.<sup>198</sup>

Overall, corporate governance through self-regulatory codes, which include a focus on social, ethical and environmental issues, aimed to, and it is likely to, reduce the need for government interference and also to contribute to the creation of greater shareholder value.<sup>199</sup> Even though variation and lack of precision are self-evident, the development of the rules is characterized by flexibility and adaptability, allowing experimentation and innovation. David Seidl describes the codes as evolutionary by their very nature, for the reason that they are meant to be revised on a continuous basis in the light of current developments.<sup>200</sup>

Codes of best practice also offer the ability to act much more quickly than where legislation is required, particularly when it comes to remedies for breaches of self-regulatory rules in a court of law. Not to mention that the civil as well as the criminal remedies available are far less than those available for a breach of a rule of the general law or of some legislative provision.<sup>201</sup> Ultimately, the absence of an express legal basis does not mean that the rules are without any legal relevance. As far as corporate governance codes are concerned, the legal system has a tendency to absorb these rules each time that the law allows for a blank norm. It is a commonly held view that corporate governance codes, due to the fact that they are widely accepted, can serve as a source of

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<sup>198</sup> The Institute of Directors, see above, note 192, pg. 2.

<sup>199</sup> Kirkbridge, J. and Letza, S., 'Regulation, Governance and Regulatory Collibration: Achieving a "Holistic" Approach', (2004), *Corporate Governance*, Vol.12, No. 1, pg. 86.

<sup>200</sup> Siedl, D., 'Regulating Organizations through Codes of Corporate Governance', (2006), Centre for Business Research, University of Cambridge Working Paper No. 338, pg. 7.

<sup>201</sup> Scottish Law Commission, see above, n. 22, pg. 14.

inspiration for judges looking for yardsticks against which they can measure issues like the conduct of directors and companies.<sup>202</sup>

The self-regulatory corporate environment looked as if it was the perfect solution. Certainly, it was not a faultless system, but it was a modern, ambitious approach for the 21<sup>st</sup> century. It was the most liberal version of regulation after complete deregulation. It had become clear that it is almost impossible to create an environment with no rules and regulations, although deregulation and market liberalization were dominant ideas during the second half of the 20<sup>th</sup> century. Self-regulation could also contribute to the improvement of corporate governance and the promotion of issues such as corporate social responsibility, ethical trading through a regulatory regime with high standards of corporate reporting, and governance which can improve competitiveness and general prosperity.<sup>203</sup>

Consequently, self-regulation was advertised as the ‘next best thing’: the best alternative. It was indeed the mildest form of compromise between state regulation and deregulation. The subsequent legal rules would be seen as reasonably fair and necessary, so everybody would comply voluntarily. Generally speaking, the success of self-regulation is based on the triptych: flexibility, adaptability and self-determination. Effective self-regulation is established only when there is transparency, accountability, consistency and proportionality.

Self-regulation was a considerate choice to replace state intervention and state regulation in today’s complex and fast-moving business world. In Europe, its unanimous acceptance was guaranteed for one more reason that has nothing to do with the system’s

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<sup>202</sup> Wymeersch, see above, note 183, pg. 6.

<sup>203</sup> Bartle and Vass, see above, note 191, pg. 922.

qualities and characteristics. The creation of the European Single Market in combination with the enlargement of the EU dictated the use of more flexible forms of regulation. Despite the fact that the number of the Member States was lower than today, the creation of the Single Market had to overcome the obstacles created by the cultural, legal and political diversity. The introduction of an effective and successful regime was a one-way solution. As a result, competition was enhanced in all levels and it was a unique opportunity for the EU to respond to the new challenges and keep up with recent developments. A good starting point was the updating and modernization of the Common Market strategy.

Therefore, the greatest challenge that self-regulation had to face was its compatibility with the European Internal Market. At this instant, it is worth pausing briefly to talk about the prospect of the European Single Market and, particularly about its regulation. Afterwards, the discussion will return to self-regulation, in order to touch upon the reasons why it failed to live up the expectations.

## CHAPTER 2

# ***EU INTERNAL MARKET: HARMONISATION vs REGULATORY COMPETITION***

### **(I) *Introduction***

This chapter sets the scene for an overview of the dynamics within the European Union with a view to putting corporate governance in the context of the EU internal market and the harmonization project. The creation of a single market for financial services is closely related to company law, regulation of companies and corporate governance. Apart from the obvious need for freedom of establishment for companies throughout the EU and effective cross-border cooperation between companies in different Member States, the creation of a single market ensures that capital markets are integrated, while their legal framework is modernized and updated, for a high level of legal certainty to be maintained. Rapid technological changes make regulation more complex in such a constantly developing business environment, because everything moves at a great speed and produces novel forms of cooperation and competition.<sup>1</sup> There are a great number of challenges for the EU legislator to overcome for the smooth operation of the internal market, as there are constant calls for operating efficiency and competitiveness of business, equivalent tax arrangements and improvements to the provisions concerning protection for shareholders and stakeholders.

The conflict between regulatory competition and harmonization has so far monopolized the discussion of what might be the best regulatory tool for the EU. The

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<sup>1</sup> Graham, C. and Smith, F. (eds), *Competition, Regulation and the New Economy*, Hart Publishing, Oxford, UK, 2004, pg. 1.

challenge that corporate governance faces within the EU is the formulation of uniform rules that incorporate an ethical perspective into the corporate functioning. This is why it is also worth examining alternative solutions as well, such as reflexive harmonization which is considered to represent the future of regulation in the EU. The EU has reached the point where it must define its own corporate governance approach, tailored to its own cultural and business traditions. Reflexive harmonization seems to combine the end result, which is the harmonization in the area of corporate governance, with the use of non-binding legal instruments in respect of diversity, a method that has been chosen as appropriate for the needs of the EU. In other words, reflexive harmonization is ‘flexible in application, but firm in the principles’.<sup>2</sup>

The chapter will first introduce the theory of regulatory competition, its historical background and its prevalence in the United States. Then, it will focus on the EU reality, as it was shaped by the Court of Justice’s (CJEU) recent judicial activity on corporate mobility. The impact of these judicial developments will be analysed with a view to determining whether the EU should keep following the path of harmonization of the Member States’ national legal systems or whether it would be more prudent to follow the American example of regulatory competition among the states. The chapter responds to this dilemma with the recommendation of a third alternative theory, reflexive harmonization, which seems to fit better with the EU perspective. It looks compatible with the now-developing EU corporate governance approach and also suitable for the enhancement of efficiency and competitiveness of businesses across Europe.

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<sup>2</sup> Geens, K. and Hopt, K.J. (eds), *The European Company Law Action Plan Revisited: Reassessment of the 2003 Priorities of the European Commission*, Leuven University Press, Leuven, 2010, pg. 83-84.

## **(II) *Regulatory competition***

### ***(i) Companies in competition***

The internal affairs of a company are dominated by private autonomy. This means that governmental intervention should be avoided or at least kept to a minimum and should not be justified unless and until the legitimacy of such intervention is established. It has been argued that it is particularly difficult as well as rather purposeless to harmonize the provisions referring to the companies' internal affairs.<sup>3</sup> The law dealing with such matters varies to reflect local values and preferences or even those of each entity itself. For example, in the United States there is no federal company legislation, but each individual state is free to design its own legal framework. As a result, there are significant variations, which are not deemed to be necessarily negative or unwanted, while in certain occasions variations are more preferable to rules coordinated among states.

States, whose economies are open to foreign trade and investments, create opportunities for companies to seek the most favourable regulatory regime, either by relocating production elsewhere or by acting as pressure groups for policy and law making.<sup>4</sup> It should not be disregarded that companies' activities as dynamic economic entities can have a significant impact on the national and even the world economy. Since value maximization is one of the driving forces for corporate decisions, as it was discussed in the previous chapter, companies are allowed to be opportunistic, balance their choices and look for the most favourable environment to conduct their

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<sup>3</sup> Ueda, Y., 'Modernizing Company Law and Regulatory Competition: Some Economic Implications', (2008) *Statute Law Review* 29(3), 154 – 172 at 159.

<sup>4</sup> Murphy, D., *The structure of Regulatory Competition: Corporations and Public policies in A Global Economy*, Oxford University Press, Oxford and New York, 2004, pg. 4.

business. More and more companies nowadays are out looking for the least stringent regulatory framework to achieve a ‘comparative regulatory advantage’.<sup>5</sup>

It is cynical but true that markets are basically economic interactions among people dealing as strangers and seeking personal advantage. The extended conflict among selfish people produces prices that allocate resources to their best uses.<sup>6</sup> In this context, companies and managers should be fully informed about all alternative regulatory packages offered by competing jurisdictions.<sup>7</sup> It is essential for the buyers to be free to make a choice based on their personal needs and values. If a particular jurisdiction does not offer a satisfactory regulatory package or reasonable distribution of information, then there must be the freedom to move to another jurisdiction. This is the essence of a free market with no internal barriers, where lack of restrictions meets independence and self-determination.

Nevertheless, a closer look would reveal that, even though citizens and businesses have been given the privilege of mobility, this does not necessarily mean that they would all choose to immigrate in search of the ideal regulatory environment. Mobility is a great privilege, but it presupposes a balance of the available options, consideration of the benefits/losses equation as well as the individual characteristics of each company. Transaction costs, labour costs, proximity to key markets and compliance costs with the new regime are some of the factors that can influence the final decision to make use of the freedom of mobility.<sup>8</sup>

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<sup>5</sup> Ibid.

<sup>6</sup> Easterbrook, F. and Fischel, D., *The economic structure of Corporate Law*, Harvard University Press, London, 1991, pg. 8.

<sup>7</sup> Esty D. and Geradin, D., ‘Regulatory Co-opetition’ in Esty D. and Geradin, D. (eds), *Regulatory Competition and Economic Integration: Comparative Perspectives*, Oxford University Press, Oxford and New York, 2001, pg. 35.

<sup>8</sup> Williams, A., ‘Globalization and the Dynamics of Regulatory Change: The Delaware effect, the California Effect, or the Persistence of National Diversity’, (2004), NBER Working Paper No. 10585, pg. 9, available in the website: [http://anthonydwilliams.com/wp-content/uploads/2006/08/Globalization\\_and\\_Regulatory\\_Competition.pdf](http://anthonydwilliams.com/wp-content/uploads/2006/08/Globalization_and_Regulatory_Competition.pdf) . See also Gilpin, R., *The Challenge of Global Capitalism*, Princeton University Press, Princeton, 2000; Gitterman, D., ‘A Race

When this pursuit of laxity and leniency becomes undesirable for some states, they may act collectively to coordinate their regulatory strategies, so as to avert a downward spiral of regulatory standards. However, as Genschel and Plumber argue, such coordination strategies are only available in cases where a critical mass of states can be easily compelled to engage in a ‘cooperative turnaround’.<sup>9</sup> The EU is a good example of a mass of states, which can cooperate successfully for the adoption of coordinated strategies, due to the limited heterogeneity of interests and its organizational structure. At the same time, regulatory competition is not incompatible with the EU, as mutual recognition and free movement encourage the functioning of the internal market. The question that remains to be answered is whether the laws of member states should pursue competition or conformity.<sup>10</sup>

### ***(ii) Regulatory competition theory***

Regulatory competition is the result of the combination of the words regulation and competition and it is useful to focus on this combination for a while. Nowadays, literally every single economic activity is subject to regulation. Regulation is about politics as it has to deal with the interaction between the players of the game. In this context, regulation is more than a legal restriction, as it always involves the art of judgement as well as the science of understanding.<sup>11</sup> Effective regulation is that which strikes the balance between conflicting interests and which resists being swayed by pressures from the interested parties. The need for regulation

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to the Bottom, A Race to the Top or the March to a Minimum Floor? Economic Integration and Labour Standards in Comparative Perspective’, in Vogel, D. and Kagan, R. (eds.), *National Regulations in A Global Economy: How Globalization Affects National Regulatory Policies*, UCIAE Edited Volume 1, Berkeley, 2002, pg. 1-41.

<sup>9</sup> Genschel, P. and Plumber, T. ‘Regulatory Competition and International Co-operation’, (1997), *Journal of European Public Policy* 4 (4), 626-42.

<sup>10</sup> Barnard, C. and Deakin, S., ‘Market Access and Regulatory Competition’ in Barnard, C. and Scott, J. (eds), *The Law of the Single European Market: Unpacking the Premises*, Hart Publishing, Oxford, 2002, pg. 202ff.

<sup>11</sup> Murphy, see above, note 4, pg. 254.

does not indicate a need for a sole regulator, who would take full responsibility for creating the ideal regulatory environment. Such a person would be the protagonist, a ‘monopolist regulator’ as Roberta Romano characterises him.<sup>12</sup> Since monopolistic regulation is not the answer, competition enters the discussion.

Competition between legal and social systems contributes to the evolution of society. This happens not only from a Darwinian perspective, but also because, without competition, the laws will sooner or later become less company-friendly and less efficient. As a result, the legal framework will not be the ideal one to promote wealth creation.<sup>13</sup>

This short etymological analysis reveals that regulatory competition is not a result of globalization or a side-effect of the modern trend of removing barriers to inter-state trade and commercial transactions. Regulatory competition came about unintentionally, in the sense that no legislator or judge was considering it as one of the potential future developments. It was neither an intentional and planned development nor a methodical result of systematic planning. Regulatory competition became extremely popular and attractive, because it brought three basic advantages. Firstly, as a result of competition, law can more effectively meet consumers' preferences and wants. Secondly, through competition, diversity and experimentation in pursuit of a more effective legal framework can be promoted. Thirdly, through competition, information on effective legal frameworks can begin to flow efficiently.<sup>14</sup>

The most considerable argument against regulatory competition is that the lack of harmonized rules will sooner or later lead to a ‘race to the bottom’. The country with the lowest standards will become the cheapest place to operate, so businesses

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<sup>12</sup> Romano, R., ‘Empowering Investors: A Market Approach to Securities Regulation’, (1998), 107 *Yale Law Journal* 2367.

<sup>13</sup> Murphy, see above note 4, pg. 141.

<sup>14</sup> Ueda, see above, note 3, pg. 166.

will rush there. After that development, the other countries will have to lower their standards to survive. This would happen where the legitimate interests of the corporate players, mainly stakeholders, are sacrificed in an effort to create regulatory packages that focus excessively and give unfettered priority to the self-interests of shareholders and executives, just because they are the most powerful actors within companies. A race to the bottom could also become reality, if a considerable number of corporate entities within the same sector or industry, such as bankers, abuses their powers. More specifically, these parties can easily relocate to a more favourable jurisdiction, and can use the fact as leverage to coerce the Member States in which they are residents to relax the regulations to their favour.

It is clear that the concept of competition, within the market in general or the market for legal rules, is quite broad and its implication even wider. Hence there is more than one way of understanding and analyzing regulatory competition. In this instance, just before taking a look at the history of the term, an attempt at a definition can be made. Regulatory competition can be defined as a process involving the selection and de-selection of laws in a context where jurisdictions - decentralized, rule-making entities, which could be nation states or other units such as regions or localities, - compete to attract and retain scarce economic resources.<sup>15</sup> A process where regulators deliberately set out to provide a more favourable regulatory environment, in order to either to promote the competitiveness of domestic industries or to attract more business activity from abroad.<sup>16</sup>

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<sup>15</sup> Deakin, S., 'Is regulatory competition the future for European integration?', (2006), Swedish Economic Policy Review 13, pg. 74.

<sup>16</sup> Gatsios, K and Holmes P., 'Regulatory Competition and International Harmonization' (1997), Global Economic Institutions Working Paper Series, No. 36, Centre for Economic Policy Research, London, pg. 2.

### ***(iii) History***

The concept of regulatory competition can be traced to Charles Tiebout's seminal article in 1956, which still remains opportune and influential, even after more than half a century.<sup>17</sup> Even though Tiebout's paper was a purely theoretical piece of work, a long literature has made extensive use of it and has built on his key insights, which makes its empirical application far too wide.

The basic assumption is that consumers are free to choose their communities, enjoying perfect mobility and perfect information. The issue of information was discussed above, so mobility comes to the centre of the attention. Mobility, here, refers to mobility of persons and resources across jurisdictional boundaries. It should be noted, though, that in real life, mobility of persons and of non-human economic resources is more limited than it is in the world of pure theory. In fact, Tiebout's model was based on a market analogy and not on a real world environment. The freedom of movement was assumed and the same happened with other conditions as well, simply for the purpose of setting up the economic model. The model was aimed at showing that, given an effective threat of exit, spontaneous forces would operate in such a way as to discipline states against enacting laws which set an inappropriately high (or low) level of regulation.<sup>18</sup>

According to Tiebout's hypothesis, a decentralized governmental system, with horizontally arrayed jurisdictions competing to attract residents on the basis of differing tax and benefit structures, produces efficient outcomes.<sup>19</sup> Put more simply, local authorities compete to attract consumers by offering satisfactory packages of

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<sup>17</sup> Tiebout, C., 'A Pure Theory of Local Expenditures', (1956), *Journal of Political Economy*, Vol. 64, No. 5, 416-24.

<sup>18</sup> Deakin, S., 'Legal Diversity and Regulatory Competition: Which model for Europe?' (2006), Centre for Business Research, University Of Cambridge, Working Paper No. 323, *European Law Journal*, Vol. 12, No. 4, 443.

<sup>19</sup> Tiebout, see above, note 17.

services in return for levying taxes at differential rates. Given the apparent diversity of the consumers' wants, consumers with similar preferences are inevitably gathered in communities, which satisfy their personal wants. The creation of uniform and harmonized communities, with citizens who all assess the services on offer in a similar way, while none of them can be made better off by moving is a strong indication that such a decentralized system will act just as all regular markets do – assuming none of the citizens can be made better off by relocating - and the market will, thus, be efficient.

Tiebout's model can also be applied to laws. Law is treated as a product and the market is moderately functioning as a competitive market for legal products. Governments appear to be suppliers of laws, in response to the demands of both natural persons and companies, who appear to be the consumers of the laws. If supply and demand reaches a point of balance, then the goal of efficiency is accomplished. The market for laws as products would have been able to satisfy the preferences of the majority of its consumers. Consumers still have the freedom and the discretion to choose which 'product' best suits them by moving between jurisdictions. Market forces play a significant role, but at the same time a form of competition is stimulated, just as in markets for products. Instead of competitive prices, there are competitive requirements. Therefore, competitive pressures within the market give a boost to innovation and experimentation, with a view to adopting as efficient laws as possible. To put it differently, consumers have the privilege to do jurisdiction-shopping in search of the most effective legal solutions, but at the same time, governments as suppliers have the ability to change the content of their laws in order to satisfy the demands of their customers.

The application of the Tieboutian model in modern societies is stopped by a big wall; it is probably impossible to have a perfect market for legal products. A perfect market presupposes an absolute lack of barriers in the freedom of movement. Customers have to overcome numerous obstacles like different languages, nationality and culture in order to move to other Member States. This is the point where theory meets real life. As anticipated, the 'pure theory model' needs refinement in order to become up-to-date and applicable. An amendment suggestion involves the active participation of the EU as legislator. The Union will have to bear the burden of perfecting the market for legal rules by bringing the model as closer to the real world as possible. This theory is described by the term 'competitive federalism'.

Roger Van den Bergh tried to apply the theory of competitive federalism in the context of the European Union. He argued that competition between legal systems requires a proper legal environment. A federal regime in which the relationship between the powers granted to the central institutions or authorities, on the one hand, and those reserved for the lower or decentralized levels of government, on the other, is clearly defined. Only in this way will there not be a sufficient number of rival suppliers of legal rules and, thus, regulatory competition will be fuelled.<sup>20</sup> Van den Bergh continues arguing that 'large parts of EC [now EU] law may be understood as devices to bring the real world closer to Tiebout's world'. All imperfections should be cured within the market for legal rules using EU Law and, more specifically, the laws relating to the freedom of movement, mutual recognition, maintenance of competition and harmonization of standards.<sup>21</sup>

The concept of competitive federalism can be summarized under two simple principles: in the search for efficient rules, legal intervention is needed, firstly, to

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<sup>20</sup> Van den Bergh, R., 'The Subsidiarity Principle in European Community law: Some Insights from Law and Economics' (1994), 1 Maastricht Journal of European and Comparative Law 342.

<sup>21</sup> Ibid., 352.

provide the conditions for the free movement of the factors of production (market creating rules) and, secondly, to offset market failures arising because of barriers to effective regulatory competition (market perfecting rules).<sup>22</sup> Basically, in relation to the EU reality, the institutions, primarily the Commission, will have to ensure that free movement is achieved and that there are no obstacles for any factors of production. Then, in the event of market failures, the Commission will have to ensure that their impact is mitigated and that the market operates in a smooth way.

A disadvantage of this theory is that it can be characterized as goal-directed, in the sense that it implies a search for efficient solutions either through the market or through law. Free competition will end up with the prevalence of one single system. That dominant system will be the ‘evolutionary peak’ around which all state systems will converge. For supporters of competitive federalism, the flight of corporations to a ‘business-friendly’ regime, like Delaware, epitomizes the whole process.<sup>23</sup> We will return to these theories later when it will be the time to examine harmonization and especially reflexive harmonization.

#### ***(iv) Regulatory Competition and Company Law***

After exploring the origins and the history of the term, the background of the theory of regulatory competition is provided. In an attempt to extend the aforementioned definition of regulatory competition and gain a complete oversight of how companies can be benefited from it, the following comments are extremely useful. The regulatory approach of a state or a country will be constantly improved through the incessant filtering and distilling of ideas and new elements, in order to meet the changing preferences, needs and expectations of the citizens. In this way,

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<sup>22</sup> Deakin, see above, note 18, pg. 10.

<sup>23</sup> Ibid., pg. 12.

regulation is competitive and the result of this competition will be a set of efficient and up-to-date laws. In that sense, regulatory competition exists by definition in every country. The competing parties are the federal authorities and the State, which basically co-exist and struggle to win the battle of competition. This regulatory co-existence brings together two autonomous ‘governments’ operating in two different but parallel levels.

Equally, if Company Law is also added to this ‘equation’, then a comparable competing interaction takes place between governments and companies. Governments traditionally represent the national interest and it is they who make the rules that companies have to comply with. However, companies play an enormous role in shaping state preferences and national priorities. As a result, the field of Company Law consists of rules that are shaped by market power, negotiations, strategic alliances, coalitions and agreements.<sup>24</sup> These rules aim to prescribe behavioural roles; they contain activity and shape expectations.<sup>25</sup> Companies traditionally want more independence and more freedom; they want to have influence on the political and economic developments of modern society. That’s why very often companies raise the flag of revolution against state intervention, asking for less rules, or even deregulation. Governments, on the other hand, want to be the sole regulator, to have the first and the last word on anything regulation-related issue. This is where competition begins.

Deregulation seems to be an attractive option, not only because the ‘laissez-faire, laissez-passer’ ideology has always had passionate supporters, but also because companies nowadays strive for more autonomy and more independence. The most fanatical supporters of deregulation are the multinational companies, some of which

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<sup>24</sup> Murphy D., see above, note 4, pg. 255.

<sup>25</sup> Haas, P., Keohane, R and Levy, M., (eds), *Institutions for the Earth: Sources of Effective International Environmental Protection*, MIT Press, Cambridge, 1993, pg. 4-5.

have the power to exert pressure for less strict rules, or even to challenge governmental decisions, in order to achieve a more lenient, if not a deregulated, environment. In this respect, Chang, after a general review of the economics and politics of regulation, has proposed the division of the last fifty years into 3 periods. The first period, between 1945 and 1970, is characterised by regulation. The second period covers the decade between 1970 and 1980, and was a 'transition' period. Finally, the third period started in 1980 and has not yet finished. This is the 'deregulation' period.<sup>26</sup>

In reality, we have not, and we are not experiencing an era of deregulation so much as an era of regulatory flux - an era when dramatic regulatory, deregulatory and re-regulatory shifts are occurring simultaneously. So far nobody can claim to have won the regulation game.<sup>27</sup> Actually, there is no need to talk about winners and losers. It is more important to create a functional and efficient legal model, even if this entails combining components of all the competing theories. As mentioned above, deregulation is an attractive choice, but it has never worked well in practice, because sooner or later the equilibrium of powers is disturbed and a fight for dominance begins.

Closing that parenthesis, even if we do not adopt Chang's division, this division illustrates the essence of regulatory competition. The primary aim of regulatory competition is to remove inefficient legal rules, but it is also evident that such competition needs to be carried out within a certain framework, because unregulated competition offers no guarantee that the set of legal rules which prevails will be the most efficient solution. Regulatory competition seems to present a

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<sup>26</sup> Chang, H., 'The Economics and Politics of Regulation' (1997) *Cambridge Journal of Economics*, Vol. 21, No. 6, 724.

<sup>27</sup> Ayres, I. and Braithwaite, J., *Responsive Regulation: Transcending the Deregulation Debate*, Oxford Socio-Legal Studies, Oxford University Press, Oxford and New York, 1992, pg. 7.

dilemma. Regulation or deregulation? Market forces or strict rules? Moreover, the two polar opposites of regulatory competition can be described by two phrases that are commonly used: ‘the race to the bottom’, where the policy framework consists of a set of rules and ‘the race to the top’, where the market will create the right balance between the conducts of all actors within the global economy. The Delaware effect, as will be discussed in detail, represents the deregulatory dynamic and it is considered to be the winner of the race to the bottom in the field of chartering requirements for companies. A good example of race to the top is the state of California. In California, environmental regulation has been always a hot issue and the levels of protection have become progressively higher and higher. The Californian market is large enough to make other states raise their own level of regulation, in order not to lose market access. This strategy involves significant risks, but large market power comes with confidence that, in the long-term, the new high-standard regulations will be adopted not only throughout the United States, but in other markets around the world. This is the so-called ‘Californian effect’.<sup>28</sup>

It would be useful at this point to touch upon the application of regulatory competition in the United States, in order to find out whether the American example constitutes a viable option for Europe or if it works better in a federal organizational model.

### ***(v) The American example - Delaware***

For the discussion of the competition of corporate regulation between the individual states of United States, a good starting point is the case of *Paul v*

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<sup>28</sup> Genschel and Plumper, see above, note 9, pg. 2.

*Virginia*.<sup>29</sup> This decision emphasizes the ‘internal affairs doctrine’, which states that the laws which apply to a corporate entity are those of the state in which that company has been incorporated. In practice, a company is free to choose the law of any state as the law which governs its affairs, irrespective of where it has its head office or its assets. No physical connection is required, and any choice shall be recognized and respected by all courts. It is doubtful, though, whether the judges of the Supreme Court in 1868 had in mind all the future implications of their judgement. As Tung advocates, ‘the doctrine did not honour private choice but its opposite—states’ territorial monopolies. Moreover, the doctrine may serve the ends of consistency and predictability in the modern context, but at its origin, consistency and predictability were subsidiary concerns to—and by-products of—courts’ concerns for the sovereignty of the incorporating state’.<sup>30</sup>

In parallel, the Supreme Court also established that states were not able to attach special requirements to corporations which had been chartered in other jurisdictions as a condition of allowing them to do business in their territory. This was later interpreted as meaning that states had to operate under a rule of mutual recognition, according to which an incorporation which was effective in one state was acknowledged by the others. What is beyond doubt is that, had this case never been judged, the famous Delaware effect would have never occurred. Our analysis would be incomplete without any mention in the state of Delaware.

The state of Delaware is world famous for its incorporation regime and for the fact that it has established its position as the paradise of incorporation. Companies, especially public companies, prefer to incorporate in the state of Delaware due to its liberal company law regime. If we go back in time, Delaware’s achievement is

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<sup>29</sup> [1868] 9 Wall 168.

<sup>30</sup> Tung, F, ‘Origins of the Internal Affairs Doctrine’ (2005), Loyola Law School (LA) Research Paper 2005-8, pg. 68.

directly linked with the aforementioned case of *Paul v Virginia*. During the second half of the nineteenth century, companies based in New York began to reincorporate in New Jersey. The reason for that shift was the looser regulatory regime. An interesting detail is that the idea for the creation of an attractive legal environment for entrepreneurs belonged to a lawyer from New York, not New Jersey. James Brooks Dill suggested and managed to convince New Jersey's politicians that such a regime would increase the state's revenue.<sup>31</sup>

New Jersey's supremacy lasted until the last decade of the century, when Delaware introduced a number of regulatory constraints on large corporations including controls over the holding of shares in one company by another. As a matter of fact the Delaware corporate regime had been originally designed to assist and to smooth the progress of a registered company under the name Du Pont. The Delaware law had been 'drafted under the auspices of the Du Pont family to protect their managerial and shareholder interests', and 'appeared relatively favourable to manager-shareholders of other corporations as well'.<sup>32</sup>

The United States have generally adopted the incorporation theory, according to which the internal affairs of a company are regulated by the law of the state of incorporation. The real seat theory has met limited acceptance, mostly for tax purposes. The secret behind Delaware's success was, in fact, based on reincorporation. Existing businesses, already incorporated in other states, were attracted to reincorporate. Delaware legislation was offering lower requirements and more freedom to senior management. As Professor Cary observed, this laxity involved 'greater freedom to pay dividends and make distributions, greater ease of

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<sup>31</sup> See Grandy, C., 'New Jersey Corporate Chartermongering, 1875-1929', (1989), 29 *Journal of Economic History* 677 at 681.

<sup>32</sup> Charny, D 'Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities' (1994), in Wheeler S., (ed.) *A Reader on the Law of the Business Enterprise*, Oxford University Press, Oxford, 1994, pg. 368.

charter amendment, less restrictions upon selling assets, mortgaging, leasing and merging, freedom from mandatory cumulative voting, permission to have staggered boards of directors, lesser pre-emptive rights for shareholders and clearer rights of indemnification for directors and officers'.<sup>33</sup>

Therefore, it cannot be argued that Delaware's dominance is only based on the lead it obtained almost a century ago. Quite the opposite: there are several factors that facilitated the strengthening of Delaware's position over the years up until the present day. Nowadays, its dominance is the result of specialization, as all involved parties have the required experience and the courts have developed an efficient case law, which can guarantee speed and certainty. This is also highlighted by the fact that, although a number of other states have tried to copy and imitate Delaware's procedures by offering sometimes a looser environment, they have failed to set it aside or to challenge its efficiency. Deakin points up that 'Delaware's primacy is that of a monopolist, able to preserve its historical advantage by exploiting the positive network externalities of a specialist bar and judiciary and a legislature more finely attuned than any other to corporate opinion'.<sup>34</sup> In fact, nowadays the state of Delaware 'attracts incorporations not because its laws are lax, but because they are efficient'.<sup>35</sup> The 'product' currently offered by Delaware should be viewed as including not only its rules, its institutional infrastructure, its specialized chancery court, and the network benefits currently enjoyed by Delaware corporations. Even assuming that another state would be able to offer the same rules with some marginal improvements i.e. lower incorporation taxes and fees, it still would not be able to attract a significant

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<sup>33</sup> Cary W.L., 'Federalism and Corporate Law: Reflections upon Delaware', (1974), 83 Yale Law Journal 663-705 at 669. See also Kaplan, S., 'Foreign Corporations and Local Corporate Policy', (1968), 21 Vand. L. Rev. 433 at 436.

<sup>34</sup> Deakin, see above, note 15, pg. 80.

<sup>35</sup> Charny, see above, note 32, pg. 371.

number of out-of-state incorporations.<sup>36</sup> Delaware simply offers efficiency, as it has managed to reach perfection in the art of matching its laws to the demands of those bound by them. That's why it constitutes an exceptional case, a phenomenon which is only one of its kind and is not likely to be repeated somewhere else, at least in the same form.

The analysis of the Delaware effect establishes free movement of economic resources as the most basic precondition for regulatory competition in company law. If companies are not completely free to move, then there is not much space available for regulatory competition. This model works really well in the USA, but will it be equally effective in the EU? The EU is frequently compared with the USA and there is a search for interrelations and parallel developments. However, the American corporate reality is different and there are not mirror images. Therefore, different problems require different solutions.

Despite the fact that scholars in the United States have been examining regulatory competition for some 30 years in order to determine whether corporate law is indeed on a race to the top, to the bottom or to nowhere<sup>37</sup>, in Europe it is a relatively new hot topic. The reason why Europe did not participate in the discussion about regulatory competition was simply because the regulatory environment in the European Union was, until recently, neither properly organized nor sufficiently operational. It was only after 1999 and the well-known 'triangle' of CJEU landmark cases that European companies obtained the right to incorporate in any EU Member State, regardless of where their business is actually run.

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<sup>36</sup> Bebchuk, L. and Hamdani, A., 'Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters', (2002), 112 Yale L.J. 553 at 557.

<sup>37</sup> Bratton, W., 'Corporate Law's Race to Nowhere in Particular' (1994), 44 U. Toronto L.J. 401.

### **(III) *The role of the CJEU***

#### ***(i) Centros, Überseering, Inspired Art and Cartesio***

Up until the landmark year of 1999, it could be argued that European companies could not easily overcome the obstacle of the ‘real seat’ doctrine, which prevented the creation of a Delaware incorporation phenomenon in Europe.<sup>38</sup> Before that date, EU Member States were divided into two groups. The first group included the United Kingdom, the Netherlands and the Nordic states, which followed the so-called incorporation theory. According to this approach, the applicable law was determined by the place of incorporation, and there was absolute freedom of choice of the most suitable or friendly company law system. In practice, a future relocation of a company to another jurisdiction did not result in a change of the applicable law. The second group included Germany, Austria, France, Belgium, Luxemburg, Portugal and Greece, countries which were in favour of the so-called real seat theory. Under this approach, the applicable law was determined by the place of the company's central administration, i.e. the real seat. In practice, there was no freedom of choice of the applicable law, as the company was established according to the law of the state in which its central administration resided.

In 1999, the CJEU with its ruling in *Centros*<sup>39</sup> seized the opportunity to show its intention of adopting the most liberal solution to the problem of incorporation. Since then *Centros* is referred to as the turning point in the area of freedom of establishment and corporate mobility, as the ruling voted in favour of the promotion of the internal market project.

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<sup>38</sup> Kubler, F., ‘Legislative Competition and Corporate Law Reform: Some Questions from a European Perspective’ in Pernice, I. (ed), *Harmonization of Legislation in Federal Systems*, Nomos Verlagsgesellschaft, Baded-Baden, Germany, 1996.

<sup>39</sup> Case C-212/97 *Centros Ltd v Erhvervs-og Selkabsstryrelsen* [1999] ECR I-1459.

*Centros* is the case through which the Court of Justice reminded the Member States that they ought to respect the companies' right to choose and to have access to the regime that best suits them. The Court ruled that 'the right to form a company in accordance with the law of a Member State and to set up branches in other Member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the EC Treaty'.<sup>40</sup> Principally, it reiterated that there should be no barriers to the free movement of labour and capital and acted as a shield against any kind of state-level pressures and interventions. Such interpretation can easily lead to its characterization as a threat to the real seat doctrine. The validity of the *siege reel* doctrine under EU Law has been questioned several times and has been classified under the heading 'obstacles to freedom of establishment', mostly because it required that companies wind up and re-incorporate every time operations were to be moved to another country. However, after *Centros* it has become prominent again with the Court's ruling against the Danish policies, where it was held that the refusal by the Danish company registrar to register a UK incorporated company with its real seat in Denmark constituted a breach of freedom of establishment.

Shortly after the liberal *Centros* judgement, European countries, instead of reaching unanimity and adopting a common approach in relation to incorporation of companies, were once again divided. Despite the fact that it was clear that freedom of establishment was clearly one of the fundamental elements for the successful creation of the internal market, several countries were more than reluctant to unquestionably follow the CJEU ruling. The example of Germany is characteristic. Germany was a traditional supporter of the real seat theory and did not particularly welcome the Court's liberalism. That was the case until 2001, when the Bundesgerichtshof, the

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<sup>40</sup> *Centros*, Judgement of the Court, at paras. 26-27.

German Supreme Court, made a reference to the CJEU regarding the freedom of establishment. The Court's decision in the *Überseering* case<sup>41</sup> repeated that it constitutes a restriction on the freedom of establishment which is, in principle, incompatible with Articles 43 EC and 48 EC<sup>42</sup>, when a Member State refuses to recognise the legal capacity of a company formed in accordance with the law of another Member State in which it has its registered office, on grounds that the company moved its actual centre of administration to the host State, and when the effect of this refusal is that the foreign company cannot bring legal proceedings to defend rights under a contract in the host State unless it is reincorporated under the law of the host State. As a result, the German courts had to change their position. The German Supreme Court in 2003 overruled the decisions of the Landgericht and the OLG Düsseldorf and delivered a judgement in line with the CJEU judgement.

In 2003 a third decision in the *Inspire Art* case<sup>43</sup> came to remove the very last remaining reservations and doubts about the total abandonment of the real seat theory by extending the arguments laid out in *Überseering*. More specifically, the CJEU ruled that applying domestic company law rules to foreign companies is inconsistent with EU law and thus constitutes a restriction on the freedom of establishment. For example, provisions regarding capital requirements, the liability of directors, or rules related to the formation of a company fall within the scope of the judgement in the *Inspire Art* case.

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<sup>41</sup> Case C-208/00, *Überseering B.V. v Nordic Construction Company Baumanagement GmbH (NCC)*, decision of 11/5/2002, referred to the ECJ [now CJEU] by the German *Bundesgerichtshof* (BGH), Resolution of 3/30/2000.

<sup>42</sup> Now Articles 49 and 54 TFEU.

<sup>43</sup> Case C-167/01, *Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd.*, decision of 9/30/2003. Kersting, C. and Schindler, C.P., 'The ECJ's Inspire Art Decision of 30 September 2003 and its Effects on Practice', (2003), 4 German Law Journal, Vol. 4, No. 12.

However, this triplet of cases was not the last word of the Court of Justice on this issue. The judgement in *Cartesio*<sup>44</sup>, delivered on 16 December 2008, brought the issue of freedom of establishment back into the headlines along with the first case to raise this issue in more than 20 years ago: the *Daily Mail* case<sup>45</sup>. The CJEU found a unique opportunity to revisit and reconsider its previous judgement, giving an answer to those who were suggesting that the *Daily Mail* case has no clear *ratio* and that the approach to exit restrictions is inconsistent with that taken to such restrictions in the case law on free movement.<sup>46</sup>

In 1988 the CJEU, in an attempt to make an interpretation of the relevant provisions of the Treaty, ruled that a company is not allowed to transfer its central management and control to another Member State while retaining its status as a company in its Member State of incorporation. ‘Arts 43 and 48 of the Treaty [now Articles 49 and 54 TFEU], properly construed, confer no right on a company incorporated under the legislation of a Member State and having its registered office there to transfer its central management and control to another Member State’.<sup>47</sup> This was the Court’s approach for years and it was confirmed in the case of *SEVIC*<sup>48</sup> in 2003. In *Cartesio*, the CJEU ruled that national rules preventing a company from transferring its seat to another EU Member State did not violate the rights under the freedom of establishment set out in the relevant Treaty Articles. Arts 49 and 54 ‘are to be interpreted as not precluding legislation of a Member State under which a company incorporated under the law of that Member State may not transfer its seat to another

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<sup>44</sup> *Cartesio Oktato es Szolgaltato bt*, Case C-210/06 [2008] ECR I-9641, [2009] ECR I0000.

<sup>45</sup> Case C-81/ 87, *The Queen v H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc* [1988] ECR 5483.

<sup>46</sup> Andenas, M., ‘EU Company Law and the Company Laws of Europe’, (2008) *International and Comparative Corporate Law Journal*, vol. 6, Issue 2, pg. 14.

<sup>47</sup> See *Daily Mail*, operative part of judgement, para. 1.

<sup>48</sup> Case C-411/03 *SEVIC Systems* [2005] ECR I-10805.

Member State whilst retaining its status as a company governed by the law of the Member State of incorporation'.<sup>49</sup>

*Cartesio* instigated several discussions as it was not straightforwardly clear whether the Court, by confirming *Daily Mail*, implicitly overturned *Centros* and of course, if the answer to the previous question is yes, whether regulatory competition has been officially dead?<sup>50</sup>

As it subsequently became apparent, the Court did not overturn or reverse its *Daily Mail* decision, but has instead built on it and extended the scope of the freedom of establishment, and as such *Cartesio* can be considered to be in harmony with *Centros*. The Court, showing consistency, also referred to its previous judgement in *Uberseering*, highlighting the fact that whether or not a company, formed in accordance with the legislation of one Member State, can transfer its registered office, or its actual centre of administration in another Member State without losing its legal personality (...) is determined by the national law in accordance with which the company was incorporated.<sup>51</sup> 'There is nothing in the *Uberseering* judgement to suggest that *Daily Mail* no longer represents good law'.<sup>52</sup> Therefore, companies can move their real seat to any of the other Member States without having to liquidate or reincorporate. At the time of incorporation, the members of the company, or the directors who act for them, are free to choose any of the now 27 EU-Member States as their place of incorporation, and hence their law as the applicable one without running the risk that the company might be considered null and void.<sup>53</sup>

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<sup>49</sup> See *Cartesio*, operative part of judgement, para. 4.

<sup>50</sup> See Kuipers, J.J., 'Cartesio and Grunkin-Paul: Mutual Recognition as a Vested Rights Theory Based on Party Autonomy in Private Law', (2009), *European Journal of Legal Studies*, Vol. 2, No. 2, 66-96 at 74-75.

<sup>51</sup> *Ibid.*, para 20.

<sup>52</sup> O'Shea, T., 'News Analysis: Hungarian Tax Rule Violates EC Treaty, Advocate General Says', (2008) *Tax Notes International*, Vol. 51, No. 5.

<sup>53</sup> Kieninger, E.M., 'The Legal Framework of Regulatory Competition Based on Company Mobility: EU and US Compared', (2004), *German Law Journal*, vol. 6, No. 4, 748.

It is certainly too early to declare that *Centros* has given the decisive shot to the *siege reel* doctrine, just because it has cast doubt on it, as it is not so simple to determine in advance the wider implications of *Centros* as far as this doctrine is concerned. The *Centros* judgement has considerably reduced the impact of the real seat doctrine for company law purposes, to the extent that within the Community, companies that meet one of the three criteria mentioned in Article 48, cannot be denied access, nor be subjected to additional burdens as a consequence of the mere fact that their seat of activity was located in the host state, or in another member state.<sup>54</sup> However, it cannot be argued that the real seat theory is dead, because, as Wymeersch points out, the seat doctrine will continue to be applied at the member state level, for internal purposes, and at the level of extra-European relations.<sup>55</sup>

Overall, a closer look at *Centros* as well as at the post-*Centros* case law reveals that in the near future the real seat theory will probably be seen as opposing – if not incompatible with – the single market rules. EU law presupposes freedom of establishment and this theory clearly constitutes a restriction. Elimination of national borders that hinder free movement of goods, people, services, and capital has been one of the basic goals of the EU and this does not only include abolition of national borders, but also the removal of any conflicting national rules and regulations. The Court's primary aim was to highlight the following point: all Member States, when acting as host states must recognise companies, which were duly set up under the laws of another Member State. It is more preferable to emphasize this regulatory aim of the

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<sup>54</sup> Drobniq, U., 'Gemeinschaftsrecht und internationales Gesellschaftsrecht, "Daily Mail" und die Folgen', in von Bar, C., (ed.) *Europäisches Gemeinschaftsrecht und Internationales Privatrecht*, Cologne, 1991, pg. 192.

<sup>55</sup> Wymeersch, E, 'Centros: A Landmark Decision in European Company Law', (October 1999), Financial Law Institute Working Paper 99-15, pg. 14.

EU rather than talking about ‘*Centros* and *Überseering* as nails in the coffin of the real seat doctrine’.<sup>56 57</sup>

***(ii) An assessment of the impact of the CJEU’s Activism***

The real value of the judgement of the CJEU in *Centros* is that it has - in conjunction with the latter cases - raised the issue of regulatory competition emerging in the EU, not only as the next hot topic of discussion, but also as a device that would trigger the general reform, which was essential in the field of company and corporate law. Following the *Centros* case, the idea of a Delaware-style competition has found supporters, who were in favour of inter-jurisdictional competition in European company law. It is worth noting that the achievement of complete freedom of movement for companies across the EU would bring the Member States closer, as the existence of different jurisdictions and dissimilar company law rules would no longer be such an obstacle. However, any movements towards this direction would, by definition, undermine the goal of European integration and would lead to distortion of the market with artificial legal technicalities.<sup>58</sup>

Governments all around the world try to create a free and liberal environment for trading. At the same time, the world trends promote-or at least point in the direction of - a completely open world market: integrated, independent and as deregulated as possible. Regulatory competition theorists note that governmental intervention often creates its own burdens and inefficiencies. Nobody denies that such

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<sup>56</sup> Kuipers, see above note 50 at 75.

<sup>57</sup> On this topic, see also Lowry, J., ‘Eliminating Obstacles to Freedom of Establishment: The Competitive Edge of UK Company Law’, (2004), *Cambridge Law Journal*, No. 2, pg. 343 and Halhuber, H., ‘National Doctrinal Structures and European Company Law’, (2001), 38 *Common Market Law Review* 1385 at 1388.

<sup>58</sup> Andenas, M., ‘EU Company Law and the Company Laws of Europe’, (2008), *International and Comparative Corporate Law Journal*, Vol. 6, Issue 2, pg. 33. See also Schmitthoff, C. M., ‘The future of the European Company Law Scene’, in Schmitthoff, C. M. (ed), *The Harmonization of European Company Law*, UK National Committee of Comparative Law, London, 1973, pg. 3, 9.

intervention may be welfare-enhancing, but, at the same time, there is always the question as to whether or not the cure is more harmful than the disease or not.<sup>59</sup> Excessive regulation, or excessive strictness, creates protectionism, which can easily become a hard-to-overcome obstacle in a free trade orientated world. Pressure can sometimes have adverse results, i.e. instead of being welfare-enhancing it may prove welfare-reducing. Negative outcomes are always likely to emerge.

Therefore, there are some voices saying that perhaps competition is not the only pathway leading to ‘the land of optimal regulation’. As Esty and Geradin conclude, ‘regulatory systems should be set up with enough inter-jurisdictional co-operation (or harmonization) to ensure that trans-boundary externalities and other market failures are addressed, but with a sufficient degree of regulatory competition to prevent the resulting governmental structure from becoming an untamed, over-reaching, or inefficient Leviathan’<sup>60</sup>. As a result, even though the EU did consider following the American model of state competition, it has so far remained loyal to its harmonization project. Actually, it is not full harmonization by mandatory measures, at least in the area of company law. The EU is a quest for a model or a new theory that could promise to minimize inter-jurisdictional conflicts. Until then, the Union continues to pursue the gradual harmonization of company laws allowing a significant margin of discretion at national level.

#### ***(IV) Harmonisation***

##### ***(i) The concept of harmonization***

Harmonisation derives from the Greek word harmony, which means synchronization, concurrence and accord. Harmonization, in the long run, means

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<sup>59</sup> Esty D. and Geradin D., Introduction XXII and XXIII in Esty D. and Geradin D., see above, note 7.

<sup>60</sup> Ibid., XXV.

minimizing the degree of variation and reducing the number of significant underlying differences in order to achieve similarity between various systems.

The antagonists of harmonization compare it to monopoly, implying excessive regulation, lack of diversity, a higher degree of complexity and uncertainty and, finally, no flexibility in adapting to the new developments. Nonetheless, they seem to forget that harmonization does not mean uniformity. Harmonization recognizes the existence of differences. Differences do not necessarily pose any threat to coexistence and co-operation. When different cultures, nationalities and traditions manage to co-exist and create a harmonized legal system, such a system combines all their virtues and values.

When the issue is harmonisation of law, harmony does not presuppose a system of similar or identical laws, as harmonization does not mean 100% uniformity. The goal is the creation of a framework within which laws will be put together and will operate efficiently without creating inequality and inconsistencies. Such a framework can be created through the introduction of a set of basic standards, the degree of flexibility of which must be agreed in advance, in order to avoid potential problems, if these standards need any kind of alteration. In this way, stability and predictability against externalities can be ensured. Externalities occur, when an activity regulated in one jurisdiction affects the well-being of people in other jurisdictions.<sup>61</sup>

Harmonisation also has an element of centralization. The minimum harmonisation requires a set of minimum standards in certain areas and gives countries the privilege and the opportunity to complete the framework by setting all the higher standards themselves. In this respect, minimum harmonisation does not

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<sup>61</sup> Hauser, H. and Hosli, M., 'Harmonization or Regulatory Competition in the EC (and the EEA)?' (1991) 46 *Aussenwirtschaft*, Vol. 46, 497, 501-502.

rule out regulatory competition. Harmonization aims at minimizing the possibilities of future market failures and to prevent, to a reasonable extent, the race to the bottom. In contrast, regulatory competition aims at putting pressure on governments to perform efficiently and effectively<sup>62</sup>. That's why within a carefully designed legal framework harmonisation and regulatory competition can be used as substitutes rather than complements.<sup>63</sup> Clear objectives and orientation are essential preconditions for the successful combination of the two – at first glance contradictory - theories.

The advocates of the harmonization theory extensively used the example of the USA. In the USA, regulatory authority resides with the states more than with the federal government. The method adopted is based on a common standard, which is applied to all states and is used as a yardstick and a reference point. Obviously, if each country was free to adopt or develop any regulatory regime it wished without taking into account the options of its neighbours, any attempt at harmonization would sooner or later be affected. Governments need a strong incentive in order to produce an optimal degree of harmonization. Once again, this rings the bell again that reminds everybody that the USA is neither identical, nor even similar, to the EU. Romano, summarizing the US experience regarding regulatory competition in company law, argues that it leads, over time, to a fairly high level of convergence between states, with the dominant model one in which mandatory rules are the exception: 'state charter competition has... produced substantial uniformity across state codes, preserving variety in its enabling approach to rules, an approach that permits firms to customize their charters'.<sup>64</sup> In the USA, harmonization means that the federal government frequently takes on the character of a 'monopoly regulator', occupying

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<sup>62</sup> Ibid., XXIII.

<sup>63</sup> Sun, J.M and Pelkmans J., 'Regulatory Competition in the Single Market' (1995) 33 *Journal of Common Market Studies* 67.

<sup>64</sup> Romano, see above, note 12 at 2394.

the field to the exclusion of state initiative. The description of a ‘monopoly regulator’, which US critics use to attack federal intervention, is entirely appropriate in a system which tends to react to extreme failures in the market for regulation by shutting down competition entirely.<sup>65</sup>

***(ii) Harmonisation in European Company Law***

Similarly to regulatory competition, harmonization in the field of Company Law is still in a premature state within the European Union. There are Directives containing important rules, but a framework for the formation and governance of companies is still far from being developed yet. This does not necessarily mean that the EU is in favour of regulatory competition or diversity instead of uniformity and stable sets of mandatory laws. So far the critique of the EU course of actions finishes with the phrase that no harmonization has been attained and that the impact of the harmonization plan has not yet been significant.

It is better, prior to any evaluation of the harmonization plan, to have a closer look at the current state of affairs within the European Union.

Harmonization is a process that promises, if not guarantees, to successfully fulfil certain conditions. The achievement of uniformity is patently obvious, because a single set of rules is the first goal irrespectively of the content and the philosophy of these rules. A single set of rules replaces all local provisions that may act as impediments to the creation of a European common market, and offers a level-playing field for all players. Apart from the evident necessity of harmonization for the creation of the integrated market, its legal justifications are multiple. First of all, it can be found in the Treaty itself. Directives and Regulations (to a less extent, as

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<sup>65</sup> Deakin, see above, note 18, pg. 13-14.

Regulations principally aim at achieving uniformity of laws) refer to the Treaty and use either Article 44 or Article 95 or both as legal basis. Apart from that, harmonization is another link in the same chain as market failures. The justification for harmonization can be found in the never-ending effort for correcting market failures, which the Member States alone cannot, or are unwilling to, correct, by making society overall better-off than in its absence.<sup>66</sup>

Advocates of regulatory competition would readily recommend as the best solution that the EU should simply follow the US example and create a similar regulatory and institutional environment in the European Union market. The question that immediately pops up is to what extent the EU has the privilege to experiment, rather than innovating through introducing rules for safeguarding companies, which operating in the common market. Also open to discussion is whether EU legislators would like to create a European Delaware phenomenon as, since the 1970s, there were voices saying that the arm of EU corps is the ‘virtual unification of national company laws’<sup>67</sup> and that protective regulators can be used as a shield against a Delaware - style effect.

Nevertheless, the development and introduction of a friendlier Company Law regime is greatly different to creating a European Delaware. As Tröger indicated in 2005, no Member State has proper incentives and political manoeuvring space to assume in the near future a similarly preponderant position like the American dominant state of incorporation.<sup>68</sup> Regardless of these theoretical assumptions, the candidate Member State, which would express the ambition to win the state

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<sup>66</sup> Movsesyan V., ‘Regulatory Competition Puzzle: The European Design’, (2006) Laboratory of Economics and Management (LEM) Working Paper Series 2006/30, pg. 21.

<sup>67</sup> Schmittoff, C., ‘The future of the European Company Law Scene’ in Schmittoff, C. (ed.), *The Harmonization of European Company Law*, UKNCCL, London, 1973, pg. 9.

<sup>68</sup> Tröger, T., ‘Choice of Jurisdiction in European Corporate Law-Perspectives of European Corporate Governance’ (2005) *European Business Organization Law Review*, Vol. 6, No. 1, pg. 12.

competition for offering charter, should be ready to face Brussels' opposition. The role of Brussels in the harmonization process is quite significant, and such initiatives should have the approval of the EU headquarters in advance. The EU is not likely to give its blessing to any Member State, so all scenarios involving Luxemburg, Lichtenstein or even the United Kingdom can only be characterized as science fiction ones.

Article 49 of the Treaty (ex Art. 43 EU) protects freedom of establishment and highlights that any restriction would make establishment burdensome. Unharmonised and thus conflicting national laws form restrictions as well. The objective of creating a single market obliged the Union to adopt a different approach. Union intervention should be limited to the introduction of general principles rather than rigidly prescriptive rules.<sup>69</sup> Flexibility was promoted as a more effective means of achieving policy goals. In the field of Company Law, flexibility encourages self-governing professional organizations, industry-level associations and self-regulating bodies, like the City Panel on Takeovers and Mergers, to participate actively in the rule-making process.<sup>70</sup>

One of the main sources of diversity in the company law systems of Europe is the treatment of stakeholders, their place in the corporate hierarchy and their role in the operation of the company. It is common knowledge that the conflict between insider and outsider systems of corporate governance reflects the difference in corporate tradition and philosophy between countries with dissimilar systems. Both systems underline the importance of stakeholders' interests in corporate government, but each one offers different methods and levels of protection. The beginning of this conflict dates back to 1973, when the first enlargement of EU took place. The Fifth

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<sup>69</sup> Deakin S., 'Regulatory Competition versus Harmonization in European Corporate Law' (2001), in Esty D. and Geradin, D. (eds), see above note 7, pg. 194.

<sup>70</sup> Ibid.

Directive on Company Law<sup>71</sup> was supposed to be the vehicle for the adoption of the insider system following the German model (two-tier board and worker representation on supervisory boards). The resistance was strong and mostly from UK, and the result is that until this day the Directive has not been enacted.

The truth is that there is no ‘one best’ system of corporate governance. Rather the two systems have different comparative advantages. The British corporate governance system better supports companies in sectors where there is a need to move quickly into and out of new markets and in which there is need for great flexibility in the use of employers. The German system, by contrast, better supports companies in sectors that require long- term commitments and investments from employers, suppliers and other stakeholders.<sup>72</sup> Convergence of these two systems seems almost impossible, while the complete abandonment or replacement of the existing corporate government system in any country seems implausible and out of the question.

In the EU, divergence in fact operates at the level of law itself and entails diversity of any corporate government practices between legal systems. At the same time, in the USA regulatory competition has led to the adoption of a system in which company laws are moderately uniform in content, but highly permissive as well.<sup>73</sup> Harmonisation at the pan-European level should not be treated as a clone of US regulation though. There is a misconception that the EU should follow the example of the USA and vice versa, but in fact the two regimes are not even comparable. What

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<sup>71</sup>See Amended Proposal of 20 November 1991 for a Fifth Directive based on Article 54 of the EEC Treaty concerning the structure of public limited companies and the powers and obligations of their organs, COM (91) 372 final). For the history of the Fifth Directive, among others, Carswell, L.A. & De Sarrau, X., *Law and Business in the European Community*, Law Journal Seminars Press, New York, 1993, 4.05 at 4-27

<sup>72</sup> Vitolis, S., Casper, S., Soscise, D. and Woolcock, J. (1997), *Corporate Governance in Large British and German Companies*, Anglo-American Foundation for the Study of Industrial Society, London, pg. 35.

<sup>73</sup> Deakin, see note 69, pg. 209.

the EU can get is ideas for future reform and valuable lessons in regulatory methodology.

US federal legislation is closer to the stereotype of a single convergent regime. To be more precise, there is not a race to the top or to the bottom, but a race to converge. It is a race to converge through unregulated competition. The result was more or less predictable: the creation of a near-monopoly supplier, i.e. Delaware.<sup>74</sup> The European perspective, on the other hand, is based more on diversity. The real seat theory was the main obstacle to convergence of systems upon a shareholder-orientated model, and it was at the same time the guarantor of diversity, which differentiated the European model from the American one.<sup>75</sup> Nobody can guarantee in advance that the European market can become the same as that of America without any functional or operational problems. There is also no clear indication that this is the objective of EU regulators. Regulatory competition can suggest possible alternative choices or solutions for the improvement of the EU strategy, but it is highly unlikely that it will become the primary European model.

Whilst discussing about alternative solutions, harmonisation once again takes its position under the microscope. Theoretically, a uniform set of rules on company law would be an effective solution. Deakin's assessment is that 'in respect of creditor and employee protection harmonised rules may be necessary to avoid a race to the bottom'.<sup>76</sup> It must be noted, however, that the current form of community initiatives is not as effective as required. Setting minimum standards as a 'floor of rights'<sup>77</sup> can implicitly initiate a race to the top by encouraging states to set superior standards.

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<sup>74</sup> Deakin, S., 'Legal Diversity and Regulatory Competition: Which model for Europe?', see note 18, pg. 13-14.

<sup>75</sup> Ibid, pg. 12.

<sup>76</sup> Deakin, see note 69, pg. 210.

<sup>77</sup> Ibid.

Teubner borrows the term co-evolution from the science of biology, in order to characterize this process. Co-evolution implies the co-existence of diverse systems in an environment where each one retains its viability.<sup>78</sup> In this way, harmonisation underscores the autonomy of national legal systems, limits competition and gives priority to a process of evolutionary adaptation of values of the state level.<sup>79</sup> As a new methodology, it combines self-regulation and external regulatory interference. Self-regulation is always the most appealing choice, but regulatory intervention should not be *a priori* rejected as long as it does not have the characteristics of inducement and provided that it does not aim at undermining the quest for a deregulated environment.

At this point, it would be helpful to shed light on the practical side of harmonisation and, in particular, what steps the Commission has taken in the direction of harmonisation. After that, it would be more suitable to give an unambiguous answer concerning the issue of harmonisation of Company Law in the European Union.

### ***(iii) Practical steps towards EU Harmonisation of Company Law***

The Commission's first step towards harmonisation, as far as Company Law is concerned, was the adoption of Directives containing appropriate rules. The first Directives were inevitably quite descriptive. For instance, the First Directive<sup>80</sup> in 1968 laid down core minimum standards for public and private companies and limited partnerships relating to disclosure of basic information. After a closer look at the next Company Law Directives, it becomes apparent that the new proposed measures were

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<sup>78</sup> Teubner, G., *Law as an Autopoietic System*, Oxford Blackwell, United Kingdom, 1993, pg. 52

<sup>79</sup> *Ibid.*, pg. 54.

<sup>80</sup> First Council Directive of 9 March 1968 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community (68/151/EEC), OJ 1968 L 65/8.

gradually leaning towards a more decentralised approach. This new approach was based on EU intervention. The Commission clearly opted for this approach, instead of laying down the rules and standards for a common regulatory environment, because it was offering more and more autonomy to the Member states (local-level actions, self-regulatory bodies). Flexibility in terms of general principles instead of firm and rigid rules does not conflict with the goal of harmonization. Prescriptive and fixed rules can easily become dogmatic. They end up being too authoritarian as their creators did their utmost to make them to be as inflexible as possible.

Nevertheless, unanimity is at jeopardy as the adoption of a common line is rested upon the discretion and good will of the Member States. A good illustration of tensions that are likely to arise is the so-called Vredeling draft Directive<sup>81</sup>. This draft Directive was an attempt to strengthen workforce participation in multinational companies and to generalize their information and consultation rights, especially in a decision that would affect workers. The draft Vredeling Directive was met with unprecedented hostility from business, European and extra-European and, despite efforts by the Commission to confine its jurisdiction, the Council in 1986 formally suspended discussion of the Directive.<sup>82</sup>

During the same period, a new version of the Fifth Company Law Directive was presented. It was intended to break the deadlock and create a commonly accepted European system. The new draft was much more flexible and it can be characterised as a form of compromise, as it included a choice between four alternative models of workforce participation. In addition, there were provisions granting Member States

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<sup>81</sup> The official title is 'Proposal for a Council Directive on procedures for informing and consulting the employees of undertakings with complex structures, in particular transnational undertakings'. O.J. Eur. Comm. (No. C 297) 3 (Nov 15, 1980). It was named after the then Commissioner for Social Affairs, Henk Vredeling.

<sup>82</sup> Streeck, W., 'Citizenship Under Regime Competition: The Case of the „European Works Councils', (1997), European Integration online Papers (EIoP) Vol. 1, No 5, pg. 8, available in the website: <http://eiop.or.at/eiop/texte/1997-005.htm#II.B>.

with the option of having representatives with the same rights to information as those on the supervisory organ, i.e. the right to information, the right to consultation on all major decisions, the right to get explanations in relation to all aspects of the running of a company and, indeed, the right to demand advice and explanations if the views of the employees were turned down.

Nobody denies that these provisions were valuable additions to the existing Company Law regime and there is no uncertainty as to whether there should have been employee participation in the companies' management and decision-making process. However, the provisions of the draft Fifth Directive met with the disapproval of several member States. The explanations were not convincing at all. The official reasons for the opposition were that the provisions were complicated and that they 'would disrupt voluntarist systems of industrial relations'.<sup>83</sup> The truth, though, was that the actual provisions were of minor importance concerning that debate and the opposition was mostly a matter of principles and ideology rather than based on the provisions of the Directive themselves.

A second attempt at harmonisation of Company Law was the scheme for the formation of a *Societas Europae* (SE)<sup>84</sup>. After almost 30 years of debate, the European Company statute was finally approved in 2001, as a promising project that would potentially work as the result of all the attempts at harmonization.

Unfortunately, the initial reactions were not so enthusiastic. In October of 2004, only six countries had implemented the regulations at the national level. The reasons for this reaction are threefold: The Regulation and the Directive on the SE provide only the basic provisions and frequently refer to the laws of the Member

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<sup>83</sup> Docksey, C., 'Information and Consultation of Employees: The United Kingdom and the Vredeling Directive', (1986), *Modern Law Review*, Vol. 49, No. 3, pg. 281.

<sup>84</sup> Directive 2001/86/CE of 8.10.2001 supplementing the Statute for a European company with regard to the involvement of employees and Council Regulation 2001/2157/EC of 8.10.2001 on the Statute for a European company (SE).

States. It could be argued that in fact there is not a single type of SE but rather 27 different ones. This is mainly due to the reluctance of Member States to give up their national company law legislation. Even those countries, which were in favour of the SE, have a strong incentive to ensure that most of the mandatory rules of the SE framework can be found in their domestic law. In this way, they make sure that they maintain the attractiveness of the project for 'their' own business people (the 'access' argument).<sup>85</sup> The ideal solution is not a single, but heavily mandatory, legal form; there should be a large menu of legal forms available to entrepreneurs and that's why the European Private Company (SPE) project must also be supported by all the Member States.<sup>86</sup> However, as it is mentioned in the Explanatory Statement of the High Level Group of Company Law Experts, 'the SE is not a uniform European form of company, but has remained a patchwork owing to the many references to national law. This increases legal uncertainty and is expensive'. Therefore, what was initially planned as a supra-national company form, independent of the national laws of the Member States, was ultimately available in a diluted form, partly governed by European and partly by domestic law, failing to regulate certain core company law issues but also important related areas such as taxation or insolvency.<sup>87</sup>

Secondly, the impact of the SE law has been relatively limited, because the Commission did not act determinedly and resolutely. It is not a hyperbole to say that the provisions on the creation and the internal governance of an SE are the product of years of negotiation and do not reflect the real intentions of its architects. The SE

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<sup>85</sup> Davies, P., 'The European Private Company (SPE): Uniformity, Flexibility, Competition and the Persistence of National Laws', (2010), ECGI - Law Working Paper No. 154/2010, pg. 30.

<sup>86</sup> McCahery, J. and Vermeulen, E., 'The Evolution of Closely Held Business Forms in Europe' in McCahery, J., Raaijmakers, T. and Vermeulen, E. (eds), *The Governance of Close Corporations and Partnerships*, Oxford University Press, Oxford, 2004, pg. 206-208.

<sup>87</sup> Frost, C., 'Transfer Of Company's Seat – An Unfolding Story In Europe', (2005), 36(2) *Victoria University of Wellington Law Review* 359 at 386. See also Davies, P., *Gower and Davies' Principles of Modern Company Law*, 8th ed, Sweet & Maxwell, London, 2008, pg. 290.

should be the response to market forces and not the result of compromise. The original idea and intention had only a few similarities with the adopted model. The goal of facilitation of cross-border mergers within the common market and support of companies operating in more than one Member States of the Union was replaced by partial – only – harmonization.<sup>88</sup>

In the absence of the 10<sup>th</sup><sup>89</sup> and the 14<sup>th</sup><sup>90</sup> Directives the SE was supposed to be the vehicle for companies wanting to merge and transfer their seats across the borders of the European Union. That perception turned out to be futile. Once again, it proved extremely difficult, if not impossible, for Member States to reach to a unanimously accepted solution. There are issues like board structure and employee representation that still remain as a thorn in the side. It is known that the relations between certain Member States are not idyllic and there are conflicts, which are so deeply rooted that they are revealed on every single occasion. The example of the Thirteenth Directive on Takeovers and its collapse in 2001<sup>91</sup> uncovers the disagreements and the inconsistency that characterizes some Member States' views on the direction of the Directives. Since the highly conflicting goals of the Member States cannot all be reconciled by any conceivable single set of mandatory rules to be contained in the Union instrument, and since the legal base in the Treaty for the instrument requires unanimity, a substantial move away from uniformity (i.e.

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<sup>88</sup> Hopt, K., 'The European Company (SE) under the Nice Compromise: Major Breakthrough or Small Coin for Europe?', (2000) *Eurelia* 465.

<sup>89</sup> Proposal for a Tenth Council Directive based on Article 54 (3) (G) concerning cross-border mergers of public limited companies COM/84/727FINAL (25 January 1985), withdrawn in December 2001, and Proposal for a Directive of the European Parliament and of the Council on cross-border mergers of companies with share capital COM(2003)703FINAL (18 November 2003)

<sup>90</sup> Proposal for a Fourteenth European Parliament and Council Directive on the transfer of the registered office of a company from one member state to another with change of applicable law XV/D2/6002/97-EN REV 2 (1997).

<sup>91</sup> The Proposal for a Thirteenth Directive on the coordination of company law concerning take-over bids of 1997 was rejected by the European Parliament on 4 July 2001 (273 votes for and 273 votes against). It was finally adopted on 21.04.2004 (Directive 2004/25/EC).

mandatory rules in the statute) will occur.<sup>92</sup> Nevertheless, the Commission should have showed political will and determination to go through with this project at any cost, because history has shown that international conventions and agreements, which are products of compromise, are rarely respected or implemented.

Another interpretation that can be given to the Member States' reluctance to give up their national company law legislation, which can potentially explain their unwillingness or inability to reach consensus in an EU level is the following: If we go back in time, and more specifically, in the period when EU was 'born', the European Commission was the defensive weapon against the 'Delaware effect' in the US. Member States understood that competitive pressures would make their national law systems more and more vulnerable and that the best shield against these pressures was harmonization. A federal authority would have to carry the burden of harmonizing Company Law, but only with one limitation- not to touch the core provisions. Obviously, Member States simply wanted to safeguard and preserve their lawmaking independence on the core of Company Law. When, a few years later, the European Commission tried to develop a real European company form, Member States felt that their autonomy and control was threatened. As a defence to any limitations upon their legislative omnipotence, they revoked their support of the Commission's initiatives.

Thirdly, the SE was heavily criticized on the basis that it has been designed for large companies only. Arguably, the focus of the legislators should fall on the creation of a corporate vehicle that will be suitable for small and medium sized enterprises (SMEs), which represent the majority in the EU. SMEs traditionally have strong bonds with a particular Member State and the local economy, which make corporate

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<sup>92</sup> Davies, see above note 87.

migration and cross-border joint ventures extremely difficult. The SE should have addressed this need and should have made relevant arrangements for SMEs.

Up until now, the success of the SE is still covered by a cloud of doubt and uncertainty. For all the aforementioned reasons, the European Company's attractiveness is inexorably decreasing rather than increasing. The SE does not appear as a single European company but rather as a construction kit with various options to choose from. While Member States remain unwilling to forfeit national legislative sovereignty and their traditional approaches concerning corporate structure and labour participation, judicial reality has already overtaken legislation. The CJEU has interpreted the freedom of establishment for companies broadly, so one of the biggest advantages of the SE project – the possibility to move across borders – has been achieved in advance by the CJEU for all companies.<sup>93</sup> This is a fact which cannot be overlooked and the final version of the SE – if any- should be brought in line with the approach taken by the CJEU.

There is no doubt that the harmonisation of company law has long been a goal of the EU and the institutions have spent too much in terms of time, effort and resources, in order to achieve a reasonably high degree of harmonization. The two projects discussed above, the SE and the secondary legislation initiatives, have been successful, despite the problems with the implementation of the SE framework, but there is still plenty of room for improvement. The next section will touch upon the issue of harmonization with a view to the future, with the purpose of finding out whether harmonization remains a plausible goal or if there should be a change in the EU strategy.

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<sup>93</sup> Frost, see above, note 87, *ibid*.

***(iv) The future of the harmonisation process***

The biggest obstacle in the creation of a genuinely common European market was the different national legal systems and the divergent legal tradition of the Member States. This diversity has raised the issue of forum shopping and re-incorporation of companies, in a different basis, though, compared to the USA and the state of Delaware. Companies in Europe must be free to move and so far the main concern has not been to prevent re-incorporations in other jurisdictions, but to eradicate phenomena of opportunistic forum-shopping or where companies immigrate as a result of non-economic reasons, re-incorporations at the expense of creditors and third parties. It is not prohibited for companies to look around in an attempt to avoid the most unfavourable jurisdiction or to find a ‘friendlier’ one, but the lawmaking autonomy of Member States as well as the rights of vulnerable parties must be protected.

It would be simple and effortless to argue that ‘unregulated competition between jurisdictions could well eliminate the most significant differences between them, but without any guarantee that the system, that eventually prevailed, would be the most efficient’.<sup>94</sup> Deakin, who is in favour of harmonisation, arrived at a conclusion that was criticised for being paradoxical. According to that conclusion, harmonisation represents the best solution within the framework of the single market, as it isolates the positive characteristics of regulatory competition and combines them with evolutionary adaptation of law. Actually, Deakin puts forward ‘reflexive harmonisation’ as the best choice for the EU and depicts it as ‘the best guarantor of

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<sup>94</sup> Movsesyan, see above, note 66, pg. 23.

diversity between national systems, and hence of experimentation in regulatory design'.<sup>95</sup>

### ***(V) Reflexive Harmonisation***

Reflexive harmonisation aspires to be the dichotomous between strict regulation and deregulation and has as its origin the theories of reflexive law. Reflexive law aims to successfully join self-regulation and external regulation. It involves a regulatory process which seeks to be effective and successful not by directly imposing certain measures or by stipulating certain outcomes. It seeks to intervene by showing the ends or by pointing in the right direction without any kind of inducement and persuasion. To put it simply, it has a procedural orientation.<sup>96</sup> This means that the law underpins and encourages autonomous processes of adjustment. It simply gives emphasis to the importance of the self-regulation processes by awarding them with law-making powers.<sup>97</sup>

Another distinctive feature of reflexive law is that it does not seek to create a perfect market or to promote the best possible solution, even though it is doubtful whether it is possible to achieve it in practice. In fact, priority is given to the method and the process of achieving optimal results rather than to the results themselves. In this context, harmonisation has a different rationale. It is not on target for creating a monopoly, by occupying the field as a monopoly regulation instead of state-level regulation.<sup>98</sup> It can be said that reflexive harmonization promotes, if not initiates, a 'race to the top', into which the participating Member States would not have otherwise entered into, as there was no motivation to do so. At the same time,

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<sup>95</sup> Ibid., pg. 22.

<sup>96</sup> Deakin, see note 69, pg. 211.

<sup>97</sup> Ibid.

<sup>98</sup> Ibid.

reflexive harmonization promotes a ‘race to the bottom’ as well, by making Member States compete on the basis of the withdrawal of protective standards. In both cases, innovation and independent solutions are encouraged, while Member States have the freedom of choice from a number of available options.

Fundamentally, reflexive harmonisation is about putting a stop to state intervention against imperfections that spoil, or are thought to spoil, the side view of the desired optimal market. These imperfections should not be rectified as they amount to no more than the differences between systems. One of the fundamental prerequisites of reflexive harmonization is the preservation of local-level diversity, since without diversity, the stock of knowledge and experience on which the learning process depends is necessarily limited in scope. In this sense, diversity of national systems is an objective in its own right<sup>99</sup>, especially for countries or groups of countries exhibiting the characteristics of the EU.

In a nutshell, the model of reflexive harmonization holds that the principal objectives of judicial intervention and legislative harmonization alike are two-fold: firstly, to protect the autonomy and diversity of national or local rule-making systems, while, secondly, seeking to ‘steer’ or channel the process of adaptation of rules at state level away from ‘spontaneous’ solutions which would lock in suboptimal outcomes, such as a ‘race to the bottom’.<sup>100</sup>

The European Works Councils (EWC) Directive<sup>101</sup> can be used as an example of reflexive harmonisation process, as it has been clearly influenced by the philosophy of reflexive law. Said Directive does not impose any specific measures, but it

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<sup>99</sup> Deakin, S., ‘Legal Diversity and Regulatory Competition: Which model for Europe?’, see note 18, pg. 5.

<sup>100</sup> Deakin, S., ‘Two Types of Regulatory Competition: Competitive Federalism versus Reflexive Harmonization. A Law and Economics Perspective on *Centros*’, (1999) 2 Cambridge Yearbook of European Legal Studies 244.

<sup>101</sup> Council Directive 94/45 (1994 OJ L 254/64)

promotes them by giving incentives to companies to make use of its provisions even as the last available choice. In essence, the Directive seeks to achieve its ends, even by giving to companies and employees the opportunity to avoid its application. It sounds like an oxymoron, but the underlying principle is that the Directive does not directly impose a uniform solution, but instead shows the path to the Member States - and to the companies- and gives them an incentive to co-ordinate and work out a solution at a states level.

Another example is the Statute on a European Private Company (SPE). The Commission designed a new corporate vehicle, ideal for small- and medium-sized enterprises, combining elements from the English limited company, the German GmbH, the Dutch BV, and the French SARL. The Statute covers a wider range of company law issues than the SE setting a list of issues to be covered by the articles of association as a minimum requirement and leaving shareholders freedom on how to regulate these issues, within the framework of the provisions of the relevant Regulation. There is no obligation on companies to adopt the proposed corporate structure and the only incentive is the benefits that it offers, such as legal certainty, reduced costs, reduced administrative burdens for small and medium companies as well as no need for reincorporation in all the EU Member States in which they want to trade. The success of this initiative will solve the problem of cross-border trading, it will solve the dilemma between incorporation and real seat theory and in turn it will bring the EU closer to its objective of *de facto* completion of the internal market.<sup>102</sup>

The process of reflexive harmonisation still carries the label of being a controversial method, because of its flexibility and lack of strict sanctions. It

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<sup>102</sup> Bernecker, A., 'A European Private Company: Is Europe's single legal form for SMEs close to approval?', (2010), Research Briefing, Deutsche Bank Research, available in the website: [http://www.dbresearch.de/PROD/DBR\\_INTERNET\\_EN-PROD/PROD000000000260277.PDF](http://www.dbresearch.de/PROD/DBR_INTERNET_EN-PROD/PROD000000000260277.PDF).

constitutes an innovative technique of integration and it is based on a radically different philosophy of compliance. Despite its novel characteristics, it has the potential of being elevated to a higher level among other less suitable solutions. Its ‘supremacy’ is justified by the fact that it does not prevent solutions based on innovation, nor does it go against diversity in the laws of the Member States. Thus, co-evolution is singled out as being a more efficient solution compared to a single monopoly regime, because, as previously mentioned, it combines autonomy and diversity with interdependence.

The question, therefore, is whether the Member States will show the required open-mindedness and willingness to actively support this method for the sake of their companies and entrepreneurs. We will return to harmonization of company law and the perspectives of reflexive harmonization in the fifth chapter, where the discussion will turn to the EU corporate governance regulation and the ambitious Action Plan. Through assessing the effectiveness of the Plan, we will investigate whether the EU regulators have considered this newly proposed technique and work out the possibility of further adopting it in the future.

## **(VI) Conclusion**

On the whole, harmonization neither limits nor negatively affects on the diversity of national laws within the European Union; on the contrary, diversity has been preserved. However, the EU harmonization project in the area of company law follows a decidedly slow rate of progress, as the bureaucracy of the EU legislative process holds it back, and becomes entangled in disagreements, heated arguments and endless negotiations between Member States and EU institutions. As a result, implementation of a broadly supported idea can easily be diluted and could be

ultimately nullified.<sup>103</sup> This is the rationale behind the gradual development of a new type of harmonization, with a view to facilitating the accomplishment of the Union's objectives with the minimum of delays and inconvenience for both companies and the business world in general. It was given the name 'Reflexive harmonization' and, if supported and further developed, it can be the European approach to regulatory competition. Such an approach can be characterized as unique and idiosyncratic, because, unlike the American experience, it emphasizes the importance of self-regulation and gives priority to the safeguarding of local diversity. In essence, it makes use of central regulation so as not to directly impose, the solutions, which may be considered as ideal at any given time, but to preserve a space for independent governance at lower levels of government. Reflexive harmonization can turn out to be the missing link in the chain which connects the regulation of companies and their operation with the many different legal systems operating within the EU. Additionally, the EU harmonization attempts do not have to go unrecognised, as reflexive harmonization can build on the achievements of harmonization, such as preservation of national autonomy and diversity, facilitation of communication between Member States and the prevention of pointless and uncontrolled competition.<sup>104</sup>

It is still too early to determine whether this solution will prove to be an efficient one. It looks promising due to its flexibility derived from the evolutionary adaptation of diverse systems to the constantly changing external conditions. The jury may still be out regarding the long-term prospects for rival systems of corporate governance in an increasingly globalized economy. However, there is much to be said

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<sup>103</sup> Ibid.

<sup>104</sup> Chalmers, D., Davies, G. and Monti, G., *European Union Law: Text and Materials*, 2<sup>nd</sup> ed., Cambridge University Press, Cambridge, 2010, pg. 710.

in favour of further development of the European approach, since it would seem to combine the values of local autonomy with system wide adaptability.<sup>105</sup>

Recently, some policymakers have suggested that linking the European Company Statute to a European corporate governance code could provide a more efficient way to induce convergence of best practice norms within the EU.<sup>106</sup> This strategy may prove highly useful and beneficial, because, through linkage, the Member States' codes would be left untouched and thereby divergence would be respected, while, at the same time, the prospect of regulatory competition by means of the European Company would be substantially diminished.<sup>107</sup>

Suddenly, the whole debate about regulatory competition or harmonization and reflexive harmonization were covered by a big shadow and lost the biggest part of their shine. They were no longer in the centre of attention. The reason for that shift is closely related to the failure of the self-regulatory corporate governance regime. It is high time to go back to self-regulation and focus on the reasons for its failure. The truth is that self-regulation in corporate governance did not fail in the sense that it was proven insufficient, or that a new more ambitious plan appeared unexpectedly. In 2001 something unexpected happened and the ideal corporate environment, as described above, was destroyed on October 16, 2001. This is the date of the Enron scandal.

Enron was a bleak moment in modern corporate history. The age of innocence was over. It seems that since then we have entered the age of cynicism and it is no small wonder as to why.

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<sup>105</sup> Deakin, see above, note 100, pg. 259.

<sup>106</sup> High Level Group of Company Law Experts, see above, note 4, pg. 67.

<sup>107</sup> McCahery, J.A. and Vermeulen, E., 'Does the European Company Prevent the 'Delaware-effect'?' (2005), TILEC Discussion Papers, DP 2005-010, pg. 22.

This suddenly precipitated a chain reaction of scandals which shook the ground beneath the feet of the powerful empire of the United States of America. This domino of collapses, scandals, and investigations indelibly marked the corporate map of the world. The numerous corporate governance reforms that started as a result of these scandals monopolized the interest of corporate Europe and were at the top of every agenda of business or regulatory discussion. Inevitably, the application of reflexive harmonization and the future of European Company law became secondary topics, not ranked very high on the political scale of importance.

Before starting to tell the story of Enron, it is worth mentioning that, in a survey conducted in 2003, sixty-three percent of the respondents said that their opinion of large corporations had changed for the worse over the last few years. It is not an exaggeration to say that the business world would never be the same again, nor is it surprising that regulators and prosecutors substantially reordered enforcement priorities as they devised new strategies to address pervasive corporate fraud.<sup>108</sup>

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<sup>108</sup> Brickey, K., 'Enron's Legacy', (2004), Washington University in St Louis, School of Law, Faculty Working Paper No. 04-06-01, pg. 1-2, available in the website: <http://wings.buffalo.edu/law/bclc/bclrarticles/8/1/brickey.pdf>.

## CHAPTER 3

### *CORPORATE GOVERNANCE AND SCANDALS*

Scandals, collapses and failures are some of the words that have been excessively used when the topic of Enron rears its heads. Hundreds of pages have been written throughout the years and myriads of opinions have been expressed to that end. The story has already become the scenario of a film and a play, as it combines elements of fraud, deceit, greed, crime, punishment, suspense, tensions, and surprises. It also brings to mind the ancient Greek tragedies, in which hubris was the ultimate sin and the heroes had to undergo the award of justice through the stages of nemesis and catharsis.

To begin with, despite the fact that there has been so much coverage of the story of Enron and the other companies that failed, there is one question still looking for an answer after all these years. Why did everything happen so suddenly at the end of 2001, as if a magic finger pressed the button that activated the domino effect of collapses? Why not five years earlier or ten years later? The easy solution is to put the blame on the usual suspects, i.e. the rogue managers and executives of these 'famous' companies. Another well-liked explanation would be to attribute everything to coincidence or bad timing. However, there is no evidence suggesting that the scandals were random, coincidental or accidental. In any event, a focus on the deficiencies of any individual board of directors cannot give a satisfactory explanation for this sudden surge of corporate governance failures. A reasonable explanation can only be found, if we look beyond the board, in

order to identify those who provide or control its informational inputs.<sup>1</sup> One would be mistaken in focusing on each situation separately seeking for a general rationalization, and equally mistaken in using generalized arguments to explain the reasons of a particular collapse. An answer that can be given at this point is that the concentration of corporate failures was ‘the natural and logical consequence of trends and forces that have been developing for a long period of time’.<sup>2</sup> Nobody had noticed that the current corporate governance systems should have been improved, in order to be at the level of the most recent requirements of the business world.

This chapter will examine the stories of the most prominent scandals, not only in the United States where two of the most illustrious collapses took place, but also in the European continent. Following an examination of the pathology of these companies, we will then go back to the symptoms, in order to determine whether collapses could have been prevented and whether there is any link or similarity among these case studies. If the scandals could have been foreseen and prevented, the burden of responsibility is not to be placed solely on the shoulders of CEOs, CFOs, and accountants, because governments, regulators, policy-makers, and whistleblowers must assume a considerable share of the blame as well.

## ***(I) American scandals***

The business world has been stunned by the avalanche of corporate accounting scandals of recent times. In particular, the American market was heavily traumatized by the wave of successive scandals that erupted in the wake of the market downturn of 2000.

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<sup>1</sup> Coffee Jr, J., ‘What caused Enron?: A Capsule Social and Economic History of the 1990’s’, (2003), Columbia Law School, Center for Law and Economic Studies, Working Paper No. 214, pg. 2.

<sup>2</sup> Ibid., pg. 4.

Enron has become a byword for fraud, dishonesty and corruption: the epitome of corporate scandals. However, the beginning of the story was different and it was impossible to predict that it would end up as the scandal that so gripped corporate America. This is why phrases like ‘post-Enron’ or ‘after-Enron’ are very frequently used in order to emphasize the big change that took place in the business world in 2001. ‘Enron’s demise is not business as usual in America’, said one investigating Congressman<sup>3</sup>, which prompts us to raise the question of what ‘business as usual in America’ actually is. If a practice is not expressly and specifically defined as illegal, why should it not be used and claimed as legal? It is a culture which defines compliance in a minimalist way, focusing on compliance with the letter of the law rather than its spirit.<sup>4</sup> This is how half-truths were included in the companies’ financial statements and this how terms like ‘subjective truth’ became part of business terminology. We will return to this division between the exact letter of, and the spirit of, corporate legislation at the end of this chapter, where an attempt will be made to look beyond the obvious causes of the scandals.

### ***(i) Enron***

Enron was seen to embody an agenda for the modernization of the corporation, while the American corporate model was the envy of the world.<sup>5</sup> Enron’s managers applied the language of ‘core competencies’, ‘asset lite’ balance sheets and ‘virtual

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<sup>3</sup> Tauzin, B., Subcommittee on Oversight and Investigations, 2002b, 32.

<sup>4</sup> O’ Brien, J., *Governing the Corporation: Regulation and Corporate Governance in an Age of Scandal and Global Markets*, NJ John Wiley & Sons, Ltd, Chichester, West Sussex, Hoboken, UK, 2005, pg. 218.

<sup>5</sup> Beavers, J.P., ‘Life in a Post-Sarbanes-Oxley Environment’, (2002), Acredula, Counsel for Boards and Executives, Vol. 3, No 5, pg. 1, available in the website: <http://www.bricker.com/Publications/articles/629.pdf>.

integration'. Enron was also, famously, the company, which claimed above all others to be 'laser focused on earnings per share'<sup>6</sup>. As Jeffrey Skilling, initially the head of Enron's energy trading business, and later the company's CEO, put it, '[we are] a company that makes markets. We create the market, and once it's created, we make the market'.<sup>7</sup>

Put differently, Enron took advantage of US accounting rules, which enable companies to set up corporate vehicles, the so-called special purpose entities<sup>8</sup>, to manage assets off balance sheet. In essence, these rules allow companies to engage in a form of risk spreading. The return on an asset can be maximized and the risk can be respectively minimized by transferring it to an SPE, which must at some point repay the debt that has incurred to the vendor company. An outside investor comes in to supply external capital and share the risk with the vendor, in exchange for which it also gets to share in the high rate of return, which the SPE can provide.<sup>9</sup>

According to a basic principle of modern company law and accounting practice, the accounts of parent and subsidiary companies in the same group should be consolidated. Otherwise, it is a fairly simple matter to shift assets between parent and subsidiary companies in such a way as to give a misleading impression to shareholders of the state of their respective balance sheets. The US Generally Accepted Accounting Principles provide that the assets and liabilities of an SPE do not need to appear on the balance sheet of the vendor company which has set it up, as long as two conditions are satisfied: (i) the independent outside investor must supply at least 3% of the total working

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<sup>6</sup> Deakin, S. and Konzelman, S.J., 'Learning from Enron', (2004), *Corporate Governance: An International Review*, Vol. 12, No. 2, pg. 135.

<sup>7</sup> Culp, C. and Hanke, S., 'Empire of the Sun: An Economic Interpretation of Enron's Energy Business', (2003), Policy Analysis No. 470, Cato Institute, Washington, DC, pg. 7

<sup>8</sup> Hereinafter referred to as SPEs.

<sup>9</sup> Deakin and Konzelman, see above, note 6, pg. 136.

capital of the SPE (minimum acceptable capital investment); and (ii) must be in a position to control the disposition of the asset or assets which are transferred to the SPE. Enron set up several thousand companies, which did not count as its subsidiaries, and therefore did not have to include their losses or liabilities in its group accounts. Using this accounting trick, Enron was enabled to replace potential liabilities with assets and earnings. So far there was absolutely no violation of any rule and nobody could foresee the storm that was coming. Up until the end of the 1990s Enron took advantage of the accounting rules regarding SPEs and truly made the most of them. As it was explained above, contributions by outside investors involve providing the necessary external capital and sharing the risk with the vendor. But what happens when there is no outside investor? Enron failed to find significant sources of support for a number of transactions, whilst it was fighting to avoid economic failure. That was the beginning of the end!

Although the first storm clouds had begun to gather, Enron's high risk accounting policy still looked prosperous and successful and the company was the most admired example of 'new economy' companies. As Kenneth Lay, the former Enron chief executive and chairman, liked to boast, as Enron's sales, profits, and stock continued an apparently unassailable ascent, 'we like to think of ourselves as the Microsoft of the energy world'.<sup>10</sup> Enron was rewarded by the stock market for following such a smart business strategy and 'few analysts were willing to fly in the face of fashion by questioning Enron's numbers'. Fashionable management ideas gave Enron enough power to be able to shield the company from awkward questions about its accounts.<sup>11</sup> Its growth impressed the capital

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<sup>10</sup> 'The Energy Giants that Flew Too Close to the Sun', The Independent, Friday 9 July 2004, available in the website: <http://www.independent.co.uk/news/world/americas/the-energy-giants-who-flew-too-close-to-the-sun-755917.html>.

<sup>11</sup> Paul Krugman, 'Death by Guru', New York Times, Dec. 18, 2001, at A23.

markets, and very few asked fundamental questions about the company's business strategy.<sup>12</sup> The stock market's general decline in the beginning of 2001 resulted in the fall of Enron's stock, while this unexpected fall further resulted in a sudden collapse in investor and market confidence. The company previously considered as being all-powerful company suffered a 39 percent loss of its stock value in the first six months alone of 2001. As Enron's credit status declined, debts automatically fell due and liabilities accumulated under the terms of its loan covenants. Enron's entire strategy depended upon being able to maintain the confidence of the credit and capital markets.<sup>13</sup>

A last minute attempt by Enron to line up a high-profile investor in order to demonstrate its financial strength did not go as planned. On the contrary, the two investment banks, JP Morgan Chase and Citigroup were accused by the Securities and Exchange Commission (SEC) of helping Enron cover up its financial weaknesses. Enron was shadowed by the dark cloud of bankruptcy when the last ray of light, the planned merger with rival energy trader, Dynegy, failed. Dynegy was about to get involved in a high-risk takeover, but Enron's share price fell below \$1, so Dynegy broke off the takeover talks.

The list of charges against Enron was quite long, as the company was accused of having, amongst other things: boosted profits and hidden debts totaling over \$1 billion by improperly using off-the-books partnerships; bribed foreign governments to win contracts abroad; and manipulated the Californian energy market and the Texas power market. To be fair, a significant amount of Enron's off-balance sheet activity did not breach the rules. What can be argued is rather that it instead creatively exploited the rules or utilized

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<sup>12</sup> Palepu, K and Healy, P., 'The Fall of Enron', (2003), *Journal of Economics Perspectives*, Vol. 17, No. 2, pg. 6.

<sup>13</sup> Deakin and Konzelmann, see above, note 6, pg. 136.

regulatory gaps, including the ‘regulatory black hole’ of derivatives. Enron indeed engaged in creative accounting as well as fraudulent accounting, both of which were designed to ‘purposefully mislead shareholders about Enron’s precarious financial profits’. Creative accounting and tax avoidance are not new phenomena and there was no doubt as to the reasons which led Enron to this type of conduct. Enron got caught out and had to expose the reality behind the façade, whereas other companies did not collapse and are perhaps they are still misleading the market.<sup>14</sup>

Enron’s Board of Directors failed to safeguard the company’s shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing their company to engage in high risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation. The Board witnessed numerous indications of questionable practices by the management over several years, but chose to ignore them to the detriment of Enron’s shareholders, employees and business associates.<sup>15</sup> Additionally, stock options led executives to misjudgments and wrong decisions. They were blinded by greed, since their remuneration was directly linked with stock prices. Apart from the members of senior staff, a significant part of the other staff’s savings was invested in Enron stock, as a result of Enron’s management active encouragement.<sup>16</sup>

The analysis of the circumstances regarding Enron’s collapse adds another dimension to its significance, if they are linked together with the shareholder value theory, which was examined above. In particular, it holds that Enron’s business model

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<sup>14</sup> O’ Brien, see above, note 4, pg. 207-209.

<sup>15</sup> United States Senate, *The Role of the Board of Directors in Enron’s Collapse*, Report prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, 8 July 2002, p. 11.

<sup>16</sup> Cornford, A., ‘Enron and Internationally Agreed Principles for Corporate Governance and the Financial Sector’, (2004), United Nations, G-24 Discussion Paper Series No. 30, New York and Geneva, pg. 6.

exemplifies the pathology of the 'shareholder value' system<sup>17</sup> and it is truly a paradox of our time that shareholder-focused capitalism is now harming shareholders.<sup>18</sup> This has happened because maximization of the shareholder value became synonymous with short-termism. Companies were focused only on their stock price. Rising prices was the only indication of successful strategy. Patience and long-term investments were replaced by short-term stock performance. The reason for that shift can be found in the way incentives were structured. In other words, the share options granted to senior management, coupled with generous managerial salaries, were pushing executives to focus on how they will increase their income, while keeping shareholders happy through high dividend returns. Enron was not the only company, which had adopted such a strategy, but it definitely took the logic of shareholder value to its extreme.<sup>19</sup> Priorities had shifted in the corporate world, but not for long. Soon it became clear that this strategy was 'built on the sand'<sup>20</sup> and collapsed together with Enron. The true lesson of Enron is that until the power of the shareholder value norm is broken, effective reform of corporate governance will remain on hold.<sup>21</sup>

Just a few years prior to Enron, there were indications and warnings, but nobody made a correct interpretation of the omens. The signs were obvious, as the East Asian crisis of 1997 highlighted the poor protection of investors in emerging markets. This crisis came just a few years after the events in Latin America, such as the Mexican peso crisis of 1994. The same happened in the Scandinavian countries in the early 1990s. East

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<sup>17</sup> Deakin, S., and Konzelmann, S., 'After Enron: An Age of Enlightenment?' (2003), *Organization*, 10(3), 584.

<sup>18</sup> Deakin, S., 'Corporate Governance after Enron: the Return to History', (2005), *Economic and Social Research Council, The Edge*, Issue 14, pg. 27.

<sup>19</sup> See above, note 17.

<sup>20</sup> *Ibid.*

<sup>21</sup> Gordon, J., 'What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections', (2002), *University of Chicago Law Review*, Vol. 69, No. 3, 1243.

Asian countries were presented as a new market, and were considered easily accessible and attractive to investors. During the second half of the 1990s, however, these economies, one by one, started to collapse. Currency rates and stock prices collapsed, investors lost confidence in securities in East Asia, and the subsequent large outflow of funds created a domino effect with worldwide impact. The financial crisis caused also political unrest with Indonesia, South Korea and Thailand being the most affected by the crisis. These countries were previously admired and were considered as the most successful emerging market economies, but the crisis brought their weak corporate governance practices to the surface. The lack of transparency, poor levels of financial reporting, the general lack of accountability, excessive levels of private sector debt and the lack of proper corporate governance structures were some of the factors that played a significant role in the crisis. There was a call for changes and all analysts highlighted the need for an immediate reassessment of the Asian model of industrial organization and finance, similar to the reassessment of mass insider privatization and its concomitant weak protection of small investors in Russia and Brazil.<sup>22</sup>

***(ii) Other Scandals: Sunbeam, Waste Management, Xerox, Quest, Global Crossing, Tyco, Adelpia***

Even though Enron has been the most publicized of the corporate frauds, it was neither the first one nor the only one. In June of 1998, it was revealed that Sunbeam had manipulated its financial statements. The irregularities were not spotted by Arthur

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<sup>22</sup> Becht, M., Bolton, P. and Roell, A., 'Corporate Governance and Control', in Constantinides, G., Harris, M. and Stulz, R. (eds), *Handbook of the Economics of Finance Volume 1B: Financial Markets and Asset Pricing*, Elsevier B.V., Amsterdam, 2003, Chapter 1, pg. 12.

Andersen, Sunbeam's auditor, or even by Sunbeam's independent directors.<sup>23</sup> Former CEO, Al Dunlap, known as 'Chainsaw Al' for his tendency to cut thousands of jobs, was accused of using phony accounting to boost Sunbeam's profits. He denied those charges, but the company was forced to restate financial results for 1996 and 1997. Sunbeam later filed for bankruptcy and its stock price lost its value as it dropped from \$53 at its peak to just pennies. A striking coincidence was that Arthur Andersen's relevant accounting documents had been destroyed. The signs were there, as were heralds of the Enron scandal, but nobody managed to give them the right interpretation.

In June 2001, Waste Management, the largest American trash hauler, was accused of engaging in a scandal of massive fraud. The company's top-executives, motivated by greed and the desire to preserve their professional and social status, used a variety of improper accounting techniques concerning its financial statements, including improper capitalization of expenses, failure to amortize, and improper use of reserves. The company's auditor, which was again Arthur Andersen, continued to give unqualified audits, while Waste Management failed to comply with Andersen's plan for the firm to get its books in order – a plan that was not communicated to Waste Management's audit committee<sup>24</sup>. Arthur Andersen, once known as the gold standard of integrity in auditing, was disciplined by the SEC with a \$7 million fine, the largest civil penalty ever, for issuing false and misleading financial statements.

In addition, it is worth mentioning Xerox's accelerating revenues from long-term equipment leases, manipulation of revenues and expenses on sales and swaps of fibre

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<sup>23</sup> Laing, J.R., 'Dangerous Games: Did "Chainsaw Al" Dunlap manufacture Sunbeam's earnings last year?' BARRONS, June 8, 1998, pg. 17.

<sup>24</sup> SEC Release No. AE - 1405, 2001 WL 687561 (June 19, 2001).

optic capacity by Qwest's and Global Crossing, and apparently rampant looting by the family controlling Adelphia.<sup>25</sup>

Xerox, the photocopying and printing giant, admitted that it had overstated its revenues by almost \$2 billion over a five year period from 1997 to 2001. Its accounting scandal was uncovered just three days after WorldCom admitted the largest fraud in the country's corporate history. The SEC accused Xerox of having misled investors and of trying to fool Wall Street by using accounting tricks for earnings manipulation. The company improperly posted revenues before they were actually made. One Xerox accounting scheme was known internally as 'project Mozart' because of its supposed creative brilliance.<sup>26</sup> KPMG was the accounting firm responsible for the multi-billion dollar scandal, as it was the auditor of the company for more than 30 years. In this instance, KPMG exhibited a pure opportunistic behavior, by agreeing to cooperate in these accounting irregularities, so as to continue the relationship with Xerox, from which KPMG would earn some \$82 million between 1997 and 2000.

Qwest, the dominant local telephone company in 14 western states, participated in a massive financial fraud between April 1999 and March 2002. The allegations against Qwest and some of its former executives were that they inflated 2000 and 2001 results by more than \$150 million through improper accounting. The SEC accused Qwest of falsely reporting one-time sales of equipment or trades of fibre-optic cables as recurring revenue.

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<sup>25</sup> Ribstein, L., 'Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002', (2002), Illinois Law and Economics Working Papers Series, Working Paper No. LE02-008, pg. 9.

<sup>26</sup> Pratley, N. and Treanor, J., 'Xerox in \$2bn scandal: Dollar plunges as firm admits exaggerating revenues', The Guardian, Saturday June 29, 2002, available in the website: <http://business.guardian.co.uk/story/0,3604,746299,00.html>.

The company restated earnings from 2000 and 2001 to erase about \$2.2 billion in revenue.

Global Crossing, a Bermuda-based telecommunications company, filed for Chapter 11 protection in January 2002, around the same time as the Enron scandal. A number of analysts highlight the similarities between this scandal and that of Enron, by describing it using the title: 'Same story, different company'. Nevertheless, yet by Enron standards of saturated media coverage, Global's incident barely registered as more than a footnote.<sup>27</sup> This uneven treatment by the Media could be explained if it is associated with the political implications of this scandal. The Democratic National Committee chairman and former Clinton fundraiser, Terry McAuliffe, made an extremely profitable investment on Global Crossing and the company made a contribution to the campaigns of the Democratic Party of the United States.<sup>28</sup> A focus on the accounting part of the case reveals charges for falsifying financial filings to hide losses, dishonest accounting and the enrichment of top executives. Arthur Andersen was once again involved in a collapse and agreed to pay \$25 million to settle a lawsuit brought by investors over its role in the collapse of Global Crossing. Its share price before the scandal was over \$60. Afterwards, it suffered a drop of 99.9 percent and each share was worth \$.06. This constituted the fourth biggest US corporate collapse and the biggest telecoms bankruptcy to date.

Tyco was among the world leaders in electrical components, under-sea telecoms systems and speciality valves, as well as product lines ranging from burglar alarms to

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<sup>27</sup> Hall, C., 'Media Avoid Global Crossing's Scandal', CNSNews.com, Wednesday, Feb. 13, 2002, available in the website: <http://business.guardian.co.uk/story/0,3604,746299,00.html>.

<sup>28</sup> During the 2000 election campaign, Global Crossing provided a hefty \$2.8-million in donations, with 55 percent of it going to Democrats, according to the nonpartisan Center for Responsive Politics. Its contributions even topped those of Enron Corp., which gave \$2.4-million during the period, according to the website: <http://www.newsmax.com/archives/articles/2002/2/12/190253.shtml>.

plastic clothes-hangers. This case is exceptional in the sense that the falsification of the corporate records did not aim to concealing the real financial situation of the company, but instead aimed to covering up private misappropriation of corporate assets. Dennis Kozlowski, Tyco's CEO, and Mark Swartz, its CFO, had received over \$170 million in loans from Tyco. The problem was that the shareholders were not informed of these loans, which, additionally, were not approved by the company's compensation committee. The undisclosed loan agreements offered zero or low interest rates and most of the loans were written off by bonuses, benefits and special payments. The list of charges against Kozlowski and Swartz was quite long: grand larceny, tax evasion, enterprise corruption, conspiracy, securities fraud and falsifying business records. They were found guilty of stealing \$150 million in unauthorized compensation, and profiting from \$400 million in share transactions carried out under false pretences.

In March of 2002, Adelphia, the sixth largest provider of cable services, disclosed that the company, through its financial statements, had tried to hide billions of dollars worth of debt and, more specifically, \$2.3 billion of off-balance-sheet debt. Three months later, Adelphia filed for Chapter 11 bankruptcy protection. The founders of Adelphia were charged with securities violations and self-dealing, as they systematically and fraudulently excluded billions of dollars in liabilities from the company's consolidated financial statements from 1998 through March 2002. The Rigas Family were using complicated accounting techniques to cover the larceny by make use of the books of off-balance-sheet affiliates, mostly family-owned entities. Deloitte, after failing to detect and uncover such a massive fraud, was obliged to pay \$50 million in order to avoid prosecution for its improper audit.

### ***(iii) WorldCom***

Not long after the first incidents of Enron, the business world was shocked once again when WorldCom, one of the largest providers of telecommunications services, admitted a multi-billion dollar accounting fraud. WorldCom appeared to have misstated billions in current expenses, i.e. fees the company paid to use transmission networks, as capital expenditures. In fact, by using deceptive accounting the company improperly reported routine expenses as investment so that its financial situation looked better than it actually was (an earnings manipulation scandal). The WorldCom scandal broke only six months after Enron had filed for bankruptcy and, in July 2002, the company sought Chapter 11 protection in the largest bankruptcy filing in U.S. history. Needless to say that, once again, these irregularities were not revealed by either the company's board or its auditor (again, Arthur Andersen!)<sup>29</sup>. In this case, however, Arthur Andersen accused WorldCom of withholding information during the audit. When Andersen discovered the irregularities, its recommendation was that WorldCom's financial statements for 2001 should not be relied upon.

Based on previous performance it would seem easy to blame Arthur Andersen for not identifying the irregularities in due time. WorldCom's accounting was not as complex as Enron's. At the same time, it would be tempting to also blame the SEC for lack of diligence, because its accountants were investigating the case of WorldCom for about three months. It was only after an internal audit that \$3.3 billion in profits were discovered to have been improperly recorded on its books from 1999 to the first quarter of 2002. Scott Sullivan, the WorldCom finance chief, was named as the architect of the

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<sup>29</sup> Ribstein, see above, note 25.

fraud and Bernard Ebbers, former chief executive, was sentenced to 25 years in prison for his role in WorldCom's collapse.

Michael Oxley underlined the significance of this scandal by saying that 'WorldCom took all the oxygen out of the room because it was so huge- four or five times larger in bankruptcy terms than Enron'.<sup>30</sup> Enron is perhaps the most famous case of corporate fraud, but certainly WorldCom should certainly be recognized as the largest corporate fraud in the American history.

The first point that can be made short after touching upon the American scandals is that they cannot be entirely attributed to the modern ways of doing business. Sunbeam and Waste Management were old-economy companies, while the problems in WorldCom apparently involved straightforward mis-characterizations of revenues and expenses. There was no uniformity on the types of fraudulent activity and irregularity. We can see examples of executives who broke the law, those who used questionable accounting techniques, and others who tried to make money at the expense of shareholders and employees. This suggests that the accounting frauds resulted more from other fundamental problems than from new business methods.<sup>31</sup> Human greed, ineffective legal rules and monitoring system, failure of shareholder value theory, an unethical business environment, and incompetent management and accountants were some of the factors that contributed, to a large or a lesser extent to the establishment of a business model that subsequently led to the aforementioned scandals.

Within less than a year the revelation of several incidents of corporate wrongdoing and misconduct by Enron, Arthur Andersen, WorldCom, Adelphia and many

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<sup>30</sup> Oxley, M., 'Rebuilding Investor Confidence, Protecting U.S. Capital Markets. The Sarbanes-Oxley Act: The First Year', (2004), House Committee on Financial Services, pg. 2.

<sup>31</sup> Miller, G., 'Catastrophic Financial Failures: Enron and More', (2004), 89 Cornell L. Rev. 423.

others have caused broad and deep problems in the economy and the financial stability of the United States of America. Individual CEOs and directors cannot be blamed for the disasters in their entirety. They did make mistakes and violations, but the wisest approach is to consider them as part of a general business model, which turned out to be unethical and dangerous for the stability of the world's financial markets.

The discussion will now turn to the scandals that took place in the countries of the European continent, the majority of which are Member States of the European Union. There are examples from countries with long traditions in corporate governance legislation, like the United Kingdom, countries which have adopted the two-tier board structure like the Netherlands, and countries with more traditional family-owned companies, like Italy.

## **(II) *European scandals***

Many Europeans were of the impression that corporate scandals were supposed to be strictly American affairs. A classic short-sighted response to a collapse like Enron's is that 'it will not happen in our company' or 'it could not happen here'. Such a response sounds rather selfish or self-centered, because as it is naïve to believe that the US scandals had nothing to do with Europe. The incentive, and the opportunity, to commit fraud are not limited to any particular system of governance, geographic region, industry, or size of company.<sup>32</sup> This point should have been clear, even before the scandals of

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<sup>32</sup> Armour, J. and McCahery, J., Introduction, in Armour, J. and McCahery, J (eds), *After Enron: Improving Corporate Law and Modernizing Securities Regulation in Europe and the US*, Hart Publishing, Oxford and Portland, Oregon, 2006, pg. 9.

Parmalat and Ahold. It was definitely the ‘American sense of greed’<sup>33</sup> that encouraged executives at Enron and WorldCom to falsify the financial results of the company and cross the line between lawful (creative) accounting and fraudulent accounting accompanied with conspiracy and corruption. The significance of Enron is further highlighted by it being the first time in corporate history that a foreign scandal initiated a Company Law reform.<sup>34</sup> But what Enron also made clear was that the world market is interdependent and any abnormality can rapidly cross the Atlantic Ocean and becomes a ‘European problem’ as well. Europe felt its impact and, consequently, had to change its perspective regarding corporate regulation. The thrust wave of the American scandals, in combination with the subsequent European scandals, revealed that there is no shield protecting Europe from mismanagement. The fraudulent behaviour at Parmalat was equally large and widespread. Profits were overstated, fictitious bank accounts with billions of euros were created and approximately €1 billion of investors’ money was siphoned off for personal use by Parmalat’s founder, Calisto Tanzi, and his friends and family.<sup>35</sup>

### ***(i) Parmalat***

The Parmalat scandal has been described by the SEC as ‘one of largest and most brazen corporate financial frauds in history’.<sup>36</sup> It gave a new dimension to the corporate

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<sup>33</sup> Rogmans, T., ‘Parmalat Scandal is a Wake-up Call for European Corporate Governance’, (2004), *Newropeans Magazine*, 31 March 2004, pg. 1, available in the website: <http://www.newropeans-magazine.org/content/view/1237/87>.

<sup>34</sup> Davis, P., ‘Enron and Corporate Governance Reform in the UK and the EU’, in Armour, J. and McCahery, J (eds), *After Enron: Improving Corporate Law and Modernizing Securities Regulation in Europe and the US*, Hart Publishing, Oxford and Portland, Oregon, 2006, pg. 417.

<sup>35</sup> Rogmans, see above, note 33.

<sup>36</sup> *Securities and Exchange Commission v. Parmalat Finanziaria S.p.A.*, Case No. 03 CV 10266 (PKC) (S.D.N.Y.), Accounting and Auditing Enforcement Release No. 1936 / December 30, 2003.

scandal debate, as it brought up the issue of effective financial control over family-owned companies and, more extensively, companies with one strong controlling shareholder. The Parmalat situation has also been labelled as the ‘European Enron’. The Parmalat group, a world leader in the dairy food business, collapsed and entered bankruptcy protection in December 2003 after acknowledging massive holes in its financial statements<sup>37</sup>.

Although financial misreporting is the most evident issue, the Parmalat case was basically a false accounting story arising from corporate governance failures. Parmalat’s financial statements did not violate the letter of the adopted accounting standards, but the overall ‘spirit’. The major issue within Parmalat was the falsification of accounts, rather than an exploitation of a gap in the accounting standards that allowed it to conceal the ‘true’ corporate financial results.<sup>38</sup> Traditional methods of fraud were also combined with ‘cut and paste’ forgery and shell companies. A good example that illustrates the ‘cooking of books’ that was taking place is the hilarious case of Bonlat, a Cayman Islands subsidiary company. Bonlat boldly claimed to have sold enough powdered milk in one year to Cuba to produce 55 gallons of milk for each and every citizen of the small island nation.<sup>39</sup> Scandalous can be also characterized the conclusion that the collapse could have been avoided simply by being more forthcoming when losses began to mount from the company’s Brazilian unit. Instead, an isolated group of corporate executives preferred to cover up these losses with fraudulent documents, unconcerned that their actions would be

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<sup>37</sup> Melis, A., ‘Corporate Governance Failures: to what extent is Parmalat a particularly Italian Case?’ (2005), *Corporate Governance*, vol. 13, No.4, pg. 478.

<sup>38</sup> Melis, G. and Melis, A., ‘Financial Reporting, Corporate Governance and Parmalat: Was it a Financial Reporting Failure?’ in O’ Brien, J. (ed.), *Governing the Corporation: Regulation and Corporate Governance in an Age of Scandal and Global Markets*, NJ John Wiley & Sons, Ltd, Chichester, West Sussex, Hoboken, UK, 2005, pg. 238.

<sup>39</sup> Sverige, C., ‘The Parmalat Scandal: Europe’s Ten-billion Euro Black Hole’, (2004), available in the website: <http://www.wsws.org/articles/2004/jan2004/parm-j06.shtml>.

sooner or later be checked by the government, by auditors, or by banks<sup>40</sup>. The decisive shot was a letter, purportedly from the Bank of America, in which the bank confirmed that Bonlat held an account containing some \$5.5 billion with the bank. When it was revealed that the account was fictitious and that the letter was not authentic, the largest cash and investment confirmation fraud ever had been discovered.

With the benefit of hindsight, Parmalat reveals some features common to companies that have faced catastrophic financial failures: massive growth, questionable accounting practices and negligent or delinquent accountants, poor underlying performance, political connections, a dominating shareholder, complex corporate structures and operational mystery.<sup>41</sup>

### ***(ii) Other European scandals: Ahold and Barings Bank***

Apart from Parmalat, which is the most famous and well-publicized case of corporate failure, there is a list of other European companies which collapsed or faced problems as a result of accounting irregularities and mismanagement. The list of European corporate scandals can be characterized as equally long as the comparable list of American scandals. Ahold, Maxwell, Polly Peck, Marconi, Alstom, BCCI, Vivendi, EmTV, and Barings Bank are some of the companies which have challenged the American scandals monopoly. In particular, the cases of Ahold and Barings Bank are two indicative examples.

Ahold, the Dutch retail giant captured the headlines, when its U.S. Foodservice Inc. unit based in Columbia was involved in a multimillion-euro accounting scandal. The

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<sup>40</sup> Erdmann, C., 'The Parmalat Scandal: Italy's Enron', (2004), Case Study, Lis 580, pg.6.

<sup>41</sup> Miller, see above note 31.

Ahold scandal became public in February 2003 and litigation filings were coming in from all corners of the globe. Finally, the company agreed to pay out \$1 billion, in order to settle a securities fraud class-action lawsuit with its shareholders.

Barings Bank, the UK's oldest and most established merchant bank, collapsed in 1995 due to the unauthorized and concealed trading activities of just one man, Nick Leeson. It was later bought for £1, by the Dutch banking and insurance group ING. This is a very good illustration of what can result from a combination of ineffective internal controls and insufficient monitoring can cause.

### ***(III) The post-scandals era***

It is clear that Europe does not have any immunity against scandals and failures. However, none of these cases became a high-publicity scandal, and none of the European cases could hypothetically rival Enron or WorldCom. But why was corporate governance not so prominent in Europe before Enron? A very common explanation is the dissimilarities between the USA and the EU and the well-known differences in the ownership structures between United States companies and those of Europe. As Coffee Jr points out, 'differences in the structure of share ownership account for differences in corporate scandals, both in terms of the nature of the fraud, the identity of the perpetrators, and the seeming disparity in the number of scandals at any given time'.<sup>42</sup> This theory is almost self-evident, but it does not fully explain why scandals take place only on the western side of the Atlantic Ocean and not on the eastern side. It could have been used as a valid explanation during the period of time that Enron and WorldCom

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<sup>42</sup> Coffey Jr., J., 'A Theory of Corporate Scandals: Why the U.S. and Europe Differ', (2005), The Center for Law and Economic Studies, Working Paper No. 274, pg. 2.

were in the centre of attention. Globalization and multinational companies have changed the world corporate map and have already left their mark. Modern companies have the characteristics of a 'citizen of the world', world trade has no boundaries, and business agreements often have universal effect, so it is not an exaggeration to argue that 'both economies are closely interconnected in the same global economy and subject to the same macroeconomic conditions'.<sup>43</sup> These developments have changed the standards.

Corporate governance systems should be always updated and in line with any new requirements. A good corporate governance code, self-regulatory or governmental, is successful and efficient, when it covers all the contemporary issues. The constant evolution of companies requires legislators and regulators to be alert and vigilant. In this respect, codes of best practice and corporate governance legislation should evolve as well, in order to reflect the image of the modern business reality and keep pace with the latest developments. Once again, it would be easy to argue that scandals came as a punishment for inadequate or out of date regulation. Nevertheless, there is no evidence to show that the corporate scandals took place due to a lack of regulation or a lack of up-to-date rules. In most EU countries, the codes are either new or regularly updated. For example, the UK is still one of the pioneers of self-regulatory corporate governance and has shown exceptional activism in updating and supplementing its codes. But there is a small detail which makes a big difference. This detail brings us back to the questions posed at the beginning of the chapter: Why did everything happen so suddenly and why during that particular moment in time?

Corporate governance codes were, more or less, regularly updated and improved before and after the outburst of collapses. The problem was that the improvements were

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<sup>43</sup> Ibid., pg. 1.

not made from a proactive perspective. There were no studies carried out to identify any future potential problems and cover any forthcoming threats. The reactive - and not proactive - character of the amendments made was obvious after the first set of scandals, as the scandals did not stop and the codes were unable to create a barrier against future collapses. This regulatory path cannot lead to the right destination. There is no real value in regulating with a view just to avoiding another Enron, soon after its collapse. Enron attracted so much attention and publicity that everybody realized what had gone wrong there. Every single one of the high-profile collapses highlighted a particular weakness or drawback of the system. All these lessons should have been used as a point of reference, but the focus should have been on the years ahead. It would have been much wiser and more effective to focus a bit more on the future rather than solely on the mistakes of the past.

To illustrate this point, most of the case studies showed that there were problems with the accounting methods which were either misleading or were based on a creative pattern. The codes of best conduct and the subsequent legislative initiatives addressed these problems and provisions were introduced that were penalizing the use of improper techniques for 'cooking books' and employing non-transparent accounting methods, and were generally targeting the phenomenon of 'book cooking'. In this way, transparency and accountability were reinforced, and the aim was to also catch accountings tricks which trod the line between legality and illegality and were widely used by a large number of companies. Therefore, the number of companies in the USA electing to restate their accounts just prior to the enactment of the SoX came as no great surprise. However, nothing was done to tackle the real threat, and this was what really motivated business

people to engage in these questionable or illegal practices and push their companies to the brink of disaster. There was no reference to the incentives, the bonuses and stock options, and the overall mentality of short-termism.

No business school in the world teaches future executives to how to manipulate profits, falsify accounts and defraud shareholders. Book-cooking and financial statements manipulation did not become so wide-spread due to business people being so blinded by greed that they were unable to realize that this trait was clouding their judgement. They were more likely convinced that their main responsibility, besides making money for themselves, was keeping shareholders happy, even if this had to involve withholding material information from them, concealing data, or falsifying accounts.

There were signs and indications long before the disasters, but nobody paid them any attention, even after the first strikes. The directors, managers, auditors and shareholders of Enron, WorldCom, Parmalat, and Royal Ahold are indeed responsible for their conduct, mistakes, misjudgements, bad choices, and negligence. They are all guilty, but only to a certain extent. These examples cannot be seen in isolation from their environment. Companies were well aware of the corporate governance rules and regulations. The rules were there and, according to the general impression, compliance with the rules would lead to the fulfillment of the companies' objectives. The problem was that the rules were not being followed. The spirit of the law is more important than the letter of the law. The duties of a director or of the auditors extend well beyond mere 'box-ticking'. Such agents are supposed to read between the lines and find the real meaning of their obligations. Enron's directors were well-educated and sophisticated people, appointed pursuant to all the legal requirements. What they did wrong was that

they did not perform their duties according to the spirit of the law and that is why they failed to prevent the disaster. Similarly, Enron's auditors did not ask the right questions 'intelligently and insightfully, unfettered by the need to consider the potential loss of large accounting/auditing fees'.<sup>44</sup> The corporate governance system, as it had been developed, was making all the corporate actors more and more accountable to the market. This is not necessarily negative, as long as there is protection against distortion and manipulation of the market by self-interested managers.<sup>45</sup> Needless to say, the outcome itself gives the answer to the question of whether there was enough protection or not.

The aforementioned case studies show that executives were looking to find ways of conducting business that arguably fit within the letter of the law, while avoiding its true intent. No statute can be effective enough to respond to such a mentality, because the objectives of the law are not the same as the objectives of those who must comply with its provisions. There were flaws in the systemic structures of corporate governance, which were revealed by the failure of each one of the companies discussed above. Even though they occurred as a result of a particular confluence of events, timing and personalities within individual companies, these failures exposed the broader regulatory shortcomings or national/sectoral dislocations that permitted poor controls and unethical behaviour to go unchecked.<sup>46</sup>

Lack of trust, transparency, and ethos look like a bomb in the foundations of free markets. Free markets rely on trust for their smooth operation. Money, stocks, pensions and reputations are at stake, and without trust failure is almost guaranteed.. The law

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<sup>44</sup> Mallin, C., *Corporate Governance*, Oxford University Press, 2<sup>nd</sup> ed., Oxford and New York, 2007, pg. 4.

<sup>45</sup> Coffee, see above note 1, pg. 4.

<sup>46</sup> Banks, E., *Corporate Governance: Financial Responsibility, Ethics and Controls*, Palgrave MacMillan, London, 2004, pg. 230.

draws the general framework of those markets and sets the limits for their operation, but the law alone does not suffice. Supporting and encouraging ethics cannot be achieved merely by legal provisions. It is everybody's responsibility from the CEO and the CFO to the lawyers, accountants and employees. No company can have as its sole motivation the need to obey the law, but at the same time it cannot be solely motivated by the desire to make more and more money. Individual ambitions and corporate greed should be limited and channelled to socially useful ends.<sup>47</sup>

More will be said in the following two chapters to examine the regulatory responses of the US Government and the European Union to these scandals and collapses. Returning to the differences between the United States and Europe, it is interesting to mention that the scandals were presented separately, not so much because there are different responses, but there are differences on another level as well. More specifically, there has been a significant difference in the public opinion and its reaction towards the scandals. In the USA there was a general feeling of failure, as if the end of the world had come. The media played a significant role in the creation and the endorsement of such an atmosphere. The rogue executives were 'crucified' and everybody seemed to expect the government and the President to solve the problem and declare the episode to have been nothing more than a bad dream. Unfortunately, there is not a magic trick that makes fraud, greed, corruption and failures vanish into thin air. At the same time, in Europe the scandals did not receive as much attention and did not have the same impact. European countries did not feel any threat not only when the domino effect of collapses started, but even when the European companies were suffering from

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<sup>47</sup> Fronhen, B. and Clarke, L., 'Scandal in Corporate America: An Ethical, not Legal, Problem', (2002), USA Today, Law & Justice, available in the website: [http://goliath.ecnext.com/coms2/gi\\_0199-2228999/Scandal-in-corporate-America-an.html](http://goliath.ecnext.com/coms2/gi_0199-2228999/Scandal-in-corporate-America-an.html).

corporate governance failures. There was no call for immediate changes or reforms. This silence was not a sign of apathy and lack of concern. It is positive that, although Europe was, in a way, obliged to make changes in order to be prepared for the future, there was no panic or extreme pressure like in the US.

The post-scandals era found the USA and Europe in diametrically different positions. Circumstances were clearly dissimilar and that was reflected by their response to the scandals. The USA converted the state of panic into a crusade to restore investors' confidence against fraud. The EU, by contrast, after a period of silence, started to organize its defence against future corporate scandals, preferring not to make crucial decisions under pressure. In simple technical terms, on the one hand, there is the Sarbanes-Oxley Act, and, on the other, are the more modest European initiatives, such as the High Level Group of Company Law Experts and the Action Plan, on the other hand.

## CHAPTER 4

# ***REGULATION IN THE AFTERMATH OF SCANDALS: THE US RESPONSE***

There is no rule or economic theory that links regulatory reforms with price declines and crashes, but past experience of more than three hundred years has taught us the lesson that the vast majority of new regulations were triggered by foregoing financial scandals and stock market failures. A significant percentage of financial reforms and new trading regulations were initiated in the aftermath of a serious crisis, in most instances as a short-term reflexive response rather than as a result of a consistent and formal consultation process or thorough discussions. What is quite worrying is the fact that, regardless of any proposed measures for correction of the problems and omissions in corporate governance regulation, the time between crashes has decreased. In the beginning, failures were taking place only once in a lifetime, then we had decades between fiascos, then they occurred every few years, and the gap has been decreasing ever since.<sup>1</sup> Nobody wants to play the role of Cassandra in a modern tragedy, but nevertheless it seems rather unlikely to see a great improvement of the situation in the near future.

This chapter will explore the issue of regulation in the aftermath of scandals, and the reaction of the United States to the failures of many publicly traded companies. The first part will briefly review the history of regulation in the United States, while the

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<sup>1</sup> Available in the website: <http://www.investopedia.com/features/crashes/crashes9.asp>

second part will explore the most controversial piece of legislation in modern legal history, the Sarbanes-Oxley Act of 2002. An attempt will be made to discuss its positive and the negative aspects, before weighing the pros and cons to find an equilibrium. One question that needs to be answered before the final assessment is whether Sarbanes-Oxley is mainly about substantive rules or about enforcement? This chapter will conclude with an overall assessment of the Act, before moving the discussion to the other side of the Atlantic Ocean and the European Union.

### ***(I) The History of Securities Regulation in the United States***

Going back in time, it appears that all of the 18th-century English regulation, as well as all of the proposed regulation of the 18<sup>th</sup> century, came immediately after sustained price declines. To be more specific, prices dropped in 1720, 1733-34, 1746-48, 1753-56, 1758-62, and the early 1770s, while the Parliament considered new regulation in the early 1720s, 1733-34, 1746, 1756, 1771, and 1773.<sup>2</sup> The same happened, after 20 years, in the United States as well. The first significant American securities regulation was passed in New York in 1792, shortly after the big crash of that year. Early U.S. regulation was not as stringent as the English regulatory laws.<sup>3</sup> However, during the Panic of 1792, and after so many New Yorkers had lost their fortune on the stock market, the public auction of securities was banned in New York. Furthermore, in New York and Pennsylvania certain time contracts were also forbidden.

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<sup>2</sup> Banner, S., 'What Causes New Securities Regulation?', (1997), 300 Years of Evidence, 75 Wash. U. L. Q. 849.

<sup>3</sup> Wright, R., *The Wealth of Nations Rediscovered: Integration and Expansion in American Financial Markets, 1780–1850*, Cambridge University Press, Cambridge, 2002, pg. 167.

If we take a closer look at the history of the relationship between collapses and regulation, the first conclusion we can draw is that the signs were always present. It was clear, sometimes more sometimes less, that a crisis was close. There was always a bell ringing, some kind of forewarning. Unfortunately, nobody managed to interpret the signs properly and, above all, in good time, taking for example the Wall Street Crash of 1929.

In the January 12<sup>th</sup> 1901's issue of *Commerce, Accounts & Finance*, the editors' recommendation was that "free, fair and full reports of industrial organizations, should be founded upon thorough, independent audits of accounts by disinterested certified public accountants, whose signed certificates, to be published with the report, are a more nearly perfect guarantee of reliability than any other yet to be discovered".<sup>4</sup> It is surprising that the independency of auditors has been a prominent topic of discussion for more than a hundred years and that the calls for independent and fair-minded auditors dated back from the beginning of the previous century. Unfortunately, these calls were largely ignored not only by the government in Washington, but also by the Wall Street regulators. During the next twenty years, and especially after the First World War, the stock market in the United States boomed. It experienced a gradual increase in value and most of the investors were making a profit.

In September 1929, the stock market began to decline in value. Investors suffered great losses, especially those who had purchased stock on credit. The stock market crash of 1929 was about to begin. 'Black Thursday' and 'Black Tuesday' (October 24<sup>th</sup> and 29<sup>th</sup>, 1929) were not too far away. The Wall Street Crash of 1929 was a black page in the history of the U.S. stock market. The shock was so strong that the United States had to undergo a dramatic economic downturn, known as the 'Great Depression'. The Great

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<sup>4</sup> Available in the website: [http://www.deloitte.com/dtt/section\\_node/0,1042,sid%253D2277,00.html](http://www.deloitte.com/dtt/section_node/0,1042,sid%253D2277,00.html)

Depression lasted for approximately 10 years and affected international trade as well as having a major impact on the economy of many countries around the globe. The size of the stock market decline is highlighted by the Richard Salsman, who observed that, ‘as late as April 1942, U.S. stock prices were still 75% below their 1929 peak and would not revisit that level until *November 1954*—almost a quarter of a century later’.<sup>5</sup>

As illustrated by the aforementioned example, it was only after the crash of 1929 and the subsequent period of Depression that proper accounting practices and audit independence were brought to the centre of attention. Once again, new rules were reactive and there were no provisions aiming at reinforcing the market’s protection against any future crisis, or against urgent situations. One could argue that if the guidelines had been closely followed since 1901, there would be fewer bankruptcies, less price variations, lower unemployment and, of course, reduced depression.

Before the Wall Street Crash of 1929, there was little regulation of securities in the United States at a federal level, as there were objections to the introduction of any federal regulation of exchanges. The crash spurred the Congress to hold hearings on the abuses and, subsequently, to enact the Securities Act of 1933. The primary aim was to reform the whole financial system, especially Wall Street, and to regulate the securities industry. As Representative Rayburn stated during the debate before the introduction of the Act, ‘the purpose of this bill is to place the owners of securities on a parity, so far as is possible, with the management of the corporation and to place the buyer on the same

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<sup>5</sup> Salsman, R. M. ‘The Cause and Consequences of the Great Depression, Part 1: What Made the Roaring ‘20s Roar’, (2004), *The Intellectual Activist*, vol. 18, No 6, pg. 16.

plane so far as available information is concerned with the seller'.<sup>6</sup> Prior to the Act, the regulation of securities was chiefly governed by state laws, the so-called 'blue sky rules'. These rules were enacted between 1910 and 1933 and governed the offer and sale of securities. The term 'blue sky law' first came into general use to describe legislation aimed at promoters who would sell building lots in the blue sky in fee simple.<sup>7</sup> Soon it became apparent that they were not sufficiently effective, as they were leading to a lack of uniformity and forum-shopping. This was followed by the Securities Exchange Act of 1934 which created the Securities and Exchange Commission (SEC). The SEC is a so-called 'independent' agency that consists of five members appointed by the President and approved by the Senate. It was initially created in order to supervise the securities market in addition to the enforcement of the new legislation. Recommendations for the creation of a SEC-style organization can be traced back in 1909, when Charles Hughes proposed in his report that federal regulation for securities to be introduced, but the time was not right then.

The new rules required companies wanting to sell securities publicly, to file a registration statement with the SEC. Through that registration, disclosure of relevant information was accomplished. Relevant information means all information about the companies offering securities for public sale as well as about the securities themselves, which should aid potential investors, in making a good investment decision. The rationale behind these rules was to provide investors with sufficient information before they make the investment. In other words, the SEC and the Security Exchange Act of 1934 was not regulating the securities markets as a whole. The Act was initially applicable to stock

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<sup>6</sup> Loss, L., *Fundamentals of Securities Regulation*, Little, 2<sup>nd</sup> ed., Brown and Company, Boston and Toronto, 1988, pg. 32.

<sup>7</sup> *Ibid.*, pg. 8.

exchanges and their listed companies and was basically regulating the secondary market<sup>8</sup>, the trading of securities between persons often not related to the issuer of these securities, i.e. agents or middlemen.

Overall, both Acts intended to prohibit any kind of fraudulent activities in relation to the offer, purchase, or sale of securities. Their success has been undisputed to this day and the reason is not that they have eliminated fraud from the worlds of securities, but because of the creation of the SEC.

The SEC has been transformed into a highly successful ‘super’ federal agency with extensive executive, legislative and judicial powers. After the passing of the SoX, the role of the SEC has been upgraded, as it is charged with implementing most of the provisions of the Act. The SEC’s mission is to ‘protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation, by overseeing the key participants in the securities world.’<sup>9</sup> The SEC is concerned primarily with promoting the disclosure of important market-related information, maintaining fair dealing, and protecting against fraud.<sup>10</sup>

Its effectiveness is based on the flexible regulatory environment that has been created, an environment that promotes market development and investor confidence.<sup>11</sup> Transparency as well as the elimination - to a reasonable extent - of accounting and investment fraud can make stock markets much more stable and more attractive to investors. The SEC has long recognized the importance of the globalization of the

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<sup>8</sup> Primary market is where the companies issue their securities.

<sup>9</sup> Available in the website: <http://www.sec.gov/about/whatwedo.shtml>.

<sup>10</sup> Ibid.

<sup>11</sup> Thieffy, G., ‘After *Lamfalussy* Report: The first steps towards a European Securities Commission?’ in Andenas, M. and Avgerinos, Y. (eds), *Financial Markets in Europe: Towards a Single Regulator?* Kluwer Law International, London, 2003, pg. 201.

securities markets for both investors looking for increased diversification and international entities looking for capital-raising opportunities in different, and sometimes larger, markets.<sup>12</sup>

## **(II) *Public Company Accounting Reform and Investor Protection Act of 2002***

Since we have been focusing our attention on the SEC and its role, it would be a good opportunity to put one more piece of legislation under the microscope. A more recent and more sweeping one, ‘the most far-reaching reforms of American business practices since the time of Franklin D. Roosevelt’<sup>13</sup>, as President George W. Bush described it, when he was signing it into law. It is the well-known and illustrious the Sarbanes-Oxley Act. The Sarbanes-Oxley Act of 2002, named after its key sponsors Senator Paul Sarbanes and Representative Michael G. Oxley, is also known as the Public Company Accounting Reform and Investor Protection Act of 2002.

As history always repeats itself, the *raison d’être* behind the Sarbanes-Oxley Act project can be tracked down to the series of large corporate frauds that occurred during the period of 2000-2002: lack of confidence, panic, criticism and, above all, market value declines of more than 500 billion dollars. The whole system of corporate accountability, financial reporting and Directors-Auditors Independence was carrying the label of failure, fraud and unreliability. New scandals were making the headlines every day. People were losing their jobs, investors were losing their fortunes, stock prices were falling, corporate giants were collapsing like towers of cards and the USA was in a weak position, exposed

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<sup>12</sup> Commissioner Paul S. Atkins, ‘Speech by SEC Commissioner: The Sarbanes-Oxley Act of 2002: Goals, Content, and Status of Implementation’, (2003), speech in University of Cologne, Germany, available in the website: <http://www.sec.gov/news/speech/spch020503psa.htm>.

<sup>13</sup> Elisabeth Bumiller, ‘Bush Signs Bill Aimed at Fraud in Corporations’, The New York Times, July 31, 2002, page A1.

and vulnerable. A decisive reaction was needed as the elections were coming and the Congress wanted to show that it remains active and it is willing to eliminate fraud. In this respect, regulatory reform appeared to be the only practical solution. In their eyes, it was like a one-way street.

Enron was the scandal that initiated the procedure for the reform. But even during the discussions and the setting up of the proper formula, the domino of scandals was making things more and more distressing. Senator Paul Sarbanes introduced Senate Bill 2673 to the full Senate on June 25, 2002. The same day it was revealed that WorldCom had overstated its earnings by more than \$7.2 billion during the past 15 months. The situation was looking almost out of control. It therefore came as no surprise that the Bill was unanimously accepted less than three weeks later on July 15, 2002 (97-0 votes). It was finally signed into law on July 30, 2002.

The new legislation was intended to be wide-ranging and revolutionary. It established new or enhanced standards for all US public companies and accounting firms, but it does not apply to private companies. It covers issues ranging from additional corporate board responsibilities to criminal penalties, auditor independence and enhanced financial disclosure, corporate and criminal fraud accountability. The Act emphasizes the importance of good corporate governance and highlights the link between corporate performance with effective control, oversight, inspection and systematic regulation. It also requires the SEC to implement rulings on requirements to comply with the new law.

The Sarbanes-Oxley Act represents the government's efforts to improve corporate disclosure and reporting, to protect investors and enhance their confidence and to increase the transparency and accuracy of financial statements. Internal monitoring and

regulation of insider misconduct became priorities. It strengthened civil and criminal liability for securities fraud. Audit committees were required to be more independent, while the role and powers of non-executive directors were increased. Corporate loans to directors were prohibited, while internal control certifications, which should be true and fair, were also required of CEOs and CFOs. Corporate governance standards were raised, questionable business practices were no longer welcome and everybody hopes, as Federal Reserve Board Chairman Alan Greenspan said, ‘we will return to the earlier practices of firms competing for the reputation of having the most conservative and transparent set of books’.<sup>14</sup>

One of the most important innovations of the Act has been the creation of the Public Company Accounting Oversight Board (PCAOB). PCAOB is a five-member, private-sector, non-profit corporation whose purpose is to ‘protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports’. Section 101 of the Act contains a list of the powers conferred to the PCAOB and each of these powers is subject to approval and oversight by the SEC. The SEC is also responsible for the appointment and the removal of its members and has the power to approve its budget and modify or overturn PCAOB rules. Section 103(a) of SOX directs the PCAOB to establish auditing and related attestation standards, quality control standards, and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports as required by the Act or the rules of the Commission. The Board is funded principally by fees from public companies, although it

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<sup>14</sup> Petra, S., ‘Corporate Governance Reforms: Fact or Fiction?’, (2006), *Corporate Governance*, Vol. 6, No. 2, 114.

does not regulate them, but it basically oversees the external auditors and the audit procedures of public companies.

As can be easily seen, the Board is not independent and this is an issue which creates controversies. A conservative activist group, the Free Enterprise Fund, and a small Nevada accountancy firm, Beckstead and Watts, LLP, sued the Board, challenging its constitutionality, because it violates the appointments clause of the U.S. Constitution (Article II Section 2). The members of the Board, as officers of the United States, should be appointed by the President with the ‘advice and consent’ of the Senate, not the SEC. The court ruled that the PCAOB is constitutional and does not violate the Constitution's mandated separation of powers among the three federal branches. U.S. District Court Judge James Robertson decided in a 14-page opinion that the plaintiffs lacked standing and was rather critical, finishing his opinion with the comment that the challenge presented ‘nothing but a hypothetical scenario of an overzealous or rogue PCAOB investigator’.<sup>15</sup>

An interesting question is also whether the SEC and PCAOB can work together to enforce Sarbanes-Oxley. When the PCAOB was created, it was taking over areas that had traditionally been the territory of the SEC. So even if we do not adopt the opinion that there is an ‘inevitable bureaucratic arm-wrestle and power struggle’<sup>16</sup> between them or that ‘the SEC was trying to reclaim lost ground’<sup>17</sup>, the two bodies were forced to work together and they had to clearly define their relationship. ‘The law was set up so that the

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<sup>15</sup> FEF v PCAOB Opinion, Case 1:06-cv-00217-JR, Document 57, Filed 03/21/2007, available in the website: <http://law.du.edu/jbrown/corporateGovernance/pcaob/documents/FEFvPCAOBOPinion.pdf>.

<sup>16</sup> ‘SEC-PCAOB arm-wrestle’, (February, 17, 2008), available in the website: [www.softwarefirst.com/50226711/secpcaob\\_arm\\_wrestle.php](http://www.softwarefirst.com/50226711/secpcaob_arm_wrestle.php).

<sup>17</sup> Ibid.

PCAOB should make independent decisions'<sup>18</sup>, according to Kayla Gillan, former member of the PCAOB, but at the same time the SEC should be comfortable with the responsibilities and the standards of the PCAOB. The SEC remains the ultimate authority, however its role is to oversee the PCAOB not to participate and play a more direct role than the one provided for it by the SoX. A positive development is the rewrite of Auditing Standard No. 5 on Financial Reporting (AS5), which was characterized by Michael Oxley as a 'collaborative effort', as 'there was a lot of give and take, back and forth, which is healthy'.<sup>19</sup>

***(i) The Sarbanes-Oxley Act: Criticism and Support***

The jury is still out there as to whether Sarbanes-Oxley has been necessary and whether it provides a practical benefit to the corporate world or not. Extensive and far-reaching reforms traditionally have either strong supporters or sworn adversaries. The same had happened again with the reforms of the 1930s. This is why it is perhaps still too early to make objective and accurate assessments. It takes time for the dust to settle and for everybody to have a clear picture. It is not yet clear whether the balancing exercise will end up in favour of the benefits or the costs. Supporters of the reform believe the legislation was useful and essential, in view of the circumstances at the end of 2001, while critics believe companies were obliged to pay a rather unreasonable price for the Enron's sins.

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<sup>18</sup> Whitehouse, T., 'A Behind-the-Curtain Look at the AS5', Compliance Week, February, 26, 2008, available in the website: [http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article\\_ID=3973](http://www.complianceweek.com/index.cfm?fuseaction=article.viewArticle&article_ID=3973).

<sup>19</sup> Ibid.

Starting with the criticism, the Act has met the condemnation and the disapproval of many academics and financial analysts. First of all, the most popular and well-used argument is about the compliance cost, which is especially high for small public companies. A 2004 study reports a 62% increase in estimated compliance costs since January 2004. A major part of the increase was a doubling of the estimate of executive hours spent on compliance activities.<sup>20</sup> Many of the smaller companies that went public in the late 1990s, along with foreign issuers that entered the U.S. market, are not reluctant to rethink their decision, as they are being forced to consider abandoning public markets for less regulated private markets.<sup>21</sup> It would be unsafe to argue that the Act has opened the exit door, but it has certainly made these companies re-design their strategy. From the time of its enactment, small companies have complained, quite rightly, that the SoX fails to differentiate among firms, so that small and madcap firms have to bear the same burden as Fortune 500 companies.<sup>22</sup>

Some scholars expand this argument to all companies and willingly admit that the SoX, instead of restoring confidence in public companies, has weakened America's stock markets by driving firms into the arms of private-equity buyers and prompting foreign firms to list their shares elsewhere.<sup>23</sup> The London Stock Exchange has successfully marketed its regulatory regime as less costly and more balanced than that of the U.S., and obtained listings from major foreign issuers, including some in Russia and China.<sup>24</sup> The

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<sup>20</sup> Carney, W., 'The Costs of Being Public After Sarbanes-Oxley: The Irony of Going Private', (2005), Emory Law and Economics Research Paper No. 05-4, pg. 7.

<sup>21</sup> *Ibid.*, pg. 1 and 16.

<sup>22</sup> Among others, see Jonathan D. Glater, 'Here It Comes: The Sarbanes-Oxley Backlash', *New York Times*, Apr. 17, 2005, § 3, at 5; see also Matthew Keenan, 'In Scandal Fallout, Small Firms Bear Big Burdens', *Boston GLOBE*, July 4, 2004, at C8.

<sup>23</sup> *The Economist*, 'Sarbanes-Oxley: Five Years under the Thumb', (26 July 2007), New York, available in the website: [http://www.economist.com/displaystory.cfm?story\\_id=9545905](http://www.economist.com/displaystory.cfm?story_id=9545905).

<sup>24</sup> Carney, see above, note 20, pg. 11.

competitiveness of the United States' capital markets was questioned for the first time in 2006 by the Committee on Capital Markets Regulation (Paulson Committee) which came to the conclusion that the 'United States is losing its leading competitive position as compared to stock markets and financial centres abroad'.<sup>25</sup> In 2007, the Paulson Committee's conclusion was also confirmed by another study prepared by McKinsey & Co.<sup>26</sup> Both reports discovered that transactions, listings, and trading volume are migrating to less intensively regulated securities markets, most notably those in London and Hong Kong.<sup>27</sup>

As far as the cost of compliance is concerned, it could be argued that if the expenses could guarantee that accurate financial information is produced at every level of the company, then the cost will be worth it, and costs are likely to decline, once compliance programs are put in place.<sup>28</sup> A commonly used counter-argument to the criticism of the high compliance costs is the fact that the increased expenses are actually one-time expenses. Companies are spending money in order to improve their individual control structure and raise the standards of their financial reporting. Consequently, when they reach the expected level, the compliance costs will be significantly reduced. Experience brings knowledge. This knowledge 'provides corporate leaders with a new lens through which they can evaluate their business—a new means of considering and

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<sup>25</sup> See Interim Report of the Committee on Capital Markets Regulation (November 30, 2006) at ix.

<sup>26</sup> Bloomberg, M. and Schumer, S., in McKinsey and Company, 'Sustaining New York's and the U.S.'s Global Financial Services Leadership' (January 22, 2007), available in the website: [http://www.nyc.gov/html/om/pdf/ny\\_report\\_final.pdf](http://www.nyc.gov/html/om/pdf/ny_report_final.pdf).

<sup>27</sup> Coffee, Jr., J., 'Law and the Market: The impact of Enforcement', (2007), Columbia Law and Economics Working Paper No. 304, pg. 4, available at SSRN: <http://ssrn.com/abstract=967482>.

<sup>28</sup> Skeel Jr., D., 'Icarus and American Corporate Regulation' in Armour, J. and Mc Cahery (eds), *After Enron: Improving Corporate Law and Modernising Security Regulation in Europe and the USA*, Hart Publishing, Oxford and Portland, Oregon, 2006, pg. 144.

controlling risk, improving the quality of their financial reporting, and driving a return on the SoX compliance investment'.<sup>29</sup>

According to a survey from PricewaterhouseCoopers, the CEOs from 30 percent of fast-growing private companies reported that Sarbanes-Oxley has affected their business within the past two years, or will do so in the near future. It is quite surprising to discover that many private companies believe that they have something to gain by embracing the spirit, if not the letter of the Act, although they do not have to comply with it. They see the Sarbanes-Oxley requirements as a best business practice and a way to address future or potential problems.<sup>30</sup>

As a result, the voices of concern regarding the high cost have created a picture of the SoX, which does not fully reflect reality. The arguments have a strong basis, but, at the same time, it would be mistaken to neglect the fact that SoX is a valuable regulatory tool for companies which want a strengthened control environment, and for the public who needs assurances that the ghosts of Enron and WorldCom have disappeared. Accuracy of financial reports, reliable audit controls, and accountability of individuals involved in financial reports and operations are indicatively some of the priorities that were set forth in the aftermath of the scandals. A look through the most objective eyes reveals that compliance with SoX can ensure that the risk of financial fraud will be minimized and the investors' confidence will be restored at least in the long run. This view has attracted a considerable number of supporters, who are not necessarily strongly enthusiastic towards the SoX, but they are in any case more modest in their criticism.

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<sup>29</sup> 'The Benefits and Challenges of Sarbanes-Oxley Compliance', (2005), Knowledge @ Emory, available in the website: <http://knowledge.emory.edu/index.cfm?fa=viewArticle&id=882>.

<sup>30</sup> Taub, S., 'Are Private Companies Embracing Sarbox?', (2005), available in the website: <http://www.cfo.com/printable/article.cfm/4102770?f=options>.

More precisely, there are commentators, who are either as yet unsure, or prefer to wait for the SoX to stand the test of time. Professor Benston's first impression was not extremely positive. 'It's not a bad idea, but it's not very meaningful'. His reaction was primarily based on the fact that 'there is no way that anyone inside a large organization can know everything that goes into the financial statement'.<sup>31</sup> According to the assessment of Cunningham, the Act is indeed an 'achievement, but it cannot be characterized as 'sweeping' substantive 'reform'. It is not a major reform; it is rather a restatement with the force of federal law'. She does not undermine its value, but, to her mind, the Act is 'loud, but not deafening; non-trivial, but not more far-reaching than any reforms since FDR. It just might work. Maybe it deserves a B+'.<sup>32</sup>

Finally, there is a group of supporters, who are not against the new legislation and believe that it signifies an attempt to forget the mistakes of the past and restructure corporate America. They recognize that the new Act was a public-relations triumph, quickly restoring confidence. The reply to the scandals was strong and it was given very quickly. Luigi Zingales, of the University of Chicago, notes that the real value of the new legislation was that the reaction was immediate and without delay, in contrast with Italy, which took 'two years and lots of bickering' to get a new law after an Enronesque scandal at Parmalat'.<sup>33</sup> Generally, the SoX brings benefits that are difficult to dispute. It represents the efforts to bring an improved corporate culture and higher ethical standards to the business world. Accuracy, strong whistle-blower policies, and trust are not tangible

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<sup>31</sup> 'Can the SEC restore investors confidence?', (2002), Knowledge @ Emory, available in the website: <http://knowledge.emory.edu/article.cfm?articleid=563>.

<sup>32</sup> Cunningham, L., 'The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And it Might Just Work)', (2003), Columbia Law Review, Vol. 35, 1005.

<sup>33</sup> The Economist, see above, note 23.

benefits in comparison to the expensive and time-consuming process of compliance.<sup>34</sup> Nevertheless, the primary aim of the new legislation was restoring the investors' confidence and the public's faith after the era of scandals. Confidence and faith are not of a tangible nature either. As SEC Commissioner Cynthia Glassman indicated, 'Sarbanes-Oxley makes clear that a company's senior officers are responsible for the culture they create and must be faithful to the same rules they set out for other employees'.<sup>35</sup>

Additionally, some analysts believe that the Sarbanes-Oxley Act should not be judged independently, in isolation from its wider environment; in other words, the rules and principles that surround it and that put the finishing touches on the legal framework for the operation of modern companies.

### ***(ii) Substantive rules or enforcement?***

Irrespective of what the analysts and academics believe about the SoX, it is essential to deal with this piece of legislation from a different perspective. It is very common to either scan the provisions of the Act trying to find defects or, on the contrary, to unquestionably acknowledge its magnitude based on the intentions of its creators. However, it is more challenging to focus on certain legal aspects and see whether the ends justify the means, and whether the means that were used can fulfill the intended mission. To be more precise, one of the most remarkable legal issues which may be

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<sup>34</sup> Ajilon Finance, 'Weighing the benefits of Sarbanes-Oxley', (2005), San Fernando Valley Business Journal, available in the website: [http://goliath.ecnext.com/coms2/gi\\_0199-4389325/Weighing-the-benefits-of-Sarbanes.html](http://goliath.ecnext.com/coms2/gi_0199-4389325/Weighing-the-benefits-of-Sarbanes.html).

<sup>35</sup> McElveen, M., 'New Rules New Challenges: From Internal Auditors to CEOs, the Sarbanes-Oxley Act is affecting employees at many levels. Learn how key requirements of the act compare to new rules proposed by the U.S. stock exchanges', (December 2002), Internal Auditor, available in the website: <http://www.allbusiness.com/legal/laws/374101-1.html>.

addressed regarding the SoX is this: is the Sarbanes-Oxley Act mainly about substantive rules or about enforcement?

The SoX was intended to shake the foundations of corporate America. It contains a huge number of provisions in an attempt to regulate the conduct of modern companies and to steer them back to the path of law and ethics. The Act has been frequently criticized as being vague and too broad. This is hardly surprising, as the Act sets only the highest level and most general of requirements.<sup>36</sup> Moreover, criticism does not apply to the entire Act. Some of its provisions may well have a substantial and lasting impact on the securities markets, even if unintended consequences will arise.<sup>37</sup>

Before analyzing the rules introduced by SoX, and their enforcement, a mention should be made of deterrence. This aim goes beyond any legal aspect of the Act and represents what the creators of the SoX had in mind. As it is widely known, SoX was born in an environment of scandals, fraud, and corporate mismanagement; as such the primary objective was crime prevention.

From the time of Jeremy Bentham to that of Gary Becker, and even nowadays, everybody stresses the importance of deterrence in finding the best way to fight crime and find the most optimal penalties. Individuals are willing to commit a crime, if the expected benefits exceed the expected benefits of the lawful activity.<sup>38</sup> In other words, it is a matter of balancing options, a matter of choice between risky criminal behaviour and

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<sup>36</sup> Montana, J., 'The Sarbanes-Oxley Act: Five Years Later', (2007), Information/Management Journal, Nov/Dec 2007, pg. 1, available in the website: [http://findarticles.com/p/articles/mi\\_qa3937/is\\_200711/ai\\_n21137912](http://findarticles.com/p/articles/mi_qa3937/is_200711/ai_n21137912).

<sup>37</sup> Perino, M., 'Did the Private Securities Litigation Reform Act Work?', (2002), Columbia Law and Economics Working Paper No. 211, St. John's Legal Studies Research Paper.

<sup>38</sup> Perino, M., A., 'Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002', (2002), Columbia Law and Economics Working Paper No. 212, St. John's Legal Studies Research Paper, pg. 5.

risk-free legitimate conduct.<sup>39</sup> It is not easy to understand the mentality of a criminal, especially of a prospective one, and lawmakers cannot rely entirely on the science of psychology, in order to prevent criminal behaviour. The first step that should be taken is to increase the probability of detection and conviction even before introducing higher penalties and stricter punishment. The same applies to almost all areas of law. If we focus now on company law, corporate crime can be more efficiently eliminated by an optimal mix of enforcement resource and the severity of punishment that maximizes social welfare.<sup>40</sup> This is what SoX should represent. It is quite premature to try and find a definite answer to the question of whether the SoX has the potential to prevent corporate crime and succeed in its deterrent operation. That is a question to be answered in the long run due to the nature of the problem and the complexity of the corporate governance structure.

The Sarbanes-Oxley Act is a wide-ranging statute which contains a list of corporate obligations and responsibilities concerning financial controls and disclosure requirements. Everyone involved in the operation of publicly traded companies is directly or indirectly affected. If our centre of attention strays beyond the big and inspired headlines of newspapers and journals about the new sweeping legislation, the SoX has not really changed pre-existing law all that much. Most of the core issues have long been under debate and nobody could be sure whether the fundamental philosophy of the US accounting standards has radically changed or new principles of financial reporting have been established.<sup>41</sup> Once again there is no unanimity among academics on this issue and

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<sup>39</sup> Ibid.

<sup>40</sup> See Polinsky, M. and Shavell, S., 'The Economic Theory of Public Enforcement of Law', (2000), *Journal of Economic Literature*, Vol. 38, No. 1, 45-76.

<sup>41</sup> Cunningham, L., see above, note 32, pg. 930-1.

there are a variety of different opinions expressed. Some observers strongly believe that the SoX ‘contains some of the most far-reaching changes that Congress has ever introduced to the business world’<sup>42</sup> or, conversely, that its ‘rulemaking has consisted of fairly minor tinkering with small bits of existing rules’.<sup>43</sup>

As it occurs in many similar situations, the truth lies somewhere in the middle. The SoX has not changed the existing law all that much and has not gone far beyond the already existing securities laws, exchange rules, and best practices,<sup>44</sup> but it has made some significant contribution to the regulatory regime. To begin with, it is noteworthy that some rules have become part of a federal law and their provisions will be given effect. As a result, auditors, directors and company officers will, in all probability, start performing their fiduciary duties more diligently and with a greater willingness out of fear of liability. In this way, emphasis has been given to these new, federally mandated, responsibilities, but there is no evidence of an intention to drastically modify the rules governing board organization and internal controls.<sup>45</sup> Pre-SoX the aim of internal controls was not to prevent fraud but the audit’s assessment of internal controls was simply a way of gaining confidence in the company's numbers.<sup>46</sup> After the SoX all companies have put their internal control under review. The Congress did not initially intend to affect the existing directors’ duties. Duties of loyalty, good faith, and care remain the same, but the Act has raised the bar for what would be a director's minimum reasonable conduct, and

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<sup>42</sup> Barry C. Melancon, ‘A New Accounting Culture’, (Sept. 4, 2002), available in the website: <http://www.aicpa.org/pubs/jofa/oct2002/melancon.htm> .

<sup>43</sup> Montana, see above, note 36.

<sup>44</sup> McDonnell, B., ‘Sarbanes-Oxley, Fiduciary Duties, and the Conduct of Officers and Directors’, (2004), Minnesota Legal Studies Research Paper No. 04-13, pg. 48, available in the website: <http://ssrn.com/abstract=570321>.

<sup>45</sup> Ibid.

<sup>46</sup> Langevoort, D., ‘Internal Controls after Sarbanes-Oxley: Revisiting Corporate Law's Duty of Care as Responsibility for Systems’, (2006), 31 J. Corp. L. 959.

behaviour that was once considered negligent may now be considered grossly negligent, as Professor Burch explains.<sup>47</sup>

The SoX is a sweeping Act in the sense that it covers a considerable number of topics and it has an effect on the vast majority of people involved in the world of companies. Nevertheless, there is nothing sweeping in the substance of the rules and it certainly did not massively change the legal corporate environment. If we use this as a basis, we need to look for the real reason behind the perception that SoX has been unquestionably and remarkably sweeping. Substantive rules were there long before SoX, but scandals were not prevented. More severe critics argue that ‘virtually all the changes brought by SoX were already in effect as a matter of custom or practice and/or due to requirements imposed by stock exchanges, regulators, state law, or other provisions of federal law’.<sup>48</sup> Further disclosure requirements are a positive step, but just the stricter character of the new rules does not serve as an explanation for the noticeable change in the behaviour of all the participants in the corporate governance game. One possible explanation, which was given, was that the probability of serious liability, uncertainty as well as the possibility of more vigilant enforcement may explain some change, but it was considered to be relatively formalistic.<sup>49</sup>

At this point, the issue of enforcement enters the discussion. Although there are not many new crimes, there has been a significant increase in the penalties for the existing crimes. The increase covers sentences comprising both fines and imprisonment. The companies’ executives, directors, and auditors face augmented fines and penalties for

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<sup>47</sup> Burch, R., ‘How Sarbanes-Oxley Changed Directors’ Duties on the State Court Level’, (2007), Wyoming Law Review, Vol. 6, No. 2, 481.

<sup>48</sup> Cunningham, L., see above, note 32, pg. 19.

<sup>49</sup> McDonnell, see above, note 44.

intentional destruction or falsification of records, wilfully defrauding shareholders of publicly traded companies, white collar crimes, failure to certify financial reports etc. Criminal liability includes imprisonment for up to twenty years, and there are penalties not only for wilful misconduct, but for negligence as well.

However, longer sentences and larger fines do not necessarily mean that the SoX will eliminate corporate crimes. Crime deterrence is dependent not only on the enhanced penalties, but on the probability of detection and successful prosecution. So, assuming that the maximum sentence for securities fraud is doubled by new legislation, but this increase has no effect on the probability of detection and successful prosecution, then enhanced criminal penalties do comparatively little to deter crime.<sup>50</sup> Likewise, fines will probably be inadequate to deter fraudulent activity where the optimal fine exceeds the defendant's ability to pay.<sup>51</sup> As it was stated above, deterrence comes as a result of the combination of severity of punishment and enforcement resources. Enhanced penalties were the first steps in giving criminals 'hard time', instead of 'easy money', according to President Bush's words.<sup>52</sup>

Despite the questionable success of enhanced penalties and the promotion of SoX as the powerful regulatory weapon against fraud, the truth is that the United States have shown remarkable intensity in their enforcement policy and give the impression that they are more dynamic and active than any other country. Coffee Jr gives a number of reasons as an explanation for this commitment, such as the American federal system and populist political tradition, the recent scandals and especially the broad retail ownership of

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<sup>50</sup> Perino, see above, note 38, pg. 16.

<sup>51</sup> Ibid.

<sup>52</sup> Elisabeth Bumiller, see above, note 13.

securities.<sup>53</sup> The United States rejected the advisory and consulting enforcement style, adopting instead a stricter approach towards the regulated entities with emphasis on enforcement actions and the imposition of sanctions.<sup>54</sup> This has led to significant increase in the SEC's authority for both oversight and rulemaking, and also for responsibilities, which were already extensive. Its resources were also significantly increased, as an adequate budget is as vital as adequate power for the Commission to be effective as much. The SEC's budget has seen an increase of 3.2% from 2007 to 2008, bringing it to \$905 million. The SEC is currently operating with a budget of \$877 million. SEC Chairman Christopher Cox said that extra funds are necessary so as for the SEC to have the tools it needs 'to address new, emerging risks in the nation's capital markets'. He also said that the SEC itself is not exempt from the need to modernize and improve and he promised that in 2008 the SEC would continue to improve its 'internal financial controls,' upgrade its financial system and provide better security for its information systems.<sup>55</sup>

Given the fact that the SEC will make good use of the enforcement resources, crime detection and subsequently crime prevention will be more effective. A strong ally in the SEC's attempts is the PCAOB, which was also granted extensive powers and is focused on the oversight of external auditors of the publicly held companies. It remains to be seen, as discussed earlier, whether the two bodies will combine their powers and coordinate their efforts.

As is becoming apparent, the SoX is more about enforcement rather than new rules and different regulatory framework for listed companies. There is neither a correct

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<sup>53</sup> Coffee, see above, note 27, pg. 74-75.

<sup>54</sup> Ibid., pg. 29.

<sup>55</sup> Rappoport, A., 'Will SEC's Budget Focus Spell Corporate Relief?', (2007), CFO.com, Regulatory Issues, available in the website: <http://www.cfo.com/article.cfm/8915870?f=related>.

nor an incorrect answer to this question, for the reason that it is not clear what exactly was expected of a law that was the result of a compromise between the Senate and the Congress, finalised in great haste just in order to put a stop to corporate malfeasance. In retrospect, the SoX was nothing but a rushed legislative reaction to Enron and WorldCom, which failed to deal with all the fundamental causes and merely responded to the symptoms of a deeper malaise.<sup>56</sup> Since Enron was representing the future of the modern business model, its failure should have led to a reconsideration of this model and its fortification against future similar threats. Unfortunately, the bloom of creative possibilities was replaced by the blight of endless fears of compliance violations.<sup>57</sup> The next section will examine the two most significant provisions that the Act introduced, their goals, and the impact they had on the business community. We will return to the issue of the Act's focus before concluding, when discussing the need for SoX's revision or not.

### ***(iii) The Sarbanes-Oxley Act: New provisions***

Two of the sections of the SOX that pose particularly significant implementation and compliance challenges are sections 302 and 404. Dozens of pages have already been written already about these two provisions, the application of which has caused great controversy amongst academics worldwide.

Before talking about the two provisions in detail, it is interesting to go a few years back in time and see for one more time that history repeats itself. The spirit of sections

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<sup>56</sup> Tomasic, R., 'And They All Lived Happily Ever After?' – Improving Corporate Law after Enron: A Review Essay (2009). Australian Journal of Corporate Law, Vol. 20, No. 2 , 232-241 at 238.

<sup>57</sup> Hunter, B., 'Punishing the Innocent: The Sarbanes-Oxley Act', The Freeman, March 2007, Volume 57, Issue 2, available in the website: <http://www.thefreemanonline.org/featured/punishing-the-innocent-the-sarbanes-oxley-act/#>

302 and 404 is not something entirely innovative in the area of securities regulation. In October of 1987 the Commission on Fraudulent Financial Reporting, better known as the Treadway Commission, published a report, in which it stressed how important it was for the top management of public companies to identify, understand, and assess the factors that may cause the financial statements to be fraudulently misstated. As a result, the SEC proposed rules in 1988 that bear striking similarities to SOX sections 302 and 404. Unfortunately, the proposals were not enacted, as they met with the disapproval of a wide range of interest groups.<sup>58</sup> This situation changed after about fifteen years when the scandals and the international corporate governance crisis made everyone reconsider. The situation was much more serious than the situation which led to the creation of the Treadway Commission. Inevitably, the issues of fraudulent and unreliable financial reporting had become prominent again. SoX is dealing with them mainly through section 302 concerning Corporate Responsibility for Financial Reports, and section 404, which covers Management Assessment of Internal Controls.

Simply put, these sections require that the CEO and CFO of an organization certify and assert to stakeholders that SEC disclosures, including the financial statements of the company and all supplemental disclosures, are truthful and reliable, and that the management has taken appropriate steps to satisfy themselves that the disclosure processes and controls within the company they oversee are indeed capable of consistently producing financial information stakeholders can rely on (Section 302). The

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<sup>58</sup> Leech, T., 'PCAOB & SEC Regulatory Expectations: 17 Steps to SOX 302/404 Compliance', (2005), Paisley Consulting White Paper, pg. 4, available in the website: [http://www.paisleyconsulting.com/website/pweb.nsf/vw\\_ContentByDocID/JMPN-6BMKUS/\\$File/17\\_STEPS\\_WHITEPAPER.PDF](http://www.paisleyconsulting.com/website/pweb.nsf/vw_ContentByDocID/JMPN-6BMKUS/$File/17_STEPS_WHITEPAPER.PDF)

company's external auditor must report on the reliability of management's assessment of internal control (Section 404).<sup>59</sup>

Firstly, section 302 requires that the CEOs and CFOs certify the accuracy of financial statements. These individuals must certify that they are 'responsible for establishing and maintaining internal controls' and 'have designed such internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared'. Disclosure, financial or otherwise, should be complete and accurate, companies are expected to evaluate the effectiveness of their internal controls over information reported to the financial markets, and management is obliged to put focus on establishing, maintaining, and regularly evaluating internal and disclosure controls. All these new internal procedures constitute a clear attempt at promoting financial disclosure. Unlike section 906, which requires a similar certificate but carries criminal penalties, only civil liability arises from section 302.

Section 404 is listed under Title IV of the Act (Enhanced Financial Disclosures), and, although only 169 words in length, has come to the centre of attention. It requires both the management and the external auditor to produce an 'internal control report' on the adequacy of the company's internal control over financial reporting. The report must affirm 'the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting' and also must contain an 'assessment, as of the end of the most recent fiscal year of the company, of the effectiveness of the internal control structure and procedures of the issuer for financial

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<sup>59</sup> Ibid.

reporting'. Choosing the end of the fiscal year was not random. This time was selected in order to give companies the time to detect any misstatements at an early stage. The true value of this section, apart from the self-evident assessment of companies' internal control, is that it ensures that the management and the external auditors have understood the importance of the fact that the assessment of the companies' controls over financial reporting should be detailed and accurate.

When the discussion turns to the necessity or the success of section 404, the cost of compliance turns out to be a major source of controversy. Nobody denies that the cost of complying with section 404 is significant and small companies are in a more disadvantaged position, due to the fact that there is a significant fixed cost involved in documenting and testing the financial controls. For example, in 2004 U.S. companies with revenues exceeding \$5 billion spent 6% of their revenue on compliance with the Sarbanes-Oxley Act, while companies with less than \$100 million in revenue spent 2.55%.<sup>60</sup> The SEC estimates that companies will collectively spend 5.4 million staff hours each year complying with SoX, and AMR Research estimates that US companies will spend \$6.1 billion on manpower, IT, and consultancy services.<sup>61</sup>

Section 404 aims at improving the quality of financial reporting of publicly traded companies. Companies are required to monitor their internal controls and procedures for financial reporting, and to test their effectiveness. There can be no denying that the compliance cost is considerably higher than before SoX, particularly for companies with incomplete or insufficient procedures. Moreover, the companies and the public were

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<sup>60</sup> Final Report of the Advisory Committee on Smaller Public Companies to the United States Security and Exchange Committee (2006), pg. 33-34.

<sup>61</sup> CFO The Magazine for Senior Financial Executives. 'Sticker shock: the true cost of Sarbanes- Oxley compliance', (2003), Vol. 19, No. 11, pg. 50.

craving for protection, but during the panic nobody considered the possible cost of the governments' initiatives to fight fraud and restore investors' confidence. It was immaterial during a period of sharp price declines, instability, and insecurity for the future of companies. It was only once when the dust had settled that business people, scholars and practitioners that started to talk about the costs of compliance.

This very commonly expressed, though one-sided, view about the costs and benefits of SoX holds that the net costs are larger than the benefits. This is because the costs always tend to be more obvious than the benefits. Therefore, the SoX can be easily classified under the label 'counterproductive'. Large amounts of executive time and company resources are required to meet the requirements of section 404. Based on the most recent survey of its members, Financial Executives International (FEI) says that the expected average first-year cost is 27,000 hours of internal time for companies with an average of \$5 billion in sales. As to the anticipated total costs of compliance, FEI found that the average first year expenditure was \$4.36 million, including \$1.34 million in internal costs; \$1.30 million in audit fees and \$1.72 million in external costs (consulting and software).<sup>62</sup>

However, one could also interpret the evidence in a different way. Maintaining strong and efficient controls is of critical importance. At the same time, internal control reporting is not free. There is no doubt that one of the main objectives of the Sarbanes-Oxley Act was to restore investors' confidence in financial reporting. Hence, its success should be primarily measured on the basis of whether the Act has helped in maintaining the public's confidence. As far as poor stock returns are concerned, a behavioural

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<sup>62</sup> Financial Executives International (FEI) Survey on SOX Section 404 Implementation (March 2005), available in the website: [http://www2.financialexecutives.org/files/spacer.cfm?file\\_id=1498](http://www2.financialexecutives.org/files/spacer.cfm?file_id=1498).

perspective would suggest that it is possible that SoX-compliant firms experienced poor post-SoX stock returns because they probably lost their abilities to fool naive investors.<sup>63</sup>

Following the introduction of the new legislation, public companies were in a dilemma. The passage of the Act affected accounting and audit costs, by increasing them significantly.<sup>64</sup> The dilemma was mostly theoretical, as companies had no other choice but to do whatever was necessary in order to reach the standards of the Act and to comply with the new requirements. They had no choice because their compliance was, and is still being, constantly monitored, both internally and externally. As a result companies, predominantly small ones, were forced to exit the public market. A 2004 survey of 110 companies that went private between 2001 and 2003 showed that the cost of being public was the number one reason cited for going private by smaller firms, relating this directly to the passing of the Act.<sup>65</sup>

#### ***(iv) Concurrent initiatives: Listing Rules***

Concurrent with the passage of Sarbanes-Oxley, the SEC, the New York Stock Exchange (NYSE), and the Nasdaq Stock Market, Inc. (NASDAQ) embarked on a complete rewriting of corporate governance standards for publicly traded companies, adding a series of independence requirements. Together, they were determined to be in

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<sup>63</sup> Iliev, P., 'The Effect of the Sarbanes-Oxley Act (Section 404)', (2007), Job Market Paper, available at SSRN: <http://ssrn.com/abstract=983772>.

<sup>64</sup> See Asthana, S., Steven B., and Sungsoo K., 'The Effect of Enron, Andersen, and Sarbanes-Oxley on the Market for Audit Services', (2004), Working Paper, Temple University.

<sup>65</sup> See Block, S., 'The Latest Movement to Going Private: An Empirical Study', (2004), Journal of Applied Finance, Vol. 14, No. 1.

line with the new federal rules and, at the same time, to take a fresh look at the corporate governance listing standards.<sup>66</sup>

Their objective was to increase board independence by mandating that: boards be composed of a majority of independent directors; boards have powerful audit, compensation, and nominating/governance committees composed of independent directors;<sup>67</sup> boards of directors and independent audit committees to be responsible for the oversight of financial reporting in companies on the behalf of the investors. Non-executive directors are not *a priori* the solution to the problem of effective internal control, if they have neither the time to spend on the company, nor strong incentives to monitor management nor the necessary information to use in order to express their ‘independent’ opinion. High standards of performance are essential as well as a clear set of goals to focus on. That’s why, board members, who cannot perform their duties due to a lack of skills or cannot understand the complexities of the business due to a lack of expertise, should be replaced. What is really needed, as Kraakman and Gilson suggested in 1991<sup>68</sup>, is a set of professional directors, who will devote a substantial amount of quality time to the company, overseeing its executives and monitoring its operation.

Two more issues that the SEC, the NYSE, and NASDAQ reflected on were the remuneration packages and the role of auditors.

First of all, remuneration packages should be proportional to the directors’ performance given their central role in a company’s operation. Mostly, though,

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<sup>66</sup> Kim, K., and Nofsinger, J., *Corporate Governance*, 2<sup>nd</sup> ed., Pearson Prentice Hall, New Jersey, 2007, pg. 137.

<sup>67</sup> House Committee on Financial Services, ‘Rebuilding Investor Confidence, Protecting U.S. Capital Markets’ - The Sarbanes-Oxley Act: The First Year, (2003), available in the website: <http://www.iasplus.com/resource/0307soxreport.pdf>.

<sup>68</sup> Kraakman, R., and Gilson, R., ‘Reinventing the Outside Director: An Agenda for Institutional Investors’, (1991), 43 Stanford Law Review 863.

remuneration packages depend on a manager's power and influence. Bebchuk and Fried accept as true that there is a link between managerial power and pay.<sup>69</sup> The easiest way to achieve high standards of performance is by weakening the link between performance and compensation. Bonuses that create incentives are desirable, only when awarded for exceptionally good performance. Stock options and bonuses should be awarded as a motive for the directors and managers to be more effective not as added pressure to meet the targets regardless of costs. Stock options come with the risk of creating conflicts of interest, simply because executives will do anything to keep the price of the stock high, even at the expense of the company's long-term strategy and welfare. The case studies in the previous the chapter offer numerous examples of executives, who were engaged in actions that fundamentally endangered their companies by taking excessive risks. Such behaviours were primarily initiated by the structure of the incentives' scheme itself, and other factors, such as the unstrained competition.<sup>70</sup>

A characteristic paradigm is the NYSE chairman and chief executive, Richard Grasso. On September 2003, Richard Grasso stepped down following a decision of the Exchange board. This decision came as a result of controversy concerning the size of his deferred compensation package. The controversy was caused not by the \$140 million value of the pay package, but by the authority and influence he had as NYSE chairman on the compensation committee. Therefore, a company should make reasonable use of such grants to executives, in order to avoid unpleasant situations in the future.

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<sup>69</sup> Bebchuk, L., and Fried, J., *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, Harvard University Press, UK and USA, 2004, pg. 80.

<sup>70</sup> Armour, J. and McCahery, J.A. (eds), *After Enron: Improving Corporate Law and Modernizing Securities Regulation in Europe and the US*, Hart Publishing, Oxford and Portland, 2006, pg. 131.

It is not by coincidence that long before the scandals there were proposals and recommendations for independent remuneration committees. Regrettably, these recommendations were either not followed or not properly implemented. The reasons were various: the complexity of matters that remuneration committees had to deal with, the increasing workload, the time commitment required and the high risk involved. If such committees had been created in all companies and had laid the foundation for good practice, then the outcome would have been different.

Secondly, accounting firms should be vigilantly inspected and disciplined in their roles as auditors of public companies. Auditors should try hard to change the way in which they are regarded by the business community. They should prove that they can overcome the bankruptcies and financial restatements of the previous years and that they are able to perform their duties, and more precisely, that they can investigate, and limit, to an acceptable level, all aspects of corporate business risk and corporate misconduct risk. Auditors must draw a clear line between accidental book-keeping errors and intentional financial statement fraud.<sup>71</sup> The impact is always negative in both scenarios, namely when accounting firms failed to discover accounting misconducts, because of negligent or not thorough investigations and when they choose not to report misconduct, in order not to jeopardize their contract with a particular company.

In November 2003, the SEC finally approved changes in the listing standards for both the NYSE's and for the NASDAQ. It is worth mentioning that the NASDAQ Rules are consistent in concept with, although not entirely identical to, the NYSE Rules. In any case, it was a positive development in the area of corporate governance, as the SoX,

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<sup>71</sup> Kinney Jr., W., 'The auditor as Gatekeeper: A Perilous Expectation Gap' in Lorsch, J.W., Berlowitz, L., and Zelleke, A. (eds), *Restoring Trust in American Business*, American Academy of Arts and Sciences, MIT Press, 2005, pg. 101.

together with the revised NYSE and NASDAQ listing standards, created new corporate governance standards. They affected the composition of the boards of directors and board committees of listed companies and contribute to increased disclosure and independence.

***(v) Implications of the Sarbanes-Oxley Act for non-US companies***

The next issue that needs to be discussed is how non-US companies perceive the compliance with SoX. Non-US companies were not exempted from the rules imposed by the Sarbanes-Oxley Act, even though the SEC traditionally used to provide exemptions for non-US issuers. The SEC had adopted this policy on the grounds that issuers would be discouraged from registering securities in the US capital markets, if new rules were an extra and unwarranted burden for them in having access to these markets. However, the SoX stipulates that even a foreign company listed on a U.S. exchange must meet all the new requirements if its shareholders include at least 300 Americans (even if they have merely invested indirectly through funds).

This rather strict approach was only mitigated, to a certain extent, for certain provisions which were indeed placing additional burdens on non-US companies. Compliance with the provisions of section 404, for example, was delayed by a year, until July 15, 2006: the reason being a failure by companies to be adequately prepared. This 12-month extension was granted in order to give non-US companies sufficient time to deal with the new rules and to put the correct processes and procedures into place. At the same time, full exemption for non-US companies, foreign private issuers, to be precise, was only provided for a limited number of provisions, For instance, the Regulation

Blackout Trading Restriction (Regulation G), as under Section 306(a) of the Act most non-US issuers are not required to file Form 8.

The main argument against the application of the SoX to non-US companies is basically the same argument that is used by its opponents in general. They suggest that the SoX was born in an environment of emergency and political flurry caused by major corporate scandals. Corporate America was in a state of panic and SoX was the jolt that would bring it back on course. Under such circumstances, the architects of the Act had no time to take into consideration all the relevant parameters, and did not have the clear mind necessary to enable them to identify all the flaws of the system and to address all the possible problems. Hence, the new legislation can be modestly characterized as incomplete. Irrespective of whether there is the intention for making additions, or merely for applying the finishing touches, it is not wise to extend the application of the Act to companies all around the world.

Moreover, there are doubts as to the feasibility of the Act outside the US, mostly because of the different cultures and norms governing the other countries of Asia and the EU, not to mention the different accounting methods and standards. For example, the United States belongs to the group of countries with dispersed ownership legal regimes, so the SoX is primarily designed for a system different to that most present in most European countries. Even the governance system of the UK is considered to be more rigorous and more shareholder-friendly than that of the USA.<sup>72</sup> Evidence reveals that the SEC has understood the complexity that such a procedure may raise and is therefore willing to allow non-US companies time to comply with the SoX requirements.<sup>73</sup>

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<sup>72</sup> Coffee, Jr., J., see above note 27, pg. 58-59.

<sup>73</sup> BBC News (03 March 2005), available in the website: <http://news.bbc.co.uk/1/hi/business/4314365.stm> .

An example showing the scepticism of the SoX is the wave of withdrawals by the UK companies, which are listed on the US Stock Exchange, since the introduction of the Act. In 2002, the majority of the UK companies asked for an exemption from, or at least an alleviation of, the measurement of the Act that applies to the non-US companies.<sup>74</sup> The French Association of Privatized Industry also joined their German, British, Greek, Dutch, Italian, Austrian, Swiss, and Polish counterparts in an effort to persuade the SEC, to liberate them.<sup>75</sup> Similarly, some companies in Japan also had second thoughts about doing business in the USA, because of the fact that they would inevitably have to accept the costs of complying with the new rules.<sup>76</sup> It is indeed sad that foreign firms view the U.S. financial markets, which were once the shining example of freedom and opportunity in the world, as something from which to be “liberate[d]” or “allowed to leave,” but are “trapped” or “held captive” by “repressive” U.S. laws.<sup>77</sup>

It is clear that there is scepticism surrounding the benefits that a non-US company would gain from complying with the Act. Advantages are compared to the disadvantages, and all interested parties are trying to find the right equilibrium. Shortly after the enactment of the Act, trading in American depository receipts had reached its lowest level in the last ten years. In April of 2003 the SEC exempted foreign companies from some of the Act’s more burdensome requirements. There was not full exemption, though, as CEOs are still obliged to certify financial results and accept personal criminal liability if the statements are proven invalid. In practice, this decision did not radically improve

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<sup>74</sup> BBC News (15 August 2002), available in the website: <http://news.bbc.co.uk/1/hi/business/2195451.stm>.

<sup>75</sup> Hunter, see above note 57.

<sup>76</sup> The Evening Standard (London) - (11 July 2005), available in the website: <http://www.thisislondon.co.uk/standard/>.

<sup>77</sup> Hunter, see above, note 57.

the situation, as foreign companies were reluctant to adopt the strict accounting rules.<sup>78</sup> Such unwillingness can be primarily attributed to the lack of such strict rules in the domestic laws of other countries. Stricter rules and additional obligations always create uncertainty, insecurity and reluctance to comply with the new rules. Companies, accustomed to complying with a certain regime, can easily be unenthusiastic towards the new status quo for fear that it will be more onerous for them. Interestingly, a survey in 2008, despite using a limited sample of only 59 de-registering companies, did not find any reliable evidence that foreign listed firms suffered as a result of the SoX or, that the SoX had a more adverse impact on de-registering companies and showed that these companies did not benefit from their de-registration announcements.<sup>79</sup>

Finally, a solution, of sorts, was offered with the introduction of Rule 12h-6 in 2007 which changed the de-registration requirements and made it easier for non-US companies to de-register from the US markets and re-list in another jurisdiction. This change was warmly welcomed and was followed by a large number of de-registrations.

#### ***(vi) The Sarbanes Oxley Act: Positive or Negative?***

In a nutshell, the Sarbanes-Oxley Act is indeed a landmark piece of legislation as far as disclosure, enhanced corporate accountability and responsibility, independence of audit committees and financial reporting is concerned. It was created as a means to prevent fraudulent behaviour in financial statements and to restore investors' confidence

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<sup>78</sup> Koehn, J.L. and Del Vecchio, S., Ripple Effects of the Sarbanes-Oxley Act, (February 2004), The CPA Journal Online, available in the website: <http://www.nysscpa.org/cpajournal/2004/204/essentials/p36.htm> .

<sup>79</sup> Doidge, C., Karolyi, A. and Stulz, R.M., 'Why do foreign firms leave U.S. equity markets? An analysis of deregistrations under SEC Exchange Act Rule 12h-6', (2008), Working Paper Series 2008-14, Ohio State University, Charles A. Dice Center for Research in Financial Economics, pg. 28, available in the website: <http://neumann.hec.ca/cref/sem/documents/080926.pdf>.

after the hurricane of corporate scandals that razed the corporate governance construction to the ground.

The academic community is still far from being unanimous on its evaluation. This divergence goes beyond the self-evident division between supporters and critics. There are critics who have reservations about its effectiveness and draw attention to the compliance costs.<sup>80</sup> They consider the Act to be nothing more than a ‘patchwork and codified response by Congress to widely publicized financial scandals’, ‘with no direct impact on improving corporate governance and financial disclosures, at least beyond those of market-based mechanisms’.<sup>81</sup> At the same time, other critics generally concluded that the Act’s costs are substantial, while the benefits are small, and have described the Act as ‘quack corporate governance’.<sup>82</sup> Others, like Bainbridge, focus on the political motivation behind it and the quality of its content. ‘Congress and the regulators have implemented a set of reforms that are deeply flawed. They have adopted policies that have no empirical support or economic justification. Worse yet, in doing so, they have eviscerated basic federalism rules that have long served us well’.<sup>83</sup> More recently, he concluded that the Act ‘sacrificed the American economy at the altar of short-term political gain’.<sup>84</sup>

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<sup>80</sup> See Ribstein, L., ‘Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002’, (2002), *Iowa Journal of Corporate Law*, Vol. 28, No. 1, pg. 1.

<sup>81</sup> Rezaee, Z. and Jain, P. K., ‘The Sarbanes-Oxley Act of 2002 and Security Market Behaviour: Early Evidence’, (2006), *Contemporary Accounting Research*, Vol. 23, Issue 3, 629–654 at 630.

<sup>82</sup> See Romano, R., ‘The Sarbanes-Oxley Act and the Making of Quack Corporate Governance’, (2005), *Yale Law Journal*, Vol. 114, 1521.

<sup>83</sup> Bainbridge, S.M., ‘The Creeping Federalization of Corporate Law’, (2003) *Regulation*, at 30, available at the website: <http://ssrn.com/abstract=389403>; see also Bainbridge, S.M., ‘Director Primacy: The Means and Ends of Corporate Governance’, (2003) 97 *Nw. U. L. REV.* 547, 562.

<sup>84</sup> Bainbridge, S.M., ‘Sarbanes-Oxley: Legislating in Haste, Repenting in Leisure’, (2006), *UCLA Sch. of Law, Law & Econ. Research Paper Series*, Research Paper No. 06-14, pg. 15, available at the website <http://ssrn.com/abstract=899593>

On the other hand, there are scholars who have suggested that the Act's importance has been overstated and predicted its effect to be modest.<sup>85</sup> Perino asserts that the Act was in reality a response to the increased political fire storm and the pressure on the Congress, as the new criminal liability provisions criminalized little conduct that was not already criminal under existing statutes.<sup>86</sup> More explicitly, the reform measures 'reflected previously accumulated policy positions that were based on experience, anecdotes, general policy arguments, and the outcome of long-running competitive posturing by "good corporate governance proponents" and their targets'.<sup>87</sup>

Finally, there are supporters, who are convinced that the Act will improve corporate governance and strengthen financial markets in the long-run.<sup>88</sup> Wiesen suggested that it is 'as broad an attempt to correct free market externalities as any legislation passed by the federal government in recent memory...it deals with what people do, not where securities go'.<sup>89</sup> A study of the early evidence of the SoX found that it has served as a 'stimulus to encourage initiatives for rebuilding the public confidence in corporate governance, the financial reporting process, and audit functions'.<sup>90</sup> In the same

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<sup>85</sup> Among others, see Cunningham, L., 'The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)', (2003), Connecticut Law Review, Vol. 35, 915 and Ahdieh, R.B., 'From "Federalization" to "Mixed Governance" in Corporate Law: A Defence of Sarbanes-Oxley', (2005) 53 BUFF. L. REV. 721, 721-23.

<sup>86</sup> Perino, M., 'Symposium Enron and its Aftermath: Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002', (2002), 76 St. John's L. Review. 671-698. See also Gordon, J., 'Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley', (2003), Columbia Law and Economics Working Paper No. 216; Harvard Law and Economics Discussion Paper No. 416 and Bainbridge, S., and Johnson, C., 'Managerialism, Legal Ethics, and Sarbanes-Oxley Section 307', (2003), Law Review of the Michigan State University-Detroit College of Law, Research Paper No. 03-13.

<sup>87</sup> Clark, R.C., 'Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too', (2005), Discussion Paper No. 525, 22 Georgia State Law Review 251- 291 at 253.

<sup>88</sup> Among others, Mitchell, L., 'The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?', (2003), Villanova Law Review, Vol. 48, 1189. See also, Brickey, K., 'From Enron to WorldCom and Beyond: Life and Crime After Sarbanes-Oxley', (2003) Washington Univ. Law Quarterly 81, 357 – 401.

<sup>89</sup> Wiesen, J., 'Congress Enacts Sarbanes-Oxley Act of 2002: A Two-Ton Gorilla Awakes and Speaks', (2003), Journal of Accounting, Auditing, and Finance, Vol. 18, Issue 3, 429-448 at 429.

<sup>90</sup> Rezaee and Jain, see above, note 81 at 654.

context, the SoX clearly had a positive effect on the accuracy of financial disclosure, as the increasing number of restatements among all types of companies, but particularly larger ones, since its adoption has indicated.<sup>91</sup> The early evidence in 2006 showed that the over-valuation that resulted from the inaccurate financial statements was estimated at \$63 billion on an adjusted basis.<sup>92</sup>

It is an extremely difficult task to conclude with convincing evidence whether the SoX in its entirety was a successful initiative or a costly regulatory overreaction. It was argued before that most of its provisions did not introduce new requirements or any radically different procedures. In addition, companies had to meet higher standards not only due to the SoX coming into force, but also pursuant to the updated listing rules adopted by the stock exchanges. Regarding the costs, new legislation created new incentives for companies to spend more money on internal audits, above and beyond the significant increase in audit costs after the scandals. In exchange for these higher costs, SoX promised a variety of long-term benefits, such as a lower risk for investors of losses from fraud and theft, more reliable financial reporting, and greater transparency and accountability, while the American economy would benefit from a better allocation of resources and faster growth.<sup>93</sup> Therefore, since the full costs are hard to quantify, and the benefits even harder, it would be more prudent to test whether it has been successful in its aims; in other words, whether it has accomplished what its creators intended to, whether

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<sup>91</sup> Reilly, D., 'Restatement Blame: Basic Mistakes', WALL ST. J., Nov. 20, 2006, at C4 in Brown, Jr., R., 'Criticizing the Critics: Sarbanes-Oxley and Quack Corporate Governance', (2006), Marquette Law Review, Vol. 90, 309 at 327-8.

<sup>92</sup> U.S. Gov. Accountability Office, GAO-06-678, Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities 11-12 (2006).

<sup>93</sup> Coates, J.C. IV, 'The Goals and Promise of the Sarbanes-Oxley Act', (2007), Journal of Economic Perspectives, Vol. 21, No. 1, 91-116 at 92.

it will stand the test of time, and whether it was the most practical solution given the circumstances.

Starting with the publicly traded companies, they were directly affected by the SoX and had to fully comprehend and effectively put the rules into practice. Going beyond the compliance costs issue, what can be said is that those companies, which took the opportunity to change their business culture by increasing transparency, putting effective internal control systems in place, and investing in independence, have already felt the benefits of the new legislation. On the contrary, those companies, which saw it as another box-ticking exercise and preferred to carry out the smallest alterations possible to avoid the fines, were unable to appreciate the difference. The Listing Rules were also extremely helpful to companies as additional guidance for improving their organization and their function, because these rules were constructed in such a way as to be compatible with the spirit of the SoX. Companies, which chose to leave their guilty past behind them and dedicated time and money in complying with SoX and the Listing Rules, have undoubtedly followed the right path for the protection of their shareholders, employees, customers, and other stakeholders.

Moving now to auditors, auditing companies were also affected by the SoX, because there were many academics, who were talking about failure of the gatekeepers<sup>94</sup> as one of the causes of the corporate failures. For instance, Coffey Jr and Tomasic have stressed the critical role of these gatekeepers in corporate law and their responsibility in

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<sup>94</sup> The term has been applied to include auditors, accountants, lawyers, securities analysts, rating agencies and even boards of directors, see Coffee, Jr., J., 'Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation', (1999), 52 *Bus. Law.* 1195, 1210-13, 1232-33. See also Coffee, Jr., J., 'Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms', (2004), 84 *B.U. L. Rev.* 301, 354.

the context of corporate scandals.<sup>95</sup> A number of auditing failures revealed the cracks in the foundations of the auditors' system of self-regulation long before Enron and the passing of the SoX. Ernst & Young had to pay a record \$335 million for the settlement of a single shareholder lawsuit in 2000. In 2001, the SEC brought a fraud case against Arthur Andersen for its involvement in the Waste Management scandal, while another SEC investigation in the same year revealed over 8,000 violations at PricewaterhouseCoopers of a clear, long-standing rule against auditors owning stock in their audit clients. These violations involved over two-thirds of the firm's top partners.<sup>96</sup>

Apart from the normal auditing services, the Big Four, PricewaterhouseCoopers LLP, Ernst & Young LLP, KPMG LLP and Deloitte & Touche LLP, (as well as Arthur Andersen before its failure in 2002) were also providing lucrative consulting services, and in certain occasions 'some auditors ceased being the emperor's gadfly and became his compatriot'.<sup>97</sup> As Healy and Palepu argued, auditing had for a long period been suffering from a 'deprofessionalization' – a loss in the capacity of auditors to detect fraud- because of increased competition, diminishing audit fees, and persistent liability risks, which reduced long-term rewards for auditing and increased incentives for rule-based accounting requiring little discretion or professional expertise.<sup>98</sup>

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<sup>95</sup> Coffee, Jr., J., *Gatekeeper – The Professions and Corporate Governance*, Oxford University Press, Oxford, 2006. See also Tomasic, R., 'Corporations Law Enforcement Strategies in Australia: The Influence of Professional, Corporate and Bureaucratic Cultures', (1993), 3 *Australian Journal of Corporate Law* 192-229.

<sup>96</sup> Coates, see above, note 93 at 96.

<sup>97</sup> Weinberg, A., 'Will KPMG Be Scared Stright?', 30 Jan 2003, Forbes.com, available in the website: [http://www.forbes.com/2003/01/30/cx\\_aw\\_0130kpmg.html](http://www.forbes.com/2003/01/30/cx_aw_0130kpmg.html).

<sup>98</sup> Healy, P. and Palepu, K.G., 'How the Quest for Efficiency Undermined the Market', (2003), *Harvard Business Review*, available in the website: <http://ssrn.com/abstract=422524>. See also Levitt, Jr., A., 'Accounting and Investor Protection Issues Raised by Enron and Other Public Companies', (2002), presented at U.S. Senate, Committee on Banking, Housing and Urban Affairs Hearing, February 12, 2002. <http://www.iasplus.com/resource/levitt.pdf>.

The SoX provisions were intended to redefine the relationship between accounting firms and companies and resolve any possible conflicts of interest by reinforcing the independence of auditors. One of the major innovations of the SoX was the restriction of the types of consulting services an auditing firm may provide to their clients. There were nine categories of prohibited services, such as book-keeping services, financial information systems design and implementation, management functions or human resources, appraisal or valuation services, fairness opinions, and outsourcing of internal audit services. Moreover, no accounting firm can provide audit services for more than five years and requires a one-year waiting period before auditor employees can accept executive positions with the client company.

DeFond and Francis noted that the SOX has transformed the auditing industry from a 'self-regulated' industry to one industry controlled by a quasi-government agency, the PCAOB.<sup>99</sup> As a result, post-SoX auditors are expected to be more vigorous and more dynamic in their role as gatekeepers. Even if we conclude that the SoX was not the most appropriate regulatory choice for the US government, the impact of its provisions on the philosophy and the operation of the accounting profession is indisputable. The reason that auditing companies have not openly expressed any disapproval of SoX's provisions is not because they believe that they have to pay for Arthur Andersen's sins. On the contrary, despite the fact that SoX forced them to change their operation and their relationship with their clients, the Big Four can still be characterized as the principal financial beneficiaries of section 404, due to the lucrative revenue stream from internal control audits.<sup>100</sup>

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<sup>99</sup> DeFond M. and Francis, J., 'Audit research after Sarbanes-Oxley', (2005), *Auditing: A Journal of Practice and Theory* 24 (Supplement), 5-30.

<sup>100</sup> Romano, R., 'Does the Sarbanes-Oxley Act Have a Future?' (2009), *Yale Law & Economics Research Paper No. 385*, pg. 103, available in the website: <http://ssrn.com/abstract=1404967>.

One of the big flaws of SoX that is not related to the wording of the provisions or the enforcement strategy is that it does not focus on the source of the real problem: the pressure placed on managers by the disclosure of the quarterly results.<sup>101</sup> The shareholder value theory was not applied correctly and failed to guide managers and directors in their decisions. The satisfaction of the stock markets gradually became their exclusive focus and it was only a matter of time before they lost control and ended up struggling to restore the accuracy of the financial statements. Gatekeepers and whistle-blowers failed to live up to the expectations of both the law and the business community, but the whole system was not stable. Short-termism, myopic business strategy, and stock price-orientated incentives were not the sound business advisors. The real meaning and the actual aims of the shareholder value theory became increasingly vague, up until the point greed became the driving force of corporate decision-making.

A change of the mode of governance was essential, not necessarily towards the enlightened shareholder value model that was advertised as the best alternative to shareholder and stakeholder value theories. However, a closer look at the SoX provisions shows that no reference was made to this problem and thus no relevant arrangement was made. New legislation did little to alter the incentives for corporate leaders to take excessive risks, as corporate culture continues to reward managers, who are willing to take risks and do not second guess the genius of their decisions.<sup>102</sup> It can be argued that the SoX has been profoundly influenced by the shareholder value theory and in this way

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<sup>101</sup> Aglietta, M. and Reberieux, A., *Corporate Governance Adrift: A Critique of Shareholder Value*, Edward Elgar, Cheltenham, 2005, pg. 246-7

<sup>102</sup> Skeel, D., *Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From*, OXFORD University Press, Oxford and New York, 2005, pg. 13.

instead of attacking the root of the evil, fertilizes it.<sup>103</sup> Subsequently, we have the oxymoron that shareholder value theory is still considered to be the right one for the American corporate governance system, and the main problem that the creators of SoX managed to identify was on its monitoring system.

Unfortunately, regulators chose to ignore the increasing fraudulent activity in the American business world in particular, which was followed by a sharp decline in ethical standards, and preferred to place the blame on gatekeeper failure and a lack of internal control. Supervision was indeed defective and gate-keeping mechanisms were malfunctioning, but the crisis was deep and it penetrated to the very foundations of the corporate governance system.<sup>104</sup> The struggle to keep the stock prices up, to maximize profits, and to achieve high returns through stock options and bonuses led to irrational choices and fraudulent activity. Companies became vulnerable, and the rest is history.

The United States has the most diverse and efficient capital markets in the world, Thomas Friedman wrote in 1997, which reward, and even celebrate, risk-taking.<sup>105</sup> A lot seems to have changed since then, the days of euphoria belong to the past and memories from the distant 1930s have returned in the US stock markets. But while in the 1930s the prevailing perception was that investors had been defrauded by offerings of dubious quality securities, in the new millennium, investors' perception is that they have been defrauded by managers who are not accountable to anyone.<sup>106</sup> Most of the provisions of SoX, though, overlooked this detail and 'aimed directly at the behaviour of CEOs like Ken Lay and Bernie Ebbers', instead of being proactive and introducing a different

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<sup>103</sup> Ibid.

<sup>104</sup> Ibid. pg. 250.

<sup>105</sup> Friedman, T., 'Dear Dr Greenspan', New York Times, February 09, 1997, sec 4.

<sup>106</sup> Zingales, L., 'The Future of Securities Regulation', (2009), Chicago Booth School of Business Research Paper No. 08-27; FEEM Working Paper No. 7.2009, abstract.

regime in the boardrooms, a sort of ‘capitalism with conscience’.<sup>107</sup> The Sarbanes-Oxley Act lacks a provision that would serve as a reminder to everyone that, apart from following the rules and avoiding conflicts of interest, business people should try to inspire an ethical corporate culture, because only in an ethical business environment will disclosure, independence, accountability and diligent oversight achieve their goals. The need for a radical change in the internal culture of all companies should have been highlighted and the spirit of the SoX should have led CEOs and CFOs to a u-turn: back to an ethical model of entrepreneurship. Emphasis on the admittedly broad principles of ethical compliance and monitoring, and the clearly articulated demand and expectation that managers behave ethically, will reduce risks, protect investors and slowly eliminate corporate malfeasance.<sup>108</sup>

***(vi) The Need for reform***

Although the SoX at the time of its enactment, was advertised as a unanimous legislative initiative, only a few years thereafter, criticism and calls for revision have replaced the statements of support. A large group of academics and business people have been treating it with scepticism, and remain unconvinced that it was the most appropriate solution, mainly due to the unfavourably high compliance costs, especially for the small companies. The government has so far refused to comment on the criticisms, either because a lot has been invested in this Act and possible recognition of a need for revision would amount to accepting defeat, or because revision is in fact a rather controversial political issue. The second possibility appears to be more convincing, because the

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<sup>107</sup> Skeel, see above, note 102, pg. 176.

<sup>108</sup> Wade, C.L., ‘Sarbanes-Oxley Five Years Later: Will Criticism of SOX Undermine Its Benefits?’, (2008), 39. Loyola University Chicago Law Journal, Vol. 39, 595- 611 at 611.

decision to revise SoX would have a wider implication in the area of corporate governance internationally, and the content of the revision would depend on which party is in power. There is a clear ideological differentiation between the Republican and Democrat views on the SoX and its need for revision.

A recent study found that slightly over half of the ‘major’ statutes enacted from 1954 to 2001 were significantly amended, on average five years after enactment.<sup>109</sup> Nevertheless, revamping legislation in the United States is conventionally thought of as being difficult given the multiple actors and veto points in the legislative process.<sup>110</sup> A number of factors can also affect a decision for legislative revision or reform and even influence the nature of the revision. A quite crucial factor is the timing of the changes, as the economic and political conditions are constantly changing. Maltzman and Shipan found that what happens after a statute is enacted is more important for legislative durability than the conditions at the time of enactment.<sup>111</sup> Patashnik offers another factor that can influence the stability of major legislative initiatives. He argues that reforms are more likely to be resisted and less likely to ‘stick’ when those adversely affected have not yet made substantial investments in order to adapt to the new regime and marginal compliance costs are high.<sup>112</sup>

In the case of SoX, timing is really important as well. The current recession has turned the spotlight onto the financial institutions, and the SoX has lost its place in the reform agenda. The present situation does not allow for bold initiatives and radical

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<sup>109</sup> Maltzman, F. and Shipan, C.R., ‘Change, Continuity, and the Evolution of Law’, (2008), 52 AM. J. POL. SCI. 252 at 258.

<sup>110</sup> Romano, see above, note 100, pg. 90.

<sup>111</sup> Maltzman and Shipan, see above note 109. See also Patashnik, E.M., *Reforms at Risk: What Happens After Major Policy Changes Are Enacted*, Princeton University Press, New Jersey and Oxford, 2008, pg. 161-69.

<sup>112</sup> Patashnik, *ibid.*, pg. 177.

changes, so it seems unlikely that the US government will initiate such a major project soon. For a piece of legislation like the SoX, which was designed and introduced in a rush and an environment of panic, a periodic review can be essential for filling in the gaps, correcting the regulatory errors and dealing with any unintended consequences. Now if the government considers the revision to be a vital part of its policy, it can incorporate the revision in its wider attempt to fight recession. This scenario seemed to be not far from reality last year when the Investor Protection Act of 2009 was introduced and the Democratic-controlled House was supposedly pushing through changes that in effect would neutralize SoX. Some were talking about the end of the SoX or its transformation into a lite-type of legislation with the permanent exemption of all companies with a market float of less than \$75 million from compliance with section 404.<sup>113</sup>

Professional lobbyists may seek the outright repeal of SoX as a bargaining tactic while planning to settle on regulatory reform as a compromise, but academics, policymakers, and the public would do well to recognize Sarbanes-Oxley as a work in progress. Rather than pushing for repeal, a more cost-effective approach would be, according to Coates, to push for the SEC and the PCAOB to use their authority to exempt or curtail requirements or prohibitions that are unnecessarily costly.<sup>114</sup> Finally, the most easily imaginable short-term congressional action on the SOX would seem to be a further extension of the postponement of section 404's applicability to the smallest firms, as

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<sup>113</sup> 'Sarbox Lite or the end of Sarbanes-Oxley?', (2009), SoxFirst, Management and Compliance, available in the website: [http://www.soxfirst.com/50226711/sarbox\\_lite\\_or\\_the\\_end\\_of\\_sarbanesoxley.php](http://www.soxfirst.com/50226711/sarbox_lite_or_the_end_of_sarbanesoxley.php)

<sup>114</sup> Coates, see above, note 93 at 112.

reducing business costs is more likely to be a greater legislative concern in a recessionary economy.<sup>115</sup>

### ***(vii) Final Assessment***

Nobody can deny that the problems that led to the introduction of the Sarbanes-Oxley Act are not new and, unfortunately, will continue to exist for long time. The ‘evils of the old order’, as President Roosevelt had characterized the threats against US capital markets, keep returning. Sometimes it looks like a vicious circle or as if history is repeating itself. The stage for the perfect storm of corporate governance lapses, as Gary Brown acknowledges,<sup>116</sup> but the story looks familiar, although the actors are different. The headlines of the 1932 newspapers could easily be used in 2002 as well, because those who forget history are doomed to repeat it.<sup>117</sup> The Securities Act 1933, the Securities Exchange Act of 1934, and the Bubble Act of 1720 did not eliminate fraud and wrongdoing, irrespective of how complete and well-designed they were as pieces of legislation they were.<sup>118</sup> The same will probably happen with the Sarbanes-Oxley Act. The Health-South scandal was the first proof positive of that.

On March 20, 2003, HealthSouth and its CEO Richard Scrushy were accused by the SEC of an accounting scandal of falsification of earnings reports. The story goes back to 1996, when Scrushy was looking for ways to control the price of the company's stock, in order to be able to meet investors’ expectations. In his attempt to achieve that, he was

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<sup>115</sup> Romano, see above, note 100, pg. 101-2.

<sup>116</sup> Brown, G. M., ‘Changing Models in Corporate Governance-Implications of the US Sarbanes-Oxley Act’ in Hopt, C., Wymeersch, E., Kanda, H. and Baum, H., (eds), *Corporate Governance in Context: Corporations, States, and Markets in Europe, Japan, and the US*, Oxford University Press, Oxford-New York, 2005, pg. 151.

<sup>117</sup> *Ibid.*, pg. 153.

<sup>118</sup> *Ibid.*, pg. 162.

accused of instructing the company's senior officers and accountants to falsify company earnings reports. At last, in June 2005 Scrusby was found not guilty. The attention-grabbing detail is that from all 36 of the accounting fraud counts against him, only one count was in violation of the Sarbanes-Oxley Act, a fact that definitely casts doubt on the enforceability of the new Act. HealthSouth was not an exceptional, isolated scandal. It was followed by other companies accused of improper accounting and manipulation of financial statements. The list of Enron-in-the-making or Enron-like companies includes Marsh & McLennan, AIG (American International Group Inc.), Krispy Kream and Fannie Mae. These could also be used as case studies, as they would confirm the conclusions made earlier. Nearly eight years after the passing of the SoX, companies are still restating earnings on a regular basis, uncovering earlier misconduct.<sup>119</sup>

Criticism and concerns has been a typical reaction to almost all new, ground-breaking legislation. Experience has shown that there is always a fear of stricter rules and increased obligations. We could use as an example the Regulation of Railways Act 1844, also famous as the Gladstone Bill. It was one of the first, if not the first, pieces of British Parliamentary Legislation of the modern era to propose nationalization as a solution to market failure.<sup>120</sup> Although it was introduced in the nineteenth century, a period of economic liberalization and *laissez-fair*-ism, the Act was a surprisingly long-lasting achievement, as its basic principles were not abolished until the Transport Act 1960.<sup>121</sup> It is noteworthy that the Gladstone's Bill was met with the fierce opposition from the

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<sup>119</sup> Geraldine Fabrikant, 'Cablevision to Restate its Earning', New York Times, Aug. 9, 2006, at C1.

<sup>120</sup> Bailey, M. F., 'The 1844 Railway Act: A Violation of Laissez-Faire Political Economy?', (2004), History of Economic Ideas, Vol. 12, No. 3, pg. 7, abstract.

<sup>121</sup> McLean, I., 'The history of Regulation in the United Kingdom: Three Case Studies in Search of a Theory' in Jordana, J. and Levi-Faur, D. (eds), *The Politics of Regulation: Institutions and Regulatory Reforms for the Age of Governance*, Edward Elgar, Cheltenham, 2004, pg. 52.

railway companies and nobody could even imagine how beneficial it would be in the long-run, and that it would set the pattern for regulation of natural monopolies not only in Britain but in USA as well (US 1887 Interstate Commerce Act).<sup>122</sup>

As far as corporate America is concerned, the Sarbanes-Oxley Act will not be the last word on corporate governance reform. There is no panacea for this ‘disease’. There is not a cure-all solution to a culture of deceit fuelled by greed, mismanagement, conflicts of interest, and failure of professional and regulatory oversight. The Sarbanes-Oxley Act is undoubtedly a decisive step in the right direction and a strong shield against corporate fraud and mismanagement. It may fall short of the mark, but it sends an unmistakably clear signal that such events should never happen again.<sup>123</sup> Clark was clear that the SoX itself has the seeds of a solution, though the seeds need to be treated with greater care in the next major reform movement.<sup>124</sup>

Any reform movement should be taken after serious deliberation through a properly formulated procedure with clearly set objectives. Romano has warned that ‘it is far easier to draft legislation in times of crisis founded on good intentions that produce unintended consequences and impose substantial costs on firms, impeding economic growth, than it is to correct such legislative blunders thereafter’.<sup>125</sup> This can be the biggest lesson for the EU legislators for any legal reforms in the area of corporate governance. The next chapter will examine the European response, which does not follow the American philosophy and ‘methodology’, but in this age of globalisation, lawmakers,

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<sup>122</sup> Ibid., pg. 51.

<sup>123</sup> Brickey, K., ‘From Enron to WorldCom and Beyond: Life and crime after Sarbanes-Oxley’, (2003), Washington University Law Quarterly, Vol. 81, 381.

<sup>124</sup> Clark, see above note 87, at 291.

<sup>125</sup> Romano, see above, note 100, pg. 112.

as Platonic guardians of the public good<sup>126</sup>, are expected to enact practical rules, reassess them periodically and revise them when necessary, taking into account all the surrounding circumstances internationally.

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<sup>126</sup> Clark, note 124, *ibid.*

## **CHAPTER 5**

### ***REGULATION IN THE AFTERMATH OF SCANDALS: THE EU RESPONSE***

After examining the American response to the corporate scandals, it is time to transfer our analysis to the European continent and particularly to the European Union. It is interesting to take a closer look at the European response for a number of reasons. The EU is the second pole in the general corporate governance debate, due to the size of the Union, its influence as well as the powers and authority of some of its Member States. The structure of the Union and the decision-making process is different. Therefore, it is remarkable that the EU did not unquestionably follow the American example and did not adopt a European version of the SoX. Furthermore, the EU managed to close its ears to all the screams of panic asking for action, regulation and reforms. Finally, even the general approach, which was adopted at the end, was different in spirit from the strict regulatory response given by the US. The European regulators confirmed that corporate governance regulation should take a completely different form, as the complexities of the Union call for different standards and different interpretations of the rules.

This chapter will have as its core subject-matter the regulatory response of the European Union towards the series of corporate collapses that took place primarily in the USA and, subsequently, in Europe. An attempt will be made to identify the rationale behind the EU response in general, the reasons and the justifications for the adopted European approach, and why it was so different than that of America. The examination

will be divided into two parts: firstly, the response at a national level, i.e. the initiatives and the self-regulatory codes of the Member States, and, secondly, the response at a pan-European level. The pan-European level will cover all the initiatives of the European Union from its early years, which were related to the creation of the internal market and the harmonization of company law, up to the more recent ones, i.e. the 8th Council Directive on Company Law<sup>1</sup>, the Financial Services Action Plan, the High Level Group of Company Law Experts, and the Action Plan of 2003. The European response and the European initiatives will be analyzed both separately and in comparison to the American ones. The chapter will conclude with an assessment of the European response and a look towards the future.

### ***European response: Why so different?***

When the topic of discussion is regulation in Europe after the corporate scandals, the first thing to note about the European reaction to these corporate scandals is that it has been quite slow to formulate. At first glance and, when compared to the US, the European Union appeared to be inexplicably inactive and diffident. There is no evidence or indications as to the reasons for this first reaction, nor are there any official statements revealing that it was a conscious and strategic political decision. Nobody can deny that there was a delay, but the fact that the final response has not come yet, is a sign that Europe has deliberately chosen to adopt a different course of action.

It cannot simply be argued that Europe is traditionally against firm regulation and it prefers self-regulatory solutions. The history of securities regulation in Europe dates

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<sup>1</sup> 84/253/EEC of 10 April 1984 based on Article 54(3)(g) of the Treaty on the approval of persons responsible for carrying out the statutory audits of accounting documents [Official Journal L 126 of 12.5.1984]

back to the 11<sup>th</sup> century, and the first trace can be found in England, appearing as a statute of Edward I in 1285, and concerned the licensing of brokers in the City of London. Four centuries later in 1697 another statute of the Parliament was dealing with brokers and stock jobbers-their number and their ill practice.<sup>2</sup> After that came the Bubble Act of 1720, a law passed by a panic-stricken Parliament during a ‘something-must-be-done’ atmosphere, similar to the situation in 2002. Consequently, regulatory tradition was not the main reason for Europe’s delay.

As previously before, the main justification for this period of silence and inactivity was the perception that such situations were not likely to arise in Europe. There can be little doubt that had a survey been conducted during 2001-2, it would have shown that the vast majority of Europeans were feeling that ‘Enron will not happen in Europe’ and that ‘scandals only happen in the greedy America’. Retrospectively, such a reaction appears arrogant or at least overconfident, but given the circumstances it seems to be a reasonably expected reaction.

A more careful look, though, would reveal that the United States’ reaction was not as impulsive as the media presented it to be. When the first wave of scandals hit the US in the late 2001, nobody would even imagine the Sarbanes-Oxley Act. There were only a few committees created to investigate the corporate failures, to identify the causes and deal with the problem as soon as possible. Stephen Labaton and Richard A. Opperl, Jr in their article in NY Times gave a political explanation to this reaction. ‘The differences between the Senate, under Democratic control at the time, and the House of Representatives and White House, under Republican control, on how to address the

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<sup>2</sup> Loss, L., *Fundamentals of Securities Regulation*, Little, Brown and Company, 2<sup>nd</sup> ed., Boston and Toronto, 1988, pg. 1.

problems were so great' that any 'corporate reform effort' would be unsuccessful.<sup>3</sup> However, after the second wave of scandals only a few months before the elections of 2002, the Congress put its scepticism and its reservations aside and passed the proposal for a new bill before the end of August.

Moving to the other side of the Atlantic, it seems as if panic did not find its way to Europe. On June 21-22, 2002, shortly after the Enron collapse, there was a meeting of the European Commission in Seville. Although there was a feeling of tragedy in the atmosphere, the Commission did not change its priorities nor did it give any special instructions to the High Level Group that would reveal any fear or anxiety. Even when it became clear that Europe had no immunity against scandals and the trauma experienced in the US could easily come to Europe, a more drastic - SoX-like - reaction was not a topic on the Agenda. Again, retrospectively, it would be easy to criticize Europe's reaction, but there is an example that basically shows that such a reaction was not random.

The collapse of Polly Peck and the Bank of Credit and Commerce International in the late 1980s and the early 1990s revealed the deficiencies in the UK's accounting and governance system. Not long after these failures, there was the Maxwell scandal and the collapse of the Daily Mirror newspaper. Clearly, the atmosphere in the UK was not ideal, the public was about to lose its trust of the government, and there were calls for legislative intervention. However, the British government chose to follow a different path: they promoted the development of codes of practice as a means of defence to these problems. The first outcome of this innovative strategy was the well-known Cadbury

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<sup>3</sup> Labaton, S. and Oppel, Jr., R.A., 'Enthusiasm Waning in Congress for Tougher Post-Enron Controls', NY Times, June 10, 2002, p. A1.

Report of 1992, which was followed by a large number of other codes up to the present day.<sup>4</sup> It is worth noting that this was not a radically different approach from that the EU adopted in the wake of the 21<sup>st</sup> century, as it will be discussed later in this chapter.

The existence of diversity in multiple levels between the US and the EU can serve as an indication that the EU should not be treated as a relatively similar regime. In fact, it has different origins, structures, priorities and, thus, is not straightforwardly comparable to the US, as it is not possible to apply the same standards of comparison. The European Union, unlike the United States, is not a federal state; it consists of 27 member states, 27 separate countries with varying histories, cultures, traditions, languages and religions. As a result, EU is practically unable to reach a consensus and make crucial decisions in a short period of time with limited or no opportunity for consultation and negotiations. The decision-making process is time-consuming, especially when unexpected events happen that put additional pressure on the Member States. The Commission had already experienced difficulties and delays with company law harmonization. Classic examples are the Fifth, Eleventh, Thirteenth, and Fourteenth draft Directives, which were held up for significant periods of time simply because ‘Member States could not agree on a common regulatory core’.<sup>5</sup>

It should also be noted that there is no European corporate governance system or European corporate law, not even a common set of rules. Europe is divided into a way due to the two different board systems, the one-tier and the two-tier system. In the two-

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<sup>4</sup> Rickford, J., ‘Do Good Governance Recommendations Change the Rules for the Board of Directors?’ in Hopt, K., and Wymeersch, E., (eds), *Capital Markets and Company Law*, Oxford University Press, New York and Oxford, 2003, pg. 466.

<sup>5</sup> Hopt, K.J., ‘Common Principles of Corporate Governance in Europe?’ in McCahery, J.A., Moerland, P., Raaijmakers, T., and Renneboog, L., (eds) *Corporate Governance Regimes - Convergence and Diversity*, Oxford University Press, Oxford and New York, 2002, pg. 190.

tier board system there is a clear distinction and segregation between the supervisory and monitoring functions on the one hand, and the managerial functions on the other hand. The unitary board, in opposition, combines both functions. There has been a long debate on the advantages and disadvantages of these two systems of internal corporate governance, instead of serious initiatives for the adoption of some common principles.

The ownership and control patterns that prevail in the EU have also been a source of controversy. There are two basic models: the outsider system or the financial markets dominated model, which is prevalent in the UK (same as in the United States), at first, and, secondly, the insider system or the bank oriented model, which is prevalent in Continental Europe. In the latter, there is concentrated ownership and control structure, and financial institutions play a central role. Ownership is more concentrated, due to the existence of strong active block-holders and weak dispersed owners, as financial institutions have the power to appoint managers, to develop strategies, and actively participate in the decision-making process. The main elements of this model are two-tier corporate boards, employee participation in management, closer monitoring of management, and more active shareholders. On the contrary, the ‘financial markets’ model is based on one-tier corporate boards dominated by insiders and its basic elements are transparency, strong minority shareholder and creditors’ rights protection, and high information disclosure.

Dispersed ownership systems need greater enforcement, because corporate law gives shareholders less control rights than in countries with more concentrated ownership. Once a nation achieves dispersed ownership, those individual owners become

an influential political force.<sup>6</sup> Their power and influence is revealed in periods of instability. For example, after scandals they demand reforms and retribution. This is the point where economics meet politics, and that's why the US have to spend so much on enforcement even compared to other countries with dispersed ownership systems. In Europe circumstances are entirely different. Stock markets are not so large, securities markets are thin and there is not extensive citizen involvement in the market. Therefore, there is much less pressure, less political influence for reforms or tighter enforcement and, of course, there is not such a powerful agency like SEC.<sup>7</sup> The stock market decline of 2000 is the best illustration of this 'enforcement gap' between common law and civil law countries. The decline was sudden and unexpected for Europe as much as it was for the United States. However, the reaction was different not because there was no economic loss, but because the loss was suffered primarily by institutional investors and not individual investors as in the US.<sup>8</sup> This is to a certain extent why there were not so many voices demanding reforms and extra protection in Europe.

Another factor is stock markets and, more specifically, because in Europe there is no stock exchange playing any role similar to that of the NYSE or NASDAQ.<sup>9</sup> However, it is true that consolidation between stock exchanges in Europe has recently accelerated. A significant development has been the merger of Euronext, the European combined stock market, with the NYSE Group on April 4, 2007. The result was the NYSE Euronext, the first transatlantic stock exchange and the world's largest exchange group,

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<sup>6</sup> Coffee, Jr., J., 'Law and the Market: The Impact of Enforcement', (2007), Columbia Law and Economics Working Paper No. 304, pg. 55, available in the website: SSRN: <http://ssrn.com/abstract=967482>.

<sup>7</sup> Ibid., pg. 61.

<sup>8</sup> Ibid., pg. 56.

<sup>9</sup> Enriques, L., 'Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms', (2003), Wake Forest Law Review, Vol. 38, 914-915.

which brings together six cash equities exchanges in five countries and six derivatives exchanges.<sup>10</sup> The first truly global marketplace group was created and there were talks for merging Deutsche Börse with NYSE Euronext. The deal for the creation of the world's biggest exchange in the outset of 2008 did not go through, but the ambitious plan can be re-examined in the future, despite the regulatory difficulties it involves. Until then, it remains to be seen whether all these major stock exchanges in Europe and the U.S. can function as one equities exchange.

Going back to the early post-scandals era in Europe, it can be argued that there was no panic, but there was reasonable scepticism about which form the European response should have. There was uncertainty as to what course of action should be taken and at which level, at a European level or in individual member states. All these give us an initial idea as to why no legislation comparable to the Sarbanes-Oxley Act has yet been passed in Europe. The major corporate scandals in Europe did contribute significantly to the acceleration of the process of coordination. The classification of the European response as 'apathy' or inactivity' is not accurate in the sense that the EU, even though it did not immediately introduce any legislative reform, it did set the mechanisms and initiated the process of preparing its response. For instance, Paul Davies disagrees with the allegations about inactivity and characterizes the European response as 'speedy and wide-ranging'.<sup>11</sup> He believes that it was the interconnectedness of the world economy and, more precisely, the commonality of approaches to corporate governance across the

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<sup>10</sup> NYSE Euronext official website: <http://www.euronext.com/landing/indexMarket-18812-EN.html>.

<sup>11</sup> Davies, P., 'Enron and Corporate Law Reform in the UK and the European Community' in Armour, J. and McCahery, J., (eds), *After Enron: Improving Corporate Law and Modernizing Securities Regulation in Europe and the US*, Hart Publishing, Oxford and Oregon, 2006, pg. 416.

developed world, that made Europe react rather than just the fact that Europe identified the threats and deliberately reacted rapidly.<sup>12</sup>

The fall of Enron and the collapse of WorldCom reached without any delay the European continent and covered the European corporate sky with black clouds. The storm was coming and the Parmalat scandal was the first thunderstorm. As it was pointed out earlier, it became clear that Europe has no immunity against corporate scandals and fraud is a disease that can infect companies worldwide. Just because Europe is like a jigsaw of different states, it is better to analyze the effects of the storm both at national level for the individual Member States, and at the European Union level, so that we may obtain a more complete picture of the European response.

### ***(I) National Level***

Corporate governance is one more brick in the wall of the EU single market. The constant expansion of the European Union, the free flow of capital, goods, services and people across EU Member States, the common currency and the multinational character of companies increase the pressure for the creation of a European corporate governance framework. All Member States have shown a strong interest in improving their corporate governance system with a view to strengthening their economies and providing a healthy environment of best practices and generally accepted principles for all companies.

Over the last fifteen years this interest has been transformed into corporate governance codes. The United Kingdom so far has the lion's share of codes, as it has developed and published more codes than any other country and, more interestingly, this

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<sup>12</sup> Ibid., pg. 417.

process has been in motion since 1992. This is a clear sign of initiative, innovation and willingness for progress and improvement, as well as an example to follow for the other Member States. The Cadbury code, for instance, has been a source of influence and inspiration for almost all European countries. The Code of Best Practice and its recommendations were incorporated into the Listing Rules of the London Stock Exchange. It was the first attempt towards better management and governance and it initiated the debate over what constitutes the best set of principles for corporate governance in the 21<sup>st</sup> century.

The UK paved the way and set the basis for the self-regulatory model in corporate governance. Self-regulation has always been much more popular than private regulation. It represents a more open-minded system, which is based on non-interventionism and non-interference by the government, and its origins go back to the *laissez-faire* principles of the physiocrats. The self-regulatory model was the response of the national authorities to the Commission's attempts and initiatives to create a common regulatory environment. The national authorities also had the industry's support, as big companies, businesses, and financial services were mostly in favour of self-regulation. Nevertheless, the Member States' disbelief of the Commission's intentions and methods was not completely justified. The Commission cannot be compared with a narrow-minded or inflexible central government, which imposes rules using its authority. Moreover, the EU harmonisation was based on the use of Directives that were transposed into national legislation. Member States have enough freedom and flexibility in transposing the content of the Directives into their national system. The self regulation model means that one moves from EU centralized law to national law. However, the political momentum

was not strong enough to support these attempts and self-regulation was seen as a means to achieve the best possible regulatory solution without any private intervention.

As a result, most of the European countries followed the successful example of the UK and made the choice to introduce their own code of corporate governance, based on the belief that differences in history, legislation, and tradition were severe barriers to the creation of one single code for all European countries. Each national code was meant to contain generally accepted principles, best practice recommendations on corporate governance issues and, at the same time, reflect the unique characteristics of each country, its culture, and its distinct business environment. Cuervo mentions several factors facilitating divergence in codes. In particular, he refers to local political interests, differences in the relevant legislation, differences in perceptions regarding the role that stakeholders should play in corporate governance, and differences in the countries' level of development.<sup>13</sup>

If we have a look at the other side of the coin, the codes, despite their distinct origins and legal status, have remarkable similarities in their general spirit and the content of their recommendations. This can be explained by the fact that the codes deal with basic governance issues and tend to express notions of 'best practice', although the translation of these ideals into actual practice, compliance and enforcement techniques significantly differ from country to country.<sup>14</sup> Additionally, there are external forces that stimulate convergence between the codes of different countries and may lead up to the

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<sup>13</sup> Cuervo, A., 'Corporate Governance Mechanisms: A Plea for Less Code of Good Governance and More Market Control', (2002), *Corporate Governance: An International Review*, Vol.10, No.2, 84-93.

<sup>14</sup> Weil, Gotschal & Manges LLP, on behalf of the European Commission, Internal Market Directorate General, 'Comparative Study of Corporate Governance Codes relevant to the European Union and its members', (January 2002), pg. 3, available in the website: [http://europa.eu.int/comm/internal\\_market/en/company/company/news/corp-gov-codes-rpt\\_en.htm](http://europa.eu.int/comm/internal_market/en/company/company/news/corp-gov-codes-rpt_en.htm).

harmonization of corporate governance systems in Europe. Examples of such external forces are the increased globalization and integration of countries in the global economy, the opening up of financial markets, the increased role of foreign institutional investors and recommendations on corporate governance practices of international organizations, such as the OECD, the World Bank and the European Union institutions.<sup>15</sup>

It appears that, when the European countries found themselves at a crossroads, they followed the path of adopting a principles-based approach, as opposed to the stricter and less flexible American rules-based approach. Even though this conclusion does not apply to all Member States, it is a fact that all 27 countries have introduced a corporate governance code for the companies operating in their territory.<sup>16</sup> A large variety of names and titles are used: ‘Corporate Governance Code’, ‘Corporate Governance Principles’ or ‘Recommendations’ and ‘Code of Best Practice’. The justifying basis is that corporate governance is more about the method, than about the substance. In this respect, codes are used as an incentive for companies to grow towards better governance practices, without necessarily having to revolutionize their internal structures and procedures.<sup>17</sup> Nevertheless, it is remarkable that, although the SoX did not receive much appreciation in Europe in its early days, some of the ‘traditional’ Member States are planning to transplant, or have already transplanted, many of the SoX’s main provisions into their own company laws. For example, France adopted the Draft Law on Financial Security in 2003, which contains provisions that are in line with the SoX.<sup>18</sup> This also shows that

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<sup>15</sup> Hermes, N., Postma, T., Zivkov, O., ‘Corporate Governance Codes and their Contents: An Analysis of Eastern European Codes’, (2006), *International Journal of Managerial Finance*, Vol. 2, No. 4, pg. 280, 285.

<sup>16</sup> An index of all codes can be found in the website: [http://www.ecgi.org/codes/all\\_codes.php](http://www.ecgi.org/codes/all_codes.php).

<sup>17</sup> Wymeersch, E., ‘Corporate Governance Codes and Their Implementation’, (2006), University of Gent Financial Law Institute Working Paper No. 2006-10, pg. 4.

<sup>18</sup> *Projet de loi de sécurité financière* (adopted by the French Senate Mar. 20, 2003), especially articles 98-116, available at <http://www.senat.fr/leg/tas02-092.html>

some of the SoX's provisions and corporate governance reform proposals for the United States have been inspired by, or are at least similar to, pre-existing soft or hard law provisions of the legal systems of some European countries'.<sup>19</sup> Similarly, in Germany a 'Catalogue of measures aimed at strengthening businesses' integrity and investor protection' was introduced in 2003 and was clearly inspired by the SoX and the American corporate and securities law.<sup>20</sup>

It cannot be argued that all codes were successful or that compliance has been uniform everywhere. The German experience of self-regulation can be used as an example that self-enforced market regulations have not always been effectively implemented.<sup>21</sup> The two attempts that did not experience the expected success were the Insider Trading Code and the Takeover Code. The explanation given was that the lack of power to sanction insider violations made them look like they essentially had no teeth, as they did not seem to pose a credible threat to anyone.<sup>22</sup> Inevitably, sooner or later they gave way to legal provisions, justifying the argument that 'financial markets do not prosper when left to market forces alone'.<sup>23</sup> On the other hand, this is the essence of self-regulation. Self-regulatory codes express notions of 'best practice' that are similar for most of the countries. What really matters about such codes is the translation of best practice ideals into actual practice. If the ideals expressed in codes reflect a striking difference from common practice, the codes may meet with resistance.<sup>24</sup> The vast

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<sup>19</sup> Enriques, see above note 9, pg. 916.

<sup>20</sup> Ibid., pg. 920.

<sup>21</sup> Nowak, E., Rott, R., and Mahr, T., 'The (Ir)relevance of Disclosure of Compliance with Corporate Governance Codes – Evidence from the German Stock Market', (2006), Swiss Finance Institute Research Paper Series N°06–11, Appendix III, pg. 37.

<sup>22</sup> Ibid., pg. 38.

<sup>23</sup> La Porta, R., Lopez-de-Silanes, F. and Shleifer, A., 'What Works in Securities Law?', (2006), *Journal of Finance*, Vol. 61, pg. 4.

<sup>24</sup> Weil, Gotschal & Manges LLP, see above, note 14, pg. 3.

majority of variations and divergence in corporate governance practices among EU Member States appear to result from differences in law rather than from differences in the recommendations themselves.<sup>25</sup>

The adopted codes contain principles rather than detailed rules. They set the framework and the guiding lines, together with suggestions, recommendations and business standards. They are being regularly reviewed and updated, in order to reflect all the latest developments. Apart from that, their flexibility is evident from the fact that they are wholly voluntary in nature and their provisions are not legally binding, as in most instances they are accompanied by a ‘comply or explain’ rule (disclosure of the degree of compliance with code recommendations, together with an explanation of any areas of non-compliance). Compliance often becomes a more binding and less discretionary option if codes are linked to the securities markets and listed companies are obliged to comply with their provisions or provide reasons for any deviations at the end of every financial year. The increased competition among markets for global capital requires a regulatory environment with high standards of transparency, efficiency and integrity.<sup>26</sup> Therefore, securities market regulators in almost all developed and emerging markets have been quite active in identifying the gaps in corporate governance regulation and are eager to raise its standards accordingly whenever necessary. The supporters of self-regulation have the firm belief that compliance will come as a result of the efficiency of the rules in combination with the pressure of market forces to those who do not comply with the provisions of the codes.

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<sup>25</sup> Ibid.

<sup>26</sup> Report of the Kumar Mangalam Birla Committee on Corporate Governance, para 2.4, available in the website: <http://web.sebi.gov.in/commreport/corpgov.html>.

### ***(i) The role of disclosure***

Corporate governance is closely connected with disclosure. In fact, disclosure plays a key role in almost all corporate governance codes, as companies are required to disclose information regarding their compliance with the codes. They should include information in their annual report on how they follow the code's provisions in dealing with corporate governance issues.

Disclosure is not a new concept in the corporate governance debate, as it has a long history behind it. In Germany, mandatory disclosure rules can be found for the first time in the amended Commercial Code of 1870. The aim was the protection of investors and creditors. However, there are analysts who believe that it went beyond the protection of individual investors and creditors by serving a general public interest.<sup>27</sup> The broad public interest basis of disclosure regulation was something radical and innovative for the second half of the 19<sup>th</sup> century. The official recognition of this basis took place in 1931, when the new Act stressed the responsibility of large corporations to the general public and the nation.<sup>28</sup>

The importance of disclosure has also been highlighted in the UK since the time of the Acts of 1933-34 and the Gladstone legislation, as the 'prime means of achieving investor protection'.<sup>29</sup> Prevention of fraud and investor protection via disclosure has been the 'classic rationale' for English securities regulation from the 1830s until the 1960s.<sup>30</sup> It was linked with securities fraud and it was assumed that disclosure of material

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<sup>27</sup> Meier-Schatz, C., 'Disclosure Rules in the U. S., Germany and Switzerland', (1986), *The American Journal of Comparative Law*, Vol. 34, No. 2, 277.

<sup>28</sup> *Ibid.*, pg. 277-8.

<sup>29</sup> Walker, G., 'Securities Regulation, Efficient Markets and Behavioural Finance: Reclaiming the Legal Genealogy', (2006), *Hong Kong Law Journal*, Vol. 36, Part 3, 492.

<sup>30</sup> Among others, Knauss, R., 'A Reappraisal of the Role of Disclosure', (1964) 62 *Michigan LR* 607, 611 and Prentice, R., 'The Inevitability of a Strong SEC', (2006), 91 (4) *Cornell LR* 775, 807ff.

information would prevent the promotion of fraudulent practices. In this way, disclosure became mandatory with a view to avoiding the repetition of the stock market crisis and has maintained its importance up to the present day.<sup>31</sup>

However, nowadays, the character and the aims of disclosure have changed. It aims at providing the investors with the appropriate means to protect themselves. Put differently, it combines investors' protection with business freedom, as investors do have the choice of acting irrationally or even against their interests (even though they usually do not).<sup>32</sup> The focus is on whether or not investors have all the available information before they make their decisions. Their final choices and their outcome are not relevant as long as investors were aware of all the relevant facts and the required flow of information enabling them to make an informed decision. In Enron, for example, there was absolutely no problem with the system of mandatory disclosure. The problem was that the market participants failed to identify or to decode the information available to them. As Jonathan Macey points out, 'the sunlight that disclosure brings about is useful only if market mechanisms are in place that are capable of observing and interpreting the information that the sunlight brings into view'.<sup>33</sup>

Disclosure is actually a 'moving target and the priority of items to be disclosed changes over time'.<sup>34</sup> This is the reason why the importance of disclosure for corporate governance and company law structures has not really changed throughout the years. This is heightened by the recent statement from the High Level Group of Company Law

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<sup>31</sup> Walker, see above, note 29, 510.

<sup>32</sup> Ibid.

<sup>33</sup> Macey, J., 'A Pox on Both your Houses: Enron, Sarbanes-Oxley and the Debate concerning the Relative Efficacy of Mandatory versus Enabling Rules', (2003) 81 Washington ULQ 331.

<sup>34</sup> Lannoo, K., and Khachaturyan, A., 'Reform of Corporate Governance in the EU', (2004), European Business Organization Law Review, Vol. 5, No 1, pg. 46.

Experts that ‘disclosure can be more efficient than substantive regulation through more or less detailed rules’.<sup>35</sup> This statement is perhaps the best way to epitomize the response at national level.

The EU Member States have added corporate governance to the top priorities of their regulatory agenda. They followed the example of the UK and, without turning their backs on the EU initiatives, devoted time and money to reinforcing their national company law and corporate governance framework. Their regimes were based on voluntary compliance, transparency, disclosure and self-enforcement. Their goal of endorsing a culture of ethical business and compliance without governmental interference or EU intervention soon vanished into thin air, as the list of companies engaged in fraudulent practices was growing. The codes of best practice and the relevant principles needed to be enforced, and voluntary compliance proved to be a hard target to achieve.

At that point, the EU, as a Union, did not follow the example of the American federal government in rushing to use its authority and powers of enforcement. The Commission’s tactic was instead to continue its harmonization project, working closely with the Member States, while accepting its time-consuming character and the resulting compromises. It was essential to establish this culture of compliance throughout Europe as the Union could not afford to put the achievement of the Internal Market into jeopardy due to a lack of voluntary compliance, low enforcement coupled with human vanity, and fraudulent activities.

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<sup>35</sup> Villiers, C., *Corporate Reporting and Company Law*, Cambridge University Press, Cambridge, 2006, pg. 181.

## **(II) *Pan-European Level***

### **(i) *The Commission's Initiatives***

If we were to transfer the debate to a pan-European level, the landscape would initially seem a bit vague. In a German book on 'European Corporate Law'<sup>36</sup>, which was published in 1999, no hint at corporate governance can be found. It is not a surprise that Germany was one of the last countries to adopt a corporate governance code, and did so in 2002. This probably sounds quite bombastic and does not refer to corporate governance in a wide context. It can be used as an indication of the fact that corporate governance *stricto sensu* was not included in the European company law harmonization agenda<sup>37</sup>, but there is no evidence that Germany had yet to discover corporate governance, which can be understood from the Commission's initiatives. First of all, there are 11 company law Directives that represent the 'first generation of common rules'<sup>38</sup>, although there is not a framework for the uniform implementation of these Directives. In 1999 the OECD Principles of Corporate Governance were also published. It was a non-binding set of standards, developed by an independent Organization, but it turned out to be extremely influential for most of the European countries and contributed to the development of their national corporate governance codes. Overall, it is hard to ignore that corporate governance and, more specifically, the weaknesses of corporate governance systems was becoming one of the 'hot' topics in the policy discussions both internationally and at EU level. What remains to be examined is whether there has been a response to the series of scandals from the European Union as an institution, whether

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<sup>36</sup> Habersack, M., *Europaisches Gesellschaftsrecht*, Beck, Munich, 1999.

<sup>37</sup> Hopt, K., see above, note 5, pg. 189-190.

<sup>38</sup> De Vicuna, A.S., 'The Legal Integration of Financial Markets of the Euro Area', in Andenas, M. and Avgerinos, Y. (eds), *Financial Markets in Europe: Towards a Single Regulator?*, Kluwer Law International, London, The Hague and New York, 2003, pg. 20-21.

there has been a European response to the SoX and, finally, if there has been a response, what is the nature of it.

It is helpful to begin by going back in time again to examine the history of the initiatives and attempts made by the European Union and its institutions. The first Directive, which relates to securities regulation, is the Listing Directive of 1979 on coordinating the conditions for the admission of securities to official stock exchange listings. The next decade, the 1980s, was rather quiet, while the last decade of the 20<sup>th</sup> century was characterized mainly by the adoption of codes in almost all European countries, as it was described in the previous section. The European Commission was not inactive, but it played the role of a *de facto* supervisor of the Member States' initiatives. It was a conscious decision not to intervene, based on the argument that 'corporate governance was an excellent area in which to apply the soft law approach and that harmonization in this area would jeopardize the strength of diversity of the national systems'.<sup>39</sup> While observing the Member States' progress, the Commission consulted on several occasions with experts as to whether EU action was required in this area.

An Ernst & Young's study in 1995 concluded that a Directive was required through which EU would set a framework of principles for corporate governance of large companies. Two years later, in December 1997, the Commission, in an attempt to increase the quality of its proposals, recommended the creation of a Company Law Forum.<sup>40</sup> It should be reminded that at that time the primary goal and the driving force for every initiative was the creation of a fully integrated market. The objective was far different from the creation of a common regulatory environment, but this does not

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<sup>39</sup> Lannoo, K., and Khachatryan, A., see above note 34, pg. 39.

<sup>40</sup> *Ibid.*, pg. 42.

undermine any attempt made by the Commission back then, as it is difficult to create the ‘European internal market’ without having a corporate governance framework in the European Union. Such a framework includes issues like corporate mobility, accounting standards, financial reporting and disclosure requirements. For example, in the beginning of the 21<sup>st</sup> century, the choice of the International Financial Reporting Standards (IFRS) was a decisive step towards the creation of the single market in Europe. The European Union decided in 2002 that all listed EU companies (including banks and insurance companies) will be required to use IFRS after 2005. IFRS can be compared with a common language for all European companies on financial reporting, which opens new horizons in the field of accounting, auditing and transparency. Attempts are also made in order to bridge the gap between IFRS and U.S. generally accepted accounting principles (GAAP) and it is true that key aspects of US GAAP and IFRS converge.

### ***(ii) The 8<sup>th</sup> Directive***

Concluding on the Commission’s initiatives and before turning to the more ‘advertised’ High Level Group of Company Law Experts and the Action Plan, it is worth referring to the EU Eighth Directive<sup>41</sup>. In fact, the 8th Council Directive on Company Law was adopted in 1984 (a few years after the Fourth Directive relating to the annual accounts of certain kinds of companies in 1978) and it belongs to the initial attempts of the European Union to harmonize company law in Europe. It cannot be argued that its content opens new ways towards the improvement of quality of companies’ audits and governance, although an attempt was made to set common minimum European standards

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<sup>41</sup> Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC.

on auditing, from auditor independence to auditing services. On 25 April 2006, the Council of the European Union adopted the Revised Eighth Company Law Directive and represented an intention to improve transparency and to restore investor confidence in the markets after the well-known corporate scandals. This would be achieved by creating ‘a new regulatory and legal environment and corporate accountability framework that would be recognized on a global scale’.<sup>42</sup> The Directive has plenty of similarities with the SoX not only in the content, but in its philosophy as well. James Turley, the Chairman and CEO of Ernst and Young, drew the picture of the 8<sup>th</sup> Directive on Company Law as being for the European business what SoX to the US SEC registrants.<sup>43</sup> Investors’ confidence, protection against fraud and accuracy of audited accounts were the central issues and international co-operation was highlighted as being essential. The co-operation with the US PCAOB is also fundamental, given the fact that there are more and more ‘doubly listed’ companies. The improvement of the international co-operation requires among others harmonized- to a certain extent- rules and EU was obliged to present something new post-Enron. As it was stated above, scandals had already knocked the door of the EU Member States and, thus, existing EU legislation was seen by US regulators as being too weak.<sup>44</sup>

If we want to have a clear picture of reality, the revised Eighth Directive will neither convert the EU to a federal state nor will it harmonize company law in Europe. Even the characterizations ‘equivalent to SoX’ or the ‘European response to SoX’ are

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<sup>42</sup> Braiotta Jr., L., ‘An Overview of the EU 8th Directive: The European Union prepares to issue its response to corporate malfeasance’, (2005), *Internal Auditor*, Vol. 62, No. 2, pg. 62.

<sup>43</sup> Turley, J., ‘Ready for the EU’s 8<sup>th</sup> Directive’, (2004), Directorship, June 2004, available in the website: [http://www2.eycom.ch/library/items/directorship\\_200406/en.pdf](http://www2.eycom.ch/library/items/directorship_200406/en.pdf).

<sup>44</sup> Moizer, P., ‘A Review of Europe’s Response to Audit Quality Concerns’, (2006), paper presented in the Workshop on Audit Quality of the European Institute for Advanced Studies in Management, pg. 3, available in the website: <http://www.eiasm.org/UserFiles/Peter%20Moizer.doc>.

rather premature. This was underlined by Jürgen Tiedje of the EU Commission, who made it clear that ‘it is not as if the 8th EU Directive were a European variant of the Sarbanes Oxley Act. Europe is not going to experience a EURO-SoX or any kind of SoX light’.<sup>45</sup> The 8<sup>th</sup> Directive is a positive development in the field of financial reporting system and auditing and it will definitely have a positive impact in the long-run. The use of IFRS and the adoption of International Auditing Standards instead of nationally based standards is a step towards integration.<sup>46</sup> The criterion for its success will be the level of enforcement. In order for the Directive to stand the test of time, the triptych of success is compliance, adaptation to the new standards and commitment to the objective that needs to be achieved.

### ***(iii) The Financial Services Action Plan (FSAP)***

Another landmark in the road towards the creation of a single market for financial services and the harmonization of the financial services markets within the European Union was the Financial Services Action Plan (FSAP). It was adopted in May 1999 and endorsed by the European Council of Lisbon in March 2000. The FSAP was a wide-ranging and ambitious project which consisted of a list of measures through which the European Commission intended to remove all remaining barriers, to provide a legal and regulatory environment, and to create a fully integrated capital market before 2005.<sup>47</sup> More specifically, it was intended to a series of regulatory and legislative measures

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<sup>45</sup> ‘The 8<sup>th</sup> EU Directive- No SoX for Europe’, Inside Sarbanes Oxley, 26 November 2007, available in the website: <http://www.insidesarbanesoxley.com/2007/11/8th-eu-directive-no-sox-for-europe.html>.

<sup>46</sup> Moizer, see above, note 44, pg. 1.

<sup>47</sup> ‘The EU Financial Services Action Plan: A Guide’, (2003), HM Treasury, the Financial Services Authority and the Bank of England, pg. 6, available in the website: [http://www.fsa.gov.uk/pubs/other/fsap\\_guide.pdf](http://www.fsa.gov.uk/pubs/other/fsap_guide.pdf).

designed to make the European market more efficient and transparent, as well as to modernize and enhance the efficiency and structure of the regulatory regime for financial services within the European Union, as Mark W. Olson stated before the U.S. House of Representatives and the Committee on Financial Services.<sup>48</sup> The primary objectives of the Plan were the creation of deeper and more liquid markets, the improvement of access to capital for companies, and the introduction of compatible national company law and corporate governance regimes, so that the availability of capital was not limited and the cost was not increased.<sup>49</sup>

The initial implementation deadline was set at the end of 2004 and proved to be unrealistic. Nevertheless, nobody can deny that achieving a completion rate was 98% (41/42 measures adopted) by 2005 was an unexpected success. The almost simultaneous and successful introduction of the Euro also had a positive impact. Moreover, it became obvious that a single European market would become a reality much more easily if there were common standards and procedures regarding corporate governance framework and greater co-operation from all the parties and institutions involved. Corporate governance covers all aspects of a company's operation, including financial issues, and this is why accounting standards and financial legislation have been added to the discussion of the Commission's role. Nevertheless, the mere adoption of the FSAP measures will not make the dream of the European integrated market miraculously come true. The introduction of new regulations and legislative provisions alone cannot remove all barriers. It must be ensured that the Member States will implement the FSAP effectively and that the way in

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<sup>48</sup> Available in the website: <http://www.federalreserve.gov/boarddocs/testimony/2002/20020522/default.htm>

<sup>49</sup> Department of Trade and Industry, 'Promoting competitiveness: The UK Approach to EU Company Law and Corporate Governance', (2005), pg. 7, available in the website: <http://www.bis.gov.uk/files/file10707.pdf>.

which these measures are implemented nationally has a genuinely liberalising effect.<sup>50</sup> Inevitably, there will be delays until full implementation. Fundamental changes take time. To put this in context, it is worth remembering that there was a time gap of almost 20 years between the time that the new Takeover Directive<sup>51</sup> was first proposed and its eventual enactment after several failed attempts.

#### ***(iv) The Lamfalussy Process***

The recognition that radical changes need time and special arrangements led to the commissioning of the Lamfalussy report into the FSAP. The rationale behind this decision was to avoid the proposed legislation becoming mired in bureaucratic wrangles.<sup>52</sup>

The Lamfalussy Report was named after Alexandre Lamfalussy, chairman of the Committee of Wise Men on the Regulation of European Securities Markets. The Committee was established by ECOFIN in 2000 and its mission was to assess the implementation process of the regulation of securities markets in the European Union. The Committee submitted its final Report to the European Council in March 2001. According to the report, a new innovative legislative approach was developed, the Lamfalussy process, that would cover the entire financial sector of the European Union and its purpose was to improve the implementation of legislation by making it more flexible, transparent, and effective. The process has four levels and concerns the

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<sup>50</sup> 'After the EU Financial Services Action Plan: A New Strategic Approach', (2004), HM Treasury, Financial Services Authority and Bank of England, pg. 7, available in the website: <http://www.hm-treasury.gov.uk/media/E/5/1B4D3E5A-BCDC-D4B3-14E1EB2D499571C2.pdf>.

<sup>51</sup> Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids.

<sup>52</sup> Ibid.

transformation of a piece of legislation from statements of fundamental principles to detailed implementation at national level.<sup>53</sup>

Level 1 refers to the adoption of new legislation by the EU Commission, the Council, and the Parliament. At the first level, the core principles of the new law are drafted and the framework legislation is created. Level 2 refers to implementation. At the second level, two new committees are involved, the Committee of European Securities Regulators (CESR) and European Securities Committee (ESC). These expert committees are assisting the Commission in adding all the required technical details to the framework legislation of Level 1. In this way, it is ensured that all the technical details are up-to-date and follow all the latest changes and developments. When the measures to be implemented are agreed on and endorsed by the Commission, the new legislation enters the process of enactment either as a regulation or as a directive. Level 3 refers to implementation at a national level. At the third level, the new legislation goes through a process of co-ordination. Co-operation is required among national regulators in order for the new rules to be in co-ordination in all Member States and also to ensure consistent interpretation of these rules.<sup>54</sup> Level 4 refers to enforcement. At the fourth level, the Commission observes the enforcement and should guarantee the consistent and timely implementation of EU legislation.<sup>55</sup>

The Lisbon Treaty brought changes to the Comitology procedure, recognised under the former Arts 202 and 211 TEU. This procedure, which was based on specialist

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<sup>53</sup> Ibid.

<sup>54</sup> European Parliamentary Financial Services Forum, 'The Lamfalussy Process: Does it work and what are the consequences of extension?', (2003), pg. 2, available in the website: [http://www.epfsf.org/meetings/2003/briefings/briefing\\_2dec2003.pdf](http://www.epfsf.org/meetings/2003/briefings/briefing_2dec2003.pdf).

<sup>55</sup> European Parliamentary Financial Services Forum, 'EPFSF Briefing: The Lamfalussy Process - Is it working? The experience of the Market Abuse Directive (MAD) and other relevant Directives', (2005), pg. 2, available in the website: [http://www.epfsf.org/meetings/2005/briefings/briefing\\_16mar2005.pdf](http://www.epfsf.org/meetings/2005/briefings/briefing_16mar2005.pdf).

committees preparing the measures to be implemented, will gradually disappear. There were voices of criticism against the Process even from its first steps. It was characterized as a cumbersome legislative process for EU financial services, as it was addressing the symptoms and not the underlying causes of the problem.<sup>56</sup> On the other hand, there were evident benefits as well. The Committee tried to ensure greater convergence, uniformity in the interpretation and implementation of new legislation, as well as speed, transparency, and flexibility. Overall, they tried to create a ‘co-operative game’ and this is the reason they chose not to include the creation of a European SEC in their proposals.<sup>57</sup>

What we can keep is that the Lamfalussy procedure, although developed primarily for the securities sector, can be used as a model for reforming the EU policy making process in general. It shows how the drafting process can positively contribute to the development of a more flexible and efficient regulatory framework for the EU and the achievement of consistency in the implementation by the Member States. It was perhaps the first time that the EU legislators recognised the fact that the EU is a *sui generis* institution and thus requires flexible solutions. Although the overriding goals in both national and pan-European level are roughly the same, the existing diversity may require considering a wider range of options. The focus was not to be placed solely on the content of the rules and the nature of the provisions. Enforcement was also of vital importance and the EU legislators had to carefully plan their initiatives even before the initial consultation process, in order to balance any conflicting interests, objections from

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<sup>56</sup> McKee, M., ‘The Unpredictable Future of European Securities Regulation: ’ A Response to Four Predictions about the Future of EU Securities Regulation by Gerard Hertig & Ruben Lee, (2003), pg. 4, available in the website: [http://ec.europa.eu/internal\\_market/securities/docs/monitoring/first-report/2003-07-comments-bba1\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/monitoring/first-report/2003-07-comments-bba1_en.pdf).

<sup>57</sup> De Vicuna, AS., see above, note 38, pg. 13.

Member States, and oppositions that may block the measures. The Lamfalussy process can be used as a road map for the proper design of EU legislation in areas other than financial services or securities regulation.

The most significant piece of legislation introduced under the Lamfalussy procedure is the Markets in Financial Instruments Directive (MiFID). MiFID is considered to be the basis of the FSAP. Despite the incorporation of company law initiatives into the Financial Service Action Plan and the ‘breakthrough’ with the enactment of the SE-Statute in 2001, the initial blockage of the Takeover Directive in July 2001 in the European Parliament led to a political deadlock as it was a major blow to the Lisbon agenda.<sup>58</sup> The reaction of the Commission was immediate: the High Level Group of Company Law Experts.

#### ***(v) The High Level Group of Company Law Experts***

In September 2001, the Commission set up a High Level Group of Company Law Experts, chaired by Jaap Winter, a legal advisor to Unilever. The group of seven experts (Winter group) was asked to provide independent advice on issues related primarily to takeover bids, and subsequently to consider general corporate governance and auditing issues and make proposals for the further modernization of company law in the European Union. As far as the Takeover Directive is concerned, the initial failure to reach the required majority in the first place created an atmosphere of disappointment for the Commission and, through the set up of the High Level Group, showed its determination to come up with an improved proposal as soon as possible. As Frits Bolkestein, the then

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<sup>58</sup> Pannier, M. and Rickford, J., ‘Corporate Governance and Disclosure in Europe’, (2005) 16 European Business Law Review 978.

Internal Market Commissioner, said, these ‘leading European experts’ are able to offer top quality advice not only on the conduct of takeovers, but also on the future of company law in the European Union and the structuring of a competitive European economy.<sup>59</sup> The good news was that the Takeover Directive was finally approved in December 2003 and came into force in April 2004.

The collapse of Enron provided the High Level Group with a new mission in April 2002: to deal with issues relating to the Enron collapse. The ECOFIN Council meeting in Oviedo in April 2002 put corporate governance on the agenda of the Group and extended its mission. The Group completed its mission with a second report ‘On a Modern Regulatory Framework for Company Law in Europe’ in November 2002. The focus of this report, as it was expected, was on financial information, non-executive directors, auditing practices and management and directors’ remuneration, together with a number of more technical company law issues, such as corporate restructuring and mobility, capital formation, group and pyramid structures, and the general future development of company law in Europe. Essentially, the Group highlighted the issues that need to be taken into consideration by the Commission, gave priority to areas where reform was required, and concluded with the advice to the Commission to set up an EU Company Law Action Plan for the future.

Irrespective of the nature and the quality of the Group’s proposals, the fact that the Commission followed most of these proposals is remarkable, if we take into consideration that the High Level Group was just a private group of ‘experts’, independent from the governments of the Member States. It had no formal authority and

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<sup>59</sup> High Level Group of Company Experts, Final Report On A Modern Regulatory Framework For Company Law in Europe, November 2002, Annex 1, at 70, available in the website: [http://ec.europa.eu/internal\\_market/company/docs/modern/report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf).

no powers had been delegated to its members. Its mission was to draft a report containing assessments, proposals and recommendations. Needless to say, these recommendations were, under no circumstances, binding for the Commission. Private groups of experts have the advantage of independence, objectivity and expertise. In most cases, there are objections about the selection criteria, the background and the competence of the experts or sometimes about the whole decision to set up an experts committee. In this case, the absence of second thoughts and doubts stems from the recent international developments in the business world and the perception that the harmonization process of company law in the EU was in jeopardy. The danger of a dead-end was clear and there were no alternatives. The mandate of the High Level Group, as outlined by its Chairman, was to ‘make recommendations on a modern regulatory framework for company law in Europe; basically to point out a new direction for the future development of company law in the EU’.<sup>60</sup>

***(vi) The Action Plan of 2003 (Communication 284)***

On May 21, 2003, the European Commission published Communication 284 (COM-284), entitled ‘Modernizing Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward’. The title reflects the rationale and the objectives of the Action Plan: enhancement of corporate governance and modernization of company law in the European Union. The Commission intended to foster the efficiency and competitiveness of business, with special attention to some specific cross-border issues, strengthen shareholders’ rights and enhance the protection for employees, creditors, and other

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<sup>60</sup> Winter, J., ‘EU Company Law on the Move’, (2004), Legal Issues of Economic Integration, Vol. 31, No. 2, 98.

parties with which companies deal. It was important to create an environment of confidence surrounding companies in the European Union.<sup>61</sup>

The problems had been identified a long time ago and the time was right for actions and solutions. Frits Bolkestein expressed the view that ‘economies only work if companies are run efficiently and transparently. We have seen vividly what happens if they are not: investment and jobs will be lost; and in the worst cases, of which there are too many, shareholders, employees, creditors and the public are ripped off’. The key issues were not new issues that came up in the discussion for the first time: corporate governance, disclosure, transparency, audit committees, directors’ remuneration, shareholder's rights, capital maintenance, groups of companies, incorporation of companies, and non-executive directors. The twenty-four proposed measures to be taken at EU level were prioritized and hence divided into three phases: short term (2003-2005), medium term (2006-2008) and long term (2009-onwards). This division and prioritization has been quite significant. The Commission presented its intentions and made its priorities. According to Hopt, it is ‘highly topical to know what the Commission intends to regulate and what it does not intend to regulate within the next five to ten years’<sup>62</sup>, in addition to the method of achieving that.

The Action Plan remains clear and straightforward even when the discussion turns to more disputed issues, like the dilemma between self-regulation and European Corporate Governance Code. It has been repeatedly emphasized that a European

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<sup>61</sup> Hopt, K.J., ‘European Company Law and Corporate Governance: Where Does the Action Plan of the European Commission Lead?’, (2005), European Corporate Governance Institute, Working Paper No 52/2005, pg. 3.

<sup>62</sup> Hopt, K., *ibid.*, pg. 2.

Corporate Governance Code is not one of the top options at this time,<sup>63</sup> but remains on the list as one of the possible future solutions. In particular, the Action Plan is in favour of self-regulation and encourages the development of best practices, in response to the needs of even more integrated markets. Self-regulation and a ‘light touch’ approach based on soft law instruments, such as recommendations, are supported by the Commission as opposed to strict central, top-down legislation, so that companies are not overburdened with too much regulation.<sup>64</sup> The Commission also rejected the option of pure, liberal, non-binding self-regulation, as it was proved that the market itself does not guarantee protection against the demons of the past.

Shortly after the publication of the Action Plan more and more Member States showed remarkable activism in taking the first steps to modernize their national company laws, and throughout the subsequent years took steps to keep their corporate governance codes updated.<sup>65</sup> Berglöf and Pajuste welcomed such efforts and considered that the Action Plan can be used as a basis for the creation of internationally accepted best practices of corporate governance and that it will play a significant role in shaping the contents of codes in all European countries, especially the Eastern European ones after the recent enlargement of the European Union. The codes of Eastern European countries

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<sup>63</sup> The Weil, Gothshal & Menges study in 2002 came up with the same conclusion; it found a high degree of convergence between the national corporate governance codes, and therefore did not advocate adoption of a single code at the EU level. Commissioner McCreevy, during the first meeting of the European Corporate Governance Forum in 2005, ruled out a European code of conduct, promoting efforts towards convergence of national rules, available in the website: <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/05/702&format=HTML&aged=1&language=EN&guiLanguage=en>.

<sup>64</sup> McCreevy, *ibid.*

<sup>65</sup> Among others, see Koulouridas, A. and von Lackum, J., ‘Recent Developments of Corporate Governance in the European Union and their Impact on the German Legal System’, (2004), *German Law Journal*, Vol. 5, No. 10, *European & International Law*, available in the website: <http://www.germanlawjournal.com/article.php?id=506>. For example, the ‘Ten-Step Program for Corporate Integrity and Investor Protection’ and the UMAG, a ‘Law on the Improvement of Corporate Integrity and on the Modernization of the Regime governing Decision-Directed Suits’ were published in Germany.

are most likely to be influenced by these practices, in the same way as it happened in the past with the other Member States' codes, the contents of which were more or less were copied by the already existing UK and USA codes.<sup>66</sup>

### ***(vii) Assessment of the Action Plan***

Following the introduction of the Company Law Directives, the adoption of the FSAP and the overall progress of the EU Law harmonization project, the EU has made significant progress in most areas of corporate governance regulation, such as disclosure, corporate mobility, shareholders rights, and remuneration of directors. The goal of harmonization has not yet been accomplished, but we should not neglect the fact that the objective of the EU was not to create homogeneity in the Common Market, but a well-functioning Internal Market.<sup>67</sup> National legal systems must be compatible, if not harmonized, sharing good practices and respecting diversity. If the corporate governance standards are raised and competitiveness is promoted, market confidence and credibility of national markets to foreign investors will be increased. The Union still needs to modernize its company law and corporate governance regulatory framework, in order to overcome the obstacles standing in its way to the future: the continuous integration of the European capital markets, the challenges of the recent enlargements, the Lisbon Treaty objectives, as well as the impact of corporate scandals and the financial crisis. In this context, the Action Plan looks more like a means to an end, rather than an end itself; it is a toolbox, which the Commission has used and will continue to use until all barriers for

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<sup>66</sup> Berglöf, E. and Pajuste, A., 'What Do Firms Disclose and Why; Enforcing Corporate Governance and Transparency in Central and Eastern Europe', (2005), Oxford Review of Economic Policy, 21, 2, 179.

<sup>67</sup> Hopt, K.J., 'The European Company Law Action Plan Revisited: An Introduction', (2010), ECGI - Law Working Paper No. 140/2010, pg. 6.

businesses are removed from the EU and/or the dream of harmonization of law becomes a reality.

The Action Plan is a living document capable of responding to changing circumstances. It will be kept under regular review, so as to ensure that the initially proposed measures are still the most appropriate ones to deal with the contemporary problems of the business world. Its measures are subject to impact assessments, which aim to ascertain whether the benefits for all Member States outweigh the regulatory costs. In addition, regular re-evaluations take place ahead of landmark events or after unexpected changes. For instance, under the new Commissioner for the Internal Market, Charlie McCreevy, the Plan was re-evaluated in 2005-6 and its measures were tested pursuant to the objectives of the Lisbon Strategy ahead of the ratification of the Lisbon Treaty.<sup>68</sup> Actually, this evaluation<sup>69</sup> resulted in the withdrawal of a number of proposals, such as the proposed regulation for a European association<sup>70</sup> and a European mutual society<sup>71</sup>. There were complaints of increasing regulatory fatigue from market participants and thus the evaluation identified the need for a short pause, allowing both companies and investors more time to digest the changes, the new requirements and to

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<sup>68</sup> Internal Market and Services Directorate, 'Consultation on Future Priorities for the Action Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union', 20 December 2005, available in the website: [http://ec.europa.eu/internal\\_market/company/docs/consultation/consultation\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/consultation/consultation_en.pdf)

<sup>69</sup> Directorate General for Internal Market and Services, 'Consultation and Hearing on Future Priorities for the Action Plan for Company Law and Corporate Governance in the European Union. Summary Report', (2006), available in the website: [http://ec.europa.eu/internal\\_market/company/docs/consultation/final\\_report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/consultation/final_report_en.pdf). See also, European Parliament resolution on recent developments and prospects in relation to company law (2006/2051(INI), available in the website: <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2006-0295+0+DOC+XML+V0//EN&language=EN>), and European Parliament, Committee on Legal Affairs (Rapporteur: Andrzej Jan Szejna), 'Report on Recent Developments and Prospects in relation to Company Law', 26 June 2006, Final A6-0229/2006.

<sup>70</sup> Amended Proposal for a Council Regulation (EEC) on a statute for a European Association, (1993) O.J. C 236/1, earlier version 1991/386/COD.

<sup>71</sup> Amended Proposal for a Council Regulation (EEC) on a statute for a European Mutual Society, (1993) O.J. C 236/40, earlier version 1991/390/COD.

reflect on the future perspectives.<sup>72</sup> Following this change of strategy, it would not be fair to base the judgement for the success or the failure of such an ambitious project solely on the degree of the implementation of its proposals. In general, no matter how well-designed and well thought-out a piece of legislation is, it has absolutely no value, if it stays in the statute book for ever and is not applied in real life situations.

In the present case, the first stage with the short-term action has been successfully completed, with the exception of the 14<sup>th</sup> Directive on the cross-border transfer of seat.<sup>73</sup> The ‘no action’ strategy of the Commission can be justified on the grounds that there are already existing possibilities for cross-border transfer of a registered office already permitted by the SE Regulation and the Cross-border merger Directive. Another justification can be found in the *Cartesio* judgment. Although the Court’s ruling constitutes a clear incentive for the Commission to put forward a proposal of the 14th Directive establishing a harmonized regime of companies’ cross-border conversion, Commissioner McCreevy expressly stated that *Cartesio* can be sufficient and that it has contributed to the clarification of the problem of the cross-border transfer of registered office.<sup>74</sup> This strategy has met the criticism of the academic community as being currently ‘unsustainable’.<sup>75</sup>

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<sup>72</sup> Baums, T., ‘European Company Law Beyond the 2003 Action Plan’, (2007), ECGI - Law Working Paper No. 81/2007, pg. 9. See also International Finance Corporation, ‘The EU Approach to Corporate Governance Essentials and Recent Developments’, (2008), pg. 4, available in the website: [http://www.ifc.org/ifcext/media.nsf/AttachmentsByTitle/IFC\\_EUApproach\\_Final/\\$FILE/IFC\\_EUApproach\\_Final.pdf](http://www.ifc.org/ifcext/media.nsf/AttachmentsByTitle/IFC_EUApproach_Final/$FILE/IFC_EUApproach_Final.pdf).

<sup>73</sup> ‘having weighed the arguments advanced [on the Commission’s Impact assessment on the Directive on the cross-border transfer of registered office (Commission Staff Working Document) of 12.12.2007 SEC(2007) 1707] Commissioner McCreevy has decided that there is no need for action at EU level on this issue. DG internal market has therefore stopped work on this area’, available in the website: [http://ec.europa.eu/internal\\_market/company/seat-transfer/index\\_en.htm#ia](http://ec.europa.eu/internal_market/company/seat-transfer/index_en.htm#ia)

<sup>74</sup> Ibid at pg. 24-25 and 38. See also Commissioner’s McCreevy Speech in Berlin on the 28 June 2007.

<sup>75</sup> Sousa, A., ‘Company’s Cross-border Transfer of Seat in the EU after *Cartesio*’, (2009), Jean Monnet Working Paper 07/09, pg. 54 ff., available in the website: <http://centers.law.nyu.edu/jeanmonnet/papers/09/090701.pdf>. See also, Vossestein, G-J., ‘Cross-Border

The other two stages are not likely to have the same fate as the first one, because the medium-term phase has been halted and the only long-term action, the introduction of an alternative regime in the 2<sup>nd</sup> Directive has been called off. This is another illustration of the fact that the EU not only cannot operate federally, but also that protectionism, national egoism and Member States' politics influence the shaping of any future steps in the area of company law.<sup>76</sup> Therefore, it would be rather premature at this point to attempt a final assessment of the Plan's implementation. The EU needs some more time to put all the pieces of the regulatory jigsaw together and put all the changes into practice.

The European regulatory approach is not a simple one. Klaus Hopt is of the opinion that 'pure solutions are academically challenging and often conceptually easy, but down at the grassroots of the economy and society they are seldom right'.<sup>77</sup> It seems to be a flexible solution in a mixed system. The right balance needs to be found between firstly regulation and market forces and, secondly, national regulation and European rules. The Commission shows no intention to suppress the individuality of the 27 Member States and regulate all corporate governance related areas through top-down strict regulation. The comply-or-explain model is broadly supported by both governments and market participants, hence, despite its practical deficiencies, it will not be abandoned. The Plan establishes a *sui generis* type of self-regulation under the supervision of the EU institutions, which will act as coordinators and guarantors of the necessary check and balances. Member States can continue with their national company law legislation and the corporate governance codes already adopted, while EU legislation will fill in the gaps

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Transfer of Seat and Conversion of Companies under the EC Treaty Provisions on Freedom of Establishment - Some Considerations on the Court of Justice's *Cartesio* Judgment', (2009), European Company Law 6 (3), 115-123.

<sup>76</sup> Hopt, see above, note 67, pg. 2-3.

<sup>77</sup> Ibid., pg. 14.

and draw the limits of States' freedom. This is in line with the notion of reflexive harmonization discussed in Chapter 2. Legislative measures that incorporate a menu of choices is available to the Member States and governments are required to achieve the intended goals using any means they consider more appropriate.<sup>78</sup> The use of 'enabling legislation' was also supported by McCreevy<sup>79</sup>, since it is more compatible with the diverse character of the EU. Uniformity is not achieved simply by imposing the same rules in all jurisdictions and expecting that these rules will be uniformly applied without any deviations. Rules do not exist in a vacuum and each country's history, tradition and individuality needs to be taken into consideration. Convergence can be achieved by focusing on the effective implementation of basic common principles.

Even if reflexive harmonization is not accepted as the most suitable method, harmonization remains a realistic target, though with certain limitation. For example, since most of the traditional Company Law Directives are being revisited, reviewed and updated, it is of paramount importance to ensure that the terminology and definitions used in different Directives are harmonized. In this way, the provisions will be clearer, the responsibilities and obligations of EU institutions and governments will be unambiguously defined, inconsistencies will be reduced and enforcement will hopefully be more effective. It could be called harmonization of the harmonization, while scholars like Baum and Andersen are using the term 'harmonization lite'.<sup>80</sup> This method promotes approximation of law, but presupposes the combination of individual national legal

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<sup>78</sup> Baums, see above, note 72, pg. 16.

<sup>79</sup> See Charlie McCreevy speaks to the European Parliament JURI Committee European Parliament JURI Committee (Committee on Legal Affairs) Brussels, 21 November 2006, available in the website: <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/06/720&format=HTML&aged=1&language=EN&guiLanguage=en>.

<sup>80</sup> Baums, T. and Andersen, P.K, 'The European Model Company Law Act Project', (2008), ECGI - Law Working Paper No. 97/2008, pg. 2.

systems with diverse legal solutions. Member States retain a degree of freedom to shape their company law and corporate governance framework as long as the enacted provisions would not disrupt the function of the Internal Market.<sup>81</sup>

The key for the success of the Action Plan is the enforcement of the measures. The period of implementation would not have been completed even if the long-term phase had been completed. Effective implementation presupposes voluntary compliance in recognition of the importance of the common objective, enforcement through a mix of state supervision and public enforcement in cases of non-compliance and periodic evaluation of the rules in practice. The combination of these three elements reveals the main objective of the EU: to create a culture of compliance accompanied by strong enforcement and review of the legislation. Modification or repeal of certain measures is not an indication of failure; on the contrary, it shows willingness to improve. This is why the temporary postponement of the last two phases of the Action Plan should not be considered as a regulatory dead-end for the EU, but as a pause for the necessary reflection. According to the Lisbon Strategy, the EU Heads of States and Governments had agreed since 2000 to transform the EU into ‘the most dynamic and competitive knowledge-based economy in the world’.<sup>82</sup>

The compliance culture that the EU tries to create along with the focus on the enforcement reminds us a bit of the American approach. The SoX basically represents a change not so much in the substance of the rules, but in the enforcement mechanisms. The government and the SEC based the establishment of their own ‘compliance culture’ on a ‘zero tolerance’ policy with constant monitoring and strict supervision. However, it

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<sup>81</sup> Ibid.

<sup>82</sup> Available in the website: [http://www.europarl.europa.eu/summits/lis1\\_en.htm](http://www.europarl.europa.eu/summits/lis1_en.htm).

needs to be clarified that neither the American nor the European legislation can create a protective shield for companies against corruption, unethical conduct, and future scandals. It has recently been pointed out that the SEC's focus under the leadership of Chairman Schapiro and Enforcement Director Khuzami will be on enforcement, 'the cornerstone of SEC's mission'<sup>83</sup>. It seems to have eventually become apparent that the key for a successful corporate governance regime is at the unanimous recognition of the value of ethical business practice and the implementation of the relevant measures for adequate protection of investors, stakeholders and companies.

The EU Action Plan clearly adopts a principles-based regulatory approach and rejects the rules-based approach, which is prevalent in the United States. The rules-based approach is based on the concept that companies must comply with a specific set of procedural requirements, thus legislation takes the form of a checklist of what to do and what not to do.<sup>84</sup> Frits Bolkestein was negative in his assessment of this approach and specifically criticized the American rules for their 'complex exceptions and exemptions', which he said could be abused by crafty lawyers and accountants.<sup>85</sup> In principles-based regulation, there is no such 'box-ticking' procedure, as the focus is not on the means or methods used, but on the end results.<sup>86</sup> Principles provide guidelines and allow flexibility in implementation, as they set minimum standards, the minimum level to which the

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<sup>83</sup> SEC Chairman Mary Schapiro, Brodsky Family Northwestern Fund Lecture, Nov 9, 2010, available in the website: <http://www.sec.gov/news/speech/2010/spch110910mls.htm>

<sup>84</sup> Jackson, R., 'Principles versus Rules: Experts have long disagreed over the best way to ensure effective governance. And, although the debate continues, several areas of consensus have emerged', (2004), Internal Auditor, October 2004, pg. 1.

<sup>85</sup> Landler, M., 'Scandal Outrages Europeans; Solutions May Be Patchwork', New York Times, December 25, 2003, available in the website: <http://query.nytimes.com/gst/fullpage.html?res=9F00E5DB163EF936A15751C1A9659C8B63&sec=&spn=&pagewanted=all>.

<sup>86</sup> Jackson, see above, note 84, *ibid*.

Union at large has to conform with.<sup>87</sup> Porsche, the German maker of sports cars, shelved its plans to list its shares on the New York Stock Exchange last year, rather than going along with the American regulation.<sup>88</sup> There appear to be two sides to this story, a positive and a negative one. The positive side is that Porsche supports the EU approach to corporate governance and finds the American regulation as too strict and demanding, or maybe too costly. The negative side concerns the impact of this decision on the reputation of the company and its attractiveness to investors. They would think that Porsche is not sufficiently well-organized to meet the tough American requirements, or even that there is something wrong with the accuracy of the company's financial statements.

At the same time, there are a number of multinational companies which have to comply with both regulatory systems as they are listed in stock markets both in Europe and the USA. We cannot reject the possibility of having European companies, which are in favour of the American approach and thus support the model of compliance with strict rules rather than compliance with principles. What is really important is not only the choice between rules and principles, but also how this choice becomes an integral part of business reality. It was shown above that scandals did not miraculously disappear after the passing of the SoX. The same can be said of the EU as well, using the case of Northern Rock as an example. The United Kingdom has been advertised as the most active country in the field of corporate governance regulation. In spite of this fact, the

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<sup>87</sup> 'Improving Governance Performance: Rules-Based vs. Principles-Based Approaches', (2004), *Leadership Acumen*, Issue 16 – January/February 2004, pg. 3.

<sup>88</sup> Landler, see above, note 85.

Financial Services Authority failed to supervise Northern Rock according to the acceptable standard, as it was admitted by Hector Sants, FSA chief executive.<sup>89</sup>

There is no value in further comparing the two approaches. The EU approach is clearly orientated and it is in line with the Commission's objectives for a more ethical and balanced business environment. It would be wrong for the EU to try to follow the American example and duplicate the legislative measures that were adopted in the US. Diversity is a reality for Europe and the sooner this becomes understood the better for European Corporate Governance. It would be naïve to believe that such a wide-ranging law as the SoX, specifically designed for the American legal system and enacted without the appropriate time for sufficient preparation, is *a priori* the best solution for the European Union. Even if the Transatlantic Corporate Governance Dialogue reaches the conclusion that the transplantation of the SoX to Europe is the most promising solution, the transition will not take place instantly. The shift will be completed after careful and methodical preparation, planning, and deliberations. Until then, there is no need for the EU to engage in a conflict with the USA for the prevalence of the European approach against the American and *vice versa*. Instead of a battle for prevalence, they must support the ongoing dialogue, as there is room for convergence and exchange of useful ideas. Mutual recognition and cooperation will definitely bring more benefits for both markets in the long run.

### ***(viii) Conclusion***

*'Enron' opened up the path to some important corporate governance reforms in Europe which previously had not been accessible. Legislating in reaction to the latest*

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<sup>89</sup> BBC News, 'Watchdog admits failure over Rock', 26 March 2008, available in the website: <http://news.bbc.co.uk/1/hi/business/7313896.stm>.

*scandal has its dangers, of course, not least the danger of overreaction, of legislating before a robust and dispassionate analysis has been established of the lessons to be learned from the scandal. On the other hand, in democracies, a public scandal makes available for reformers that most precious of legal commodities, legislative time. For corporate law, not otherwise likely to be given a high political ranking, the scandal, by breaking down the stranglehold which interest groups are often able to lay upon the process of reform, may provide an important opportunity to make changes which the prior consensus had prevented...'<sup>90</sup>*

Enron and other subsequent scandals brought the European countries before a unique challenge of designing and implementing one of the most wide-ranging reforms in the business history. The success of the Internal Market and the future of the European Union as a distinctive model of state were at stake. The EU managed to avoid the two loopholes that Paul Davies has identified: overreaction, and regulation without analysis of the lessons to be learned. The EU response to the wave of scandals was carefully planned and came as the natural extension of the earlier initiatives and the already initiated harmonization process. The Commission tried to decode the lessons from the mistakes of the past and to gain experience from the American response and the first signs of the post-scandals era. At the same time, the EU legislator bought time to organize their upcoming measures and not be under pressure like the US Government was and to not have to deviate from the regulatory path the EU has been following for the last 30 years. Finally, the legislator took advantage of the momentum, using it to override much of the opposition<sup>91</sup> from individual Member States, which were sceptical regarding the necessity of the proposed reforms.

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<sup>90</sup> Davies, see above, note 11, pg. 441-2.

<sup>91</sup> Among others, see Hopt, note 61, pg. 7. 'The criticism reaches from fundamental opposition under the subsidiarity principle and the economic concept of regulatory competition to more specific critiques of the single actions proposed'.

It is far easier in times of crisis to draft legislation that, despite being founded on good intentions, produces unintended consequences and imposes substantial costs on companies, thus impeding economic growth, than it is to correct such legislative blunders thereafter. However, policy-makers and legislators took their time to ascertain how best to proceed, given the causes of the scandals and the possible consequences of their decisions in the long run.<sup>92</sup>

Summarizing all of the above, the European Union's choice, as reflected in the Action Plan, is to reject the 'one-size-fits-all' approach and instead vote for respecting diversity, approximation of law, and strong enforcement. The Commission opted to establish a set of basic principles as guidelines for Member States, and then for the close co-ordination of national codes and legislation. The proposals were and will be introduced following consultation and thorough cost-benefits analysis, and each Member State will re-examine its company law and corporate governance regime so as to be in line with the Action Plan's principles. All measures adopted, as well as all future proposals, will be under regular review and evaluation depending on the changes in the social, political and economic environment. The crux, and intellectual challenge, lies in finding the right mix of instruments, answering to whether and what degree of mandatory or fall-back law is needed, and, if so to what degree, and, furthermore if it is needed, what the role of the EU should be.<sup>93</sup>

The next Chapter will attempt to test the EU approach on its suitability to prevent future scandals and effectively protect markets and companies in Europe from new 'Enrons' and 'Parmalats'. In other words, the Action Plan's culture of compliance will be

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<sup>92</sup> Romano, R., 'Does the Sarbanes-Oxley Act Have a Future?', (2009), Yale Law & Economics Research Paper No. 385, pg. 112.

<sup>93</sup> Hopt, see above note 67, pg. 8.

assessed and we will look for additional ways of reinforcing this culture and enforcing its provisions, so that the investing public retains its confidence in the stability and operation of the markets, the companies continue to operate in a safe environment, and policy-makers are confident that nothing can bring back memories from the period of scandals.

## CHAPTER 6

### ***THE WAY FORWARD FOR CORPORATE GOVERNANCE***

The previous two chapters focused on corporate governance regulation in the aftermath of scandals both in the USA and the European Union. The shock for the business world was strong and a response was essential, if not unavoidable. They were obliged to ‘clean up the mess’<sup>1</sup>, stand on their feet again, and find ways to prevent similar situations in the future. The aim of this chapter is to make an assessment of these responses in an attempt to shed light on the future of corporate governance. The day after tomorrow is coming and it is vital to have a clear picture of it, in order to determine whether the steps that are being made are in the right direction or not. The responses represent the vision that these countries have for the post-scandals era and reflect their idiosyncrasy and their expectations. The USA has provided us with sufficient evidence of its policy objectives, as the SoX constitutes a straightforward representation of the American *modus operandi* when dealing with crises. The EU Action Plan is indicative of the EU’s philosophy, but its step-by-step implementation in combination with its recent reassessment raise several questions regarding its effectiveness for preventing future crises and whether it is the Union’s final word on corporate governance regulation in the aftermath of the notorious corporate scandals and collapses.

This chapter will attempt to deal with the way forward for corporate governance after the corporate scandals. The potential role of ethics as the missing link between corporate regulation and corporate success will be examined, before the discussion turns to the nature and characteristics of a possible ethical framework for modern corporate governance. In this context, the concept of ethics and the culture of compliance will be discussed, while the

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<sup>1</sup> Leuz, C., ‘We Need Smarter Regulation, Not More’, (2009), Forbes Online, Commentary 02 September 2009, available in the website: [http://www.forbes.com/2009/02/09/dynamic-financial-regulation-opinions-contributors\\_0209\\_christian\\_leuz.html](http://www.forbes.com/2009/02/09/dynamic-financial-regulation-opinions-contributors_0209_christian_leuz.html).

compatibility of this culture with the EU corporate reality will be examined. The chapter will conclude by shedding some light on the next day of regulation in the EU and the USA.

## **(I) *Crises and Regulation***

History has shown that regulation usually emerges after periods of crisis. However, such regulation has ‘rarely come about as a consequence of rational deliberation’, but it takes the form of ‘panic stricken short-term responses to the crisis that has just passed’.<sup>2</sup> A series of new laws and rules is being introduced aiming at restoring the public’s confidence and preventing a similar crisis from happening again. These two objectives seem to be equally important and characterize almost all major contemporary reforms. However, regulators and policy-makers seem to focus their attempts on achieving the first objective, namely restoring public confidence and are less tailored in achieving the more fundamental objective of preventing future scandals and collapses.

Crisis-driven intervention often fails to find the right balance between over-regulation and deregulation. Increased regulation has been one of the most common post-crisis strategies, but fails to offer any guaranteed results. Besides, optimal regulation is not necessarily the same as strict regulation. At the same time, regulatory gaps or absence of regulation has rarely been the real problem. Panic has never proved to be a good advisor. Financial markets are inherently unpredictable and prone to extremes<sup>3</sup>, but this does not mean that there is no time for a more thoughtful and comprehensive approach in order to address the financial issues and problems.

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<sup>2</sup> Andenas, M., ‘Who is going to supervise Europe’s Financial Markets’ in Andenas, M. and Avgerinos, Y. (eds), *Financial Markets in Europe: Towards a Single Regulator?*, Kluwer Law International, The Hague, 2003, xvi.

<sup>3</sup> Congressional Oversight Panel, ‘Special Report on Regulatory Reform: Modernizing the American Financial Regulatory System: Recommendations for Improving Oversight, Protecting Consumers, and Ensuring Stability’, January 2009, pg. 2.

As Minsky pointed out, ‘there is an inherent and fundamental instability in our sort of economy’ and argued that ‘the processes that generate financial fragility are natural or endogenous to the system’.<sup>4</sup> He was one of the first to discuss financial instability more than 50 years ago and he argued that crises are part of the economy’s evolutionary process: ‘when crises are successfully contained, then risky practices are validated and this sets the stage for subsequent crises’.<sup>5</sup> In other words, the periods between two crises, the so-called ‘tranquillity periods’<sup>6</sup>, are the most crucial, because they encourage not only more innovative behaviour, but more risk-taking as well.<sup>7</sup> As a result, tranquillity is inevitably disrupted by excessive risk-taking and market instability, the economy moves away from equilibrium and an atmosphere of uncertainty is created in the markets. Lack of confidence in combination with insufficient or inefficient regulation prevents financial markets from functioning properly, often with detrimental results. Arthur Levitt, former Chairman of the Securities and Exchange Commission (SEC) was clear that: ‘disclosure systems that are founded on high-quality standards give investors confidence in the credibility of financial reporting - and without investor confidence, markets cannot thrive’.<sup>8</sup> There are so many people that are affected and so many vulnerable parties involved that total absence of regulation is inconceivable. A well-designed legal framework with clear and effective rules is essential to replace fraudulent practices and insecurity and contribute to the harmonious operation of the financial markets.

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<sup>4</sup> Papadimitriou, D.P. and Wray, L.R., ‘Minsky’s Stabilizing an Unstable Economy: Two Decades Later’ in Minsky, H.P., *Stabilizing an Unstable Economy*, Yale University Press, USA, 2008, xii.

<sup>5</sup> Ibid, xi and xii.

<sup>6</sup> Ibid xi.

<sup>7</sup> Ibid xii. See also High Level Group on Financial Supervision in the EU, Report, Brussels, February, 25, 2009, available in the website: [http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf), at point 112: ‘In such an environment, investors and shareholders became accustomed to higher and higher revenues and returns on equity which hugely outpaced for many years real economic growth rates. Few managers avoided the ‘herd instinct’ – leading them to join the competitive race even if they might have suspected (or should have known) that risk premia were falling and that securitisation as it was applied could not shield the financial system against bad risks’.

<sup>8</sup> Kothari, S. P., ‘The Role of Financial Reporting in Reducing Financial Risks in the Market, in Building and Infrastructure for Financial Stability’, in Rosengren, E.S., and Jordan, J.S., (eds), *Building an Infrastructure for Financial Stability*, Federal Reserve Bank of Boston Conference Series, No. 44, June 2000, pg. 91.

President Lincoln once wrote that ‘the legitimate object of a government is to do for a community of people, whatever they need to have done, but cannot do *at all* or cannot *so well do* for themselves - in their separate and individual capacities’.<sup>9</sup> A wise policy-maker first decides whether it is necessary to intervene and, if so, which is the most efficient way to do so. The goal should be to overcome the deficiencies of the existing regulatory regime and create the appropriate safeguards for the future. Sometimes, the existing regulatory framework just needs to be revised. There is no need for an expansion of the regulatory perimeter. The existence of rules is not an end itself. Lack of regulation for a legal phenomenon does not by definition justify a regulatory intervention. A reform can be equally accomplished through the deletion of unnecessary provisions or through replacement of unproductive rules. It is the methodology of reform that counts, not just the content. Regulation is a form of compromise between competing objectives. So, it is not advisable to overload an already overcrowded regulatory framework. Careful planning is always essential, because incorrect rules are no better than no rules.

In relation to corporate governance in Europe, it would not be an exaggeration to argue that the relevant sets of rules have reached a high level of quality and efficiency after so many reforms and updates. As discussed in the previous chapters, the goal of harmonization has not been accomplished, but the notion of reflexive harmonization can be of critical importance, as it supports mutual learning and is clearly focused on the preservation of diversity as such. There has been a recent trend towards the application of reflexive modes of governance in the EU. It is still early to talk about a shift of approach, but the idea of ‘deliberate polyarchy’, emphasized by Charles Sabel and Jonathan Zeitlin, seems to be taking root in EU policy. Reflexive harmonization can be seen as the latest in a series of developments, which have seen the emergence of more reflexive modes. As such, it will, at

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<sup>9</sup> Fehrenbacher, Don E., (ed.), *Speeches and Writings, 1832-1858: Speeches, Letters, and Miscellaneous Writings, the Lincoln-Douglas Debates*, Library of America, New York, 1989, pg. 301.

least initially, be treated as an ‘informal’ mechanism, complementary to the ‘formal’ legal mechanisms associated with lawmaking via directives and Court judgements.<sup>10</sup>

From that point the responsibility passes to the other side: those to whom the regulation is addressed. Good corporate governance is not just following the letter of the law. Regulation can reinforce the foundations of the system and support any attempt for economic growth. But regulation itself is not enough to ensure that companies will not fail. Compliance and enforcement play a central role for the overall assessment of a regulatory initiative. A very recent example supporting the above argument is the Satyam Computer Services fiasco. On the 7<sup>th</sup> of January 2009, Ramalinga Raju, the Chairman of the Board of Directors of the company, resigned after admitting that Satyam's accounts had been falsified. It was the second time within a year that the company's name was in the headlines of the business newspapers within the same year. The paradox is that the first time was when Satyam Computer Services was the winner of the Golden Peacock global award for 2008. This award is given by the World Council for Corporate Governance for excellence in corporate governance.

The nature of the rules is not the real cause for the corporate failures, as companies have failed and continue to fail everywhere even after reforms and new legislative initiatives. It is not about making a choice between strict rules or voluntary codes, and between severe penalties or market forces. Penalties and fines, for instance, can have an intimidating effect, but they do not solve the problem in the long run. If an event with widespread and severe economic and social consequences keeps on repeating itself, the onus is surely on the

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<sup>10</sup> Sabel, C. and Zeitlin, J., ‘Learning from Difference: The New Architecture of Experimentalist Governance in the European Union’, (2006), paper presented to the Theory of the Norm Workshop, FP6 project ‘Reflexive Governance in the Public Interest’, Brussels, 27 October 2006. See also Deakin, S., ‘Reflexive Governance and European Company Law’, (2009), *European Law Journal*, Vol. 15, Issue 2, 224-245 at 244-5.

authorities to change something.<sup>11</sup> It seems it is time for corporate governance to move forward, away from traditional regulatory solutions, because none of them so far seem to be successful in preventing similar crises from happening again.

Since financial stability is almost unattainable, the next objective should be to mitigate the effect of this instability and its consequences on the markets, the companies, investors, and stakeholders. Therefore, the focus of any post-crisis reform should be dual: firstly, to reverse the negative effect, dealing with the existing implications of a crisis/scandal, by supporting the market, strengthening the legal framework and restoring the public trust and confidence; and, secondly to prevent similar events in the future, by identifying the gaps in the current regime, assessing the potential threats and protecting vulnerable groups. In other words, a combination of reactive and proactive action is essential. Past experience can be used as a guide for the future, but not exclusively, because if regulation is only targeted at specific types of failures, it runs the danger of becoming myopic.<sup>12</sup>

In the USA, the SoX introduced stricter liability accompanied with severe penalties and fines in an attempt to build a protective wall against fraud. However, failures and restatements were not eradicated. The Act addressed some of the pathologies of the system, such as creative accounting, the (in)effectiveness of the boards of directors, lack of independence, and insufficient supervision, but made no reference to corporate incentives, executive remuneration, or short-termism. There were statements suggesting that the SoX ‘may be increasing accountability and reducing risk-taking in a way that could be construed

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<sup>11</sup> Brunnermeier, M., Crockett, A., Goodhart, C., Persaud, A.D. and Shin, H., ‘The Fundamental Principles of Financial Regulation’, (2009), Geneva Reports on the World Economy No 11, International Centre for Monetary and Banking Studies and Centre for Economic Policy Research, foreword.

<sup>12</sup> Kay, J., ‘More Regulation Will Not Prevent Next Crisis’, Financial times, 26 March 2008, available in the website: <http://www.johnkay.com/2008/03/26/more-regulation-will-not-prevent-next-crisis>.

as positive'<sup>13</sup> and that it has the capacity 'to reward truthful corporations and their management'.<sup>14</sup>

However, the reform failed to make legislation proactive and align the remuneration / bonus packages with the sustainability of a company's performance. The establishment of an 'ethics culture' was not encouraged, although a few years earlier unethical business conduct evidently led several companies to the brink of bankruptcy or collapse.

It could be argued that in Rule 33-8177<sup>15</sup> the SEC defined the term 'code of ethics' and introduced written standards designed to deter wrongdoing and to promote ethical handling of conflicts of interest, disclosure, compliance with applicable laws, prompt internal reporting of violations, and accountability for adherence to the code. However, no guidance was given on how to create this code and the development of the core values as it was believed that specific code provisions and compliance procedures were best left to individual companies. Furthermore, there is not yet any solid empirical evidence to suggest that the requisite societal environment for an ethical corporate culture, including appropriate situational constraints on behaviour, has developed or is developing in such a way as to support SoX's ethical mission or that the SoX encourages the kind of behaviour and transparency that is exhibited by ethical role models.<sup>16</sup> Even the certification requirements in sections 302 and 906, discussed in Chapter 4, do not really contribute to the reinforcement of ethical behaviour, because senior executives are overwhelmed by compliance-related activities for fear of criminal liability and strict penalties, affording them little time to engage in the kind of open, transparent interactions with each other and others in the corporation that

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<sup>13</sup> Langevoort, D.C., 'The Social Construction of Sarbanes-Oxley', (2007), 105 Mich. L. Rev. 1817 at 1828–33.

<sup>14</sup> Frankel, T., 'Using the Sarbanes-Oxley Act to Reward Honest Corporations', (2006), 62 Bus. Law 161 at 161 ('Honest corporations should receive a competitive advantage by receiving relief from some of the provisions of the Act so that those provisions are imposed only on rogue corporations').

<sup>15</sup> SEC Final Rule #33-8177, *Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002*, issued on January 23, 2003, available in the website: <http://www.sec.gov/rules/final/33-8177.htm>.

<sup>16</sup> MacLeod Heminway, J., 'Does Sarbanes-Oxley Foster the Existence of Ethical Executive Role Models in the Corporation?', (2008), *Journal of Business & Technology Law*, Vol. 3, 221-242 at 235.

will enable the establishment, transmission, and internalization of ethical values in the company.<sup>17</sup>

It is not possible to legislate people into good and ethical behaviour.<sup>18</sup> The mere existence of codes of conduct or codes of ethics is not sufficient without the involvement of the management team in the active implementation, effective monitoring, and enforcement of these codes. The role of the board of directors and executives is to set the appropriate ethical tone for the company and act as role models for all employees, demonstrating credibility and integrity on a daily basis.<sup>19</sup> Ethical leadership is closely connected with compliance. The more managers behave as ‘ethical leaders’ and role models, the more likely they are to influence the employees and gradually establish ethical behaviour.<sup>20</sup> ‘Executives and directors must be role models whose behaviour mirrors the company’s code of ethics. And they must act on what they say. After all, ethics and values are matters of the feet and the heart, not just matters of the mouth’.<sup>21</sup>

Since the ‘ethical culture starts at the top and is conveyed by example’<sup>22</sup>, corporate directors and executives have a duty and the unique opportunity to reinforce their company’s protection against fraud, mismanagement, and corruption. They must introduce and support a model that will influence operational practices in creating and sustaining an ‘organizational

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<sup>17</sup> Ibid., at 236. See also Fiorelli, P., ‘Will U.S. Sentencing Commission Amendments Encourage a New Ethical Culture Within Organizations?’, (2004), 39 Wake Forest L. Rev. 565 at 573.

<sup>18</sup> Persaud, A.D. and Plender, J., *All you need to Know about Ethics and Finance: Finding a Moral Compass in Business Today*, Longtail Publishing Ltd, London, 2007, pg. 196-7.

<sup>19</sup> Mintz, S.M., ‘Corporate Governance in an International Context: Legal Systems, Financing Patterns and Cultural Variables’, (2005), 13 Corporate Governance 582 at 584. See also Horber, F., Presentation at the United Nations: Corporate Governance—Implementation, Challenges, and Trends (Feb. 9, 2005); Petersen, L.E. and Krings, F., ‘Ethical Codes of Conduct and Employment Discrimination’, (2009), *Journal of Business Ethics* 85, 501–514; MacLeod Heminway, see above, note 16 at 233.

<sup>20</sup> Petersen and Krings, *ibid.* at 510. See also Brown, M. E. and Trevino, L. K., ‘Ethical Leadership: A Review and Future Directions’, (2006), *Leadership Quarterly* 17, 595–616.

<sup>21</sup> Freeman, R.E., ‘Create a New Story About Business: We Have a Unique Moment to Make a Lasting Difference in Corporate Practice. This is a Moment We Must Seize’, *Dir. & Bds.*, Mar. 22, 2005, at 26.

<sup>22</sup> Ardichvili, A., Mitchell, J.A. and Jondle, D., ‘Characteristics of Ethical Business Cultures’, (2009), *Journal of Business Ethics* 85, 445–451 at 450.

culture that encourages ethical conduct and a commitment to compliance with the law'.<sup>23</sup> An ethical culture might act as the missing link between corporate regulation and effective performance. The next sections will examine the role of ethics as the missing link between corporate regulation and efficient corporate performance. Since ethics already exists in corporate governance structures, an attempt will be made to define the concept of ethics in the context of corporate governance regulation and to outline the nature of an ethical corporate governance framework. Then, the discussion will turn to examine the compatibility of ethics with the US and the EU legal systems and, in particular, with the EU response which is still under formulation.

## **(II) *The role of Ethics as the missing link***

Multinational companies operating in different countries are obliged to find the golden line between numerous and frequently contradictory rules, inconsistent laws and conflicting interests. There is the perception that, in today's ruthless and ultra competitive business environment, the companies that survive are those which focus on the profit-driven objectives. However, even if profit maximization is taken to be the sole corporate objective, the method of achieving that objective is more complex than simply focusing on short-term gains. Modern companies have to devise a system, which ensures that their goals are sustained without compromising their future needs. Business is not just numbers and stock prices, and this was confirmed in more than one case during the last few years. An injection of morality, fairness and integrity is essential for the establishment of an ethical culture, as companies are entering into the age of enlightenment. The theory of enlightened shareholder value, as analysed in Chapter 1, has opened a new gateway for businesses which want to sustainable, profitable and successful in their business strategy.

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<sup>23</sup>United States Sentencing Commission, 2004, available in the website: <http://www.ucdmc.ucdavis.edu/compliance/pdf/ussg.pdf>.

The business model, based on sheer profit maximization, led to growing pressure on managers and chief executives to meet market's expectations. In an era in which managers enjoyed paternalistic power with relatively little accountability, the temptation for executives to cook the books in order to show credibility with the markets was almost irresistible. Gradually the excessive demand for value and short-term profitability created a 'hitting the numbers' culture.<sup>24</sup> The introduction of incentives in the beginning of the 1990s further reinforced the short-termist culture, instead of solving the problem of agency costs. Lucrative bonuses, performance-related incentives, and stock options instead of closing the gap, created by the separation of ownership and control, have brought the opposite result. Managers were not only motivated to push up the company's share price at any cost, but they were also incentivised not to blow the whistle.<sup>25</sup> It is fair for managers to be rewarded through bonuses when the company meets its targets. The problem, however, is when the choice of corporate objectives is not based on the company's resources and potential, but instead on short-term priorities or unrealistic targets. Corporate strategy defines (or at least should define) corporate priorities and expectations and not *vice versa*, especially if the focus is on how performance standards will be met or how numbers will be hit. In this way, companies' success and the whole industry's culture become tainted.

A good corporate strategy is one that sets the right goals and determines the most efficient way to accomplish them within the limits of the law and the company's potential. Not all companies will always be successful and profitable. Risk is inherent in the concept of entrepreneurship and failure, as well as success, should be included in the vocabulary of all corporate actors. This is why companies have always been willing to pay good salaries to talented managers, who would choose the right pathway and drive them to success. Missing a target is not the end of the world and does not necessarily mean that the management team

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<sup>24</sup> Persaud and Plender, see above, note 18, pg. 9.

<sup>25</sup> *Ibid.*, pg. 9-10.

needs to be replaced. There are numerous factors and variables that can influence the performance of a company. For example, prudent management involves not only the achievement of all goals, but also the effort to mitigate the loss in case things go wrong.

This is where incentives become important. Incentives work when the performance evaluation and reward systems are properly designed. Incentive schemes and bonuses should be linked with long-term value creation, not short-term stock performance. For example, quarterly reporting and monthly assessments should not be used as evaluations of the managers' abilities, because they are short-term indications and maintain an atmosphere of pressure on managers and directors to bring profits and immediate results. Such an atmosphere had a detrimental effect on companies like Enron and it is dangerous because it disorients managers from the implementation of the company's long-term strategy. If the incentives scheme of a company is not designed to reward excellence in performance, but is result-based, it forces or tempts managers to tailor their decisions and make choices that are not based strictly on business criteria. Incentive systems should be deliberately and clearly tied to behaving in concert with the code of ethics and accomplishment of non-economic goals in addition to economic outcomes, namely the welfare of shareholders and the success of the company as a whole.<sup>26</sup> In addition, the decision-making process in an ethical culture should be designed to consider the ethical ramifications of business decisions instead of cost-benefit analyses alone.<sup>27</sup> After all, ethics are internal to business and not imposed upon business activity from outside.<sup>28</sup> Achieving the right balance among decision authority,

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<sup>26</sup> See Trevino, L. and Weaver, G. R., 'The Role of Human Resources in Ethics/Compliance Management: A Fairness Perspective', (2001), *Human Resource Management Review* 11(1), 113–134.

<sup>27</sup> Ardichvili *et. al.*, see above, note 22, at 456.

<sup>28</sup> Cosans, C., 'Does Milton Friedman Support a Vigorous Business Ethics?', (2009), *Journal of Business Ethics* 87, 391–399 at 398.

performance evaluation, and compensation will ultimately drive shareholder value as well as ethical behaviour.<sup>29</sup>

Profits are crucial for the reputation of companies and their attractiveness to the investing public. Profitability is an indication of a healthy business environment and an illustration of how a good idea becomes a successful enterprise. Even Pope John Paul II has spoken of the 'legitimate role of profit as an indication that a business is functioning well'.<sup>30</sup> Profits also play an important role in the attractiveness of a company and its recognition. However, managers put themselves and their companies before the wrong dilemma: shareholder value or ethics, where shareholder value means profits and ethics means loss of money. There is no evidence showing that ethical conduct leads to a reduction of profit and financial downturn. On the contrary, it has been reported that the stock market rewards companies with admirable corporate governance and high ethical standards by valuing them highly.<sup>31</sup> There are even studies reporting that companies with more comprehensive corporate governance tend to pay more in dividends.<sup>32</sup> As shown earlier in the Thesis, the myopic pursuit of shareholder value has been one of the major causes of corporate scandals and this is the reason why enlightened shareholder value was introduced and the establishment of an ethical culture is considered to be the missing link between corporate regulation and effective performance.

It is worth noting that profits are not only for the pockets of the shareholders and executives; part of the profits (even a small percentage) is invested in research and

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<sup>29</sup> Brickley, J.A., Smith, Jr., C. and Zimmerman, J.L., 'Corporate Governance, Ethics and Organizational Architecture', (2003), *Journal of Applied Corporate Finance*, Vol. 15, No. 3, 34-45 at 45.

<sup>30</sup> White, T.I., *Business Ethics – A Philosophical Reader*, McMillan Publishing, New York, 1993, pg. 76.

<sup>31</sup> Baek, H., Johnson, D. and Kim, J., 'Managerial Ownership, Corporate Governance, and Voluntary Disclosure', (2009), *Journal of Business & Economic Studies* 15(2), 44–61; Choi, T. and Jung, J., 'Ethical Commitment, Financial Performance, and Valuation: An Empirical Investigation of Korean Companies', (2008), *Journal of Business Ethics* 81, 447–463; Epstein, M. J., McEwen, R.A. and Spindle, R.M., 'Shareholder Preferences Concerning Corporate Ethical Performance', (1994), *Journal of Business Ethics* 13, 447–453.

<sup>32</sup> Among others, Farinha, J., 'Dividend Policy, Corporate Governance and the Managerial Entrenchment Hypothesis: An Empirical Analysis', (2003), *Journal of Business Finance and Accounting* 30, 1173–1209; Jiraporn, P. and Ning, Y., 'Dividend Policy, Shareholder Rights, and Corporate Governance', (2006), *Journal of Applied Finance* 16, 24–36; Pinkowitz, L., Stulz, R. and Williamson, R., 'Does the Contribution of Corporate Cash Holdings and Dividends to Firm Value Depend on Governance? A Cross-Country Analysis', (2006), *The Journal of Finance* 61, 2725–2751; Sawicki, J., 'Corporate Governance and Dividend Policy in Southeast Asia Pre- and Post-Crisis', (2009), *European Journal of Finance* 15(2), 211–230

development. In this way, companies reinforce their foundations and pave the way for expansion. If executives overstate profits, they are actually misleading themselves as to the profitability of their own companies, which means that they misallocate capital and in the long run they inflict a cost on the wider economy.<sup>33</sup> Therefore, the real dilemma is not about ethics and profits; it is between being lawful and ethical, and collapsing. If we revisit the Enron or the WorldCom saga, this argument is further justified.

Enron will always stand out as a turning point in the chronology of regulation: the time before and after Enron.<sup>34</sup> Hundreds and hundreds of pages have been written about this company. A large number of articles, reports and studies can be found about what happened, what went wrong, and what the future may be. As was accurately described, ‘the tale of Enron is a story of human weakness, of hubris and greed and rampant self-delusion; of ambition run amok; of a grand experiment in the deregulated world; of a business model that didn’t work; and of smart people who believed their next gamble would cover their last disaster - and who couldn’t admit they were wrong’.<sup>35</sup>

Considering the post-Enron experience, it can be argued that the Enron collapse did not have an exclusively negative side. In fact, it taught the commercial world a painful but extremely useful lesson. It is not only the rules that count, because exclusive reliance on the law is not sufficient either. The way we make business, the corporate culture, is also important. Enron was characterized by ‘a culture that valued only deal-making and money’.<sup>36</sup> Corporate decisions were not filtered through any proper values or principles and, although the company had a code of ethics in place, the values were not translated into measurable

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<sup>33</sup> Chryssides, G. and Kaller, J., *Essentials of Business Ethics*, McGraw-Hill, London, 1996, pg 84.

<sup>34</sup> Hopt, K., ‘Modern Company and Capital Market Problems: Improving European Corporate Governance after Enron’ (2007). ECGI Law Working Paper No. 05/2002, ECGI Finance Working Paper, pg. 446.

<sup>35</sup> Elkind, P. and McLean, B., *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron*, Penguin Group, USA, 2003, pg. xxi.

<sup>36</sup> Windsor, D., ‘Business Ethics at "The Crooked E"’ in Rapoport, N. and Dharan, B., (eds), *Enron: Corporate fiascos and their implications*, Foundation Press, New York, 2004, pg. 659, 676.

performance and desired observable behaviour.<sup>37</sup> The story of Enron showed how important and necessary corporate culture is and exposed the fact that there is room for business responsibility and corporate ethics in modern multinational companies. Ethical companies are valued highly since ethical commitment leads to a competitive advantage over other companies. Ethical behaviour usually translates into improved employee morale, better reputation, improved investor relations, and a lower cost of capital, all of which lead to better financial performance in the long-run.<sup>38</sup>

The stories of Enron and WorldCom underlined the necessity of having a corporate conscience and a culture built around knowing the difference between right and wrong.<sup>39</sup> Modern companies cannot really afford to be unethical. It is easy for companies to get trapped in a vicious circle, where only a thin line separates success from failure. The trap is to believe that nobody is really interested in the viability and the prospects of the company, so long as stock price is high and numbers can hide reality. Henry Thoreau argued that ‘it is true enough said that a corporation has not conscience. But a corporation of conscientious men is a corporation with a conscience’.<sup>40</sup> Enron failed, because ‘its leadership was morally, ethically and financially corrupt’.<sup>41</sup>

### **(III) *An Ethical Framework for Corporate Governance***

Ethics have been increasingly recognised as the missing link in the chain that links corporate performance with success, because there is a growing consensus about opportunistic behaviour, self-interested agents, and erosion of business culture. For example,

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<sup>37</sup> Zinkin, J., *Challenges in Implementing Corporate Governance: Whose Business is it Anyway?*, Wiley and Sons, Singapore, 2010, pg. 64.

<sup>38</sup> Pae, J and Choi, T.H., ‘Corporate Governance, Commitment to Business Ethics, and Firm Valuation: Evidence from the Korean Stock Market’, (2010), *Journal of Business Ethics*, pg. 1-26 at 20.

<sup>39</sup> Wee, H., ‘Corporate Ethics: Right Makes Might’, (2002), *Business Week* available in the website: [http://www.businessweek.com/bwdaily/dnflash/apr2002/nf20020411\\_6350.htm](http://www.businessweek.com/bwdaily/dnflash/apr2002/nf20020411_6350.htm)

<sup>40</sup> Duban, J., ‘Conscience and Consciousness: The Liberal Christian Context of Thoreau's Political Ethics’, (1987), *The New England Quarterly*, Vol. 60, No. 2, 208-222 at 216.

<sup>41</sup> Bryce, R., *Pipe Dreams: Greed, Ego, and the Death of Enron*, Public Affairs, USA, 2002, pg. 12.

Hans Blommestein, Head of the Emerging Financial Markets Programme at the OECD, has specifically talked about a lowering of ethical standards amounting to a paradigm shift in the business landscape<sup>42</sup>, while in early 2005, John Reed, then Chairman of the New York Stock Exchange (NYSE), was amongst those who observed that ‘the cult of stockholder value has been corrupting’ and ‘a disturbing breakdown of values in corporate America’ is at the ‘root of the recent business scandals’.<sup>43</sup>

***(i) Ethics: Not a novelty?***

Ethics is not a new concept in the area of corporate governance. It already existed in the business culture internationally. Self-regulatory codes with which compliance is purely voluntary and the only mechanism for the enforcement of their provisions has been the power of the market are a good example. Companies and market participants have adopted the principles and provisions of these codes even without the intimidating effect of sanctions, because they recognise the value and the usefulness of their recommendations. Voluntary compliance incorporates an ethical element, as these codes are intended to show companies and their managers how to achieve their overriding goals and how to design their strategy without using questionable, unethical or illegal means. It was argued earlier in this Thesis that the nature of the codes’ recommendations was surprisingly similar all around the world, as the vast majority made reference to values like integrity, transparency, accountability, fairness and respect. There are also some notable initiatives, not originating from governments, which highlight the ethical character of voluntary compliance. For instance, the Equator Principles were adopted by ten global financial institutions, which agreed to comply voluntarily to a number of environmental and social principles developed by the World Bank

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<sup>42</sup> Blommestein, H. J., ‘How to Restore Trust in Financial Markets’, in Dembinski, P., Lager, C., Cornford, A. and Bonvin, J-M. (eds), *Enron and the World of Finance: A Case Study in Ethics*, Palgrave MacMillan, Basingstoke, 2006, pg.184.

<sup>43</sup> Berlowitz, L and Zelleke, A., ‘Introduction’ in Lorsch, J.W., Berlowitz, L. and Zelleke, A., (eds), *Restoring Trust in American Business*, MIT Press, Cambridge MA, 2005, pg. 2.

and the International Finance Corporation in an attempt to promote socially responsible conduct and sound environmental practices in relation to project finance initiatives.<sup>44</sup> Globalization theory suggests a process of convergence in which codes of ethics would not only become more commonplace, but also that the institutionalization of standards and values that serve the larger community would be embodied in formal communication guidelines.<sup>45</sup> This sounds promising, but it is still early to be sure. Such initiatives are always welcome and constitute steps in the right direction.

Corporate social responsibility (CSR) has become more and more prominent recently. However, CSR should not be confused with ethics, as it is a much narrower concept. CSR is related to social and political goals, such as labour rights and environmental protection. A company can be socially responsible, for instance, but this does not necessarily make it ethical. Once again, Enron can be used as an example. Whilst the suspicious accounting practices and handling of SPEs were taking place, on the surface Enron appeared to operate with respect, integrity, and excellence, i.e. the organization's three core values. It produced an annual CSR report, it gave millions in charity donations and took part in several environmental and community initiatives, having won awards from the Council on Economic Priorities for corporate conscience and from the US Environmental Protection Agency for its role in the campaign for climate protection.<sup>46</sup>

The stories of the scandals have brought words such as credibility, trust, ethics, and responsibility to the forefront of our minds. The arm of reform must sweep much further than the mere structure of financial reporting systems. The old 'disclose and self-regulate' paradigm in financial markets has been widely castigated as the main culprit of the current

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<sup>44</sup> Banks, E., *Corporate Governance: Financial Responsibility, Controls and Ethics*, Palgrave Macmillan, Basingstoke, 2004, pg. 320. According to the official website of Equator Principles (available in: <http://www.equator-principles.com/index.shtml>), there are 71 official adopters so far.

<sup>45</sup> Stohl, C., Stohl, M. and Popova, L., 'A New Generation of Corporate Codes of Ethics', (2009), *Journal of Business Ethics* 90, 607–622 at 618.

<sup>46</sup> 'Enron: The Ultimate Lesson in Irresponsibility: CSR Left Reeling from the Biggest Failure in US Corporate History', (2003), *Strategic Direction*, Vol. 19, No.6, 10-13 at 10.

global financial catastrophe. However, this does not diminish the value of disclosure as regulatory technique; it simply calls for a radical rethinking of its uses, processes, volume, timing, and format in order to make it more effective and better adapted to actual market conditions.<sup>47</sup> Indeed, reform must encompass wider issues of corporate governance and responsibility so that one day integrity and business can once again sit comfortably within the same sentence.<sup>48</sup>

For some commentators, voluntary codes of conduct, although without enforcement mechanisms, have an important educational value for corporations as well as developing countries.<sup>49</sup> Others believe that the emergence of codes of conduct, which are essentially voluntary, is an acknowledgement of the inadequacy of efforts to protect the environment, human rights, and labour standards through traditional governmental and intergovernmental regulation.<sup>50</sup> The truth probably lies somewhere in the middle. It would be ideal if we could go back to the years of the Governor of the Bank of England, who was controlling participants in the financial markets by raising his eyebrows.<sup>51</sup> Like legal sanctions, economic sanctions are inevitably imperfect. Both types of sanctions need to be supplemented with a regime of social and moral sanctions that would encourage everyone to consider the effects of his/her conduct on the company's stakeholders. A balancing exercise is required, where all the advantages and disadvantages of an action are balanced and filtered before a decision is taken. The rationale behind each decision is to promote the success of the company as a

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<sup>47</sup> Avgouleas, E., 'The Global Financial Crisis and the Disclosure Paradigm in European Financial Regulation: The Case for Reform', (2009), *European Company and Financial Law Review*, Vol. 6, No. 4, 440-475 at 475.

<sup>48</sup> See above, note 46, at 13.

<sup>49</sup> See Epstein, E.M., 'The Good Company: Rhetoric or Reality? Corporate Social Responsibility and Business Ethics Redux', (2007), 44 *AM. BUS. L.J.* 207 at 210.

<sup>50</sup> Chesterman, C., 'The Turn to Ethics: Disinvestment from Multinational Corporations for Human Rights Violations - The Case of Norway's Sovereign Wealth Fund', (2008), *American University International Law Review* 23, 577-615 at 603. See also Moore Dickerson, C., 'Ozymandias as Community Project: Managerial/Corporate Social Responsibility and the Failure of Transparency', (2003), 35 *CONN. L. REV.* 1035 at 1036-37; Weissbrodt, D., 'Business and Human Rights', (2005), 74 *U. CIN. L. REV.* 55 at 55; Williams, C.A. & Conley, J.M., 'Is There an Emerging Fiduciary Duty to Consider Human Rights?', (2005), 74 *U. CIN. L. REV.* 75 at 77.

<sup>51</sup> Bradley, C., 'Transatlantic Misunderstandings: Corporate Law and Societies', (1999) 53 *U. MIAMI L. REV.* 269, at 309.

whole. This means that directors and managers should be prepared to refrain from a particular action, even if this decision would reduce the company's profits in the short-term, but would be beneficial for its interests in the long-run.<sup>52</sup> The fact that becoming more ethical may be a profitable course of action should be regarded as a collateral benefit.<sup>53</sup> Even Milton Friedman, who could not accept that corporate decisions are taken on the basis of anything different from a pure economic calculus, has asserted that maximizing profits needs to take place 'within the rules of the game....the basic rules of the society, both those embodied in law and those embodied in ethical custom'.<sup>54</sup>

### ***(ii) Ethics v Profits***

There are plenty of companies worldwide that have profit-driven strategies, but they are 'equally guided by a core ideology – core values and a sense of purpose beyond just making money'.<sup>55</sup> There are no timeless management principles or any other secrets behind consistently successful companies. An ethical and transparent business culture is essential for the long-term success of a company and it is beneficial for both the shareholders and stakeholders' interests. This Thesis does not intend to promote a new model, a sort of ethical shareholder value. Companies have always been out looking for the best strategies, those which would increase their value. Successful performance in both short and long-term can be the outcome of an ethical culture and this is where the whole misunderstanding has its roots.

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<sup>52</sup> See Shavell, S., *Foundations of Economic Analysis of Law*, Harvard University Press, USA, 2004, pg. 598–646; McAdams, R.H., 'The Origin, Development, and Regulation of Norms', (1997) 96 MICH. L. REV. 338 at 339–54; Posner, E.A., Efficient Norms, in Newman, P. (ed.), *The New Palgrave Dictionary of Economics and The Law*, Macmillan, London, 1998, pg. 19–23.

<sup>53</sup> Longstaf, S., 'Relationships, Behaviours and Interactions of people in Corporate Governance', (1999), Banker's Journal, (Institute Bank - Bank Malaysia), Issue No 109, pg. 94, available in the website: <http://www.ethics.org.au/about-ethics/ethics-centre-articles/ethics-subjects/corporate-governance/article-0025.html>.

<sup>54</sup> Friedman M., 'The Social Responsibility of Business Is to Increase its Profits', The New York Times Magazine, 13 September 1970, cited in Reinhardtand, F.L. and Stavins, R.N., 'Corporate Social Responsibility, Business Strategy, and the Environment', (2010), Oxford Review of Economic Policy, Vol. 26, No. 2, 164-181 at 166.

<sup>55</sup> Collins, J. and Porras, J., *Built to Last: Successful Habits of Visionary Companies*, Century Business, London, 1994, pg. 8.

Ethics are not incompatible with profit maximization. Ethics refer to the whole operation of a company - objectives, business decisions and priorities, day-to-day handling of issues and problems - and they cover every aspect of a company's conduct and practices. In other words, the behaviour of a company is characterized as ethical based on the way it copes with its daily affairs, its problems, as well as the hierarchy of its objectives. Companies have identified a set of objectives which they try to accomplish. Ethics refer to the means used for the accomplishment of these objectives. Still, since one of the primary objectives of modern companies is usually the pursuit of profit, this does not automatically make a company unethical. The question of ethical behaviour will be answered following an assessment of the whole culture of the company.

Globalisation poses difficult ethical challenges for companies, as it is hard for a multinational company to implement a single code of ethics in all its subsidiaries and branches around the world, because of fundamental differences in traditions, customs, laws, perception of ethics, and culture in general. However, universality does not mean strict uniformity. Codes of ethics are nothing more than formalised public statements used as guides for both present and future behaviour. A certain degree of variation is acceptable when talking about companies operating in different continents. However, it would not be surprising to discover that most companies across sectors share almost the same objectives and values. The lack of significant differences in the number and content of codes of ethics across sectors may suggest that the pressures to 'think globally' are universally being felt by companies regardless of the sector in which they operate.<sup>56</sup> No matter what their structure or physical location, companies must accommodate the complexities of operating within a multicultural communicative, legal, moral, and social context where boundaries between

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<sup>56</sup> Stohl, *et.al*, see above, note 45, at 618. See also Carasco, E. and Singh, J., 'The Content and Focus of the Codes of Ethics of the World's Largest Transnational Corporations', (2003), *Business and Society Review* 108, 71-94.

domestic and international organizing are progressively more blurred.<sup>57</sup> Homogeneity is not a formal requirement, because stated objectives do not always equate to actual behaviour. Nevertheless, in the era of globalization, where multinational companies are so powerful that they can even influence political decisions, it would be ideal to have unanimity regarding the value of ethical culture and a degree of convergence on the nature of this culture.

### ***(iii) Ethics Defined***

So, what is this ethical culture that can ideally play the role of a point of reference for all companies worldwide, irrespective of where they operate, where they are registered or where their shareholders come from?

Culture is defined as accepted behavioural standards within the confines of a specified group as guided by a pattern of shared learned beliefs, traditions, and principles.<sup>58</sup> If we accept that ethics is ‘a set of formal and informal standards or conduct that people use to guide their behaviour’<sup>59</sup>, an ethical code is ‘not just an instrument that serves the interests of the company, but has – or should have – a broader normative claim’.<sup>60</sup> We could start, for example, with a set of values commonly accepted as important, such as fairness, truth, compassion, reverence for life, anti-discrimination. Equally, a set of minimum standards on health and safety rules or anti-corruption legislation would be a positive step towards convergence as well.<sup>61</sup> If properly defined, all the above could be used as minimum standards; first on a national, and then on an international basis.

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<sup>57</sup> Stohl *et al.*, *ibid.* at 607.

<sup>58</sup> Trevino, L. K., ‘Developing and Changing Organizational Ethics: A Cultural Approach’, (1990), *Research in Organizational Change and Development* 4, 195–230; Bolman, L.G. and Deal, T., *Reframing Organizations: Artistry, Choice and Leadership*, 2<sup>nd</sup> ed., Jossey-Bass, San Francisco, CA, 1997.

<sup>59</sup> Wood, L., ‘Beyond the Oxymoron: Can Business Ethics Pay?’, (2002), *The Galt Global Review*, May 15, 2002, pg. 2.

<sup>60</sup> Kaptein, M. and Schwartz, M., ‘The Effectiveness of Business Codes: A Critical Examination of Existing Studies and the Development of an Integrated Research Model’, (2007), *Research Institute of Management, RSM Erasmus University, Erasmus*, 1–42 at 7.

<sup>61</sup> Kidder, R. M., *Moral Courage: Taking Action When Your Values Are Put to the Test*, William Morrow, 2005.

However, for the purposes of this Thesis, the concept of corporate ethos goes beyond a simple list of values like honesty, integrity, confidentiality, fair dealing, compliance and independence. Moreover, this ethos has nothing to do with religious beliefs, such as the Christian sermon that we should love each other as Jesus Christ loved us or the Confucian' dictum 'do not impose on others what you yourself do not desire'<sup>62</sup>, and philosophical ideas, such as Kant's duty to 'be kind where one can' or to 'act so that you treat humanity, whether in your own person or in that of another, always as an end and never as a means only'<sup>63</sup>. Ultimately, ethics should also be distinguished from morals, because morality refers to and defines personal character, whereas ethics stress a social system in which those morals are applied.

This Thesis does not intend to provide a general overview of ethics, as it focuses only on the creation of the right 'ethos' that will guide corporate executives in developing a culture of compliance in their company. The establishment of such ethical culture can contribute significantly in filling the gaps of the existing legislative and self-regulatory framework, in improving corporate governance structures nationally as well as internationally and, finally, in strengthening the defences of the business community against future scandals and crises.

#### ***(iv) Ethics in Practice***

The ethical culture for modern companies is based on five pillars: mission and value driven; shareholder/stakeholder balance; leadership effectiveness; integrity; and long-term perspective.<sup>64</sup> In other words, companies are expected to have 'clarity of mission and values, reflected in ethical guidelines and behaviour' is driven by an organization that

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<sup>62</sup> Analects: XV.24, quoted in Cosans, see above, note 28 at 395.

<sup>63</sup> Kant, I., *Foundations of the Metaphysics of Morals*, Macmillan Publishing Company, New York, 1785 [1985], pg. 14 and 46.

<sup>64</sup> Ardichvili *et. al.*, see above, note 22, at 448.

‘institutionalizes ethical values’ and ‘build[s] relationships of trust and respect’.<sup>65</sup> In this corporate culture, where core business functions are aligned with the organizational processes, an environment is nurtured ‘that actively eliminates people who don’t share the values’ and sustainability over ‘long periods of time.’ This implies an existence of mechanisms that choose for suitability between organizational values and individual values; a form of natural selection, which gleans deleterious behaviour from the ethical organization.<sup>66</sup>

In practice, modern companies do not have to re-write their constitutions and replace their whole management team. There are, however, a number of steps that companies need to follow very carefully, because each builds on the previous steps. Compliance with the relevant laws and regulations is the first step. Companies are legal persons and, as creatures of the law, they are organized according to, and operate within, the framework designed by the relevant company legislation. The introduction of a code of ethics is quite significant because, although it does not guarantee ethical behaviour, it helps to eliminate uncertainty about ethical standards and highlights that everybody in the company works to implement the corporate vision with regard to both strategy and ethics.<sup>67</sup> The next step concerns the implementation of the code, because the code by itself is not sufficient to guarantee ethical behaviour, because compliance can easily become a box-ticking exercise, a routine, which will not bring the desired change of culture within the company. The implementation of the code should aim to make the company become ‘both a value-based and a *values*-based organization’.<sup>68</sup> The last step involves enforcement and reward. Reward does not only compensate compliance, but also together with performance evaluation will drive up shareholder value as well as encourage ethical behaviour.<sup>69</sup> On the other hand, penalties should also encourage ethical behaviour and should not be specifically designed to generate

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<sup>65</sup> Ibid., at 450.

<sup>66</sup> Ibid.

<sup>67</sup> Brickley, *et.al.*, see above, note 29 at 43.

<sup>68</sup> Ibid.

<sup>69</sup> Ibid., at 45.

blind compliance. A culture of fear may, therefore, breed operating inefficiencies without necessarily increasing ethical corporate culture.<sup>70</sup>

An ethical culture is associated with a structure that provides for equally distributed authority and shared accountability. The company complies with the legal requirements, its incentives systems rewards ethical conduct and promotes the corporate mission and, last but not least, it has an ethical code of conduct that is clear, well communicated, is specific about expected procedures and practices, thoroughly understood, and enforced.<sup>71</sup> In this way, all parties involved understand what is expected from them and what standards they need to reach. Managers and directors cannot know what they ought to do, unless they first know the moral principles that they should bring to bear. Doing business involves an endless string of dilemmas. There is no universal consensus on how to deal with these dilemmas. Ethics involves learning what is right and wrong, and then doing the right thing. The actual process of resolving such ethical dilemmas is what makes a good leader. Success is closely related to the company's leadership and ethical background. Effective leadership involves a great deal more than just developing an appropriate strategic or ethical vision for the company - it is also critical to motivate people to implement that vision.<sup>72</sup> Striking the right balance between conflicting interests in demanding circumstances, when there is no time or no sufficient information, is what all companies are looking for from their management team. Most ethical decisions have multiple alternatives, extended consequences, mixed outcomes, uncertain consequences, and personal implications.<sup>73</sup> No rule or code can replace this process by offering the right answer for each given dilemma, because no law can resolve all moral dilemmas. Good rules and good governance alone do not make a company successful. Rules

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<sup>70</sup> Fiorelli, see above, note 17, at 573.

<sup>71</sup> See Trevino, L., Weaver, G. R., Gibson, D. and Toffler, B., 'Managing Ethics and Legal Compliance: What Works and What Hurts', (1999), *California Management Review* 41(2), 131–150.

<sup>72</sup> Brickley, *et.al.*, see above, note 29 at 45.

<sup>73</sup> Anstead, S.M., 'Law Versus Ethics in Management', (1999), *Human Resources in Technology Organizations*, pg. 3, available in the website: <http://ansteadsue.tripod.com/ethics.htm>.

and ethics cannot be seen separately. The ethical part aims to support and strengthen the power of the rules. If rules are the skeleton, ethics is the flesh to the bones.

Corporate strategies should be developed in a way that allows core values and principles to co-exist. It is not simple to translate best practice into corporate action. Core values are those which must not be ‘compromised for financial gain or short-term expediency’.<sup>74</sup> Early strategy scholars have already pointed to the general importance of moral issues within the scope of corporate strategy.<sup>75</sup> Over the last 30 years, an increasing number of scholars have been working on the ethics - strategy link, a fact which is indicative of the importance of ethics for the modern business world and the close relationship between ethical and successful conduct.<sup>76</sup>

A reformed corporate culture in combination with a more effective form of regulation seems to offer a reliable solution to the existing corporate governance problem. It is too early to present any guarantees that no more scandals will happen in the future, but there will definitely be a noticeable improvement in the way people tackle the issue of corporate governance not only in the EU or the USA, but worldwide as well. Ethics are not presented as the cure-all solution. Ethics cannot make the lives of people perfect in the empirical world that exists, but ethics can prevent, or reduce the amount of, certain harms.<sup>77</sup> In the context of corporate governance, ethics can play the role of a *sui generis* filter. All corporate decisions

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<sup>74</sup> Collin and Porras, see above, note 55, pg. 73.

<sup>75</sup> Among others, see Barnard, C., *The Functions of the Executive*, Harvard University Press, Cambridge, MA, 1956; Learned, E.P., Christensen, C.R., Andrews K.R. and Guth, W.D., *Business Policy: Text and Cases*, Richard Irwin, Homewood, IL, 1969; Andrews, K. R., *The Concept of Corporate Strategy*, Dow Jones-Irwin, Homewood, IL, 1971.

<sup>76</sup> See Bonini, S. M. J., Mendonca L.T., and Oppenheim, J. M., ‘When Social Issues Become Strategic’, (2006), *McKinsey Quarterly* 2, 20–31; Dowling, G. R., ‘Corporate Reputations: Should You Compete on Yours?’, (2004), *California Management Review* 46(3), 19–36; Frigo, M. L., ‘Mission Driven Strategy’, (2003), *Strategic Finance* 85(2), 8–11; Hosmer, L. T., ‘Strategic Planning as if Ethics Mattered’, (1994), *Strategic Management Journal* 15(Summer Special Issue), 17–34; Robertson, C. J. and Crittenden, W. F., ‘Mapping Moral Philosophies: Strategic Implications for Multinational Firms’, (2003), *Strategic Management Journal* 24(4), 385–392; Singer, A.E., ‘Strategy as Moral Philosophy’, (1994), *Strategic Management Journal* 15(3), 191–213

<sup>77</sup> Robin, D., ‘Toward an Applied Meaning for Ethics in Business’, (2009), *Journal of Business Ethics* 89, 139–150 at 140.

will pass through this ethical filter, which will distil and purify the forthcoming ideas and initiatives.

It is a fairly demanding task to strike the appropriate balance between the corporate objectives and the ethical objectives that are added by corporate governance rules and codes. Each company should be very clear on defining their aims, objectives and goals in addition to the means for their accomplishment. The road to success is not one-way. The framework, which combines rules and ethical standards, will be set, but then it is up to the companies to implement it. Codes of ethics are most often perceived as tangible evidence that a company has recognized a need for, and has made a commitment toward, ethical behaviour. Strict compliance is fundamental to the success of the regulatory framework, because transparency is increased and companies obtain an advantage in their business environment. Needless to say, compliance refers to all people related to the operation of a company, from the senior management to the employees. All the human resources of the company should be encouraged to participate in the creation of an ethical and supportive business environment. Corporate governance is based on the relationships among all the participants in this complex environment. Corporate objectives are the same for all participants, even though the effect of the company's conduct and performance may vary or may be indirect. The success of the company is the overarching objective, but, as the model of enlightened shareholder value advocates, success is associated with the interests and the benefit of all the members as a whole. Enlightened shareholder value has been a part of UK company law rules after the introduction of the Companies Act 2006, and this shows that the United Kingdom breaks new ground once again as far as corporate governance is concerned. The UK intends to 'bridge the interests of shareholders and stakeholders by connecting environmental sustainability and

social responsibility to long-term shareholder value'.<sup>78</sup> Moreover, one should not disregard the fact that ethics already exist within business structures. Members of all companies need to recognize the value of ethics and understand that the burden of responsibility rests on everybody's shoulders.

Nowadays, the boards of directors, bearing the legal responsibility to make decisions on behalf of shareholders, seem to have adopted a culture of profit and sales, focused on cash flow maximization. At the same time, their monitoring and supervisory role has been undermined and the development of a long-term business strategy has been rather disregarded. This has not always been a considerate choice. In plenty of occasions, the argument that has come out is that the board is unable to fully understand the complex nature of the business carried out, or the risks to which the company is exposed. Inevitably, the boards were unable to monitor the business and press the alarm button before it was too late. But, even if the whole board is replaced with new directors, executives, and non-executives, there are still no assurances that the company will be able to avoid the mistakes of the past. Corporate philosophy cannot change instantly. The current profit-orientated philosophy did not emerge out of nowhere. For directors acting in good faith is no longer enough. They should encourage commitment to ethical behaviour and focus on developing a culture designed to achieve best practice through a process of balancing all interests. Furthermore, a company that does not neglect the ethical dimension of all its activities is building a good reputation, as it supports the creation of a business environment of trust. A good corporate reputation also gives a short-term competitive advantage, as the company becomes attractive to investors and an example-to-follow. The next goal and the big challenge is to obtain a long-term sustainable competitive advantage, which is the result of exploiting an enduring

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<sup>78</sup> Villiers, C., *Corporate reporting and company law*, Cambridge University Press, Cambridge and New York, 2006, pg. 96.

core of relevant capability differentials cultivated by responsible management of tangible and intangible internal skills and assets.<sup>79</sup>

Accountants have also been linked with the well-known corporate failures. Accounting ethics were in question as well. There are plenty of cases where accountants were accused of a lack of ethical sensitivity, a lack of professionalism, a lack of independence, and impartiality. Even if we accept that they were not just self-interested, they often faced a huge dilemma, when they had to choose between doing their job properly and face the danger of losing their jobs, or making improper judgements and remaining employed. For example, the accountants at Arthur Anderson did not behave with honesty, and integrity when auditing Enron. As a result, shareholders were harmed, the company collapsed, and some Arthur Anderson accountants were held legally liable for their breach of business ethics. Ethics is once again the key because accountants do not have to resolve any conflicts of interests, but have to remain independent and unbiased. Shareholders, managers, directors, and investors rely on the accountants' work so much that their credibility should not be debatable. The corporate collapses have resulted 'in a widespread disregard for the reputation of the accounting profession', but improvement of ethics can bring trust back again.<sup>80</sup>

Corporate governance rules should incorporate the ethical standards of the society in which the companies operate. Companies are an integral part of the general social environment. Thus, their conduct influences the developments of the ethical standards, while at the same time the companies themselves are affected by these standards. Self-regulation, through using soft law and minimum standards, is intended to strike the balance between rules and ethics. Recommendations of self-regulatory codes were a mixture of legal

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<sup>79</sup> Petrick, J. and Quinn, J., 'Integrity Capacity as a Strategic Asset in Achieving Organizational Excellence', (2001), *Journal of Measuring Business Excellence*, Vol. 5, 24-31. See also, Azmi, R.A., 'Business Ethics as Competitive Advantage for Companies in the Globalization Era', (2006), available in the website: <http://ssrn.com/abstract=1010073>; Verhezen, P., 'Integrity as Good Reputation', (2005) *International Conference on Ethics and Integrity of Governance: A Transatlantic Dialogue*, Belgium.

<sup>80</sup> Dellaportas, S., 'Making a Difference with a Discrete Course on Accounting Ethics', (2006) *Journal of Business Ethics*, Vol. 65, No. 4, 394.

requirements with current business practices, while voluntary compliance was promoted instead of enforcement for fear of sanctions. The system appears as a circle, with the rules coming from the companies and also being addressed to them. Companies, especially powerful multinationals, have the power to influence political choices. Governments in a lot of countries had to adjust their long-term planning to take into account the effect that a particular reform would have on the business world. Business practices had the advantage of being a combination of rules and ethical standards, a mixture of what the companies were obliged to do by law together with what was customary and generally accepted in practice. However, the corporate scandals at the end of the 20<sup>th</sup> century demonstrated that self-regulation could not maintain high ethical standards of conduct or create a stable corporate architecture.

The intervention of governments was necessary and they had two choices: either to take action and regulate with a view to devising the right rules that would represent their vision for the society, or to just provide incentives for the companies to operate ethically. As it became apparent from the examination of the US and the EU initiatives, they did not share the same vision for the future of corporate governance, and thus adopted two different approaches.

#### **(IV) *The next day of regulation: EU and USA***

Since the missing link has been identified, an attempt will now be made to evaluate the future of corporate governance regulation after the aforementioned initial responses. The focus will be on the European Union, as it has started to feel the pressure not only from the other developing and developed countries, but also from the Member States. The EU proposals for the problem of corporate governance regulation must be finalised, so that the EU response is finally articulated.

The USA, by adopting the Sarbanes-Oxley Act, made a conscious and deliberate choice. The SoX was the result of a legislative process that had started before the collapse of Enron. The wave of scandals just accelerated the procedure and helped in overcoming any second thoughts and reservations. Certainly, such a significant and complicated piece of legislation could not be flawless, especially in a period when news of successive failures and collapses was still in the newspaper headlines. The final draft of the Act was finalized under great pressure of time, and subsequently there were unavoidable weaknesses. There was no time for revision, reflection, or consultation. However, it still represents the US response to the accounting scandals and the answer of the American government to the question of ‘which is the optimal corporate governance model’.

There is still no consensus as to whether the SoX was indeed the best choice. Its supporters point out that the Act has aided the return of the public confidence in financial reporting. Its opponents, on the other hand, cite the exodus of capital and corporations from US public markets due to high compliance costs.<sup>81</sup> It is certainly not a supernatural regulation and it did not magically save corporate America. However, the SoX also contains several provisions which are innovative and useful; sections that could be used constructively as a model for reform, as well as principles that could become part of the European strategy. Looking at the SoX objectively, it appears to be a step in the right direction, especially if we take into consideration the nature of the United States as a country as well as the atmosphere of panic after WorldCom. As Banner describes, and Coffee Jr agrees, ‘when the bubble bursts, scandals flow, and, eventually, new regulation’.<sup>82</sup> History repeats itself and this is what happened in the US. The USA is a federal state with a central government that has been fairly active in regulating corporate governance. Compared to the European Union, the US

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<sup>81</sup> Garner, D. E., McKee, D. L. and McKee, Y. A., *Accounting and the Global Economy after Sarbanes-Oxley*, M.E. Sharpe, New York and London, 2008, pg. 23.

<sup>82</sup> Banner, S., ‘What Causes New Security Regulation? 300 Years of Evidence’, (1997), Washington University Law Quarterly, Vol. 75, No. 2, 849; Coffee Jr, J. C., ‘A Theory of Corporate Scandals: Why the United States and Europe differ’, (2005) Columbia Law and Economics Working Paper No. 274, pg. 1.

government has been sensitive with, and responsive to, corporate governance issues and it has significantly contributed to the development of securities regulation since the 1930s. Following the period of insecurity before the introduction of the SoX, the government tried to alleviate the conflict of interest between dispersed small share-owners and powerful controlling managers, as this was the most crucial issue.<sup>83</sup> There was a general agreement that the concentration of power in the hands of top management was excessive and there was no balance between management, on one hand, and shareholders and stakeholders, on the other hand. The most appropriate solution for the US government was a new stringent legislation based on strict enforcement and compliance.

On the other hand, the EU has not given its final response yet. Until now it appears determined to follow its harmonization project either using the traditional method that the Commission has been using for the last 30 years or upgrading it to the more modern method of reflexive harmonization. What has been clear so far is that the EU is not willing to follow the US example, although the US government would definitely prefer having the EU as an ally in this crusade against corporate mismanagement. It is no secret that the USA envisages ‘a universal, global, single set of regulations that would allow businesses, financial firms, and investors to operate in a completely borderless world’.<sup>84</sup> The EU does not reject a relationship of mutual support and cooperation, but it is not in favour of adopting the same regulatory model. Regardless of the EU’s negative position, this idea is not enforceable yet. ‘A single worldwide set of standards would permit investors around the world to benefit from a high level of comparability and a consistently high level of quality’; even the Chairman of the SEC admits that such vision is quite attractive, albeit ‘utopian’.<sup>85</sup>

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<sup>83</sup> Enriques, L. and Volpin, P., ‘Corporate Governance Reforms in Continental Europe’, (2007), *Journal of Economic Perspectives*, Vol. 21, No 1, pg. 127.

<sup>84</sup> Christopher Cox, Speech by SEC Chairman, Keynote Address to the 2007 US-EU Corporate Governance Conference, Washington, DC, October 9<sup>th</sup>, 2007, available in the website: <http://www.sec.gov/news/speech/2007/spch100907cc.htm>

<sup>85</sup> Ibid.

If the EU did share the same vision as that of the USA, there would be two options available. The first one would be the adoption of the SoX by the European Union in its current form, and the second option would be the creation of a European version of it. The EU could adopt the provisions of SoX by transporting it directly to the European legal order without any amendments. This can be achieved through a Regulation, which is directly applicable and there is no need for incorporation into the Member States' national legislation. Alternatively, the Commission could use the SoX as a model and create a new version in the same spirit, but specially designed to fit in the European legal order; an EU-SoX. The arguments in favour of any of the two options are related to the achievement of uniformity, legal certainty and a high level of regulatory quality.

Despite the positives of achieving this sort of uniformity, it has to be noted that it is not simple at all for the EU to put that plan into practice. Taking into consideration the length of the process for the creation of the draft European Constitution, the negotiations, the disagreements, and the conflicts of interests, it is almost certain that it will take long time for all Member States to reach an agreement on a corporate governance formula. As stated above, the EU consists of 27 countries with different legal systems and diverse historical, social, and political backgrounds. Additionally, any future enlargement will make the situation even more complicated. Given the fact that corporate governance is by definition an area of law characterized by complexity, any proposal for reform should acknowledge these characteristics and should give incentives for showing good will, spirit of cooperation, and willingness to compromise from all sides.

The EU appears to be reluctant to deviate completely from self-regulation and is in favour of a system of corporate governance that focuses on 'improving efficiency and competitiveness of EU firms, aiding in the development of the Single Market and facilitating

and empowering growing cross border investment'.<sup>86</sup> The key words are harmonization and convergence of law. It would be really helpful if an effective internal market in the area of company law had already been created. Even before the introduction of the Action Plan, mobility and non-discrimination of companies were high on the list of priorities. The 10<sup>th</sup> and 14<sup>th</sup> Directive, on cross-border mergers and transfer of seat respectively, were aiming to remove the last remaining obstacles in the creation of a common internal market. They deal with the issue of company mobility and their focus is on increasing competitiveness within the Single Market. Competition has been considered as invaluable in the area of company law. 'Mobility and non-discrimination lead to competition among national institutional structures and thereby may over time lead to a degree of harmonization by market forces'.<sup>87</sup> This is the reason why there should be no barriers to the choice of jurisdiction of incorporation and no 'government sanctioned discrimination of firms and individuals from different countries'.<sup>88</sup>

Overall, what has been also quite clear from the EU initiatives is that the EU is against rigid rules and excessive regulation and that it decided to work on the adoption of a more principles-based approach that would be 'tailored to European cultural and business traditions'.<sup>89</sup> The European response was clear: no strict regulation and no European SoX.

At this point, since the discussion is on the issue of a European SoX, it is worth pausing for a moment to make a reference to the Directive 2008/30/EC on statutory audits of annual accounts and consolidated accounts.<sup>90</sup> This Directive gave the premature impression

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<sup>86</sup> European Shadow Financial Regulatory Committee, 'Corporate Governance in Europe', (2002), Statement No. 15, available in the website: [http://www.ceps.eu/Article.php?article\\_id=282](http://www.ceps.eu/Article.php?article_id=282).

<sup>87</sup> Ibid

<sup>88</sup> Ibid

<sup>89</sup> Iatrou, A., 'European Response: The European Union's Corporate Governance Standards will impact insurers as investors and as providers of coverage to corporations', (2003), Industry Strategies, available in the website: <http://www.thefreelibrary.com/European+response:+the+European+Union%27s+corporate+governance...-a0111111958>.

<sup>90</sup> Directive 2008/30/EC of the European Parliament and of the Council of 11 March 2008 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, as regards the implementing powers conferred on the Commission.

that the EU has finally decided to adopt the American regulatory approach. There were inevitable comparisons as there were common aims and objectives. However, Jürgen Tiedje, the Head of the Audit Unit at the European Commission's Directorate General-Internal Market branch in Brussels, made it clear that there was no intention of creating a European SOX or a 'SOX lite'.<sup>91</sup> In actual fact, it was another step in the EU's harmonization process. The Commission and the European Parliament, in cooperation with the Member States, were working together for years on the revision of the Eighth Company Law Directive on the qualification of statutory auditors, which dated back to 1984. Before the introduction of the Directive in 2004, the EU did not change its standard regulatory process and published two recommendations relating to quality assurance for the statutory audit in 2000, and to statutory auditors' independence in 2002. The aim was to harmonize the accounting practices and increase the quality of statutory audit. It can be argued that this Directive does follow the example of the SoX, but its main intention was to create a protective shield against future financial scandals by enhancing the provisions on statutory audits and the duties of statutory auditors. The harmonization of the procedures for statutory audits of annual accounts and consolidated accounts would make financial reporting more credible and would restore the public's confidence. 'If implementation is reasonably consistent and balanced, then there will be a robust system to protect the independence and quality of financial reporting audits in Europe, to the benefit of the public interest and all those who rely on the reports of statutory auditors'.<sup>92</sup>

Until now, despite pressure from the American side, the first wave of scandals in Europe (Vivendi, Ahold) and the strong shock that Parmalat caused, the EU has been relatively stable and attached to this approach. The Action Plan rejected the solution of

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<sup>91</sup> 'Eighth EU Directive- No SOX for Europe', European Internal Audit Briefing, November 2007, Issue 10, pg. 2, available in the website: [http://www.eciia.org/images/stories/dwn\\_pub/dp\\_07/eciia%20newsletter%2012-07.pdf](http://www.eciia.org/images/stories/dwn_pub/dp_07/eciia%20newsletter%2012-07.pdf).

<sup>92</sup> Prof. Henri Olivier, Secretary General of the European Federation of Accountants, 'Statutory Audit Reformed', 01 March 2006, available in the website: <http://www.the-financedirector.com/features/feature204>.

adopting a European Union Corporate Governance Code of any form. In the Plan there was also no indication that the EU intends to use its authority to provide corporate regulation, at least not extensively. The initiatives of the EU have been mostly recommendations, proposals for Directives and consultation documents. Recommendations were chosen because they are not binding upon Member States, while the consultation documents show the political will of the EU institutions and they allow the Member States to express comments, views and reflections before any formal legislative action.

On an individual basis, Member States have chosen different routes to follow. The vast majority of them have introduced corporate governance codes, but there are also countries which have chosen legislation as a means of dealing with problematic issues. No European jurisdiction, though, has taken the path of formally laying down full, detailed corporate governance provisions in the law itself, as happened in the USA with SoX.<sup>93</sup> There are separate specific national provisions dealing with corporate governance issues and during the last few years more and more ideas stemming from the SoX are being adopted by European legislators as well.<sup>94</sup>

Finally, if we touch upon the latest EU proposals on banking regulation, the adopted approach remains the same. The recent proposals<sup>95</sup> from the High Level Group on Financial Supervision in the EU led by the former head of the International Monetary Fund, Jacques de Larosière, opted for ‘a more pragmatic and incremental approach toward strengthening supervision’.<sup>96</sup> Although these proposals are not directly related to the corporate scandals, they are indicative of the European regulatory mentality. The Larosière Report clearly talks

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<sup>93</sup> Wymeersch, E., ‘Enforcement of Corporate Governance Codes’, (2005) ECGI Working Paper Series in Law Paper N° 46/2005, pg. 3.

<sup>94</sup> Among others, see section 404 SoX and article 117 L.de Sécurité financière; Spanish Companies Act art 116.4 (d) as modified by L. 26/2003 of 17 July 2003.

<sup>95</sup> Report of High Level Group on Financial Supervision in the EU, (2009), Brussels, available in the website: [http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf) .

<sup>96</sup> Available in the website: <http://www.nytimes.com/2009/02/25/business/worldbusiness/25iht-ubanks.4.20436700.html> .

about ‘harmonization of national regulatory rules’ and a ‘common European rulebook’, in order to achieve a level playing field for all companies in the EU Single Market.<sup>97</sup> The proposals do not depart from self-regulation, as there are only recommendations: non-compliant countries will be named and shamed publicly, a policy that resembles the model of ‘comply or explain’. The Report is clear that ‘there should be no illusion that regulation alone can solve all these problems and transform the mindset that presided over the functioning of the system’, while there is also a mention that over-regulation should be avoided because it slows down financial innovation and thereby undermines economic growth in the wider economy.<sup>98</sup>

Despite the fact that the Report refers to stronger supervision, ‘safeguards of financial stability and sustainability of economic growth’<sup>99</sup>, it only focuses on the weaknesses of the existing system by identifying the problematic areas and admitting the mistakes of the past. It is positive, though, that the Report mentions proactive regulation and talks about effective crisis management procedures. The focus of every initiative should be on the prevention of crises and the early detection of the symptoms through adequate supervision and quick response to the ‘early warnings’.<sup>100</sup> The pre-crisis periods, the so-called tranquillity periods, are the right time to act. The existing rules can be improved and strengthened with enhanced supervision and emphasis on enforcement. In this way the weaknesses are identified early, the gaps are covered, and there is a plan for action ready in the event of a new crisis.

In this way, we return to the questions about the future of the EU: what is the regulatory path that the EU should choose, taking into account the European regulatory tradition, the recent international initiatives, and the expectations of the Member States? And secondly, does ethics fit in this now-developing EU corporate legal order? The answer to the

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<sup>97</sup> Available in the website: [http://ec.europa.eu/internal\\_market/finances/committees/index\\_en.htm](http://ec.europa.eu/internal_market/finances/committees/index_en.htm) .

<sup>98</sup> High Level Group on Financial Supervision in the EU, see above, note 95, point 114 and pg. 13-14.

<sup>99</sup> See above note 91, point 51, pg. 15.

<sup>100</sup> Ibid, point 30, pg. 11.

second question is affirmative, as ethics must have a heightened role in modern companies, not only in the EU, but internationally. Regarding the first question, there is no longer a dilemma between self-regulation and strict state regulation. It is widely accepted that a regulatory framework, which is built on detailed and meticulous rules, seems more suitable and is advisable for reasons of legal certainty, at the same time as the need for flexibility and for a legislation that encompasses all the latest developments requires general standards that do not focus on matters that are too specific.<sup>101</sup> The European legislator acknowledged that strict general rules can set up a strong legal defensive mechanism against scandals, while fines or penalties can be equally successful as deterrent factors. However, the EU has already cast its vote of confidence for harmonization, convergence, and flexibility. The driving force for this decision has been the recognition that corporate governance regulation is more than strict rules and fines. Corporate governance is about the philosophy behind making business; it is a set of rules, principles and standards concerning capital, risk taking, venture and ethics. Accordingly, any future reform proposals should have as their primary aim to transform the corporate philosophy from myopic and profit-driven to a more enlightened and ethical culture of compliance. Otherwise the long string of EU initiatives for the harmonization of EU corporate regulation and the improvement of corporate governance standards will be doomed to failure.

Europe had the time to think, balance the options, reflect and then act. The US government's reaction to the scandals was not an example-to-follow for Europe. It was a lesson-to-be-learned; a case-study on management of crises as well as on efficient planning and implementing reforms. Enron, WorldCom, and associates are by no means *just* American balance sheet scandals.<sup>102</sup> Actually, they are not just American scandals. Globalization and the multinational character of modern companies make it almost impossible to categorize

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<sup>101</sup> Irujo, J.M.E., 'Trends and Realities in the Law of Corporate Groups', (2005), *European Business Organization Law Review* 6, pg. 72.

<sup>102</sup> Hopt, see above, note 34, pg. 484.

some scandals as American and others as Europeans or to perceive corporate governance as a non-universal term. The interdependence of the world economies has reached such a level that no crisis can remain within the borders of a country, especially the USA. There should be attempts for a coordinated coherent regulatory response. This does not imply that there should be a one-size-fits-all solution or a universal code of corporate governance. It is not a secret that we need transparency, fairness, efficient supervision, prevention policy and good risk management. Reform implies an improvement through correction of errors without radical alterations of the fundamental characteristics. The core is preserved and there follows a procedure of redressing serious mistakes and removing of any defects. Consequently, a reform will be successful only if it is well-planned, well-organized and well-timed.

#### **(V) *Future challenges and the EU response***

Going back to the early history of business organizations is quite instructive, as it has clearly illustrated that the problem caused by bad corporate governance is no new phenomenon. In actual fact, corporate governance is a subject area that is as old as the corporate form itself.<sup>103</sup> The examination of the corporate scandals showed that all the corporate governance mechanisms, from the management and the directors to the shareholders and the auditors, either failed in their role or their performance was below standard. This problem requires a solution that we should continue to search for. The regulators failed, the same happened with the supervisors and so far no set of rules seems good enough to cure all corporate diseases and eliminate fraud and corruption. In this context, what are the odds of having a European Enron or WorldCom in the near future?

Even someone, who is inherently optimistic, would not be confident in giving a negative answer to the above question and this is by no means satisfactory. Nobody wishes the

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<sup>103</sup> Du Plessis, J. J., 'Corporate law and corporate governance lessons from the past: ebbs and flows, but far from "the end of history ...": Part 1', (2009), *Company Lawyer*, Vol. 30, Issue 2, 44.

repetition of such a disaster, especially during the current financial crisis. The crisis is not directly linked with corporate governance as such, but there are some common symptoms: failure to exercise proper due diligence, unsound risk management practices and weak supervision. Moreover, the causes can be traced back to the pre-crisis phase, the ‘tranquillity period’. During the period of strong global growth and prolonged stability, market participants sought higher yields without an adequate appreciation of the risks and failed to keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.<sup>104</sup> Instead ‘in the middle of the crisis, when circumstances look dire and chunks of the financial system are falling off, proposals get radical. But after each crisis is over, these radical plans are tidied away’ and what remains is calls for better disclosure, greater transparency independence and risk management.<sup>105</sup> The current financial crisis drew our attention to an old lesson that we need to revise. Legislation needs to be proactive rather than reactive. It is essential to control the period of growth and stability, in order to be able to avoid - or at least to predict - any forthcoming crises. Action should be focused on achieving that end. We cannot keep our fingers crossed or just hope that new scandals will not take place.

The EU has made significant steps forward and corporate regulation has been one of the priorities during the last few years. The jigsaw is not yet complete. Adding the missing pieces will allow everybody to have a clear picture of the final regulatory face of Europe. So far the regulatory framework looks deficient, as the Commission has not produced a complete legal framework for corporate governance. The EU is not ready to face the new challenges and a possible wave of scandals will find Europe ill-prepared. New scandals will have disastrous consequences on the European capital markets and the public confidence will hit

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<sup>104</sup> ‘Declaration of the Summit on Financial Markets and the World Economy’, November 15, 2008, available in the website: <http://georgewbush-whitehouse.archives.gov/news/releases/2008/11/20081115-1.html> .

<sup>105</sup> Persaud, A., ‘The Inappropriateness of Financial Regulation’, VOX, May 2008, available in the website: <http://www.voxeu.org/index.php?q=node/1102> .

rock-bottom. This is not a pessimistic prediction; it is a realistic one. If an Enron-like scandal happens in Europe soon, it would destroy the current atmosphere of positivism. In such an occasion, nobody can predict the real impact of the scandal and the economic knock-on effects globally. One scenario is that the EU institutions will be obliged to follow the American course of action being in a state of panic. It will not make any difference whether the final choice is the adoption of SoX as it is, or the adoption of identical provisions through a number of consequent Directives. An alternative scenario is the creation of a pan-European Code of Corporate Governance, which will be introduced in a rush (as with the SoX), simply in order to reverse the negative climate, boost investor confidence and prevent another stock market crisis.

In neither scenario would the adopted solution be the right one. Furthermore, none of them would be in line with the EU strategy so far, nor would correspond to the nature of the response that the European legislators have in mind and have been trying to shape all these years. The transplantation of SoX into the EU legal order is out of the question for a number of reasons, particularly because the EU is against mandatory provisions and the whole underlying philosophy of the SoX contradicts the EU corporate governance vision. On the other hand, a Corporate Governance Code does not represent the optimal solution either, at least for the time being. This Code would only be successful if it was the result of a joint project supported by all Member States. Unfortunately, this moment has not come yet as Member States have not achieved the necessary degree of convergence that would allow this kind of initiative. In October of 2004 the creators of a report that was prepared for the European Corporate Governance Conference in the Hague, including Jaap Winter, the Chairman of the High Level Group of Company Law Experts, admitted that any attempt to create and introduce an EU code on corporate governance 'would either be futile because it would not be able to set out best practices at a level which is of real practical importance, or

would become a very complex document containing all sorts of different applications and exemptions to accommodate local practices and rules'.<sup>106</sup>

The EU response is still under formulation and the focus is on the quality of the future regulatory steps. The aims and objectives must be clear and well-defined. The recognition by the European Commission that pure self-regulation is ineffective can only be interpreted as a positive development. As Roberts *et.al* state, 'a self-regulatory market approach based on non-binding recommendations' would be futile as sound corporate governance, especially '[i]n view of the growing integration of European capital markets'.<sup>107</sup> As discussed earlier in this Thesis, self-regulation will always be an attractive choice. Regardless of this fact, more realism is required. Pure self-regulation does not provide adequate protection against fraud, corruption and poor governance. The absence of enforcement mechanisms combined with voluntary compliance and internal monitoring has unfortunately proved to be unsuccessful and inefficient. The corporate failures made that explicitly clear. Apart from the scandals, self-regulation does not provide adequate protection against future threats. The EU looks determined to avoid this pitfall and ethics could play a key role. The Union's main intention is not only to improve the existing regulatory regime, but also to reinforce it with mechanisms that will detect and eliminate fraud and misconduct before it is too late. A self-regulatory legal framework reinforced with a moral compass can be an effective solution for the EU

To state the matter briefly, the EU basically tries to create a formula that will lead to the harmonisation of corporate governance rules taking into account the special characteristics of the Member States. This is why reflexive harmonization was discussed in

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<sup>106</sup> Hopt, K., Garcia, J.G., Rickford, J., Rossi, G., Christensen, J.S., Simon, J., Winter, J., 'European corporate governance in company law and codes', (2004), Report prepared for the European Corporate Governance Conference, The Hague, 18 October, available in the website: [http://www.icaew.com/index.cfm/route/156463/icaew\\_ga/en/Library/Links/Corporate\\_governance/Corporate\\_governance\\_by\\_country/Corporate\\_Governance\\_Europe](http://www.icaew.com/index.cfm/route/156463/icaew_ga/en/Library/Links/Corporate_governance/Corporate_governance_by_country/Corporate_Governance_Europe), pg. 2.

<sup>107</sup> Roberts, R., *et.al.*, 'Spilt Milk: Parmalat and Sarbanes-Oxley Internal Controls Reporting', (2004), International Journal of Disclosure and Governance, Vol. 1, Issue 3, 222.

Chapter 2 as a model that combines diversity with harmonization. Diversity is not incompatible with harmonization, especially if the EU works on and promotes the introduction of a model code of ethics. This code will not be binding - at least in the beginning - but it will be used as sort of benchmark for the Member States and the companies. Regarding its content and its drafting process, given the fact that there is neither an International Corporate Governance Organization nor a Universal Corporate Governance Code, a good starting point for the Commission would be to use the legal, social, historical, and ethical traditions of the Member States as sources of inspiration. Provided that the Commission introduces a working document, which will be further developed and improved in the context of the ongoing Transatlantic Dialogue with the United States, an Ethics Code or an equivalent declaration would be introduced. This code could subsequently be incorporated in the Listing Rules of the major Stock Exchanges, and would then gradually influence small and medium-sized companies. A similar initiative was taken by the NYSE in November 2003, when it took action against corporate corruption by requiring its members to adopt and disclose a code of business conduct and ethics for directors, officers, and employees and to promptly disclose any waivers of the code for directors or executive officers. The code highlights areas like conflicts of interest, corporate opportunities, confidentiality, fair dealing, and compliance with laws, rules, and regulations.<sup>108</sup>

It is indeed a very ambitious and far-reaching plan, but there are already similar initiatives concerning voluntary principles and codes of conduct embracing best practice especially in the field of human rights, such as the Principles for Responsible Investment, promoted under the auspices of the UN Global Compact.<sup>109</sup> It is worth mentioning, though, that there are also voices of concern asking for a fixed and more practical solution. Their arguments are that the business community, in this way, will be able to ‘avoid the confusing

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<sup>108</sup> McCraw, H., Moffeit, K.S. and O’Malley Jr, J., ‘An Analysis of the Ethical Codes of Corporations and Business Schools’, (2009), *Journal of Business Ethics* 87, 1–13 at 3.

<sup>109</sup> See, e.g., Mark Turner, *Blueprint for 21st Century UN Global Compact*, FIN. TIMES, June 13, 2006, at 4.

and conflicting application of various standards in Member States where they are incorporated and listed, as well as to have a stronger and more convincing European approach in particular to be able to compete in regulatory terms against the American legalistic and enforcement driven approach'.<sup>110</sup> Inflexibility, uncertainty, insufficiency, and over-regulation are buzzwords that the EU legislators want to avoid. Europe has been traditionally heavily-regulated domestically and its initiatives show that it is moving away from prescriptive national legislation in corporate governance and attempting to adopt a more uniform approach, despite the different corporate governance structures among Member States.<sup>111</sup> The rejection of a one-size-fits-all approach is not recognition that harmonization is a goal that cannot be achieved, because reflexive harmonization can create minimum standards and common values, respecting diversity and allowing national legislations and market forces to play their role.

So long as harmonization is not achieved in Europe, the US model will continue to appear as being the regulatory competitor of EU. There is no opposition between the EU and the US as far as corporate governance regulation is concerned. There are two different models, but both sides recognize that none of these models is perfect and 100% efficient. Each one of them is accepted as equally valid, subject to its compliance with certain core principles.<sup>112</sup> Therefore, companies have the flexibility to choose the one they consider better for their own needs and this is a unique privilege. The key is to coordinate, not to centralize.<sup>113</sup> Harmonisation is a process, not an end result, so achieving consistency in the proposed policy is more important than looking to introduce identical rules at any cost. This brings us back to the issue of reflexive harmonisation, as introduced in the second chapter,

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<sup>110</sup> Hopt *et.al.*, see above note 105, pg. 64-65.

<sup>111</sup> Shu-Aquaye, F., 'Corporate Governance Issues: United States and European Union', (2007), Houston Journal of International Law, 22 March 2007, Vol. 29, 583.

<sup>112</sup> Greene, E. and Boury, P.M., 'Post-Sarbanes-Oxley Corporate Governance in Europe and the USA: Americanisation or Convergence?', (2003) 1 International Journal Disclosure and Governance 33.

<sup>113</sup> Acharya, V., 'Some Steps in the Right Direction: A Critical Assessment of the de Larosiere Report', VOX, March 2009, available in the website: <http://www.voxeu.org/index.php?q=node/3185> .

where only the aspects of undeniable significance should be harmonised. In this way, diversity is respected and the problem of lack of consensus for full harmonisation is set aside. This perspective should not be rejected and seems to be more attractive than a method of coordination, which would be based on a learning process to allow the exchange of experience and best practices. Having accepted that, the need for mutual recognition and cooperation comes to the surface. Both sides have the same amount of responsibility to work towards this direction and promote this solution. It is not so complicated to make their approaches mutually consistent and effective in achieving the same goals. It is not the first time that something like that would happen. It has happened before with the converging of International Accounting Standards and US Generally Accepted Accounting Principles in 2006.<sup>114</sup>

## **(VI) Conclusion**

The US Sarbanes-Oxley Act and the EU Action Plan, in combination with the other EU initiatives, symbolize the foundations on which the reconstruction project of international corporate governance has been based after the dark period of scandals, collapses, insecurity, and panic. Nobody knows precisely how the day after tomorrow will look like. The USA has invested heavily in the SoX and as such it will continue to support it. Despite the criticism, Americans consider it as a strong and radical response to an extremely serious problem. The Action Plan appears to be more like a roadmap for the future. The EU has chosen to go with the challenge of harmonization of law and started by setting short, medium, and long-term goals. The whole business world is involved in the quest for optimal corporate governance regulation. What has become clear for the foregoing analysis is that the US and the EU regulation will reach high levels of efficiency only if they manage to incorporate an ethical

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<sup>114</sup> Cardilli, M.C., 'Regulation without Borders: The Impact of Sarbanes-Oxley on European Companies', (2004) 27 Fordham International Law Journal, 820.

element. The regulatory framework which they have designed will only be complete and efficient, if an ethical culture is established.

The field of corporate governance draws from many varying disciplines: law, economics, ethics, politics, management, and finance. In this respect, understanding the issues raised by corporate governance requires familiarity with the concepts, assumptions and terminology of each of these fields, plus a willingness to synthesize and even transcend them.<sup>115</sup> There is no curse of the guilty past that follows modern companies. The mistakes which have been made can be used as a useful guide and point of reference for the future, as, following the right direction, they can show the way that leads to a safer, more dynamic corporate governance habitat. Ethics could play an active role in developing and safeguarding this habitat.

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<sup>115</sup> B. Minoru Makihara, Chief Executive of Mitsubishi Corporation, cited in Deakin, S. and Hughes, A., 'Comparative Corporate Governance: An interdisciplinary Agenda', (1997), *Journal of Law and Society*, Vol. 24, No. 1, pg. 8.

## CHAPTER 7

### *CONCLUSION*

‘Corporate governance is an internal system encompassing policies, processes and people which serves the needs of major stakeholders by directing and controlling management activities with good business savvy, objectivity and integrity. Sound corporate governance is reliant on external marketplace commitment and legislation plus a healthy board culture which safeguards policies’.<sup>1</sup> The succession of corporate scandals before the dawn of the new millennium revealed that corporate governance structures needed to be improved and reinforced. Legislation can provide a general framework of operation and a set of basic rules, but modern companies need to undergo a deep change in their culture, in order to stay away from fraudulent practices and unethical conduct. Rules draw a clear line between behaviour that is considered to be acceptable and that which is considered unacceptable, but they do not have the power to encourage the adoption of a particular mentality or to stimulate a radical change in the philosophy of doing business internationally. Therefore, ethics has been suggested as an additional solution, which would bring a change in corporate philosophy of modern companies through the development of a more ethical business culture.

The shift towards ethics is not a new trend. The notion of social responsibility of business was introduced more than 45 years ago by Milton Friedman in 1962, who spoke about companies staying ‘within the rules of the game, without deception and fraud’.<sup>2</sup> For him, the responsibility of business is ‘to make as much money as possible, while conforming

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<sup>1</sup> O’Donovan, G., ‘A Board Culture of Corporate Governance’, (2003), *Corporate Governance International Journal*, Vol. 6, Issue 3, available in the website: <http://first.emeraldinsight.com/interviews/pdf/odonovan.pdf>.

<sup>2</sup> ‘There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud’. See Friedman, M., *Capitalism and freedom*, University of Chicago Press, Chicago, 1962, pg. 133.

to the basic rules of society, both those embodied in the law and those embodied in ethical customs'.<sup>3</sup> Christopher Stone also examined the 'culture of the corporation' in 1975 and was realistic in assuming that the dominant orientation of companies will remain toward profit, expansion, and prestige.<sup>4</sup> His suggestion was that we cannot rest 'upon anything firmer than the corporation's good intentions', but we need to fight the pre-existent corporate cultures, so that no underlying attitudes remain untouched.<sup>5</sup> The business environment was not yet ready to welcome and adopt such far-reaching proposals.

The proposals suggesting changes in the policy framework rather than in the letter of the rules are also not new. More than 30 years ago, Kydland and Prescott had emphasized the importance of 'pondering not only the desirable policy for a given set of circumstances but also the framework likely to produce the best policy over time'.<sup>6</sup> The focus should be in the long-run, with a view to creating a 'consistent policy'.<sup>7</sup> Time-consistent policy is that in which 'the planned response to new information remains the optimal response once the information arrives'.<sup>8</sup> Policy makers should behave in a systematic way focusing on the achievement of their long-term goals without short-term deviations. 'The search for a good policy rule should be limited to a comparison of alternative policy rules in order to select the one with the most attractive operation characteristics'.<sup>9</sup>

The issue of short-termism in corporate objectives had already been specifically addressed and it has been highlighted as one of the most significant factors contributing to

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<sup>3</sup> Milton Friedman, 'The Social Responsibility of Business is to increase its Profits', New York Times, September 12, 1962, sect. 6, pg. 33, col. 2.

<sup>4</sup> Stone, C. D., *Where the Law Ends: The Social Control of Corporate Behavior*, Harper & Row Publishers, New York, 1975, pg. 230 and 236.

<sup>5</sup> *Ibid.*, pg. 229.

<sup>6</sup> Buol, J. and Vaughan, M., 'Rules vs. discretion: the wrong choice could open the floodgates', (2003), *The Regional Economist*, Issue January, pg 10.

<sup>7</sup> See Kydland, F.E. and Prescott, E.C., 'Rules Rather than Discretion: The Inconsistency of Optimal Plans', (1977) *Journal of Political Economy*, Vol. 85, pg. 473-491.

<sup>8</sup> Walsh, C.E., *Monetary Theory and Policy*, 2<sup>nd</sup> ed., MIT Press, Cambridge, Mass., 2003, pg. 363.

<sup>9</sup> Buiter, W.H., *Macroeconomic theory and stabilization policy*, Manchester University Press, Manchester, UK, 1989, pg. 95. See also Prescott, E.C., 'Rules rather than Discretion: The Inconsistency of Optimal Plans', (1977), *Journal of Political Economy*, Vol. 85, 473-491.

excessive risk-taking.<sup>10</sup> Therefore, proposals were stressing the importance of having management interests aligned with the long-term sensible interests of the companies, in an attempt to find a common point of reference for everybody's legitimate expectations. In this way, excessive risk-taking could be avoided and there would be incentives for safe, and sound behaviour<sup>11</sup>, as an individual's performance would be evaluated over time together with the company's long-term interests. Once again these proposals were not put into practice for the improvement of corporate governance structures.

This Thesis supports the aforementioned proposals and its reflections are in line with their spirit. The EU should consider introducing and adopting a corporate governance regulation based on the improvement of the existing rules supported by provisions that will enhance the role of ethics and will contribute to changing the existing corporate culture. This regulation needs to be consistent with clear and long-term goals, in addition to one fundamental aim: to create a strong business environment of transparency, accountability and independence with vigorous supervision that operates following ethical rules and principles: an ethical culture. Ethics hold the antidote for the problem of crises and being proactive is the only way to prevent future crises or at least mitigate their effect. This was also confirmed by the study in chapter 3 of the companies that collapsed or faced the threat of collapse during the last ten years. All the case studies can be used as examples of the impact that the lack of an ethical culture can have in a business environment. Apart from the obvious absence of an ethical element, self-regulation also failed to live up the high expectations and is rather unlikely to stage a big comeback. The business world was obliged to change its strategy and

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<sup>10</sup> See Bebchuk L, and Fried, J., *Pay without Performance: The Unfulfilled Promise of Executive Compensation*, Harvard University Press, Cambridge and London, 2004; Bebchuk, L., Fried, J. and Walker, D., 'Managerial Power and Rent Extraction in the Design of Executive Compensation', (2002), 69 *University of Chicago Law Review* 751-846; Bebchuk, L. and Fried, J., 'Executive Compensation as an Agency Problem', (2003), 17 *Journal of Economic Perspectives* 71-92; Bebchuk, L, and Fried, J., 'Pay without Performance: Overview of the Issues', (2005), *Journal of Applied Corporate Finance* 8-22.

<sup>11</sup> Bernanke, B. S., Chairman of the Federal Reserve System, 'The Financial Crisis and Community Banking', speech at the Independent Community Bankers of America's National Convention and Techworld, Phoenix, Arizona in March 20, 2009, available at the website: <http://www.federalreserve.gov/newsevents/speech/bernanke20090320a.htm#fn3>.

ethics could guarantee a smooth transition into a new era where doing business is based on values, principles, long-term perspective and accountability. In other words, an ethical culture can be the missing link for the future of corporate governance, as well as the key for the successful reform of the existing regime. Corporate and personal ethics can become an efficient substitute for external regulation and internal control within the companies provided that corporate leaders are effective in implementing the business strategy and ethical vision of their companies.<sup>12</sup>

The USA chose the same regulatory path that was chosen in the previous crisis of the 1930s. When having to make such decisions under the pressures of time and public protests, the result, most of the time, is not the desired one. The discussion in chapter 4 showed that the high compliance costs, especially for small and medium-sized companies, were one of the main arguments of SoX's critics. The fact that the SoX has brought about a sweeping reform is not an indication of successful regulation and Congress will soon have to fill in the identified gaps. Ethics could facilitate this gap-filling process by making corporate executives more conscious of their role. Profit-maximization and ethics are not incompatible and the case studies in Chapter 3 are excellent illustrations of what can happen when ethics are left aside. The SoX invested too much in creating a compliance culture rather than an ethical culture. The focus was on the penalties and the compliance costs instead of how companies will manage to cure the wounds that creative accounting, book cooking and boosting revenues left on the American business community. Corporate leaders must set an example that all employees have to follow. This is a long process that takes time and effort.

The EU, on the other hand, has a unique opportunity to take a step forward and put a ground-breaking proposal on the table, providing a blueprint for future global financial

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<sup>12</sup> Persaud, A.D. and Plender, J., *All you need to Know about Ethics and Finance: Finding a Moral Compass in Business Today*, Longtail Publishing Ltd, London, 2007, pg. 194.

architecture.<sup>13</sup> As Ben Bernanke, the chairman of the Federal Reserve, pointed out, ‘the world is too interconnected for nations to go it alone in their economic, financial and regulatory policies’,<sup>14</sup> underlining the importance of international cooperation against any current or future crisis. The structural and cultural conditions of each market must be taken into account, as must the social and political context in which companies operate.<sup>15</sup> Therefore, EU legislators have to bear in mind that their proposal must be a comprehensive regulatory response, ‘driven by international as well as European single market considerations’.<sup>16</sup>

### **(I) Ethics, incentives and self-improvement**

‘There is a great world of expertise and intelligence and information to be synthesized in ways that have probably been attempted before, but perhaps not with the vigour that we will need to show in the future, internationally as well as domestically’.<sup>17</sup> The business world is in at a crossroads and the search for the most appropriate regulatory regime will eventually stop when the element of ethics is added in the formula. This is the link between corporate regulation and high standards of transparency, market efficiency, and investor-shareholder protection. At present, ethics represent the best defensive mechanism against any future crisis. The issue is how this theoretical artillery can be used in practice. Its value will be calculated on the basis of its success in a field where most of the previous recommendations, proposals, and plans have failed. It may fall short as well, but it is definitely worth giving a try.

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<sup>13</sup> Acharya, V., ‘Some Steps in the Right Direction: A Critical Assessment of the De Larosière Report’, VOX, March 2009, available in the website: <http://www.voxeu.org/index.php?q=node/3185>.

<sup>14</sup> Bernanke, B.S., Chairman of Federal Reserve, ‘The Crisis and the Policy Response’, speech at the London School of Economics in January 13, 2009, available in the website: <http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm>.

<sup>15</sup> Zinkin, J., *Challenges in Implementing Corporate Governance: Whose Business is it Anyway?*, Wiley and Sons, Singapore, 2010, pg. 15.

<sup>16</sup> Lannoo, K., ‘The Road Ahead After De Larosière’, (2009), Centre for European Policy Studies (CEPS), Brussels, available in the website: [http://fmg.lse.ac.uk/upload\\_file/1279\\_LannooPaper.doc](http://fmg.lse.ac.uk/upload_file/1279_LannooPaper.doc).

<sup>17</sup> The House of Lords EU Committee, ‘The Future of EU Financial Regulation and Supervision - Volume II: Evidence’, HL Paper 106-I, 14th Report of Session 2008-09, pg. 165, available in the website: <http://www.publications.parliament.uk/pa/ld200809/ldselect/ldcom/106/106ii.pdf>.

### ***(i) Ethics in corporate governance***

First of all, ‘there is no authoritative body which can decide what is and what is not counted as business ethics’.<sup>18</sup> A code of ethics can be defined as ‘a statement setting down corporate principles, ethics, rules of conduct, codes of practice or company philosophy concerning responsibility to employees, shareholders, consumers, the environment, or any other aspects of society external to the company’.<sup>19</sup> In some countries, like the United States, the adoption of a code of ethics has become a mandatory requirement for some companies, but studies have shown that ‘the mere existence of a code alone will (be) unlikely (to) influence employee behaviour’.<sup>20</sup> If there is a gap between the existence of explicit ethical values and principles and the attitudes and behaviour of the companies, then it is self-evident that even the best code is not sufficient to eliminate misconducts and ensure ethical behaviour.<sup>21</sup> If there is no consistency between the content of the code and the actual practice, then codes of ethics have no practical value, as the companies’ culture will not ultimately change. The source of the corporate governance problems as well as the starting point for the solutions can be found in the corporate culture. This was confirmed by the findings of the 2005 US National Business Ethics Survey, which emphasized that culture is very influential in ensuring that a company behaves ethically.<sup>22</sup>

Ethics must become an integral part of the business philosophy and should be used as a benchmark for every business decision. More importantly, an ethical culture needs to be nurtured on a continuing basis. Core ethical values should be integrated into every company’s goals, strategies, processes, and operations, in such a way that decision making is affected at

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<sup>18</sup> Davis, P. and Donaldson, J., *Co-operative Management. A Philosophy for Business*, New Harmony Press, Cheltenham, UK, 1998, pg. 68.

<sup>19</sup> Langlois, C. C., and Schlegelmilch, B. B., ‘Do corporate codes of ethics reflect national character? Evidence from Europe and the United States’, (1990), *Journal of International Business Studies*, Fourth Quarter, 522.

<sup>20</sup> Schwartz, M., ‘Effective Corporate Codes of Ethics: Perception of Code Users’, (2004) *Journal of Business Ethics*, Vol. 55, Issue 4, at 340.

<sup>21</sup> Webley, S. and Werner, A., ‘Corporate Codes of Ethics: Necessary but Not Sufficient’, (2008) *Business Ethics: A European Review*, Vol. 17 No. 4, at 405.

<sup>22</sup> Ethics Resource Centre, ‘National Business Ethics Survey – How Employees View Ethics in Their Organizations 1994–2005’, (2005), Washington DC.

all levels throughout the company.<sup>23</sup> All decisions and plans must be passed through the corporate ethical filter. If these values are successfully embedded, a radical change of mentality is possible. Such a change is not easy for several reasons. Principles like integrity, objectivity, confidentiality, independence, and fairness cannot be taught individually and there can be no guidelines for dealing with conflicts of interests. Professional behaviour can be monitored and supervised, but morality and competence are too vague. Moreover, codes of ethics are not a means by which companies seek to exercise power, control and ownership.<sup>24</sup> In such a case, there is a serious lack of the right motivation, as codes cannot be effective as control mechanisms or as instruments of compliance. Finally, the number of people who need to be included in this huge project of bringing ethics back to business culture is really indefinable.

In practice, a balanced ethical environment can only be created if we raise the awareness of all parties involved. All participants in the corporate governance structure must transform their mindset and learn to interact in an environment of fairness and morality. 'It is not a question of strict rules or self-regulation anymore; it is a question of self-improvement'.<sup>25</sup> Self-improvement is achieved through training, incentives and constant guidance. Corporate leaders play a central role, not only because their behaviour affects the whole company, but also because they are primarily responsible for aligning incentives with ethical behaviour and compliance with the codes, both corporate and ethical.

There are numerous examples of companies, which have not only adopted a code of ethical conduct, but have also organised regular seminars for employees on business ethics. However, even the most formal and well-designed seminars do not guarantee the expected

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<sup>23</sup> Webley and Werner, see above, note 21, at 412-413.

<sup>24</sup> Healy, M. and Iles, J., 'The Establishment and Enforcement of Codes', (2002), *Journal of Business Ethics*, Vol. 39, No.1, 123.

<sup>25</sup> Saltmarsh, M., 'Banks Make a Proposal to Monitor New Risks', *The New York Times*, July 11, 2009, available in the website: <http://query.nytimes.com/gst/fullpage.html?res=9C0CE2D6173FF93AA25750C0A96F9C8B63&scp=15&sq=d e%20larosiere&st=Search> .

results. This happens because ethics cannot be taught or learned like a university module and even obligatory attendance will not improve the situation. The secret is on the method of training. The content of the code of ethics must be clearly communicated to everybody in the company. Communication is the key word. All the necessary information must be explained in detail and there should be ample time for discussions and reflection. Training should aim towards raising the awareness of a company and creating a link between the moral values and corporate strategy and culture. Training should be intended to provide the tools that people can use to reach an ethical decision on their own and teach them to consider the consequences of their actions well in advance.<sup>26</sup> Embedding ethics in a company can be a long and intellectual process, the success of which is based on communication and general participation.

Ethics is part of the business reality and the management team ought to realize that its role is not limited to just introducing a code of ethics. Most importantly, managers and directors must be part of this teaching and learning process. Managers, who set clear standards and expect the best from everybody, including themselves, are able to create ethical cultures.<sup>27</sup> Such behaviour has proved to be more effective than any formal training session.<sup>28</sup> Laufer and Robinson showed that, when the behaviour of employees and managers is consistent with the codes, this can effectively influence the rest of the people in the company.<sup>29</sup> In this way, ethical behaviour is not imposed but rather gradually becomes part of the corporate culture. It is not something that has been passed down to the employees as a mandate by the managers.<sup>30</sup> That's why it is of fundamental importance for the effectiveness

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<sup>26</sup> Arjoon, S., 'Striking a Balance Between Rules and Principles-based Approaches for Effective Governance: A Risks-based Approach', (2006), *Journal of Business Ethics*, vol. 68, No 1, pg. 55.

<sup>27</sup> Stevens, B., 'Corporate Ethical Codes: Effective Instruments for Influencing Behavior', (2008), *Journal of Business Ethics*, vol. 78, No 4, at 604.

<sup>28</sup> Adam, A.M. and Rachman-Moore, D., 'The Methods Used to Implement an Ethical Code of Conduct and Employee Attitudes', (2004), *Journal of Business Ethics* 54, 225–244.

<sup>29</sup> Laufer, W. S. and Robertson, D.C., 'Corporate Ethics Initiatives as Social Control', (1997) *Journal of Business Ethics* 16, 1029–1048.

<sup>30</sup> Stevens, see above, note 27, at 607.

of a code that managers and directors themselves comply with its principles, setting the example, while inspiring everybody in the company.

**(ii) *The role of incentives***

Incentives are afforded great importance in this respect. Corporate practices and corporate culture cannot be transformed supernaturally and business people who have become skilled at following this particular philosophy cannot remove it without a trace. They need incentives that will facilitate the elimination of self-interests and the implantation of ethical values in their mindset. Incentives should reflect commitment to a responsible and ethical behaviour. In other words, they should not only prevent violations of legal and ethical rules, but also promote a culture that encourages ethical conduct.<sup>31</sup>

It is also worth mentioning that incentives are listed as one of the factors that created the conditions for the corporate scandals. More specifically, the structure of the existing executive compensation and incentive pay arrangements contributed, to a certain extent, to the establishment of a corporate culture of short-termism and excessive risk-taking. At Enron, the company culture rewarded strong financial performance at any cost, even if ‘book-cooking’ was part of the strategy.<sup>32</sup>

Incentives can be best designed so as not to be so closely related to stock prices and short-term results. The structure of the executive compensation should obligate executives to take into account the full effect of their decisions on the companies and to design their strategy with objective and realistic criteria. If management incentives are aligned with the long-term goals of the companies, then the possibilities of having conflicts of interests are reduced. It is very difficult to strike a balance among the sometimes conflicting interests of all parties and there is no need for common goals and interests. Priority should be placed on

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<sup>31</sup> Arjoor, see above, note 26, pg. 56.

<sup>32</sup> Stevens, see above, note 27, 605.

achieving the company's goals and objectives in a manner that is consistent with the company's standards for ethical business conduct.<sup>33</sup> Profit maximization and risk-taking is not illegitimate and payment with stock options is not illegal, but an enlightened approach is required. 'When executives' pay-offs have been tied to highly levered bets on the value of the companies' assets'<sup>34</sup>, which is a common problem with banks, executives are encouraged to take risks and then hide themselves behind the veil of limited liability. There is evidence that managers, who have weaker incentives to serve shareholder interests, take less risk.<sup>35</sup> Risk-taking should not be prevented, as it is inherent in the business-making process. Business managers, though, have no inalienable natural right to pursue profit or any other objectives unhindered by other people's expectations.<sup>36</sup> Incentives can be extremely useful in monitoring and limiting risk-taking to a reasonable level, while executive compensation structures should remain as they are. 'Regulators should be willing to intervene only when they observe deviations from sound practice', as was suggested in the 'FSF Principles for Sound Compensation Practices', issued by the Financial Stability Forum in April 2009.<sup>37</sup>

### ***(iii) The three levels of self-improvement***

In this way, ethics manage to coordinate the three elements that play the most influential role in the corporate governance structure, namely policy makers, governments and companies. This process of coordination aims at improving the overall effectiveness of

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<sup>33</sup> Johnson, K., 'Next Steps: Designing an Outcomes-based Ethics and Compliance Program Evaluation,' (2005), Ethics Resource Center, available in the website: <http://www.ethics.org/resource/next-steps-designing-outcomes-based-ethics-and-compliance-program-evaluation>.

<sup>34</sup> Bebchuk, L. and Spamann, H., 'Regulating Bankers' Pay', (2009), Harvard Law and Economics Discussion Paper No. 641, pg. 1, available in the website <http://ssrn.com/abstract=1410072>.

<sup>35</sup> Gorton, G. and Winton, A., Financial Intermediation, in Constantinides, G., Harris, M. and Stulz, R., (eds), *Handbook of the Economics of Finance Volume 1A: Corporate Finance*, Elsevier B.V., Amsterdam, 2003, pg. 526-529. See also, Brewer III, E., Hunter, W.C. and Jackson III, W., 'Deregulation and the Relationship between Bank CEO Compensation and Risk-Taking', (2003), Federal Reserve Bank of Chicago Working Paper 2003-32.

<sup>36</sup> Davis and Donaldson, see above, note 18, pg. 74.

<sup>37</sup> Financial Stability Forum, 'FSF Principles for Sound Compensation Practices', available in the website: [http://www.financialstabilityboard.org/publications/r\\_0904b.pdf](http://www.financialstabilityboard.org/publications/r_0904b.pdf).

corporate regulation by strengthening the bonds among policy makers, governments, and companies. Even though it is extremely difficult for them to have common interests, it is still possible to share the same vision for the future of corporate governance. This is why the proposed self-improvement must take place at all three levels.

At the first level, the policy makers, being at the top of the pyramid, must ensure that they have the necessary degree of independence from any external pressures and influence in order to work properly. Their role is fundamental and, thus, they need to be equipped with a long-term view. They cannot be successful and productive unless they feel that they are surrounded by an atmosphere of support. Policy makers must show that they are working in an environment of transparency and accountability. A culture of ethics will provide invaluable help in singling out the suitable regulatory solution for each given problem, while maintaining high standards of objectivity and fairness. If they limit their interventions to the necessary degree and show a willingness to offer rules that will bring security and stability, then the phenomenon of unsuccessful reforms will disappear. The focus is on the quality and the practicability of the rules, not just on whether new rules were introduced. Enhanced disclosure, tough enforcement, and efficient internal governance mechanisms are tools that can provide protection to investors and shareholders without reducing the independence of directors.<sup>38</sup> Excessive legislation can create problems of legal certainty and reduced supervision. Policy makers that put international cooperation and sound regulation as their priorities are indispensable nowadays. Citing the words of José Manuel Durão Barroso, the President of The European Commission, ‘policy makers build real trust, coherence, and consistency among European supervisory authorities in order to ensure that a stronger Europe emerges from the crisis’.<sup>39</sup>

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<sup>38</sup> See Enriques, L. and Volpin, P., ‘Corporate Governance Reforms in Continental Europe’, (2007), *Journal of Economic Perspectives*, Vol. 21, No. 1, 117-140.

<sup>39</sup> José Manuel Durão Barroso, President of the European Commission Launch of Lamfalussy Report Brussels, 16 June 2009, available in the website:

At the second level, governments should change their current mentality and realize that corporate governance or financial markets are not unregulated, so it is not entirely their fault if scandals take place. In addition, the role of the government is not to legislate after a crisis in order to restore public confidence and help people make up for any loss suffered. This cycle of market euphoria, scandals and collapses, followed by regulatory tightening – most of the times rushed and often disproportionate and ill-judged – seems to have become endemic.<sup>40</sup> The famous expectation gap problem is real, since there is a gap between society's expectations and the government performance. However, high expectations should not create more pressure. Politics is a field which is outcome-based and the criterion of a successful government is its achievements and its ability to realise the anticipated results. The problem of corporate governance is not a few falsified financial statements and a group of rogue executives. Enron, WorldCom, and Arthur Andersen 'all had formally implemented brilliant systems of corporate governance and compliance - they just did not live according to those'.<sup>41</sup> Corporate failures underline the need for a more ethical business philosophy, as supervision was weak and the watchdogs failed to identify the warning signs. Rules should be combined with ethics, and governments should strengthen international cooperation with a view to achieving compliance and legal certainty.

At the third level, we find the companies. Following all the aforementioned discussion of regulation and ethics, the path that leads to the solution of the problems of corporate governance seems to be open. At this point, it is up to the companies themselves to follow it or not. Companies should not only continue to comply with the rules and regulations, but also to become more ethical, to obtain an ethical culture. The ethical part of regulation refers to the personality and the behaviour of each single person. So, it is up to all those involved in

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<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/299&format=HTML&aged=0&language=EN&guiLanguage=en> .

<sup>40</sup> Persaud and Plender, see above, note 12, pg. 192 and 195.

<sup>41</sup> Wieland, J., 'Corporate Governance, Values Management, and Standards: A European Perspective', (2005) Business and Society, Vol. 43, No. 1, 77.

the day-to-day business as well as the decision-making process of a company to decide whether they want to be a part of the solution or not. It is all about compliance with the rules whilst at the same time maintaining a minimum level of ethical behaviour. The companies and their members need to understand that they should get more actively involved in the process of finding a solution. Compliance should be voluntary and not the result of fear of the fines. Voluntary means understanding the problem, realizing the need for finding solution, respecting the current initiatives, and accepting challenge to be a part of the solution. Governments could give incentives to companies that maintain high ethical standards. The purpose is to encourage companies to change their previous *modus operandi* and incentives, such as tax benefits, which acts as a reward for ethical performance, can have positive effect. It may sound ironic to reward behaviour, which should have been typical and not the exception of the rule, but compromises are sometimes unavoidable. Companies and their members should change their mentality at any cost, and incentives can be part of the strategy for the promotion of an ethical business culture.

At the end of the day, if a company chooses to be unethical and aims only at irrational profit maximization only, it faces the same dangers as Enron, WorldCom, and plenty of other companies which collapsed. The essence of ethics is not related to the fear of being sued or being dissolved, because, as it was argued earlier, ethics play the role of the filter for all decisions. The proposed ethical culture does not offer guidance to individual companies on how to make a choice or how to deal with ethical dilemmas. Nevertheless, even if companies and their members cannot understand the value and the benefits of ethical culture, compliance would still be welcome as a result of fear of the fines and penalties. Albert Einstein once said that 'if people are good only because they fear punishment, and hope for reward, then we are

a sorry lot indeed'.<sup>42</sup> Fear of punishment is indeed irreconcilable with ethical behaviour, but, in our case, companies are free to decide whether they wish to participate in this change of business philosophy or not. The directors or managers, who will make such decision, should bear in mind that, as it became clear from the discussion about the value of the SoX and the future of US corporate governance regulation, a culture of compliance is not synonymous to an ethical culture. If their company fails, dozens of people will be made redundant, they will lose their jobs and their shares, and they will be stigmatized as being unethical. Also, even if the company does not collapse, it will not be able to establish a strong bond with its stakeholders and create a good reputation. Instead, if they choose to follow the path of fairness and morality, their company will obtain a good reputation and will become attractive to new investors (vertical benefit) and to other companies that wish to expand (horizontal benefit). Ethics can fulfil a double function by defining appropriate behaviour for the company, sending out a message to the wider community about the type of behaviour that can be expected in the future.<sup>43</sup>

Companies that have developed and maintained a culture based on core ethical values are equipped with all the necessary mechanisms to survive the recent financial crisis, to combat corruption and fraud, and build their future on a stable basis. Compliance, supervision, integrity, and transparency can further enhance the effectiveness of the corporate strategy, even within the most adverse conditions. They are not affected by conflicts of interests, stock-market prices, corporate governance scandals, or financial meltdowns. Such companies can be optimistic about their future irrespective of the country they operate in and the type of the adopted regulation therein. All the interested parties, from the employees to

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<sup>42</sup> Einstein, A., 'Religion and Science', New York Times Magazine, November 9, 1930. See also, Hermanns, W., *Einstein and the Poet: In Search of the Cosmic Man*, Branden Press, Brookline Village, Massachusetts, 1983, pg. 68.

<sup>43</sup> Page, M. and Spira, L., 'Ethical Codes, Independence and the Conservation of Ambiguity', (2005), Business Ethics: A European Review, vol. 14, No. 3, at 313.

the management, and from the shareholders to the least affected stakeholder, must understand their ethical responsibilities and need to adjust their conduct to meet the required standards.

The day after tomorrow for both the EU and global corporate governance is closely connected with ethics. There is no need for a new generation of rules or for a completely new model of governance. ‘We have already done enough groundwork to pave way for a robust, yet well-functioning financial system’.<sup>44</sup> The only thing missing is to add the ethical part, which will act as a safeguard against fraudulent practices, wrongdoings and mismanagement. ‘Regulatory ambition should be set now, while the fear of the current crisis is fresh and not when the crisis is over and the seat belts are working again’.<sup>45</sup>

Put it simply, ethics can be the missing link in the regulatory chain between corporate governance regulation and efficient corporate performance. The establishment of an ethical culture can be achieved by filtering all corporate decisions through the company’s core values, reflected in its code of ethics and the behaviour of its senior management. This would enable corporate governance standards to be raised and would smooth the process of minimizing the costs and maximizing the benefits. However, it is worth noting that ethics must operate within a properly designed regulatory system which is sensitive to national needs or practices as well as capable of transcending national and regional differences. It is also auspicious for the suitability of ethics as the missing link that an ethical culture has the potential to improve both the EU and the US regulatory systems, because there is no need for the Americans to renounce the SoX and for the Europeans to adopt another approach. In this way, ethics could be the basis for every future reform or amendment of the corporate governance regulation worldwide.

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<sup>44</sup> Persaud, A., ‘The Inappropriateness of Financial Regulation’, VOX, May 2008, available in the website: <http://www.voxeu.org/index.php?q=node/1102>.

<sup>45</sup> Acharya, see above, note 13.

## **(II) *The future of EU corporate governance***

In this context, EU corporate governance regulation cannot be seen isolated from the whole system of law-making and its characteristics. The creation of the internal market has created a vigorous debate about whether harmonization is the most appropriate method. Globalization and the multinational character of modern companies have raised a lot of questions about whether there is one method that can safely lead to the much-desired convergence of corporate governance laws. Harmonization has been the choice of the EU legislators, but it cannot be so easily applied in practice, as we have witnessed in the last few years. Harmonization in the area of company law has proved to be remarkably burdensome and there were several difficulties due to the different legal systems and traditions. Differences in terminology and multiplicity in the legal concepts have led the EU legislators to adopt a strategy of common minimum standards, according to which a limited number of topics are harmonized. This ‘salami’ process of harmonization is not consistent and inevitably leads to lack of homogeneity, as only a certain number of topics are covered, while other closely related ones remain unaffected.<sup>46</sup> Such a solution cannot be characterized as successful and has been at the centre of criticism as being a ‘fragmentary and compromise solution’.<sup>47</sup>

Mutual recognition, minimum standards and subsidiarity provide a framework for regulatory competition, which reduces the scope for strategic regulation and dilemmas.<sup>48</sup> Regulatory competition includes a comparative element, and the idea of searching for the best solution created high expectations for better results than the Commission-driven harmonization. Nevertheless, regulatory competition can become unstable if, for example,

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<sup>46</sup> Andenas, M., ‘EU Company Law and the Company Laws of Europe’, (2008), *International and Comparative Corporate Law Journal*, Vol. 6, Issue 2, pg. 39.

<sup>47</sup> *Ibid.* See also Grundmann, S., ‘The Structure of European Company Law: From Crisis to Boom’, (2004) 5 *European Business Organisation Law Review* 601.

<sup>48</sup> Gatsios, K. and Holmes, P., ‘Regulatory Competition and International Harmonization’, in Newman, P. (ed.), *The New Palgrave Dictionary of Economics and the Law*, Vol. 3, Macmillan, London and Basingstoke, 1998, pg. 271-275.

mutual recognition is not achieved. Additionally, there is always the fear that regulatory competition will end up leading to a race to the bottom if there is no framework to control and regulate it. Lastly, ‘the more pluralistic orientation of many European company laws (for instance, towards employee representation) does not permit a simple choice between the different national laws which would be necessary for an effective competition’.<sup>49</sup> In the United States, the result has been an ‘uneasy and fluid allocation of corporate law between the federal government on the one hand and the individual states (led by Delaware) on the other’.<sup>50</sup> For this reason, actually, the SoX dealt with corporate governance from an extensive scope, limiting the autonomy of the states.

From what it appears, both harmonization and regulatory competition are neither a panacea nor a menace. In fact, they should be seen as complements, rather than substitutes to one another.<sup>51</sup> Reflexive harmonization, which seems to be an intermediate solution, considers diversity among Member States as a ‘resource, which, when coupled with mutual monitoring and benchmarking, provides a basis for experimentation and mutual learning’.<sup>52</sup> As discussed in chapter 2, the focus is on the process and the methods used, not on the end result as such. It is a new and innovative solution that builds on the weaknesses of the other options and the special requirements of the EU environment. It will soon become obvious whether it can stand the test of time and prove to be more successful than the two previously mentioned solutions.

One extremely important parameter in the quest for the right formula is the issue of a company’s choice of incorporation (jurisdictional competition - real seat theory and

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<sup>49</sup> Andenas, see above, note 46, pg. 34. See also, Merkt, H., ‘Das Europäische Gesellschaftsrecht und die Idee des „Wettbewerbs der Gesetzgeber“’, (1995) 59 *RebelsZ* 545 (554-560).

<sup>50</sup> Armour, J., Hansmann, H. and Kraakman, R.H., ‘The Essential Elements of Corporate Law’, (2009), Oxford Legal Studies Research Paper No. 20/2009; Yale Law, Economics & Public Policy Research Paper No. 387; Harvard Law and Economics Research Paper No. 643; Harvard Public Law Working Paper No. 09-39, pg. 31, available in the website: <http://ssrn.com/abstract=1436551>.

<sup>51</sup> Sun, J.M. and Pelkmans, J., ‘Regulatory Competition in the Single Market’, (1995), *Journal of Common Market Studies*, Vol. 33, No. 1, pg. 88.

<sup>52</sup> Deakin, S., ‘Reflexive Governance and European Company Law’, (2007), *Comparative Research in Law and Political Economy*, CLPE Research Paper 20/2007, Vol. 3, No. 5, Special Issue: EU Governance, pg. 1.

incorporation theory). As it was shown in chapter 2, the EU had initially decided in favour of ‘hard law’ harmonization through Directives, coupled with the stimulation of regulatory competition through the Court of Justice’s judgements in relation to freedom of movement, following the *Centros* case.<sup>53</sup> This strategy is no longer unanimously accepted. ‘Institutional investors have become more and more willing to look beyond their home jurisdictions in search of profitable investment opportunities’.<sup>54</sup>

The EU with 27 Member States is obliged to operate following a *sui generis* form of democracy. Harmonization cannot work through the introduction of common minimum standards only. The common legal solutions must be ‘tailored precisely and appropriately to local needs and preferences within each Member State’.<sup>55</sup> In this way, the Community will have the opportunity to give answers to both existing and future regulatory dilemmas. This method implies ‘steering the process of domestic evolution’.<sup>56</sup> The autonomy of the Member States has to continue to be respected as well as the diversity of their national legal orders.

Therefore, the open method of coordination has recently been added to the agenda. It is a ‘soft law’ approach designed to encourage joint action, peer pressure, benchmarking and indicators. It bears strong resemblance to self-regulation, further improved with a combination of short, medium and long-term reporting periods. Once again there are no sanctions, but the results are evaluated and a common approach is commonly decided afterwards. The essence of this approach is the use of centralised regulation to preserve a space for ‘autonomous governance at lower levels of government’.<sup>57</sup> It deviates from the traditional decision-making process and supports a model of inter-governmentalism. It is

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<sup>53</sup> *Ibid.*, Abstract.

<sup>54</sup> Pritchard, A.C., ‘London as Delaware’, (2009), University of Cincinnati Law Review, forthcoming; University of Michigan Law & Economics, Olin Working Paper No. 09-008, available in the website: <http://ssrn.com/abstract=1407610>.

<sup>55</sup> Dougan, M., *National Remedies Before the Court of Justice: Issues of Harmonisation and Differentiation*, Hart Publishing, Oxford, 2004, pg. 188.

<sup>56</sup> *Ibid.*

<sup>57</sup> Deakin, S., ‘Two Types of Regulatory Competition: Competitive Federalism versus Reflexive Harmonisation. A Law and Economics Perspective on *Centros*’, (1999) 2 Cambridge Yearbook of European Legal Studies at 258.

really doubtful, though, whether the open method of coordination, which has been adopted in the areas of employment and social protection, can be introduced to company law. Furthermore, it faces the same problem that made self-regulation ineffective: lack of sanctions and no supervision cannot guarantee conformity and strong enforcement, because compliance rests upon the discretion of the countries (or the companies).

What is positive is that the EU shows that it still seeks the best available option. The experience of the SoX with its ‘trans-territorial impact’ showed that fraud and mismanagement have no particular national identity and that ‘moral standards and value management systems for risk prevention’ are essential in all countries of the world.<sup>58</sup> The jury may still be out as to the long-term prospects for rival systems of corporate governance in an increasingly globalised economy, but the EU is on a quest for dynamic efficiency. In this way, it manages to combine the values of local diversity with system-wide adaptability.<sup>59</sup> Finally, it should not be forgotten that even if the EU creates a regulatory regime that can ensure fairness, accountability and protection against fraud and corruption, the problem is not solved. Likewise, even if consensus is attained over ‘universal core moral values’<sup>60</sup> that need to be a part of every company at any cost, the battle against corporate misconduct is not over. This happens simply because these rules and values need to be put into practice, to be followed, and to be respected by all parties involved. Proposing solutions is different from implementing them.

The recent financial crisis confirms the importance of solid corporate regulation to the world economy, and the need for ethical and effective initiatives. The ‘Lecce Framework’ is the latest initiative of the Group of Eight leading nations, in order to ‘establish a set of

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<sup>58</sup> Wieland, J. and Fürst, M., ‘Moral als element der good corporate governance in banken’ [Moral as an element of good corporate governance for banks], in Wagner, A. and Seidel, C., (eds.), *Ethik in der Bankenpraxis*, Bankakademie Verlag, Frankfurt and Main, Germany, 2004, pg. 21-43.

<sup>59</sup> Deakin, see 7note 56, pg. 259.

<sup>60</sup> Waddock, S., ‘Creating Corporate Accountability: Foundational Principles to Make Corporate Citizenship Real’, (2004), *Journal of Business Ethics*, Vol. 50, No. 4, 323.

common principles and standards to improve corporate governance and the general conduct of international business'.<sup>61</sup> It is positive that there was no attempt to introduce a brand new legislative framework, but the Ministers tried to create a comprehensive framework, building on existing initiatives, to identify and fill the existing regulatory gaps and foster the broad international consensus needed for rapid implementation. In the Final Statement, they mentioned among other the strengthening of business ethics as one of the Framework's aims.<sup>62</sup> The fact that the United States do not actively support this Framework undermines its importance, but even as a declaration of good intention, it shows that the creation of an ethical business culture is under way. It remains to be seen whether ethics will remain in the corporate governance reform agenda and it will not be sacrificed by the disagreement regarding the promotion of a global financial regulatory framework or not.

The business world has suffered too much during the last decades and seems to be determined to avoid the same mistakes that caused the corporate governance failures and provoked the financial crisis. This Thesis supports the argument that corporate governance will not end up being an uncured disease and a strongly enforced and implemented legislation in combination with an ethical corporate culture will soon be created.

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<sup>61</sup> Betts, P., 'Europe needs to boost corporate governance', Financial Times, June 17 2009, available in the website: <http://www.ft.com/cms/s/0/d25ea6f0-5b6f-11de-be3f-00144feabdc0.html>.

<sup>62</sup> Paul Maidment, 'Lecce Framework Has No Teeth', Forbes, 13 June 2009, available in the website: <http://www.forbes.com/2009/06/13/g8-finance-ministers-recession-opinions-lecce-framework.html>; See also, 'The Lecce Framework', Forbes, 13 June 2009, available in the website: <http://www.forbes.com/2009/06/13/g8-lecce-framework-markets-economy-full-text.html>.

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