CORPORATE GOVERNANCE AND CULTURE: UNDERPINNINGS OF THE EUROPEAN MODEL

By Richard L. Wise

The subject of corporate governance seemed to burst suddenly upon the scene only a few short years ago with the startling shock of the rapid demise of Enron and WorldCom, and Congress' rush to judgment with its passage of what has become known as the Sarbanes-Oxley Act. These events have also given renewed voice to calls for greater shareholder involvement in corporate governance issues in general, and in the director nomination process in particular. Often, advocates of such views point to the traditions within most European countries of providing for greater input in corporate governance, not only by shareholders, but by major groups that have a stake in the corporate enterprise.

Richard L.. Wise is currently general counsel and senior director to WorldWide PCE LLC, and has 28 years in private legal practice, including having served as a founding partner of both McCabe/Gordon PC and Gordon & Wise LLP, and, most recently, having served as a member of Eckert Seamans Cherin & Mellott LLC in Boston. He is counsel to Louis J. Muggeo & Associates LLC in Salem and to Dunbar & Rodman LLP in Newton. Wise holds a bachelor's degree in philosophy from Boston University, a Juris Doctor degree from Northeastern University Law School and has completed the coursework for a Master of Arts degree in international relations from The Fletcher School. He is a member of the International Corporate Government Network and an adjunct faculty member of The Round Table Group.

There is, indeed, a major current debate as to whether corporate governance models, and particularly those of multinational corporations, will converge on one, universal model, or whether there are intrinsically limits to any possible convergence. That issue will not be discussed at any length here. This article seeks only to analyze some of the basic distinguishing features of the continental European corporate governance model and the cultural underpinnings of that model so that those wishing to delve further into the convergence debate will have a basis for understanding why the continental European system (hereafter, the "European model") is formulated the way it is. Since form should follow function, it is my hope that they will thereby have a basis for deciding whether those principles are relevant to our own culture and problems. As the human mind only perceives concepts by means of contrast, some comparisons will necessarily need to be made to our own culture and systems as well; but such examples shall be put forth only to highlight the differences of the European model.

As a preliminary matter, we need to know what it is that we are talking about when we use the term "corporate governance." While there are admittedly different views of the matter, ultimately, "governance," whether one is dealing with a body corporate or a body politic, concerns itself only with power. It is a catch-all term for (a) the structural allocation of power within the organization and (b) the system or methodology adopted by the entity for authorizing such power's lawful use. Yet just as language, to a large extent, limits or determines the perspective through which its speaker views the world or ideas that may be articulated, a governance system is not a stand-alone, independent universe. Rather, it is to a large extent, and especially on a macro level, reflective of and determined by the culture and social organization of a country. This is true because culture and social organization provide not only ideas and values, but also strategies of action themselves. Thus, and in this way, all organizational arrangements spring from the social and institutional structures within which they must operate in as frictionless a fashion as may be possible.

Using the above definition, therefore, let us look briefly at some of the cultural and historical imperatives that have molded the European model. Professor Jeswald W. Salacuse, in his article *Corporate Governance in the New Century*, 25 The Company Lawyer 3 at pp 69-83 (March 2004; herein, "Salacuse"), has categorized them into seven key topics, and I draw on much of his analysis here.

1. Stockholder Concentration

In the EU, it is common to have stock ownership concentrated in the hands of controlling groups and even in the hands of the government. For example, in Germany, Spain, France and Italy, the mean largest voting block of stock is 49.6 percent, 40.1 percent, 29.4 percent, and 52.3 percent, respectively. In Austria, Belgium, Germany and Italy alone, a single investor or related group of investors control more than 50 percent of the voting stock of all non-financial listed corporations. In addition, governments commonly

retain controlling blocks in large companies. In the EU, the state is still the largest direct or indirect shareholder in 45 out of 143 large privatized enterprises; in France, four large privatized companies account for 20 percent of market capitalization of the Paris Bourse and the comparable figure for the Milan exchange is 36 percent. Further, government stock holdings also often include so-called "golden shares" that give them super voting rights on various issues so that their consent to agreed-to changes or programs must be obtained in order for them to be adopted. On the other hand, in the United States, not only is the government not a significant shareholder in any publicly traded corporation, but the mean percentage ownership for the largest block of stock for NYSE corporations, for example, is only 8.5 percent (dropping to 3.7 percent, 1.8 percent and 0.9 percent, respectively for the second through fourth largest blocks of stock).

The implications of these differences for corporate governance models are significant. In their 1932 classic work, *The Modern Corporation and Private Property*, Adolf Berle Jr. and Gardiner Means identify the problem and inherent conflict of interest that arises when ownership of a firm is separated from management thereof, as is the case in the typical United States public corporation. Indeed, in view of the high dispersal of shareholder ownership within this country, the dominance of management within the corporate governance system becomes even more apparent. On the other hand, with the low dispersal of stockholder ownership being typical within the EU, ownership is far more involved in management and the problems identified by Berle and Means become far less significant.

2. Public Share Ownership

One consequence of the concentration of stock ownership in controlling groups within the EU is a lessening of the involvement of the public generally in stock ownership itself. But the truth is that stock ownership is a far less common phenomenon in Europe than in the United States. For example, one survey estimates that, either directly or indirectly, half of the adults in the United States own shares in corporations, whereas only 20 percent of German adults, for example, own any shares. This lack of any wide dispersion of stock ownership within the EU makes the issue of stockholder rights a less pressing issue than here.

3. Shareholder versus Stakeholder Focus

As professor Cass Sunstein pointed out in his work, *The Partial Constitution*, a core historical distinction between the United States government and the government of Great Britain at the turn of the 19th century was that ours established a constitutional *democracy* whereas Great Britain had a constitutional *monarchy*. In doing so, James Madison and the other founders sought expressly to reject the historical monarchical traditions that, originally at least, provided for the establishment of rules based on the naked preferences of a monarch, and to replace them with a tradition founded on the concept of a "republic of reason." (Thomas Jefferson was similarly referring to the "divine rights" of kings in his famous admonition, "Question with boldness even the existence of a God; because, if there be one, he must more approve of the homage of reason, than that of blindfolded fear.") When one combines that major premise with our derivative traditions, such as all individuals being endowed with equal rights, or that "The history of liberty is a history of the limitation of government power, not the increase of it," (Woodrow Wilson), we find our culture placing a high value on individualism and on promoting freedom of contract and choice. In the corporate context, this establishes a political environment that seeks to enable and enhance what a corporation's organizers desire to do, leaving to market forces the decision as to which entities will thrive and which entities fail.

Within the Unites States, even while corporations were creatures of the law of the individual states, principles of federalism and of interstate commerce required and encouraged the mobility of corporations from state to state. As a result, jurisdictions could compete for corporate business by offering broad discretion and protections to the organizers of corporations. Thus, U.S. law followed an "enabling approach;" that is, everything would be permitted unless it was specifically prohibited.

European countries had no such traditions. Their model of corporate governance arose within the context of monarchical legacies where corporations existed with the "leave" of the government. There could be no competition between countries for corporate domicile as one nation could not interfere with another's sovereign rights and prerogatives. European law itself therefore developed in a fashion so as not to facilitate the type of corporate mobility as enjoyed within the U.S. As a consequence, the European corporate model reflected more of what has been called a "mandatory" approach; that is, unless specifically permitted, everything would be prohibited. Further, it followed that the corporation, as a creature of and deriving benefits—such as unlimited life, limited liability for owners, separate legal recognition—from the state, should in turn acknowledge and account for the needs of the society of which it was a part. This was particularly true for the large number of privatized corporations in which the State still retained a significant interest (through "golden shares") so that the state could be assured that its social welfare policies would be followed.

The foregoing brief summary highlights what may be the most important philosophical difference between the European model of corporate governance and what is called the Anglo-American model. For while the current primary issue for U.S.-based companies is the issue of holding managers responsible and accountable to it shareholders for purposes of maximizing their profits, the European model focuses more on assuring that society is able to control corporations so as to assure the implementation of the society's social welfare goals. Thus, by way of example, the ALI Principles of Corporate Governance, reflecting the American model of corporate governance, provides that the primary objective of a corporation, and hence, of its directors, is to *maximize profits* and shareholder value for shareholders. On the other hand, the Organization for Economic Co-operation and Development's Principles of Corporate Governance, which follow more the European model, takes the view that "the board is chiefly responsible for *monitoring managerial performance* and

achieving an *adequate return* for shareholders... ." [Emphasis added.]

This lessening of the focus on shareholders and their rightful return is replaced with a more pronounced focus on advancing the interests of those groups and organizations that may be affected by the decisions of the corporation. These other parties are commonly called "stakeholders" in the enterprise and this model of corporate governance is referred to as the "stakeholder model." In many European countries, such as in Germany, policies of co-determination actually require employees to have a formal voice in corporate governance. Another manifestation of this model is the "relational board structure" where other parties, such as lenders, suppliers, civic and labor groups, and the like are given seats on the board because of the corporation's relationship with them, rather than because of any stock ownership interest.

4. Shareholder Rights

Within the U.S., there is a supervening construct of statutory and common law principles and requirements that limits abuses of power and protects minorities from abuse. However, as discussed above, the markedly lower level of public involvement within the EU, combined with direct government involvement in many public corporations and a much stricter focus on "stakeholder interests," results in EU laws and regulations having significantly less focus on protecting shareholder rights. Indeed, one study on the subject of laws protecting shareholder rights gave the U.S. a score of 5 (with 6 being the highest) while Austria, France, Germany, Italy, Norway, Spain and Switzerland received scores of 2, 2, 1, 0, 3, 2, and 1, respectively.

5. One Board or Two?

Boards of directors have essentially two functionalities: operational guidance and oversight. In the Anglo-American model, these functionalities are combined in one, unitary board. With the European focus on a stakeholder model of governance, many countries and larger corporations actually divide these two functionalities into two separate boards. In Germany, for example, there is a lower board, the "Vorstung," which is a made up of manager-directors, appointed by the upper board, who supervise and direct the day-to-day operations of the company. In effect, the powers of this board are much akin to the powers that are vested in one CEO in the United States. The upper board, the "Aufstichsrat," is a supervisory board that is made up exclusively of nonmanagers and many stakeholders. Members of the Vorstung are prohibited by law from being on the Aufstichsrat.

Table 1: Corporate Governance Models

ANGLO-AMERICAN MODEL	EUROPEAN MODEL
1. management dominated	1. controlling shareholder dominated
2. shareholder focused	2. stakeholder focused
3. wide public share ownership	3. narrower public share ownership
4. strong shareholder rights	4. weaker shareholder rights
5. unitary board structure	5. two-level board structure
6. single powerful leader	6. consensus or divided leadership
7. shareholder litigaton culture	7. weak litigation culture

6. Unitary or Divided Leadership

Americans, historically, have placed a premium on individuality to the point where we have been described as being addicted to the "cult of the personality." In a survey on the subject of various cultures' value systems by Charles Hampden-Turner and Alfons Trompenaars, Americans received far and away the highest rating for individualism, with a score of 91 on a 100-point scale, while citizens of France, Germany, Spain and Japan received scores of 71, 67, 51 and 46, respectively. Indeed, one representative of a major U.S. pension fund observed, that "good corporate governance has never created a great company — great leaders, great CEOs have done so." Similarly, Europeans place greater value on principles such as "social solidarity," rights of labor and good faith in commercial dealings as opposed to Americans, who favor unfettered competition, "employment at will" and "freedom of contract." Thus, on the issue of whether society would be benefited better by increased competition as opposed to increased cooperation, the same study revealed that while 70 percent of U.S. managers agreed with that proposal, that percentage in Germany, France, Sweden and Japan dropped to only 41, 45, 39 and 24 percent, respectively.

Thus, in European cultures, where there is far less focus on the individual while a focus on community values and cooperation is more the norm, management of the firm becomes more of a group effort. On the other hand, in the United States, the fortunes of the enterprise are generally ascribed to the leader. As a consequence, the average CEO in Europe also earns almost half of what a CEO for a similar U.S. corporation would earn.

7. Litigation Culture

The markedly increased focus on shareholder rights within the Anglo-American model compared to the European model of corporate governance has already been touched upon. But the United States has two other attributes of its system that do not exist within the European model. These are the private right of action and the concept of class action lawsuits that permit attorneys' fees to also be recovered. These two attributes markedly strengthen the power of individual shareholders, no matter how small. On the other hand, Europeans typically look with disdain on what they perceive is our rampant litigation culture.

Salacuse (at p. 82) conveniently summarizes the differences between the two models as shown in Table 1.

The importance of a properly functioning governance system, both for bodies politic

and corporate, cannot be overstated. As noted professor Mario Guillen has established, "a poorly conceived [governance] system can wreak havoc on the economy by misallocating resources or failing to check opportunistic behaviors." The question then presents itself as to how we should begin to think about structuring a proper and internally consistent corporate governance system for a particular country. We take for granted the fact that a detailed Environmental Impact Statement is required before any new, major physical construction may be undertaken anywhere within the United States. Therefore, inasmuch as the environment within which a corporate governance system is to operate has equal importance with respect to such system's construction, an appreciation of that cultural, historical and legal environment must be a prerequisite to any responsible future planning.