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# Corporate Boards and Corporate Democracy

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This paper argues that the US corporate scandals symbolised by Enron represent a challenge to corporate governance not adequately addressed by reforms of 2002 including the Sarbanes–Oxley Act and proposed rule changes by the SEC (Securities and Exchange Commission) and NYSE (New York Stock Exchange). These changes reflect a minimalist approach to corporate governance and its regulation. The intent is to provide the minimal amount of regulation of governance in order to keep investors committed to stock markets. Effective reform in corporate governance means making corporate boards more representative and democratic. This position draws on the work of legal scholars arguing for more diversity on US corporate boards and builds on the presumed advantages of diversity for better decision-making and strategy formulation. Among the proposals made are that there should be at least two candidates for each board seat, nominations should come from shareholders, the board and employees, and that a majority is required for election to the board. Board elections must also be ratified by a majority of employees of the firm. This is designed to provide a middle ground between the German concept of co-determination and the US approach of self-perpetuating oligarchic boards. There are many legal, ideological and political barriers to these forms but if representative governance and democracy are truly valued, they should be applied to an institution that has huge impact on the lives of individuals and communities in the contemporary world.

- Board of directors
- Corporate governance
- Corporate interests
- Diversity
- Enron
- Representation
- Sarbanes–Oxley

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IN THE SPRING 2003 ISSUE OF *THE JOURNAL OF CORPORATE CITIZENSHIP* there was a call for new thinking about corporate social responsibility and citizenship in the context of a 'Turning Points' feature (Waddock 2003). The intent was to spark controversy, be provocative and provide a forum for emerging ideas and perspectives. Hopefully, this essay will meet this goal.

This essay grows out of teaching a Capstone MBA course in strategy where ethics is mandated as a major theme. The idea that firms should be ethical and act in socially responsible ways is appealing but unsatisfying. Corporations might articulate a devotion to ethics and corporate responsibility so long as these values do not conflict with other interests, such as maximising sales revenue, cost reductions, profits, perceived competitive advantage over competitors or managerial autonomy. When ethics and corporate responsibility come into conflict with one or more of these goals, it is likely that the former will suffer relative to narrower and commercial interests. Every firm has an implicit hierarchy of interests. In the best of all possible worlds, they might respond to all of these interests; in reality, corporations must sometimes choose which interests to pursue and which to ignore.

These conflicts inevitably lead to the question of power and who holds it in the modern corporation. Who has the power to define, in practice, the hierarchy of interests that any firm will pursue at those critical junctures when one interest is subordinated and another held dear. Who defines the hierarchy of interests of a corporation is a question of corporate governance. This line of analysis was developed against the background of the Enron-era corporate crises. The dramatic and sometimes astonishing failures in corporate governance at the start of the new millennium led to the Sarbanes–Oxley Act of 2002, and proposed corporate governance changes by the SEC (Securities and Exchange Commission) and the NYSE (New York Stock Exchange). These reforms, while perhaps admirable, did not seem to address the basic issue of who defines the hierarchy of interests of a modern corporation in the United States.

Since the first draft of this essay, the world has continued to change providing a different, hopefully richer, context for discussing corporate governance. In its search for a plausible rationalisation for the war in Iraq, the Bush administration has discovered the emotional power of democracy. The elections in Afghanistan, Palestine and Iraq suggest that, quite possibly, the disruptive influence of American power would be a catalyst for reform of the political process in the Middle East, a hope reinforced by the announcement of modest democratic reforms in Egypt and Saudi Arabia. Holding elections, especially under conditions of either war and/or hegemonic control of a political process, hardly constitutes democracy but nevertheless these are important steps. A second, somewhat parallel and maybe more important movement was the successful challenge of a flawed electoral process in the Ukraine. This suggested that, independent of US power and influence, even the façade of democratic participation can become a powerful catalyst for change. Similar democratic pressures may be operating in the republic of Kyrgyzstan. The issue in the Ukraine and Kyrgyzstan, at least in part, involved the legitimacy of electoral processes. If democracy in the Middle East is now the official policy of the United States and if democracy has such strong appeal, what then of democracy in the United States and with regard to corporate governance? This question is a focal point of this essay.

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## Shareholder democracy

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'Shareholder democracy' has acquired, at least among reformers, something of an ironic meaning. It is that form of democracy that has little or no authenticity in the context of

democratic theory. As Joo (2003) writes in the context of exploring the barriers to a more democratic process that would facilitate ethnic-minority representation on corporate boards of directors:

The formal structure of corporate governance envisions a kind of republican democracy in which shareholders vote for directors . . . Despite the formal trappings of 'corporate democracy,' directors have far more power over election outcomes than shareholders do. At election time, the incumbent board typically nominates a slate of candidates without input from shareholders. Furthermore, the management slate usually runs unopposed . . . Corporate law discourages shareholders from mounting opposition campaigns (Joo 2003: 744-45).

A study of bureaucracy as a representative institution for racial and ethnic minorities found that interests are not heard until there was effective representation (Selden *et al.* 1998). Authentic shareholder democracy would be a clear advancement of democratic theory in the US economic sphere.

Corporate governance has been viewed in a narrow conceptual framework. The implicit premise behind US corporate governance appears to be less corporate governance is better corporate governance. This probably stems, in part, from the strong ideological bias of laissez-faire capitalism in the US compared with other developed capitalist countries in Europe and parts of Asia. It also reflects the supremacy of property rights over other, more democratic rights, entrenched in the very design of the US Constitution. As Sarra (2002: 717) observes, 'corporate governance is . . . situated in a highly codified property regime that reflects and reinforces the historical distribution of property'. It also reflects the evolution of corporate law during and after the industrial revolution in the United States. The approach to corporate governance has been designed in the United States to provide just enough protection for investors to sustain a system highly dependent on equity markets for capitalisation (Stout 2004: 780). Thus, corporate governance has evolved historically in response to various crises such as Enron and other breakdowns in existing governance; it is highly reactive. Laws and regulations define the *minimal* limits of the most egregious acts of unlegitimated corporate power. The system *invites* pushing the limits of legality in the service of the narrowest of interests of corporate management and their co-dependent boards of directors. As the US Senate report on Enron concluded, the Enron Board of Directors:

knowingly allowed Enron (to engage) in high risk practices (US Senate 2002: 14)

knowingly allowed Enron to conduct billions of dollars in off-the-book activity to make its financial condition appear better than it was, and failed to ensure adequate public disclosure of material off-the-book liabilities that contribute to Enron's collapse (US Senate 2002: 38)

and approved:

excessive compensation for company executives, failed to monitor the cumulative cash drain caused by Enron's 2000 annual bonus and performance unit plans, and failed to monitor or halt abuse by the Board Chair and [CEO] of a company-financed multimillion dollar, personal credit line (US Senate 2002: 52).

With each historical cycle of disaster, a new wave of law and regulation is enacted to re-establish trust in the system by investors. This creates stability until a new era of corporate managers and co-dependent boards have the motivation and devise more sophisticated techniques to circumvent their fiduciary responsibility to shareholders.

While the business and financial media initially described Enron as an 'outlier' in terms of its failed governance, it was quickly followed by the collapse of WorldCom, with 65,000 employees, and other publicly traded companies (Sarra 2002: 715). What is extremely important in the context of the minimalist corporate governance hypothesis is that the reforms of 2002—Sarbanes–Oxley, SEC regulations and NYSE proposed changes

in listing requirements—addressed only the interests of shareholders.<sup>1</sup> However, at the time of its collapse in December 2001, Enron Corporation was the seventh-largest company in the United States with over US\$100 billion in gross revenue and more than 20,000 employees worldwide (Sarra 2002: 715). Enron is extraordinary not only for its systems failure but for the breadth and depth of harm it did not only to employees who lost jobs and pension funds, but also for the economic harm it did to communities, creditors and customers. What is striking about the reforms is that they have addressed only the harm to shareholders.

Shareholders serve a useful ideological function in the US system of corporate governance. Serving their interests, however nominally, directs attention away from larger issues of corporate misconduct. According to Sarra (2002: 717), these issues include serious environmental harm, occupation health, harmful consumer products, continuing racial and gender discrimination, and failure to comply with labour standards. Depending on one's perspective on corporate behaviour, the list might be expanded, narrowed or dismissed altogether. However, what is crucial to the advocacy of a more authentic form of corporate democracy is that corporate governance can and, I argue, should, be viewed in a broader socio-economic-political context than mere shareholder rights.

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### What context for corporate governance?

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It is important to view corporate governance through a larger societal lens than the property rights of shareholders. The modern corporation affects the lives of individuals and communities through their employment practices, capacity to shape patterns of consumption, impact on the environment, and their ability or inability to compete globally. There is a strong and powerful connection between US companies pursuing profits and the growth of outsourcing and the rise of the US trade deficit. While outsourcing is now rationalised as good for the US economy, it is eerily similar to the 'hollowing-out' of the US economy that was such a great concern in the late 1980s when Japan appeared to have a stranglehold on key technologies and industries, often facilitated by joint ventures, licensing and strategic alliances with the very US firms they were challenging. The decisions of corporate managers are today shaping the economic future of the US without any formal process of representation or legitimacy.

As long as the mandate of corporations in a 'free market' is to maximise their interests (profits, shareholder value, and/or top management team compensation and stock options), there will be inevitable conflict and tension between the interests of the firm and the larger interests of society. For example, with regard to environmental sustainability, corporations now dominate the political process in the United States and are now encouraged to extract public resources for the private benefit of a few while regulatory restraints on pollution are diluted. If the political process can no longer function in the US to protect a 'public interest', perhaps, ironically, a more democratic corporate process can.

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1 Chandler and Strine (2003: 957), Chancellor and Vice Chancellor, Delaware Court of Chancery, refer to the '2002 Reforms' as a 'package'. They argue that these reforms prescribe a host of specific procedures and mechanisms that corporate boards must employ in governance of their firms. These prescriptions impinge on the managerial freedom permitted to directors by state corporate law and will fuel a new round of dialogue between the three sources of corporate governance policy that predominate in the American system: the federal government (principally through the SEC), state governments (through their corporate codes and the common law of corporations) and the stock exchange (through its rules and listing requirements).

The American Revolution was driven by abhorrence of taxation without representation. Today, corporations make decisions with far-reaching consequences without representation from those who are directly and indirectly affected by those decisions. Current corporate governance 'excludes from decisions those who are often most affected by corporations decisions' (Brennan 2003: 43). The argument that corporations are private may have legal standing but is also a legal fiction. Corporations exist as sanctioned by states. They are, in theory, creations of the state to serve a larger public interest. In a relatively simple economy, just pooling capital to pursue economic projects of scale, might have legitimately been construed as serving the public interest. But the contemporary world is much more complex. The actions of corporations inevitably have consequences far beyond the good derived from pooling of capital.

The definition of 'private' relieves corporations of responsibility for the consequences of their actions. While this may be consistent with a hard-line laissez-faire ideology, it is not consistent with democratic theory, which suggests that individuals ought to have at least a representative voice in decisions that affect their life and welfare.

There is also the issue of unlegitimated power. The power of corporations over our collective lives continues to grow. From the perspective of an individual citizen, corporations are largely unchecked, unlegitimated concentrations of power. If corporate boards select management and senior management shapes the selection of the boards, from where does the legitimacy of huge concentrations of corporate economic and political power come? Self-perpetuating and self-serving corporate oligarchy not only fails to deliver sustained social responsibility, it violates a basic premise of democratic theory with regard to participation and representation. Even when some corporations behave ethically and responsibly, we have a situation akin only to 'benevolent monarchy'.

As the norms of the Reagan-Thatcher era of deregulation have become embedded in the political culture of the global economy and as the power of unions has been harnessed in the US and the UK, and as Euro-Communism faded from Europe with the fall of the 'Iron Curtain', the power of employees has been radically diminished. A fundamental check on corporate autonomy that once existed, however marginally, has eroded. Lord Acton's dictum that 'power corrupts' and 'absolute power corrupts absolutely' has been seen as a disease of government. The political culture of the US accepts as axiomatic that, since corporations reside in the private not public sector, they are immune from the corruption of power. However, the financial and accounting scandals of the first years of the 21st century should remind us that any great concentration of unchecked power is inherently a peril to the general welfare.

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## Virtues of a more democratic corporation

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Some of the most compelling arguments for a more democratic corporate process have come from those seeking more representation for minorities and women in corporate governance as a means of creating more opportunities for minorities and women in senior management. Thomas W. Joo, a professor of law at the School of Law, UC Davis, argues that the doctrine of unilateral director power over board composition reduces the likelihood that questions will be raised about the behavioural bias towards homogeneity and thus helps to perpetuate the exclusion of minorities and women from corporate governance and, as a consequence, senior management. Ethnic and gender diversity is associated with better managerial decisions. According to Dallas (2001), the advantages to heterogeneous boards include the following:

- ▶ By bringing together a wide range of viewpoints, they excel in 'complex decision making requiring creativity and judgment' (Dallas 2001: 1,391).

- ▶ Diverse directors may also engage in more rigorous decision-making and monitoring processes because of their varying and sometimes conflicting perspectives (Dallas 2001: 1,400-1,401).
- ▶ They may be more likely to monitor one another.
- ▶ They will make decisions by considered discussion and negotiation rather than by consensus (Dallas 2001: 1,401).
- ▶ They will consider counter-arguments (Dallas 2001: 1,402).
- ▶ They may be less likely to be over-confident (Dallas 2001: 1402).
- ▶ They may be less likely to take extreme positions.

To this list, other benefits of diversity can be added. Diversity can:

- ▶ Contribute to the firm's conscience with regard to issues of ethics and social responsibility if board members represent more than simply the financial interests of mainstream shareholders
- ▶ Focus on the firm's strategic direction assessing how value is created: for example, not through financial and asset manipulation but the development of new products and new markets
- ▶ Increase sensitivity to opportunities and threats to the firm from its external environment. The narrow social class basis of boards as now constituted isolates them from the rich and complex reality of life in the United States and beyond.<sup>2</sup>

Environmental scanning and awareness must be strong and active. This assures the recognition of both opportunities and threats. But this assumes a genuine desire and commitment to know about the firm's environment and its impact. A diverse board will probably have an authentic desire to understand the firm's environment.

What is remarkable is how many companies pursue strategies that don't make sense (Finkelstein 2003). For example, most US firms in the airline industry lose money following the same dominant logic and doing the same things while one airline, Southwest, differentiates itself in its product offering and has a consistent record of profitability.<sup>3</sup> The pursuit of growth as an end in itself invites a host of dysfunctional strategic behaviours including acquiring unrelated businesses. M&A (mergers and acquisitions) typically creates paper value and appears to be a quick and seemingly easy way to increase sales and profits. But it is mostly smoke and mirrors. We live in an era when junk bonds, hedge funds and Internet start-up firm valuations are often divorced from reality.

Homogeneous and self-perpetuating boards do not guarantee the development and implementation of a sustainable corporate strategy. Whether these homogeneous boards are independent or not does not appear to be decisive. The Enron Board of Directors was, after all, nominally independent. Homogeneous boards are more likely to be associated with the worst consequences of 'group-think' and the limitations of corporate 'dominant logic'.

2 Ironically, firms can become so removed from this rich and complex reality that they need to hire costly consulting firms, such as Gary Hamel's Strategos, to teach them how to pursue innovations grounded in customer experience. See, for example, Harvard Business School 2003.

3 Government bail-outs of the airline industry, as in the United States after 9/11, simply compound bad corporate strategy with bad industrial policy. How this happens is an important research question and may reflect the political power of large, mature industries that compete more effectively in the political arena than in the market.

Another fundamental reason for reforming corporate governance is to strengthen the foundation for corporate ethics. Management should not be the sole arbiter of what is or is not ethical behaviour. Self-regulation is a common argument on behalf of corporations. Self-regulation will only represent the interests of society if the diverse interests of society are represented on a firm's board of directors. Under the existing regime of corporate governance in the United States, voluntary self-regulation is little more than a diversion and delaying tactic by corporations that promote it.<sup>4</sup>

External regulation, the next line of defence against the abuses of corporate power, is both a blessing and a curse. When regulation exists, the regulators may be drawn from industry or regulation can be heavy-handed, inefficient and counter-productive in finding a proper balance between the interests of society and the interests of corporations.

Calls for co-operation between corporations and non-governmental organisations (NGOs) to preserve the environment or address social problems are impressive and commendable but minuscule compared with the scope of social, economic and environmental problems confronting communities and nation-states worldwide. Every long journey may begin with a single step; however, when it comes to solving national, regional and global problems through experimental collaboration between corporations and NGOs, we must be concerned that for every step forwards there are several steps backwards.

The argument that corporate social responsibility is correlated with better financial performance may have the weight of empirical support but may beg the real question.

A preoccupation with instrumental consequences renders a theory that accommodates economic premises yet sidesteps the underlying tension between the social and economic imperatives that confront organisations. Such a theory risks omitting the pressing descriptive and normative questions raised by these tensions, which, when explored, might hold great promise for new theory, and even for addressing practical management challenges (Margolis and Walsh 2003: 280).

Empirical findings are limited by the bounded rationality of corporate decision-makers who through misperception, greed, arrogance and other human frailties may reject the findings if they looked at them.

In short, self-regulation, governmental regulation, collaborative NGO–corporate problem-solving and enlightened self-interest can all potentially mitigate the worst tendencies of narrow corporate self-interest, but all depend on optimistic assumptions. A more direct and a more effective approach may be more heterogeneous boards elected in a more democratic fashion. Such a reform would give meaning and substance to self-regulation, obviate the need for governmental regulation or diminish the tendency to subvert or circumvent it through the political process, increase the sensitivity to the empirical findings of scholars in the area of corporate social responsibility, and breathe life into the concept of enlightened self-interest.

Authentic corporate democracy in the election of boards fundamentally challenges the myth that corporation management left to its own devices will produce the most good for the most people while being efficient, competitive and strategically astute.

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4 As an anonymous reviewer noted, self-regulation has worked well in banking in London, the world's largest financial centre in the industry. Sometimes self-regulation is effective, sometimes not. The variations may reflect corporate, industry and national political cultures and is a fascinating area for future comparative research. Just as the Sino-Soviet dispute of 1960 stimulated the field of comparative communism, cross-national differences in corporate governance, ethics and social responsibility should stimulate studies in comparative capitalism.

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## Specific board reforms

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The primary vehicle of reform is the board. There are some basic structural and process changes that will drive the corporation towards becoming a more representative and democratic institution. Two fundamental kinds of reform are required: wider and more effective participation through representation and better protection of the civil and economic liberties of individual constituents of corporate strategy and corporate action. This essay focuses on the former without discounting the importance of the latter.

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### Selection: key to wider and more effective representation

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The selection process must create effective paths of representation for shareholders and stakeholders while meeting a standard of simplicity. Senior management, existing board members, employees and shareholders ought to be empowered to make nominations. In the case of employees, nomination would require a petition signed by some reasonable percentage of the employees. In industrial firms with a large unionised labour force, a union representative might seem an attractive candidate for a directorship role. In knowledge-based companies, employees might actually seek out independent candidates who represent not only their interests but also that of the firm and who would bring real value to the board.

An important principle of representative democracy is electoral competition. Without a choice of candidates, shareholders under the current system in the United States may withhold their vote from an incumbent director but cannot effectively vote for an alternative candidate (Joo 2003: 758).<sup>5</sup> Withholding one's vote is a futile gesture because election to the board does not require a majority vote of shareholders but only a plurality of the votes cast once a quorum is met (Joo 2003: 745). Thus, in an uncontested election, the nominees of the incumbent board are guaranteed victory regardless of the number of votes withheld by shareholders (Joo 2003: 745). As Blair and Stout (1999: 311) have observed, 'shareholders in public corporations do not in a realistic sense elect boards. Rather boards elect themselves.'

In October 2003, the SEC proposed an amendment to proxy rules that would require the corporation to list shareholder nominees in the corporate proxy materials; but, as Joo (2003: 763) observes, these conditions are so restrictive that the procedure is unlikely to be of much practical use in changing the composition of the board.

An alternative system would require at least double the nominees as open board seats with or without organised slates of competing candidates. A majority vote by shareholders ought to be required with run-off elections as necessary. Finally, the election would have to be ratified by a majority vote of employees with one vote per employee. It is the latter requirement that is intended to shift corporate governance in a fundamental and more democratic way. This proposal is somewhere between the German model of co-determination which guarantees that corporations of a certain size have direct employee representation on the board and the American model that guarantees that boards are self-perpetuating oligarchies.

The rationale for employee participation is straightforward. First, they have a long-term stake in the firm's financial health, reputation and performance. Their vision may be more long-term than that of senior management. Employees depend on the firm to provide jobs, benefits and future retirement income. Employees have more of their economic future invested in the firm than most investors, who are notoriously fickle. Second, they know the firm in a way that is rich and grounded, albeit differently from

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<sup>5</sup> Joo describes some of the impediments to competitive board electoral contests.

top management and existing board members. Third, the partial empowerment of employees in the context of corporate governance is a check on the self-perpetuating and oligarchy quality of existing boards. Fourth, employees, as a whole, represent a wider range of potential interests and outlooks than top management and existing directors. They may recognise the interests of other stakeholders more quickly and fully than those who now make up boards. If employees rejected a selection of the board, another candidate would have to be presented for ratification and voted on within a short period of time.

The intent is not to deny or replace a corporate political process that implicitly shapes corporate strategy, operations and policy. Rather the intent is to make that process more visible and transparent and create a clear avenue by which the diverse and conflicting interests of stakeholders can find expression in the board without hamstringing corporate management that must be fast, agile and business-oriented in a highly competitive global economy.

### Duration of terms

The duration of board terms should be finite but might vary. What is most important is that the renewal of a term for directors ought to be subject to an electoral process as thorough and rigorous as the initial election. Furthermore, there ought to be a recall process whereby any board member could be removed. A recall might be instigated by (1) a majority of the board, (2) one-third of the employees of the firm or (3) some percentage of shareholders. After print and corporate intranet discussion over a relatively short period, no longer than one month, if half of the shareholders or two-thirds of the employees of the firm voted for a recall, it would be executed.

### Ombudsman

Corporations ought to create a permanent ombudsman attached to the board so that the interests of stakeholders can have a legitimate and fair hearing in the absence of direct representation on the board. Stakeholders are otherwise reduced to unseen consequences of corporate strategy and corporate decisions. The chief ombudsman ought to be a non-voting *ex officio* member of the board. The existing board electoral regime cannot effectively represent the diverse, often conflicting, demands on a corporation. A new regime, even if more democratic, might not either. The alternative arenas for integrating and satisficing stakeholder demands on the firm will be the courts and direct action, which may take the form of strikes, boycotts, sabotage and terrorism. There is evidence to suggest that these alternative arenas extract a significant cost on the market value of a corporation (Bowman and Useem 1995).

An important role of an ombudsman would be to address issues of abuse of corporate power at the expense of employees, employees of subcontractors and whistle-blowers. With regard to international employee or subcontractor abuse, a board ombudsman would need to be proactive. It is virtually impossible for women or children who are being psychologically, physically or sexually abused while working in a sewing factory in Indonesia to complain to a local supervisor. The local supervisor is likely to be the perpetrator. Therefore, there must be periodic on-site inspections by an investigative audit committee, already used by some firms, and a local ombudsman must be available. Part of a proactive approach might be for the ombudsman to effectively communicate the firm's standards of civil and human treatment throughout the firm and its alliance network.

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## The critique of ‘plebiscite management’

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Bowman and Useem (1995: 32) are critical of what they call ‘plebiscite management’. They argue that when institutional investors press poorly performing companies to improve and well-performing companies not to stumble, they seldom tell them how to do so. Yet there are notable exceptions.<sup>6</sup>

An occasional investor advisory on a company’s strategy raises few concerns for corporate governance. After all, many companies are already well familiar with unsolicited suggestions from a host of would-be interveners, particularly in the wake of publicised disasters and scandals. When occasional comment slips into frequent intervention, however, concerns do arise. Paramount among these is the extent to which investment managers are familiar enough with market conditions, company history, and strategic options to render effective advice. Many managers do not think they are; the chief executive of a large telecommunications services company offered a public assessment that would be privately expressed by many: ‘There is a move by pension funds to assert that they can assist management. But I have never seen a list of great triumphs of those who manage money who go out to manage a company. There is nothing to tell me that these state pension groups in New York, California, and New Jersey know anything about how to run a company’ (Useem 1993: 155-56).

The new power of concentrated shareholdings may lead institutional investors to press for improved performance. Critics of wider participation fear companies could be faced with owners vetting their business plans. Routine management decisions would be transformed into the non-routine. According to these critics, plebiscite management is inherently unwieldy (Bowman and Useem 1995: 33).<sup>7</sup>

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## Rejoinder to the critiques of plebiscite management

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Wider and more effective representation on corporate boards will be associated with ‘strategic anarchy’ and ‘decisional gridlock’ by the defenders of the status quo. Those who sit in command of an iron-clad oligarchy which allows them to run a modern corporation as if their personal fiefdom and their academic apologists are bound to see anarchy and decisional gridlock as the result of replacing the current regime. Monarchs of old probably looked on representative democracy in the same fashion.

The plebiscite management critique is interesting and reflects the deep-seated hostility to genuine democracy that exists in the West where the word ‘democracy’ is admired more in theory than practice. But the critics misuse the word ‘plebiscite’. Corporate democracy does not mean that all will vote on all management decisions. The term is used in a pejorative sense and this distracts attention from the real issue—unlegitimated power and the lack of representation in corporate governance.

Bebechuk (2005) observes that the case for insulation of management from shareholder intervention is not justified by ‘fears that shareholders would use their power too little, too much, or in the wrong ways’. Reducing management insulation can ‘address

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6 Several public pension funds sought a voice in General Motors’ decision on a CEO succession in 1990 (their offer was accepted). Several private money managers asked Chrysler Corp. to consider a specific executive for a CEO succession in 1992. Their advice was rejected. Various investors pressed USX in the early 1990s to divide its steel and oil business, which led to the creation of separate classes of stock linked to the two businesses (Bowman and Useem 1995: 32).

7 Bebechuk (2005) argues that shareholder power should be able to adopt provisions to corporate governance that would allow shareholders to initiate and vote on proposals regarding specific corporate decisions. Ironically, fear of greater shareholder involvement in specific corporate decisions and resistance to meaningful democratic reforms may bring about decision-specific interventions.

major problems of corporate governance that have long troubled financial economists and legal scholars’.

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## Conclusions

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It may be technically, economically and politically feasible to have a corporate ‘command economy’ and, in a sense, that is a way of describing the status quo. If we value democracy and representative government, then we must find innovative ways to institute democratic reforms in corporate governance. The interests of both shareholders and stakeholders must be addressed in any system of corporate governance. Shareholders, particularly large institutional shareholders, are increasingly active and pushing for corporate governance reforms.<sup>8</sup> The idea that corporations should be responsive to stakeholders is widely accepted (Starik 1994).<sup>9</sup> However, the conventional wisdom is that this should be at the discretion and convenience of corporate management and their boards.<sup>10</sup>

Democratic reform can and should be compatible with strategic clarity, competitiveness and operational efficiency. Good corporate governance does not mean that firm performance becomes irrelevant. Good performance is instrumental to social responsibility, as Kotter and Heskett (1992) observe:

We found that firms with cultures that emphasised all the key managerial constituencies (customers, stockholders, and employees) and leadership from managers at all levels outperformed firms that did not have those cultural traits by a huge margin. Over an eleven-year period, the former increased revenues by an average of 682 percent versus 166 percent for the latter, expanded their work forces by 282 percent versus 36 percent, grew their stock prices by 901 percent versus 74 percent, and improved their net incomes by 756 percent versus 1 percent.

My assumption in this essay is that ‘good corporate governance’ is grounded in more democratic corporate governance. If the board of directors is a bridge between a corporation and its environment, then the composition, selection, qualifications and duties of the board is a critical issue. Representation is about an institutional process by which the voice of the governed has an input on those doing the governing.

It has been argued that outside directors may enhance the reputation and credibility of a firm and help it acquire resources (Boeker and Goodstein 1991) and establish and maintain legitimacy (Pfeffer and Salancik 1978). There is nothing in these proposals that would negate these goals. Indeed, a more diverse and representative board is likely to have more legitimacy among shareholders and among the larger community of stakeholders.

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8 Bebechuk (2005) argues for increasing the power of shareholders to replace directors and exercise influence on other issues. Given that this was a 79-page article in the *Harvard Law Review* by the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics and Finance and Director of the Program on Corporate Governance at Harvard Law School suggests that increasing attention will be directed at the power of corporate management and boards.

9 Stakeholder theory, at one extreme, posits that anyone or anything that is affected by the organisation’s activities—including animals, fish and inanimate objects—are all potential stakeholders (Starik 1994). A moderate view of stakeholder theory posits that some ‘mutually dependent relationship’ must exist and if not dealt with properly may lower corporate performance (Nasi *et al.* 1997). From this perspective, the corporation exists at the intersection of a range of interests.

10 Formal representation of non-shareholders’ interests is much stronger in the European Union than in the United States (Broberg 1996).

This essay has not argued against the pursuit of self-interest by corporations. We agree that 'self-interest may not always be good, but it constitutes an indispensable driver' (Bowman and Useem 1995: 27). It is not the pursuit of corporate self-interest that is the problem; the problem is the narrow base of people who have the right and power to define that corporate self-interest by themselves and for themselves. Corporate governance must guarantee that the firm provides direct and indirect channels of representation for all those who are affected by corporate decisions and behaviour.

Shareholder primacy lets management and their co-dependent boards frame issues in a way that systematically excludes stakeholders. The primacy of shareholder values derives from a tendency to assign primacy of property over other values in US society. While this should be challenged on its own basis, in the context of corporate governance, it is largely a rationalisation of the status quo (Bebechuk 2005: 912). It is a rationalisation because directors' failure to maximise corporate performance, however, does not by itself give shareholders a cause of action.

Directors owe a duty of care to shareholders. Although this duty of care is sometimes said to incorporate a 'duty' to enrich shareholders, this 'duty' is largely unenforceable. The duty of care is qualified by the so-called business judgment rule. Under this rule, courts do not evaluate directors' business decisions under ordinary negligence principles but under a more deferential standard (Joo 2003: 747; Gevurtz 1994: 278-79).<sup>11</sup>

Our argument is not that shareholder interests are unimportant but the concept is 'played' by the defenders of the status quo to evade meaningful reform in corporate governance. In fact, shareholder interests may need to assume greater importance in the future. If President George W. Bush's plan to create an 'ownership society' through the incremental privatisation of social security succeeds, then protecting the rights of those who have an increasing percentage of their wealth tied up on the stock market becomes an important foundation for a stable and civil society.

However, change will not come easily; it most clearly won't come from minimalist reforms in response to periodic dysfunctions in corporate governance. State corporate law, SEC and stock exchange rule changes are all embedded in the status quo. The socioeconomic interests and political outlook of the regulators are closely aligned with those managers and board members who now run corporations. Change will have to come from outside this cosy group of individuals. It will come, if at all, from pension funds, labour unions and organisations taking on the cause of small individual investors. In an 'ownership society', where so many may become increasingly dependent on the integrity, national loyalty and competitive and strategic competence of corporations, it may come from a group such as AARP (American Association of Retired Persons), a huge association of retired people in the United States. Since diversity is a likely result of a more representative and democratic process, groups committed to diversity are also natural allies of a democratic movement.

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<sup>11</sup> In the case brought by Disney shareholders over the compensation and termination of Michael Orvitz as company president, the Delaware Court of Chancery found that the plaintiffs sufficiently pleaded a breach of duty of care where the alleged facts suggested that the directors failed to 'act in good faith and meet minimal procedural standards of attention'. The court found that the carelessness of the directors was so severe as to suggest that the directors did not 'exercise any business judgment' (see Joo 2003: 748-50).

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