

EUROPEAN BOARDROOMS AND THE
AMERICAN LAW INSTITUTE PROPOSALS

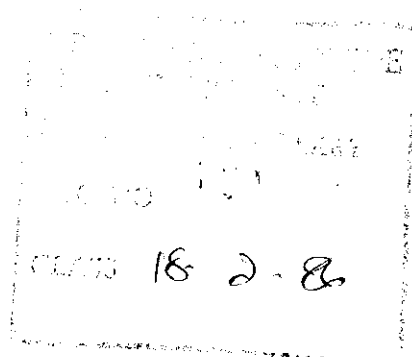
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ABSTRACT

In May 1982, the highly prestigious American Law Institute (A.L.I.) proposed new rules to regulate the governance of large corporations. Although the furore of opposition from the world of business has still delayed the vote to accept these proposals, the interest aroused in both political and commercial arenas in an international context has been considerable. Not only would the proposals change contemporary strategic decision-making for most U.S. multi-national corporations, but, if replicated in other countries would revolutionize the Boardroom.

This paper analyses the implications of the A.L.I. proposals if implemented in a European environment. It argues that, if left to the business world, the proposals would be rejected on the criterion that companies would reduce their commitment to any risky project, particularly international ventures. In the academic sense, companies would sub-optimize their profile of strategic risk. Corporate economic performance would deteriorate in the medium-term.

Conversely, since corporate law is made statute by politicians, not directors, the attraction of appearing to be societally empathetic makes it likely that many of the A.L.I. proposals will be the subject of international debate. Subject to this, it is vital for international corporations to put their own house in order, rather than encourage further political intervention. The paper concludes by proposing means to effect this proactive transition.

INTRODUCTION

In 1978 a group of conservative and highly prestigious U.S. lawyers and legal academics were charged with the brief to investigate the contemporary adequacy of corporate law with regard to corporate governance and structure. In May 1982, the report was distributed for discussion and endorsement at the annual meeting of the American Law Institute (A.L.I.). Such was the furore emanating from the world of business as to the A.L.I. proposals that the vote for acceptance was postponed until mid-1984 and has still to be enacted. Whereas opposition from the business world has little abated, the political importance of A.L.I. makes it very unlikely that the direction of the proposals will be diverted. Thus within the U.S. corporate context, a "ratcheting" towards an ever increasing litigious environment seems inevitable. This paper documents the main A.L.I. proposals, and argues that if transplanted within a European context, particularly the United Kingdom (U.K.), a major shift in Boardroom structure would occur. Further, European multi-national companies would reduce their commitment to any risky projects, particularly international ventures, which could well affect the pattern of international trade. Since corporate law is made statute by politicians, not company directors, the attraction of appearing to be societally empathetic makes it likely that many of the A.L.I. proposals will be adopted by Europe's socialist politicians. Given this likelihood, it is important for international corporations to put their own houses in order rather than encourage further political intervention.

THE A.L.I. PROPOSALS

At first analysis, the A.L.I. draft proposals seem conservative and frequently merely formalise what has been considered good practice in the Boardrooms of many international corporations. It states that "first-tier" companies, using size of assets and sales revenue as the ranking criterion, should demonstrate a majority of external directors to internal directors. Further, these companies should establish an audit committee, and a nominating committee, independent of management manipulation.

Both of these recommendations would cause little opposition within the United States. Since the 1960's, external directors have formed a majority in the largest American corporations, with the proportion of that constituency increasing each decade (Vance, 1983). Similarly all corporations listed on the New York Stock Exchange are required to form an audit committee of independent

directors, and many have adopted the formation of a committee to nominate senior management and Board appointments (Dayton, 1984).

However, it is within the following proposals that controversy emanates. Firstly, the imperative of the Board is stated to conduct the affairs of the corporation to effect "corporate profit and shareholder gain." The wider constituencies of the "stakeholders" -- customers, managers, employees, and communities -- are deliberately excluded. Secondly, the A.L.I. committee formalises the distinction between corporate governance and corporate management -- it separates Board from management functions, a delineation which many academics have argued against strongly (Andrews, 1982, Norburn, 1983). But, it is a third proposal that has caused the uproar, which addresses the issue as to what constitutes an acceptable standard of business judgement. Directors would have a legal obligation to exercise "reasonable" investigation into managerial decision-making prior to any major corporate transaction, and would be protected against legal liability only when "a rational basis for the business judgement" could be demonstrated. Thus any derivative action against the corporation would be dismissed only if, in the view of the Court, this "rational basis" could be proven. In the event of such a situation, the plaintiff would have the right to access of corporate data in order to determine whether a commercial decision was in the corporation's best interest. With hindsight, any strategic shift which proved less than successful could well be the object of litigation. The diversification of U.S. oil companies away from their base business would be difficult to defend. Would Exxon now pay \$1.28 for Reliance Electric? Would Mobil now choose to enter retailing via Montgomery Ward?

EFFECTS IN EUROPE

1. Current Board Models

The crux of the A.L.I. debate lies in the attempt to determine corporate governance and to allocate accountability. Within a European context the same debate has been conducted over the last decade and has resulted in different formats of Board structures, reflecting a range of political decisions enacted through the legal system with regard to company law. At one end of the spectrum lies the "Mitbestimmung" -- the two-tier structure of West Germany. Here the top-tier (Aufsichtsrat) fulfils the function of strategic endorsement, and is comprised by an elected body with

equal numbers of shareholders, and of jobholders' representatives. The second-tier (Vorstand) is responsible for executive implementation and since it is nominated by the Aufsichtsrat, is rarely in conflict. Since A.L.I. proposes to challenge management's exclusivity in decision-making by its attempt to diminish the current defenses to derivative action, the model of Mitbestimmung would by its very format encompass the interests of wider constituencies -- both shareholders and jobholders. Figure 1 illustrates the separation of corporate governance from corporate management.

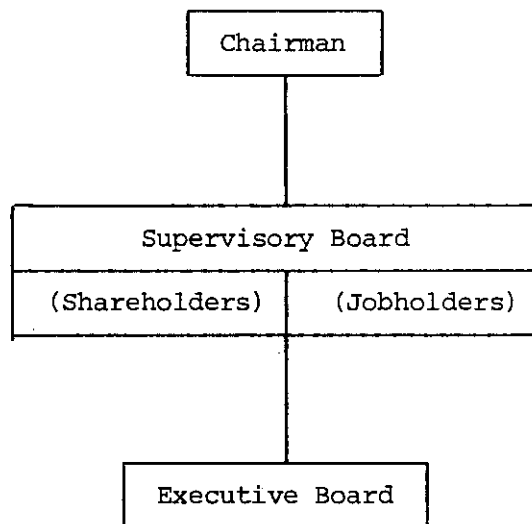


Figure 1

At the other end of the spectrum lies the British model. As with American structures, this model is of unitary design but differs relative to the proportions of insider to outsider directors. In Britain internal directors comprise the majority with most large companies having but three non-executive directors (Korn/Ferry 1980, Heidrick & Struggles, 1983). Recognising potential conflict of interest with regard to strategic decision, both the Confederation of British Industry, and the Institute of Directors, have attempted to increase the impact of the external director by recommending increases in their representation, but not to a point where they comprise a majority. As with the German model, the British direction is to widen the definition of shareholder ownership to include stakeholder constituencies. Figure 2 illustrates the simplicity of the structure, and the combination of corporate governance and management at the same hierarchical level.

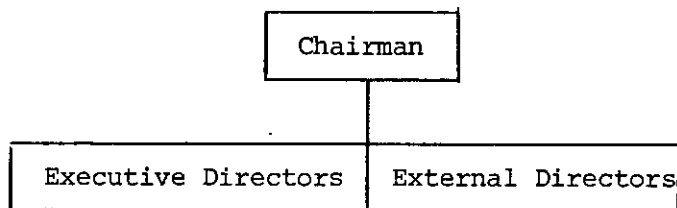


Figure 2

Thus by mutual trust in the case of the German model, or by incremental evolution in Britain, the general direction in Europe coincides with the A.L.I. objective of an improvement in corporate responsibility. It does not, however, result from direct intervention from the legal profession into matters corporate.

2. Political Implications

Whereas European Boards would consider A.L.I.'s narrow definition of the corporate mission as the single-minded pursuit of profit-maximisation and shareholder gain to be naively simplistic, it is within the European political world that the A.L.I. proposals have found support. European socialist parties have long considered "big business" to be appropriate targets for control, and whereas emphasis on shareholder gain would be anathema, the concept of constraining company initiatives by retrospectively challenging the "rational basis for business judgement" is extremely attractive. The governments of France, Spain, Portugal and Greece are all pro-interventionist. The Government's position in the U.K. is less defined: whereas Mrs Thatcher's administration is undoubtedly pro-capitalist, for example, her policy of de-nationalisation, her position has tended to support small business freedoms at the expense of larger companies control. Should the current rise in popularity of Neil Kinnock continue (the leader of the British Labour Party), the prospect of corporate control along A.L.I. lines will increase.

3. Commercial Implications

Irrespective of political dialectic between Republic and Democratic (U.S.), Conservative and Labour (U.K.), Christian Democrat and Social Democrat (West Germany), the underlying trend is towards greater corporate control.

If this is to be implemented by case law to protect against individual corporate abuse, support will be found in the European business world. But if an A.L.I. approach is implemented, a substantially negative reaction will ensue for commercial reasons. This will be seen to have at least four effects.

a. Companies will reject risky projects.

Given the current acceptance of a portfolio concept of strategic business units where the cash-flows of mature businesses finance the growth of low-market share, high growth-potential businesses, many Boards are likely to avoid future "acorn" initiatives since failure could make them legally accountable. By minimising higher risk project exposure, companies will therefore concentrate upon more mature sectors where revenue and cost sensitivities are less volatile. But mature sectors, by definition, usually exhibit little growth, and thus are unlikely to sustain the business in the longer-term. In the economic sense of the term opportunity-cost, companies who fail to balance their product/market portfolios must be sub-optimising. By concentrating on a number of current low-risk activities, the risk profile must increase in the future as those sectors shift into decline.

b. Companies will focus upon short-term horizons.

For similar reasons, Boards will focus upon even shorter-term pay-off. It has already been argued that U.S. and U.K. companies evaluate success on a much shorter time-frame than their Japanese competitors (Norburn & Miller, 1981). Indeed, Biggadike's (1979) study of Fortune 200 U.S. companies shows a seven-year period before break-even following major diversification. Given the major U.S./U.K. criterion for management performance evaluation to be the annual return on divisional assets managed, this existing focus on the short-term will increase. Any front-loaded, cash-out project will appear much less attractive irrespective of the pay-off from the cash-flows in the medium-term. Investment myopia may well develop, resulting in less competitive industrial structures toward the end of this decade.

c. Companies will focus upon domestic markets.

Again, if the risk of derivative action exists, the attraction of overseas markets will diminish given their increased risk propensity relative to domestic markets. In retrospect, would French companies choose Iraq: would the British, Nigeria: would Mexico and Brazil still be attractive to U.S. banks? The probable effect would be a concentration upon the domestic market, which given the importance of the manufacturing sector within the European economies, will increase intra-national competition in what is essentially static to low-growth demand conditions. Those companies with high fixed costs will be particularly vulnerable to volume loss, and will defend market share vigorously. The temptation to price at marginal cost, already prevalent in the European steel industry, will increase, resulting in insufficient profit margins to sustain the asset base of the business. The trend towards decreasing fixed costs by closures and redundancy will accelerate, further exacerbating social trauma in many regional areas of heavy industry concentration.

d. Protectionism will increase.

As a result many industries will argue that, if they are precluded by the acceptance of A.L.I.-type proposals from their traditional overseas markets, their own domestic markets should be protected. Cries for protectionism are already endemic in Europe -- for example, the French Government's "neutrality" in tacit support in the French farmers' hi-jacking of lambs from England, pork from West Germany, and wine from Italy.

Although unlikely that the four commercial effects discussed above would occur simultaneously, sufficient concern must exist as to the implications of a substantial shift in the pattern of international trade.

4. Board Structural Implications

If a director could become subject to a retrospective accusation that he paid insufficient weight to what appeared to be a straightforward decision which subsequently proved a commercial failure, who would want to be a director?

Since efforts are being made currently to increase the proportion of external directors within most European countries where unitary Boards predominate, legal enactment of the A.L.I. proposals would reverse this initiative. By emphasising the role of the Board to be concerned exclusively with monitoring the conduct of management, the Board becomes distanced not only from strategic decision-making but also engenders an atmosphere of "Big Brother". The effect of the proposals would therefore be to formalise the separation of corporate governance from corporate control, a situation in antithesis to that strongly recommended on both sides of the Atlantic (Wommack, 1981; Vance, 1983; Norburn, 1986).

CONCLUSIONS

That corporate misbehaviour exists is not in contention, indeed company law does need to be strengthened an example of which is seen in the 1984 Gower report to protect investors in the City of London. But for the A.L.I. proposals to mandate Board behaviour for all multi-national companies is far too inflexible. If A.L.I. were implemented within a European context, the very justification of the proposals -- "to conduct business for corporate profit and shareholder gain" would be made more difficult. Corporations would adopt short-term, low risk, domestic strategic positions, a certain formula for diminishing profit in the longer-term.

Some of the A.L.I. proposals should however be welcomed in Europe. Implementation of the U.S. derived Audit, Remuneration, and Nominating committees would all improve Board structures and should become established practice. But, if the European corporation is to pre-empt potential political intervention it is important that Boards eschew both their unwillingness to debate their current "modus operandi" and their criterion for determining composition and structure. The very secrecy of Boardroom practices can only encourage external suspicion. It is entirely in the interests of all Boards to be seen to be more open-handed, and in dialogue with all stakeholders constituencies. It is only when this condition is effected, that the probability of an A.L.I.-type intervention will be reduced. Board reform should start from within.

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