CHENGBO GU

SHADES OF CORPORATE GOVERNANCE

A REVISED MODEL OF STAKEHOLDER THEORY FOR EXPLAINING HOW FORMS OF REGULATION IN GERMANY AND THE UK PROTECT STAKEHOLDER INTERESTS

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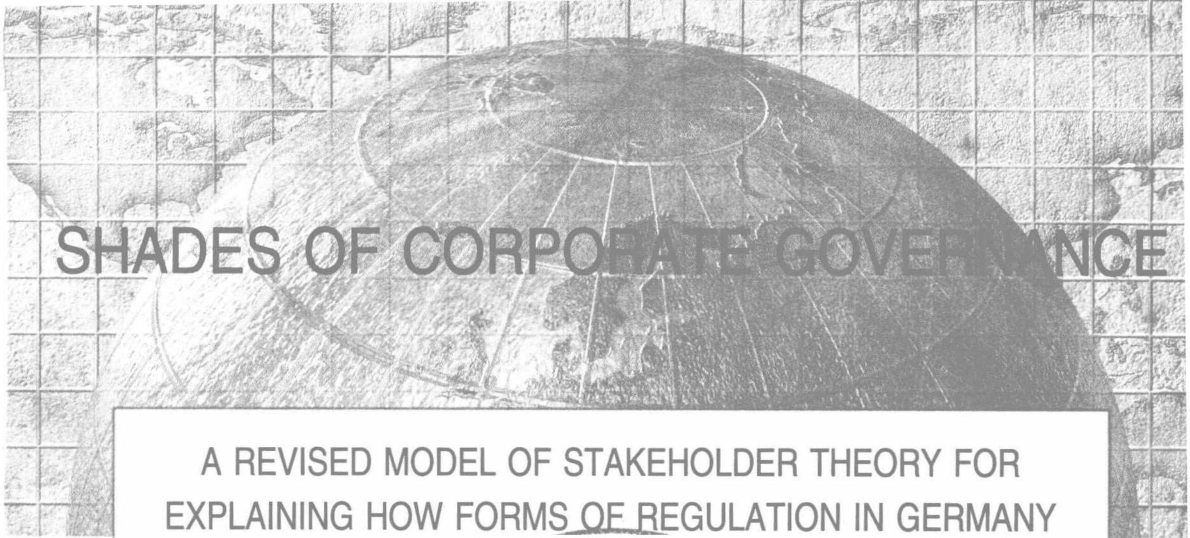

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ABSTRACT

Traditionally, corporate governance is studied through an agency theory or stakeholder theory type lens. The major difference between the two pertains to whose interests the firm should be run for, whom the management of the firm should be accountable to, and whether different firm constituencies should be treated with different levels of priority. For many people stakeholder theory is normatively preferable because it broadens the firm's responsibility to all constituencies of the firm, integrates the firm's economic purpose with ethical behaviour, and refocuses the managerial attention on the firm's long-term performance. However, due to stakeholder identification difficulties and the lack of an obvious way to operationalize the approach, stakeholder theory remains under-developed and has yet to be implemented effectively.

To address these weaknesses, the book attempts to provide a theoretical and practical framework for the implementation of stakeholder theory and the associated accommodation of stakeholder interests. The framework revises the original model of stakeholder theory, and in doing so represents a shift of governance focus, away from an emphasis on managers' morality and management strategies for protecting and balancing stakeholder interests, to an emphasis on the monitoring role, and effects of, stakeholders and other regulators in the process of protecting and balancing stakeholder interests. By integrating the tripartite influences of the stakeholder monitoring system, the civil regulatory system, and the legal regulatory system, the framework provides stakeholders and other civil and legal regulators with opportunities and capacities to jointly influence and control the management decision making and the concomitant behaviour of the firm.

The potential of the framework for explaining and improving stakeholder practice is considered and demonstrated by applying the revised model of stakeholder theory in Germany and the UK, jurisdictions with different legal and corporate governance systems as well as different economic and social cultures. In looking at different legal, economic, and social conditions, the book is able to demonstrate how different factors combine to protect stakeholder interests in different ways. This demonstrates that although the combination of factors is different in Germany and the UK, they nevertheless protect stakeholder interests in their own unique way.

LIST OF ABBREVIATIONS

ABI	Association of British Insurers
AGM	Annual General Meeting
AIC	Association of Investment Companies
CAC	Central Arbitration Committee
CEO	Chief Executive Officer
CFP	Corporate Financial Performance
CIA	Central Intelligence Agency
CLRSG	Company Law Review Steering Group
CSP	Corporate Social Performance
CSR	Corporate Social Responsibility
DTI	Department of Trade and Industry
ELM	External Labour Market
ESV	Enlightened Shareholder Value
EU	European Union
FTSE	Financial Times and Stock Exchange
GDP	Gross Domestic Product
ILM	Internal Labour Market
IMA	Investment Management Association
NAPF	National Association of Pension Funds
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development
ONS	Office for National Statistics
R&D	Research and Development
SIF	Social Investment Forum
SRI	Socially Responsible Investor
TCE	Transaction Cost Economics
UK	United Kingdom
US	United States

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2010c. The UK Stewardship Code. The United Kingdom: Financial Reporting Council.

CONTENTS

ABSTRACT

LIST OF ABBREVIATIONS

LIST OF STATUTES

CHAPTER ONE

INTRODUCTION ········ 1

Section 1. 1 Research Background ········ 1
Section 1. 2 Research Objectives ········ 4
Section 1. 3 Research Methodology ········ 5
Section 1. 4 Structure of the Book ········ 8

CHAPTER TWO

AGENCY THEORY VERSUS STAKEHOLDER THEORY ········ 10

Section 2. 1 Introduction ········ 10
Section 2. 2 Agency Theory ········ 10
2. 2. 1 Overview of Agency Theory ········ 10
2. 2. 2 Agency Conflicts and Solutions ········ 11
2. 2. 3 Support and Criticism of Agency Theory ········ 14
Section 2. 3 Stakeholder Theory and Stakeholder Model ········ 21
2. 3. 1 Stakeholder Theory ········ 21
2. 3. 2 Difficulties and Solutions to Identification of Stakeholders ········ 25
2. 3. 3 Difficulties and Solutions to Implementation of Stakeholder Theory ········ 36
Section 2. 4 Conclusion ········ 46

CHAPTER THREE

THEORETICAL FRAMEWORK FOR IMPLEMENTATION OF STAKEHOLDER THEORY ······ 47

Section 3. 1 Introduction ······ 47
Section 3. 2 Revised Model of Stakeholder Theory ······ 48
3. 2. 1 Interest Alignment Mechanisms ······ 48
3. 2. 2 Civil Regulation and Social Capital ······ 50
3. 2. 3 Statutory Regulation and Legal Enforcement ······ 57
3. 2. 4 Justification of Revised Stakeholder Theory Model ······ 62
Section 3. 3 Applying the Model in Germany and the UK ······ 65
3. 3. 1 Reasons of Applying the Model in Germany and the UK ······ 65
3. 3. 2 Classifying by Legal Systems ······ 66
3. 3. 3 Classifying by Corporate Governance Systems ······ 68
Section 3. 4 Five Mechanisms for Protecting Stakeholder Interests ······ 69
Section 3. 5 Conclusion ······ 72

CHAPTER FOUR

BOARD OF DIRECTORS IN GERMANY AND THE UK ······ 73

Section 4. 1 Introduction ······ 73
Section 4. 2 Board of Directors ······ 74
4. 2. 1 Functions of Board of Directors ······ 74
4. 2. 2 Composition of Board of Directors ······ 75
4. 2. 3 Independence of Board of Directors ······ 80
4. 2. 4 Size of Board of Directors ······ 85
Section 4. 3 Board of Directors in Germany ······ 87
4. 3. 1 Strict Separation of Control and Management ······ 87
4. 3. 2 Codetermination between Employees and Shareholders ······ 90
4. 3. 3 Monitoring Power and Effects of Banks ······ 93
Section 4. 4 Board of Directors in the UK ······ 96
4. 4. 1 Weak Independence of Board of Directors ······ 96
4. 4. 2 Board Composition without Stakeholder Representatives ······ 97
4. 4. 3 Non-Exhaustive Reform of Company Law ······ 99
Section 4. 5 Discussion and Conclusion ······ 101

CHAPTER FIVE
INSTITUTIONAL INVESTORS IN GERMANY AND THE UK …… 105

Section 5. 1 Introduction …… 105
Section 5. 2 Supervisory Role of Institutional Investors …… 106
5. 2. 1 Significance of Institutional Investor Activism …… 106
5. 2. 2 Monitoring Incentive of Institutional Investors …… 107
5. 2. 3 Monitoring Ability of Institutional Investors …… 108
5. 2. 4 Possible Barriers of Institutional Investor Activism …… 110
5. 2. 5 Approaches of Institutional Investors for Stakeholder Protection …… 114
5. 2. 6 Impact of SRI Investments on Stakeholder Interests …… 116
Section 5. 3 Institutional Investors in Germany …… 118
5. 3. 1 Internal Blockholders' Control and Stakeholder Protection …… 118
5. 3. 2 Development of Socially Responsible Investment …… 119
5. 3. 3 Market for Partial Corporate Control …… 120
Section 5. 4 Institutional Investors in the UK …… 121
5. 4. 1 Increase of Institutional Share Ownership …… 121
5. 4. 2 Institutional Investor Activism and Social Reporting System …… 122
5. 4. 3 Social Performance of Institutional Investors …… 125
Section 5. 5 Discussion and Conclusion …… 126

CHAPTER SIX
MANAGERIAL COMPENSATION SYSTEM IN GERMANY AND THE UK …… 130

Section 6. 1 Introduction …… 130
Section 6. 2 Managerial Compensation System …… 131
6. 2. 1 Managerial Compensation and Stakeholder Protection …… 131
6. 2. 2 Managerial Compensation Arrangements and Package …… 132
6. 2. 3 Managerial Performance Measurement …… 134
6. 2. 4 Complementary Effects of Other Governance Mechanisms …… 136
6. 2. 5 Impact of Managerial Compensation on Stakeholder Interests …… 138
Section 6. 3 Managerial Compensation System in Germany …… 143
6. 3. 1 Development of Managerial Compensation System …… 143
6. 3. 2 Legal Reform of Managerial Compensation System …… 144

Section 6.4 Managerial Compensation System in the UK ········ 146
6.4.1 Remedies for Weak Influence of Stakeholders ········ 146
6.4.2 Impact of Say-on-Pay Regulation ········ 148
6.4.3 Civil Regulatory Pressure of Non-Governmental Organisations ········ 149
Section 6.5 Discussion and Conclusion ········ 150

CHAPTER SEVEN
MARKET FOR CORPORATE CONTROL IN GERMANY AND THE UK ········ 154

Section 7.1 Introduction ········ 154
Section 7.2 Market for Corporate Control ········ 155
7.2.1 Hostile Takeover and Internal Governance Failure ········ 155
7.2.2 Barriers of Market for Corporate Control ········ 157
7.2.3 Takeover Impact on Stakeholder Welfare ········ 158
Section 7.3 Market for Corporate Control in Germany ········ 165
7.3.1 Takeover Market and Takeover Regulations ········ 165
7.3.2 Takeover Barriers in Germany ········ 167
Section 7.4 Market for Corporate Control in the UK ········ 170
7.4.1 Takeover Regulations of the UK ········ 170
7.4.2 Elimination of Takeover Barriers in the UK ········ 171
7.4.3 Stakeholder Protection in Takeover Process ········ 173
Section 7.5 Discussion and Conclusion ········ 175

CHAPTER EIGHT
TRADE UNION AND LABOUR MARKET IN GERMANY AND THE UK ········ 179

Section 8.1 Introduction ········ 179
Section 8.2 Trade Union and Labour Market ········ 180
8.2.1 Governance Role of Employees ········ 180
8.2.2 Trade Union and Firm Performance ········ 180
8.2.3 Labour Market and Firm Performance ········ 185
Section 8.3 Trade Union and Labour Market in Germany ········ 189
8.3.1 Social and Economic Culture in German Labour Market ········ 189
8.3.2 Strict Legal Protection for Employment ········ 190

8. 3. 3 Collective Agreement and Employee Protection 192
8. 3. 4 Strict Employment Protection and Labour Market Flexibility 193
Section 8. 4 Trade Union and Labour Market in the UK 194
8. 4. 1 Social and Economic Culture in UK Labour Market 194
8. 4. 2 Trade Union Recognition and Employee Protection 195
8. 4. 3 Insufficient Rights to Information and Consultation of Employees 197
8. 4. 4 Protection to Other Employee Rights and Stakeholder Interests 199
Section 8. 5 Discussion and Conclusion 200

CHAPTER NINE
CONCLUSION 205

Section 9. 1 Discussion and Contribution 205
9. 1. 1 Significance and Completeness of Stakeholder Theory 205
9. 1. 2 Significance of Revised Stakeholder Theory Model 206
9. 1. 3 Implementation of Stakeholder Theory in Practice 208
Section 9. 2 Possible Limitations of This Research 211
Section 9. 3 Implication for Future Research 212

REFERENCES 214

FIGURES

Figure 1: Revised Stakeholder Model 35
Figure 2: Revised Model of Stakeholder Theory 63

TABLES

Table 1: Stakeholder Theory Model in Practice-Board of Directors 104
Table 2: Stakeholder Theory Model in Practice-Institutional Investors 129
Table 3: Stakeholder Theory Model in Practice-Managerial Compensation System 153
Table 4: Stakeholder Theory Model in Practice-Market for Corporate Control 178
Table 5: Stakeholder Theory Model in Practice-Trade Union and Labour Market 204

CHAPTER ONE INTRODUCTION

Section 1.1 Research Background

Corporate governance is traditionally studied within two competing and predominant theories of the firm, namely agency theory (also known as shareholder primacy principle or shareholder wealth maximization norm) and stakeholder theory, and both theories "have dominated corporate law for the past 25 years or so, with both having their roots much further in the past" (Keay, 2008: 665; 2010: 36). From the perspective of agency theory, corporate governance is viewed as "the set of mechanisms-both institutional and market-based-that induce the self-interested controllers of a company (those that make decisions regarding how the company will be operated) to make decisions that maximize the value of the company to its owners (the suppliers of capital)" (Denis & McConnell, 2003: 2). Thus, under this view, managers are considered agents of shareholders and their major objective is maximization of shareholder value (Hill & Jones, 1992; Jensen & Meckling, 1976). By way of contrast, stakeholder theory focuses on the web of relationships that exist between a firm and its constituencies who have a stake in the firm, and with how the firm management accommodates those interests in its decision making (Clarkson, 1995; Donaldson & Preston, 1995; Freeman, 1984). This implies managers have social as well as financial and legal responsibilities to the firm, with managers duly having to take account of stakeholder interests in the running of the firm (Blair, 1995; Hasnas, 1998). Thus, corporate governance under this perspective is defined as "the determination of the broad uses to which organizational resources will be deployed and the resolution of conflicts among the myriad participants in organizations" (Daily, Dalton, & Cannella Jr, 2003: 371). As a result, agency theory and stakeholder theory therefore differ with respect to whose interests the firm should be run for, to whom management should be accountable, and to whom priority should be given to amongst competing constituencies, and due to these differences both theories are usually placed in direct opposition to each other (Kaler, 2006).

Nowadays, agency theory has often been challenged because 1) its normative foundation (i. e., shareholder wealth maximization or shareholder primacy) is inconsistent with some fundamental legal concepts (e. g., 'personification of the corporation' or 'corporate legal personality') (Lan & Heracleous, 2010; Stout, 2008); 2) its traditional view (i. e., shareholders have the ownership of the modern company) is empirically incorrect (Boatright, 1996; Letza, Sun, & Kirkbride, 2004; Stout, 2002); 3) its argument (i. e., shareholders are the sole residual claimants of the firm) is questionable (Blair & Stout, 1999, 2001; Lan & Heracleous, 2010); 4) its interpretation (i. e., the firm management only has economic and legal obligations) is a misunderstanding and unethical (Cragg, 2002; Dodd Jr, 1932; Heath, 2006; Lantos, 2001); 5) its descriptive statement (i. e., the firm is viewed as a nexus of contracts between shareholders and managers) is too narrow and incomplete (Mitchell, 1992; Pedersen, 2006; Uzzi, 1996, 1997); and 6) its operational feasibility and efficiency (e. g., the maximization of shareholder value is not a clear objective, as different shareholders have different aims, time horizons, and risk preferences toward investments) are also problematic (Block, 1972; Keay, 2008; Ryan & Schneider, 2002). (see detailed discussion in section 2. 2. 3. 2)

On the contrary, stakeholder theory is perceived to be a more normative acceptable theory, since 1) its normative foundation (i. e., the firm management should take moral obligations toward all stakeholders) is more consistent with some legal concepts (e. g., 'personification of the corporation' or 'corporate legal personality') (Mark, 1987; Stout, 2008); 2) its description of relationships between the firm and its stakeholders (i. e., economic value creation of the firm must rely upon all stakeholders to provide support) is more realistic and closer to the business practice of the modern company (Pfeffer & Salancik, 1978); 3) its argument (e. g., each group of stakeholders merits consideration for its own sake, and no stakeholder group should have prima facie priority over another) is more ethical than the principle of shareholder primacy (Clarkson, 1995; Donaldson & Preston, 1995); and 4) its strategic perspective (i. e., the firm needs to ensure their survival and success in the long term by satisfying all its stakeholders) is more appropriate to reflect the relationship between economy and society (Collier, 2008; Freeman, 2004; Freeman, Wicks, & Parmar, 2004; Jones, 1995; Uzzi, 1996, 1997). As a result, stakeholder theory is often regarded as practically beneficial as socially responsible behaviour of the firm will ultimately sustain financial returns (Waddock & Graves, 1997; Wood & Jones, 1995). (see detailed discussion in section 2. 3. 1. 2)