

THE MYTH OF THE “ANGLO-SAXON MODEL” OF CORPORATE GOVERNANCE

Is the Myth simply a mix of EU jealousy at perceived UK best practice internationally plus a lack of understanding the very different historical development of the US and the UK?

Almost certainly yes. But we need to split the EU version of the myth from the US's. First let us look at the EU's. The notion that these two very different approaches to business and especially corporate governance can be contained in the phrase “Anglo-Saxon” is a nonsense for both historical and cultural reasons. But it is a convenient nonsense in that it helps bind many members of the European Union, especially France and Germany, to a type of conspiracy theory that says the US and UK collude in terms of corporate governance development to thwart the economic and political development of the EU. They argue frequently that if only the UK threw its weight strongly behind their political aspirations for the EU, then Europe's economic and political development would soon outstrip the US. But this argument fails, amongst other issues, to recognise sufficiently the long history of mercantilism and independence which is deep in the UK's culture. To this should be added a strong sense of scepticism about any large and only notionally democratic institutions like the European Commission, and a sense of the absurd which results in a very distinctive brand of humour, about themselves and others.

In comparing legal systems there is a seemingly insurmountable difference between the history of the UK's (and later US's) development of Common Law and its accretion of Case Law over the centuries to provide legal precedents which are developed further by the judiciary, and e.g. the French Code Napoleon with its firmly codified statutes and a very different judiciary role. One can see the two systems in action, and sometimes conflict, in e.g. Mauritius. There are also other legal system differences within the EU e.g. with the Dutch law which is based more on Roman Law. Again one can see the tensions between these two systems in South African Law, albeit in a more successful combination. The current development of "European Union Law" is a brave attempt to bridge this gap but is a slow and difficult process.

So what differentiates US and UK Corporate Governance?

A parallel path between the US and UK was followed from the developments in the seventeenth century into the mid-nineteenth century through a combination of the creation of joint stock ventures and later, limited liability companies, the political economics of Adam Smith and the notion of "moral sentiment", and the stress on the very collegiality of the directors of a company through their joint and several liabilities in the fulfilment of their duties all reinforces these.

The two countries had already different approaches to governance in that the US had chosen to have a written constitution and the UK maintained its centuries old belief in the value of an unwritten one. These set an early mindset for the US to rely more on a "rules-based" approach and for the UK to maintain a more pragmatic "principles-based" approach to governance generally. In addition the UK is a unitary nation with a strong central government. The US had created a deliberate, balancing tension

through its constitution between the role and powers of the States and that of the Federal government. This latter has had a profound effect on US corporate governance.

The two countries seem to have started to diverge around the middle of the nineteenth century as very different role models for direction-givers appeared. As the UK developed its world-spanning empire the need for altruistic young men to administer it on behalf of the Westminster government was delivered by the rise of the Public School systems (confusingly titled as they were very much private schools). Strong values of absolute honesty, physical and mental toughness, accountability and acknowledgement of hierarchy were established and reinforced often through sport – rugby and especially cricket being seen as the epitome of excellent behaviours and values. A later quotation sums up this “Corinthian spirit” approach for me:

As I see the breed, he is one who has not merely braced his muscles and developed his endurance by the exercise of some great sport, but has, in the pursuit of exercise, learnt to control his anger, be considerate of fellow men, to take no mean advantage, to resent as a dishonour the very suspicion of trickery, to bear aloft a cheerful countenance under disappointment, and never to own himself defeated until the last breath is out of his body.

These admirable sentiments created the “stiff upper lip” and “my word is my bond” approach to organisations in a time of peace and fast-rising wealth, in both civil administration and business and created an image and expectations of the English which are still found often internationally today.

The US had very different issues with which to deal in the middle of the nineteenth century. In 1861 they were in their second civil war, in which the effects of rapid

industrialisation and the demand to open up The West coincided with the *causus belli*. To ensure final victory President Abraham Lincoln was able to do deals with US entrepreneurs that in return for a continuing supply of modern weapons and cash he would be suitably disposed to the rapid opening up of The West and the effective sequestration of the “Indian” lands. This is significant to me as from this time onwards US corporations begin to use the title “President”, and “Vice President”, for the heads of their corporations, whilst the title “director” is relegated to that of a senior executive and remains so thus creating semantic confusion both in the US and the rest of the world. To a great extent many of these presidents opening up The West saw themselves running their own empires beyond the writ of Washington’s law. This mindset, in turn, set up a tension between “big business” and the Federal legislators which continues today. This has been made more noticeable as the States, especially Delaware, have had the ascendancy over Washington on generally accepted corporate governance practice and legislation.

It is significant that Federal legislation has been meagre, and essentially securities-based. In 1932 the Companies Act was a response to the Wall Street Crash of 1929 and is admitted in US papers of the time to be essentially a cut-and-paste job from the UK’s earlier Act. It was not until 2002 and the Sarbanes-Oxley Act (SOX) that Federal Law was enacted again; with mixed consequences to which I shall return. I feel that it is also significant that US corporate governance is controlled by the Securities and Exchange Commission and its legalistic mind-set, whilst the UK’s has the Financial Reporting Council, a spin-off from the Financial Services Agency which has, significantly, set itself up as a Company Limited By Guarantee thereby bringing itself under the Companies Act and giving itself more levels of discretionary judgement, and financial autonomy than a normal governmental agency.

The US mind-set towards business seems to have developed in a very different way

to the UK's. There was undoubted tension between the Federal states and the "business barons", later characterised in the media as "robber barons", who seemed to be the embodiment of Adam Smith's warnings of the dangers of these new corporations having unlimited power, unlimited size, unlimited licence and unlimited life. Hence the continuing battle using Anti-Trust, and Fraud, legislation which characterises the public perception of much of US business, as well as the astonishing continuous use of litigation to resolve disputes of whatever size.

A quick review of US business literature throws up some iconic works. Perhaps the most generally referenced is the 1932 *The Modern Corporation and Private Property* by Berle and Means. To many business folk around the world this is the definition of the US approach to, and defence of, their brand of capitalism. They argue that:

In the Darwinian struggle for survival the American public company is the winner because of its reliance on the largely unfettered powers of strong managers and the existence of small, fragmented shareholders weakened by their inability to coordinate ... if the shareholders do not like the exercise of managerial power, they could sell. This structure is seen to far outweigh in efficiency the costs that it incurs.

Such thoughts are often found still in the US business community and I think that it is no surprise that Ayn Rand's passionate, if indifferently written, defence of US capitalism, *Atlas Shrugged*, is still the most-quoted book by US CEOs in 2006.

But there have always been signs of people warning of the dangers of such a pro-business mindset and ironically these grew as US business and government were coming together more. This convergence at the start of the Cold War was viewed sceptically by many as being more driven by anti-consumer and citizen thoughts than any altruistic breakthrough on the side of business. Later Dwight D Eisenhower's

1961 Presidential Retirement speech warned:

We have been compelled to create a permanent armaments industry of vast proportions. Added to this, three-and-a-half million men and women are engaged in the defense establishment. We annually spend more than the net income of all US corporations. This conjunction of an immense military establishment and a large arms industry is now in the American experience. The total influence – economic, political, even spiritual – is felt in every city, every state house, every office of government.

In the councils of government, we must guard against the acquisition of unwarranted influence, whether sought or unsought, by the military industrial complex. The potential for the disastrous rise of misplaced power exists and will persist.

The tension between big business, the Federal Government and the citizens continues today.

One can argue that the development of corporate governance in the US since the 1950s has been influenced greatly by the relaxed regulatory powers of the Chancery Court of Delaware. Unsurprisingly most US corporations are registered there and, so, subject to its laws. But these have allowed some alarming abuses of corporate governance power and process amongst which two stand out in particular. First, the whole notion of having an independent board of directors has been eroded by two actions – allowing the CEO to insist that they are also Chairman of the Board and the subsequent packing of the board with “yes men”. Indeed in my travels in the US the most frightening comment about the US board which I hear is a snigger followed by the comment “oh, that’s ten friends of the CEO, a woman and a black”. The implications of coercion and subsequent corruption are obvious in such a system and

are in contradiction to the UK's Second Principle in its 2003 Combined Code of Corporate Governance:

There should be a clear division of responsibilities at the head of the company between the running of the board and the executives' responsibility for the running of the company's business. No one individual should have unfettered powers of decision.

Second, Delaware allowed the passing of the Law of Plurality. Most citizens are oblivious to its existence. It states that in the process of the election or re-election of a director to the board of a Delaware registered company, the shareholders/owners have the right to vote for such a person proposed by the existing board, and can abstain, but they cannot vote against them! In terms of a self-sustaining and unquestioned monopoly this seems fine for existing directors but is scandalous in terms of thwarting the American dream of creating the "shareholding democracy". In these cases shareholders seem to have no rights – except as Berle and Means say to sell their shares. One can begin to see why in many other parts of the world US corporate governance is seen as approaching junk status.

The rushed Sarbanes-Oxley Act of 2002 was meant to be a major step forward in reforming US corporate governance. It has improved greatly US company's reporting standards and processes and helped put some arms-length distance between directors, shareholders, auditors, consultants, investment bankers, lawyers, business journalists etc. However, it has become clear that this has done so in a bureaucratic manner and at great cost both to the companies themselves and to the US's business reputation in the wider world. It is noticeable the number of foreign companies listing now on the UK's main and secondary exchanges rather than the US's. But the SOX has had a number of other negative effects. First the SEC has ensured it has

draconian powers so, in extreme circumstances, if a CEO has mis-signed their *quarterly* accounts however unwittingly the maximum penalty they can have from the courts is a five million dollar personal fine and twenty years in jail! I pointed out jokingly on CNN at the time that if I were a US CEO in these circumstances I would choose my US state carefully, then lure my CFO there, and shoot them. In most states you only get twelve years for murder and are likely to miss the five million dollar fine. It is a no-brainer. Second, the very people who were meant to be reined in under SOX – auditors, management consultants and bankers etc. – seem to be the very people who are benefiting most from it as their income streams multiply wonderfully through them implementing it. Who was it who said that over time any new law usually achieves the opposite effect from that intended? Indeed some observers, me included, have wondered if the continuation of SOX will do more harm to US capitalism than Karl Marx could ever have dreamt?

The increasingly global rejection of the US's approach to corporate governance is made worse by the current geo-political notion of that government ensuring the "extra-territoriality" of US laws, thus trying to extend the writ of US law overseas wherever it is possible. This growing unfriendly view of US corporate governance processes, structure and political ambition has not been helped by the global publicity surrounding the Enron case. Although there were many other contemporary scandals – WorldCom, Adelphia, Imclone etc. – this one grabbed the public's imagination. It is interesting that it was brought under the old tried and tested Fraud Law, not any corporate governance legislation, and worth remembering that the accused were found guilty in 2007 and are to be jailed for a long time. However, this verdict has not restored the massive personal losses incurred by the people of Houston or any other part of the world, nor the continuing damage to the US's corporate governance credibility.

Perhaps one of the few truly beneficial results was the anonymous email which circulated the financial markets of the world in 2002. It defined “Enron Capitalism”:

You have two cows. You sell three of them to your publicly listed corporation using letters of credit opened by your brother-in-law at the bank. You then execute a debt/equity swap with an associated general offer so that you get all four cows back, with tax exemption on five cows. The milk rights on six cows are transferred via an intermediary to a Cayman Islands company, owned secretly by your Chief Financial Officer, who then sells the rights to all seven cows back to your listed public corporation. Your annual report states that your corporation owns eight cows with an option on six more.

Whatever happened to Normal Capitalism?

You have two cows and buy a bull. Your herd multiplies and the economy grows. You sell the bull and retire.

There are growing signs of a shareholder fight back and which interestingly are not labelled immediately as un-American activities. CalPERs and other shareholder activists are becoming increasingly vocal and exerting much more pressure on fund managers to ask probing questions about the effectiveness of US boards and the corporate governance in general. The long-term and thoughtful US corporate governance activists Bob Monks and Nell Minnow have said that:

Boards will be under much greater scrutiny in the future. Observing a board in action is an exercise in Hiesenberg’s Uncertainty Principle – it changes both that which is being observed and the observer – in both cases usually for the better.

It is noticeable that with the UK’s principles-based approach of “comply-or-explain”,

with the separation of the chairman of the board and chief executive roles, with a much less litigious culture, and with increasingly well tested corporate governance regulations and the new codification of director's duties under the 2006 Companies Act the UK and US systems of corporate governance are diverging quickly. Who will become the most influential in world terms?

In the end it all depends on what goes on behind the boardroom door and the probity of the directors' actions. Is there the political will to allow the US to pull itself out of its current corporate governance mess? And, if so, will they adopt a more flexible principles-based route, or will they simply please the lawyers and consultants and just invent more boxes to be ticked?

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Context:

This paper was developed initially from the chapter "The Delaware Delusion" in my book *Thin On Top: Why Corporate Governance Matters*, Nicholas Brealey Books, 2003; and from my input to the Institute of Chartered Accountants of England and Wales conference on 10 January 2007 in London as part of the *Beyond the myth of Anglo-American corporate governance* initiative, which has resulted in the publication in March 2007 of the ICAEW's paper *How differences between the US and UK securities markets create pressures and point to opportunities for international policy, investment, business and accounting*.